

THE FLEXIBLE NEW DEAL:

Making it work

by Ian Mulheirn and Verena Menne

Supported by



FIRST PUBLISHED BY

The Social Market Foundation, September 2008

ISBN: 1-904899-60-9

11 Tufton Street, London SW1P 3QB

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ACKNOWLEDGEMENTS

This project would not have been possible without the generous support of Remploy. We are particularly grateful to Dan Murphy for his assistance throughout.

The authors are indebted to the participants of the roundtable discussion held in June 2008, and to our expert interviewees, whose contribution to the ideas in this report was substantial.

The authors would particularly like to thank Graeme Cooke, Richard Johnson, Jeff Masters, Helen Morrell, Andy Shields, William Smith and Natalie Tarry.



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FOREWORD

RT HON STEPHEN TIMMS, MP

Helping people to get a job, build a career and lift themselves out of poverty are absolutely central to what this government is about. There are more than three million more people in work and 600,000 fewer children in poverty since we were elected. This hasn't happened by accident. It is because we have set about transforming our welfare state – from one that abandoned people on benefits, to one where more support comes with higher expectations, and no one is written off.

The New Deals have been key. We now have a decade of evidence and experience about what works in helping people into employment. Building on this learning, and adapting to today's labour market challenges, we are now creating a single, flexible New Deal. This marks a radical development: rewarding outcomes rather than processes; and shifting from standardised programmes to providers offering people personalised support to get back to work.

The first flexible New Deal contracts will start next year. We will be evaluating their impacts closely, and listening to feedback from everyone who shares our goal of sustainable employment for all. I therefore very much welcome this report, which strengthens the Social Market Foundation's track record of invaluable contributions to public policy debate. The report discusses issues which will be central to the effectiveness of flexible New Deal:

- ensuring providers focus on helping people with complex barriers to work, as well as those closer to the labour market;
- promoting sustainable employment and progression at work;
- creating a market that operates fairly and transparently – for both prime contractors and subcontractors; and

- ensuring that specialist providers, particularly third sector organisations, have the opportunity to contribute and to thrive.

The economy is currently in a tough period, bringing uncertainty for many. We remain committed to the approach based on rights and responsibilities which has helped deliver the highest level of employment in our history. This includes investing in excellent services to support people into employment, and working hard to keep the labour market strong. Our recent welfare reform Green Paper underlined our commitment, including implementing in full the vision set out by David Freud in his report to the DWP last year.

I welcome this report. I hope that readers who are stimulated by it will respond to the current consultation on the DWP Green Paper *No one written off*. And I look forward to working with the SMF and many others to deliver our goals: an 80% employment rate, and the eradication of child poverty.

EXECUTIVE SUMMARY

During the long period of sustained economic expansion since 1992, the number of unemployed people in the UK has steadily fallen. The number of people on inactive benefits has also begun to decline in the past four years. There have been three pillars to this success, all of which the government can take some credit for: benign macroeconomic conditions, effective tax and benefit policies to make work pay, and employment activation programmes. This report focuses on the latest stage in the evolution of the third of those pillars.

Since 1997, the government has developed a range of welfare-to-work policies designed to help people actively to seek work. These active labour market policies were targeted at people who might, in years gone by, have been allowed to fall out of mainstream employment and thereafter find it very hard to return. Over the past 11 years, there has been a steady increase in the extent to which these employment services have come to be provided by private and third sector organisations.

The various New Deal programmes, set up by the present government shortly after it came to power, represented an important policy development in this area. But, as part of the government's efforts to find more effective ways to help long-term unemployed people into work, from October 2009, the New Deal for Young People (NDYP) and New Deal 25+ (ND25+) will be replaced by a programme called the Flexible New Deal (FND).

Under the new system, for the first 12 months of a person's Jobseeker's Allowance (JSA) claim, they will be assisted in their work-search by a Jobcentre Plus adviser. However, the 100,000 long-term unemployed people claiming JSA at any one time tend to have unique and complex needs. Those needs are therefore ill-suited to the relatively cheap, one-size-fits-all approach that is so

successful for the majority of JSA claimants. So, after 12 months, jobseekers will be passed on to private and third sector contractors operating the FND programme.

By contracting out the commissioning role for those who are unemployed for more than 12 months, the government hopes that FND will achieve two radical changes in the way the whole system works:

- 1 The method of funding will change to an **outcome-based payment system**. Rather than being commissioned to deliver set processes, such as training courses or set weekly work-focused interviews, private and third sector contractors will be paid for actually getting people into sustained employment, however they see fit. This approach brings with it a focus on results rather than on procedures and represents a clear shift in emphasis for contractors from mandating processes to delivering outcomes.
- 2 The new system will interpose **a layer of large private sector prime contractors** between the state and smaller, more specialist organisations, rather than referring individuals directly to specialists from Jobcentre Plus as happens currently. This model has the effect of concentrating the private contractor market in the hands of relatively few organisations.

Through these two key changes, FND offers the chance of a highly tailored approach to individual jobseekers' problems to help them find sustainable employment. The combination of few restrictions on what contractors must do with each client and payment based on achieving job outcomes gives contractors strong incentives, as well as the flexibility necessary, to find what works best for each jobseeker. The new approach will also harness the innovative capacity of the private and third sectors to develop effective ways of helping a group of people whom state provision has failed for too long. Moreover, the system of outcome-based

commissioning has the potential to drive down the costs associated with existing intensive employment support programmes, which are scatter-gun in their approach and therefore wasteful.

FND was therefore conceived to build on the previous active labour market programmes, but also to succeed in ways that they had not. To do so, there are four things FND must achieve. It should:

- commission the services of **reliable and cost-effective** contractors;
- **help all clients** rather than just those easiest to help;
- support people to **sustain their employment** once in work; and
- encourage **innovation** and a diversity of approaches to helping clients into employment.

Despite its advantages, the new system is not without the risk of unintended consequences: these are the subject of this report. While the high-level vision of FND has huge potential, its execution risks undermining that vision. The reliance on second-best regulatory tools to drive good performance from contractors is unlikely to succeed.

Rather, the Department for Work and Pensions (DWP) needs to look again at how it can design aspects of the FND market to align incentives between jobseekers, contractors and government in order to fulfil these aims. Setting market forces in support of, rather than in tension with, the government's goals is both possible and necessary for success. Taking each in turn, this report looks at how the implementation and delivery of FND measures up against these yardsticks of its potential success and asks: what else should be done to make the Flexible New Deal work?



THE BIDDING PROCESS

The bidding process for FND contracts, to be awarded in April 2009, will require prospective prime contractors to estimate a number of clients for whom they expect to find work. Since the annual contract value in each FND region is fixed by DWP, the number of job outcomes anticipated by bidders will effectively set a uniform payment for achieving each one. Firms bidding with more ambitious outcome levels will therefore receive lower payments per outcome, because the money will be spread more thinly between clients.

The performance of existing programmes with similar client groups suggests that the value of the contracts on offer will not be sufficient to achieve the 13-week sustained employment outcomes hoped for by DWP. The Invitation to Tender outlines the Department's expectation for firms to bid for 13-week sustained employment rates of around 55%, where previous programmes have achieved much less. Such a high level of performance implies that contractors will also be expected to operate with very little money per job outcome.

There are also concerns about the tendering process itself. The bidding environment is characterised by a lack of information about the precise composition of the FND client group, the likelihood of differential macroeconomic effects on regional labour markets over time, and the prospect of burgeoning welfare-to-work contracts in the future. There are therefore good reasons to think that prospective contractors will err on the side of the ambitious. Against this backdrop, DWP's uncertainty about the composition of competing bids – wishful thinking or a good business model – will make it difficult for it to assess the quality of bids in terms of price. This is, however, a variable that determines half of the Department's decision about contract allocation.

This combination of uncertainties also poses substantial risks for the government in terms of the deliverability of the bids,

the chances of government having to bail out a provider and DWP's future tendering rounds. The Department should issue more realistic, central performance estimates, providing detailed information about how they were derived, to inform the market and hence elicit a more viable range of bids. DWP would then be better placed to probe bidders about their justification for diverging from the central performance estimate. This approach would minimise the risks to the Department.

Recommendation 1

The Department for Work and Pensions should replace the national performance expectations with a more realistic assessment of central case outcome levels. The data and modelling that underpin the central case should be made available to all Flexible New Deal bidders.

The Department should combine this approach with Pre-Award Clarification interviews with bidders to evaluate the basis on which bids diverge from the DWP central case.

MAKING THE FLEXIBLE NEW DEAL WORK FOR EVERYBODY

The uniform payment to contractors for each job outcome achieved has serious implications for harder-to-help jobseekers, who will require more support at greater cost. Under the proposed uniform payment structure, those furthest from the labour market will inevitably not be offered services appropriate to their needs – they will be 'parked'. This will occur because the design of the payment system sets the profit motive of contractors in tension with the aim to help all clients. This need not be the case and its effects are in the interests of neither the jobseeker nor the taxpayer.

Since clients remain with prime contractors for only 12 months, the latter have strong incentives to identify those they can help quickly and park others. Setting a financial penalty – a kind of negative outcome payment – on contractors for each person who leaves after 12 months without work would limit this behaviour by making parking costly. The fine should be combined with a higher service fee to sharpen both risk and reward faced by contractors, rather than to reduce the value of contracts overall.

Recommendation 2

The Flexible New Deal should offer higher service payments to prime contractors, combined with fines for failure to place a jobseeker in employment by the 12-month point. This would be a cost-neutral change for DWP and contractors, while sharpening risk and reward for the latter.

The analysis given in Chapter 3 shows that not only do the long-term unemployed form a heterogeneous group, but that some personal characteristics are both observable and strong predictors of job placement success. This makes it easy, and indeed necessary, for providers with limited resources to focus their efforts on clients with the greatest chances of job success at the expense of others. The problem is aggravated where ambitious outcome targets are set in the bidding process, since these providers will have very limited money to support each client.

There is a range of possible solutions to the problem of parking. Under the planned flat outcome payment, DWP is placing a lot of faith on the competitive pressures of the tendering round to drive performance. However, with long-term contracts and a desire for a stable core of providers, this pressure is unlikely to be enough to prevent parking. Client choice will be limited as a mechanism to improve performance. Proposed regulatory controls such as Action Plans, similarly, will have

little impact on ensuring that everyone gets the help they need if the necessary support makes no financial sense to contractors.

Rather than using second-best regulatory solutions to parking, DWP needs to focus on using the payment structure, again, to align the incentives of jobseekers, contractors and government. To this end, a system of variable payments that better reflect the costs of helping different people within the caseload is required. Many people argue that statistical profiling techniques are insufficiently accurate at predicting the costs associated with getting someone into work and are difficult to implement.

The solution, however, is simple: instead of attempting to tie different payments to types of individual, DWP should offer increasing payments per person helped into work. In other words, payments should increase as the contractor gets further into the cohort of jobseekers. This would allow contractor staff the flexibility to shift resources to those who turn out to need it most, while guaranteeing the contractors' shareholders a profit for helping all clients, where currently they would go bust for doing so. Such an approach would provide incentives for the capacity building necessary if FND is to work for everyone.

Recommendation 3

The Flexible New Deal should offer prime contractors outcome payments that increase for each additional client they place in employment. This would provide the resources needed to develop the capacity to help all jobseekers, rather than just those closest to the labour market.

Overall, there is a compelling case for a graduated payment structure tied to the proportion of jobseekers helped. In contrast to DWP using blunt regulatory tools designed to steer service

provision in the right direction, a graduated payment structure would align government and contractor objectives. It

- removes the need for process-based regulations;
- does not rely on any profiling tools;
- is relatively easy to administer; and
- offers a much more credible basis for judging relative success between contractors than performance against bid target, as currently proposed.

ACHIEVING SUSTAINABLE EMPLOYMENT OUTCOMES

Paying providers according to the number of jobseekers they help into work sets strong incentives to find jobs for people. From a personal, social and financial point of view, however, a valuable outcome is not simply a job start, but sustainable employment that minimises the person's chances of returning to welfare.

Evaluation of Employment Zones (EZs) shows that the quality of jobs achieved under that programme was typically worse than that of jobs achieved through mainstream New Deal Programmes. EZ job retention after ten months was no better than that for New Deal participants and it seems likely that job quality was a factor in this. FND, in offering contractors 26-week sustained employment payments, goes further than any previous programme in encouraging contractors to find their clients good job matches and provide in-work support. However, it does not go far enough for the Department to get real value for money.

Analysis of the Labour Force Survey also suggests that the rate at which new job-starters leave employment remains high even after they have sustained work for 26 weeks. One year after finding

work, only around half of previously long-term unemployed people remain in work. This points to the need for much longer retention bonuses for contractors, so that they can support clients in work for a full 12 months.

Current contract values should be increased, using the identifiable additional benefit savings, to fund substantial bonus payments for each 12-month sustained employment outcome in excess of the normal retention level.

Recommendation 4

Providers should receive a bonus payment for every additional job retained for 12 months, which could be financed through the additional benefit savings made. This payment structure should be piloted as part of the trials announced in the recent Green Paper, *No one written off*.

ENCOURAGE INNOVATION AND DIVERSITY IN THE SUPPLY CHAIN

The Flexible New Deal market structure has largely been designed around a desire to ensure that prime providers have sufficient influence to join up the services necessary to help jobseekers with a diverse range of needs. This role involves significant economies of scale and means that the appropriate market structure is one in which large firms commission the services of smaller specialist providers. The relationships between prime contractors and local or specialist providers offer scope for flexibility and innovation, if those relationships work well.

But this structure is not without problems: it creates pervasive market failures in the form of monopsony power for prime contractors, resulting from their unique position as buyers of

subcontracting services in each area; and asymmetric information between primes and subcontractors about the nature of the clients being passed on.

The unbalanced distribution of market power risks constraining subcontractors' independence, limiting their flexibility and scope for innovation, with consequences for FND delivery. Asymmetric information about jobseekers between prime contractors and subcontractors, together with unregulated relationships that allow the former to transfer the financial risk for job outcomes onto the latter, threaten to marginalise specialist providers in FND delivery.

In the light of these problems, it cannot simply be assumed that the structure will work well either for jobseekers or for the taxpayer. Existing measures to counter these concerns, such as the Code of Conduct, are too weak, and these dynamics therefore continue to pose a serious threat to the success of FND.

There are a number of steps that the Department could take to tackle these market failures. Increasing transparency between prime and subcontractors would be a relatively simple way of strengthening the bargaining position of subcontractors and helping to develop good working relationships between all parties.

Recommendation 5

To provide transparency for subcontractors, prime contract specifications, as well as caseload transferred and payments made to subcontractors, should be made publicly available.

In trying to fulfil the role of market regulator, while simultaneously ensuring stable delivery, DWP faces a conflict of interest. This makes it difficult for the Department credibly to threaten to censure or sanction organisations that do not adhere to the Code of Conduct.

DWP should therefore devolve the role of monitoring the market to an independent body that does not face the same constraints, and which has the power to impose meaningful sanctions.

Recommendation 6

To enhance credibility, the power to fine and censure contractors in breach of the Code of Conduct should be devolved to an independent regulator or ombudsman.

The problems that result from asymmetric information could be resolved if the Department were to require that prime contractors offer a significant non outcome-contingent component of their fee to subcontractors. Such an intervention is necessary if the interests of the parties in the supply chain are to be aligned. Doing so would ensure that prime contractors do not have an incentive to park clients by subcontracting them. It would also provide incentives for prime contractors to be fully engaged in the search for effective delivery partners, since their profit margins would be more dependent on it.

Recommendation 7

Prime contractors should be required to offer a two-part payment structure to subcontractors – part outcome-contingent and part paid regardless of job placement success – so that their payment more closely reflects the structure of the deal between prime contractors and the Department. This would ensure that prime contractors retain a stake in the subcontractor's success and therefore avoids the incentive for primes to park through subcontracting.

Finally, while FND promises to make the most of third sector involvement in terms of delivery, the best organisations in the sector have more to offer and DWP should take advantage of this. Third sector organisations' outreach work often offers the chance to engage people who would never otherwise step into Jobcentre Plus. The new regime should encourage this work, by allowing those clients to bypass the Jobcentre Plus stage of employment support and be assisted by specialist providers, under FND, directly.

Recommendation 8

To make the most of third sector outreach work, the government should consider allowing specialist providers to find and help disengaged individuals directly, rather than requiring them to go through the gateway process. For many of the most vulnerable claimants, such an approach would be alienating, expensive and counter-productive.

So FND has huge potential to deliver substantially more effective employment services for the long-term unemployed than existing programmes. But its proposed implementation threatens to undermine that promising design. Adopting these recommendations offers the best way to make the Flexible New Deal work.

CHAPTER 1: THE FLEXIBLE NEW DEAL IN CONTEXT

Summary

From October 2009, the Flexible New Deal (FND) will replace the existing New Deal employment programmes for unemployed young people and adults. For the first 12 months of a person's Jobseeker's Allowance (JSA) claim, they will be assisted in their search for work by a Jobcentre Plus adviser. Jobcentre Plus is well equipped to deal with large volumes of jobseekers who typically return to work quickly. However, long-term unemployed people tend to have unique distinct needs that make helping them ill-suited to the standard approach that is so successful for the majority of JSA claimants.

So, 12 months into their JSA claim, jobseekers will be passed on to private and third sector contractors operating the FND programme. Rather than being commissioned to deliver set processes, these contractors will be paid according to how many clients they get into work with significant discretion over how they achieve that goal. The combination of few restrictions on what they must do with each client and payment by results gives contractors strong incentives to tailor the support available to each jobseeker.

There are four things that the new programme will need to achieve in order to improve on the ones it is to replace. FND should:

- commission the services of reliable and cost-effective contractors;
- help all clients rather than just those easiest to help;
- support people to sustain their employment once in work; and

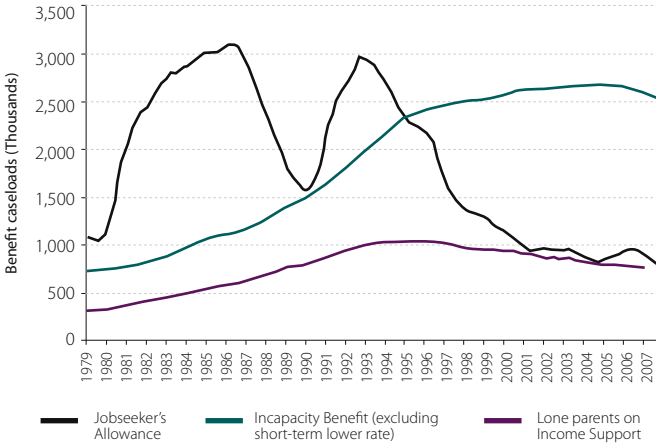
- encourage innovation and a diversity of approaches to helping clients into employment.

However, the proposed implementation of FND raises serious questions about whether the programme will be able to succeed in these aims. The Department for Work and Pensions (DWP) therefore needs to look again at how it can design aspects of the FND market to align incentives between jobseekers, contractors and government. Doing so will enable the new programme to fulfil its potential.

Since 1997, the government has made the development of an active labour market policy a central part of its drive to achieve full employment. During the long period of sustained economic expansion since 1992, the number of unemployed people in the UK has steadily fallen, while the number of people on inactive benefits has also begun to decline. Such improvements have prompted the government to announce a range of ambitious goals for employment policy. These include:

- a lone parent employment rate of 70% by 2010;
- an employment rate of 80%; and
- a reduction in the number of Incapacity Benefit claimants by one million.

Figure 1.1: Benefit claimants 1979–2007



Source: Department for Work and Pensions, *No one written off: reforming welfare to reward responsibility* (London: HMSO, 2008), 28.

There have been three pillars to this success: benign macroeconomic conditions, policies to make work pay and employment activation programmes designed to get workless people actively to seek work. Without doubt, 64 consecutive quarters of growing national output have underpinned the success in boosting employment rates. On the policy side, innovations in terms of financial work incentives have also been central to these changes. For example, an evaluation by the Institute for Fiscal Studies suggests that the introduction of Working Families' Tax Credit, forerunner to the current tax credits system, increased lone parent employment by around 5.1 percentage points.¹ But active labour market policies, implemented by DWP and represented by the different New Deal programmes, have played an important role. These policies aimed to activate people who might, in years gone by, have been allowed to fall out of mainstream employment and thereafter found it difficult to return.

¹ HM Revenue and Customs, *Did Families' Tax Credit work? The final evaluation of the impact of in-work support on parents' labour supply and take-up behaviour in the UK*, by Mike Brewer et al. (London: HMRC, 2005).

THE NEW DEAL PROGRAMMES

Shortly after coming to power, the Labour government implemented the New Deal for Young People (NDYP), aimed at JSA claimants below the age of 25, and the less intensive New Deal 25 Plus (ND25+), aimed at adult jobseekers.

NDYP is a mandatory, intensive programme of employment support for 18 to 24 year-old jobseekers after six months of claiming JSA. The programme consists of a gateway period which entails a directed job-search for the client, working with a Jobcentre Plus adviser. Six months after starting on the programme, if the individual has still not found work, he or she is obliged to choose between four options. These include supported employment, education or training, an environment task force and voluntary work. If they fail to undertake one of these options, claimants are faced with a reduction in benefits.²

ND25+ is a similar mandatory programme, albeit less intensive than NDYP. The adult programme begins after 18 months of a continuous JSA claim, and involves a greater level of requirements from the jobseeker for them to continue to claim benefits. These include training, preparations for work and periods of work experience.

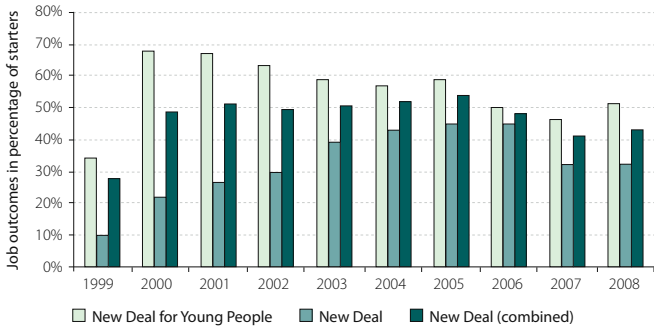
The early years of both programmes were deemed to be successful. An evaluation by De Giorgi estimated that NDYP hanced employability of participants by 6–7%.³ Similarly, Blundell et al. found, in their NDYP evaluation, that it increased the chance of males finding work within four months (after six months of unemployment) by 10–11 percentage

2 For a very brief overview, see DWP, *Reducing dependency, increasing opportunity: options for the future of welfare to work. An independent review to the Department of Work and Pensions*, by David Freud (London: HMSO, 2007); for a more detailed description of the programme, see Richard Blundell et al., *Evaluating the employment impact of a mandatory job search assistance programme*, Working Paper 01/20 (London: Institute for Fiscal Studies, 2002).

3 Giacomo De Giorgi, *Long-term effects of a mandatory multi-stage programme: the New Deal for Young People in the UK*, Working Paper 05/08 (London: Institute for Fiscal Studies, 2005).

points, compared to a pre-programme baseline probability of 24%.⁴ Van Reenen estimated that the New Deal had led “to an increase in ‘steady state’ youth employment of over 17,000.” He sees enhanced job-search as accounting for about a fifth in this increase and concludes that, overall, the benefits outweigh the costs of the programme.⁵

Figure 1.2: Success rates of the NDYP and ND25+



Source: Department for Work and Pensions, New Deal administrative data.

Note: Success rates are based on job starts (spells).

But while these programmes appear to have been successful in earlier years, their recent performance has been less impressive. From the available administrative data, for example, the number of job outcomes achieved on both NDYP and ND25+, compared to the number of clients starting on the programme, has dropped significantly since 2004 (see Figure 1.2).⁶

A defining characteristic of mainstream labour market programmes to date has been their focus on commissioning different types of intervention, regardless of whether they are known to lead to a job. It is often unclear how effective certain courses and interventions are and, being paid for the process, the

4 Blundell et al., *Evaluating the employment impact*, 29.

5 John Van Reenen, *No more skivvy schemes? Active labour market policies and the British New Deal for the young unemployed in context*. Working Paper 01/09 (London: Institute for Fiscal Studies, 2001), 22.

6 Based on DWP administrative data: on flow (spells) and job outcomes (spells) for the NDYP and ND25+.

providers have no incentive to find out. This raises the question of whether it might not be better to pay providers by results, or, in the jargon, to shift the focus from processes to job outcomes. Since sustained employment outcomes are an objectively verifiable measure of success, a switch to paying providers for achieving them could create a much more efficient and targeted employment service. This payment structure was first introduced in 2000, under the Employment Zones scheme, in 15 of the most deprived areas of the UK. This approach was the prototype for the Flexible New Deal, which will start to deliver employment services in October 2009.

EMPLOYMENT SERVICES FOR UNEMPLOYED PEOPLE FROM OCTOBER 2009

From October 2009, the existing New Deal programmes for jobseekers will be rolled into one programme known as the Flexible New Deal (FND). The programme consists of four stages of gradually increasing levels of 'conditionality' on the jobseeker – or job-search requirements expected from the client in return for their continuing to receive JSA:

- 1 The first three months after a new JSA claim is made is known as Stage 1. By the end of this period, typically around 60% of jobseekers have moved back into work.⁷ Because of the transitory nature of this unemployment, this stage consists simply of fortnightly meetings between the claimant and the personal adviser at Jobcentre Plus, as well as ready access to information about job vacancies.
- 2 From the three-month point of the claim, in Stage 2, jobseekers will be required to attend interviews with their advisers on a more regular basis. They will also have to widen their job-search criteria in terms of travelling time, wage level and hours of work.

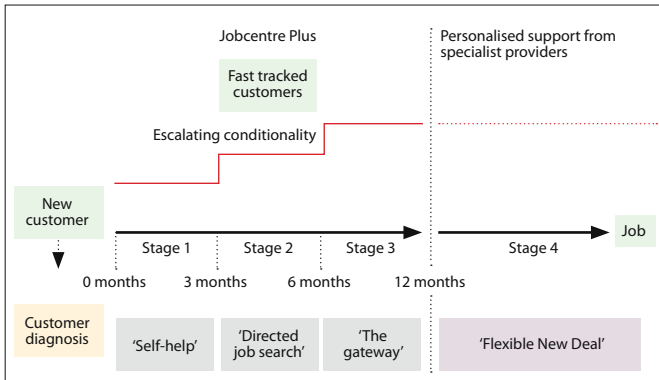
7 DWP, *Ready for work: full employment in our generation* (London: HMSO, 2007), 52.

- 3 Six months into the claim, conditionality on claimants will increase further (Stage 3). They will be required to work with advisers to draw up a back-to-work action plan, involving a range of mandatory activities aimed at increasing the chances of finding employment.

- 4 The one in ten JSA claimants who fail to find work after 12 months will move onto a programme of more intensive and specialist employment support. This fourth stage is known as the Flexible New Deal – the focus of this report. Unlike the preceding three stages, which are delivered by Jobcentre Plus, Stage 4 will be delivered by private contractors who are paid by DWP for the number of sustained job outcomes they achieve.

This pathway, up to Stage 4, is illustrated in Figure 1.3.

Figure 1.3: Jobseekers’ Allowance regime and Flexible New Deal from 2009



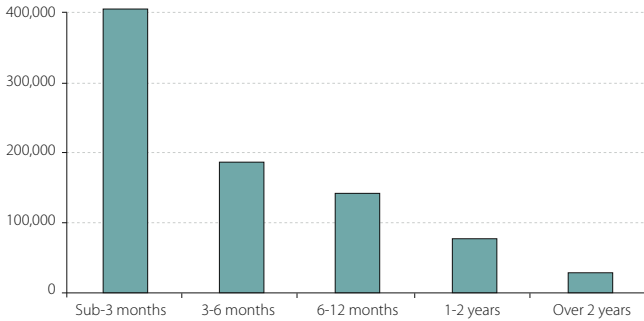
Source: Department for Work and Pensions, In work, better off: next steps to full employment (London: HMSO, 2007), 81.

After 24 months on JSA, unsuccessful FND jobseekers will move on to a further stage (Stage 5), which may involve a mandatory work

element under the Community Work Programme outlined in the recent Green Paper *No one written off*.⁸

Figure 1.4 gives a sense of the volume of clients involved at each stage of the new system. The majority of unemployed people claim JSA for less than three months after Stage 1, and at any one time around half of claimants have been receiving support for less than three months. Of the jobseekers registered in June 2008, this group accounted for 12% of claimants. Under the new programme, it is these people who will be referred to private and third sector FND contractors.

Figure 1.4: JSA claim duration, June 2008



Source: Office for National Statistics, Jobseeker's Allowance administrative data.

HOW WILL THE FLEXIBLE NEW DEAL WORK?

Once jobseekers reach the end of Stage 3, the FND gateway, they will either choose, or be allocated to, a private or third sector contractor, referred to here as the prime contractor. These organisations will be required to provide clients with more intensive employment support services. Similar to the Employment Zone programmes described above, the new system will move away from the *process* focus of the existing New Deal. Instead, FND will pay prime contractors for

8 DWP, *No one written off: reforming welfare to reward responsibility* (London: HMSO, 2008), 42.

achieving sustained employment *outcomes* by whatever means they find to be effective. Under this 'black box' approach, prime contractors will have unprecedented flexibility over the kind of support they provide.

FND contracts will be issued to private and third sector contractors operating in different regions of the UK. To test the effectiveness of different market structures, some regions will be served by one contractor, while in others two organisations will compete for clients, to allow a measure of choice for jobseekers.

In order to achieve a degree of stability in the prime contractor market, contracts will run for between five and seven years. Performance management metrics will be used by DWP to inform the re-tendering process when the initial contracts come to an end. The re-tendering process therefore offers the opportunity to weed out the poorly performing providers and drive up the quality of provision. The merits and limitation of this are discussed further in Chapter 3.

A key part of the vision is that by making prime contractors focus on job outcomes, they have strong incentives to call upon the services of a range of smaller specialist providers, or subcontractors, who have expertise in helping people with very specific needs. FND also gives prime contractors the flexibility to tap into well-connected local organisations, which may be better able to place jobseekers with appropriate local employers. The subcontractor layer will typically involve smaller organisations than those involved in the prime contracting layer. Many different subcontractors will engage with each prime contractor on a call-out basis as and when different specialist interventions are needed. The relationship between the two layers will be governed by a Code of Conduct issued by DWP, and the financial relationship between the two layers is left to be determined by the parties themselves. The implications of this are discussed further in Chapter 5.

The prime contractors' role is therefore one of coordinating the many services required to tailor provision to different clients with specialised needs, and taking "the lead in helping the local networks develop."⁹ This role offers significant economies of scale, both because multiple providers would not have sufficient clout effectively to coordinate disparate services, and because the complexity introduced by multiple prime contractors would involve wasteful duplication. Further, high-volume contracts for long time periods offer the necessary scale to attract the best companies from around the world, companies with access to a substantial amount of capital. Powerful prime contractors, paid by results, will be in a position to find out what works and drive good performance from subcontracting organisations.

The value of the FND contracts to prime contractors is split into three parts. The first 20% of the budget is offered to contractors as a regular monthly service payment. This money is not job-outcome-contingent and reflects some of the costs providers will incur in fulfilling the minimum requirements the Department expects of contractors. The next 50% of the money available to contractors for each jobseeker, is paid when the person has achieved 13 weeks of sustained employment. The remaining 30% of the contract value is awarded to the contractor if the jobseeker sustains his or her employment to 26 weeks.¹⁰

This payment structure clearly creates strong incentives for the contractor to find the most efficient way to get a client into employment and to sustain that person in their job for at least 13 weeks. The shift to an emphasis on outcome also frees up providers to try different and tailored approaches for each client. In this way, FND has the potential to release innovative capacity to develop new ways of helping a group of people whom state provision has failed for too long. It therefore offers a step-change in service provision to those furthest from the labour market.

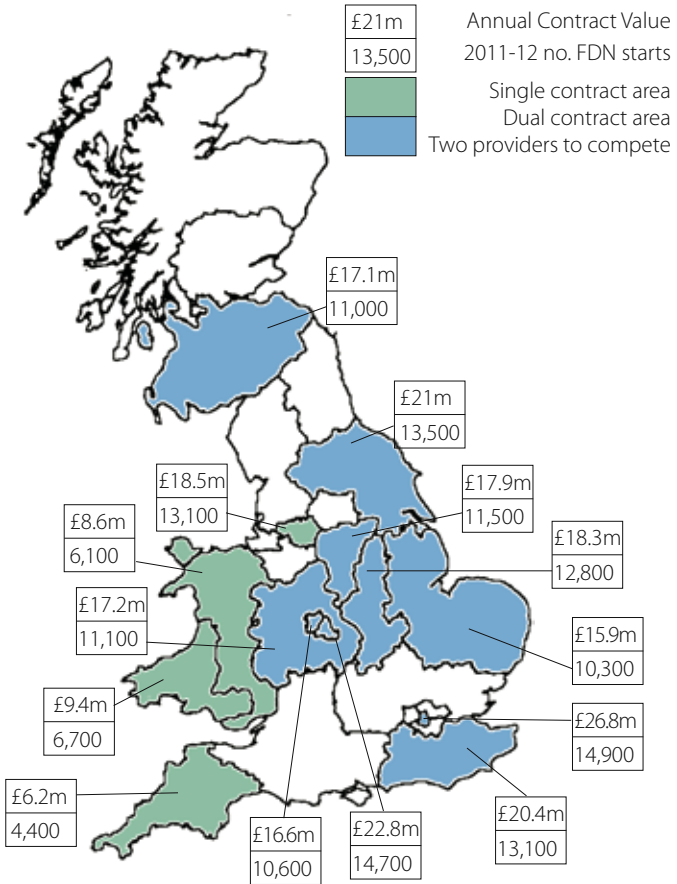
9 DWP, *Reducing dependency, increasing opportunity*, 63

10 DWP, *Phase 1 – flexible New Deal provision specification and supporting information* (London: HMSO, 2008).

WHERE WILL FND CONTRACTORS OPERATE?

FND will be rolled out in two parts, with Phase 1 contracts starting in October 2009. Under this commissioning round, contracts to operate the programme will be issued for 14 areas of the UK.

Figure 1.5: The 14 FND regions, annual contract value and estimated caseload



Source: Department for Work and Pensions, Phase 1 – flexible New Deal provision specification and supporting information (HMSO: London: 2008).

The relatively small number of contracts and size of the operating regions reflect the need to ensure a sufficient volume of clients to attract large and capable contractors with substantial resources into the FND market. At the same time, DWP has been keen to limit the size of contracts in order to ensure a healthy diversity of providers and a contracting environment conducive to innovation. In 10 of the 14 areas, two contracts to operate FND will be issued, while each of the remaining four will be run by a lone contractor.

The map shown in Figure 1.5 shows the 14 areas of the UK that will comprise Phase 1. The areas shaded green¹¹ represent those for which only a single operating contract will be issued. The blue¹² areas will be served by two providers who will compete with each other for jobseekers. Contracts for the remaining areas are expected to be issued next year, to begin in April 2010.

Box 1.1: The Flexible New Deal at a glance

- FND is a new programme designed to tackle long-term unemployment, with services starting in October 2009.
- Under FND, all employment support services for JSA claimants who have been unemployed for a year will be contracted out to private and third sector organisations.
- A network of private and third sector prime contractors will be paid by results, receiving money for getting

11 These are: North & Mid-Wales and South-East Wales; South Wales Valleys and South-West Wales; Devon & Cornwall; and Greater Manchester Central and Greater Manchester East & West.

12 These are: Ayrshire, Dumfries, Galloway & Inverclyde, Lanarkshire & East Dunbartonshire and Edinburgh, Lothian & Borders; North-East Yorkshire & the Humber and Tees Valley; Derbyshire and South Yorkshire; Coventry & Warwickshire, The Marches and Staffordshire; Leicestershire & Northamptonshire and Nottinghamshire; Cambridgeshire & Suffolk, Norfolk and Lincolnshire & Rutland; Birmingham & Solihull; Black Country; London Central and Lambeth, Southwark & Wandsworth; Kent and Surrey & Sussex.

clients into work and helping them to remain employed for 13 weeks. Contractors will receive a further payment if the client remains in employment after 26 weeks.

- The 'black box approach' of FND means that there are very few process requirements on the contractor. Rather, they are allowed the freedom to try different approaches to getting people back to work. The combination of few restrictions and outcome-based payment gives contractors strong incentives to find out what works best for each client. This could include a wide range of interventions, from providing skills training and dealing with personal barriers to work, to giving advice or supporting clients with expenses such as work clothes and travel needs.
- Crucially, this approach also gives prime contractors the flexibility to draw on the skills of smaller specialist providers and well-connected local organisations. Working with these subcontractors allows the prime contractors to meet the specific needs of their clients.
- Contracts to operate FND will be issued in April 2009 for 14 geographical areas in the first phase, with contracts for the remaining areas of the UK issued in October next year. In 10 out of the 14 Phase 1 areas, two prime contractors will compete for clients, while, in the remaining four, single-operator contracts will be issued.
- In the dual-contractor areas, jobseekers will be able to choose their preferred contractor from October 2010.

- Contracts will run for between five and seven years, depending on performance. DWP will measure the success of different prime contractors using metrics such as the number of outcomes they achieve and customer satisfaction ratings. In dual-contractor areas, DWP will re-allocate clients from the poorer to the better-performing contractor where individuals do not express a preference.

WILL THE FLEXIBLE NEW DEAL WORK?

The implementation of FND offers a huge opportunity radically to improve the support provided to the long-term unemployed. The new programme was conceived to build on the previous active labour market programmes, but also to succeed in ways that they had not. To do this, FND must achieve four things. It should:

- commission the services of reliable and cost-effective contractors;
- help all clients rather than just those easiest to help;
- support people to sustain their employment once in work; and
- encourage innovation and a diversity of approaches to helping clients into employment.

But the implementation of the new programme raises questions about whether it will be able to achieve these aims. The reliance on second-best regulatory tools to drive good performance from contractors and to achieve success in all four of the above goals is unlikely to succeed. Instead, DWP needs to look again at how it

can design aspects of the FND market to align incentives between jobseekers, contractors and government. Doing so will enable FND to fulfil its potential.

THE STRUCTURE OF THIS REPORT

Taking each area in turn, this report looks at how the implementation and delivery of FND measures up against these yardsticks of its potential success and asks: what else should be done to make the Flexible New Deal work?

Chapter 2 considers the tendering process for Phase 1 FND contracts and questions whether it will deliver stable and cost-effective services. Contract values are fixed and indicative estimates of the number of jobseekers provided each year by DWP. The tendering process requires competing bidders effectively to estimate a uniform cost per job outcome. But with the rapidly changing profile of long-term jobseekers, as a result of radical changes elsewhere in the benefit system, there is very little information on which to base estimates of likely performance. Moreover, the payment structure means that more ambitious bidders are rewarded with lower outcome payments. This raises the possibility that contractors will be forced to provide a low-cost, low-quality service which may not even attain the performance levels of the outgoing programmes. To prevent this, DWP should play an active role in enhancing the information available to prospective contractors to ensure that they are able to make realistic bids.

Chapter 3 looks at the impact of the uniform outcome payments, offered to contractors for finding clients work, and at the system's ability to help all jobseekers rather than just the easiest ones. It uses original statistical analysis to show that the client base is very diverse and contains people with very different chances of finding work. Under these circumstances, the uniform outcome payment is likely to give providers little choice but to ignore the most needy

clients, who would cost more to help than the outcome payment in case of success would bring in. This part of the report goes on to suggest that the problem could be solved without the need for onerous regulatory remedies. Payments which reflect the costs of helping different clients into work would align the objectives of jobseekers, contractors and the government.

Chapter 4 addresses the question of whether FND can succeed in achieving long-term sustained employment outcomes for jobseekers. Outcome payments for providers are heavily weighted to sustaining people in employment for 13 weeks, with a further payment at 26 weeks. However, it is doubtful whether these payments will be sufficient to focus contractors' minds on the need to prevent 'revolving door' employment, which often results when jobseekers are only loosely attached to the labour market. The chapter looks at ways to focus extra resources on longer-term support and retention. It identifies savings from benefit payments that would otherwise be necessary as the source of extra money to provide clients with the support they need to remain in work.

Chapter 5 looks at the issues thrown up by the market design of FND and asks whether this could jeopardise the innovation and cost-effectiveness of the programme. The economies of scale involved in coordinating specialist services lend the role to large prime providers. But their relationship with small specialists needs to be carefully considered. Proposed measures for regulating the market are currently insufficient and lack the credibility to make the market work well. More effective solutions are suggested to ensure that the employment service supply chain is as effective and innovative as it can be.

CONCLUSION

While substantial progress has been made in welfare-to-work since 1997, FND offers a radical departure even from existing active labour market policies. The new regime offers a focus on what counts – sustainable employment outcomes – rather than on programmes of employment support that may or may not lead to success.

The implementation of the new programme is, however, in danger of undermining the features that characterise the general approach, and give the model such potential. The remainder of this report considers how well FND, as currently conceived, will measure up to what a successful programme would look like.

CHAPTER 2: THE BIDDING PROCESS AND ITS IMPLICATIONS FOR DELIVERY

Summary

Under the bidding process for the Flexible New Deal (FND), prospective contractors will state the number of job outcomes they anticipate achieving in a given contracting region. This process will effectively set a uniform payment for achieving each one. Firms bidding with more ambitious outcome levels will receive lower payments per outcome, because the available money, pre-announced by DWP, will be spread more thinly between clients.

The performance of existing programmes with similar client groups suggests that the value of the contracts on offer will not be sufficient to achieve the 13-week sustained employment outcomes hoped for by DWP. The target of getting 55% of clients into sustained employment – the performance levels desired by DWP – implies that contractors will be expected substantially to outperform past programmes with much less money per job outcome.

There is considerable uncertainty around the achievable level of job outcomes under the new programme. Firms also face the prospect of a growing market in welfare-to-work delivery over the coming years. There are therefore good reasons to think that prospective contractors will err on the side of ambitious bids in order to win FND business.

This environment, in turn, will make it difficult for DWP to assess competing bids in terms of price, since it will be hard to discern bids based on wishful thinking from those underpinned by a good business model. Despite this danger, price is a variable that will determine half of the Department's decision about contract allocation.

This combination of uncertainties poses substantial risks for the government in terms of the deliverability of the bids, the chances of government having to bail out a provider and DWP's future tendering rounds. The Department should issue more realistic, central performance estimates, providing detailed information about how they were derived, to inform the market and hence elicit a more viable range of bids. DWP would then be better placed to probe bidders about their justification for diverging from the central performance estimate. This approach would minimise the risks to the Department.

From October 2009, people who remain unemployed for more than 12 months will be referred to large private or third sector contractors who will be paid according to the number of job outcomes they achieve for their clients. Under the outcome focus of the FND, therefore, and in contrast to existing New Deal programmes, the bidding process requires firms to make a judgement about how successful they think they will be.

The theoretical advantage of a competitive tendering process, such as that now underway for Phase 1 contracts, is that DWP will be able to identify those firms that are able to operate most efficiently and at lowest cost. This chapter examines the bidding process, considers its implications and asks whether this approach is compatible with DWP's desire for stable and cost-effective service delivery.

THE CONTRACTING PROCESS AND ITS IMPLICATIONS FOR THE PAYMENT STRUCTURE

Under the contracting process for Phase 1, indicative annual contract values have been issued by DWP, along with estimated

numbers of clients that prime providers could expect to see coming through their doors in each year (see Table 2.1). As part of their bid, prospective prime contractors are required to tell the Department what proportion of the projected caseload they expect to be able to get into work for 13 and 26 weeks, respectively. With a fixed contract value, a fixed estimate of the anticipated caseload and narrow band of outcome rates that might be expected, bidders effectively calculate a cost per sustained job outcome. From the Invitation to Tender, it appears that the bidders' respective costs will carry 50% weighting in the decision over awarding the contract.¹³

For example, if a contract is worth £10 million per year for an anticipated annual caseload of 10,000 clients, a firm that expected to be able to get 100% of those people into work would, in effect, be bidding at a cost of £1,000 per client. This figure represents what it considers to be the average cost of helping each successful client. A firm that thought the cost per jobseeker outcome was closer to £2,000 would therefore only be able to offer to get 50% of the clients into work with the money available. The other component of DWP's decision over contract allocation will be determined by different attributes of the bids received, such as the perceived viability of a firm's business model and the way in which it will seek to involve specialist providers.

Using cost-based bidding in this way creates perverse incentives. The more ambitious the bidding prime contractor, in terms of the anticipated number of outcomes it will achieve, the less money it will have to spend on each client. In the above example, the bidder that expected to help 100% of its clients was bidding to do so at half the cost per job compared to a bidder expecting to help only half its clients. Further, the likely costs associated with helping the tougher half of the caseload into employment would surely be higher than for the easier half.

13 DWP, *Invitation to tender, instructions for bidders* (London: DWP, 2008), 14.

PAST PERFORMANCE OF COMPARABLE EMPLOYMENT PROGRAMMES

Using data showing the proportion of participants of the New Deal for Young People (NDYP) and New Deal 25 Plus (ND25+) programmes (with similar client groups to that for FND) who moved into employment, it is possible to get an idea of the level of sustained employment outcomes that each prime contractor could anticipate achieving. This, in turn, gives an idea of the cost per job outcome that might form the basis of bids.

Table 2.1 shows estimates for reasonable costs per outcome that those bidding for a contract might work with in each of the 14 FND areas of Phase 1. It shows that, in a typical area, a reasonable 13-week outcome rate, under the current programmes, is around 40% of the caseload (for NDYP and ND25+). With the given contract values, this yields a cost per outcome of around £3,900. In fact, the cash available to spend on each person who actually achieves sustained employment will be significantly less than the 'cost per outcome' calculated here, since contractors will expend resources trying to help all clients to varying degrees.

Table 2.1: Estimated costs per sustained job outcome

Region	April 2011 – March 2012: no. of FND starts ^a	Annual contract value ^a	Possible 13-week outcome rate ^b	Cost per sustained outcome ^c
Ayrshire, Dumfries, Galloway & Inverclyde, Lanarkshire & East Dunbartonshire and Edinburgh, Lothian & Borders	11,000	£17.11m	42%	£3,700
North East Yorkshire & the Humber and Tees Valley	13,500	£20.99m	42%	£3,700
Greater Manchester Central and Greater Manchester East & West	13,100	£18.52m	41%	£3,400
Derbyshire and South Yorkshire	11,500	£17.86m	42%	£3,700
North & Mid Wales and South East Wales	6,100	£8.59m	43%	£3,300
Coventry & Warwickshire, The Marches and Staffordshire	11,100	£17.18m	42%	£3,700
Leicestershire & Northamptonshire and Nottinghamshire	11,800	£18.32m	40%	£3,900
Cambridgeshire & Suffolk, Norfolk and Lincolnshire & Rutland	10,300	£15.91m	42%	£3,700
Birmingham & Solihull	14,700	£22.82m	35%	£4,400
Black Country	10,600	£16.56m	36%	£4,300
South Wales Valleys and South West Wales	6,700	£9.39m	46%	£3,000
London Central, Lambeth, Southwark & Wandsworth	14,900	£26.78m	27%	£6,700
Kent, Surrey & Sussex	13,100	£20.37m	39%	£4,000
Devon & Cornwall	4,400	£6.19m	49%	£2,900

Notes

- a DWP, *Flexible New Deal – phase one, invitation to tender, provision specification and supporting information* (London: DWP, 2008), 90. These calculations use 2011–12 client caseload estimates rather than 2009–10 or 2010–11 estimates. The stock of long-term JSA claimants and changes to the tax benefit system in the first two years may mean that 2011–12 figures are the closest indication of steady state client volumes.
- b Based on DWP New Deal administrative data. Historic average 1999–2006.
- c Total contract value divided by anticipated number of outcomes; assumes that 80% of job starts are sustained for at least 13 weeks.

While the possible 13-week outcome rates shown in the table are based on historical performance data for groups whose

composition will be slightly different from that of FND, it gives a ballpark idea of what is possible. However, the supporting documentation of the Invitation to Tender gives DWP's 'national performance expectations':¹⁴ benchmark performance levels which DWP anticipates that prospective contractors will reflect in their bids. These levels are significantly higher than those suggested by historical data for existing programmes.

The national performance expectations are for contractors to get 55% of their clients into work for 13 weeks, with 50% sustaining employment to 26 weeks. That would represent a 15 percentage point improvement on the average historical performance of the existing New Deal programmes at 13 weeks. This has clear implications for the cost-per-outcome that the Department wants to see. For an average FND region, sustaining 55% of the caseload in employment for 13 weeks would imply a cost per outcome of around £2,800.

Evidence from Employment Zones suggests that providers were able to achieve 13-week sustained outcomes for 35% of their clients, at a cost of £5,110 per outcome.¹⁵ Even accounting for the fact that EZs operated in deprived areas, the national performance expectations look very ambitious on these figures. They will require 57% higher 13-week outcome performance than achieved under the EZs, with 45% less money per outcome.

Performance management by DWP will operate largely on the basis of measuring contractor performance against that set out in their own bid (see Chapter 3). The combination of this payment structure with the proposed performance measurement system means that the risk associated with prime contractors attempting to hit ambitious job outcome targets are substantial. Contractors that fall

14 DWP, *Flexible New Deal – Phase One. Invitation to tender. Provision specification and supporting information* (London: DWP, 2008), 93.

15 DWP, *Reducing dependency, increasing opportunity*, 55

short of an ambitious forecast number of successful job outcomes, will, as a result, receive a considerably smaller income than the less ambitious bidders, and will also run the risk of having their contract terminated early. In itself, setting high expectations for delivery may be a sensible strategy for DWP, by raising expectations of what can be achieved. However, because of the risks involved for contractors trying to achieve those performance levels, discussed below, such ambitious targets could actually threaten the delivery of the programme. In the long run, this could cost the government much more.

AWARDING THE CONTRACTS: WILL THE WINNER BE CURSED?

Six or more organisations will bid for each available FND contract under Phase 1. DWP hopes that such a field of competitors will be able accurately to estimate the number of outcomes they can expect to achieve. In effect, the bidding process is therefore an auction, with the contract going to the organisation that bids the highest number of target outcomes (and therefore at the lowest cost per client). This raises a question about whether the successful contractors will suffer the 'winner's curse'.

The winner's curse is a problem mostly known from auction theory, whereby the winning bidder is likely to overpay for the item purchased. For FND contracts, this problem could arise if bidders offer a high target number of job outcomes for an unrealistically low unit price. This situation is desirable neither for the commissioner nor for the private contractor. If the bid is unrealistic, the contractor may find that they spread resources so thinly that they massively underperform on their targets. As a consequence, they risk short-changing jobseekers who need the most help, while jeopardising their continued operation. An unstable prime contracting tier is also likely to be very damaging for performance. This problem varies to the extent to which contracts are awarded based on the lowest price.

There is a range of reasons why contractors are unlikely to be able to make an accurate assessment of the number of outcomes they might expect to achieve with the available money.

First, the whole FND structure is very different from the current regime. Under NDYP, the gateway phase of job-search before moving onto the programme is just six months, while under ND25+ it is 18 months. With the FND gateway for both groups moving to 12 months, contractors can expect to get a mixture of harder young clients and easier older ones. But for both groups, the change means that currently achieved outcome levels are not directly relevant.

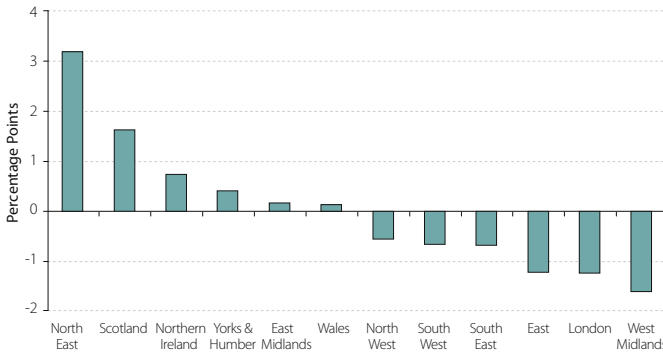
Second, while current Jobcentre Plus success metrics are based on the number of job starts achieved, the metric for FND contractors is different. Under the new regime, contractors will be paid for 13- and 26-week sustained employment outcomes. This again means that current levels of job starts for Jobcentre Plus clients are difficult to read across to FND. Since data is not available on the 26-week retention rates for those currently finding work through Jobcentre Plus, it is hard for bidders to know what level of success to expect from these groups.

Third, there are substantial changes taking place elsewhere in the welfare-to-work system, which will further muddy the water for contractors trying to assess targets for their client base. Lone parents on welfare whose youngest child is older than 11 will, from October this year, be required to look for work. The age will be lowered to 7 in 2010, pushing even more lone parents down the JSA route. Similarly, reforms to the Incapacity Benefit system are likely to change the number of people on JSA and, therefore, contractors' caseload mix.

A fourth reason why contractors will find it difficult to bid with realistic outcome targets is that over the seven-year life-span of

contracts, regional differences in macroeconomic performance mean that regional labour markets will evolve in different ways. A region's labour market could, over time, become significantly more or less slack, with implications for the chances of placing clients. Figure 2.1 shows how employment rates across UK government office regions changed over just four years, between 2002 and 2006. While employment rates in the North-East and Scotland shot up over the period, others, like those of London and the West Midlands, deteriorated. This creates problems for making a fair comparison between the performance of providers in different parts of the country over the period of the contract.

Figure 2.1: Percentage point change in regional employment rates Autumn 2002–6



Source: Labour Force Survey, 2002–6.

With the prospect of burgeoning private and third sector involvement in welfare-to-work over the coming years, many organisations may risk very low profits in this first round of contracting in order to get a foot in the door. This will become an even more tempting strategy if the new, AME-DEL funding mechanism, outlined in the recent Green Paper, is rolled out further.¹⁶

¹⁶ DWP, *No one written off*, 74.

Overall, then, the lack of clarity around what outcome levels contractors might anticipate poses a risk to FND delivery, particularly if the more cautious and capable operators are outbid by over-optimistic competitors. The consequences of such an outcome would be bad for jobseekers, prime contractors and the subcontracting supply chain. Given the implications for service provision, it is likely that the Department would have to bail out struggling prime contractors with extra money in the event of their going bust. Ultimately, therefore, choosing the cheapest provider could end up being the government's most expensive option.

Bailing out contractors would also send a very damaging message to other contractors and prospective bidders for other DWP work, by encouraging them to make unrealistic bids to win business. This kind of event would place the burden of determining the financial risk associated with any given bid on DWP, rather than on the bidding firm, despite the obvious difficulties involved with the Department trying to make that call.

DWP should therefore issue a realistic guideline central case performance level to replace the national performance expectations. The data and modelling on which these figures are based should be openly available to all prospective contractors. This would enable them to judge for themselves how realistic they think the guidelines are, and assess where and how they could improve on them. By informing the market, this approach would elicit a more viable range of bids and lower the risks to government.

DWP should combine this with Pre-Award Clarification interviews with all bidders. These would be similar to the Post-Tender Clarification meetings held for Pathways to Work contracts, but before the decision on contract allocation is made. These meetings would give DWP scope to probe bidders about the basis on which their outcome targets diverge from the DWP central case.

Recommendation 1

DWP should replace the national performance expectations with a more realistic assessment of central case outcome levels. The data and modelling that underpin the central case should be made available to all FND bidders.

The Department should combine this approach with Pre-Award Clarification interviews with bidders to evaluate the basis on which bids diverge from the DWP central case.

CONCLUSION

The bidding process for Phase 1 of FND will effectively set a uniform payment for each job outcome attained by a contractor. Payments will be lower for contractors that bid with ambitious outcome targets.

Past performance with similar client groups suggests that the value of the contracts on offer will only be sufficient to achieve 13-week sustained employment outcomes of around 30–40% of the client caseload. However, the national performance expectations dictated by DWP suggest that firms should be looking to bid for 13-week sustained employment rates of around 55%. This seems unrealistic on the available evidence.

Given the lack of information about the composition of the FND client group, the likelihood of differential macroeconomic effects in different regions over time, and the prospect of burgeoning welfare-to-work contracts, it will be difficult for DWP to assess the quality of bids in terms of price. This is, however, a variable that determines half the decision concerning the allocation of contracts.

This combination of uncertainties poses risks for the government in terms of the deliverability of the bids, the chances of government

having to bail out a provider and DWP's future tender rounds. The over-ambitious national performance expectations appear to have exacerbated this problem. To reduce the risk, DWP should publish realistic, central case performance targets and detailed information about how they were derived. It should combine this approach with an interview process to scrutinise bids.

But there is a further problem with how outcome payments are determined through the bidding process. An important implication of the bidding process is that providers will make a loss on any client they help into work at a cost of more than the cost-per-outcome figure. In fact, given the need to try to help all clients at least to some extent, contractors will lose money when spending much less than this figure. The implications of this uniform outcome payment for harder-to-help clients are the subject of the next chapter.

CHAPTER 3: REACHING THE HARDEST-TO-HELP

Summary

Harder-to-help jobseekers will require more support at greater cost. While this idea underpins the Flexible New Deal vision, it is not reflected in its implementation. Under the proposed uniform outcome payment structure, helping those furthest from the labour market will be uneconomic for contractors. Clients in need of the most support will therefore not be offered services that are necessary to finding and sustaining work. They will, in other words, be 'parked' by contractors. The cause of this problem is that the design of the payment system sets the profit motive of contractors in tension with the aim to help all clients. This need not be the case, and its effects are in the interests of neither the jobseeker nor the taxpayer.

The analysis of this chapter shows that, among the long-term unemployed, some personal characteristics, such as educational attainment, are strong predictors of job placement success. Parking is therefore both easy and profitable for contractors. With limited resources, contractors can be expected to focus their efforts on clients with the greatest chances of job success, at the expense of others.

There is a range of possible solutions to the problem of parking. As it stands, the Flexible New Deal (FND) will rely heavily on three key tools to limit it:

- the threat to contractors of a competitive re-tendering round,
- binding Action Plans between client and contractor; and
- client choice and reallocation of market share between firms in dual-contractor regions.

But these will have little impact in ensuring that everyone gets the help they need if the necessary support fundamentally makes no financial sense to contractors.

Rather than using second-best solutions to parking, DWP needs to focus on using the payment structure to align the incentives of jobseekers, contractors and government. To this end, a system of variable payments that better reflect the costs of helping different people within the caseload is required. Many people argue that statistical profiling techniques to achieve this are insufficiently accurate at predicting the costs associated with getting someone into work and are difficult to implement.

There is, however, a better solution: instead of attempting to tie different payments to types of individual, DWP should offer increasing payments per person helped into work. In other words, payments should increase as the contractor gets further into the cohort of jobseekers. This would allow contractor staff the flexibility to shift resources to those who turn out to need it most, while guaranteeing the contractors' shareholders a profit for helping all clients, where currently they would go bust. Such an approach would provide incentives for the capacity building necessary if FND is to work for everyone.

Jobcentre Plus is very effective in helping the overwhelming majority of jobseekers back into work quickly. About 90% of people who claim Jobseeker's Allowance (JSA) move off that benefit and back into work within a year.¹⁷ The service provided to JSA claimants in their first year of an unemployment spell is a cost-effective, one-size-fits-all programme with gradually increasing levels of directed job-search and benefit conditionality as time goes on.

17 DWP, *Ready for work: full employment in our generation*, 53.

This approach overcomes the problem that expensive welfare-to-work programmes for all jobseekers represent poor value for money, since the vast majority will find work quickly and of their own accord.

One year into an unemployment spell, the problems faced by the remaining 10% of people on JSA are diverse and complicated. Successful jobseekers are all alike, whereas every unsuccessful jobseeker is unsuccessful in his or her own way. For this group of the 'hardest-to-help', therefore, both substantial resource and an individually tailored programme of employment support are necessary. In an effort to help these clients, FND is characterised by a personalised approach and higher levels of funding per person than in the first 12 months.

This innovative and radical model offers a potentially powerful means of reaching the hardest-to-help. However, the way in which outcome payments are structured will make the difference between a programme that fulfils its aim of helping everyone and one that offers only a marginal improvement in job outcomes on existing programmes. Making FND work for everyone is the focus of this chapter.

RISKS OF CREAM-SKIMMING AND PARKING

The major advantage of a uniform outcome payment system is its simplicity and the fact that it puts a minimal administrative burden on the contractor and DWP. Harnessing the profit motive to help a diverse population of long-term unemployed promises a step-change in the help these people receive, allowing flexibility in financing and jobseeker support. However, with a uniform outcome payment, the profit motive of contractors is set in tension with the aim to help all clients, resulting in damaging consequences. This need not be the case.

Uniform outcome payments encourage providers to ignore, or park, the hardest-to-help clients.¹⁸ In practice, this means directing only minimal resources towards helping any client where the costs associated with finding them work are expected to exceed the outcome payments in case of success. Parking is therefore a concern from a social justice perspective, since some people will receive only minimal help from the contractor when they should, arguably, be entitled to at least the same level of support, if not support proportionate to their needs. But beyond the social justice argument, parking represents a problem for the taxpayer. A single, childless, unemployed person would typically claim around £6,300 per year in Jobseeker's Allowance and Housing and Council Tax Benefit.¹⁹ Not helping people to find work is not cheap.

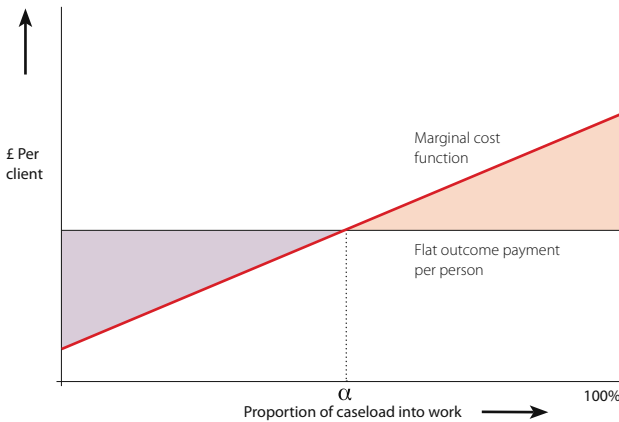
Figure 3.1 illustrates the financial incentives for parking under uniform outcome payments. Within a cohort of jobseekers who have been out of work for a year or more, people will inevitably vary in terms of their distance from the labour market: some jobseekers are easier to employ than others because they face fewer barriers to work, for example by being better qualified. This means that as providers work their way through the caseload from the easiest to the hardest cases, the cost of helping each additional client into employment rises. In Figure 3.1, this rising cost is represented by the upward sloping red line. With a uniform outcome payment represented by the flat black line, the contractor has an incentive to provide services to jobseekers up to the point where the marginal cost of helping the next client exceeds the outcome payment (α). Help for clients furthest from the labour market will be minimal, because in helping them, the provider would incur a loss. Consequently, they get parked – either on purpose or inadvertently.

18 See, for example, *ERSA Response to DWP Commissioning Strategy – Interim Report* (London: ERSA, 2008), 9.

19 Based on 2008–9 single person JSA of £59.15 per week, HB for rent of £50 per week and CTB for Council Tax of £12 per week.

Crucially, it should be noted that such actions are not evidence of the pernicious intentions of self-interested contractors, but are an inevitable and, arguably, efficient response to the payment structure. If £4,000 is insufficient to get someone into employment, then it makes sense for the provider instead to concentrate that money on someone for whom it is more likely to make a difference.

Figure 3.1: Parking under a uniform outcome payment structure



The corollary of parking, under a uniform outcome fee, is 'cream-skimming'. This usually pejorative term is often used simply to mean helping easier clients to find work quickly. It is unclear, however, whether such a case-management approach from prime contractors is undesirable. From both the client's and the taxpayer's point of view, it makes sense to help 'quick win' clients first, rather than keeping them at the back of the queue while dealing with clients for whom a successful outcome is less likely. This is particularly the case where the available resources are simply insufficient to help those clients furthest from the labour market.

Rather, as understood in this report, cream-skimming involves contractors providing capacity to help only the easier clients, at the expense of others, solely because those clients offer the greatest

financial return. In contrast to the looser definition above, such behaviour is in the interests of neither the taxpayer nor jobseekers, and should therefore be avoided. Echoing the problems caused by the proposed payment structure for incentives to provide the necessary capacity, Dave Simmonds has argued that “the new top-tier providers for Flexible New Deal need to be geared up and incentivised to provide the capacity that will be needed. This will involve the Treasury recognising that there are significant economic and social returns to investing in this group rather than continuing to ‘park’ them.”²⁰

Cream-skimming and parking are not a problem just for the prime contractors assisting jobseekers in-house. When prime contractors do not have the necessary resources and flexibility to pass on similar incentives to their subcontractors (in the form of higher payments for tougher clients), cream-skimming and parking become a risk throughout the supply chain.

To deter cream-skimming and parking, other measures have been proposed, which aim to encourage providers to transfer some of the surplus made on helping the easier clients (represented by the blue area in Figure 3.1) to more intensive efforts for more costly clients. But as the marginal cost of an outcome rises, the payment structure means that it is not in the firm’s financial interests to do this, since it will make an increasing loss on each extra client (the red area). This misalignment of incentives therefore throws the burden of driving good performance from providers onto cumbersome regulatory measures. This is neither efficient, nor in the spirit of FND, which aims to get away from the need to regulate provision and a process-focused approach to welfare-to-work.

However, this analysis does not lead to the conclusion that uniform outcome payments should be higher. This would provide

20 Dave Simmonds, “Challenges 2009: make or break?,” Centre for Economic and Social Inclusion Working Brief (London: Centre for Economic and Social Inclusion, 2008), 7.

the financial incentive for prime contractors to direct the necessary resources at those further from the labour market. But it would do so in a highly inefficient way, effectively offering contractors substantial and unnecessary margins on easier clients. Rather, it shows the need to design a system which uses the existing funding in a smarter way. That is, a system that aligns the incentives of providers and DWP and under which providers help *all jobseekers simultaneously and according to need*. What this means in practice is considered further below.

ARE ALL FLEXIBLE NEW DEAL CLIENTS EQUALLY HARD TO HELP?

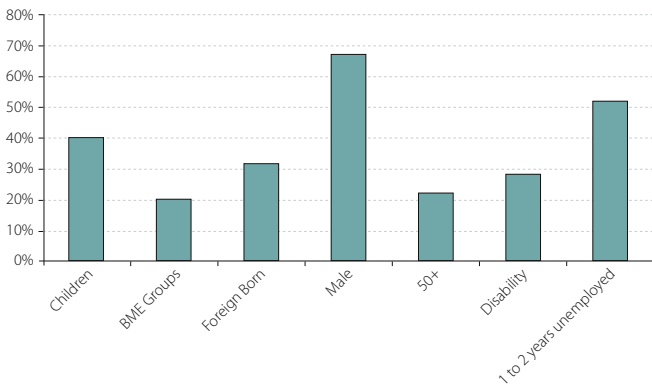
The above analysis rests on the idea that the costs associated with helping long-term unemployed people into work vary from person to person. The more homogenous the group in question is, the fewer are the problems of cream-skimming and parking under a uniform outcome payment structure. Diagrammatically, this means a much flatter marginal cost curve than that shown in Figure 3.1. If every client costs the same amount to get into work, then there are no quick wins or hard-to-help clients in the caseload. In this case, a uniform outcome payment is, depending on its level, sufficient either to help everyone or to help no one. On the other hand, if the cost of helping individuals does vary but it is impossible for contractors to spot the easiest ones, then it could be argued that a uniform fee will at least afford everyone the same level of assistance, even though that may not be sufficient for many.

Along these lines, some have argued that, since over 90% of JSA claimants move into work within the first year of their claim, those who form the relatively small group of long-term unemployed are equally hard to help.²¹ In other words, risks of cream-skimming and parking are thought minimal, because this group and, therefore, the costs are homogeneous.

21 Participant at a seminar on the Flexible New Deal held by the Social Market Foundation, 18 June 2008.

Is this a reasonable assertion? When comparing the group of long-term unemployed to the rest of the labour force, arguments for the homogeneity of the former seem compelling: they share problems related to the long-term detachment of the labour market. However, it is important to remember that in terms of background and characteristics, the long-term unemployed are a diverse group – a fact that is reflected in FND’s tailored approach. According to the Labour Force Survey (LFS), around 40% of long-term JSA claimants have children, slightly more than half have been unemployed for more than one year but less than two years (the remainder having been unemployed for two years or more) and around a fifth are from black or minority ethnic (BME) groups (see Figure 3.2).

Figure 3.2: Characteristics of the long-term unemployed

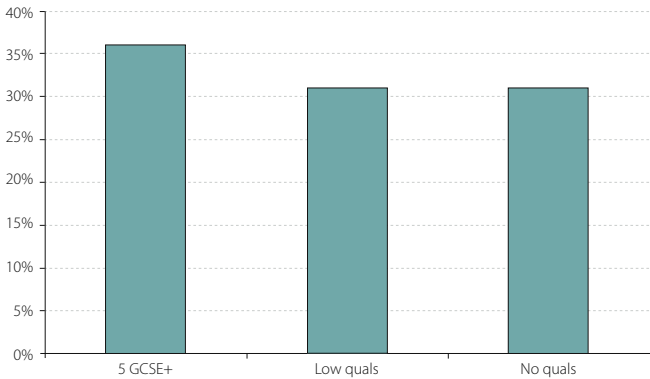


Source: Labour Force Survey, 2004–7

The qualification profile of the long-term unemployed is also very mixed, with a roughly equal split between people with five-or-more GCSEs or higher qualifications, those with lower qualifications, and jobseekers with no qualifications (see Figure 3.3). Common sense would suggest, for example, that it would be much easier to help someone into work who holds educational qualifications than it would a client who has none. Consequently it would be reasonable to suggest that the distance from the labour market for

long-term unemployed people with different levels of qualifications would be reasonably varied. But can this be demonstrated?

Figure 3.3: Qualification levels among the long-term unemployed



Source: Labour Force Survey, 2004–7

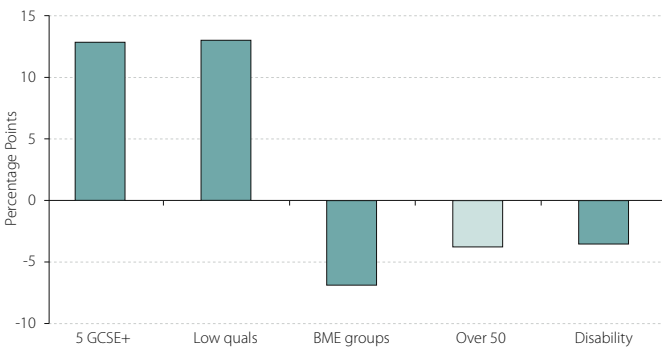
By regression analysis, it is possible to ascertain whether any of the observable characteristics of the long-term unemployed are associated with higher chances of finding employment. Taking a pooled cross-section of long-term unemployed people from the quarterly Labour Force Survey from 2005 to 2007, it is possible to determine the probability of a long-term unemployed person being in work three months later, given their characteristics.²² Individuals' characteristics associated with lower or higher chances of an employment outcome can then be taken as reliable indicators of similar people's average distance from the labour market. There will always be variation in labour market readiness within groups of people with similar characteristics. But this kind of analysis shows whether there are any differences between groups on average.

²² This analysis employed a cross-section of more than 1,000 people, recorded in the LFS between 2004 and 2007, who had been unemployed for a year or more. Analysis employed a probit model, controlling for individual characteristics including highest educational qualification, sex, being from a BME group, age, having children, having a work-limiting disability, or being born outside the UK. Full details available from the authors upon request.

Stark average differences between groups of people with different characteristics would make it easy for contractors to identify people with the highest chances of achieving a job outcome.

The results of this analysis show that being under 25, being male, having children or having been born abroad are not associated with any difference in the chance that a long-term unemployed jobseeker will have found work three months later. However, having no qualifications, having a disability, being over 50 or being from a black or minority ethnic group do appear to be associated with significantly lower chances of imminently finding employment. These results are displayed in Figure 3.4.

Figure 3.4: Association between personal characteristics and employment chances three months later



Note: Darker bars represent statistical significance at 5% level; lighter bars at 10%.

Source: Authors' calculations and Labour Force Survey 2004–7.

On average, long-term unemployed people in the sample had a 9.4% chance of finding work within the next three months. But the variation within the sample is huge. For example, having 5 or more GCSEs is associated with higher chances of a person finding work in the following three months by 12.8 percentage points, compared to someone with no qualifications, whose chance of imminent employment is around 3%. Indeed, having any qualifications at all

is associated with much greater chances of imminent jobseeker success. This means that the two-thirds of clients with some qualifications are around five times more likely to get a job than the third with no qualifications.

So, not only is there substantial variation in the chances of finding work between different groups of people among the long-term unemployed, but those who are hardest-to-help are also readily identifiable. It is clear, therefore, that contractors will necessarily bias their efforts towards the easier-to-help group.

While some characteristics of jobseekers are observable (e.g. age and sex), perhaps the most important single factor, motivation to find a job, is not something easily captured in survey data. It is impossible to know whether differences in motivation are correlated with the personal characteristics captured in this analysis. But to the extent that motivation is separately observable by employment advisers, it only adds to the scope for contractors to distinguish those most likely to find work from those who will cost too much.

The above analysis attempts to isolate the contribution to employment chance associated with a variety of individual characteristics. In practice however, many long-term unemployed people face overlapping disadvantages, which further reduce their chances of finding employment without substantial help. Around 30% of long-term unemployed in the sample had at least two of the characteristics associated with significantly lower employment chances identified in the regression analysis.

Under these conditions, it does not make sense for contractors to direct resources at the more disadvantaged group, given the much lower chances of outcome success and the opportunity cost of the resources. Currently, then, there is no financial case, within contract periods, for the private sector to provide the capacity to

help those furthest from the labour market. Regardless of their good intentions, and under pressure to hit stringent outcome targets, prime providers are bound to focus their resources on the marginal client or risk losing their contract.

Some contractor representatives have argued that their advisers would “never park any of our clients.”²³ However, if it is the case that some contractors do not try to target the clients with the highest chances of success, then it is likely that they must instead be bidding on the basis of poorer outcome targets than their competitors who do target the easier clients. In other words, the bidding process inevitably favours contractors who, consciously or not, intend to park the hardest cases.

Despite the payment structure and caseload heterogeneity implying considerable cream-skimming and parking incentives, these phenomena have been hard to prove under existing schemes. This is primarily because the hardest-to-help are, by definition, the least likely to find work, so their failure to do so can be put down to that rather than their having received insufficient help. Nevertheless, a perception of pervasive parking in the Australian Job Network has been the driving force behind many of the reforms to that system since its introduction.²⁴ These changes, as well as the relative similarity of the welfare-to-work regimes of Britain and Australia, make the latter an important case study, which holds valuable lessons for Britain. In this report we will draw on a number of evaluations and analyses of the Australian system.

Perhaps the easiest way to determine whether parking occurs is to examine the attitudes of those operating employment service contracts. These are, after all the people who have to face the consequences of decisions about how best to allocate their

23 Participant at a seminar on the Flexible New Deal held by the Social Market Foundation, 18 June 2008.

24 Productivity Commission, *Independent review of the job network*, Report No. 21 (Melbourne: Productivity Commission, 2002), section 3.13.

resources. Evidence from an evaluation of Employment Zones shows that managers clearly recognised a spectrum of clients, suggesting that parking is a feature. One EZ manager painted a picture of the heterogeneity of their clients, explaining that they come from one of “two ends of a scale: you either get really good ones that are quite easy to work with [or clients with] real huge problems.”²⁵ For some clients, particularly those with mental health conditions, some Employment Zone managers questioned whether referral onto the programme was appropriate given these clients’ needs.

BEYOND THE PAYMENT STRUCTURE: FURTHER INCENTIVES FOR PARKING

Under FND, once they have been referred to a contractor after 12 months of unemployment, individual clients will remain with that organisation for a further 12 months only. This suggests another cause for concern, namely that parking will become a problem under the FND model. Until the 2003 contracting round, jobseekers in the Australian system were placed with a provider for a time-limited period. Since providers knew that, after three years without finding work, a client would no longer be their responsibility, there was an added incentive to park more difficult clients, particularly when their initial efforts to help those clients had failed.

In recognition of the perverse incentives that resulted from this framework, the 2003 contracting round required that clients remain with the same provider until they are found work. Making providers take on indefinite responsibility for jobseekers was claimed as one of the key drivers behind the greatly increased ‘net impact’ at a Social Policy Conference in 2005.²⁶

25 Evaluation of single provider *Employment Zone extension*, DWP Research Report No. 312, by Rita Griffiths, Stuart Durkin and Alison Mitchell (London: HMSO, 2006), 63.

26 Sheridan Dudley, “Not just any job. The right job in a sustainable community.” Paper to the Australian Social Policy Conference (Sydney: University of New South Wales, 2005), 3.

The Australian experience suggests that such a short time period with a provider, under FND, may be a cause for concern, since it means that the costs of parking a client are low in terms of the required minimal level of interventions.

The fact that the jobseekers on the FND have different needs which make it possible to park them begs the question why payments do not reflect costs in a more adequate way. So far, DWP has decided to go down the route of simplicity with a flat payment scheme and mitigate the described adverse effects with a range of regulatory interventions. These measures are discussed below. Options for a payment scheme that better reflects the variable cost of helping different clients are set out after that.

HOW CAN PARKING BE PREVENTED?

While the bidding process is supposed to commit contractors to helping as many clients as possible, performance management is a key part of preventing parking once contracts are under way. There are two broad ways of driving good performance and thereby limiting the negative impact of the payment structure. In a top-down approach, government can evaluate success and reward accordingly; alternatively, jobseeker choice can be used to drive up performance via competition between contractors. These two mechanisms are reflected in the first contracts issued: whereas four of the regions will be served by one provider, the remaining ten will have two providers each, thus allowing for evaluations of the two models after the first round of contracting.

Driving high-quality performance: choice

The choice mechanism is what ensures consumer satisfaction in competitive markets and puts pressure on firms to produce higher-quality products at lower prices. Choice also has the potential to empower unemployed people, allowing them to find the right

services for them, rather than being pushed around an anonymous welfare-to-work system. However, there are a number of problems with reading across the benefits of choice in, say, the groceries market to welfare-to-work.

First, where consumer choice is informed about what is and what is not a 'good product', choice can be an extremely powerful driver of performance. If customers are not well informed, the effectiveness of choice is substantially weakened. But informed choice in complicated markets is harder to achieve when the deciding agent does not face repeated opportunities to choose that allow for trial and error. In choosing groceries, if a food turns out not to be to one's liking, the cost to the consumer is small and he or she has the chance to make a better choice the next time. Individual choice does not work in this way for employment services, however: it is not a repetitive choice. Determining need and assessing the options is much more complex than it is for food.

Second, when buying groceries, the impact of choosing what to eat falls entirely on the individual making that choice. In the realm of welfare-to-work, the choices of the jobseeker affect not only themselves, but also the taxpayer, since benefits represent an externality associated with the unemployed person's choices. Indeed, the taxpayer's interest in the jobseeker making a successful choice is substantial, since the annual benefits bill for a single childless person in Local Authority housing, at around £6,300, is roughly equal to the income tax liability of a family earning £40,000. Where the interests of those two parties are not aligned, this problem of agency may not lead to the socially optimal outcome for some jobseekers.

Third, choice is problematic where the provider's profit depends upon the kind, rather than just the number, of customers they attract. In a supermarket, every client who buys a tin of beans pays the same price and yields the same profit. In an outcome-based

payment system with choice, however, there is a strong incentive for providers to try to ‘choose’ the cheapest clients to help, perhaps through selective advertising. Even a slight shift in a contractor’s client base can substantially reduce costs. This contrasts strongly with most markets where choice drives performance, in which the cost of a good is either uniform or reflected in the price charged. In short, under welfare-to-work conditions, choice is a much more complicated proposition than in many other markets. Simple parallels can therefore be very misleading.

Where choice in welfare-to-work has been tried, it has not appeared to be the powerful tool for driving performance that might have been hoped. Centrelink, the Australian gateway agency, estimated that only around 20% of jobseekers chose their provider; other clients are matched with a provider through an automated referral system.²⁷ A different study found that around a third of the jobseekers who did choose an ‘intensive assistance provider’ did so based on provider location. In other words, they chose the service provider closest to their home.²⁸ It has also been suggested that the likelihood of someone exercising choice is correlated with their educational attainment, suggesting that the long-term unemployed, around two-thirds of whom have fewer than 5 GCSE passes (see above), will be less likely to exercise choice.²⁹ As Peter Lilley puts it: “Choice is important, but experience in some other countries suggests that benefit recipients do not pick and choose between welfare to work providers as much as scheme designers would like.”³⁰

Choice should not be written-off solely on the basis of the Australian experience, however. The problems of location-

27 Productivity Commission, *Independent review of the job network*, section 8.1.

28 Department of Employment, *Workplace relations and small business, job network evaluation. Stage One: implementation and market development* (Melbourne: Productivity Commission, 2000), 77-78.

29 Productivity Commission, *Independent review of the job network*, section 8.4.

30 Peter Lilley, “Paying for success – the international experience of contracting out,” in Peter Lilley and Oliver Marc Hartwich, eds, *Paying for success. How to make contracting out work in employment services* (London: Policy Exchange, 2008), 13.

based choice there may prove less relevant in the more densely populated UK, especially in urban areas.³¹ In addition, while many may not exercise choice, having the option could be important where variation in provider performance is significant. Whether the other problems surrounding choice could be overcome remains an open question. Comparing the FND areas with two contractors (and therefore choice) to the ones with a single contractor might provide insights on these issues and hold lessons for the future.

The foregoing discussion raises questions about the capacity for customer choice to improve provider performance and prevent parking. But the problems, noted above, of agency and of providers choosing jobseekers raise questions about whether choice, far from improving performance, might actually damage it by encouraging parking. Where those who want to work go to the best-performing provider, or where providers select the most motivated people through careful marketing, choice may not deliver good results from either the individual's or the taxpayer's perspective. While it has potential, therefore, choice in welfare-to-work is no panacea, and arguments about its limitations are not simply founded on a patronising or paternalist reading of the issues.

Driving high-quality performance: top-down performance management

Uncertainties about the effect of customer choice on performance lead to the question whether performance management from above – allocation of jobseekers by Jobcentre Plus – is preferable. Performance measures for each contractor can include evaluations of the length of time for which employment is sustained, earnings over time, progress in skills and social achievements, and process measures such as frequency of client contact and customer

31 May Lam, *Choice and voice in welfare reform* (London: Ingeus Centre for Policy and Research, 2008), 28.

feedback.³² These measures can then be used to judge which contractors are performing best, as a means of deciding which should and which should not have their contracts renewed at the next contracting window.

The process of re-contracting therefore acts as a surrogate market mechanism, forcing poorly performing companies to exit and rewarding better performing ones with more business. This mechanism can be described as competition *for* markets rather than competition *within* markets. Under the Australian system, for example, each provider's performance is assessed every six months. Subsequently, business is relocated from the poorly performing providers to the better ones. Contract extensions are also based on performance.³³

As in Australia, a star rating system will be introduced in the UK. Performance will account for 70% of the star rating, quality of provision for 20% and compliance and contractor issues for 10%.³⁴ The performance part of the rating is derived by comparing the number of job outcomes achieved by a contractor against the target number set out in their bid. Performance against one's own target is then compared to other contractors' performance against target. Consequently, if adverse labour market conditions across the country mean that the target outcomes turn out to be over-optimistic, a contractor's performance measure does not suffer unless it underperforms on its target by even more than its competitors underperform on theirs.

It is hoped that this kind of performance measurement, by comparing contractors' relative performance, will create 'yardstick'

32 May Lam, *Performance measures for welfare-to-work programmes: the relevance of the Australian star ratings to the UK* (London: WorkDirections, 2007).

33 Alison Durbin, "Creating and managing an employment services market." Paper presented at the International Conference of the Austrian Presidency of the Council of the European Union "Innovations in Labour Market Policies: Challenges in Times of Globalisation," Vienna, Austria, 16–17 February 2006.

34 DWP, *DWP contracted employment provision star rating*, explanatory note.

competition across the different operating areas, preventing parking by encouraging contractors to work hard to achieve more job outcomes. However, comparison of providers will be difficult and may lack credibility for three reasons outlined in Chapter 1:

- 1 It will be hard for contractors to know, before FND begins, what level of outcomes will be realistic, making the targets, against which they will be measured, something of a shot in the dark. This means that a contractor could be performing better than others but, because its bid turned out to be over-optimistic, the firm is penalised.
- 2 Macroeconomic conditions are likely to treat different labour markets differently and unpredictably, making relative performance against target an unfair method of comparison. This is particularly likely to be the case over the seven-year lifetime of a contract, when regional labour market fluctuations can vary substantially.
- 3 Finally, in FND contract areas with two providers, customer choice will have an impact on the extent to which contractors' performance is comparable. One provider may attract more customers who are closer to the labour market already, which means that this provider will outperform competitors with more disadvantaged jobseekers in their caseload.

The threat of not having one's contract extended to the full seven years or renewed thereafter is key to DWP's ability to drive performance. But apart from lacking credibility for the above reasons, the limited sanctions available to DWP for poor performance make such an approach a very blunt method of performance management. Contracts will only be renewed every five to seven years; since 80% of contracts are to remain with a "stable core of reliable providers,"³⁵ as

35 DWP, *In work, better off: next steps to full employment* 10.

DWP has decided, the 'stick' of re-contracting will not be effective in reducing parking, since the threat to remove contracts will be heavily circumscribed. This approach will therefore act only to put a floor on very poor performance, not to reward excellent contractors. Rather, excellent contractors will, perversely, be rewarded with reduced margins as they get the more costly clients into work.

None of this is to suggest that the market stability desired by DWP is unnecessary: evidence from the Australian contracting round of 2003 shows that regular changes of contract can have a very damaging impact on performance.³⁶ What it shows, however, is that there are serious limitations to such top-down performance management when used as a tool for driving high-quality performance. Taking the focus off the payment structure and requiring performance management to do the heavy lifting is, therefore, unwise.

The nature of the welfare-to-work market lends itself to having only very few prime contractors, stability, and possibly only limited customer choice. Many of the mechanisms for improving performance in other markets are consequently very restricted in this case. This makes the internal incentives faced by the firm – the outcome payments associated with different clients, and minimum service requirements – all the more important if parking is to be prevented.

Individual Action Plans

Given the difficulties associated with either instituting effective competition or artificially managing the market through performance management, internal incentives and requirements take on greater importance in making FND work for those hardest to help. Once a client has moved onto FND after one year of unemployment, the contractor will be required to draw up an

36 Lam, *Performance measures for welfare-to-work programmes*, 21.

Action Plan of interventions tailored to the individual needs of the jobseeker. By binding both the jobseeker and the service provider to an agreed Action Plan, it is hoped that the parking of more difficult clients can be avoided.

Given that a key innovation in FND is the shift from process- to outcome-focused commissioning, Action Plans form one of just a few process-focused jobseeker measures. In this otherwise black box process, providers have to agree on these Action Plans with each individual.³⁷ Theoretically, if one of the parties does not stick to it, this will result in an “appropriate sanction.”³⁸ By monitoring the relationship between the provider and the individual using Action Plans, DWP hopes that their existence will mitigate parking.

Similarly, providers have the power to sanction jobseekers who do not comply with the Action Plan or other requirements: they can use mandatory work experience to enforce cooperation on the Plan. In addition, every jobseeker will be required to undertake at least four weeks of work experience by the time they finish Stage 4.³⁹

By prescribing a certain level of intervention, Action Plans induce providers to spend a certain amount of time and money on each individual. The pre-commitment of those resources acts as an incentive for the provider to get the client into work to recoup those costs through the outcome payment. Parking individuals therefore comes at the price of the Action Plan, which therefore can be seen as something like a fine on parking.

A problem, however, is the involvement of the provider in setting the plan up. Without onerous regulation, contractors

37 DWP, *In work, better off*, 89.

38 *Ibid.*, 49.

39 DWP, *No on written off*, 13.

will have incentives to develop either very basic, or unspecific, plans in order to give themselves some flexibility in provision. In a system with limited resources, such an outcome is inevitable. That flexibility means that in many cases this 'fine' might be too low effectively to deter parking. If the services agreed to under the Action Plan are significantly less costly than helping the jobseeker in question into work, parking still pays. For the Action Plan to have clout, DWP would have to prescribe a minimal level of intervention which was relatively high; it would also need close monitoring and enforcement. But in reducing contractor flexibility, such a system would impose a high administrative burden on both the provider and DWP, and would threaten the outcome-based approach that gives the FND approach such potential. Furthermore, Action Plans are only necessary if there is a danger that providers will not otherwise do what is necessary to help a client into work. Their existence is, in other words, evidence that the financial incentives for providers are not appropriate to making FND work for everyone.

Box 3.1: More job outcomes – but growing regulation in Australia

The Active Participation Model in Australia had a significant net impact on employment outcomes. It includes programmes such as Job Search Training (achieved a net impact of 11.2%), Customised Assistance (10.1%), Work for the Dole (7.3%) and Mutual Obligation (8.2%).^a

All four of these programmes, however, are process-focused measures: in each case the Department of Employment and Workplace Relations bought a specific service, rather than paying for a job outcome. This focus on processes introduces more bureaucracy and hinders innovation. In consequence, this increasing amount of direction from the Department, coupled with decreasing competition in the market, led to a situation in which the original objectives of commissioning became obscured.

Peter Saunders has noted that: “As things have turned out, increasing central control has curtailed flexibility and has to some extent reproduced the old top-down system of bureaucratic management.”^b While it is clear that the market for employment services needs to be kept in place by an adequate framework, it is an important lesson not to impose excessive regulation which threatens the original objectives of contracting out, and is likely to reduce the net impact in the long run. The recent discussion paper looking at future reforms of the Job Network can be read in that spirit: it criticises parking and recognises that there is room to reduce the administrative burden on providers.^c

- a For details on these programmes, look at: Department of Employment and Workplace Relations, *Customised assistance, job search training, work for the dole and mutual obligation – a net impact study* (Canberra: Department of Employment and Workplace Relations, 2006).
- b Peter Saunders, “The experience of contracting out employment services in Australia,” in Peter Lilley and Oliver Marc Hartwich, eds, *Paying for success: how to make contracting out work in employment services* (London: Policy Exchange, 2008), 32.
- c Department of Education, Employment and Workplace Relations, *The future of employment services in Australia: a discussion paper* (Canberra: DEEWR, 2008).

Fines

A less process-focused means of deterring parking than imposing Action Plans would involve using an explicit fine on the prime contractor when a jobseeker leaves the provider after 12 months without having found a job. This is not, however, intended to introduce a further risk to contractors by taking money away from them. Rather, a fine system should be combined with higher service payments than those currently planned. The net effect of a fine and a higher service charge would be that contractors hitting their job outcome targets would be no worse off than under the current proposal. Underperforming contractors would be penalised and higher achievers rewarded with more money, sharpening the risk-reward trade-off that is essential to FND success.

Recommendation 2

The Flexible New Deal should offer higher service payments to prime contractors, combined with fines for failure to place a jobseeker in employment by the 12-month point. This would be a cost-neutral change for DWP and contractors, while sharpening risk and reward for the latter.

Implicit fines have already been used in Employment Zones. Under this programme, contractors were paid 21 weeks' JSA money, but where they were not able to help someone into work, they had to pay a full 26 weeks of JSA to the client. Failure to place a client therefore left contractors with a loss. When providers placed a jobseeker in a job more quickly, they could keep the saved JSA money. The time-relation of this fine might lead to perverse incentives in that the time pressure leads to poorer quality for the more disadvantaged. However, as has been pointed out by providers, the system created a momentum at the beginning of the relationship between the client and the provider.⁴⁰

While Action Plans might be considered best practice and inform the customer feedback as part of performance management, there should be no need for DWP to *require* such processes. Instead of making contractors jump through process hoops by imposing increasing amounts of process regulation (see Box 3.1 on the Australian case), it would be better to set a fine, which would create disincentives to park, while at the same time leaving the market the flexibility it needs to deliver.

Ultimately, for the reasons described above, the re-contracting process and Action Plans are far from sufficient to prevent parking under a flat fee payment structure. The underlying financial

40 Interview with Employment Service Provider, July 2008.

incentives in the proposed system are such that policymakers will feel the need to increase the amount of regulation built into the system, as happened in Australia (see Box 3.1), to tackle parking. This approach would involve DWP writing increasingly refined and intricate contracts in the hope that, at some point, the contract will capture all eventualities and be 'complete'. A complete contract would solve the problem of non-aligned interests between contractor and government because it would leave no room for discretion or interpretation for either party.⁴¹ However, such an approach would almost certainly fail to micromanage the market successfully and would confound the black box principle behind FND. Cream-skimming and parking are very hard to observe and so it would be difficult to monitor and enforce a contract which would prohibit these things explicitly. Complete contracts and effective regulation are therefore not a realistic option and further efforts in that direction should not be made.

Rather, DWP can remove the need for regulation and monitoring by aligning the incentives of jobseeker, contractor and government through the outcome payment system. While other, second-best mechanisms of performance management are doomed to failure, if the payment system is correctly designed, the market will do the rest.

VARIABLE OUTCOME PAYMENTS

The basic insight behind FND is that the payment structure can be used to align incentives between contractor and procurer. As discussed above, a problem arises when the payments offered do not reflect the costs incurred in helping a given person into work. An efficient outcome therefore relies upon a better match between the cost incurred by the contractor in helping an individual, and the price paid by the Department.

41 For a formal discussion of commissioning and incomplete contracts, see Oliver Hart, "Incomplete contracts and public ownership: remarks, and an application to public-private partnerships," *The Economic Journal* 113 (2003), 69–76.

Such an approach has not been adopted for Phase 1 of FND because of the difficulty of getting variable pricing right, the complexity it would introduce⁴² and, arguably, a sanguine outlook on the risks associated with a flat-fee structure. In practice, divining the right price for each jobseeker has tended to be the key stumbling block for variable payment structures. A range of approaches has been suggested to identify those jobseekers who need more help.

One approach that is commonly suggested uses the observable characteristics of individuals to determine how much employment support each will need. At one extreme, simple payment differences can be based on one variable, such as the length of prior unemployment. This approach is based on the assumption that the length of unemployment is a good indicator of the service needs of an individual. It provides an incentive to providers to deal with those who have been unemployed for the longest. The problem with this approach, however, is that even if two individuals have been unemployed for a similar period of time, they might still have very different needs. Length of unemployment only explains part of how easy or difficult it is to help a jobseeker into work. Basing outcome payments on length of time unemployed may be an improvement on a flat fee approach. But there remain many other attributes about a person that dictate how difficult they will find it to get work.

An alternative approach is therefore to supplement length of unemployment with other characteristics that tend to be strong predictors of employment chances. This can be used to create a number of different groups on which to base outcome prices. But such a classification approach recreates the flat outcome payment: the same risks of parking remain within each group, particularly where the motivation of clients is easy to determine through the discretion of advisers.

42 Interview with DWP officials, May 2008.

Taking this approach to its logical conclusion, statistical profiling, based on a large number of individual characteristics, can be used to determine the cost of helping a person into work. This is the basis on which the Australian Job Seeker Classification Instrument operates. Without doubt, profiling is an improvement on the flat payment structure suggested at the moment, but opinion is divided over how accurate statistical profiling is.

The doubt stems from two concerns about the approach. First, it may be impossible ever to capture the full range of personal characteristics that determine how much help a person will need to get into work. Second, while the average employment chances of a group may be determined (as shown above), there is substantial uncertainty about the chances for any one individual. This occurs because there is a random element in a search for work, which means that two identical people will not find a job at exactly the same time.

On the first count, some argue that, since profiling fails to take account of the jobseeker's motivation as the single biggest determinant of outcome success, it is misleading.⁴³ For others, profiling offers a much more efficient, fair and consistent way to allocate resources than do uniform outcome payments or employment adviser discretion.⁴⁴

43 Participant at a seminar on the Flexible New Deal held by the Social Market Foundation, 18 June 2008.

44 *Targeting services in the individual consumer strategy: the role of profiling*, DWP Research Report No. 192, by Chris Hasluck (London: HMSO, 2004), ii.

Box 3.2: Lessons from abroad – profiling in other countries

Australia – Job Seeker Classification Instrument (JSCI)^a

To refer jobseekers to an appropriate agency, the JSCI identifies three types of jobseekers: highly disadvantaged jobseekers for early Intensive Support, jobseekers to be referred to literacy and numeracy training and jobseekers who require a Job Capacity Assessment (JCA) identifying specific barriers to employment.

The classification is conducted through a 15-factor model measuring the probability of becoming long-term unemployed after controlling for all other factors which capture demographic, social status, health, ability/attainment and ethnicity characteristics. A threshold value for the sum of weighted points from all factors determines whether a jobseeker will be classified as highly disadvantaged. A specific set of factors identifies those who will be undergoing an additional JCA.

Through the JCA individuals get further categorised as to their specific disadvantages and whether they qualify for more detailed forms of supports or supplementary benefits. When circumstances change, the profile established can be re-evaluated by the Employment Agency to update the individual's JSCI.

The Netherlands – developing the Kansmeter^b

The profiling system of the Netherlands, the Kansmeter, has seen significant changes over recent years. The previous focus on a theoretical position of jobseekers in the labour market (i.e. the distance between jobseeker and the labour market based on qualification, employment history and personal characteristics) has been shifted to concentrating on the capability of jobseekers to search for new employment.

Instead of the four distinct previous groups, only two tracks remain: Stream A with clients who can search for a job, and Stream B with those who cannot. Stream A clients are categorised according to their ability to successfully search and apply for a new job individually. The number of vacancies there are in the relevant sectors of employment for them is also considered. Reassessments of the classification are conducted after three, six and nine months. Stream B clients are assessed with regard to the applicability of re-integrative programmes, or public insurance in combination with personal employment service.

- a Australian Workplace, "Job Seeker Classification Instrument (JSCI)", www.workplace.gov.au/workplace/Programmes/JobNetwork/JobSeekerClassificationInstrumentJSCI.htm; page last modified 23 April 2008.
- b Helmut Rudolph and Regina Konle-Seidl, "Profiling for Better Services" (paper presented at the European Profiling Seminar, Nuremberg, Germany, 12–14 January 2005).

Many have argued that, because of the shortcomings of statistical models, the best 'profiling tool' is in fact the employment support adviser. Because of the subtleties involved, a front-line adviser might be much better positioned to estimate how much support a jobseeker needs. A different approach, therefore, could take advantage of this knowledge and have the adviser do the needs assessment. An important condition for adviser discretion is that it is informed – which can be difficult to achieve, as Box 3.3 shows.

In addition, introducing a payment scheme based on adviser discretion sets major incentives for providers to classify jobseekers as highly disadvantaged to boost the revenues associated with getting them into work. Overall, the very fact that the personal adviser is in a unique position to judge someone's needs creates an information asymmetry with the state that can lead to inconsistencies in treatment and fraud. As Hasluck puts it, adviser discretion can be "open to challenge on the grounds of its subjective and unsystematic nature, leading to possible inconsistency,

inaccuracy, and potential for use to achieve ends other than those in the client's best interest."⁴⁵

Box 3.3: Informing advisor discretion in Australia

In addition to the statistical assessment, Centrelink customer service staff have the discretion to identify whether jobseekers need more personalised support, called Personal Support Programme. This secondary classification is aimed at identifying "disability and/or personal characteristics that severely disadvantage jobseekers."^a

To support the Centrelink staff in taking this decision, the Job Seeker Classification Instrument lists a range of characteristics which can be indicative of possible problems. It lists aspects such as the client's being "too loud", "too quiet", having an "inability to reason" or "unusual dress", and having "inappropriate make-up application". Although the report cautions against interpreting these characteristics in isolation, it is difficult to see how a balanced judgement could be made based on this list.

The attempt to make advisor discretion more objective and better informed therefore led to a situation in which prejudices were strengthened and front-line staff were encouraged to think in terms of barriers to work rather than the abilities of each individual.

a Catherine McDonald, Greg Marston and Amma Buckley, "Risk technology in Australia: the role of the job seeker classification instrument in employment services," *Critical Social Policy* 23:4 (2003), 515.

Graduated payments according to statistical profiling

It is impossible to be exact in classifying individual jobseekers because there is always an element of luck involved in how quickly they find work. The above classification instruments all have their merits, but none of them is sufficient to capture, in advance, the needs of an individual and the costs to the provider in an exact, efficient and fraud-proof way. Ultimately, contractors need the flexibility and the incentives to shift resources around from client to client according to how much assistance each turns out to need, without the unhelpful constraint of each client carrying their own 'price-tag'. To achieve such a payment structure would be to realise the full potential of FND.

To incentivise contractors to allocate resources for the benefit of all jobseekers, they must be confident that, in doing so, they will be appropriately rewarded. Outcome payments can reflect varying costs without a pre-determined price having to be attached to each client. A good way to achieve outcome payments that reflect costs is therefore to offer them in such a way that they increase the further through the caseload the contractor gets. Assuming that the jobseekers with the lowest service needs find their way back to work the quickest, outcome payments start at a relatively low level for the first ones helped into work. The deeper the provider gets into the stock, the more support jobseekers require, as a result of which the associated outcome payments rise.

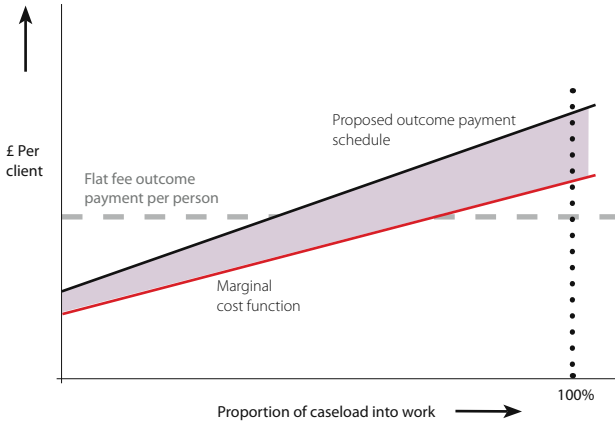
So while getting the first person into work might carry an outcome payment of £1,000, for example, successfully placing the hardest-to-help person might be rewarded with £15,000, justifying the diversion of resources required to help that individual. A similar funding gradient model has been suggested by Mansour and Johnson as the most effective way to align interests between the contractor and the government.⁴⁶

46 Jane Mansour and Richard Johnson, *Buying quality performance: procuring effective employment services* (London: WorkDirections, 2006).

If set at the right level, the marginal payment to the contractor rises in line with, and always exceeds, the marginal cost of helping the next client, so that each client carries a profit. To maximise profit, contractors need to get as far as possible into their client caseload. In order to do this, they have strong incentives to develop the capacity to help all jobseekers simultaneously. This occurs because profit is clearly linked to the quantity of successful job placements rather than also being conditional on the costs associated with those clients.

Figure 3.5 gives a graphical illustration of the relationship between the cost of helping clients and the rising revenue associated with each additional outcome. In contrast to a uniform outcome payment shown in Figure 3.1, marginal revenue here increases in line with marginal cost.

Figure 3.5: Incentives under a graduated payment structure



The appropriate starting level and gradient of the payment schedule could be variables that form part of each would-be contractor's bid during the tendering process. This would allow regional differences in operating cost to be reflected in the bids. However, this approach would make evaluating and comparing bids very difficult.

A better approach might instead be for DWP to set the funding gradient from the outset. In removing price competition from the tendering process entirely, this would avoid the risk of the winner's curse (see Chapter 2) in an environment with so much uncertainty.⁴⁷ It would also ensure that service quality does not suffer unduly, as has been the case in environments where price competition has been central.⁴⁸ Implementing different graduated payments in different areas would enable DWP to discover what works best. It would also determine the market price for supporting the full range of clients into sustained employment – a desire indicated in the recent Green Paper.⁴⁹

Box 3.4: How graduated payments could work in practice

There are two reasonably simple methods by which a graduated payments scheme could be implemented. In the first, DWP could make a minimal outcome payment at the time when the client moves into work. At fixed intervals, the Department would calculate additional top-up payments according to the proportion of a given cohort of jobseekers whom contractors succeeded in getting into work. This mechanism has the disadvantage that rewards for contractors would lag behind the substantial up-front costs they would incur.

To allow more real-time reward, an alternative payment mechanism would involve determining the rate at which a cohort of jobseekers typically finds work. Contractors would then be paid top-ups according to where their outcomes are ahead of the expected trajectory. This would ease any cash-flow problems that providers might face.

47 Serco Institute, *Competition and contracting: learning from past experience*, by Gary L. Sturgess (Hong Kong: Efficiency Unit, 2008), 8.

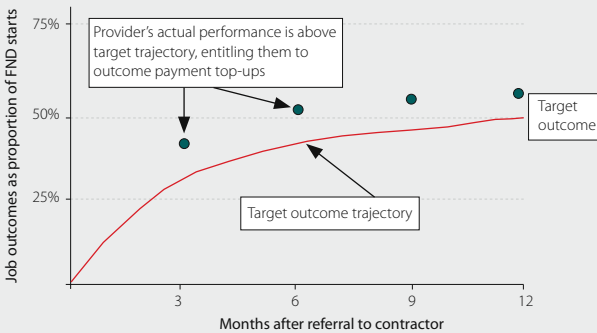
48 Peter Saunders, "The experience of contracting out employment services in Australia," in Peter Lilley and Oliver Marc Hartwich, eds, *Paying for success*, 15–33.

49 DWP, *No one written off*, 74.

For example, in a caseload of 100 jobseekers referred to a provider, in order to be on-target to achieve job outcomes for 50% of clients after 12 months, it might be expected that 10 would have found a job by the end of month one, 8 by the end of month two, 6 by months three, and so on. The typical rate of job entry would be determined from administrative data.

Performance above the expected trajectory – getting 11 people into work in month one, or 9 into work in month two, for example – would put the provider on course to get further into the caseload than anticipated. This would therefore entitle them to a top-up payment.

Figure 3.6: Assessing contractor performance in real-time



Overall, there is a compelling case for graduated payments according to the proportion of jobseekers helped. Instead of DWP using blunt regulatory tools designed to steer service provision in the right direction, graduated payments align government and contractor objectives. A funding gradient according to proportion of caseload helped into work therefore has a number of advantages in reducing cream-skimming and parking:

- it removes the need for process-based regulations;
- it does not rely on any profiling tools;
- it is relatively easy to administer; and
- it offers a much more credible basis for judging relative success between contractors than performance against bid target, as currently proposed.

Recommendation 3

Flexible New Deal should offer prime contractors outcome payments that increase for each additional client they place in employment. This would provide the resources needed to develop the capacity to help all jobseekers, rather than just those closest to the labour market.

CONCLUSION

The analysis of this chapter shows that not only are the long-term unemployed a heterogeneous group, but that some personal characteristics are both observable and strong predictors of job-placement success. Under the proposed uniform payment structure, those furthest from the labour market will inevitably be parked. This will occur because the design of the payment system sets the profit motive of contractors in tension with the aim to help all clients. This need not be the case and its effects are in the interests of neither the jobseeker nor the taxpayer.

The range of proposed regulatory and performance management measures to limit the scope for providers to park clients is unlikely to make much difference. Rather than using second-best regulatory solutions to parking, DWP needs to

focus on using the payment structure to align the incentives of jobseekers, contractors and government. To this end, a system of variable payments that better reflect the costs of helping different people within the caseload is required.

DWP should offer increasing payments per person helped into work as the contractor gets deeper into the client caseload. This would realise the real potential of FND by allowing contractor employment advisers – the people with the best information about what resources are needed where – the flexibility to shift resources to those who turn out to need them most. Meanwhile, contractors' shareholders would be guaranteed to make a profit for helping everyone, where currently they would go bust. Such an approach would provide incentives for the capacity building necessary if FND is to work for everyone.

But aligning the incentives of contractors and government to prevent parking is only one dimension along which the current proposals could be improved. Many people who have been out of work for long periods need in-work support to ensure that they do not fall out of employment soon after having found work. Creating the incentives for providers to prevent such 'revolving door' employment is the focus of the next chapter.

CHAPTER 4: ACHIEVING BETTER JOB RETENTION AND PROGRESSION

Summary

The focus of the Flexible New Deal on payment by results creates strong incentives for contractors to find people jobs. A valuable outcome from a personal, social and financial point of view, however, is not simply a job start, but sustainable employment that minimises the person's chances of returning to welfare.

Evidence for the experience of Employment Zones, the prototype for FND, suggests that clients typically found lower-quality jobs than comparable people on the main New Deal programmes. It seems likely that this was a factor in the findings that Employment Zone job retention after 10 months was no better than for comparable New Deal participants. In offering contractors 26-week sustained employment payments, FND goes further than any previous programme in encouraging them to find good job matches for their clients and provide in-work support. However, it does not go far enough for the Department to get real value for money.

The analysis of this chapter suggests that the rate at which new job-starters leave employment remains high, even after they have sustained work for 26 weeks. Much longer retention bonuses are therefore needed for contractors, so that they can support clients in work for a full 12 months.

Current contract values should be increased, using the identifiable additional benefit savings, to fund substantial bonus payments for each 12-month sustained employment outcome in excess of the normal retention level.

From the perspective of both the long-term jobseeker and the taxpayer, what really counts is not simply a job start, but sustainable employment. FND represents a significant improvement even on Employment Zones, where contractors were rewarded for achieving job retention at 13 weeks, but no more. Under the incoming programme, 30% of the contract value will be tied to achieving sustained employment to 26 weeks.⁵⁰ This chapter looks at whether this will be sufficient for FND to achieve its aim of producing longer-term sustainable job outcomes for clients.

RETENTION AND PROGRESSION

Paying providers according to the number of jobseekers they help into work sets strong incentives to find jobs for people. But a valuable outcome from a personal, social and financial point of view is not simply a job start, which may end in unemployment shortly afterwards. From the taxpayer's perspective, sustainable employment that minimises the person's chances of returning to welfare is desirable. In addition, Lisa Harker identifies sustained employment as a key element in the strategy towards the eradication of child poverty.⁵¹ Staying in work is thus not only important for the current generation, but also for future ones. Preferably, work should also be fulfilling and offer opportunities for progression. Sustainable employment is a good indicator of job satisfaction in this regard. For these reasons, a successful welfare-to-work outcome has more dimension to it than simply job starts.

Evaluation of their performance by Hales et al. shows that EZs were more successful in achieving full-time job starts than were New Deal comparison areas. However, there was also strong evidence that job quality and job satisfaction were worse in EZs. Among those jobseekers who attended EZs, 17% were dissatisfied

50 DWP, *Phase 1 – flexible New Deal provision specification and supporting information*, 23.

51 DWP, *Delivering on Child Poverty: what would it take?*, by Lisa Harker (London: HMSO, 2006), 8.

with their job, compared with only 7% of comparable people who went through the main programme; 49% were paid less than £4.60 per hour compared to 38% under the New Deal; and 52% of the jobs were in the lowest occupational groups, versus 39% of similar clients passing through New Deal.⁵²

This picture of poorer-quality job outcomes was reflected in the retention figures for EZs, which were ultimately no better, after 7–10 months, than those for New Deal participants. Indeed, the authors conclude: “Neither of the programmes seemed to have had an appreciable longer-term impact in raising the chances of their participants experiencing sustained periods of paid work.”⁵³

Under FND, contractors will have both 13- and 26-week outcome targets. While this is an improvement on the EZ incentive structure, providers’ focus will remain on short-term outcomes. There is no financial incentive for contractors to focus on sustaining outcomes beyond the 26-week point, and the lion’s share of the financial reward is weighted to the 13-week point.⁵⁴ Despite the incentives, many contractors aim to find their clients sustainable work, but the structure of FND payments provides them with few resources to support that aspiration.

Currently, most long-term unemployed people who do find work sustain it for only a few months. Data from the LFS suggests that, in recent years, of the long-term unemployed people who find a job, 80% are still in work between three and six months later. However, 9–12 months after starting a new job only about

52 John Hales et al., *Evaluation of Employment Zones. Report on a cohort survey of long-term unemployed people in the zones and a matched set of comparison areas* (London: National Centre for Social Research, 2003), 92–100.

53 Ibid.

54 DWP, Phase 1 – *flexible New Deal provision specification and supporting information*; 20% of the contract value is paid to contractors as a service fee, with 50% paid on the achievement of an employment outcome sustained for three months, and the remaining 30% tied to an outcome sustained for six months.

half remain employed.⁵⁵ Crucially, this suggests that providing incentives for contractors to support people in work up to 26 weeks is only half the battle. Thereafter, significant numbers fall out of work again before the 52-week point.

With such a high proportion of jobseekers stuck in ‘revolving door’ employment, alternating between transient work and benefits, employers have little to gain by training such people. The unwillingness to invest in employees who they think may not remain for long makes the work less fulfilling and lowers the employees’ chances of progression. This further loosens their commitment to employment. For long-term unemployed people, making a failed move into employment may make it even harder to find work in the future.

With many jobseekers and employers stuck in this trap, the welfare-to-work system has a crucial role in breaking the cycle and promoting sustainable employment. By committing to fund sustained employment, therefore, the government can achieve a much higher return on its welfare-to-work investment. Evidence from the Employment Retention and Advancement (ERA) pilot programme shows that where support was offered to employees to stay in work, they were more likely to work full-time and to advance in their jobs than clients who did not receive that support. Examining the impact of the programme on participants in the New Deal for Lone Parents showed that the ERA group on average earned 29% more after 12 months in employment than they would have done without the programme.⁵⁶

55 Labour Force Survey and authors’ calculations.

56 DWP, *Implementation and first year impacts of the UK Employment Retention and Advancement (ERA) demonstration*, Research Report 421, by Alan Marsh et al. (Leeds: HMSO, 2007), 7.

ACHIEVING HIGHER QUALITY OUTCOMES AND SUSTAINABLE JOBS

A common argument in welfare-to-work has been about whether the focus of spending to achieve sustainable employment should be on 'work first' or 'skills first'. Advocates of 'work first' argue that firm-specific human capital is crucial to an employee's chances of success and progression. The 'skills first' approach, by contrast, emphasises the connection between low-quality jobs and revolving door employment. On this view, only by providing people with appropriate skills will they be able to find fulfilling and therefore sustainable employment.⁵⁷ The focus has often been on which of these two horses the state should back.

FND offers an exciting opportunity to find out what works for different people and different jobs. But it can only do so if the right incentives are in place. Once the focus has changed from helping someone into work to helping someone into sustainable work, through longer-term outcome payments, the antagonism between work first and skills first becomes less stark⁵⁸ and purely empirical. The black box process ensures that the providers assess which route will be best for each individual: supporting them in the informal learning process of being in work, and enhancing it with formal training where necessary.

FUNDING LONGER-TERM RETENTION

The simple, effective and direct option of achieving sustainable employment would be to make additional payments to providers after 12 months of job retention. This approach has the advantage that it is relatively easy to administer and leaves it up to the provider to work out how job retention is best achieved for different people and

57 For a very brief summary of this debate, see Michal Myck, "How the New Deal works," *Fiscal Policy*, for *Economic Review* 19:3 (2002).

58 See, for example, Department for Work and Pensions and Department for Innovation, *Universities and skills, work skills* (London: HMSO, 2008).

different employers. Not putting longer-term outcome payments in place threatens the success of FND by missing an open-goal opportunity to shift the focus in welfare-to-work to what really counts: sustained employment. Crucially, this report does not recommend that resources be shifted from the current payment structure. Those resources, and more, will be needed to ensure that all clients can be helped. Rather, the current contract values should be increased, using the identifiable additional benefit savings. This money would fund substantial bonus payments for each 12-month sustained employment outcome in excess of the normal retention level.

The idea of using savings in the benefit spending that would have been necessary (had the individual not found or sustained employment) to fund the employment programmes, has been outlined in the Freud Report and by professional groups such as ERSA.⁵⁹ As the recent welfare-to-work Green Paper announced, this funding model will be piloted in five areas of the UK for long-term claimants of Incapacity Benefit from 2010.⁶⁰ These pilots should be extended to include some long-term JSA claimants. In the past, the difficulty with adopting this approach has been proving that the up-front investment in expensive employment services does in fact save future benefit expenditure as claimed. In other words, it is difficult to measure the counterfactual: how many of the provider's clients would not have sustained employment for a year without the extra support, and how much is this worth to the exchequer? Calculating the value of that 'additionality' for different groups of jobseekers has always been problematic.

In his report,⁶¹ David Freud suggested using the rate at which jobseekers move back into work as the basis for calculating the savings a provider makes by increasing that off-flow rate.⁶² It would

59 ERSA *Response to Freud Report* (London: ERSA, 2007), 3.

60 DWP, *No one written off*, 74

61 DWP, *Reducing dependency, increasing opportunity*, 70.

62 *Ibid.*

be wrong to assume that, once in work, all clients then remain there indefinitely, as the earlier LFS figures suggested. Consequently, it cannot be assumed that an extra person for whom work is found will save the taxpayer even one year's benefit expenditure. To calculate savings, the necessary extra information is, therefore, whether and for how long the people moved into work remain there compared to what otherwise would have been the case. The Freud Report used evidence on lone-parent return-to-benefit rates to answer this question. But such rates vary substantially between different client groups.⁶³ Benchmark return-to-benefit rates for different client groups should be easy to obtain from administrative benefit data.

In the absence of administrative data, the longitudinal LFS, which interviews respondents five times, at three-month intervals, over the course of a year, gives an idea of the current return-to-benefit rates for the long-term unemployed clients of FND. Box 4.1 shows how this data can be used to calculate the proportion of clients who currently sustain employment for 12 months, and put an approximate value on each additional client sustaining for that long.

Recommendation 4

Providers should receive a bonus payment for every additional job retained for twelve months, which could be financed through the additional benefit savings made. This payment structure should be piloted as part of the trials announced in the recent Green Paper, *No one written off*.

63 For example, the Freud Report shows that for lone parents who find work, 74% remain off benefits one year later, while LFS data suggests that for long-term unemployed people that figure is between one third and one half.

Additionality calculated in this way does not take account of how easy it will be for providers to attain or exceed the norm at different points in the business cycle. Calculating bonus payments by performance against the norm does not safeguard the Department against windfall profits for providers in an economic upswing, when placing and retaining people in work should be easier. But nor does it cushion providers in a downturn, where job retention may become more difficult to achieve. Over the cycle, however, these fluctuations should even out.

Box 4.1: Bonus payments of £3,200 per additional job sustained

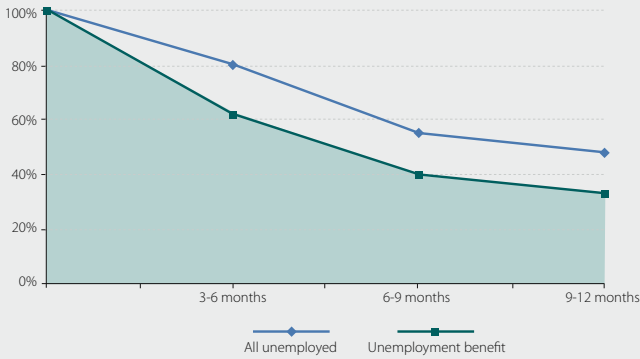
One year of unemployment for a single, childless person, aged 25 or over and living in local authority housing, typically costs the state around £6,300 in benefits, including JSA, Council Tax Benefit, and Housing Benefit.^a

Currently, as shown in Figure 4.1, 48% of the caseload of long-term unemployed people (one year and over) remain in employment for at least 12 months once they find work. Around half of those who leave work within a year of starting have done so by month six, which means that the Treasury saves around £3,250 (half a year's benefits), on average, for each additional person sustaining a job.^b This saving could then be the basis for a bonus payment to providers for every extra jobseeker they manage to sustain in work to 12 months beyond the 48% who would have done so anyway. Government revenues benefit from positive net tax payments from each person while in work for longer, and the reduced chance that a person sustaining work to 12 months will move back onto benefits in the following years.

a Based on 2008–9 single person JSA of £59.15 per week, HB for rent of £50 per week and CTB for Council Tax of £12 per week.

b This ignores tax and tax credits, which for a full-time single childless person on the minimum wage would generate a net contribution to the exchequer. This also assumes that the person has no Housing Benefit entitlement once in work.

Chart 4.1 Proportion of long-term unemployed sustaining employment



Source: Labour Force Survey 2004-07

CONCLUSION

The achievement of sustainable employment outcomes that minimise a person's chances of returning to welfare would represent success for FND from a personal, social and financial point of view. However, past experience shows that providing incentives for 13-week sustained employment was insufficient to have a significant impact on the chances of achieving longer-term sustained employment for jobseekers. While FND, in offering contractors 26-week sustained employment payments, goes further than any previous programme, it does not go far enough for the Department to get real value for money.

Analysis of the Labour Force Survey also suggests that the rate at which new job-starters leave employment remains high, even after they have sustained work for 26 weeks. This points to the need for much longer retention bonuses for contractors so that they can support clients in work for a full 12 months. This can be achieved by increasing current contract values, using the identifiable additional

benefit savings, to fund substantial bonus payments for each 12-month sustained employment outcome in excess of the normal retention level. This approach should form part of the new funding mechanism pilots, announced in the recent Green Paper.

Chapters 3 and 4 have dealt with ways in which DWP could better align the interests of providers with better value for money from the system overall by helping as many jobseekers as possible and achieving sustainable outcomes. Chapter 5 turns to the employment service supply chain and considers the implications of the relationship between prime and subcontractors for the innovation and effectiveness of delivery.

CHAPTER 5: GETTING THE BEST OUT OF THE SUPPLY CHAIN

Summary

Prime contractors' relationships with smaller specialist providers and organisations with good connections to the local community offer scope for flexibility and innovation where those relationships work well. The role of prime contractors, as coordinators of disparate services, offers significant economies of scale. This means that it is important that they have sufficient influence to perform that coordination role and are large enough to limit costs.

But this market structure for the Flexible New Deal (FND) creates pervasive market failures in the relationship between prime contractor and specialist provider – an imbalance of market power and asymmetric information. These market failures mean that it cannot simply be assumed that the structure will work well either for jobseekers or for the taxpayer.

The proposed measures to deal with these problems are too weak. A government policy largely characterised by benign neglect towards the subcontracting relationships poses a serious threat to the success of FND.

The monopsonistic market structure gives prime contractors excessive power to drive down the prices paid to subcontractors, which threatens to limit contractors' flexibility and scope for innovation, with consequences for FND delivery. This relationship should be monitored by an independent body with the credibility to threaten meaningful sanctions against parties that do not act in the spirit of the Code of Conduct.

Under FND, there is a problem of asymmetric information about jobseekers between prime and subcontractors. This is

compounded by unregulated relationships that allow the former to transfer the financial risk for job outcomes onto the latter. This dynamic threatens the involvement of specialist providers in FND delivery. The problem could be resolved if the Department were to require that prime contractors offer a significant non-outcome-contingent component of their fee to subcontractors. Such an intervention is necessary if the interests of the parties in the supply chain are to be aligned, so that prime contractors do not have an incentive to park clients by subcontracting them. Unless risk-sharing is enforced in this way, subcontractors will inevitably become marginalised, and primes will increasingly try to deliver less specialised interventions in-house rather than drawing on specialist knowledge to help all jobseekers.

Under the Australian Job Network, employment service contractors, as employment specialists, undertake most of the client-facing work themselves. Under the Flexible New Deal, by contrast, DWP will interpose a layer of large prime contractor firms to manage a supply chain of subcontractors, rather than work with clients themselves. The vision behind FND is therefore not simply that employment services will be commissioned, but that the whole commissioning function itself will also be put out to tender. DWP hopes that this will increase diversity and innovation from contractors and allow for very tailored client support, both of which are difficult for the state to deliver. Combined with outcome payments for prime contractors, this model will drive prime contractors to be discerning consumers of the services provided by subcontractors.

As described in Chapter 1, a jobseeker is referred to a prime contractor after 12 months of unemployment. At that stage, the contractor is required to undertake an assessment of the client in order to develop a tailored action plan of interventions. Having

determined the client's needs, the prime contractor will then determine the organisations whose services they will require to help the client into employment. Primes are paid a regular monthly service fee as well as an outcome fee contingent on finding employment for each client.

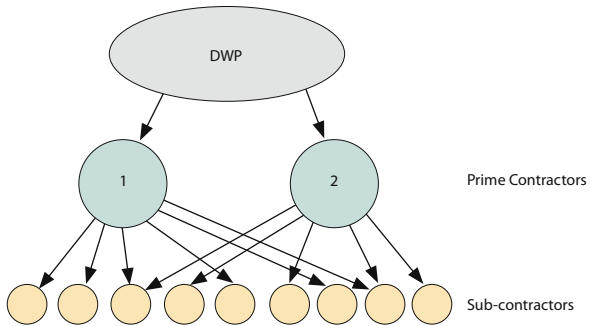
As stressed earlier, the defining characteristic of FND is that there is no prescribed process for getting jobseekers into employment. In the same spirit, the subcontractual relationships between primes and specialist providers will largely be left to look after themselves. The position of the subcontracting organisations relative to the prime contractors is the focus of this chapter. In dealing with prime contractors, the government cannot ignore their interaction with other providers. Avoiding market failures will be central to encouraging innovation and a diversity of approaches to helping clients into employment.

A CONCENTRATION OF MARKET POWER WITH PRIME PROVIDERS

Chapter 1 detailed the reasons why FND was designed around a single or dual-contractor market structure for prime contractors operating in each region. The most important of these is the existence of significant economies of scale in the role prime contractors are expected to play. Prime contractors will be expected to coordinate complex interventions for different clients from a large number of specialised subcontractors. Having established such a supply chain, the cost to the prime contractor of helping extra individuals falls as volume increases. This means that having only one or two prime contractors in each area carries substantial cost and coordination advantages for DWP. In this regard, the market for services for the long-term unemployed, as envisaged under FND, starts to look something like a natural monopoly: it is characterised by high-fixed costs and lower marginal costs, such that one firm may be able to produce the necessary output at lower social cost than many

firms.⁶⁴ A diagrammatic representation of how the market might look in a dual-contractor area is shown in Figure 5.1.

Figure 5.1. FND market structure in a dual-contractor area



Despite the clear attractions of a regional monopsony, the decision over how to structure the prime contractor tier involves a trade-off with the costs of such a contracting model. For example, having only one contractor withdraws the possibility of using customer choice as a means to drive better performance from contractors. For this reason, a monopsony without careful regulation runs the risk of unnecessarily high prices and profits for contractors.

The lack of a local comparable operator also makes relative measurement of prime contractors' performance more difficult, since no two contractors operate with the same population or in the same labour market. As a result, performance management must instead rely on some form of yardstick competition. Provider performance is compared across different regions, taking account of the different challenges involved in working in each part of the country.

64 A technical difference is that in a natural monopoly there is only one seller of a product, whereas in this market structure, the service buyer – the prime contractor – is the party with the power to drive down the price paid to subcontractors. This is known as a monopsony.

For all these reasons, the concentrated prime contractor structure places more weight on the re-tendering process to keep contractors' power in check. But this may lack the credibility to be effective in markets where stability of provision is important for performance. Indeed, the Australian experiment of shaking up Job Network provision, to keep providers on their toes, came at the cost of a noticeable drop in performance during the transition to the new contract in 2003.⁶⁵

Given the scale of the coordination task, DWP is surely right to concentrate market power in the hands of one or two large contractors per region. That the market structure is broadly correct, however, is not to say that it does not pose significant risks to the delivery of FND. It carries important implications for the rest of the employment service supply chain.

A key observation of welfare economics is that in competitive markets firms seeking to maximise profits will, in doing so, act also in the interests of consumers (in this case, jobseekers and DWP, and therefore, by proxy, the taxpayer). Once the assumption of perfect competition is withdrawn, however, the firm's profit-maximising strategy is no longer aligned with consumers' interests. Due to the concentration of market power in the hands of prime contractors, these are conditions that will exist, by design, in the relationship between the prime and subcontractors. As a result, serious consideration must be given to the consequences of having only one or two prime contractors purchasing the services of subcontractors in any one area, and what can be done to ameliorate those consequences.

In any market where such monopsonistic power exists, the outcome will not, left to its own devices, be optimal for the consumer. In the case of FND, the imbalance is something that has

65 Lam, *Performance measures for welfare-to-work programmes*, 21.

raised questions from other independent research organisations.⁶⁶ Furthermore, the nature of FND means that the problem is compounded by the unique composition of the subcontracting sector with which prime contractors can expect to deal.

The problems associated with the distribution of market power are exacerbated in cases where the subcontractor is a third sector organisation (TSO). Where subcontractors are private firms, a degree of market power is less of a cause for public policy concern, since private subcontractors will only remain in the market if there remains a profit to be made.

By contrast, the mission-driven nature of TSOs compounds their disadvantage in negotiating contracts. For TSOs, the decision to enter or exit the market is dependent on more than just its financial viability. The fact that the organisation's mission is its reason for being unavoidably weakens the organisation's negotiating position. This gives prime providers scope to drive down the prices they pay without risking the possibility that the subcontractor will exit the market. For these reasons, pressures on TSOs' margins are likely to be a significant feature of the market without effective measures to prevent this from happening.⁶⁷

PROBLEM OF ASYMMETRIC INFORMATION AND CASCADING OF RISK

Imperfect competition, then, is one source of concern for the successful functioning of the new market under FND. However, there is a further cause to doubt that the proposed employment service market is sufficiently competitive to deliver optimal outcomes. Once clients go through the gateway and are passed on to prime contractors, those organisations are required to assess the

66 Simmonds, "Challenges 2009: make or break?" 3–8.

67 Paul A. Grout and Michelle J. Yong, "The role of donated labour and not for profit at the public/private interface," CMPO Working Paper Series No. 03/074 (2003).

needs of an individual and determine appropriate interventions. When those interventions are to be delivered by a third party, the prime contractor has information about the client's likelihood of finding work that may not be available to the subcontractor.

As discussed in Chapter 3, the advantages of using adviser discretion to determine interventions for clients are closely bound up with information asymmetries between the adviser and external organisations. Where payments to subcontractors are based on achievement of job outcomes, this 'information asymmetry' raises the possibility that the procurer of services can increase their profit by passing a jobseeker off as more likely to find work than they actually are.⁶⁸

A fee per outcome might be agreed between prime and subcontractor based on an idea of the kind of clients that will be passed on. There is then a strong incentive for prime providers to help the easier clients for whom in-house help will be cheaper than the outcome fee they will have to pay for sending the client to the subcontractor. Meanwhile, the prime will see it as advantageous to pass on those clients it deems more costly to help than the subcontracting fee they would have to pay.

The subcontractor will consequently face pressure to raise the fees it charges, once the costs it incurs turn out to be higher on average than the payments it receives under the terms of its deal with the prime contractor. As the costs of subcontracting rise, primes become less willing to call upon subcontractors' services. This iterated process leads to a gradual reduction of the subcontractor's market share and gradual take-over of subcontractor activity by the prime. The net effect of this dynamic would be to marginalise specialist providers, with serious consequences for the effectiveness

68 For the seminal article on this problem, see George A. Akerloff, "The market for 'lemons': quality uncertainty and the market mechanism," *The Quarterly Journal of Economics* 84:3 (1970), 488–500.

of FND in reaching those furthest from the labour market. This dynamic is not driven by bad faith on the part of either prime or subcontractor, but by the existence of an information asymmetry in the market.

This incentive for prime providers to help those closest to the labour market and pass on those least likely to find work was a concern expressed in the response to DWP's consultation on the commissioning strategy.⁶⁹ But the problem only arises because incentives between the prime and subcontractor are not aligned. Where the prime contractors can offer subcontractors a purely outcome-based payment, they can pass on the full risk of not attaining a job outcome to the subcontractor. It is this payment structure that encourages primes to exploit information asymmetries.

This cascading of risk from prime to subcontractor is in stark contrast to the payment structure offered to primes by the Department. Under the terms of contracts offered by DWP, 80% of the contract value is outcome-contingent for prime contractors. The remaining 20% of the contract value is provided as a service payment, entirely unrelated to whether or not job outcomes are achieved. The service payment can therefore be seen as a form of insurance for prime providers against the risk that they will be unable to get a given client into work. This payment is made despite the key justifications for using large prime contractors – namely their size, their access to capital and their attendant ability to bear such risks.

In many cases, no such service payment is made to subcontracting specialist providers at present under the outcome-based Pathways to Work programme.⁷⁰ Hence, it seems likely that prime providers

69 DWP, *Commissioning strategy*, 37.

70 Interview with a welfare-to-work provider, June 2008.

will often use their market position to transfer all the risk onto subcontractors under FND. While this may mean that they can focus the resources saved on helping other clients, it is potentially very damaging to the subcontracting organisations. This concern was also raised in ACEVO's Inquiry into Pathways to Work.⁷¹

Box 5.1: Full risk pass-through under Pathways to Work

The outcome-based Pathways to Work programme was launched nationally in April 2008, to help new Incapacity Benefit claimants into employment. The principles on which Pathways operates – privately contracted employment support funded by outcome-based payments – are very similar to those for FND, although the client group is different.

In Pathways, some jobseekers claiming Incapacity Benefit – although a smaller proportion than envisaged – are referred to a specialist providers by the prime contractor operating in the area. Others are assisted by the prime contractor in-house. Payments are made to the subcontractor for each client successfully placed and sustained in employment.

From interviews conducted with organisations represented in both the prime and subcontracting spheres, it appears that, typically, no payment is forthcoming where the subcontractor fails to find work for a client. By contrast, the prime provider receives a service payment in respect of each client referred to it by Jobcentre Plus. Having passed the client on to a subcontractor, the prime contractor often incurs very few ongoing costs for having this person on their books. This payment structure therefore means that the prime provider can make a profit, or at least minimise the loss, even when

71 Mavis McDonald, Mike Shaw and Roy Ayliffe, *Independent inquiry into DWP Pathways to Work contracting* (London: ACEVO, 2007).

attempts to place clients in work fail. The bulk of the cost of failure typically falls on the subcontractor.

The volume of people being passed on to subcontractors adds another element of risk for those providers. Since prime contractors are not obliged to commit to sending a set number of clients to the subcontractor, volumes are unpredictable. While this may be unavoidable, the risks could be mitigated by altering the payment structure for subcontractor's services.

a Based on interviews with both prime and subcontractors, June 2008. The involved organisations asked not to be named.

Such a suboptimal distribution of risk, dictated by the distribution of market power in the supply chain, has far-reaching consequences for jobseekers and subcontractors alike. It is undesirable for three reasons:

- 1 First, smaller organisations, with greater cash-flow problems and limited access to capital, are typically ill-equipped to bear the full financial risk and yet are likely to end up doing so.
- 2 Second, full pass-through of risk to subcontractors is problematic because it greatly reduces incentives for prime providers to work hard at find the best subcontractors for a given client.
- 3 Finally, full risk transfer also creates opportunities for prime contractors to park clients through subcontracting, meanwhile the prime pockets the service fee paid by DWP.

IMPLICATIONS FOR THE FLEXIBLE NEW DEAL

Arguments that the implementation of FND needs to consider the treatment of subcontractors are often interpreted as special

pleading with the aim of excusing poor performance. The focus of this report is squarely on getting the best outcomes for jobseekers and the taxpayer, so it does not attribute any intrinsic benefit to involving subcontractors that would justify special treatment. However, a proper understanding of the FND contracting structure – one that is characterised by concentrations of market power in the hands of those procuring services and asymmetric information – gives cause for concern. These market failures threaten the innovation and effectiveness of the subcontracting sphere and therefore the success of FND.

Ultimately, therefore, the clear information asymmetries in the relationship between the prime and subcontractors threaten the viability and involvement of a subcontracting tier in FND. This therefore poses a significant threat to FND delivery. Without regulation, it would be naive to expect that “risk [will be] fairly assigned across the supply chains in a way that allows the small and specialist providers to play their full part.”⁷²

Meanwhile, the imbalance of market power between the contracting layers poses problems for the independence of subcontractors and the pluralism of the system. Both problems risk damaging the things that make it attractive to involve the subcontracting specialists in the first place. Similar concerns are apparent from the consultation exercise launched by the Green Paper *In work, better off*, published in July 2008. For a system that is intended to “tap the experience and expertise [of] third sector organisations,”⁷³ this would represent a substantial failure. For these reasons it is important that the government thinks carefully about how to prevent such problems occurring.

72 DWP, *Commissioning strategy*, 11.

73 DWP, *In work, better off*, ch. 4 para. 36.

EXISTING PROPOSALS TO MITIGATE THESE PROBLEMS

In partial recognition of some of the dangers described above, DWP has recently focused on what can be done to mitigate them. The Code of Conduct, set out in the Commissioning Strategy, describes best practice in the relationship between prime and subcontractors.⁷⁴ As yet, however, the Code remains vague in its prescriptions and many of the descriptions of good practice will be unmeasurable in practice.

For example, the Code recommends that “funding should be on a basis that is fair to the different organisations involved and reflects relative ability to bear particular risks.”⁷⁵ While the sentiment is clearly sensible, it remains unclear who will arbitrate in cases where one party perceives the contractual relationship to be unfair. While DWP has adopted the role of refereeing the market, its involvement promises to be minimal, and the Commissioning Strategy makes it clear that using the Department as a grievance route is to be no more than an “option of last resort.”⁷⁶ Furthermore, because of the nature of the information asymmetry referred to above, it will be difficult for subcontractors to know that they are getting an ‘unfair’ deal, still less to prove it, making it difficult to blow the whistle on such treatment. Finally, it would be a brave subcontractor that would jeopardise its relationship with a prime contractor by shopping it to the Department for appearing to act in bad faith. This grievance procedure will indeed be an option of last resort, and up to that point too much power will rest with prime contractors.

Where DWP does receive complaints and is required to act on any evidence of uncompetitive behaviour, it is difficult to see how the

74 DWP, *Commissioning strategy*, 31.

75 *Ibid.*, 32.

76 *Ibid.*

Department can credibly threaten to punish the prime contractor. As Dave Simmonds of CESI recently wrote, it is “not clear whether DWP can both be the champion of subcontractors and balance the interests of top-tier contractors.”⁷⁷ With a commitment to working with a “stable core of reliable providers,”⁷⁸ the Department needs to consider its interdependent relationship with prime providers in the longer term and will inevitably err on the side of not rocking the boat. While DWP will no doubt work hard to monitor the market and ensure that drastic abuse of market power is avoided, it needs to be realistic about what can reasonably be achieved given the difficult balancing act already being performed.

KEEPING PRIME CONTRACTORS’ MARKET POWER IN CHECK

The question of how to prevent abuses of market power from occurring under FND is a difficult one. But the clear evidence of substantial market failures means that more must be done to make the market work better by rebalancing power between the contracting tiers, either through regulation or some other mechanism. Far from contradicting the spirit of FND, better stewardship of the market will allow the new regime to get the best out of both prime contractors and providers, to achieve results for jobseekers.

One approach, which DWP has attempted to facilitate, is to encourage smaller providers to submit joint bids to prime contractors as part of a consortium, or Special Purpose Vehicle. The aim would be to rebalance the market power of the prime with increased power for the specialist provider tier. How such a consortium would work in practice and whether it would be able to exercise significant power over the terms of cooperation offered by prime contractors are open to question.

⁷⁷ Simmonds, “Challenges 2009: make or break?,” 6.

⁷⁸ DWP, *Commissioning strategy*, 10.

Such a solution might be in the interests of subcontractors themselves, and may therefore command their support. It is less clear that consortia would be in the interests of jobseekers or the taxpayer. As discussed above, while there is a need for large-volume prime providers with long contracts, that structure necessarily curtails competitive pressures that drive higher quality outcomes in other markets.

Encouraging consortia in the subcontracting layer will further and unnecessarily reduce the competitiveness of the provider market, making it harder for primes to change suppliers where subcontractors do not perform adequately. The prospect of shoring up the position of (possibly underperforming) incumbent organisations by reducing flexibility in the subcontracting market is not one that those concerned with making FND work for jobseekers should welcome. Consequently, the Department should look for other ways in which to make the market work without further constraining the flexibility that will be necessary for innovation and performance improvement.

Increasing transparency would be a less intrusive way of strengthening the bargaining position of subcontractors. This requirement on primes could comprise the terms of the prime contractors' agreements with the Department, as well as the type of clients referred to subcontractors and the payments offered. Such a development would allow subcontractors to understand the financial basis of the contract between primes and the Department. Without such a measure, it will be difficult to achieve the "excellent subcontractual relationships" described in the Commissioning Strategy.⁷⁹ Since prime contractors are already required to report annually to the DWP the amount paid to their subcontractors,⁸⁰ it would be no increased administrative burden to make these publicly available.

79 Ibid.

80 DWP, *Invitation to tender, Instructions for Bidders*, 6.

Recommendation 5

To provide transparency for subcontractors, prime contract specifications, as well as caseload transferred and payments made to subcontractors, should be made publicly available.

However, the structure of the FND market can and should learn from the way other markets with natural monopoly provision are controlled. In the electricity market or the railways, for example, the infrastructure is controlled by a monopolist who sells access to a variety of supply organisations. This relationship is, in all cases, carefully regulated to prevent monopolists from abusing their market position at the expense of providers and customers. The most effective way to ensure the good functioning of the FND market would therefore be to appoint an independent regulator or ombudsman.

In FND, although the responsibility for managing the subcontractors will rest entirely with the prime providers, DWP will, under current proposals, monitor the relationship between the two to some extent, to check that all parties adhere to the Code of Conduct.⁸¹ Given the need for DWP to maintain good relations with prime contractors, however, it is not clear that the Department will be in a position credibly to threaten to deal with contractors that act inappropriately. Where DWP has an incentive to communicate success, an independent body taking on that role would not face such a conflict of interest in announcing problems with the systems or infringements upon it.⁸² By investing an independent actor with the power to censure and fine organisations for concealing

81 Ibid. "The responsibility for managing and monitoring subcontractors' compliance with contractual requirements will rest entirely with the selected Prime Contractor. DWP will however seek evidence throughout the life of the eventual contract that the Prime Contractor is exercising this responsibility effectively and that, where necessary, it agrees continuous improvement plans with its Subcontractors."

82 DWP, *Contracting out welfare to work in the USA: delivery lessons*, by Dan Finn (Leeds: HMSO, 2007), 20.

information or exploiting market power, as the Centre for Economic and Social Inclusion has argued,⁸³ the DWP has the best hope of minimising such behaviour.

One such actor would be an independent ombudsman. An FND ombudsman could deal with grievances put forward by either the prime contractor or, more likely, the subcontractor and assess the case against the Department's Code of Conduct. The advantage of using an ombudsman would be that the role, while independent from that of the service commissioner (DWP), does not entail intensive and onerous monitoring of players in the market. It is therefore a cheap and light-touch option with more credibility, through institutional independence, than the current proposals.

On the other hand, however, using an ombudsman relies on the aggrieved parties identifying and naming problems. This might not be a realistic assumption for the subcontracting sector under the FND. Since subcontractors rely on having clients passed on to them by the prime contractors, making an official complaint about a prime contractor would not be without risks for them. Subcontractors might decide to endure such problems rather than risk losing the prime contractor's business. Furthermore, the pervasiveness of information asymmetries in the relationship between the two parties makes it hard for subcontractors to know whether they are, in fact, getting a raw deal. In consequence, while it would be an improvement to the current proposals, it is not clear whether an ombudsman would be an adequate solution for FND.

An alternative option would be to use an independent regulator in monitoring the relationship between prime and subcontractors. Such a structure would carry greater credibility, lowering the chances that the regulator would ever need to intervene in

83 Simmonds, "Challenges 2009: make or break?", 6.

practice. The drawback to this option would be substantial added bureaucracy, however.

Recommendation 6

To enhance credibility, the power to fine and censure contractors in breach of the Code of Conduct should be devolved to an independent regulator or ombudsman.

Lessons on how best to structure markets from other areas where economies of scale necessitate monopoly provision are therefore instructive. By ensuring clarity and independently monitoring the relationship between the contracting layers in some way, FND can ensure that subcontractors have the independence and flexibility to innovate. This, in turn, would ensure that prime contractors and DWP get the best out of the supply chain.

RISK-SHARING RELATIONSHIPS

While it might work as a solution to the monopsonistic power of prime providers, an ombudsman would find it much more difficult to resolve the problems caused by asymmetric information. Any requirement to monitor the kinds of clients being passed on to specialists would become unworkably bureaucratic. But preventing steady reduction in market share for subcontractors and parking by subcontracting for jobseekers is far from impossible.

As discussed above, only the ability to transfer the full risk of failing to achieve an employment outcome makes it profitable for prime contractors to pass on clients they do not believe will find work. The payment structure offered to primes by the Department, combined with the ability to offer fully outcome-based payments to subcontractors, positively encourages such behaviour.

DWP should reconsider the terms of the subcontractual relationships which are at the root of this problem. Under the outcome-based contracts issued to date, providers have typically found themselves bearing the full financial risk of being unable to deliver an outcome for the client. Where subcontractors bear all the risk, the prime contractors become financially indifferent to whether the customer is found work. This is not the basis for a successful FND market with the interest of jobseekers at heart.

By requiring that primes offer a 'more insured' contract to subcontractors than the one they receive from the Department, it becomes in the prime provider's interest only to use the supply organisations that it anticipates will have a good chance of success. Furthermore, by enforcing risk-sharing, such a requirement would ensure that prime contractors have incentives to get the best performance from subcontractors.

In practice, it would require that prime contractors offer a two-part payment for a subcontractor's services: an outcome payment contingent on finding the client work, and a service fee per client that does not depend on their finding work. This service fee would not be an ongoing, regular payment, thus binding prime contractors to pass a certain number of clients on to a given subcontractor each month. Such an approach would limit prime provider flexibility and be wasteful. Rather, the service fee would accompany each client but not be outcome-contingent. To be effective in aligning incentives, the subcontractor service fee should, in its value, reflect the monthly service fee paid by DWP to prime contractors, in being worth around 20% of the outcome payment value.

Recommendation 7

Prime contractors should be required to offer a two-part payment structure to subcontractors – part outcome-contingent and part paid regardless of job placement success

- so that their payment more closely reflects the structure of the deal between prime contractors and the Department. This would ensure that prime contractors retain a stake in the subcontractor's success and therefore avoids the temptation for primes to park through subcontracting.

Such a payment structure would align incentives because both parties to the deal have a stake in a successful outcome for the client. Aligning contractors' incentives with those of the jobseeker and taxpayer in this way offers the simplest and most effective method of ensuring that asymmetric information problems do not compromise the operation of FND. It is also much simpler to monitor and enforce than any alternative way of limiting the asymmetric information problem, which is, by definition, difficult to observe.

OUTREACH AND THE THIRD SECTOR

Because of the 12-month gateway period, the hardest-to-help jobseekers often do not begin to receive the assistance they need until more than a year after becoming unemployed. In most cases this is unavoidable. Given the very rapid off-flow rate from Jobseeker's Allowance and the difficulty in accurately identifying, on day one, those who will need intensive support on the basis of observable characteristics, such an approach is inevitable if costs are to be contained.

But for some of the most excluded groups of long-term unemployed people, particularly those out of work for the longest, moving through a long-winded gateway process can be an alienating experience. The danger is therefore that, by the time jobseekers get to the specialist providers who can help, they have further disengaged from the labour market. Sensibly,

the system will allow Jobcentre Plus to identify people who can be fast-tracked to specialist support. If it is to be effective, these rules must be flexible and there should be no incentives for Jobcentre Plus advisers to hang on to clients they do not have the resources to be able to help.

One of the most promising features of FND is the emphasis on the need for contractors to have local credibility and strong links with the community in order to be able to use those networks to help find and sustain people in work. There are obvious benefits to using small and specialist organisations at the delivery end of FND. But DWP should go further. Specialist providers, particularly third sector organisations, typically invest in a large amount of outreach work (going out and actively seeking clients) to identify and help people who otherwise would not think of or want to re-join the labour market.

For some of the most disadvantaged, the prospect of being passed around a long and complicated gateway process is a substantial barrier to engagement. The outreach work of specialist organisations represents a promising avenue for helping such people. DWP should explore ways in which these valuable connections can be used to direct help at some of the most excluded people.

Recommendation 8

To make the most of third sector outreach work, the government should consider allowing specialist providers to find and help disengaged individuals directly, rather than requiring them to go through the gateway process. For many of the most vulnerable claimants, such an approach would be alienating, expensive and counter-productive.

CONCLUSION

The economies of scale involved in the coordination role envisaged for prime contractors means that the market lends itself to a few large firms exclusively (or almost exclusively) commissioning the services of smaller specialist providers in each part of the country. But this structure is not without problems. It creates:

- pervasive market failures in the form of monopsony power for prime contractors, resulting from their unique position as buyers of subcontracting services in each area; and
- asymmetric information between primes and subcontractors about the nature of the clients being passed on.

The unbalanced distribution of market power risks constraining subcontractors' independence, and limiting their flexibility and scope for innovation, with consequences for FND delivery. Asymmetric information about jobseekers between prime and subcontractors, together with unregulated relationships that allow the former to transfer the financial risk for job outcomes onto the latter, threaten to marginalise specialist providers in FND delivery.

In the light of these problems, it cannot simply be assumed that the structure will work well either for jobseekers or for the taxpayer. Existing measures to counter these problems, such as the Code of Conduct, are too weak and these dynamics therefore continue to pose a serious threat to the success of FND.

DWP should therefore hand over the role of monitoring the market to an independent body that does not face the same conflicts of interest that the Department would. Such an independent body would then have the credibility to threaten meaningful sanctions against parties that do not act in the spirit of the Code of Conduct.

The problems that result from asymmetric information could be resolved if the Department were to require that prime contractors offer a significant non-outcome-contingent component of their fee to subcontractors. Such an intervention is necessary if the interests of the parties in the supply chain are to be aligned, so that prime contractors do not have an incentive to park clients by subcontracting them.

Finally, while FND promises to make the best of third sector involvement in terms of delivery, the best organisations in the sector have more to offer and DWP should take advantage of this. Where TSOs' outreach work offers the chance to engage people who would never engage with Jobcentre Plus, the new regime should encourage that work by allowing those clients to bypass the gateway stage of FND and be assisted by specialist providers directly.

CHAPTER 6: CONCLUSION

This report set out to examine the Flexible New Deal programme to commission employment services, for the long-term unemployed, on a payment-by-results basis. It has considered how likely the implementation of FND will be to achieve four key aims:

- to commission the services of **reliable and cost-effective** contractors
- to **help all clients** rather than just those easiest to help;
- to support people to **sustain their employment** once in work; and
- to encourage **innovation** and a diversity of approaches to helping clients into employment.

In each area there is cause for concern that FND will not, in practice, be as effective as it could or should be. Chapters 2–5 explain in some detail how FND implementation is likely to jeopardise the above aims. But, beyond the detail, there is a common theme to these shortcomings: a failure to structure elements of FND in a way that aligns incentives between contractors and government.

This failure has led to a growing reliance by DWP, even 13 months before the programme goes live, on process-focused requirements for contractors in their dealings with clients. These regulations are aimed at patching up the symptoms without addressing the underlying causes of the problem – the tension in the relationship between procurer and contractor. Unless these tensions are resolved, it is unlikely that FND will deliver the kind of step-change in performance that the government hopes for. The new programme is therefore in danger of failing to live up to its theoretical potential.

Alignment of contractors' incentives with those of government, through the outcome payment structure, is central to the success of FND. This is the most obvious example of where the implementation of the new programme fails in its intention to harness the power of the market.

The imperative to help all jobseekers rather than just the easiest clients is made much more urgent by the plans announced in the recent Green Paper, *No one written off*. The outline proposals include the piloting of a Community Work Programme. Some will see this 'Stage 5' provision as a form of punishment for unsuccessful jobseekers, while others will consider it a necessary part of helping long-term unemployed to developing a work habit. Either way, introducing such strong conditionality, with presumably limited support to address barriers to work, is much more controversial where some jobseekers have been parked in the FND stage.

It is possible to use the existing FND funding in a smarter way, to achieve more and better outcomes through a graduated payment structure. However, it seems clear that the current level of funding limits the performance improvements that can be made. Since these arbitrary limits are currently unrelated to the ongoing benefit claim costs of unsuccessful jobseekers, they do not offer taxpayers value for money.

The AME-DEL funding model, through which contractors are paid from the benefit savings they make, offers the most promising avenue for achieving more effective and efficient employment services. As the recent Green Paper announced, this funding model will initially be trialled in three regions from 2010, with two further pilot areas to follow. It will be important to use these pilots to test the scope for more effective payment structures for jobseekers as well as Incapacity Benefit claimants. Determining the counterfactual benefit bill for jobseekers' costly employment

programmes will always be difficult, but not trying to do so will ultimately be more expensive.

Finally, the Green Paper's intention to determine the market price for supporting people into sustained employment is to be welcomed. Finding out what it takes to reach those furthest from the labour market is essential if the case is to be made for those resources.

The introduction of FND marks an important and exciting step in the rapid evolution of a distinctive welfare-to-work system in the UK. The challenge for the future is to combine an efficient payment structure with a funding mechanism that reflects the costs of not helping people into work. Achieving this combination is crucial if the next generation of welfare-to-work is to be more effective for jobseekers while, at the same time, costing the taxpayer less.

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