



The future of public services regulation

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Executive summary

This paper looks at the implications for public services regulation of current policies to develop a mixed economy of provision with greater autonomy for providers and greater choice for users.

Government proposals to reduce the number of public service inspectorates from 11 to four address the overlap problem and will reduce bureaucracy; but the proposals do not address the function of regulation - what is it for and what should it do?

The focus of public sector regulation to date has been mainly on service provision and single institutions. This is now changing as a combination of more autonomous and independent providers on the supply side and greater individual choice on the demand side indicates a more market-based approach to some aspects of public service delivery.

The principles of Strategic Regulation - improving services, user focus, value for money in regulatory activity, allocating resources proportionate to risk, and regulators working in partnership - still apply. Regulators' activities need to be more closely aligned with priorities for improvements in public services. The regulatory framework should support self-assessment by organisations and internal processes for improvement.

As the quantum of inspection reduces, there will be more reliance on performance indicators and hence the quality, robustness and independence of data will become crucial. There will be further moves towards a more holistic approach to service delivery bringing together the combined contributions of local agencies on an area-wide basis to achieving broadly defined outcomes such as regeneration and community safety. In response, regulators must move towards an area-wide focus for their work, and must ensure value for money by following the public pound through partnerships as well as through single organisations.

In the longer term, regulation will need to adapt for the Government to achieve its goals for public services in a more competitive, mixed system. Regulation will continue to be important in achieving economy, efficiency and effectiveness in public services, and in ensuring equity and fair access. But the role of regulation will vary according to market conditions - whether public services are provided as public sector monopolies or under conditions closer to a competitive market. In the latter case, market pressures may be able to take on some of the burden, in terms of standards, enforcement and improvement, for example, that would otherwise be borne by regulation.

Health and social care are further along this path than other public services, and should therefore be seen in a different light. Some services will - rightly - remain as public sector monopolies, while for others the outcome will be somewhere in between.

We need to think through the relationships between regulators on the one hand, and commissioners, providers and users of services on the other. The principles of Strategic Regulation (particularly proportionality and risk-based assessment) remain key - the goal is a different form of regulation rather than more regulation.

With regard to *commissioners*, regulation should ensure that: the market works to the benefit of all local residents; value for money is obtained through procurement and commissioning; choice is informed and is exercised; there is sufficient capacity to make choice real; there is fair access to the market and no discrimination; and outcomes are at least as equitable as under monopoly provision. Furthermore, commissioners of services should be collectively responsible for cross-cutting outcomes on an area basis.

With regard to *providers*, all (public, private and non-profit) should be subject to the same rules of play. In competitive sectors, regulators should set floor targets, using choice and competition to drive improvement. The role of regulators is enabling. In monopoly sectors, regulators will need to set targets to drive standards and improvement - the role of regulators here is pro-active. Regulators will also assure users and taxpayers of the accuracy and truthfulness of provider claims.

Regulators must also communicate more directly with *users*, supplying information in an effective way. The goal is to increase accountability downwards to users, replacing the top-down accountability of central

targets. Information can be distributed to users by non-profit or even private agencies as well as by the public sector.

The role of regulators is changing. In the past, there was a plethora of regulators focused on individual services, using corporate assessment as the main tool. Currently, we are in transition as the Government continues the move to a slimmer but more effective Strategic Regulation, with a key need for regulation to ensure value for money in commissioning and procurement.

In the future, there will be moves toward market-making, assurance and modernised audit, and away from detailed inspection. Not all services will or should move at the same pace. It is likely that the direction and speed of change will be most significant in health and social care, with other services on a continuum, including at the other end a continuation of public sector monopolies. The key goal is to ensure that regulation both supports the needs of service users and reflects the operational realities confronting commissioners and providers.

1. Introduction

This paper addresses two related issues:

- (i) Current Government proposals, announced in the 2005 Budget, for a rationalisation of the public services regulatory framework, and in particular a reduction from 11 to four national inspectorates.
- (ii) The longer-term implications for the regulatory system of a future in which public services are delivered in a more mixed economy, with public bodies being increasingly autonomous and user choice much more widespread.

The purpose of this paper is to set out the broad outlines of a modernised regulatory system which will continue to support improved standards in public services, deliver value for money and provide assurance to the public, in a changed context with greater emphasis on choice and competition. The paper does not address structural or operational issues (i.e. who should do what and how) but looks more at how regulators might go about their business.

2. The immediate issues

Where we are starting from

In this paper, we use the term 'regulation' in its broad sense to refer to the range of activities undertaken by public sector regulators, i.e. encompassing audit and inspection as well as regulation in the strict sense (licensing, compliance, prescription). The Public Audit Forum (PAF), which brings together the public audit agencies, defines the goals of audit, inspection and regulation as being "to protect public funds and help to continuously improve the quality of public services".

More specifically, **audit** comprises the audit of accounts and underlying financial systems and processes, including whether public money was spent for the purposes for which it was intended. Public sector audit has also always been concerned with the proper stewardship of public funds - whether organisations have proper arrangements in place to secure economy, efficiency and effectiveness ('value for money') in the conduct of their affairs. **Inspection** is the process of periodic, targeted scrutiny, and the reporting on whether services are meeting national and local performance standards and targets and the needs of service users. **Regulation** (as defined by the PAF) is "the process by which public sector activity and market forces are directed for the public good", including the registration of bodies and monitoring compliance.

In practice, much of the activity of public sector regulators has been focused on the capacity of different public sector organisations to deliver services on the ground. Public sector regulation shares some characteristics with private sector regulation. For example, common to both sectors are the assurance of minimum standards, and the protection of vulnerable people who are in a poor position, or unable, to exercise rights.

However, there are clear differences between public and private sector regulators in terms of how they seek to achieve their aims. Regulation in the public sector has increasingly moved towards the corporate assessment model, in which external inspection is used as a tool to improve the governance, performance management and financial management of the organisation. In the private sector, governance, performance management and financial management are left to shareholder pressure, company law and the market to deal with (sometimes unsuccessfully). Moreover, while there is usually a clear regime for dealing with organisational failure in the private sector, this is not something with which regulators normally get involved.

Public sector regulation is the need to provide a substitute for market pressures, mainly via inspection and performance audit, in order to drive improvement. This is very distinct from performance management. Performance management - which can and should be about outcomes as well as processes - is an internal procedure, with internal accountabilities. Driving improvement through public services regulation requires credible, independent assessment of outputs and outcomes. These assessments must be externally focused and accountable, and the findings made available to the public.

Getting regulation right is essentially about *balance*. Those at the receiving end of regulation will almost always be in favour of a lighter touch. But providers will generally want some regulation - to provide assurance and to discourage unfair competition in the private sector, and to challenge practice and stimulate innovation in the public sector. The public want assurance and are generally favourable to regulation. At the same time, they are impatient with 'red tape', hence the need for regulators to show that their activities are proportionate, targeted and make a difference.

Current proposals for rationalisation

In the 2005 Budget, the Government announced a rationalisation of national public services inspectorates from 11 to four. Subject to consultations, some of which have now closed, the proposals are for:

- a single justice and community safety inspectorate from 2007, bringing together the separate inspectorates for the constabulary, the Crown Prosecution Services, Court Administration, Prisons, and Probation
- bringing the inspection of children's services by the Commission for Social Care Inspection (CSCI) and the work of the Adult Learning Inspectorate into the Office for Standards in Education (Ofsted)

- merging CSCI and the Healthcare Commission into a single body by 2008
- merging the inspection functions of the Audit Commission and the Benefit Fraud Inspectorate to establish a local services inspectorate.

The Government's aim is to reduce and refocus inspection activity. The new bodies are expected to:

- better identify and disseminate best practice, including taking a risk-based, proportionate approach
- take account of users' perspectives across service and institutional boundaries and comment on those pathways
- focus on outcomes and improvement
- provide value for money.

There have been a number of drivers of these reforms. First, the findings of the Hampton and Arculus reports and the work of the Better Regulation Task Force, all emphasise proportionality and its risk basis - echoing the approach of Strategic Regulation (see below). Second, there is the need to further reduce overlap and multiple inspections. Finally, there are the increased costs of inspection - external inspection of UK public services rose from £250m in 1997/98 to £550m in 2002/03 (Office of Public Service Reform - OPSR).

Reducing the number of regulators may be necessary in order to remove overlap and duplication. But simply merging organisations may not lead to reduced costs or improved value for money - it depends on how it is done. "It is far from clear that mergers always cut costs. Ofcom, the newly converged communications regulator, currently costs more than the five regulators it replaced" (Cowling 2005).

Merging organisations will raise important questions about the focus of activity. For example, with regard to the Healthcare Commission/CSCI merger, the majority of CSCI activity relates to licensing and regulation of care homes and domiciliary care providers. It will be important to give due weight to this but without crowding out other aspects of the organisation's business. It will also be important to avoid the creation of new 'silos' around the four new super-regulators.

More significantly, Government has indicated that it wants to change not only the *form* but also the *content* of regulation. What regulators do is more important than how many there are. This paper concentrates on what they might do.

Principles of regulation

Public sector regulation will continue to be refined and become smarter in its approach. It is likely to place greater weight on the use of performance indicators, which will raise questions about the quality of the underlying data. It will also use inspection and corporate assessments more sparingly, as a follow up to apparent poor performance, rather than as a general tool subject to diminishing returns as the inspected bodies learn to 'play the game'.

The Office of Public Services Reform (OPSR) has set out 10 principles for public services inspection, covering detailed processes of inspection as well as some of the broader issues (see Appendix 1 for detail). Although valuable, these 10 principles are too detailed to provide a broad framework for guiding regulatory activity as they range from overarching principles to specific points about the conduct of inspections. A broad set of principles can be found in the concept of 'Strategic Regulation' which has set a framework for the work of the Audit Commission and has been influential generally in public sector regulation.

The key principles of Strategic Regulation are:

1. Regulation should be aimed at improvement. Strategic Regulation goes beyond just providing assurance, and looks for ways to drive up standards; regulators need to ask questions about leadership, risk, performance management, culture and the governance framework.
2. Service delivery and improvement should be judged from the perspective of the user. Regulators can act as a substitute for market forces through which user preferences might otherwise be powerfully articulated. In the public sector there are also specific concerns about equity of access to services and of

service delivery.

3. Value for money should be sought for the taxpayer, both from the regulated organisations and from the regulator's own activities.
4. Resources should be allocated proportionately to risk. Attention should be focused where the risks are greatest and the capacity to deal with them is weakest. In practice this means that the excellent should be left relatively alone and attention given to those with greater need to improve performance.
5. Work should be carried out in partnership with other public bodies and regulators. Regulators should work together to avoid duplication and ensure that their collective activity is more than the sum of the parts. Those regulated should see regulation as a helpful tool for improvement and use challenged self-assessment and peer review.

Note that points 1, 2 and 3 are about ends, while 4 and 5 are about means.

Improvement

The impact of regulation on improvement in public services has been highly variable. In some services, regulation and inspection have been regarded as key drivers of improvement. In others, the role of inspection in driving improvement is less clear cut. And indeed some services (for example, the NHS) have improved largely in the absence of inspection and regulation. In addition, the focus of regulation and inspection varies across sectors, from what is effectively an external performance appraisal of individuals or small teams to an overall view of corporate capacity.

A sharper appraisal and more consistent approach is now needed in three areas.

First, there needs to be a clearer understanding in each sector of the role of inspection and regulation in complementing the other levers for improvement - targets, performance management, financial incentives, legal constraints and market forces. The role of inspection and regulation does not have to be the same for each sector as the levers and the way they are deployed will also vary. But a clear articulation of the role and contribution of inspection and regulation will make it easier to decide whether the chosen route is likely to be the most appropriate and give value for money in its own right and will also help determine how the resources available to the regulators could best be deployed. This may in turn make it easier to judge impact as the role and expectations attached to it would be much clearer.

Second, and following on from this, regulators might themselves be given a clearer set of objectives, expressed in terms of outcomes rather than inputs or processes. These might, for example, be tied to longer term PSA targets and/ or local priorities. This would again give greater focus to their work and measurement of impact and the regulator's own value for money would be more easily assessed. Such an approach would not compromise the regulator's independence of methodology, assessment or judgment. But it would make clearer where the regulator's contribution was expected to be greatest and also enable better assessment of its effectiveness.

Third, it is clear from the experience of the Audit Commission and others that the way in which an organisation manages itself and its performance is crucial. If the organisation has successful and effective internal mechanisms for driving improvement, the regulator can step back. Hence, one aim of regulation should be to ensure that such arrangements are operating well, perhaps only intervening when there is evidence of failure. This would remove the need for regular rounds of inspection. Indeed, it is likely that such inspections will produce diminishing returns over time as the regulated learn the rules of the game and adapt their behaviour accordingly. This type of approach, where individual organisations have strong corporate capacity and internal controls and where inspection is concentrated on those who were at risk of failure or who had failed, would have to be linked to sound, effective risk management (see risk section below).

Within inspection, a shift in focus is already happening from organisations and processes to outcomes. This development is to be welcomed, and is clearly in line both with Government priorities and with the principles of strategic regulation. However, there are some potential risks. By aiming at a broader, integrated approach, inspection may lose its focus. Specialisms can be compromised in order to deliver an integrated, comprehensive assessment. By way of an example, in the case of Joint Area Reviews, there is a balance to be struck between the assessment of outcomes for all children, and the specific needs of the most vulnerable.

The aim of the regulatory system should therefore be to support self-assessment and internal processes for continuous improvement and innovation, not to generate a mechanical compliance regime. “Inspectors and auditors largely frame the standards which organisations are expected to meet. Over time, they tend to set out detailed expectations to which institutions are expected to conform. If not carefully watched, this can easily lead to a culture of compliance in which innovation and creativity are regarded as unacceptable risks. This is not inevitable, but inspectorates need to be constantly aware of the risk that it may happen.” (Bell, 2004)

Users

Viewing the service from a user perspective is a powerful and central regulatory tool. Many regulators and inspectorates now adopt this approach. But more could be done by regulators and inspectorates to address their work directly to users as well as to managers and also to show more clearly that they are taking on board users' concerns. User focus is not an optional add-on, but is crucial to the model of modernised regulation, and is complementary to the concentration on management issues set out above.

User focus is particularly important for future developments where choice becomes an important driver. This is considered further in section 3 of this paper.

Taxpayers

Value for money for taxpayers should always be a key concern for regulators. This will increase in the future - in part as a consequence of the implications of the Gershon Review, but more broadly because taxpayers wish to see demonstrable and significant progress in services for the extra money being put in. Furthermore, as significant real increases year-on-year in public services budgets are replaced by lower growth, there will be constant and unremitting pressure to deliver more and better from the existing resources.

There should always be a clear link between use of resources and service standards. This is not always clearly evident in current approaches. The importance of value for money and the use of resources have recently been strengthened in Comprehensive Performance Assessment (CPA). The Healthcare Commission is developing a similar approach for its new system of assessment which will apply for this year. However, proactive concern for value for money is less apparent in other areas.

Audit has a crucial role to play in ensuring that taxpayers' money is properly used and value for money achieved. Financial audit is the oldest form of 'regulation' and is associated with the proper stewardship of public funds - whether public money has been properly and effectively spent. This is a particular imperative given that the public usually has no choice in whether it should fund particular services. Probity and good governance have come to be expected but we should not lose sight of the crucial underpinning provided by public sector audit with its linked concerns of an organisation's financial standing and whether that organisation has proper arrangements to secure the three 'e's' - economy, efficiency and effectiveness - in conducting its affairs.

Good governance has long been a public sector audit issue and it is perhaps ironic that in this instance the private sector is moving towards the public through, for example, the publication of the Higgs Report and, in the USA, the audit requirements being imposed through Sarbanes Oxley. Given the crucial underpinning role of audit, there are important reasons why there should be a single auditor for the local public sector and a single audit regime. Two key considerations are:

- the impossibility of splitting audit of different council functions between different inspectorates (children, social care and local services) when local authorities are single bodies with single set of accounts
- the increased role of partnerships at local level, discussed below, where funds are transferred and pooled, financial arrangements become more complex, and partnerships of agencies rather than individual institutions are responsible for delivery. There is a clear case for a single audit regime with a single auditor, to avoid losing track of the money and how it is being spent.

Maintaining a single audit regime need not in itself create additional bureaucracy when matched against

the four planned inspectorates. One of the strengths of CPA is its ability to bring together a series of judgments from different inspectorates into a credible overall assessment. Audit is one aspect of that. It is also the approach being adopted by the Healthcare Commission, which will explicitly rely on judgments made by other organisations in bringing together an overall assessment of performance. This will still be needed following the creation of the four inspectorates, one of which (the merged Healthcare Commission and CSCI) will itself cover both the NHS and part of local government.

What will be important are the development of effective partnerships through clearly delineated responsibilities and information sharing between the various parties. In health this is already occurring through the development of a Code of Audit Practice with clear responsibilities and which is jointly owned by the Healthcare Commission and the Audit Commission and explicit legal permission for information sharing. It is a model which could be followed elsewhere and which is discussed further below (in the section on partnerships).

Proportionate to risk

This is a key principle, which needs to be followed through in practice. There may be an argument for baselining particular services, i.e. with 100 per cent coverage in the first instance, but thereafter regulation and inspection should be proportionate to the risks of the organisation and its ability to manage its own affairs to a high standard. This approach to proportionality is in line with the approach to improvement set out above, and builds on, for example, existing Audit Commission practice in relation to CPA.

In the future, as the quantum of inspection diminishes, there will be greater use of and reliance on data. This raises issues both of data quality and of data interpretation. First, there will be an increased requirement for data to be reliable, consistent and of good quality; action is needed on this. Second, there are issues, some highly technical, about how to interpret statistical data for performance indicator (PI) purposes. The Royal Statistical Working Party on Performance Monitoring in the Public Services (2003) argued that "PIs should be seen as 'screening devices' and not over-interpreted." Quantitative performance targets should have a "sound basis" and take account of knowledge about key sources of variation. Moreover, "motivational targets which are not rationally based may demoralise and distort". In addition, there should be more use of sampling to identify trends and highlight suitable PIs that would demonstrate where bodies stand on particular issues.

Therefore, inspection might only be needed if an organisation fell below standard in some key PIs, or if other factors came to light. This is close to the current approach of Monitor - where Foundation Trusts are given a low risk rating and are subject to little interference provided they hit key targets/standards.

Partnerships

There are two issues here. First, there is a growing policy focus on a more 'holistic' approach to service delivery that prioritises the combined contribution of local agencies to tackling broadly defined goals (community safety, regeneration). Second, the importance of regulators working in partnership is increasing.

The move towards a more area-based rather than sector-specific approach to service outcomes implies both that the focus of regulators should similarly move more strongly toward an area-based approach, and that a different set of skills may be needed to deliver effective strategic regulation in this changed context. The area focus for service delivery is already becoming more important. There are already 20 pilot Local Area Agreements, 66 more are being negotiated, and agreements will be rolled out to all top-tier authorities by 2007. The direction of travel is clear: greater cohesion between all providers in an area including pooling of funds and the need for monitoring and accountability arrangements to match the developments taking place on the ground.

We should therefore more explicitly recognise the area agenda and that some particularly difficult problems such as community safety and public health can only be addressed by local statutory agencies working together effectively.

To some extent, this conceptual change is already taking place. For example, the move towards Joint Area Reviews subsumes many aspects previously covered in separate inspections into one process, involving the

contributions of primary care trusts (PCTs), police and other agencies as well as councils. Arguably this shift is more significant than the administrative merging of CSCI's children function into Ofsted. The organisational changes in creating four inspectorates must not undermine this. The regulatory regime may have four inspectorates focused on four services but the reality is that in some very important areas for citizens and for their quality of life, the separate agencies need to work together. The regulatory regime must recognise this and adapt accordingly. A key function for regulators will be the traditional audit role of following the public pound, ensuring that it is spent wisely and spent well. The processes are perhaps more complex in partnerships, but the principle remains. Shared responsibility must not mean diminished accountability.

One practical product from an area-based approach would be a combined report from the four proposed regulators on how well services were being provided in an area, how well the local statutory bodies were working together to produce greater value from their individual allocations and how effectively they were tackling issues which can only be addressed collectively.

Partnership working is of course already established between regulators. As noted above, one of the strengths of CPA is that it incorporates the judgments of others to give a rounded view and there are other clear instances of joint inspections. In health the principles of partnership and how inspectorates need to work together to have maximum impact and to minimise bureaucracy have been set out in the Healthcare Inspection Concordat. The concordat is voluntary. But there is a case for cooperation between regulators to be formally required and backed by ministers.

Conclusions for the immediate agenda

This analysis suggests the following conclusions for the immediate agenda.

In proceeding with its proposals to rationalise public services regulation, Government should:

- Address the function as well as the form of regulation
- Ensure that the principles of Strategic Regulation are applied
- Specify more clearly its objectives for regulation/inspection in the public services and how it should work alongside other tools for improvement
- Ensure that the new regulatory regime explicitly takes account of the need for and growing importance of partnerships between statutory bodies locally as well as of individual service delivery
- Recognise that the creation of four inspectorates may solve some problems but they will inevitably not be able to cover all aspects within their remits (nor do they need to), so the way in which they work together and draw on other information such as audit will be equally important.

Regulators should:

- Ensure that regulatory activity strengthens internal mechanisms for improvement
- Align their activities with priorities for improvement, focusing on outcomes and impact
- Apply the principle of proportionality to risk
- Ensure that user focus is central to activities
- Be confident that PIs and other data are robust, accurate and independent; and make use of best practice in both the design and interpretation of PIs
- Work closely in partnership to develop area-wide assessments
- Ensure that value for money is fully taken into account in all their work. Following the public pound in partnerships will be just as important as it currently is in individual organisations.

3. How might regulation of public services change in the longer term?

Despite changes in the delivery of public services (such as the purchaser/provider split in many sectors) the focus of regulators' activities is often still rooted in an implied model of monopoly public sector provision. However, this is now changing under the impact of greater **choice and competition**.

A combination of the drive for devolution, more autonomous and independent providers and much more individual choice of service and provider means a more market-based approach to delivering public services. Public sector regulation in some senses substitutes for market pressures in driving improvement and focusing on the needs of users. The issue is whether the approach to public sector regulation needs to change either because market pressures mean some aspects become unnecessary or because regulation itself must help secure the style of service delivery that the Government wishes to see.

This highlights another important distinction - between the roles of *commissioners* of services and *providers* of services. Commissioners will need to take a broad view of their responsibilities, including outcomes in their area as a whole, considerations of equity, access and diversity, the need to 'join up with' other commissioners locally, and increasingly, responsibility towards ensuring an orderly market locally. Providers will have to adapt, in some instances, to a more market-based system, with incentives and penalties to match.

Regulating a more market-based system of provision

In a more competitive system, to what extent can markets carry some of the load that is necessarily borne entirely by regulation under monopoly provision?

In a mixed economy of provision, it will be possible to make greater use of market mechanisms to generate improved outcomes. But in which parts of the public services is it reasonable to expect greater use of market mechanisms to generate efficient, effective and equitable outcomes? And what is the appropriate mix of market and regulatory mechanisms in each type of public service?

It is hard to imagine any circumstances in which there would be no role for regulation. Even in relation to purely private goods, there will be a continuing need for health and safety regulation, consumer protection, and so on. When public money is involved, the regulatory function also includes saying whether public money overall has been well spent on a service. On these and other matters, the public will continue to need independent judgment. Private contributions are increasing - for example, 30 per cent of social care users fully fund their own care. However, in most cases, users, even when exercising choice, will be spending taxpayers' money, rather than their own.

There will need, therefore, to be an emphasis throughout on sustaining and improving quality and on efficiency - following the public pound. Regulation of public services is different from other types of regulation and market competition, which are about providing information and a level (competitive) playing field.

At the same time, the move to a more market-based system of providing public services will mean increasing involvement of private sector regulators. For example, the Office of Fair Trading recently (May 2005) published a major study of care home provision, under its powers to investigate where "any feature, or combination of features, of a market in the UK for goods and services is or appears to be significantly harming the interests of consumers". Moreover, in its 2005-06 Annual Plan, the OFT identifies 'healthcare markets' as one of five priority themes "where we propose focusing particular attention".

Some argue that regulation should be almost entirely reactive, the assumption being that generally market pressures will ensure standards and performance, and intervention should be triggered only where there is clear evidence of market or financial failure. This analysis seems overly sanguine. Recent experience in the private sector (for example, that of Enron) has shown that just reacting to events can lead to disastrous outcomes. With public services, even where competitive pressures can be introduced, the pace of change will not be rapid, there will be considerable adjustments, and issues of access and equity will continue to be important. Many areas of monopoly or close-to-monopoly provision will remain.

How would the key goals of Strategic Regulation operate in a more competitive environment? We are concerned with the three 'e's' - economy, efficiency, effectiveness, as well as user preferences and equity considerations. We therefore need to think through how achieving these goals will be different under competition and what the appropriate role of regulation is under these circumstances.

Increased choice, especially when allied to greater competition between providers, will create important opportunities for generating both service improvements and increased efficiencies. But choice and competition are not a panacea, nor are they a 'one-size-fits-all' solution.

The impact on both price and quality of introducing choice into previously monopoly systems of service provision will vary according to other characteristics of the market and the regulatory system. So in healthcare, the effects of competition depend on important aspects of the healthcare market, including whether prices are set centrally or not, who makes the choice of provider and the availability of information on quality and price. The research evidence suggests that greater competition is associated with lower growth of costs and lower prices, but the evidence on quality is more mixed. Where prices are generous, quality is likely to increase. But where prices fall and buyers are concerned about costs, quality falls (Burgess, Propper and Wilson 2005).

The prudent conclusion is that the effects of marketisation per se on price and quality will depend on the nature of the service provided, the details of the market reform and the funding, institutional and regulatory factors underpinning the market.

Furthermore, the extension of choice in the delivery of public services will also have effects on the behaviour of institutions and the relationships between them. This has already been seen, for example, in the effects of introducing Foundation Trusts and Payment by Results into the NHS. Across the public services, the current Government agenda includes going beyond encouraging competition between units within the public sector to also bringing in 'independent' (i.e. private, sometimes profit-making) providers. So private firms are increasingly doing the same job as public sector organisations. Examples include Treatment Centres in the NHS, private and voluntary sector social care providers, City Academies and independent providers in education, private developers competing with housing associations for social housing grant, and so on.

In practice the distinction between 'real' competition (involving the private sector) and competition that is limited to semi-autonomous units within the public sector may be more apparent than real. Evidence from the US indicates that there are no significant differences between the pricing behaviour of for-profit and not-for-profit hospitals and that not-for-profit hospitals use their market power in a way similar to for-profits (Burgess, Propper and Wilson 2005). This suggests that even where competition in the UK is limited to hospitals trusts working within the NHS, there will be genuine competition - as well as attempts at collusive and anti-competitive behaviour.

The introduction of choice and competition will not remove the need for regulation to achieve both economy (price) and effectiveness (quality) goals but it will change the nature of regulation. Where standards and improvement are predicated on the effects of competition, regulators will need both to ensure that competition exists, and that competition is directed towards the appropriate ultimate ends.

Capacity is a key aspect of whether increased competition will lead to greater user choice. So in education, for example, if there is no increase in capacity (the supply of school places) then real choice will reside not with pupils and parents but with suppliers - popular or 'over-subscribed' schools. If the supply side is flexible, and successful schools can expand, then in theory parental choice can become a reality. Theoretical models suggest that choice plus supply-side flexibility in education reduces 'sorting' or segregation of pupils, while choice in the absence of supply flexibility increases sorting (Burgess, Propper and Wilson 2005). But the practical policy question is the extent to which the supply side can genuinely be expanded at constant quality and constant cost. Can 'excellent' schools become much larger (or be franchised) and continue to be excellent? There are, as yet, no clear answers.

More immediately, there is a policy trade-off - for choice to be meaningful, there has to be some flexibility in the system. But flexibility in this instance means some level of excess capacity to allow choices to be made. So a policy of choice and a policy of reducing surplus places will conflict. In addition, there will be

some places, particularly in rural areas, where it is unrealistic to assume there can ever be effective competition, for purely geographical reasons.

Once again, a successful choice and competition policy will reduce the need for *some* aspects of the regulatory system. To a limited extent, markets, or quasi-markets can substitute for regulation, but there will remain a regulatory role, for example on standards, access and probity.

We also need to think through more clearly the differing roles of regulation in regard to the commissioners as distinct from the providers of services. This is complex, not least because some organisations (such as councils and PCTs) combine aspects of both roles. Regulation will also need to address the fact that there will be a complex mix of public and private sector providers with different governance structures and pressures, although all wholly or mainly funded by public money.

In principle, some waste and duplication could be removed by providing greater clarity in specific instances about whether to regulate commissioners or to regulate providers, rather than try to regulate both. Duplication can also be reduced by recognising that part of the role of commissioners is analogous to that of regulators. Commissioners can use their contractual relationships with providers to secure both specific outcomes and value for money. In a more market-based system, contracts between commissioners and providers can take up some of the burden (standards, enforcement, improvement) otherwise borne by regulation.

Regulators need a somewhat different relationship with commissioners. Under monopoly provision, the regulator's question is: 'Have you met your targets?' In the future, the question may be: 'Are you providing accurate information to your public to enable them to choose? Have you ensured an effective system in this area to enable people to make choice happen?' There will be some overlap between the roles of commissioners and regulators in a more market-based system - but generally commissioners will be primarily concerned with allocating resources, and regulators with ensuring the effectiveness of the resources used.

Health and social care are more fully engaged on this new path compared with other public services, and should therefore be seen in a different light. However, it is not clear even in the cases of health and social care that value for money in procurement is currently being achieved or that the commissioning process more generally is delivering value for money. This suggests a clear role for the regulator in ensuring value for money in procurement and commissioning.

It is therefore useful to think separately about the relationships between regulators and (i) commissioners; (ii) providers; and (iii) users.

Regulators and commissioners

Regulators will need to do more than respond to market conditions and ensure the flow of information. They will additionally have to ensure that an orderly market exists. Regulators will need to take a view on whether those charged with making the market work (for example, strategic health authorities, local councils) were succeeding, if necessary by arranging for new suppliers.

This goes beyond the traditional regulatory role of licensing (if they are the licensing body) to include **market-making**. The licensing role is a key part of what many public regulators do: is this organisation fit to trade? Market-making goes further: does this organisation need to trade? Is there adequate competition locally? Market-makers would need to ensure that residents can effectively exercise choice, that there is enough capacity to do so, and that residents are in a position to make the choices and are not being unfairly treated or discriminated against. This is a role that councils are already performing - for example, in regard to residential and domiciliary care. With a market-making function, regulators may need to intervene where there is evidence of failure on the part of commissioners as well as providers.

How can we ensure that choice is available to all, and can be exercised by all? In some cases, the exercise of choice will require user support, as shown in the example of patient advisers. The requirement could go further - for example, to require that the exercise of choice and the move to a mixed economy increases equity in the system overall.

Even if markets clearly led to increases in quality and reductions in price for the average consumer, there would be a regulatory role in ensuring equal access to services and in dealing with distributional issues. It is important not to lose sight of these equity issues, but also to bear in mind that non-choice systems can also have poor distributional outcomes. For example, the evidence on equity in the NHS is not clear-cut and there are at least some studies that show that more deprived individuals and families use the NHS less than their levels of need would indicate they should (Dixon et al. 2003).

The focus of service delivery and service outcomes is increasingly moving towards an area-wide approach in which the actions of several different commissioners and providers have to be co-ordinated. Policy emphasis is increasingly focused both on broadly-based and 'joined-up' targets (wellbeing, regeneration, outcomes for children, outcomes for older people, and so on) as well as the existing emphasis on specific service outputs. Government has clearly signalled its goal for a more integrated, cohesive form of service provision at local level, as shown, for example in the development of Children's Trusts.

Mechanisms are also changing, and we are effectively in transition at present from a system of numerous and often loosely organised partnerships at various levels, to one in which partnership working - including pooled budgets and strengthened governance and accountability - is increasingly formalised.

Corporate assessments and performance management have been successful tools for driving up service quality in recent years, and will continue to do so in the near future. However, looking beyond 2008, after 10 years of operation there is a risk of diminishing returns. Currently, different sectors have different ways of assessing performance. For local services, CPA brings together a range of assessments at local authority level - but there is as yet no mechanism for doing so area-wide.

The role of corporate assessment in single institutions is therefore likely to be smaller in the future. Conversely, there will be an increased need to develop ways of regulating the quality, cost and effectiveness of service outcomes, and outcomes for users and residents more generally at an area-wide level. Hence we are not looking at the abolition of corporate assessment. A revised model of corporate assessment will be a key regulatory mechanism at institutional level over the next few years. But beyond that, new forms of corporate assessment will be needed for local partnerships/boards, and it should remain in the regulatory toolbox for use in specific circumstances where councils and other bodies are either at risk of failure or would benefit from external challenge.

Even where there is a predominant area focus to service outcomes, it will be important to balance the assessment of area outcomes as a whole against outcomes for specific groups, particularly the most vulnerable. That will mean a balance between the new focus on markets and on areas and what could be called the traditional role of regulation and inspection in defending the interests of the most vulnerable. In addition, it will be important that the emerging focus on areas does not lead simply to *more* rather than *different* regulation; ideally, the quantum of regulation/inspection activity should remain constant, if not actually diminish.

Regulators and providers

Some providers will have a mix of services, some of which are monopolies while others are subject to competitive pressures. Foundation trusts are a case in point. In other cases, private providers may be treated as if they were in fact public or quasi-public sector organisations and able to access government funds for particular purposes. Private builders and housing associations are the example here, where private builders will be able to access funds hitherto only available for Registered Social Landlords.

In both cases the question arises as to how such organisations should be treated given that it would be undesirable for institutions to be subject to split regulation. Three points of reference might help. First, the degree of competition to which the organisation is subject overall. Second, it should be possible to reflect the mixture in differential approaches to standard-setting for specific services. It seems reasonable that standards should be different depending on whether the service is provided under monopoly or competitive conditions. That is, where a reasonably competitive market exists, floors standards would genuinely be 'floors'. If the service was provided at zero user cost (in health, for example), competition has to be on quality. With user charges, competition will be on a mix of price and quality.

In general, standards would be expected to be higher as a result of competitive pressures. But under monopoly, floor standards would effectively be ceilings too, so in these cases, regulatory standards would need to be higher. So the role of the regulator will be different depending on market conditions: an enabling role where competition exists, and a more proactive role driving up standards where there is a monopoly.

Third, where the organisation is substantially a monopoly, regulation might focus on corporate capacity, but with corporate assessment held in reserve to be used where there are clear signs of service or financial failure.

Finally, regulators would also have a role in assuring both users and taxpayers of the accuracy and truthfulness of claims made by providers.

Regulators and users

For a more competitive system to be effective, users must not only be making choices, but these must also be informed choices. So regulators will need to speak more directly to users in a form they can readily understand and make use of. This means providing information directly to users to enable choice to be effective across the market. For example, the OFT recommended in May 2005 that a national gateway for care home information should be set up, and that local authorities should publish directories including information such as what services authorities are obliged to provide, a list of care homes in their area and the services they provide, their prices and whether additional top-up payments above authority funding are needed.

Should this further imply that regulators themselves should produce something closer to a *Dr Foster* or *Which?* type guide rather than, for instance, the standard Ofsted report or complex health-outcome data aimed at professionals? This raises a subsidiary question: does this function have to be performed by state-funded public sector regulators? *Which?* Magazine is a charity providing a public service; the *Times Good University Guide* (and others) uses publicly available data to construct rankings and give advice to prospective users of higher education services; and so on. The key point is that as the services are funded through taxation and choice/competition is intended to be a driver of value for money, the provision of adequate and proper information cannot be left to chance. It should not require additional payment to get this information and it needs to be readily available to all to ensure free and fair access to choices and the range of services offered.

There are further issues about the level and nature of the information that is available, and the different ways in which service users and providers will make use of it. In healthcare, for example, it is generally providers that respond to information, rather than patients. In all healthcare systems it is rare for patients directly to choose providers or treatment - the decision usually goes via an intermediary, be it a GP or an insurance provider or an ambulance service. This can raise principal/agent problems where intermediaries have their own interests as well as those of their clients.

Interpretation of information such as performance indicators and league tables is often flawed. Incorrect interpretation of information can lead not just to inefficiencies, but can actually generate worse outcomes. For example, in the early 1990s, both New York and Pennsylvania adopted a report card system in which mortality rates for coronary artery bypass surgery were reported by surgeon and by hospital. There were both beneficial and harmful effects, but on balance "report cards led to higher levels of resource use and worse health outcomes, especially for sicker patients. Thus, the [conclusion is that] at least in the short run - these report cards decreased patient and social welfare" (Dranove et al. 2003). The role of the regulator must be to interpret such information - or to ensure that it is interpreted - in a way that is most helpful to the public and to the delivery of the three 'e's' in spending public funds.

More broadly, there is the question of whether strengthened local accountability - particularly a stronger link between spending, local taxation and the local ballot box - reduces the need for centralised regulation of service standards. It might be argued that the choice of low tax/low services or high tax/high services is properly a question for local democracy to determine, with the role of regulators limited to providing information to local taxpayers as to the efficiency and effectiveness with which the local authority and its partners have implemented those democratically determined policy choices. But even in a situation of much greater local autonomy, which looks unlikely in the short term, regulators will continue to play a role

in relation to national standards, and also in regard to probity and assurance.

The overall aim must be to increase accountability downwards and outwards to users and local stakeholders, replacing the top-down accountability of central targets.

4. Conclusions for the medium term

Over the next five years there will be moves towards a mixed economy of provision. In some sectors choice will become a more significant factor driving demand, while on the supply side there will be a wider range of independent providers, including both not-for-profit and profit-making firms. These developments will be most advanced in the areas of health and social care. In other services areas there is less scope for moving towards a more market-based form of provision; and in some areas monopoly public sector provision will, rightly, remain the norm.

The direction of travel of policy is clear, although it is important not to exaggerate the pace of change. It will be a more complex system with, if all goes well, higher satisfaction and improved efficiency, but also with higher expenditure - with the increase in spending coming from a mix of private and public resources.

In those services where a more competitive market can be introduced, with a variety of providers including profit-maximising firms, shareholder pressure and competition could take on some of the burden of driving up standards and driving down unit costs. At the other end of the scale, some services will remain as public sector monopolies. In other services the outcome may be somewhere in between. This suggests a complex regulatory landscape: a mixed economy of provision will require a mixed economy of regulation.

Regulation of public services at present is one-dimensional with a focus on institutions and service delivery. In the future, the system will have to become more multi-dimensional:

- placing a focus on areas as well as institutions
- dealing with commissioners as well as providers
- paying attention to market signals as well as to administrative data
- regulating both competitive provision and monopoly provision.

The challenge is to move towards a more multi-dimensional system while keeping the regulatory burden as light as possible. Public services regulation will continue to be complex and, in line with the principles of Strategic Regulation, regulators will need to work even more closely in partnership and demonstrate their own value for money.

Past experience suggests that movement towards a genuinely mixed economy of public services will not be rapid. It will be different in different sectors and there will be a genuine question of whether sufficient capacity can be generated to enable a market to operate. Some bodies, like Foundation Trusts, will find they have a mix of monopoly (e.g. A&E) and contestable services (e.g. elective day cases).

The overall position is summarised in the diagram below:



Where both choice pressures and supply side competition are strong, there can be some movement along a spectrum from the traditional, process-centred public regulation towards a regime which is somewhat closer to private sector, or framework regulation, with market pressures taking on some of the burden of ensuring efficiency and good governance. But there will be other cases where choice pressures and supply competition are weak - and in some services absent completely.

The regulatory regime should always be appropriate to these different market conditions. This means recognising that many organisations will be somewhere in the middle of the diagram. Moving towards framework regulation would be appropriate only in circumstances where providers are subject to effective

external financial pressures and are allowed to fail. Across much of the public services, this will not be the case. The regulatory regime should be flexible both across different types of organisations, and also flexible across time - that is, it should be able to respond to the changing circumstances of organisations that progress along the continuum.

We think that regulation may need to be significantly different in the future in relation to **commissioners, providers and users**:

1. Regulation of commissioners of services should aim to maximise the value for money gains from the effective and appropriate use of choice and competition, and to ensure fair access to services and equitable outcomes for users.

A key test for local councils and health bodies would be whether they had succeeded in making the market work to the benefit of local residents. This would require assessments that go beyond the current regulatory framework and our view of local authorities and PCTs. They would need to ensure that residents can effectively exercise choice, that there is enough capacity to do so, and that residents are in a position to make the choices and are not being unfairly treated or discriminated against. Regulation would also need to address equity and diversity issues. Audit of any payments system would sit alongside this.

Competition in public sector provision might also bring a need for specific market regulators who could intervene in the operation of the market and in cases of institutional failure, whether financial or of service standards, take over some of the functions of commissioners.

Unlike regulators such as Ofcom, whose function is to regulate a monopoly provider, public sector regulators will increasingly be dealing with situations involving some degree of competition among providers, but with monopsony power of commissioners (purchasers). Regulatory scrutiny will therefore need to be applied primarily to commissioners. This does not imply more regulation - but rather a different form of regulation.

In view of the above:

- The regulation of commissioners of services and of providers of services may need to be separated in concept if not in regulatory responsibility.
- Regulation will help ensure commissioners will be collectively responsible for the achievement of service outcomes on an area basis.
- Regulators must ensure that where a market operates that is funded through public money, there is equity of access to services.
- Proportionality of regulatory activity should be defined not just in relation to risk but also in relation to the extent to which market pressures do or do not help achieve specific outcomes.
- Regulators will play a role in ensuring that commissioners (particularly PCTs and councils) act as market-makers and ensure appropriate capacity and an orderly market locally.
- Corporate Assessments of partnerships/boards working across a local authority area will be needed. Post-2008, the role of Corporate Assessment of institutions will diminish, being held in reserve for where there is service or financial failure.

2. Regulators should provide a level playing field of regulation between private and public providers, particularly in health education and housing. In a mixed economy, it is important that all providers (public, private, non-profit) are subject to the same regulatory 'rules of the game', and are equally required to meet equity/social justice objectives as well as the three 'e's'.

In a mixed provider economy, regulators will need to review the accuracy and truthfulness of claims made by providers. Markets require accurate information to work well. Commissioners, as well as users, need information in appropriate forms if they are to make the best decisions. Providers hold the relevant data, and need to be obliged to provide information that is relevant, accurate and timely. Providing assurance about such information could become a vital function of regulation.

This may mean that assurance for purchaser, user and taxpayer might be a much stronger theme than

improvement for some sectors and providers - a model that is in some ways closer to a private sector regulatory framework than the traditional public sector regulation. This opens up the possibility in these more competitive sectors of a reduced burden of regulation. Where choice, competition (or contestability) and capacity are all present, floor targets are more appropriate. Under monopoly, higher standards will be necessary, as there are no market processes to drive improvement and quality gains.

3. Regulators should speak directly to users in a form they can readily understand and make use of to enable choice to be effective across the market. This might also increase accountability in those cases where upwards accountability has been significantly reduced and replaced by greater local accountability. Within regulation itself, there could be a purchaser/provider split, with public authorities ensuring that key information is provided, but not necessarily providing it themselves. For example, this could be achieved through the use of Which? or Dr. Foster type guides, produced by non-profit or private agencies. Regulators must increasingly focus on the information available to users to make choices, its accuracy and availability. To do this they themselves must speak more directly to users.

If our analysis is accurate, it is clear that regulation of public services in the future would be different. In principle, it should be possible to reduce the burden of regulation, as some of the outcomes that are required from regulation in a public sector monopoly could be met by market processes in a more mixed system. This should not be assumed. But a careful specification of the regulatory regime, paying close attention to the degree of choice, competition and contestability in each case, should allow for a more flexible approach while still maintaining the traditional goals of public sector regulation.

The ultimate goal of public service regulation will not change, but the means used to secure it will. Regulators will continue to provide assurance to the public and ensure value for money for the public pound. But rather than achieving this solely via benchmarking, performance management systems and cost-efficiency, regulators will also have an important role in making local markets operate effectively and equitably.

This will not be an easy transition. But if the Government's current and proposed reforms to the delivery of public services are to succeed, regulation will need to operate in a different way from how it emerged in an era of public sector monopoly provision. Relationships with service users will need to change, so that a reduction in top-down pressure from centrally-driven targets can be replaced by user pressure from below to deliver effective and equitable outcomes. This holds out the possibility of a regulatory regime for public services that is less intrusive into the daily work of operational service delivery, but which will enable a sustainable process of continuing service improvement.

In the past, public services regulation has involved a relatively large number of separate regulators, mostly focused on individual services and using corporate assessment as their main tool. Currently we are in a period of transition, with the impact of PSX(I), Hampton and Arculus shifting the system towards a leaner but more effective form of Strategic Regulation. Within this, there is an urgent need for regulators to change their focus and also to raise their game in terms of ensuring value for money in the commissioning and procurement of services. This will not be easy, given that procurement will happen via a mix of collective decision-making by commissioners and individual service procurement by users.

Over the next three years, there will be considerable institutional change as the Government implements its commitment to move to four public service regulators. It is important that during this time, these necessary operational considerations do not divert attention from the broader issue of the role of regulation in public services reform and in ensuring continuing service improvement, value for money and responsiveness to users. The future role of public service regulators is likely to involve ensuring that commissioners make local public service markets work; and providing assurance and modernised audit, away from detailed inspection.

Not all services will or should move at the same pace. It is likely that the speed and direction of change will be most significant for health and social care. In education, there will be some, but less pronounced, movement in this direction. For other services, public sector monopoly will remain. The key point is to ensure that regulation both supports the needs of service users and reflects the operational realities confronting commissioners and providers.

5. Key messages

- We have a clear set of principles - Strategic Regulation - that work. These need to be applied to the changing context of public services regulation.
- Government and regulators need to ensure that what regulators do lines up with other aspects of the system to produce sustained and sustainable improvement. Regulation must add value to the dynamics of the system.
- The regulatory framework must be flexible enough to deal with organisations ranged along a spectrum from traditional monopoly provision to more competitive contexts. It must also be flexible in dealing with a system that will be changing over time.
- Greater reliance on data will make it even more important to assure the quality, independence and robustness of data used both to make assessments and to provide information directly to the public. This should be a key function for auditors.
- Regulators must ensure value for money by following the public pound not just in single organisations, but in partnerships and eventually on a comprehensive area-wide basis.
- Regulators must develop ways of speaking directly to users and providing service users with both the information and the capacity to exercise choice meaningfully.

Appendix 1 - Office of Public Services Reform (OPSR) principles of public services inspection

Public service inspection should:

- a) Pursue the purpose of improvement
- b) Focus on outcomes
- c) Take a user perspective
- d) Be proportionate to risk
- e) Encourage self assessment by managers
- f) Use impartial evidence, wherever possible
- g) Disclose the criteria used for judgment
- h) Be open about the processes involved
- i) Have regard to value for money, including that of the inspecting body
- j) Continually learn from experience

OPSR (2003)

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