

Better Public Services

DRAFT ISSUES PAPER:

Best-Sourcing Public Services

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Every day in New Zealand, millions of taxpayers' dollars are spent to deliver vital public services. Some of these services are provided directly by Crown-owned agencies while others are Crown-funded but provided by non-Crown entities.

This paper sets out the State Sector Reform Secretariat's current thinking on some of the critical issues associated with measures to further strengthen the delivery of public services. This includes an analysis of where there may be scope to consider further options to progress the best-sourcing of goods and services that have traditionally been provided exclusively by Crown agencies, including places where citizens could be given greater choice in who provides the services paid for by the government.

Overseas best-sourcing refers to the move away from the reactive mindset which assumes that the state must necessarily provide any particular public service in favour of a framework that facilitates evidenced-based selection of providers on a case-by-case basis.

Best-sourcing practices are aimed at strengthening service delivery while minimising the costs to taxpayers who ultimately pay for the provision of all public services. New Zealand already widely uses other non-state sector providers, but we can be better at embedding in the country's existing decision-making framework.

This issues paper is part of a series of backgrounders that will be prepared by the State Sector Reform Secretariat to support the work of the Better Public Services Advisory Group.

CONTENTS

<i>Executive summary</i>	3
<i>Objectives</i>	7
<i>Issues and analysis</i>	7
<i>Conclusions</i>	12
<i>Annex One: Factors decision-makers need to consider</i>	13

Executive summary

Best-sourcing is when the Crown's choice of providers is conducted within a transparent, contestable framework in which the provider of any given service is selected on the basis of the evidence of that provider being able to deliver high quality services cost-effectively, compared with other potential providers.

Ideally, having a robust framework in place which actively facilitates best-sourcing will encourage a strong focus on the quality of service delivery as well as the opportunity to periodically and methodically monitor whether particular service deliverers are effectively meeting the policy objectives set by democratically-elected governments.

Best-sourcing involves drawing on a range of possible providers, and a range of possible ways of doing business, ensuring that funding goes to providers that can best deliver the desired quality and quantity of any given service at the best price.

New Zealand and overseas evidence clearly indicates that oftentimes the Crown and its agencies are best-placed to deliver a particular service. In some cases, however, non-Crown organisations may be able to provide better quality, more tailored and better value-for-money services.

Best-sourcing involves having a framework within which continuous conscious, evidence-based choices can and are made – and where there is a greater level of accountability around the process for selecting service providers.

For specialist services provided on everyone's behalf (such as prisons) the Crown will look at the choices of who does the work based on quality and cost specifications that the Crown sets. But for services provided directly to citizens (such as rest home care and early childhood education), sometimes the consumer is best placed to determine what suits them best.

Having an open and transparent framework to encourage choice means suppliers are under constant pressure to provide ongoing evidence on how and why they should continue to be the service provider – a framework which encourages efficiency and innovation.

Best-sourcing is primarily about ensuring the highest quality service provision: it is about maintaining pressure on suppliers and potential suppliers to ensure that taxpayers are receiving new and better ways of doing things for the best value for money.

Best-sourcing sometimes means the Crown is best placed to do the work. Sometimes the Public Service is the most efficient provider. In some areas of service provision the Crown may decide the additional risks associated with relying on providers that the Crown does not directly manage are too great. In other areas, the Crown may judge that the potential marginal benefits offered by a non-Crown entity providing a particular service are outweighed by the greater benefits of consolidation and coordination offered by the Crown providing the service.

Using a best-sourcing approach for allocating funding between multiple providers encourages ongoing innovation and service improvements even where services are provided by the Crown and its agencies.

The New Zealand state sector currently uses best-sourcing in many places. There remain examples, however, where public services in New Zealand are provided by Crown agencies where, in other jurisdictions, the same public services are being provided by

non-state providers. Where this is the case, further exploratory work is required to examine where a more contestable approach in New Zealand might promote the strengthening of those public services, cost savings to taxpayers and a greater facilitation of innovation.

As a general rule, the legislative framework in New Zealand does facilitate transparency and competition in the provision of public services and the principle of best-sourcing is not inconsistent with the Public Finance Act.

However, there may be specific legislative or non-legislative barriers to transparency in some areas and this may mean that best-sourcing is not being utilised as fully as it might be in some areas. This may, for example, be due to a lack of knowledge and expertise in developing contestable options.

This paper sets out the ways in which best-sourcing can help drive better public services, some possible principles for determining when it is most useful, and an assessment of current usage, including the potential barriers to greater use.

Status quo and problem definition

The Better Public Services work is based on three principles for ensuring that New Zealand's state sector is properly geared to meet modern challenges:

- clearer priorities (the Crown only doing what it is best placed to do);
- high quality services; and
- reduced waste.

Best-sourcing is one way for the state sector to ensure value-for-money...

Best-sourcing is a tool that supports all three of these principles. It focuses the Crown's efforts on the things it can do most efficiently, and uses non-Crown entities for delivery where they are better placed to provide certain services. Transparency and contestability encourage existing providers to continuously improve performance, increasing the quality of the service and reducing costs.

Best-sourcing explicitly challenges the assumption that Crown entities are necessarily the best or only provider of a particular public service because it recognises that, in general, "making it" has fewer incentives and policy choice opportunities than either "buying it" or "regulating for it to happen". It also recognises that when the Crown and its agencies have an assumed monopoly in the provision of a particular public service, an unintended consequence of that assumption might be sub-optimal for society and for individual citizens that receive or use that service.

However, best-sourcing is much more than outsourcing to others. It also includes:

- *leveraging consumer choice* more effectively to further enhance the value of the service to the consumer, but also to put performance pressure on providers (for example, for rest home care the government controls the quality and access to subsidies, but then lets the resident choose the place that suits them best, maximising the value of the support given from an individual's viewpoint);

- **using regulation rather than direct Crown provision** to support a dynamic where state agencies are responsible and accountable for ensuring a good or service is produced, rather than either producing it themselves or buying it in (for example, the recent Financial Services Disputes Resolution Services regulated that financial service providers must belong to a resolution service, and regulated who could provide it, but then left the private sector to organise it themselves);
- **using competition based on a metric other than price** to achieve a better policy outcome (for example, research performance has been used to determine funding with the Performance Based Research Fund); and
- **using alternative metrics to “pay” for work done by the public service** so that there are robust incentives for better performance and innovation (for example, using volume or some other characteristic like population for determining how much funding is provided).

Best-sourcing fundamentally involves asking two questions:

- is the Crown consistently and systematically making the right call between telling consumers who their provider must be for public services (as opposed to having a transparent and accountable framework which offers greater choice of providers)?; and
- is the Crown consistently and systematically ensuring that the frameworks are in place to permit the best choice to be made between the three options “make it”, “buy it” and “regulate for it to happen” for any given public service?

...by introducing disciplines that drive costs down and quality up

Best-sourcing can improve quality and price by emulating the disciplines that the private sector has found effective in promoting lower costs, higher quality and innovative services in competitive markets.

Economic growth is driven by innovation and productivity gains. It is very important that the productivity performance of the large public sector in New Zealand is significantly strengthened in the years ahead in order to deliver increases in New Zealanders’ per capita incomes and to narrow the income gap with the richest societies in the world.

The empirical evidence shows that it is competition that encourages firms to constantly look for better ways of conducting business. This means that they:

- **experiment**, often using small tests which are abandoned quickly if they don’t work. The private sector is willing to tolerate the “waste” of failure, in the hope of gaining through developing improved techniques for the future. (Economists call this “dynamic efficiency” and often, on a snapshot, it looks much more chaotic and wasteful than the clean and tidy “static efficiency” model of current best practice. For instance one article about this issue is titled “*The innovation deficit in public services: the curious problem of too much efficiency and not enough waste and failure*”^[1].);

^[1] Potts, Jason (2009) *Innovation: Management, Policy and Practice* 11 34-43

- ***actively adopt new ways of doing things.*** Recent research suggests that firms changing the way they operate are more important for productivity growth than good firms expanding and poor ones shrinking in the market. Further pressure comes from new firms entering the market with new ways of doing things which, if worthwhile, spread through the rest; and
- ***tend towards specialisation,*** only doing what they need to do themselves (including maintaining a core competency to manage their purchases) and buying anything else in.

Government operations (whether policy, management or services) are less likely to demonstrate these attributes. This is partly because there are fewer consequences should they not perform (as they are guaranteed their funding), but it also reflects some critical differences in their environment. In particular:

- ***public sector innovation can involve greater risk*** in part because the government is often a near-monopoly provider, but also because it provides services that are particularly important to the community. This rewards a culture that is risk-averse, particularly when there are clear accountabilities and if people are less likely to be held responsible for doing it ineffectually if it is the same ineffectual way that it has always been done;
- ***innovations are exposed to higher and earlier levels of public scrutiny*** because of a Parliamentary and media framework that rewards pointing out examples of public sector waste and which is intolerant of the normal waste that occurs when experimentation takes place. This leads to a preference for efficiency now over the possibility of greater efficiency over time;
- ***the pressure for consistency across the whole operation makes it more difficult for them to incrementally experiment*** (people dislike the “postcode lottery” of something being trialled in only one area or on one group of people). It also makes it difficult to specialise. The expectation is that they will be all things to all people within the area they have been given to manage;
- ***it is more difficult for a new idea to get picked up*** as the “market” is closed to new entrants meaning the old must be willing to change first. Innovations have the potential to be disruptive (e.g. require fewer people or different skills, or different methods of operation) and there is little incentive for those concerned to choose change;
- ***the public sector often has additional costs,*** notably the costs associated with accountability and the transparent reporting required for Ministerial and Parliamentary scrutiny. In addition sometimes the government is also committed to a higher cost structure (such as labour costs) and finds it difficult to reduce these commitments; and
- ***innovation and productivity performance can be harder to measure in the public sector,*** and it can therefore be harder to hold leaders to account for the choices they make.

Objectives

There is scope to use best-sourcing more in the New Zealand state sector

In 2007, New Zealand was ranked fourth in the OECD for the proportion of public services purchased from non state entities (excluding transfers like social welfare) which means that New Zealand has a track record for being an “early adopter” of utilising non-Crown providers to deliver public services or inputs when compared with overseas jurisdictions.

Experience here and overseas suggests that best-sourcing is a tool that is very useful when used in the right places, and that the gains can be far wider and more important than just cost savings. For instance, in the past some of the greatest gains have been from:

- ***a greater focus on achieving the policy objective*** (e.g. Performance Based Research Fund raised the focus on research quality and volume, and had the effect of raising New Zealand’s research performance relative to Australia and the rest of the world^[2]);
- ***greater flexibility for others*** (e.g. using transferable fishing quotas has enabled the industry to develop over time without the impositions of a slow administrative system or government having to pick winners and losers);
- ***better meeting the needs of the consumer*** (e.g. the pressure from alternative services has encouraged kindergartens to rethink their part-day session approach and increasingly adopt flexible care that reflects changing work patterns); and
- ***using the skills of others for specialist services*** (e.g. RNZAF tendered out the provision and maintenance of its basic flight training planes to take advantage of the skills and scale in the private sector).

Issues and analysis

Promoting a greater use of best-sourcing is likely to need clearer guidance than currently exists on when best-sourcing may be useful.

There are several important conditions needed to enable best-sourcing and to manage the risks to get the best results. These will dictate the approach that is most appropriate.

The approach taken to best-sourcing depends on the nature of the activity ...

There are different ways in which best-sourcing can be done, and the best approach depends on the nature of the activity.

^[2] See http://www.educationcounts.govt.nz/publications/tertiary_education/35982

- **Individual services:** Where government is supplying a service to a particular individual, giving the consumer choices will encourage suppliers to be more customer-focused and to consider the “soft” needs which are difficult to specify in a supply contract. (A current example of this approach is the current rest home system, where the individual chooses the rest home, and the funding then moves with them. This means they can choose the home that is most comfortable for them, or closest to family etc.).
- **Generic services:** For areas where there are already multiple suppliers (either in the private and non-governmental organisation (NGO) sector or within the Crown) the best approach is to have a competitive process to determine who gets the job. This kind of competition can be done in many ways – buying “off the shelf”, a tender process, or allocating money by performance (as with research funding under the Performance Based Research Fund).
- **Unique services:** For things that are unique, using best-sourcing will often be through complex contracts, often covering many years. The recent and current work on public-private partnerships (PPPs) in prisons and schools are one way of handling these situations. But there are also others. For instance, where skill is important, or service failure has particularly serious consequences, best-sourcing is most likely to be achieved through tenders only open to approved suppliers, contracts that share the risks, and contracts with ongoing public sector involvement.

But there are some basic conditions that are always needed...

The basic conditions that are needed for best-sourcing to succeed are some objective way of assessing performance and when there are options for who does the work. This means that some of the basic requirements are:

- **multiple suppliers exist** (either outside the public sector, or multiple Crown agencies doing the same thing. Thought should also be given to ways new suppliers could develop in time with some kind of transition, and alternative arrangements that have worked in other countries);
- **the government knows what it wants and can enforce it** (including quality and other “soft” areas, and recognising political constraints);
- **ministers are willing to live with some change** as most of the potential gains from using a contestable process are lost if the government specifies the contract so tightly that there is little chance for innovation and cost-saving change to be introduced;
- **there is a stable policy environment over the term of the contract** as once a contestable process reaches a commitment; the government has a binding contract for the duration; and
- **the likely benefits from best-sourcing exceed the likely costs and risks of implementing it.** Any contestable option should also be evaluated against the potential benefits for citizens of a coordinated “one stop” and the potential for capturing economies of scale.

...and requires management of a number of risks

There are also some risks in moving to a best-sourcing environment, and recognising these and ensuring the up-front design of the contractual arrangements address them, is a major key to minimising them. This means that an exploration of change requires serious consideration of the following points:

- ***costs of change*** in terms of senior management time, staff morale, and transition cost. Costs are likely to be lower when there is already an established market, where the current settings are close to defining price, quality and standards; where there are other areas of government that are similar but managed contestably; or where overseas precedents that can be drawn upon;
- ***ensuring the essential design protects the government's policy intent.*** The incentives in best-sourcing can lead to changes in behaviour on behalf of suppliers or consumers, some of which may be difficult to predict and may undermine the policy intent. This can expose government to risks, particularly to lower standards and from quantity pressures. The government needs to maintain adequate levers to address these as part of the initial design. (For instance, over the past decade promises to pay subsidies for every tertiary student did not adequately protect the government from the incentives to stimulate new demand or lower quality standards. A carte blanche promise to fund all students in effect made the Crown a budget taker rather than a budget maker);
- ***the potential loss of control though effective capture by organisations that are less accountable.*** Governments need to be able to maintain control over performance issues when it no longer has the hierarchical structures in place that exist in government departments. This risk is greater if there are few alternative providers or the activity requires very specialised or costly assets. In many cases there is a very real trade-off between the administrative ease of dealing with only a few other parties and the risks of having all eggs in a few baskets. Careful contract design, risk sharing arrangements, and maintaining alternatives (either alternative outside providers or keeping some in-house capability) is an absolutely critical part of any successful effort to effectively manage these kinds of risks;
- ***the risks of creating a different kind of monopoly provider*** because there is not really a competitive market. Working in this environment requires strategic thinking about how to develop a more sophisticated market which will engender healthy competition between suppliers and dialogue between suppliers and purchasers; and
- ***capability to manage contractual or other contestable environments*** both now and into the future. This means giving serious consideration into the ongoing capacity to manage others, including core knowledge and expertise. In some cases this risk can be managed by using others for only part of the work: this would give a benchmark against which the performance of the remaining operation can be measured, but also retains core knowledge and capacity.

The UK Audit Office has identified the critical success factors in its programme of market testing as:

- having solid benchmarking information on the cost, quantity and standards of the existing operation;

- adequately resourcing the change where the people doing it are knowledgeable of the business and having the necessary negotiation and other skills;
- giving a realistic timeframe and scope; and
- an honest and realistic recognition that there are not immaterial costs in the ongoing running of a contestable system as it requires monitoring and, at times, corrective intervention. In some cases these ongoing costs could be considerable (particularly if the system is complex and difficult to accurately monitor).

Best-sourcing is possible within the current public management system

It is important to emphasize that current settings in the public service in New Zealand do not typically impose legislative or regulatory barriers to managers increasing the use of best-sourcing as appropriate.

Legislative Issues

The State Sector, Public Finance and Crown Entities Acts provide the framework for public sector management in New Zealand. Ministers are charged with setting the direction and priorities for departments and Crown entities (through documents such as statements of intent and output agreements or plans). The Cabinet collectively has choices around what kind of agency it wishes to perform a function although, in practice, some services have come to be traditionally placed in departments (particularly activities involving the coercive powers of the state as there is often little ability for the Chief Executives to delegate these powers other than to employees, nor may it be desirable to do so - e.g. the power to arrest by police).

Existing legislation entrusts departmental Chief Executives and Crown entity boards with accountability for implementing Ministers' decisions in the most efficient and effective manner possible. Usually they are accountable to their Minister for this, though sometimes officials have independent statutory roles. However, the general legal framework is that Ministers have an initial decision around which organisation is to be the provider, but then the key decision maker according to the legislation is the Chief Executive or board depending on the type of organisation.

In practice, both the setting of the direction and priorities and the decisions on implementation tend to be more collegial between the Minister and Chief Executive/board than the legislation suggests, with departments having an input into the development of their Minister's objectives, and the Minister expressing views about the implementation of the decision. Even more importantly, often the policy and funding settings are predicated upon the current mode of delivery – so the Chief Executive's options are limited in the absence of a change to the overall policy settings.

Some agencies are subject to their own specific legislation as well. However, a statutory requirement for responsibility does not necessarily prohibit a "make or buy" decision; though it may mean that the department cannot outsource the ultimate responsibility for the activity (this issue arose, for instance, for contracted prison services, but did not mean there were no options).

Probity Issues

The need for transparency and fairness in government business, and various commitments under international trade agreements that New Zealand governments have freely entered into over the years, has led to some limits being put around procurement, particularly by departments. This has resulted in Cabinet-mandated rules, administered by the Ministry of Economic Development (and actioned through their procurement website), that are premised on open tendering being the default option.

A recent review of the procurement regime found that many of the perceived barriers to flexibility result from an interpretation which may be unduly risk averse. Audit has also found similar behaviour, and its most recent guidance^[3] stresses using a principles-based process, managed by mature procurement practitioners.

Other potential barriers

So, officials' initial advice is that current legislative and probity issues do not seem to be real barriers to further use of best-sourcing in the state sector. It may be, however, that perceptions are different from reality – both for those working within the state sector, or those who might have proposals for better ways to produce the goods and services government currently provides. Some of the possible barriers may be:

- there may be a cultural or institutional bias against using the private sector for the provision of public services, for example, reflecting generalised fear or distrust of profit-making in this context;
- public service managers may not have actively considered the benefits to be gained from seeking opportunities for using contestable options;
- even when best-sourcing is considered, it can tend to focus solely on contracting with the private sector, and therefore overlook other dynamic options such as using best-sourcing within the state sector, and using different forms of contracting with the private sector beyond standard contracts and PPPs;
- the current procurement approach does not encourage new ideas from outside the public sector. It tends to rely on government determining the need for a good or service, and seeking ideas from potential providers. When those outside the public sector do submit ideas, often their evaluation does not give the submitter an assurance that it will be fair and impartial. (In particular, proposals are likely to be referred to the department that will be the potential competitor and which may be faced with difficult decisions and transition costs such as redundancies if it goes ahead. This not only provides a barrier to getting the new ideas accepted, but also probably inhibits others from suggesting alternatives at all); and
- finally, often the best (and sometimes the only) alternative to one government agency "making it" for themselves is for another state agency to do it for them. While there are examples of inter-agency "purchases", experience suggest the process for setting these up are slow and sometimes more difficult to organise than outsourcing to the private sector (which may be due to factors such as the lack of an enforceable contract and committing future years' appropriations).

^[3] Available here: <http://www.oag.govt.nz/2008/procurement-guide>

Conclusions

The analysis in this paper suggests that there may be under-utilised opportunities from a greater use of best-sourcing in the state sector and that while there are barriers in the system, they are not large and they are surmountable.

This paper makes the case for greater use of best-sourcing in the state sector, but throughout we have stressed that it should be a pragmatic approach that helps manage risks and make sensible trade-offs. Overall, greater use of best-sourcing has the potential to support better value-for-money in the provision of goods and services by the government. The likely way to achieve this is in supporting state sector decision-makers in asking more questions and exploring alternative arrangements. It will not always be the case that others, outside the government, are better placed – but in most cases, it will be worth testing.

Annex One distils this thinking into a set of practical considerations that state sector managers could take into account when making any decision about producing goods and services. These are designed as a set of prompts that could result in more frequent and active consideration being given to the potential use of best-sourcing and therefore better value-for-money overall.

Annex One: A summary of the factors decision-makers should consider

Consider long-term capability

Managers need to maintain the capacity to perform the public sector's key roles – including its role in advising the government-of-the-day on policy, its ability to understand what sorts of outcomes are required, and the ability to set up strategic arrangements to get the best from those who deliver services. There are also sometimes legal or other legitimate restrictions which limit the choices available (either permanently or until the legislation can be changed). However, even within its key roles, the public sector should use others when it is best to do so.

Consider the bigger picture

The State Sector Act requires Chief Executives to ensure their departments are efficient, effective and economical^[4] – which should include being able to demonstrate that they have made the best choice between “making it”, “buying it” or “regulating for it to happen”. To do this, managers need to know their own cost structures and what others would charge for achieving the same outcomes (without assuming that they would do them in the same way), and whether the alternative of “regulating for it to happen” is possible and the costs it would impose on others.

Consider the nature of the operation and the government's policy objectives ... and what that means for alternatives

- ***Services to individuals*** should consider enabling consumer choice to encourage suppliers to be customer focused and to consider the “soft” needs which are difficult to specify in a government contract.
- ***Generic services*** where there are already multiple suppliers (either in the private and NGO sector or within the government) should consider a competitive process to determine who gets the job.
- ***Unique services*** will often be by complex contracts, often covering many years like PPPs, mixed ownership models, or long-term contracts. Where skill and/or where service failure has significant consequence, more complex approaches such as relational services, contracts that share the risks, and contracts with ongoing public sector involvement will be required.

Be able to demonstrate the balance of risks and benefits of different options

Demonstrating best-sourcing requires managers to weigh the potential benefits of using others against the risks. The long-term as well as short term benefits and risks should be considered. For instance, the benefits should include not only the immediate cost-

^[4] The State Sector Act makes Chief Executives responsible to their Minister for “the efficient, effective and economical management of the activities of the department”. (section 32(d))

savings and/or service improvements, but also the potential for new and innovative approaches to be developed, the ability for the government to move from poor providers to better providers over time, and the potential gains from having to define what is required and rigorously measure performance. The risks should include not only the risks associated with change but any issues around policy rigidity because of the length of the contract, whether best-sourcing would work if there is no appetite to encourage innovation and change, and the risk of being tied to underperforming providers (including the “soft” ties associated with political considerations).

Consider the skills and expertise needed to get the right outcome

The right choices about the kind of contract and its interaction with policy settings are essential for success (and the key behind many failures). In particular:

- the new incentives introduced are likely to result in unintended consequences so it is important that levers are built into contracts to deal with these;
- setting the wrong objectives and poor contract management more generally can result in ineffective risk transferral (in particular it may transfer profits to others but keep the risk with the government);
- consider the ongoing skills and knowledge that will be needed into the future. Maintaining sufficient core knowledge and capability is a significant risk mitigator. In some circumstances this may mean it is sensible to retain a core capacity in-house. Its performance can be benchmarked against the market, but knowledge and skills are retained; and
- if the market is not developed properly (i.e. not enough adequate alternative suppliers), the result could be a different kind of monopoly provider, which could undermine the drive for better value for money. This requires strategic consideration about how to develop a more sophisticated market and engender healthy competition between suppliers and dialogue between suppliers and purchasers.

Consider the management of the transition

Trying to push forward with best-sourcing without capability in the right strategic procurement, and project and contract management skills increases the likelihood of failure. This means there are likely to be costs of change in terms of senior management time and potentially needing to hire in the right skills, as well as considerations like maintaining staff morale and transition costs. The transition is likely to be easier and less costly when there are:

- already multiple suppliers in the private, NGO or public sectors;
- similar operations, either here or overseas, that have successfully used others (so that the best method and perils and pitfalls are known); and
- potential multiple suppliers that could be developed over time with a change in policy settings.