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First-best-world economic theory and the second-best-world of public sector outsourcing: the reinvention of the Soviet Kombinat by other means

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Abstract

This paper examines how public sector outsourcing has performed in the UK, one of its leading exponents. It sets out the theoretical economic logic behind it, the unanticipated risks in its conception, and the deepening problems with its intensification. It shows how, when we put the market rhetoric of New Public Management to one side, outsourcing necessitates the central planning of private actors, and how the success of this venture hinges on the viability of the outsourcing contract as a fully effective junction of instruction and control. As contract theory tells us, however, the more complex and dynamic the good, the less a contract can guarantee effective control over its production. Moreover, as the critical economics of Soviet central planning teaches us, the resulting asymmetries in information and leverage are just the start of bargaining games that the state (and taxpayer) cannot win. As the paper shows, a state that outsources its complex tasks puts itself at a chronic informational disadvantage, renders itself dependent on poorly controlled private monopoly service providers for essential services that form part of a matrix of interdependent services, and cannot exit failing contracts under acceptable terms. In the USSR a remarkably isomorphic set of hazards had driven Nikita Khrushchev back to the drawing board by 1965.

Keywords: outsourcing, New Public Management, neoclassical economics, financialisation, supply-side reforms.

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Introduction

The New Public Management (NPM) prioritised three strategies to transform the post-war state: disaggregation of public hierarchies into smaller, leaner, supposedly more firm-like units; competition between these units and with outside contractors and finally, incentivisation; the substitution of a no longer trusted public service professionalism with corporate-management systems like targets, budgeting by results, performance pay and high salaries for top managers, with assets to follow those who drove best within the new rules.[1] Democratic states have always bought the standardised goods they need for their tasks from the private sector: everything from paper to MRI scanners. But since the introduction of NPM under Margaret Thatcher, successive UK governments have moved beyond procurement of basic goods to the system-wide outsourcing of complex public goods and services ('outsourcing' hereafter). This outsourcing now extends from the management of prisons and clinical services to the employment of essential administrative and frontline staff. As a result, the internal dynamics of state action were bound to change, but not necessarily in the directions expected. In what follows I examine how outsourcing has performed in the pioneering UK, the theoretical logic behind it, the unanticipated risks in its conception, and the deepening problems with its intensification. My research strategy is not to dispute the neoclassical economic micro-foundations of these reforms, so to accept for the sake of argument that

[1] Dunleavy, Patrick and Christopher Hood. 1994. From old public administration to new public management. *LSE Public Policy Group.*

individuals are rational, utility maximising actors, but to evaluate how rational actors are likely to behave and indeed have behaved within the prevailing incentive systems created by outsourcing. The question is simple: if outsourcing isn't working, why not?

Outsourcing has spread steadily across advanced capitalist economies but an assessment across 15 EU states found no association with reduced public sector expenditure or employment.[2] Austerity has spurred outsourcing in middle-income countries, encouraged by international financial institutions such as the International Monetary Fund and the European Union, but in Central Europe it is implicated in rising political corruption and massive taxpayer losses.[3] Such political exploitation is nevertheless a symptom of a deeper architectural flaw, because outsourcing fulfils none of the core 'first-best-world' economic assumptions used to justify its adoption but all of the baleful predictions of less doctrinaire, 'second-best-world' economic theories elided by its advocates, in particular, the predictions arising from contract theory and the critical economics of Soviet central planning.

If we put the market rhetoric of NMP to one side, outsourcing necessitates the central planning of private actors, and the success of this venture hinges on the viability of the outsourcing contract as a fully effective junction of instruction and control. As contract theory tells us, however, the more complex and dynamic the good, the less a contract can guarantee effective control over its production. Moreover, as the critical economics of Soviet central planning teaches us, the resulting asymmetries in information and leverage are just the start of bargaining games that the state cannot win. A state that outsources its complex tasks puts itself at a chronic informational disadvantage, renders itself dependent on poorly

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[2] Alonso, José M., Judith Clifton and Daniel Díaz-Fuentes. 2013. Did New Public Management Matter? An empirical analysis of the outsourcing and decentralisation effects on public sector size. *Public Management Review* Volume 17, Number 5: 643-660, 656.

[3] Innes, Abby. 2016. Corporate State Capture in Open Societies. *East European Politics and Societies and Cultures* Volume 30, Issue 3: 594–620.

controlled service providers for essential services that form part of a matrix of interdependent services, and cannot exit such contracts under favourable conditions. In the USSR an isomorphic set of hazards had driven Nikita Khrushchev back to the drawing board by 1965.

Public sector outsourcing is now the dominant governance reform strategy across multiple countries and the paper argues that this constitutes a deepening systemic risk to the democratic state. Where incentive systems are misconceived then rational people are directed to do damaging things, and rational, conscientious people will be forced to spend additional effort trying to ameliorate the damage of the incentive systems they are in. Deteriorating service quality, rising cost and the demoralisation of public service professionals are baked into the prevailing incentive system around outsourcing, as they were under Soviet central planning.

The performance of UK public service outsourcing

The theoretical logic of outsourcing is that market-based solutions generate better outcomes than public ones because the governance of private organisations is more transparent, flexible, efficiency focused and disciplined by owners. So how has outsourcing performed in the UK? Before the 2010-2015 Coalition government the UK ranked fourth in Europe, after the Netherlands, Germany and Finland for the proportion of outsourcing in total government consumption. Shifting from 46.6% in 1983 to 56.06% by 2011 this expenditure was significantly more centralised in the UK however: by 2011 58.9% of German expenditure was decentralized within its federal structures, but where the Netherlands decentralized some 36% this was 22.8% in the UK.[4] UK central government outsourcing accelerated sharply under New Labour, from £37bn to £67b. They grew from £9bn to £16.5bn in healthcare; in

[4] Alonso et al. 2013, 656

education from £1.8bn to £3.7bn, while in local authorities they grew from £16bn to £32.5 bn.[5] After Prime Minister David Cameron announced that he would "release the grip of state control" on public services UK government spending on outsourcing nearly doubled from £64 billion to £120 billion between 2010-2015, with particular increases in justice, welfare and defence: all arenas of service complexity and with significant implications for public safety.[6] Since the 'legitimate use of force in a given territory' is the classical Weberian definition of 'a state' per se: its outsourcing marks how profound these changes are.

Legislative steps were also taken to ease the process: private sector companies taking over public sector staff were no longer contractually required to hire employees on the same terms after 2010. In October 2013 it was made easier for public servants to carry their pensions over to the private sector and in the 2015 budget George Osborne removed VAT charges for companies bidding for government work. At the same time tens of thousands of staff were transferred to private sector management. According to Information Services Group Consultancy these changes drove a 125% increase in contracts, from 536 under the previous Labour government to 1,185 under the Coalition. This made the UK the second largest outsourcing market in the world after the US.[7] This 'second wave' was driven strongly by the Confederation of British Industry's Public Services Strategy Board, whose 2011 'Open Public Services' White paper proposed that government open as many public services as possible to private provision: the promise being that with the opening of £280 billion of services, efficiency savings of 11 per cent would save government £22.6 billion.[8]

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[5] Gill Plimmer. 2015. Public service outsourcing jumps under coalition. Financial Times, April 30th Available from https://www.ft.com/content/244f0bd8-eccb-11e4-a81a-00144feab7dem, accessed 3rd April 2018.
[6] Plimmer 2015.
[7] Plimmer 2015.
[8] Wilks, Stephen. 2014. The public services industry: a constitutional blasphemy and a democratic perversion. LSE British Policy and Politics blog. Available at

The National Audit Office estimated that by 2014-2015 government was spending £242 billion on private sector contracts: some £50 billion in finance capital for the funding of ongoing PFI contracts with the remaining £192 billion split in half between outsourcing contracts for provision and standard procurement. In total this amounts to 31% of total government spending, where total staff costs represent some 26 per cent (or £194 bn) and social transfers/benefits another 30 per cent (or £218 bn).[9] By 2014 the UK public service industry accounted for 6% of GDP and 1.6 million staff: over three times the number of civil servants employed by Whitehall.[10]

In their prize-winning research Dixon and Hood establish that over the last thirty years reported UK administration costs have nevertheless risen by 40 per cent in constant prices, despite a third of civil service numbers being cut over the same thirty year period. Total public spending over the same period has doubled, while the indicators for quality and fairness in service delivery have deteriorated. Complaints and judicial challenges have soared and running costs have been driven up in outsourced domains in particular.[11] By 2014, the verdict of the Public Accounts Committee inquiry into outsourcing was damning. "Government", it concluded "is clearly failing to manage performance across the board, and to achieve the best for citizens out of the contracts into which they have entered..." And "so far, the contracting out of services has led to the evolution of privately-owned public monopolies, who largely, or in some cases wholly, rely on taxpayers' money for their income. The state is then constrained in finding alternatives where a big

http://blogs.lse.ac.uk/politicsandpolicy/the-alternative-civil-service-a-constitutional-heresy/, accessed 7th August, 2017.

[9] NAO report. 2016. Government Commercial and Contracting: an overview of the NAO's work. Available at https://www.nao.org.uk/report/government-commercial-and-contracting-an-overview-of-the-naos-work/, accessed 10th September 2017.

[10] Wilks, 2014.

[11] Dixon, Ruth and Christopher Hood. 2015. *A Government That Worked Better and Cost Less*? Oxford: Oxford University Press. See especially Chapters 4 and 5. See pages 70-79 for their discussion on measurement challenges.

private company fails."[12] For all the talk of competition the vast majority of contracts had been awarded to large public service industry multinational firms – some 73% of procurement spending.[13] More than £4bn of taxpayers money was spent to four companies in 2013 alone – Serco, Capita, Atos and G4S - raising concern in the National Audit Office that such firms were 'too big to fail', despite their repeated weakness in service delivery. Atos and G4S were also judged to have paid no corporation tax at all, owing to 'tax planning'.[14]

Outsourcing has proved straightforwardly undermining to democratic accountability insofar as public expenditure has increasingly fallen behind the cloak of commercial confidentiality. Serco, Capita, Atos and G4S have nevertheless all been discovered in delivery failures too egregious to hide. To demonstrate how consistently perverse the prevailing incentives have apparently been we can make just a small selection from an extensive list of fiascos reflecting poor contractual oversight and dilatory corporate governance.

In 2013 Serco had to repay £68.5 million, G4S £109 million to the Ministry of Justice after a Serious Fraud Office investigation found that the companies had charged the MoJ for services it had not performed.[15] The duopoly was stripped of the contract which was handed to Capita, only for arrests to be made in 2017 after Capital employees were paid by criminals to fit loose tags.[16] In 2013 Serco was accused of

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[12] House of Commons Committee of Public Accounts. 2014. *Contracting out Public Services to the Private Sector*, Forty-seventh Report of session, 2013-2014, HC 777, March 14th Available at https://www.publications.parliament.uk/pa/cm201314/cmselect/.../777/777.pdf, accessed 20th January 2018

[13] Report by the Comptroller and Auditor General. 2016. *Government's spending with small and medium sized enterprises*, HC 884, 7th March. Available at https://www.nao.org.uk/report/governments-spending-with-small-and-medium-sized-enterprises/, accessed 4th February 2018.

[14] Bowers, Simon. 2013. Public sector paid big outsourcing firms 4 billion pounds NAO report reveals. 12th November. *The Guardian*. Available at https://www.theguardian.com/politics/2013/nov/12/public-sector-paid-outsourcing-firms-4-billion-pounds, accessed 5th February 2018.

[15] HC 777, 2014.

[16] Gayle, Damian. 2017. Capita staff 'paid by criminals to fit electronic tags loosely' *The Guardian* 4th February. Available at https://www.theguardian.com/uk-news/2017/feb/04/capita-staff-paid-by-criminals-to-fit-electronic-tags-loosely, accessed 4th February 2018.

covering up extensive sexual abuse of immigrants in Yarl's Wood Immigration Removal Centre.[17] A year later it was criticised for using immigrant detainees as cheap labour, paid as little as £1 an hour.[18] Serco was nevertheless awarded the new contract to run the Centre. Serco withdrew from the contract for out-of-hours GP services in Cornwall in December 2013 after it left the country short of doctors. A company whistle-blower revealed the company had falsified 252 reports to the NHS regarding Cornish services.[19] Serco frequently withdrew from contracts at the moment government required improvement, leaving the taxpayer to pay switchover costs. G4S, the only rival to Serco in security outsourcing has a similar litany of service failures to its name, the most notorious being the urgent deployment of 3,500 British troops to guard the 2012 London Olympics due to the shortage of adequately trained G4S staff, contracted for the task.[20]

Capita had a 'business process management' UK market share of 29% in 2016.[21] In 2014 at least five of eight Liverpool NHS Trusts that had contracted their payroll and recruitment to Capita in 2012 withdrew because of concerns about service quality.[22] Awarded a 4 year contract to be sole provider of administrative services for GPs, opticians and dentists by NHS England in June 2015, by July 2016 the *Health Service Journal* reported "a large backlog of unprocessed correspondence relating to

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[17] Townsend, Mark. 2013. Detainees at Yarl's Wood Immigration Centre facing sexual abuse, *The Observer*, 14th September, Available at https://www.theguardian.com/uk-news/2013/sep/14/detainees-yarls-wood-sexual-abuse, accessed 4th February 2018.
[18] Rawlinson, Kevin. 2014. Private firms are using detained immigrants as cheap labour. *The Guardian*, 22nd August. Available at https://www.theguardian.com/uk-news/2014/aug/22/immigrants-cheap-labour-detention-centres-g4s-serco, accessed 4th February 2018.
[19] Lawrence, Felicity. 2012. Serco gave NHS false data about its GP services 252 times. *The Guardian*. 20th September. Available at https://www.theguardian.com/society/2012/sep/20/serco-nhs-false-data-gps, accessed 4th February 2018.
[20] Olympics Security Not Compromised, Theresa May Says, *BBC News*, 12 July 2012.
[21] Capita: Annual Report and Accounts, 2016. Available at http://investors.capita.com/~/media/Files/C/Capita-IR-V2/documents/capita-annual-report-2016.pdf, accessed 6th March 2018.
[22] Dowler, Crispin. 2014. Trusts exodus from Capita HR contract. *Health Service Journal*, 18th June. Available at https://www.hsj.co.uk/news/finance/trusts-exodus-from-capita-hr-contract/5072024.article, accessed 8th April 2018.

patients" and failure to manage the movement of paper records between practices.[23] A survey of GPs in August 2016 found 85% were missing records of recently registered patients, 65% had experienced shortages of clinical supplies and delays and 32% had suffered missed or delayed payments, including for GP trainees.[24] In 2014 the Department for Works and Pensions (DWP) had to supplement a Capita role in the distribution of personal independence payments for the seriously ill and disabled. Terminally ill patients had nevertheless died before receiving their due support.[25]

Atos, a French IT company, failed to resolve the DWP's Work Capability Assessment failures when target setting apparently incentivised the company to make brutal and recklessly ignorant assessments of people with serious disabilities. The DWP's own statistics showed that 2,380 had died after being found 'fit for work' and refused support, with many others found to have suffered irreparable mental distress from the prospect of choosing between employment while severely, even terminally ill, and penury.[26] By the last three months of 2016 two thirds of appeals saw the judgements overturned.[27] Negative spillovers to MPs and third sector agencies were significant: Citizens Advice reported Personal Independence Payments complaints as the biggest single issue dealt with by its national network

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[23] Thomas, Rebecca. 2016. NHS England investigates primary care support services after serious incident'. *Health Service Journal* 21st July. Available at https://www.hsj.co.uk/finance-and-efficiency/nhs-england-investigates-primary-care-support-service-after-serious-incident/7009427.article, accessed 8th March 2018

[24] Baines, Emma. 2016. Derailing the NHS. *London Review of Books*, 1st December.

[25] Malik, Shiv. 2014. Civil servants deployed to help Capita clear PIP assessments backlog, *The Guardian*, 6th April. Available at https://www.theguardian.com/society/2014/apr/06/civil-servants-capita-pip-assessments-backlog, accessed 3rd February 2018.

[26] McIntyre, Niamh. 2017. Scotland bans private firms from carrying out benefits assessments, *The Independent*, April 28th. Available at https://www.independent.co.uk/news/uk/politics/scotland-benefit-assessment-ban-private-companies-social-security-agency-department-work-pensions-a7706896.html, accessed 4th February 2018.

[27] Bloom, Dan. 2017. Appeals against cruel disability assessments reach record high. *The Mirror.* 9th March. Available at https://www.mirror.co.uk/news/politics/appeals-against-cruel-disability-assessments-9998087, accessed 5th February 2018.

of 300 advice centres. It handled 50,000 PIP cases every three months and had seen a 37% increase by 2017.[28]

The first-best-world economics of complex outsourcing

So where does outsourcing go wrong? The answer is, unfortunately, at the start. A fundamental point of disagreement in contemporary economics is that between 'first best world' and 'second best world' economists, where, as Rodrik puts it, the first group's instinct is always to apply the first-best reasoning to the case, ignoring market imperfections in related markets, while the second group almost always presumes some market imperfections in the system. [29] To this may be added a long-standing tension between those who stand by mathematical modelling as a complete method and those who see it as a useful adjunct to less formal and more empiricist forms of comparative theorising and evaluation. Outsourcing is rooted entirely in first-best world neoclassical microeconomics and a method of purely deductive-theoretic reasoning: *i.e.* in chains of logical reasoning that flow from explicit axioms to necessary outcomes, like Pythagoras's theorem. This is a form of argument that does not calibrate or check itself with observable reality as in other social sciences, including more critical neoclassical economics, but with the axiomatic reasoning or maths that 'proves' it.[30]

The first analytical step, the basis for rejecting the public sector as the apt production regime for public goods, comes from 'public choice' theory. Public choice theorists

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[28] Butler, Patrick. 2017. Disability benefits system is 'inherently flawed' campaigners tell MPs. *The Guardian* 6th March. Available at https://www.theguardian.com/society/2017/mar/06/disability-benefits-process-is-inherently-flawed-mps-told, accessed 5th February 2018.
[29] Rodrik, Dani. 2007. Why do economists disagree? August 5th. Available at http://rodrik.typepad.com/dani_rodriks_weblog/2007/08/why-do-economis.html, accessed 24th March 2017.
[30] McCloskey, Deidre. 2005. The Trouble With Mathematics and Statistics in Economics, *History of Economic Ideas*, Volume 13, Number 3: 85-202, p. 90.

claimed that systemic capitalist crises of the 1970s and 1980s[31] were founded in state failure and that the roots of that failure lay in the state's properties as a monopoly supplier of goods and services and as the monopsonist purchaser of other goods and services. This conclusion is reached by deploying neoclassical economic assumptions about rational, self-interested actors who use "cold deductive (and instrumental) logic to optimize within a closed system of given factors and preferences".[32] By applying the utilitarian model of economic man within deductive, stylized models of bureaucratic, governmental and electoral choices it purported to explain the expansion of the public sector, stagnating economic growth and deteriorating public service performance in the 1970s as 'fated'.[33] The empirical basis for accepting this diagnosis was and remains exceptionally weak, however. As Dunleavy explains, budget-maximising models commonly drew "casual support from the extent of post-war government growth, but there are multiple other possible explanations and no multi-variate tests which satisfactorily establish any causal link from bureaucratic behaviour to expansion."[34] Such microeconomic analyses likewise offered no insight into the highly varied historical 'public production regimes' of different states and their origins in the specific preferences and needs of their electorates and private production regimes.

It nevertheless followed from this potent metaphor of an exploitative monopoly firm that, in its ideal condition the state should be radically reduced to a 'night-watchman' to enforce constitutional guarantees of contract, property rights, law and order and defence. Vertically integrated, public means of providing services were disparaged on the basis that services would be over-supplied and the

[31] For an excellent summary see Hindmoor, Andrew. 2006. Public Choice, in Hay, Colin, Michael Lister and David Marsh, *The State: Theories and Issues*, Basingstoke: Palgrave Macmillan.
[32] Richard Bronk, *The Romantic Economist: Imagination in Economics* (Cambridge: Cambridge University Press 2009), p. 197.
[33] Bronk, Richard. 2009. *The Romantic Economist: Imagination in Economics*. Cambridge: Cambridge University Press, 6.
[34] Bronk 2009, 247.

administration over-staffed out of self-interest.[35] As David Cameron put it: "From now on diversity is the default in our public services…instead of having to justify why it makes sense to introduce competition…the state will have to justify why it makes sense to run a monopoly". [36] Despite the fact that governments enacting NPM have carried diverse views on market fallibility in principle, from *laissez faire* to the new Keynesianism, when translating the doctrinaire public choice critique of bureaucracy into solutions the pervasive tendency has been to reach for first-best-world neoclassical microeconomic remedies: a step from a theoretic-deductive diagnosis to theoretic-deductive prescriptions.

For the diagnosis of the state's putative rent–seeking to be solved by bringing to bear the efficiencies of innovative firms and efficient markets requires that first-best-world archetypes will constitute the reality of new public service firms and markets, or their administratively created analogues. Outsourcing has evolved through a variety of modes since the 1990s, namely competitive tendering, partnership working (particularly in the uses of Public Finance Initiatives), strategic-commissioning and prime-contracting[37] but it can be broadly understood as the contracting out of public services that have historically been conducted by public servants. This, however, is a context that does not lend itself naturally to any of the conditions of the first-best-world neoclassical imaginary.

Sins of omission

The difficulties arise as soon as you consider the prospective market for collective goods, which is significantly different to the market for private goods. In most

[35] Dunleavy, Patrick. 1991. *Democracy, Bureaucracy and Public Choice*. London: Harvester Wheatsheaf; Savas, Emanuel. 1987. *Privatization: The Key to Better Government*. Chatham, NJ: Chatham House.
[36] Cabinet Office. 2011. Prime Minister's Office, 10 Downing Street and The Rt Hon David Cameron MP *Speech on Open Public Services*, Available at http://bit.ly/1yK7Xxw, accessed 6th March 2018.
[37] Bovaird, Tony. 2016. The ins and outs of insourcing and outsourcing: what have we learnt from the last thirty years? *Public Money and Management*, Volume 36, Issue 1: 67-74.

commercial transactions around simple goods and services there is a clear customer and a clear supplier and if the product or service is poor the consumer can simply move on. Performance is effectively assessed by consumer satisfaction with the service and its price. But in 'public service markets' there may be the following difficulties, as neatly summarised by the Institute for Government:

- Lack of clarity about who the customer is – there may be a range of parties with conflicting needs (to take the probation service, is the customer the offender, the victim, the government, the courts, the society?)
- Few (or no) providers with a track record in supplying that service, and barriers to entry may be high (e.g. training costs, lack of experience)
- No established way of determining a fair price (what's the outcome to be priced? Reoffending rates, inspection ratings, feedback from users?)
- No easy way to measure performance (causes of reoffending rates, for example, are complex, but an important measure of performance,
- All markets have to contend with competition and company law, but public service markets also need additional regulation to reflect the public interest and often complex statutory obligations around a given service.
- If performance is poor, a lack of alternative suppliers makes it difficult to switch provider.[38]

So what happens if you outsource such multifaceted and dynamic service tasks regardless? In the first place the question of 'who the customer really is' is misleading insofar as it has encouraged theoretic analyses and commissioning models to consider non-choice versus choice environments for end-users of services.[39] These ignore the reality that the only actual market relationship remains that for outsourcing procurement, in which the state remains not just the sole customer,[40] but also the ultimately liable party for service delivery, failures and their

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[38] Private Versus Public Markets, Institute for Government, Available at https://www.instituteforgovernment.org.uk/publication/private-vs-public-markets, accessed 8th September 2017.

[39] Le Grand, Julian. 1991 *Equity and Choice*: *An Essay in Economics and Applied Philosophy*. London: Harper Collins.

[40] Crouch, Colin. 2015. The Paradoxes of Privatisation and Public Service Outsourcing, *Political Quarterly*, Volume 86, December: 156-171.

costs: a position unique to the state. The advocates of outsourcing argue that its potential to reduce public spending and improve government flexibility and performance emanate from the high-powered incentives for efficiency provided by market competition plus the discipline of the capital market, where (shareholder) owners require transparency and high performance and because private firms are relatively free of political interference.[41] So how do these promises fare when we move from the theory of firm behaviour within efficient markets, to practice?

In reality, given that the work outsourced is frequently to run public assets or to provide and manage teams of essential personnel, the economies of scale are such that only large businesses will tend to be eligible. Given additional barriers to entry of the market for provision, not least lack of experience with government contracting on this scale and the punitive costs of low-chance competitive tenders for small and medium-sized (SME) companies, public service markets are naturally highly oligopolistic markets with weak competition. Within this context of weak competition, the questions arising around the values of the service, its pricing and performance measurement and around company law, contractual regulation and switching provider all depend for their answer on the quality of the outsourcing contract itself and its oversight. For outsourcing to work, this agreement between the state as customer and the public service industry contractor needs to operate as the effective junction of instruction, control and reward. And when we start to unpack the likely contractual failures - the asymmetries in the bargaining and monitoring positions between these contractual 'players' and the misalignment of their respective incentives - it becomes apparent how comprehensively unrealistic the first-best-world justifications are.

[41] Jensen, Paul and Robin Stonecash. 2005. Incentives and the efficiency of public sector outsourcing contracts, *Journal of Economic Surveys*, Volume 19, Number 5: 767-787, 768. See especially Osborne, D. and T. Gaebler. 1992. *Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public Sector*. NewYork: Addison-Wesley.

Complexity and incomplete contracts

Transaction cost economics and contract or 'property rights' theory are adjacent in their analytical focus so that where contract theory concentrates on the problem of trying to align the interests and incentives of the buyer and seller in an initial contract, transaction cost economics focuses on the costs of trying to govern those ongoing contractual relations.[42] Both nevertheless tend to concur that all complex and or dynamic contracts are unavoidably incomplete[43] and the higher the complexity and contingency of the contract the higher their likely incompleteness and the risks of minimal sufficient effort or 'satisficing' behaviour on the part of the contractor. They also tend to agree that complex contracts are incomplete by reason of bounded rationality, meaning that each actor wants to act rationally (understood as making informed cost-benefit analyses of their options), but they are necessarily limited in how rational they can be by the incompleteness of their information due to the uncertain, contingent, complex or unquantifiable character of key aspects of the task at hand. In contrast to government procurement for standardised goods, most public service tasks carry some and frequently all of these characteristics.

The problem is that if "human actors are not only confronted with needs to adapt to the unforeseen (by reason of bounded rationality), but are also given to strategic behaviour (by reason of opportunism) [say, a profit-seeking motive], then costly contractual breakdowns (refusals of cooperation, maladaptation, demands for renegotiation) are likely to happen."[44] Both transaction cost and property rights theory would duly note that contracts understood as 'promises to behave' are hardly self-enforcing, by reason of opportunism. Moreover, the possibility that courts could insist on resolving conflicts after the fact is limited by reason of non-

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[42] Williamson, Oliver. 2002. The theory of the firm as governance structure: from choice to contract. *Journal of Economic Perspectives:* 171-195, 174, 188.
[43] Williamson, Oliver. Edited by Gengzuan Chen. 2017. *Contract, Governance and Transaction Cost Economics*. Singapore: World Scientific, 87.
[44] Williamson 2017, 87

verifiability, *i.e*. by the stubborn fact that most of the behaviours within the tasks and services we are talking about are unobserved and difficult to codify.[45]

Once such an incomplete contract is signed in a poorly competitive market however, a government hands over its own monopoly control to another monopoly – typically a single business – with the moment of contracting the fleeting moment of market competition.[46] In addition, as multiple contract authors have noted,[47] when any unforeseen contingency within the incomplete contract arises, the government will have to approach the contractor to renegotiate, providing profit-seeking companies with the opportunity to raise their price through the course of renegotiation: an appropriation of an undue rent known as 'hold-up'. Far from simply being able to go back to the 'market' moreover, the switching costs around government services are likely to be prohibitive, assuming, indeed, that an alternative provider at scale is available.[48] The same risks attend un-negotiated cost overruns, which in first-best-world theory could be penalised by the loss of contract, except in practice the financial and organizational cost of changing provider are again prohibitive, not to mention the political cost, creating a low credible threat of exit. Given the necessary term-length of these contracts and the complexity and non-codifiability of many of the tasks, the government-buyer will duly find itself over a barrel in the face of contractors who rationally operate, for reasons of opportunism, according to a plain text reading of the contract. As Williamson noted, such leverage is likely to make financial savings at the beginning of the contract disappear over time, potentially to be replaced by significantly higher costs.[49]

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[45] Williamson, Oliver. 1993. Opportunism and its Critics. *Managerial and Decision Economics*, Volume 14: 97-107, 97.
[46] Colin Crouch, 2015.
[47] Williamson, Oliver. 1976. Franchise bidding for natural monopolies. general and with respect to CATV. *Bell Journal of Economics* 7: 73–104; Schmalensee, R. 1979. *The Control of Natural Monopolies.* Massachusetts: Lexington Books.
[48] Jensen and Stonecash 2005, 775
[49] Williamson, 1976.

To summarise: the micro-foundations of outsourcing assume that you can make a market for public goods and services and that this will create customer choice, whether that consumer is the citizen service-user or a government agency. In practice this model is a poor description of the really-existing terrain because the state remains both the only partner in the market relationship but also, quite unlike the buyer of first-best-world theory, the continuous bearer of the liabilities and costs of supplier failure. The model is also misleading through the omission of likely interaction effects from highly imperfect conditions for contract. Firstly, the more complex the service or good, the longer the duration of the contract and the greater the contingencies or uncertainties that the supplier might face, the less the outsourced tasks are amenable to codification and hence to robust contracts that can adequately protect the buyer. This adds unanticipated and destined to be high costs for the management and supervision of all such 'incomplete' contracts and of the 'non–contractible' elements relating to service delivery. Frequent contractual failures require repeated and given a poor bargaining position, expensive renegotiation.[50] These conditions are endemic within public service goods and services.

The substitution of private for public duly occurs in conditions where the following market failures are rife: the public service markets are dominated by monopoly or oligopoly firms (which render a private provider relatively immune from the self–correcting mechanisms of market competition); information problems (from radical uncertainty or complexities in requirements, and from asymmetries around who holds good information between buyer and seller); 'hold' up problems (where relationship–specific investments encourage the other party in the transaction to exploit the loss of bargaining power entailed by sunk costs) and through negative

[50] Hefetz, Amir. and Mildred E. Warner. 2012. Contracting or Public Delivery? The Importance of Service, Market and Management Characteristics. *Journal of Public Administration Research and Theory* Volume 22, Issue, 2: 289-317.

spillovers (that is to say, damaging external effects not reflected in the original price of the transaction).[51] The negative spillovers from incomplete contracts in public service outsourcing, moreover, are exceptionally socially damaging. Hard to codify tasks intrinsic to a given public service are rationally sloughed off by private providers and left to families, volunteers, charities and other public services to answer. As interdependent services come under satisficing corporate performance then systemic failures become inevitable.

Financialised firms and extractive financial markets

The almost completely compromised nature of the marketplace for services is not the only issue, however. What the doctrine of outsourcing completely fails to address is that large firms in contemporary capitalism and PSI firms in particular are not the efficiency-seeking, innovative actors under attentive ownership of first-best world economic theory but the financially extractive, shareholder maximising firms of second-best-world reality. [52] These operate under increasingly dysfunctional pressures from the capital market and from activist hedge funds in particular. The Bank of England's Chief Economist, Andrew Haldane, has warned that UK firms risk "eating themselves" as they direct formerly reinvested earnings into ever increasing dividend payouts and share buybacks to further hike share prices.[53] Forthcoming EU-funded research by Sakinç shows that following a steadily rising trend, by 2016 the UK companies in the S&P 350 averaged combined share payout and buyback expenditure of 150% of their net income – an unsustainable

[51] Bronk 2009, 160
[52] See William Lazonick's research to explore the trend.
[53] Giugliano, Ferdinando. 2015. BofE's Haldane says corporations putting shareholders ahead of wider economy. *Financial Times.* July 25th 2015 [online] https://www.ft.com/content/7d347016-32f4-11e5-b05b-b01debd57852, accessed 1st June 2017.

trend.[54] As Michael Porter in the *Harvard Business Review* points out, generating revenues for a company is potentially "a far cry from generating value".[55]

As Leaver has shown, all four PSI firms discussed earlier are highly financialised and this is typical across the wider class of quoted multinationals. Even a quick review of their accountancy and payout practices reveals a set of incentives that could hardly be further from the first-best-world archetype of diligent corporate governance. When it comes to 'weightlessness', *i.e.* a test for 'goodwill' defined as the net present value of future cash flows over and above their book value, Leaver finds that Capita is highly leveraged to the future as are Serco and G4S - comparable with Carillion, which collapsed in 2018. The French company Atos was least dependent on forecast cash flows as against current book values. Leaver's second, 'goodwill impairment test' divides 'goodwill' by shareholder funds, to see how much the 'intangible assets' that make up 'goodwill', such as the value-added attached to their brand name, solid customer base etc. would have to be impaired to wipe out those funds. By this measure an impairment of net present values of future cash flows of only 25% would wipe out Capita's equity. G4S stands as the next at risk, with Serco ranked lower, *i.e.* as *equivalent* to the now collapsed Carillion. Atos again was the least at risk as of 2016. Leaver's test for 'contract impairment risk' looks at the relation between net income and net operating cash-flow, where a positive figure suggests a firm is over-booking - exaggerating - its profits. Here Carillion stood out as the only firm that consistently reported net profits higher than its net operating cash-flow, which made a 'correction' inevitable. On Leaver's final 'distributional affordability' test the idea is to add dividends and share buybacks and assess whether they're affordable out of net operating cash-flow.[56] He found

[54] Sakinç, Erdem. 2017. Data presented at Technical meeting of the GOFINPRO research group, 23 November, 2017, SOAS, cited with permission of the author.
[55] Porter, Michael. 2001. Strategy and the Internet. *Harvard Business Review*, March: 62-78.
[56] Leaver, Adam. 2018. Outsourcing firms and the paradox of time travel. 12 February, SPERI Political Economy Blog. Available at speri.dept.shef.ac.uk/2018/02/12/outsourcing-firms-and-the-paradox-of-time-travel, accessed 25th February 2018.

Carillion to be consistently guilty on this front but Capita, Serco and G4S have come close.

The new CEO of Capita in January 2018 declared that the company required the suspension of the dividend as it sought to rebuild its cash in the face of the company's 'short term focus', its lack of 'operational discipline and financial discipline' as well as a reliance on acquisitions for growth, including 17 acquisitions in 2014 and 16 in 2015. Capita had paid out more than £1billion in dividends between 2011 and 2016 even as its pension deficit rose from £86 million to £380 million.[57] Likewise G4S and Serco were forced to rebuild their businesses after profit warnings followed continuous, poorly integrated acquisitions. On the verge of bankruptcy in 2013 the new CEO of Serco found it had no single coherent register documenting its 700 businesses[58] suggesting the operating values of a Ponzi scheme more than a value-creating corporate strategy. Commenting for the *Financial Times*, Leaver noted how the fragility of their balance sheets predisposes these companies to blow up. With few tangible assets and high borrowing against intangibles, (which surely include the expectation of strong profits within an ever-expanding non-competitive sector under doctrinaire governments) they carry no residual value if the business fails. Failure is also difficult to anticipate given the accounting discrepancies, although as the Chief Executive of the Financial Reporting Council noted, due diligence is hampered by a lack of competition and significant conflicts of interest in the 'Big Four' accountancy companies, KPMG, Pricewaterhouse Coopers, Deloitte and Ernst and Young.[59] Leaver concludes that the financial model

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[57] Plimmer, Gill. 2018. Capita's new chief gives scathing summary of group's problems. *The Financial Times* January 31st. Available at https://www.ft.com/content/a28a2b96-0671-11e8-9650-9c0ad2d7c5b5, accessed 3rd February 2018.
[58] Plimmer, Gill. 2018. Carillion collapse shakes UK outsourcing industry model. *The Financial Times* 18th February Available at https://www.ft.com/content/9668f25e-2901-11e8-b27e-cc62a39d57a0, accessed 19th February 2018.
[59] Kollewe, Julia. 2018. Calls for more scrutiny of top accountancy firms after Carillion collapse, 2018 *The Guardian* January 30th. Available at https://www.theguardian.com/business/2018/jan/30/carillion-collapse-prompts-fresh-scrutiny-of-uk-accounting-giants, accessed 3rd February 2018.

is essentially "leveraged gambling on future income flows." [60] The policy is effectively booby-trapped against any government keen to reverse it.

If we ask ourselves what the core business logic in the public services industries tends to be it is useful to refer to the MIT Business Model Archetypes which are based firstly on what types of rights are being sold, which gives rise to four basic business models - creator, distributor, landlord and broker - and what types of assets are involved - physical, financial, intangible, and human - a scheme which creates 16 detailed business model archetypes. [61] Public service industries typically fall into their category of 'landlord' in two of their three possible senses. The first sense is of physical landlords who provide temporary use of physical assets (like houses, airline seats and hotel rooms, or say, medical facilities, schools or day centres), through various means such as rent, lease, admission, or other similar terms. The second is of contractors and consultants who provide services produced by temporary use of human assets (e.g. NHS trained nurses, probation officers). The third sense is that of lenders who provide temporary use of financial assets (like money): a widening market for financial firms in supply-sider environments. As the MIT authors find from the survey of actual firms in the fiscal year 2000, selling use of assets to customers was more profitable and more highly valued by the market than selling ownership of assets. In addition to the use-ownership differences, they found that business models based on non-physical assets were more profitable and associated with higher market capitalization than those based on physical assets.[62]

Public service industries thus fall into the most profitable revenue categories in this survey - a spur to confident lending - but for the landlords of physical assets there's an issue of asset depreciation over time with use, requiring investment spending.

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[60] Plimmer, 2018.
[61] Weill, Peter. Thomas W. Malone, Victoria T. D'Urso, George Herman and Stephanie Woerner. 2004. Do some business models perform better than others? *MIT Sloan School of Management Working Paper* No. 226, May: 7-12.
[62] Ibid p. 23-25.

Where governments are leasing out public assets to private landlords, in all their variety, this asset depreciation remains the public and not the private liability. International Public Sector Accounting Standards actually require that assets attached to outsourcing contracts remain reported on the public sector accounts where the sector either regulates or can take up ownership at the end of the contract.[63] The training of public service personnel for private contractors is likewise overwhelmingly a publicly-funded endeavour. Although, as Quiggan has shown, as contractors of human resources, PSI firms are likely to seek to reduce their costs to optimise the contract and this creates strong incentives to weaken working salaries and actively replace high skilled and experienced professionals for cheaper, lower skill, younger staff with lower pension liabilities, all of which are damaging to service quality.[64] In business model terms then, public service industries have clearly found the sweet spot for generating higher financial revenue streams but through means misaligned from the public interest, as contracts offer poor control and the creation and maintenance costs of assets, physical and human, the costs of service replacement given poor contractual performance and the ultimate financial liabilities around contractual failure or firm-bankruptcy will all fall back onto the public purse.

On the financing side, as the extensive critical literature on 'PFI' reports, the difficulty of writing complete contracts for finance and the dependency on government for continuing service provision has tended to provide an extractive leverage over the terms of lending and financing. As Hellowell and Vechi show, in conventional private sector investment projects the ability of capital providers to achieve their expected returns requires that they make a decent forecast of the costs

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[63] Haslam, Colin. 2015. Outsourcing is leaving public sector bodies financially exposed. *Public Finance*, CIPFA, 30th October. Blog. Available at https://www.publicfinance.co.uk/opinion/2015/10/outsourcing-leaving-public-sector-bodies-financially-exposed, accessed 4th February 2018.

[64] Quiggin, J. 2002. Contracting out: promise and performance. *Economic and Labour Relations Review* Volume 13, Issue 1: 88–104.

of production and the expected demand for it. But in public private partnerships where financing is outsourced but repaid by the taxpayer the operator typically assumes no demand risk. "The operator's income is guaranteed if the assets are available to users at the specified standard. Neither firm managers nor investors have an incentive to ensure that the project delivers net benefits to society or is affordable for the government in the long run. Despite the use of private finance, it falls to government employees to secure those objectives."[65] In the case of a failing contract in a large infrastructure project such as a hospital trust, capital payments must nevertheless continue to be made to the private finance provider, meaning that actual service delivery is crowded out, *e.g.* via cuts in staff, to free up the necessary finance.[66]

The reinvention of the Soviet Kombinat by other means

Within a first-best-market world the reasoning behind outsourcing is impeccable. When it comes to prevailing incentives in the second-best world of incomplete information and weak competition, however, public service industry firms *qua* 'firms' bear a marked resemblance to Soviet state-owned enterprises. Like Soviet SOEs they operate in a doom loop of low incentives for consummate performance, high incentives for satisficing performance plus a lack of effective disciplinary mechanisms. Effective central oversight is disabled because of contractual incompleteness and no, or at best weak competitive pressure and leverage over the procurement agent arising from the necessity of unbroken production. The isomorphism is not exact: Soviet planning issues were primarily about (potentially) private goods, poor information flows arising in the coordination of planned

[65]Hellowell, Mark and Veronica Vecchi. 2015. The non-incremental road to disaster? A comparative policy analysis of agency problems in the commissioning of infrastructure projects in the UK and Italy. *Journal of Comparative Policy Analysis: Research and Practice*. Volume 17, Issue 5: 519-532 p. 529.
[66] Ibid. p. 523.

allocation and planned production, and the consequences of poor incentives around production and innovation arising from top down evaluation criteria ('imperative planning').[67] Outsourcing is about public goods, information weakness arising from asymmetrical contracts and the implications for service quality and cost from inescapably incomplete top down evaluation criteria. The affinities between PSI firms and Soviet SOEs are nevertheless extensive. They characterise not just the pathologies of the contract at year 't' but how it is in the nature of the production regime that the state can't correct failures in production and spiralling cost through 'market exit' at year t+1, t+2 etc. but gets dragged instead into bargaining games it cannot win.

Governments engaged in outsourcing are beset by what the critical economics of communism called 'soft budget constraint', where the state finds itself locked into dysfunctional relationships with firms - the dispersed, information-holding periphery - because of the essential nature of continuous production, the low availability of alternative producers and the political risks of acknowledging systematic flaws in the prevailing doctrine. As Janos Kornai explained in *The Socialist System*, "The concept of "budget constraint" is familiar from the microeconomic theory of the household: the sum available to a decision maker places a constraint on the consumer's spending that he or she can choose to incur." So what happens, asks Kornai, if a state-owned firm's spending exceeds its budget constraint? And what happens if this is a regular occurrence? Kornai identified four forms of regular assistance, to which we can add the parallel forms in outsourcing.

> 1. *Soft subsidy.* The adjective "soft" implies that this is not a case of a state subsidy at a level expressly laid down for a longer period. The amount of the subsidy is the subject of bargaining…Negotiations are made either in advance, before the amount of subsidy has been laid down, or during and

[67] Ellman, Michael. 2015. *Socialist Planning*. Cambridge, Cambridge University Press, Chapter 2.

> after the period covered by the subsidy, to improve on the sum promised in advance."

Similar permissive bargaining is the likely response, at least initially, towards contingencies that can't be codified and contractual overspend within incomplete PSI firm contracts.

> 2. *Soft taxation*. "Soft" does not imply that the amount of net income the firm is obliged to pay in (the "tax") is low. It means the amount is subject to prior and/or subsequent bargaining. The more possible it is to "beat down" the firm's taxation by pressure or pleading, the softer it is.

As seen, tax-avoidant 'tax planning' is the more likely route for PSI firms within highly permissive (jurisdictionally 'competitive') neo-liberal corporate tax schemes. However, debt financing of public service industry expansion through mergers and acquisitions is also enabled by, again, highly permissive tax write-offs against borrowing. Soft taxation consequently enables a capitalist version of…

> 3. *Soft credit*. On the one hand under the Soviet system, "soft" refers to the situation where the credit contract with the bank does not follow general, uniform principles, but a firm in trouble can "whine" for credit that actually includes a veiled grant.

The functional equivalent for large PSI firms in private financial markets is that credit is achieved without any innovation or value-creating development but simply to facilitate new incomes streams via mergers and acquisitions, even though the increased gearing ratio for the company (the ratio of its debt to shareholder equity) makes it more vulnerable to changes in discount rates, growth rates and cash flow forecasts. But this is not the only available route to soft credit.

In a world of notably elastic accounting rules, as Leaver has shown, PSI firms increasingly use accounting measures to leverage the future, either by securitising their future income streams, creating holding companies in tax havens or by over-optimistically booking profits based on forecasts and estimates. As Leaver notes, this last strategy is particularly available to outsourcing companies operating within long term contracts, so that where the proportion of costs and revenues relative to the final cost and revenue are hard to estimate for any given balance sheet date, these can be booked based on forecasts for what company believes the total profitability of the contract will be. In the first instance this is 'pulling income from the future' so that money can be borrowed on the basis of the 'improved' profit and loss statement. Should they get these forecasts wrong moreover, a government dependent on an overly indebted public service industry provider is likely to prove amenable to the exaggeration of costs if not an actual bailout via 'improved' contract conditions.[68]

There is an additional opportunity for creative accounting in large infrastructural projects, like hospital trusts, which potentially benefits both governments and the private contractor but not the public purse. As Hellowell and Vecchi show, payments to the private operator are likely to be indexed in the contract to the Retail Price Index that is typically higher than other measures such as the GDP deflator. Simple indexing charges using these measures will in most years result in a real-terms increase in the unitary charge. This is particularly problematic for capital-intensive infrastructural projects where, since interest rates are fixed in nominal terms, less than half of the operator's costs are sensitive to changes in the price level. By structuring a unitary charge so that the proportion linked to inflation is larger than the inflation-sensitive element of the operator's costs, the operator can offer a lower bidding price confident that the extra revenue from over-indexing will allow the "back ending" of debt service payments and shareholder payouts. Governments may be happy to structure payments like this because costs can be deferred to later

[68] Leaver 2018.

indeed, to other governments, but the net cost to the public purse is higher than if charges that were indexed were an accurate reflection of price-sensitive costs.[69]

Finally, Soviet firms could benefit from what Kornai called soft administrative pricing.

> 4. *Soft administrative pricing…* A significant proportion of prices in a classical socialist economy are set administratively. These seem to be prices dictated bureaucratically to the firm, but, in fact, they can be "softened" by vertical bargaining with the price authorities. There is advance bargaining: the goal of the firm, branch directorate, or ministry is to make the pricing authority "acknowledge" the costs in the price, however low the efficiency of production. There is subsequent bargaining also. A price rise is sought if extra costs have been incurred. In some other cases a disguised price rise is made. The quality assumed when the price was set is lowered, or a good material is substituted by an inferior material, or certain finishing processes are omitted.[70]

This scenario is highly probable within public service outsourcing where prices and processes are not set by a market (there is, for example, no competitive market price for the rehabilitation of criminal offenders) but by the valuation of complex target indicators that are set and priced 'administratively'. The risk of price softening to the corporate advantage is high in conditions where the contractor has leverage given any combination of sunk costs, high negative spillover costs of service disruption or high cost of supplier substitution (given the new opportunity for hold-up). This is to say, under typical conditions.

Between their initial operating conditions and the lack of available disciplinary options over time the affinities between a PSI firm and a Soviet SOE run deep. The outsourcing contract operates as a form of planning instruction and as an imperative to be realised, not as a forecast or 'indicative plan' to be considered;

[69] Hallowell and Vecchi 2015, 529.
[70] Kornai, Janos. 1992. *The Socialist System: The Political Economy of Communism*, Princeton: Princeton University Press, 141-144.

prices are predominantly administrative and soft; contracts are typically long, incomplete and exit is punitively expensive financially, organisationally and politically; the continuation of production is essential, hence government operates under chronic soft-budget constraints. The relationship is intrinsically and institutionally politicised: in the UK case, following repeated failures, the Cabinet Office operates as the direct interface with major outsourcing companies.[71] Demand for the good or service is typically guaranteed. As a result, multinational PSI firms resemble neither the efficiency-achieving, value-creating innovators of neoliberal promise (and more often, SME reality), nor the high performing residual public corporations of the UK, like the global prizewinning BBC. They look more like the separated-at-birth twin to the Soviet 'Kombinat' business group. Under doctrinaire governments they likewise benefit from an increasingly all-embracing nomenclature of commodities to be produced. In contrast to the Soviet system, however, money is anything but passive within the outsourcing production regime.

From the taxpayer's point of view the contemporary outsourcing architecture is *more* dysfunctional in its setting of corporate incentives than the Soviet system. Under central planning, state owned enterprises had poor incentives to fulfil targets because wages were flat, because ideological motivation was undermined, particularly in those Central European states that experienced Communism as an imperial imposition, and because the fulfilment of a target prompted an increased target in the following year, requiring more effort for no additional reward. Under supply-side outsourcing, PSI firms are incentivised both within their financial and (stock holding) executive pay structures and by the incompleteness of the contractual specifications to actively 'sweat' the contract, since beyond creative accounting measures the profit margins originate in its strictly legal, plain text reading. At the same time these firms now operate under powerful financial market

[71] HC 777 2014. Ev 2.

incentives to maximise shareholder dividends even at the expense of productive reinvestment in the sustainability of the firm itself. The tougher any government tries to be in contract pricing the more damaging the consequences from margin-seeking by the firm are likely to prove. Rather than consider the collapse in 2018 of the major UK public service company, Carillion, as an outlier these companies are better understood as acting rationally under the prevailing incentive structures. Carillion was aberrant only in misjudging the moment when the financial market would baulk at the scale of its of reckless borrowing in the face of unsustainable executive and shareholder payouts.

The standard counter-argument to objections around monopoly is that the reputational effect on dominant firms acts as a disciplining guarantee against satisficing contractual behaviour in the light of potential new market entrants. But in monopoly or at best duopoly environments with high barriers to entry under doctrinaire governments who are also increasingly structurally dependent on the survival of the dominant firms, the reputational damage to poor providers is apparently nil. A Public Accounts Committee investigation found that Serco and G4S were awarded fourteen new contracts by five Departments worth £350 million even as they were being investigated by the Serious Fraud Office for defrauding the MoJ and *after* the Justice Minister at the time, Chris Grayling made a public commitment to make no awards until the case was resolved: the Ministry of Justice was among the five.[72] *Čest práci!* as the Czechoslovaks used to have to say (Honour labour!).

It is also worth noting that the National Audit Office is unable to access accurate statistics on outsourcing despite its proven hazards. As the Director of Commercial and Contracting at the NAO, Joshua Reddaway explains: "Unfortunately, data on

[72] Plimmer, Gill and Sarah Neville. 2014. G4S and Serco won Whitehall work despite being 'on probation', *Financial Times*, December 10th Available at https://www.ft.com/content/6f1c35c6-7f90-11e4-86ee-00144feabdc0, accessed 5th February 2018.

UK government outsourcing of goods and services as a proportion of its expenditure over time does not exist – as far as we are aware – in a consistent and comparable format. This is the case for both central and total government. This is because there is no accounting or statistical distinction made between spending on general public procurement and outsourcing. In the absence of this data, we have in our previous work attempted to arrive at estimates for this proportion but not over time.[73]" Such assessment is about to become harder. In April 2017 it was announced that an unspecified number of contracts due to expire would be renewed owing to the overburdening of the civil service by Brexit following civil service cuts of 26% over the previous decade. The number of contracts due for renewal is large owing to the commencement of multiple 10-year contracts by the Thatcher government in 1986, their perpetuation under Labour in 2007 and their 2017 expiry. Under staffing pressures, then, not just oversight capacity but even the brief, supposedly corrective moment of competition may be lost.

Sins of commission

Just as the sins of omission are written into the microeconomic DNA of the first-best-world neoclassical view so serious risks attend the potential remedies. A core insight from 'varieties of capitalism' theory is that in markets for private goods, where products are complex, use non-standard technologies or are specific in their customer orientation, then market failures, and in particular information asymmetries between firms and clients or between managers and providers of finance may be more prevalent. Hence it has proven more effective in such markets for clients, shareholders and creditors to have the capacity to monitor and control companies through embedded, non-market mechanisms such as ongoing customer support, board seats for stakeholders enabling privileged information, and business

[73] Author Correspondence, 5th September 2017.

association monitoring of quality control and network reputation. The higher skills base required for high quality manufacturing has likewise been sustained through cooperation between business associations and trades unions on training, wages and unemployment systems. This 'relational capitalism' has allowed the 'coordinated market economies' (CMEs) of Austria, Germany and Scandinavia to lead in 'diversified quality production'.[74]

If the world consisted of standardised widgets and their public service sector equivalents, markets could be made to work. But public goods are far closer to the complex goods produced best via cooperative coordination than the simple goods and transactions of the neoclassical paradigm. However, in a doctrinal scheme that rejects relational public or private systems *a priori*, as built on optimistic delusions around the possibility of cooperation and hence positive-sum transactional games, supply-siders are bound to understand NPM reform failures as rooted in state, rather than market failures. Within supply-side doctrine the consistent solution is consequently to make public institutions more market-like and their personnel closer to the utility-maximising archetype. Since the democratic state shows no signs of withering away as implicitly promised within the wider supply-side revolution, however, such intensification is fated to push this project to higher levels of paradox.

Following its highly critical 2014 inquiry, the cross-party Public Accounts Committee concluded that "Government needs a far more professional and skilled approach to managing contracts and contractors, and contractors need to demonstrate the high standards of ethics expected in the conduct of public business, and be more transparent about their performance and costs."[75] The remedy: to tighten the negotiation and cost component of contracts and improve the

[74] Hall, Peter and David Soskice 2001 *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. Oxford: Oxford University Press.
[75] HC 777, 2014.

commercial and corporate expertise of the state both fail to address the intrinsic flaws in the model: the endemic incompleteness of contracts for complex goods and services and the financialisation and lack of competition for large public service industry firms. Indeed, as soon as you think seriously about what it would take to create fully competitive service markets and sustain them, against their natural tendency to failures around complex goods, or to build their equivalents through administrative imitation of market functions, the necessary bureaucratic effort would make Leonid Brezhnev blush.

The Institute for Government is the leading UK think tank for improving government effectiveness and works closely with Whitehall on ongoing administrative reform. To try and tackle the higher complexity of public service markets the Institute has set out what it calls a 'market stewardship framework'. As they point out, whereas "Commissioning models often focus on understanding user needs and choosing the right providers market stewardship takes a broader perspective – considering how to set the rules of the market so that competition between those providers works effectively". Their framework requires the following:

- Determine the outcomes you are looking for, balancing the needs of all those affected by the service
- Ensure there is enough money to pay for the services required
- Ensure users have good information on which to base their decisions
- Decide how to encourage new entrants into the market
- Decide the criteria to use for selecting providers
- Decide how to monitor performance, reward high performers and punish poor performers
- Decide the process for switching providers if performance is not acceptable, while maintaining service continuity and standards[76]

[76] The Market Stewardship Framework, Institute for Government. Available at https://www.instituteforgovernment.org.uk/publication/market-stewardship-framework, accessed 10th March 2018

The Stewardship programme follows logically from critical neoclassical analysis as to the nature of market failures insofar as it speaks to improving competition. But while the necessary remedies are apt in theory they are extraordinary in their practical implications. In the first place, the requirement to 'determine the outcomes you are looking for' while 'balancing the needs of all those affected by the service' is driven by the weaknesses of contracting more obviously than it is a coherent proposition for encouraging market efficiency. Moreover, duly determined outcomes would need to 'complete' the contract to be effective. Rather than defining exact and comprehensive outcomes, pre-NPM public services operated according to continuing obligations and new political priorities as implemented via professional standards, generalist or expert training and clear public service codes of practice and ethics within budgetary limits. By contrast, the requirement to comprehensively anticipate and quantify outcomes for contractual clarity is bound to become more bureaucratically rigidifying the more complex the task.

Even without attempts to build 'complete' outcome indicators, contract theory has warned that where any agent has to perform a number of different tasks, the effort will be allocated to the task most easily measured and hence rewarded. In these conditions, argue Holmstrom and Milgrom, the agent may rationally choose to increase productivity at the expense of the quality of the output.[77] Hart, Shleifer and Vishny likewise model how, in a world of incomplete contracts, an archetypal (*i.e.* non-financialised) private firm has stronger incentives both to reduce costs and to improve quality than the public sector but that the cost-reduction incentive may overwhelm the quality improvement incentive if quality is difficult to measure (i.e. it is non-contractible).[78] These risks already attend outsourcing contracts *before* you

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[77] Holmstrom, B. and P. Milgrom. 1991. Multitask principal-agent analyses: incentive contracts, asset ownership, and job design. *Journal of Law, Economics and Organization* Volume 7, Special Edition: 24–52.
[78] Hart, Oliver., Andrei Shleifer and Robert Vishny. 1997. The proper scope of government: theory and an application to prisons. *Quarterly Journal of Economics* 112: 1127–1161.

add in the intensification of extractive cost-incentives originating from financialised PSI firms.

The history of the Soviet economy would also, to put it mildly, warn against supposedly remedial attempts to 'complete' outcome indicators. The combination of cash limits plus targets under communist planning was found to create perverse incentives against innovation or optimisation of performance. Indeed, so long as the objective in production was to fulfil the agreed plan target there was no incentive to achieve any output, sales or profit defined away from the current bargain, with higher quality service the equivalent for outsourcing. Output maximisation likewise proved counterproductive as it amounted to an invitation to the centre to impose a harder target for the next planning period.[79] The Soviet planning experience is a cautionary tale of rigidifying performance outcomes in the face of changing needs and technologies, so that the greater the precision of the performance outcome the lower the incentives for initiative, [80] whether you understand that as an entrepreneurial or vocational spirit for innovation.

The accurate planning of production outcomes moreover, depends on forecasts, which in turn depend on good information about the status quo. With an intensified combination of payment-by-results incentives and contracts to PSI firms characterised by pseudo-synoptic outcome targets, outsourcing would only travel further into the territory of the rational incentives for misinformation, private 'orders of importance' and the allocation-production discrepancies characteristic of the Soviet planning system. As Kornai noted of the provider down the delegated production chain, "It may not be in his interest to transmit [accurate information]… It may be fully in his interest to pass it up in a distorted form." The fuller the set of specified outcomes moreover, the greater the incentive towards the pragmatic self-

[79] Myant, Martin. 1993. *Transforming Socialist Economies: The Case of Poland and Czechoslovakia*. Aldershot: Edward Elgar, 17.
[80] Kornai 1992, 118.

ordering of priorities by their ease of completion or low cost, rather than according to their social value. Under Soviet planning, private 'orders of importance' occurred within emphasised indices and to manage when all indices were emphasised equally. And as Kornai noted: if the regulatory net was not dense enough to cope, the holes had to be plugged with a succession of new regulations, with the inevitable consequence a "proliferation of the bureaucracy."[81]

Just as the annual technical, production, and financial plan of each enterprise had to be operationally anticipated by the *tekhpromfinplan* mechanism within the Soviet Supreme Council of the Economy in the 1930s, before it was devolved to ministries, so outsourcing government agencies would have to develop more synoptic planning and oversight capacity not just over but between their interdependent contracts, the more that contractual interdependencies were considered or comprehensive outcome and resource planning was adopted. This is the allocation-production planning world of the classic Soviet system, and it was the growing discrepancies between allocation and production information that notoriously rendered these 'the economies of shortage'.

In the Soviet Union the reform of the distorting effects of extensively determined target outcomes was postponed by the war and Stalinism, but by the 1960s under Nikita Khrushchev the CPSU was actively debating decentralisation and enterprise rights. The focus of Yevsey Liberman's proposals, so influential on the Kosygin economic reforms of 1965, was the enterprise and its dysfunction under planning targets. Specifically, Liberman criticized, as had others, the too numerous and often mutually contradictory success indicators to which the enterprises were subject, hence the reform goal became to increase enterprise management flexibility and reduce the targets.[82] This raises a question: if Soviet communists were rejecting fully

[81] Kornai 1992, 130

[82] Laferty, Thomas. 1982. The Soviet Central Planning Process: New Methods and Continuing Problems. *The Journal of Social, Political, and Economic Studies* Volume 7, Number 3: 207-240, 210-214.

determined outcome planning in the 1960s as 'excessively rigidifying', should it seriously be tried again in the name of 'market efficiency'?

Ensuring that there is enough money to pay for the services required is a prerequisite for any public expenditure but it becomes harder around outsourcing given the asymmetries between supplier and buyer as already illustrated. As the Public Accounts Committee concluded, cost overruns in outsourcing are a chronic feature and by no little amount. In 2014 the National Audit Office concluded that the Aspire IT contract with Her Majesties Revenue and Customs had cost double the original contracting price and with double the profit for the contractors.[83] Without viable solutions these power asymmetries will continue.

The requirement to guarantee that users operate with good information is misleading and more difficult than it sounds. Again, the 'Stewardship' logic is that market competition in publicly funded provision creates firm-like-customer orientation and enables consumer choice. Ignoring for a moment that the state remains the only substantive customer, for the market metaphor to add up the end-user 'customers' should be able to make an informed choice, and a choice has to exist. But this diagnosis is disingenuous for the majority of outsourced services. Setting aside how the expertise aspects of public services like medicine guarantee information asymmetries for 'customers', contracts are typically given to provide the single service in a given area, which leaves the *de-facto* consumer choice between a single privately run public service versus paying for a fully private provider versus support foregone. Moreover, users of public services tend to need or even to be legally obliged to use those services: disabled citizens seeking to access their independence are not shopping for a handbag. Guaranteed demand in the market

[83] Stokdyk, John. 2016. HMRC Aspire contract will end in 2017, Accounting Web, 30th March Available at https://www.accountingweb.co.uk/tax/business-tax/hmrc-aspire-it-contract-will-end-in-2017, accessed 3rd March 2018.

for private goods is typically a recipe for poor service and price-gouging in the absence of powerful regulation.

The lack of effective choice is sharper for the true customer, government, when signing contracts for private services that may last anything between one to ten years. The deepest flaw in this reasoning, however, is that 'improving information' as a solution follows from the purely nodal, microeconomic logic of an analysis between customer and seller in a market for simple goods. It elides the fact that the state is mandated, if not statutorily required to provide individual services while balancing the needs of all as relate to that service and beyond. The 'improvement of information' assumes that completely informed individual consumer choices are compatible with the wider social interest but they rarely are. For example, accelerated exclusion of 'underperforming' pupils is simultaneously a rational consumer choice by a majority of parents in a given school, a rational choice for an individual school evaluated by pupil performance, a calamity for the struggling students so excluded, an unanticipated cost to the remaining education and social services system and a suboptimal outcome for the national skills base, let alone for society. Department of Education figures show that sponsored academies and free schools, conceived of as outsourced individuated 'firms' competing for parents, permanently exclude pupils at double the rate of other state secondary schools.[84] Democratic governments are elected to resolve conflicts between individual preferences and the public interest not deepen them at the taxpayer's expense. While an extensive body of social policy research shows how the welfare state has historically been most effectively accessed by the educated middle classes, it is a backward step to build this pathology into the architecture of the state itself.

[84] Adam, Richard. 2015. English schools see first rise in exclusions in eight years, *The Guardian* Thursday 30th July. Available at https://www.theguardian.com/education/2015/jul/30/english-schools-see-first-rise-in-exclusions-in-eight-years, accessed 10th March 2018.

To encourage higher public service industry competition 'Market Stewardship' urges the state to encourage not just new large firms but SME providers who, in the light of the real practices of PSI firms are practically guaranteed to prove more innovative, efficient and concerned for reputation. But while SME contracting could be better managed by well-resourced local authorities around limited and coherently codifiable tasks, to manage this in central agencies raises serious challenges around economies of scale, the bureaucratic costs of managing multiple small contracts and the capacity of smaller contractors to compete for, let alone manage larger contracts at a competitive price. Failed competitive tenders are a damaging cost for SMEs.

This market-making consequently requires ideological contortion. The supposedly rational, neoclassical state-as-individual consumer has to think about not just its immediate financial interest but build a better future market for itself, regardless of interim cost and the further rise in logistical complexity for tendering and the increased transaction costs from *that*. It also has to take on and solve the liabilities if those contractors fail. Imagine a market for bread where the condition for buying your daily loaf is an additional commitment to buy several days a week from local artisanal bakeries at marginally higher immediate cost and where the service or total failure of any large supplier means you become personally liable for supplying their fraction to the local population (which would make that artisanal bread a better deal than it first looked). Under such risky conditions the rational consumer would probably learn to bake their own.

The last three requirements for effective Market Stewardship: to decide the criteria for selecting providers, to decide how to monitor performance, reward high and punish low performers and to decide the process for switching providers while maintaining service continuity and standards, all hit on issues already raised. In a functioning, highly competitive market for standardised goods a consumer can typically choose between price and quality with those two factors traded off to produce an abundance of options. But as we know from the discussion about writing robust contracts for complex goods, the risk for the state is that prices may rise unexpectedly in hard to specify contracts and service quality is difficult to define fully and to monitor effectively. In effect, one might choose to emphasize either price or quality, depending on one's resources, but the state's ability to guarantee either over the life of an outsourcing contract is fated to remain poor.

As for the remaining two: the conventional reward for performance in a market for, say, clothing, is to buy again from that provider. But in a public service market the reward of ever more contracts to a single provider encourages the consolidation of what is a naturally weakly competitive market and thwarts the requirement to encourage multiple providers. The conventional way to punish poor provision is to reject that provider, but the difficulty of suspending public service production makes such punishment less credible, particularly in sectors where that provision approaches monopoly, such as security and defence. These constraints give leverage to PSI firms.

In relation to monitoring performance and managing contractual change, the Public Accounts Committee 2014 recommendations followed a wider tenet of NPM reforms, namely to increase the business expertise within the state. To argue that ongoing failures are due to the insufficient transformation of public employees into commercial actors has been the consistent government line. Indeed, it is the only actionable option within the doctrine, where stronger regulation within private markets is ruled out. Successive UK governments have duly endowed large business corporations with the kind of access and leverage in policy making and control over public funds only otherwise available in countries categorised as grossly corrupt.

To offer a few examples: as of 31 March 2015, there were 69 Non-Executive Directors across 17 central UK Government Departments charged with the 'strategic leadership' of the department and with powers, since 2011, to recommend the removal of the Permanent Secretary, the most senior civil servant, were they to prove 'obstructive'.[85] Usually appointed through 'informal' methods, fully 94% of NEDS came from businesses and frequently from businesses active in the department's field of operation and procurement. In a 2010 Public Accounts Committee report on the revolving door into the junior and senior civil service expressed "fears that core civil service values could be diluted by an influx of outside recruits who do not share the same public service ethos as a career civil servant" and noted that by 2008 40% of the top 200 civil servants were external recruits and to the senior civil service more widely some 54%, with the majority of external recruits drawn from business year on year. The same report found that senior external recruits were typically paid some twenty per cent more than existing civil servants at the same level of seniority and stayed for shorter periods.[86]

At the same time departments' overall spending on consultants and temporary staff has increased by up to 90% since 2011–12: to between £679 million and £775 million in 2014–15. Since 2010 the largest six suppliers received three-quarters of the assignments let through Crown Commercial Service consultancy agreements."[87] When the 'Big Four' accountancy firms can provide the government with accountants to draw up tax laws and then advise their private clients on how to exploit loopholes around the legislation they helped to write,[88] it indicates the state has reached a problematic level of non-transparent porosity to private business interests. As Colin Crouch argues, the UK state now operates as a semi-permeable

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[85] The Government Lead Non-Executive Director's Annual Report, Financial Year 2014-2015, Available at: https://www.gov.uk/government/.../2014-15_Annual_Report_gov_non_exec.pdf, accessed 15th March 2018

[86] Public Accounts Committee. 2010. Insiders and Outsiders: External Appointments to the Senior Civil Service, HC 241, 2nd February: EV 48 Table 1, EV 49 Table 2 and p. 16.

[87] Public Accounts Committee. 2016. Use of Consultants and Temporary Staff, PAC Inquiry, published 18 April, Available at https://publications.parliament.uk/pa/cm201516/cmselect/cmpubacc/726/72602.htm, accessed 9th August 2017.

[88] MPs say big accountancy firms use insider knowledge for tax avoidance, *The Telegraph*, 26 April 2013 Available at https://www.telegraph.co.uk/news/uknews/10020133/MPs-say-big-accountancy-firms-use-insider-knowledge-for-tax-avoidance.html, accessed 20th August 2017.

membrane [89] in which doctrinally supply-sider governments refrain from intervention in the private sector but business access to the input, throughput and output functions of the state is actively encouraged. Moreover, this pervasive corporate penetration of state structures has occurred while self-regulation around lobbying, cronyism and revolving doors by MPs remains essentially unreformed from the era of the bounded post-war state. Arguably one of the most significant structural effects of the supply-side revolution is to obviate the need for the corporate corruption of politics in any conventional sense. The concept of 'state capture' is inexact when unprecedented public money and authority are granted to barely accountable monopoly private actors as a matter of public policy. The systemic risks to the social and fiscal contracts and hence to liberal democracy are nevertheless unprecedented.

Conclusions

Really-existing outsourcing is characterised by powerful enterprise concentration, poor-to-atrocious performance and chronically lagging, increasingly Kafkaesque bureaucratic oversight. Networked fields of business around growing public service industries nevertheless lobby for further 'market' expansion, with rights to tender reinforced by EU competition rules. Given ongoing parallel cuts in core civil service capacity and bureaucratic Taylorist reforms that disintegrate administrative functions, the result is multi–level institutional asymmetries in resources, information and political-economic power. Intensification of this process threatens the failure of the UK state in many of its most important activities.

When it comes to trying to resolve the problems of incomplete contracts there have been further innovations in theory. The direction taken in legal contract theory is

[89] Crouch, 2015, Ibid.

towards 'relational' contracts. Here, formal, specified, transactional contracts are rejected in favour of agreements based on trust and reputation and sustained by the mutually understood value of the future relationship, in which the explicit terms of the contract are only set out in outline.[90] This development, so practically familiar in the pre-NPM administration and coordinated market economies, emphasises the importance of long term relationships and contradicts the public choice emphasis on provider capture, its rejection of long term utility calculations, tacit knowledge or normative properties such as professional ethics or consummate behaviour understood as *esprit de corps*. The contract theory thread from theoretical economics has focused more on why relational contracts might be needed as a supplementary technique, rather than on their capacity to improve the actual efficiency of the 'incomplete' governance relationship at hand, about which they are pessimistic. In organisational reform terms these theories argue for unified ownership (vertical integration) in the absence of credible contracts, *i.e.* where the bilateral hazards of contract relations mount up.[91]

More than any reversion to either unified ownership, though this is now happening in less doctrinaire local authorities operating under hard budget constraints, or towards the recommended methods for an improved Market Stewardship, the dominant government solution under 'austerity' is to drive an ostensibly harder bargain around pricing and costs in outsourcing, with government agencies accepting only the lowest cost tender as a matter of course. But the risk here is of chronic adverse selection. Given the objective difficulty of establishing accurate pricing in incomplete contracting, only the most reckless firms with least regard for service quality and most determined to deploy a later strategy of 'hold up' will

[90] Macneil, Ian and David Campbell. 2001 *The relational theory of contract: selected works of Ian Macneil*. London: Sweet and Maxwell.
[91] Mouzas, Stefanos and Keith. 2013. Contract research today: where do we stand? *Industrial Marketing Management* Volume 42, Issue 6: 1057-1062.

rationally underbid for contracts with no guarantee they can stay within the resulting margins. The collapsed Carillion was just such a repeat 'winner'.

In the hard test for outsourcing it is insufficient to say private sector firms are inefficient and seek private benefits: one would ideally show they do not resolve the inherent market failures around public goods better than public provision. The aggregate analysis of Dixon and Hood that reports higher administrative running costs and deteriorating service quality indicates exactly that. This paper has sought to explain why. The first best assumptions behind outsourcing are demonstrably false. Not only that, but the policy has willed into existence the asserted pathologies it was supposed to resolve. The rent-seeking behaviour of public servants proclaimed in the neoclassical imaginary of public choice has been replaced by actual, ever-expanding opportunities for systemic-rent seeking by large private business actors that operate under powerful incentives to maximally extract value, not least by inflating costs, while the taxpayer continues to foot the bill. The private architecture, moreover, has none of the systems of public accountability attached to the old public service regime. The result is epic scope for moral hazard. That public services continue to operate as well as they do under such a framework is, if anything, a testament to the resilience of the still-denied, historical, vocational public service ethos under a new production system that incentivises the worst of public and private regimes, and few, if any, of their virtues.

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