‘An Economic Critique of the Case for Contracting-out Government Funded Human Services’

A Submission to the Productivity Commission Inquiry into Reforms to Human Services

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Contents

1. Introduction

This submission focuses on just 2 elements of the Productivity Commission's Terms of Reference; these are the application of competition to the contracting-out of human services and the difficulties in creating, monitoring and regulating efficient contracts between governments and for-profit or not-for- profit non government entities for the delivery of these services. The study uses the contracting-out of prison services in Western Australia as a case study to demonstrate the theoretical and practical problems of efficient contracting out. Specifically, it draws on the recent reports by the WA Economic Regulation Authority (ERA), an entity similar to the PC in terms of its scope of work and adherence to the neoclassical approach to economic analysis and public policy, which strongly advocated for a extension of the existing limited contracting-out of WA prisons. [1]

By selecting an appropriate economic theory, especially a simplified version of neoclassical analysis, the case for contracting out government funded human services can be readily made. This is due to assumptions regarding perfect information, absence of perverse incentives and complete contracting. It is imperative however, that the PC consider the outcomes of actual contracting out of government services, because in many instances the actual outcomes do not meet the high expectations of proponents. This gap between high expectations and reality is due to fundamental flaws in the original economic case for contracting-out. This is indeed the result in the specific instance of the contracting out of WA prisons.

1.1 Broader context for the PC Inquiry Into Human Services- Neoliberal public policy

The neoliberal approach to public policy has dominated western, and primarily Anglophone, states over the last 3-4 decades. In Australia the key pivot point in public policy was the 1993 Hilmer Report into *National Competition Policy*, which copied the neoliberal public policy template from the UK and established the vast legislative and bureaucratic apparatus in federal and state governments, such as COAG, the ACCC and ERA, for its implementation. All major political parties, with minor variations, subscribe to the neoliberal doctrine.[2] The recent *Federal Competition Policy Review* (Harper Review, 2015) recapitulated the arguments in Hilmer and advocated *inter alia* for extending contracting-out to government funded 'human services'.

The following brief account focuses on three core aspects of neoliberalism and describes how they inform the work of ERA and the PC. These ideas are reducing the role of the state in the

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[1] This submission is based on reports undertaken for the Western Australian Prison Officers' Union (WAPOU) in response to the WA Economic Regulation Authority's (2015) *Inquiry into the Efficiency and Performance of Western Australian Prisons* (*https://www.erawa.com.au/cproot/13841/2/WAPOU%20Submission%20to%20Prisons%20Draft%20Report.pdf*)

[2] Wolfgang Streeck (2015: 75) provides this succinct summary of a few key features of neoliberalism: 'In short, it is the idea, and the corresponding practice, that it is the duty of governments to install, impose and enforce market relations wherever possible. Political intervention in the economy must refrain from redistribution, except from the bottom to the top, to create 'incentives' for growth. The assumption is that people at the top work more if they pay lower taxes on higher incomes, whereas people at the bottom work more if you take away their social security and lower their wages. It also means that public provision should be replaced with private purchases, so people work more. Whereas under Keynesianism economic growth was expected to come from the allocation of spending power to people with low incomes, under today's neo-liberalism...growth is to be the result of income flowing to the already rich.' For a detailed account of the historical development of neoliberalism see Cahill *et al* (2012).

delivery of publicly funded services through means such as privatisation and contracting out; adherence to 'managerialism' and the centrality of financial incentives in driving performance improvement. This section also briefly highlights some of the adverse economic and social outcomes from the adoption of neoliberal policies.

Neoliberalism is a set of economic, political and ethical propositions. The core ideas are based on the pre-Keynesian theory of economic *laissez-faire*, or more formally a very simplified version of neoclassical economics, to provide a rationale or justification for its approach. Neoclassicals view the economy as a self-regulating mechanism in which unfettered competition in production, labour and capital markets is the key to prosperity. This view supports reducing the existing multiple roles of the state in the economy. It supports reducing the share of total state expenditure and tax in the economy; reducing its role in the direct provision of services such as utilities, welfare, education and prisons and supports deregulation of economic activity. Aside from these economic arguments, reducing the role of the state is also supported by neoliberal political analysis of the state. It views the state as irredeemably captured by 'rent seeking' interests in industry and society, including politicians and bureaucrats, who use the taxing and regulatory power of the state for self-serving ends. Neoliberalism also views society as essentially a self-organising organism wherein, following Adam Smith, the pursuit of individual self-interest is transformed into an overall harmony of interests across society.

Central to neoliberal public policy is substantially reducing the 'size of the state' or, where state activities are in the nature of a 'public good', have them subject to competition for their delivery. Public goods are economic activities that are essential for the operation of a modern economy but which, due to factors such as externalities and non-excludability, will not be supplied, or be under-supplied, by a private market. These activities include services like education, defence and law and order. Other services, especially infrastructure provision like electricity, telecommunications, rail and roads are 'natural monopolies' in that generally it is wasteful to duplicate the infrastructure by having competing private providers. Prior to the rise of neoliberalism state provision of infrastructure services was justified to prevent private owners exploiting monopoly pricing power; the state generally has much lower borrowing costs to fund their construction than the private sector and there are often compelling reasons for parts of these services to be subsidised. Examples of the latter are uniform price of stamps for letters to ensure communication for citizens within a country or subsidising passenger rail services to reduce car pollution and accidents.

As noted above public goods must be provided but, according to neoliberal public policy, they need not be supplied by the state directly. There are three neoliberal solutions: corporatisation of public services, whereby the broad objectives of a publicly owned business are reduced to a single goal of maximising return on assets; privatisation and contracting-out of a publicly funded entity.

These solutions rely on the concept of 'competition' and the accompanying benefits of choice and efficiency. Competition is both a means and an end in neoliberal public policy. Neoliberalism strongly endorses the idea that the singular focus of the firm must be maximising of 'shareholder value', or more formally profit maximisation. Competition is argued to promote allocative efficiency (production is optimally organised to meet the needs of consumers) and productive efficiency (marginal revenue from factors equals marginal output of factors). Applied to the WA prison system ERA (2015: 251) suggests 'competition encourages businesses to compete for customers (in this case the Department) and can result in lower prices, better quality, greater choice, and higher levels of innovation'.

The central idea of managerialism is managerial prerogative. John Quiggin (2003) has observed: 'the central doctrine of managerialism is that the differences between such organisations as, for example, a university and a motor-vehicle company, are less important than the similarities, and that the performance of all organisations can be optimised by the application of generic management skills and theory. It follows that the crucial element of institutional reform is the removal of obstacles to 'the right to manage'...The rise of managerialism has gone hand in hand with that of the radical program of market-oriented reforms variously referred to as Thatcherism, economic rationalism and neoliberalism... it is claimed the optimal policy is to design organisations that respond directly to consumer demand, and to operate such institutions using the generic management techniques applicable to corporations of all kind. The main features of managerialist policy are incessant organisational restructuring, sharpening of incentives, and expansion in the number, power and remuneration of senior managers, with a corresponding downgrading of the role of skilled workers, and particularly of professionals'.

To get public and private operators of prisons to conform to the needs of the customer financial incentives and dis-incentives are necessary. 'Central to establishing an efficient prison system is the identification of the incentives that align the interests of the prison operator with those of the State....Incentives are central to a well-designed prison system because, if they are harnessed appropriately, they will maximise the chance that prisons achieve the objectives set out in the performance framework. Incentives can encourage prisons to find more innovative ways to effectively rehabilitate prisoners and reduce costs, ultimately improving performance' (ERA 2014: 49). (The very considerable problems of constructing contracts and incentive systems that do not lead to perverse effects and opportunism on the part of contractors and the cost of monitoring performance are dealt with below).

Based on the actual outcomes of neoliberal policies a different view emerges of the neoliberal public policy agenda. Neoliberal policies do not reduce the role of the state in the economy; rather they change its form. For example, contracting-out publicly funded, but privately delivered services, does not reduce public expenditure, it simply expands the scope for capital (private profit making firms) to enter new spheres of economic activity from which it was previously excluded. Frequently contracting-out public services has led to failure of provision, cost blow-outs causing serious economic and social problems and blurring responsibilities for outcomes between the contractor and contractee. For example, the threat of financial loss or 'abatements' for failure to meet contractual obligations was insufficient incentive for Serco to maintain standards in surgical instrument sterilisation and cleaning functions at Fiona Stanley hospital (ABC June 2015). Similarly, the threat of loss of the WA prison transport contract was insufficient for Serco to meet contractual obligations (The Australian 2015). Other contracted-out activities, such as employment and job seeker services have been 'rorted' tens of millions of dollars by private and not for profit providers (ABC February 2015).One of the most stark examples of the failure of contracting-out has been the waste of hundreds of millions of dollars of public and private money on publicly funded private vocational education and training colleges (Bita 2015; Toner 2014).

Similarly, privatisation does not eliminate the state but shifts its role to that primarily of a regulator of private monopolies or oligopolies. For a range of reasons the outcomes of this regulation are very often, very poor. For example, following privatisation and corporatisation the electricity sector, it became one of the most heavily regulated under National Competition Policy rules. However, because, rather than despite of this regulation, between 2007 and 2012 the weighted average Consumer Price Index for household electricity prices across all capital cities increased by 57%, compared to an overall increase in the CPI of just 14.5%. Average weekly earnings increased by 27.5% over the same period (Chester 2013: 3). The reasons for these bad outcomes include the inability of regulators to know the true costs and profitability of regulated private firms; perverse incentives created by the deeply flawed system for regulating prices, such as the guaranteed return on investment in the electricity network, and the need to provide high returns to encourage both initial sale of the assets and bidding for future privatisations.[3]

[3] In support of its advocacy of greater competition ERA (2015: 237) cites the recent Federal Competition Policy Review (Harper Review) which promoted 'the need for greater competition in the human services sector', like disability services, health and education 'which has traditionally been shielded from competition, to improve performance'. The economics editor for the Fairfax group of newspapers, Ross Gittins wrote, more in weariness than in anger, that ' to frame them [human services] as part of competition policy is an old economists' trick: take an area that has always been outside the market-place and marketise it. Take the world as it is and make it more like the textbook assumes it to be. Apply the economists' two magic answers: getting the incentives right and introducing competition and choice and everything will fix itself without the economist ever needing to come to grips with the causes of the particular inefficiencies that are causing the problem. Brilliant but often disastrous'. He then goes on to cite the multiple failures in contracting-out child care, TAFE, job services, and public funding of private education. 'Think of all the money federal governments have pumped into private schools in the sacred name of choice, without any evidence of this wider competition leading to higher standards of education on either side of the fence' (Ross Gittins 30/11/2015, SMH, p. 28).

2. Problems with competition in the delivery of human services

2.1 Benefits of competition

ERA identifies four benefits from contracting-out and competition in the provision of publicly funded prisons- choice; better quality; innovation and reduced cost. 'Public money is scarce, and the Government is responsible for ensuring that these funds are spent appropriately. The Department cannot be sure that resources are being spent efficiently if it does not consider all available options. It is through robust competition that the Department is able to consider the options that are available to it' (ERA 2015: 250). This section focuses on just two of these claims, that prisons satisfy the conditions necessary for efficient contracting-out to achieve competition between suppliers and that completion promotes innovation in prison services. The issue of quality and cost is dealt with in section 3.

2.2 Transaction cost economics

The argument that contracting-out is the optimal approach to efficiency is, frankly, silly. First there are many ways an organisation can seek to ensure its efficiency, aside from contracting-out its operations. For example, it can identify global best practice organisations that are widely recognised as high performing and seek to emulate their practices. For prisons this would include high performance on security and low recidivism. An organisation can thoroughly evaluate its practices to determine what are producing desired outcomes, what do not, the reasons for this outcome and effect remedial change. Third, it can investigate whether the resourcing for the task it has set itself is adequate.

ERA's argument for contracting-out and competition is founded on a simple and indeed, simplistic, economic theory and *a priori* judgement that competition is an optimal method for resource allocation. The decision by an organisation to contract-out activities and the conditions for optimal contracting have been the subject of intense academic research, a field known as Transaction Cost Economics (TCE). TCE teaches us, and leading orthodox economists have widely accepted that determining how an organisation should allocate its means to achieve its desired ends should be founded on a detailed empirical analysis of costs, risks and potential benefits.

TCE finds that direct administrative guidance is the most appropriate form of governance where the following conditions are met:

- the service or product is a core activity and central to the commercial survival and/or role of the organisation. Under these conditions contracting-out introduces risk both the organisation and to the wider society, if failure to deliver an adequate service, generates negative social externalities. Failure to deliver an adequate quality and quantity of prison services unarguably generates these wider social costs. The significance of activities generating large social costs arising from contracting-out to a private provider is that these costs are not borne by a private contractor. The contractor therefore, has no commercial interest in their mitigation
- the activity is subject to significant uncertainty regarding the volume of services to be delivered and/or its specification demanding therefore flexibility and rapid response to changed circumstances
- it is difficult to precisely identify all inputs, outcomes and their precise costs entering into production of the service making it difficult or impossible to create an efficient contract

- related to this latter problem is information asymmetry between a contractor and contractee. Where a contractee knows more about the contracted service than they declare this can result in exploitation of a contractee, especially when they seek to shift risk from themselves onto the contractee. The same problem can happen in reverse.

These conditions describe the WA prison system. TCE highlights the risk to both contractee and contractor arising from these conditions. ERA just does not engage with the risks associated with contracting out prison operations.[4]

Unfortunately, for ERA a particularly pertinent example of exactly the risks from contracting-out described by TCE is given in the Serco plc *Annual Report 2014-15.* Serco is a large multinational service delivery organisation, prominent in the market for contracted out government services. Serco is the contractee for two prisons in WA. Over the 2014-15 financial year Serco brought losses of £632 pounds to account on revenue of £3.9bn. These realised losses and contingent liabilities not yet brought to book are described as being 'onerous'. The *Annual Report* attributes these losses in part to opportunism/malfeasance on the part of some employees, such as the UK Electronic Prisoner Monitoring Programme which resulted in contract cancellation and large damages payments. More importantly, Serco simply made errors assessing costs and risks before entering into many contracts. The combined effect of realised losses, future anticipated losses, failure to deliver current contracted services and wider 'reputational damage' is to imperil survival of the firm. Confirming a prediction of TCE, the broader social costs of failure to deliver core government services, which Serco describes as its core business, is barely if ever noted in the *Annual Report*. The overwhelming concern is diminished shareholder value.
It is worth quoting the *Annual Report* at some length:

'Our success depends on our ability to write contracts which balance risk and reward and meet the contractual requirements into which we have entered with our customers, which could be through direct delivery of services, through the use of sub-contractors, or through Joint Venture consortium partners. We are subject to risks associated with bidding for and entering into contracts (most of which are multi-year and/or fixed price contracts), including correctly assessing and agreeing pricing terms that provide for a level of return on the contract appropriate to the risks involved, accurately anticipating the costs of strict performance conditions, employee requirements and other obligations, correctly evaluating contractual and operational risks, and the risks of potential early termination or change of scope of contracts by customers...Unclear, ambiguous, misread, misinterpreted contract obligations and expectations of contract performance can result in perceived or actual contract non-compliance and/or poor performance.

We are party to a number of contracts that are multi-year, fixed price, carry strict performance conditions and/or contain volumetric or other risks relating to original bid assumptions that have proven incorrect, and we expect to result in losses, as a result of which we have determined the contracts to be onerous. In the second half of 2014 there were several

[4] ERA (2015: 267-271) devotes several pages to outlining the principles 'of good contract management'. But these are dealt at a very high level of generality, taken as they are from a manual by the Australian National Audit Office (*Developing and Managing Contracts – Better Practice Guide*, Canberra, Government of Australia, 2012). The ANAO describes the purpose of the manual in the Forward. 'The Guide is intended to be a general reference document for senior managers, contract managers and stakeholders who are involved in the development and management of contracts. The Guide does not address specific issues that relate to high-value, complex contracts'. This surely describes contracting-out a prison.

contracts where operational issues and/or discussions with our customers resulted in us substantially revising upwards our estimates of the costs to complete our obligations under such contracts or lowering our revenue expectations. A risk-based independent review of our principal contracts to identify loss-making contracts against a specific scope revealed that we have a number of contracts that have, or are expected to result in, or could result in material loss, which we have determined to be onerous. The costs to complete these contracts outweigh the financial benefit, and they are, therefore loss-making resulting in lower than expected returns and economic damage for which provisions have been made in the accounts, and there is a risk that the losses damage our reputation...It has not been practical to complete a full legal, operational and financial review of every contract, given the scale, complexity and volume of the contracts and the cost and time that this would have taken. No assurance can be given that the onerous provisions that we have recorded will be sufficient to cover the losses ultimately incurred under the contracts for which onerous provisions have been made or that further provisions for such contracts will not be required in the future or that the costs of fulfilling other contracts to which any member of the Serco Group is a party will not exceed the actual or expected economic benefit under such contracts resulting in the need for further onerous provisions for such contracts. Inevitably, the review of contracts was carried out at a specific point in time and with the information available at that time, which may not prove to have been entirely accurate or complete. Further, the review could not cover all possible circumstances on all contracts under which losses could in the future possibly be incurred. Contracts that have not been reviewed may in future become loss-making; and losses on contracts that have been reviewed may turn out to be worse if, for example, the review was based on information which is subsequently superseded or revised in light of any further review work undertaken or circumstances under the contract change. Similarly, we may have over-estimated the provisions taken with respect to one or more of our contracts. The onerous provisions that have been made are management's best judgement at the time of the review. The onerous provisions are subject to change if additional information comes to light in the future. If additional provisions and/or increased costs need to be recognised in the future, this may result in lower returns and economic, reputational and other impacts associated with onerous contracts, which could materially adversely affect our business, financial condition, results of operations and prospects...If the proposed Rights Issue does not proceed and we are unable to obtain further waivers of our financial covenants under our financing agreements, and we are unable to avoid a breach of our financial covenants or cross-defaults through the successful implementation of one or more funding alternatives including proposed disposals, shareholders are at risk of losing all or a substantial amount of their investment in the Group *and the Group is at risk of not being able to continue as a going concern*' (SERCO 2015: 15-16, *italics added*).

2.2.1 Incentives and opportunism

ERA provides an unbalanced analysis of economic incentives and the profit motive as it presents these as producing primarily positive outcomes for prison performance and does not give sufficient weight to the many examples where financial incentives have either promoted opportunism on the part of prison contractors or have been unable to prevent unethical and/or criminal behaviour. ERA deals with these issues at a high level of generality with anaemic statements like 'the performance measure must not encourage perverse behaviour' (ERA 2015: 7). It does not enter into a detailed analysis of the problems of contracting-out prison services and certainly fails to consider even the fundamental question, is this essential public service even suitable for contracting-out?

At its base ERA's argument that contracting-out will lead private providers to deliver efficient, effective and ethical services rests on the positive incentive, the promise of profit, and negative incentives, financial loss for failure to meet performance standards and/or contract termination and possible damage to the contractee's goodwill.[5] For example, 'contracts...establish a range of financial incentives and penalties that can be applied to Serco depending upon its performance. Having the outcomes clearly articulated in contracts, and subject to specific financial incentives and penalties, makes Serco accountable for achieving the outcomes expected by the Department...In addition, Serco is subject to fixed term contracts and knows that, if it does not meet the required standards, its contract will not be renewed. This would not only result in the immediate loss of business, but also affect its reputation and potentially its chances of winning business in other jurisdictions' (ERA 2015: 119).[6]

It s difficult to reconcile this high-minded understanding of contracting with the following four brief examples of contrary behaviour:

- in June 2015 DoCS chose not to renew Serco's prison transport contract for another five years apparently due to a series of high profile escapes (http://www.abc.net.au/news/2015-06-16/wa-prisoner-transport-contract-to-go-to-tender/6550474)
- Serco (2015: 6) records a number of 'traumatic events of 2013' that occurred in the UK, specifically 'overbilling in our [prisoner]Electronic Monitoring contracts and misreporting of data on the Prisoner Escort & Custody Services' (p.6). This resulted in the cancellation of contracts; penalties of around £70m; 'investigation by the Serious Fraud Office' and further potential 'financial penalties and mandatory debarment from prequalifying for future contracts with UK Government entities' (Serco 2015: 17)
- Serco had its contract to run New Zealand's Mt Eden prison cancelled and faces penalties of $1m after a number of severe contractual failures (http://m.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=11558364)[7]
- the possible problems for clarity and transparency that can arise from related party transactions have already been mentioned in relation to the Private Registered Training Organisation ASPAC and Acacia. Another important example is the training of prison guards for Serco's two privately run New Zealand prisons by a Private Registered

[5] It hardly needs commenting but all of these benefits and costs were articulated in the Serco 2014-15 Serco plc Annual Report, though it laments they did not prevent all of the risks of non-performance being realised and imperilling the company's survival.

[6] ERA's argument for the benefits of fixed term contracts can easily be turned on its head. A finite term of a contract can encourage a contractor to maximise its return given that contract renewal can be unrelated to performance. This is especially in a policy field as contested as contracting-out prisons. It will be recalled that Serco noted that continuity of its business model was heavily dependent on government goodwill to the general policy of contracting-out. In addition, managers of contracted-out services can be subject to personal incentives or bonuses from head office, such as those requiring reduced costs, that can imperil meeting contract conditions.

[7] The Mt Eden debacle confirmed an important prediction made by TCE analyuis. One reason why the risk of contracting out a prison service is excessive is where the contractee (in this case the Department) has to maintain large surplus production capacity to guarantee continuity of supply should the contractor fail to deliver according to the contract or enters bankruptcy. Unfortunately, for ERA 'NZ Corrections boss Ray Smith said the department had enlisted a "crack team" of 20 corrections staff that would take over the running of the prison indefinitely.'(Serco under fire at Mt Eden Prison after NZ smartphone fight club scandal. http://www.news.com.au/technology/gadgets/mobile-phones/serco-under-fire-at-mt-eden-prison-after-nz-smartphone-fight-club-scandal/news-story/720ee3acdca357a6506ce2d1abd2dc32).

> Training Organisation owned by Serco. 'Serco became so consumed with moving as many prison guards as it could through its training school that it left its new employees at risk when they started on the job, a New Zealand Qualifications Authority report has found. In a report critical of Serco NZ Training, NZQA found the company's initial training course had been deliberately structured to tick the legal boxes needed to get new employees into prison and working. In doing so it created patchwork training leaving "Serco employees with the basic requirements to perform as prison officers" but creating "a risk to the employees working in a complex and high-risk environment like prisons". The NZQA report studied the private Serco Training facility which exists solely to train prison guards to work in Mt Eden and Wiri prisons. Serco Training is owned by Serco, the company which has the contract to manage the private prisons' (*Serco training left new staff at risk* Nov 9, 2015 m.nzherald.co.nz).

2.3 Competition, contracting-out and innovation

We now turn to ERA's claim that contracting-out and competition promotes innovation in prison services. This is based on the assumption of a necessary link between 'the profit motive of the private sector and the role of innovation in assisting private enterprise to be efficient, improve products, and open new markets' ERA (2015: 247). ERA fails to note the complex and, often, perverse effects of economic incentives on agent behaviour. The literature on the economics of innovation clearly establishes that the relationship between private profit and innovation is highly complex and that it is illicit to assume that competition by itself will promote private investment in innovation. The construction industry serves as an excellent case study. It is the second largest industry in Australia in terms of output, and has arguably the most intensely competitive industry structure, with literally tens of thousands of competing contractors, low barriers to entry and a mostly unregulated workplace. Of all industries it is one of the closest to meeting the orthodox economists' nirvana of perfect competition. Unfortunately, it also has one of the lowest rates of innovation and productivity growth. Loosemore, Martin 2015 https://www.be.unsw.edu.au/content/opinion-why-construction-industry-needs-innovate.

Second, the innovation literature teaches us that the private sector (with the exception of mega-corporations like IBM and 'big pharma') will not undertake 'basic research', that is, research designed to create new knowledge. Rather, the profit motive skews private research and innovation into applied research which uses existing knowledge to adapt products and services to the market. By contrast basic research is inherently risky as the successful search for new knowledge, by definition, cannot be guaranteed. Equally, there is no prospect for immediate financial return as the findings from basic research require additional investment and research to convert new knowledge into practical outcomes. Finally, the findings of basic research typically cannot be patented. Put simply, the outcome of basic research is in the nature of a 'discovery', like genes for breast cancer or mathematical theorems. These are distinguished from 'inventions' or the output of applied research, which can be subject to patents or copyright (Calvert and Martin 2001). The consolidated impact of all these characteristics is that firms and competitors cannot be excluded from using the basic research produced by others, greatly reducing the incentive of private firms to invest in this essential activity. The significance of this extended and arcane disquisition for the inquiry into contracting-out human services is that it is most unlikely private contractors will undertake the type of basic research that the prison system needs. An example is investment in high quality, large scale development and evaluation of prison programmes to improve their efficiency and effectiveness. Indeed, confirming this analysis the WA Department of

Corrective Services Commissioner recently committed to invest in exactly this type of research capacity.[8]

2.4 How will competition work in practice?

Finally, it is also important to highlight very briefly a few problems arising from ERAs failure to detail the practical mechanics of its proposed tendering and competition process:

- how will efficiency and cost saving gains arise from contracting and competition? This somewhat startling question arises from the fact that ERA does not reconcile a fundamental conflict in its approach. On the one hand all prison services, the outcomes of those services and the 'efficient price' of each service will be precisely defined by DoCS using the methodology prescribed by ERA. This data is the basis for measuring system performance. ERA describes this methodology in strict economic terms as providing a precise 'marginal opportunity cost' of these services. Where, therefore, is the scope for bidders to compete on price when the most efficient set of prices has already been determined by DoCS? (The concept of 'efficient price' is examined in section 3).
- mandating and prescribing in enormous detail the services to be delivered and their outcomes precludes any alternative approach to achieving desired prison outcomes. Where, therefore, is the scope for bidders to compete on innovation when the exact set of services to be delivered has already been determined by DoCS? If price and service is prescribed and mandated what then is the basis for competition within ERA's model?[9]
- ERA is keen for not-for profit entities to be included in competition for providing prison services (ERA 2015: 272). This raises the interesting dilemma, by definition a not-for profit entity is not 'commercial' or profit driven. The whole basis of ERAs claim that efficiency and innovation will be enhanced by competition is that entities such as SERCO are driven by their 'commercial interest'. This is not an argument against the involvement of the not-for-profit sector, rather it highlights the difficulty of incorporating involvement of this sector into the economic theory of organisational performance proposed by ERA
- ERA does not confront the problem that the private market for provision of prison services will be a concentrated oligopoly. Indeed ERA (2015: 257) recognises the possibility 'that a tender process attracts only one alternative provider (as was the case when the Wandoo contract was tendered in 2011)', but tries to discount the possibility of a monopoly supplier by suggesting 'that the presence of a public sector competitor introduces genuine competition'. Aside from the fact that just two potential bidders is a highly concentrated

[8] 'I have set an ambitious goal for the Department of Corrective Services to reduce recidivism rates by six percent a year. To achieve this we must become a learning organisation. We must identify the characteristics of effective practice and use this knowledge to pursue a culture of continual improvement. In support of this goal I have embarked on an ambitious reform program that aims to radically change the way we do business. The Department is now working to build the evidence base needed to design and deliver programs that are tailored to, and proven to be effective for, different offender groups and offence types. This evidence has already told us the programs need to be delivered within an integrated, individualised, case management framework that extends beyond the structural confines of the Department and provides greater support for offenders upon release. This is a role that the Department can only undertake in partnership with the community and with the involvement of all sectors' (DoCS 2014: Foreward).

[9] ERA may respond that it avoids these problems by only prescribing an output or outcome, not the inputs or precise activities that produce an outcome. This is consistent with the neoliberal approach to contracting. This is meant to make space for innovation in prison service delivery. But in seeming to solve one problem, that is to avoid prescribing 'how' a service is delivered, it has created another devastating problem. It is simply impossible to establish the 'efficient price' of delivering a prison service without precisely detailing all of the inputs that enter into its production. In other words, it is simply not possible to set the price of a service or products without knowing all of its inputs. This is taken up in section 4 dealing with benchmarks.

oligopoly, it assumes that a public supplier will actually bid, or indeed be permitted to bid. Orthodox economics recognises that in such concentrated markets the degree of competition over price, quality and innovation cannot be predicted. In such markets firms' decisions over price and output are interdependent and indeterminate and rely on second-guessing the reaction of a limited number of competitors. In other words, in such markets the degree of competition depends on strategy, which is why the most common approach to the study of oligopoly is a field of economics called game-theory (Varoufakis1995).

ERA frequently refers to the current Acacia contract as an exemplar of the benefits of contracting-out and competition. ERA creates the impression that the contractor is given a global fixed sum per year to run the facility and then it is in the commercial interest of the contractor to minimise costs and drive a wedge between costs and income- by reducing the former it increases profit. A closer examination of the contract reveals that the contract imposes few constraints on the contractor to limit its costs, at least for several major items of expenditure. This arises because the contract is essentially a cost-plus contract, which means that the contactor is fully compensated for any increases in costs occurring over given period. For example, Schedule 1 of the Acacia Prison Services Agreement between DoCS and Serco allows for full compensation for any increase in wages and insurance above the CPI and an automatic CPI increase is made to the Base Operating Sum, an amount designed to meet all variable costs (DoCS 2006, Schedule 1: 120-123). Maintenance at Acacia is the subject of a separate contract between DoCS and specialist provider.

A final and crucial observation is that despite making the virtues of competition a core argument for contracting-out (along with benchmarking) ERA admits that due to a number of problems simply benchmarking prisons may be a preferable and more feasible approach to prison improvement than open tendering all prisons and services. The reasons for this are the high cost in bidding for contracts and the anticipated slow pace of the contracting-out process given the large resources involved in assessing bids, negotiating and customising contracts for each prison.

Thus ERA (2015: 257) states there are 'considerable barriers to entry in compiling tender documents to operate a prison or supply prison services. The ERA has been told that it can cost over $1 million to compile a tender document to bid to operate a prison. Such barriers to entry may result in only large private sector providers participating in a tender process (commissioning or direct procurement)'. In addition, 'ERA observes that of the 120 prisons under the authority of the National Offender Management Service in England and Wales, only ten per cent of them have been subjected to a commissioning process in the six years since a commissioning framework was introduced in 2009. If the same proportion of prisons in Western Australia were subject to commissioning over the proposed five year term of a Service Level Agreement, only one or two would be subject to a commissioning process (ERA 2015: 264). These constraints lead ERA (2015: 258) to conclude it 'is neither practical nor optimal for the Department to subject every prison to a commissioning process at the expiry of its Service Level Agreement. The cost alone would be prohibitive when compared to the likely benefits'.[10] This last statement is truly extraordinary, if the cost of subjecting all prisons to successive rounds of competition (commissioning) exceeds the likely benefit, where is the justification for subjecting any prison to competition?

[10] In a footnote to this statement ERA (2015: 258) expands on this claim. 'The cost of undertaking a commissioning process for the Department is considerable. Given the considerable cost to non-public providers of participating in a commissioning exercise, it is unclear whether they would have the financial appetite or human capital to participate in multiple commissioning exercises concurrently.'

3. Impossibility of precise cost comparisons and cost-benefit analysis in heterogeneous human services

Over a period of more than 2 years ERA conducted an exhaustive inquiry into the case for contracting-out WA prisons and introducing competition between prisons through the process of 'commissioning', where existing public and private providers bid for funding based on meeting financial and operational performance benchmarks ERA could not finally determine first, whether there would be efficiency gains from its radical proposals and second, the quantum of these gains. 'The ERA acknowledges that it has not costed the introduction of commissioning. Conducting a full cost-benefit analysis of reform is a significant undertaking and was not possible with the time-frame and resourcing provided for this Inquiry' (ERA 2015: 239). This is an unsound basis for public policy. The critical point is that ERA's advocacy for contracting-out was based on *a priori* reasoning founded on neoclassical principles and was not based on evidence of relative costs and benefits of public vs. private provision of prisons. The reason for the absence of evidence is that the precision in costing and pricing of inputs and outputs across a service delivery organisation as complex as a prison system is impossible. Even achieving approximate costings requires a heavy reliance on assumptions, many of which are highly disputed. This section details some of these reasons for the impossibility of arriving at precise, or even approximate, comparisons of costs and outcomes in complex services delivery organisations.

Competition between and within public and private providers and benchmarks specified in contracts are the keys to driving improved performance. 'The ERA identified four categories of prison performance that should be measured in benchmarking. These categories are safety and security, rehabilitation, prisoner quality of life and management. Each category represents an outcome that a good prison should deliver' (ERA 2015:143). These four objectives have their associated 26 performance measures. ERA (2015: 125) approvingly cites the UK benchmarking model developed by the National Offender Management Service as the template for its approach. 'The purpose of the program was to:

- Define what should be delivered (the outcomes and outputs for services) – so consistent services could be delivered across all areas of the business;
- To know exactly what it costs to deliver each service' (ERA 2015: 125)
- In addition ERA proposes it own method to compare performance across prisons by controlling each benchmark for factors such as the range of different prisons and prison classifications and prisoner needs.

It will be shown that ERA's proposed specification, costing and benchmarking programme is subject to four distinct and insoluble problems. First, how to establish a causal relationship between a particular prison service or activity and a desired outcome; second, the ERAs concept of an 'efficient cost' requires calculating the 'marginal opportunity cost of a service', and thirdly this cost must be adjusted for all factors that can affect both the price and outcome of all services across different prisons (ERA 2015: 134). Finally, there is a fundamental contradiction between ERAs demand for precision in specifying standards, outcomes and prices of prison services but also requiring contractors to innovate.

3.1 Establishing a causal relation between services and outcomes

In constructing prison benchmarks ERA explicitly states it is only interested in ends and not means: only prescribing outcomes that prison services are supposed to deliver. Contracts should not prescribe the inputs or processes to achieve these outcomes. It does this because indifference on the part of the principal to means creates room contractors to innovate in achieving outcomes with potential gains in quality and lower cost. Specifying only outcomes in a contract between DOCS and a contractor is also seen as the best way to ensure clarity and accountability over what precisely is being bought with taxpayers' money by the Department and to achieve value for money.

There are three basic problems with this approach to benchmarks. First, ERA cannot be and actually is not indifferent to how outcomes are achieved. Second, it is not true that the price of a good or service can be given without precisely specifying all the inputs that go into its production. The only way ERA can know the cost of prison services is to precisely define what they are and the standards they are to achieve. This, in fact, is exactly what the specification, benchmark and costing exercise is intended to do.[11] The reason for this gap between the intention, to focus only on outcomes, and the reality can be found in ERAs adherence to the neoliberal world-view, which, as noted above, gives priority to notions of contractual flexibility and experimentation. Gary Sturgess (2012: 8) for example writes that:

'Contracting for outcomes rather than inputs...and paying providers based upon their results, also serves to increase the diversity of service models, since [principals]...are not specifying the ways in which inputs are to be connected to outputs and outcomes. Payment by-results has increased the amount of experimentation with alternative service models, results has increased the amount of experimentation with alternative service models'.

But these two problems are relatively minor issues, and could be dismissed by some as mere academic quibbling. The third problem however, is far more serious. This problem was highlighted in the Western Australian Prison Officers Union's response to the ERA *Draft Report* and is neatly summarised by ERA (2015: 135) in their *Final Report:*

'Dr Toner submits that to be of analytical use, the ERA performance measures and benchmarks have to solve three quantitative problems:

☐precisely define the prison services that contribute to achieving the four objectives of the prison system;

☐rigorously establish the relationship between the quantity and price of each prison service and the extent to which it contributes to achieving prison objectives; and

☐complete these tasks for all sixteen Western Australian prisons...

[11] That ERA's specification, benchmark and costing exercise is actually focussed on inputs is evident from its description of how performance in meeting the core objective of prisoner rehabilitation is to be measured. What is being measured is not the outcome itself but simply the chief inputs or services that are presumed to cause this outcome. 'The performance of individual prisons in rehabilitating prisoners is difficult to measure...prison Superintendents have little control over many of the factors that contribute to a prisoner reoffending...There are seven factors that are identified to contribute to the likelihood that a prisoner will reoffend on release. These factors are: accommodation; education, employment and training; budgeting and debt management; drug and alcohol dependence; physical and mental health; family connection; and attitudes, thinking and behaviour. Therefore, the performance measures the ERA has recommended in this area are largely limited to a prison's ability to maximise prisoner participation in, and completion of, programs, education and employment (ERA 2015: 144-145). An even larger problem arises in measuring the other core prison objective 'prisoner quality of life'. ERA simply sets out a number of options, including surveys and a particularly resource intensive method called MPQL that it notes but does not recommend any specific measure (ERA 2015: 145).

‘He] considers that even if it were possible to develop such benchmarks, it would only be warranted if two conditions are met: the Department must be able to fully control all inputs of the prison system; and the Department must also fully control expected outputs (such as improvement rates in recidivism and rates of efficiency improvement)... Dr Toner submits that neither of these conditions apply...[and] concludes that under these circumstances, benchmarks and performance standards act not to drive improvements, but simply to quantify the gap between expectations and reality. Dr Toner states that performance targets and benchmarks are important for organisations...[and] considers this is true if the setting of these targets and the data collection are both feasible and useful. Dr Toner considers the sheer complexity and unrealistic ambition of the ERA’s proposal means they are neither feasible nor useful’.

ERA does not dispute this characterisation of what it is recommending. Indeed, the unlikely response was that ‘ERA agrees with Dr Toner that the Department needs to undergo a process of defining the services delivered in prisons that contribute to achieving objectives and the price and quantity of those services in each prison’ (ERA 2015: 136). In other words, ERA casually suggests that more work needs to be done without confronting the mind-boggling complexity of what it is recommending, nor does it give any clarity about the method for the task. This all left for DoCS to solve.

The issue here is not specifying prison services and the delivery standards, as noted previously, that task has already been undertaken by DoCS in exhaustive detail in its *Policy Directives*, *Adult Custodial Rules*, *Assistant Commissioner Custodial Operations Notices*, and *Compliance Testing Standards* for public prisons. Rather, the problem lies in ERA’s insistence that DoCS must devise a method that will establish a *causal* relationship between a precisely defined quantity and quality of services and precisely defined outcomes. ‘ERA has been mindful that cost allocation should be based on principles of causality, objectivity, consistency, and transparency’ (ERA 2015: 53). Unless this relationship can be established it is not possible to show that the services and benchmarks recommended by ERA are an improvement on the current approach. Second, it must establish that prison services and standards are the uniquely optimal solution in terms of efficiency and effectiveness in meeting prison objectives. Unless this second problem is solved the claim that ERAs benchmarking and contracting model will deliver more efficient and superior services is undermined. (This second problem is taken up in section 3.2).

However, the theoretical and practical problems in establishing the relation of cause and effect in prison services and outcomes are prodigious. To take an obvious example, exactly what services contribute to achieving the objective of safety and security within prison? Possibly, all of them? (More formally, the problem that arises here is the pricing of ‘joint products’ where inputs from a production process lead to multiple outputs). It is most unlikely that services say, directed at the objective of rehabilitation will not positively affect the behaviour of prisoners whilst still incarnated. If so, it raises the difficult issue of how then, to allocate the benefit and cost of services directed to the rehabilitation objective to the security objective? If this is not done, inefficiencies will arise as services are being paid for but the benefits and effect on achieving objectives are being incorrectly assessed. This will result in services being either over-supplied or under-supplied. Inability to accurately allocate the costs and benefits of particular services across objectives will be an especially pressing problem where, under contracting-out, different prison services are divided by different private firms or even different divisions within the same firm. Once these ‘spill-over’ effects become apparent, say in the example above, this will lead a supplier of security services to diminish supply of their service and rely on a different supplier to maintain their rehabilitation service.

ERA concedes the obvious practical problem that, given the current state of knowledge and expertise, DoCS is just unable to answer these questions. Moreover, even assuming the theoretical problems can be addressed it will take many years and probably decades for rigorous information to be collected to construct service specification, benchmarks and costings. Contracts require DoCS to ‘clearly define the services to be delivered, and the funding and staffing required to efficiently deliver those services. This is fundamental to ensuring that prisons have sufficient financial and staff resources to deliver the service standards expected under Service Level Agreements ’(ERA 2015: 265). ‘However...the Department faces a number of longstanding issues with its planning and processes, and in the way in which it collects and uses information to make good decisions’ (ERA 2015: 121). In particular, the Department lacks analytical and research capacity in programme evaluation.

‘In order to deliver programs effectively, the Department needs to:
☐ assess the program needs of prisoners on entry, allocate them to programs and then assess how effective those programs have been for individuals; and
☐ assess, at a system wide level, how effective programs have been at addressing the needs of prisoners collectively’ (ERA 2015: 213). This is an important and welcome recommendation, though ERA does not acknowledge that rigorous evaluations can take a long time.

The ‘gold standard’ for programme evaluation is to randomly allocate matched cohorts of prisoners to different interventions with another matched ‘control’ group receiving no interventions and then assess the outcomes. In the case of assessing the effect of programmes on say, recidivism this is not only extremely complex where prisoners undertake multiple programmes but also can take years for outcomes to emerge in the case of long-term prisoners but also sufficient time needs to lapse after release from prison to properly assess the outcome. ERA already accepts that it is not possible to evaluate the actual rehabilitation outcomes of a single prison as prisoners typically pass through multiple establishments over the course of their stay.

3.2 What is an ‘efficient cost’?

Despite the great weight ERA gives to the concept of an ‘efficient cost’ in its model to create a more efficient and effective system the term is never explicitly defined. Given the term is used by an entity called the Economic Regulation Authority; it is not unreasonable to suggest the term has an orthodox economic meaning. This is also supported by the various connotations given by ERA to the term as well as its published statements on the definition of economic efficiency. [12] We use these various sources to build up a meaning of the term: First, central to the orthodox idea of efficiency is equating the marginal cost of a commodity *c*, that is, the cost of production of the ^{ith}unit of output of *c* with the ^{jth}unit of revenue earned

[12] For participants in the WA wholesale electricity market ERA produced a paper defining the economic meaning of short and long-run marginal price. Apparently, there was some confusion in this market due to different meanings of these terms viewed as accounting concepts or economic concepts. ERA (2008) Portfolio *Short Run Marginal Cost of Electricity Supply in Half Hour Trading Intervals Technical Paper* (Author: Adam McHugh)
https://www.erawa.com.au/cproot/6317/2/20080111%20Short%20Run%20Marginal%20Cost%20-%20Technical%20Paper.pdf

on that output. Maximum allocative efficiency is achieved when marginal cost and marginal revenue equal the price of the commodity set under perfectly competitive conditions. This is to be distinguished from average cost which is just total output divided by total revenue. ERA (2015: 123) explicitly supports the use of marginal analysis for allocating resources efficiently in the WA prison system: 'the contract for Acacia sets out the funding due to Serco for different levels of prisoner population. This approach acknowledges that there is a marginal cost to increasing a prison's population. The ERA recommends that Service Level Agreements with public prisons contain similar funding tables'.[13]

Maximum allocative efficiency requires markets to be 'perfectly competitive', though, the actual market for prisons is and will remain be oligopolistic.[14] ERA seems content not to investigate this thorny issue in any detail, as to investigate too deeply would reveal the essential indeterminacy of outcomes from markets which are not 'perfectly competitive'. ERA certainly anticipates significant advantages in terms of cost and efficiency from adopting its recommendations to enhance 'competition'.

Second, as ERA allows that its recommendations will entail adjustments in all inputs, interventions and even constructing new more suitable prisons, the 'efficient cost' of delivering these changes is thus a 'long-run' marginal cost.

Third, as all consumers are resource constrained they must choose what commodities to buy or forgo. The inevitability of choice is known as 'opportunity cost'- to gain one commodity another 'must be given up' (ERA 201: 129). Optimising these choices involves equating the marginal utility (or benefit) of a commodity with its marginal price and comparing this with the ratio of utility to price of all other commodities.

Four, consumers must have some way of adjusting the prices of similar commodities for quality differences and similarly, producers must have some way of adjusting the prices of similar inputs to production that they buy to make commodities. An efficient cost requires the construction of quality adjusted prices for inputs and outputs. Orthodox economic theory assumes that consumers create valid and reliable quality-adjusted price indexes of the output of firms and producers quality-adjusted price indexes of their inputs used in production. Optimising marginal decision-making is still required; it is simply augmented or complicated by the need to adjust these decisions for quality differences. Applied to the analysis of prison reform ERA (2015: 48) argues that a 'substantial, but well-targeted investment that raises current costs, can be efficient in the long-term, reducing recidivism, and consequently avoiding the future costs for the Department, courts, police, and the wider community'. In other words, an 'efficient cost' for prison services is not necessarily the lowest because of quality differences between services producing different outcomes.

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[13] Actually, the contrat between DoCs and Serco for running Acacia is not based on marginal cost adjustments for changes in prison population. 'In 2013-14, on average, 3,220 prisoners had served a prior prison sentence. With a cost per prisoner per day of $334 (in 2013-14), this equates to a daily cost of $1,075,480. This figure is a reflection of total cost. While the ERA acknowledges that a figure based on marginal cost would be more accurate, it has been unable to calculate this cost because the Department has been unable to provide the requisite data (ERA 2105: 73). Apparently, DoCS have been charged by ERA with supplying this data.
[14] One of these conditions that definitely informs ERA's approach is the assumption that all 'economic agents' have perfect knowledge of all possible influences on price and output. Only with such an assumption can ERA recommend DoCS compile information that, in effect, gives it and all competitors the necessary information to optimise all decisions.

Finally, a variation on this issue is that comparing the efficiency of prisons in meeting their core objectives and performance benchmarks requires adjustment for differences in the capacity of prisoners and prisons to convert inputs into outputs. For example achieving the same performance on security will be more costly for a maximum security prison to achieve than a low security prison farm. Thus 'two prisons performing equally effectively will not necessarily have equal costs' (ERA 2015: 48).[15]

Efficient pricing is thus 'the long-run marginal opportunity cost'. Applied to the prison system in making such key decisions as what rehabilitation services should be purchased it requires the criteria of price, quality and effectiveness of one intervention be precisely compared using the same criteria against all other possible interventions. [16] Another way to express this is that an 'efficient price' is actually a way of measuring change in the productivity of prison services and prisons.

Lest it be thought that the foregoing represents a caricature, ERA applies this logic in the analysis of rehabilitation outcomes from prison industries. WA prisons produce a whole range of commodities in prison industries such as 'primary produce, catering, laundry and clothing' as these 'can reduce the cost of Imprisonment'. More importantly, employment in prison industries also generates rehabilitation outcomes. However, from ERA's perspective this creates a resource allocation problem as 'each prison industry will have an opportunity cost in terms of time and money... prison industries should not be pursued simply because they may generate some rehabilitation outcomes. Industries should only be pursued if they will result in *the best* rehabilitation outcomes *for a particular level of investment in time and money*. If not, the Department should consider investing in other, non-industry, rehabilitation activities' (ERA 2015: 129-130 *italics added*). ERA (2015: 275) concluded with a formal recommendation to establish the efficient cost of these services: 'the Department of Corrective Services undertake a rigorous cost-benefit analysis of prison industries. The Department should only continue these industries where it can be demonstrated that the benefits outweigh the costs and the net benefits exceed those of alternative activities'. [17]

[15] One factor that drives the need to establish precise cost comparisons for 'similar' services is that in a large state like WA there will be large differences in the rate of inflation of these services, not just differences in price levels which ERA notes (2015: 65).

[16] This view of what ERA is means by the term 'efficient cost' is identical to that employed in the UK by specialists at the London School of Economics who were commissioned by NOMS to efficiently price prison services in preparation for commissioning. 'The costing approach was guided by economic theory, reflecting the opportunity cost of activities undertaken...The aim has been as far as possible to measure the opportunity cost of the activity or intervention to society in order that the full resource implications of opportunities or benefits lost are reflected, rather than expenditure to a single agency or sector. In order to reflect the full resource implications of any activity, it is also important to identify the resource consequences in the long-run...the focus is on the impact of implementing changes on the margin of the offender management service as a whole. A marginal cost is the cost of an additional unit of activity or providing a service to one extra person. Based on these economic principles, the aim has been to estimate (as far as possible) the long-run marginal opportunity cost to society'' (Nadia Brookes, Barbara Barrett, Ann Netten and Emily Knapp (2013) *Unit Costs in Criminal Justice* (UCCJ) http://www.pssru.ac.uk/archive/pdf/dp2855.pdf p.7).

Needless to say, as with ERA, this grand ambition, guided by orthodox economic theory, could not be realised. What was actually produced by the LSE group was a remarkably thorough and detailed adding-up exercise of the unit costs of a great number of prison services, mostly focussed on rehabilitation and health. There was no comparison of the quality-adjusted price of services controlled for their relative effectiveness in achieving their objectives.

[17] ERA demands DoCS solve an even more complex optimisation problem when it comes to self-sufficiency and rehabilitation outcomes for prison industries. Many prison industries supply all the needs of the prison in a

The fictional character of an 'efficient cost' is also revealed in ERA's admission that it cannot calculate something as basic as an appropriate 'prison capacity... rate [or] the daily average prisoner population as a percentage of the capacity of the prison' (ERA 2015: 117). This is 'because there are multiple definitions of prison capacity and competing views among corrective service agencies and stakeholders as to which of these definitions should be used to measure prison utilisation' (ERA 2015: 117-118). This is an extraordinary admission as without a rigorous scientific basis for the optimum number of prisoners within a facility it is impossible to know the efficient level of resources a prison should receive. ERA (2015: 180) notes this is a serious problem in its attempts to identify 'a prison's capacity to provide services and its staffing levels. Prisoners require access to services such as health, education and rehabilitation programs in order for a prison to achieve its objectives. Similarly, prisons require a sufficient number of prison officers in order to safely accommodate its prisoners.... The ERA identified rehabilitation and health as the services that should be considered in a measure of capacity. The ERA sought advice from key stakeholders on how the capacity of these services could be measured. Stakeholders expressed a view that measuring service capacity is complex because service needs vary significantly between prisoners cohorts... There is similar difficulty in assessing required staffing capacity. The number of staff required in a prison differs based on the difficulty of managing particular cohorts of prisoners... Therefore, due to the complexities in measuring services capacity and required staffing levels, the ERA has not developed an alternative measure of prison utilisation.' ERA adopts a pragmatic solution and adopts 'design capacity' as its preferred measure of prison capacity. Now, this may well be a desirable outcome for the welfare of prisoners but it is not based on economic principles and therefore cannot be deemed an efficient outcome in the sense that ERA would use that term.

To conclude this discussion, not only are the information requirements to derive 'efficient costs' huge, more importantly, the data relating to say, relative rehabilitation outcomes from all actual and possible prison activities, simply does not exist. As argued above it could never be obtained. The essential point for policy is that unless these exacting, and indeed, impossible, conditions are meet there is no *a priori* argument to justify ERAs approach to prison improvement over any other approach. Second, because of the multiple problems in actually measuring 'efficient cost' ERA simply cannot *empirically*, demonstrate that its specification, benchmarking and costing programme is superior to alternative approaches to improve system performance. Finally, it shows the limits of using the 'other-worldly' assumptions of orthodox economics, especially in its extreme form, for public policy. (Another major flaw in the idea of efficient cost is revealed in the next section).

range of commodities and their production also leads to certain rehabilitation outcomes. For all of the commodities in which the system is self-sufficient DoCS is required to assess not only whether it is cheaper to source these from external suppliers but also to assess the rehabilitation benefits derived from these self-sufficient industries against all alternative rehabilitation interventions. 'The ERA acknowledges that it may be possible to justify paying a higher price for goods and services produced through prison industries (compared to the price of purchase from external providers) to reflect the rehabilitation benefits achieved for prisoners. However, again, the Department has not undertaken sufficient analysis to determine the extent of rehabilitation benefits being achieved from prison industries focussed on self-sufficiency and cost of these benefits'. It is also worth noting that the achievement of self-sufficiency in the production of certain items really 'grates the gears' of orthodox economists. Self-sufficiency is equated with the ultimate economic 'sin': industry protection and 'autarky' prior to nations' entering the blissful state of 'free trade'.

3.3 Problems in Comparing Prison Cost and Performance

Section 2.2.3 described in detail ERA's proposed approach to use its specification, benchmarking and costing programme to enable valid comparisons across prisons. Aside from the obvious comparisons of performance against benchmarks, such comparisons are essential to ensure equity in funding across prisons. To make valid comparisons a number of problems must be solved. The first is how to compare the cost of prisons? 'Costs and service requirements will vary from prison to prison, reflecting the specific circumstances of each prison. Service Level Agreements for individual prisons will need to reflect this variation to ensure an appropriate level of funding' (ERA 2015: 125) Second, is it possible to validly compare the achievement of different prisons against key performance indicators when it is known that objectives like rehabilitation are strongly affected by factors such as the classification of prisoners? For example, maximum security prisoners will be more resistant to the effects of rehabilitation programmes than minimum security prisoners.

This section identifies difficulties with ERA's solutions. First, it is not possible to reconcile the definition of an 'efficient price' and the central place it has in ERA's analysis with its claim that it is not possible to make valid comparisons of cost per prisoner across different prisons. Second, there are major issues with ERA's selection of the independent variables to adjust for differences in the capacity of prisons to achieve benchmarks.

To briefly recap ERA's analysis of prison benchmarks. ERA says the first problem identified above is insoluble as it agrees with WAPOU's submission to the *Draft Report* that it is not possible to adjust for all the factors that lead to cost differences across prisons. 'Dr Toner considers that it is not possible to develop cost benchmarks because of the high variability in cost per prisoner per day, driven by differences in the prison population, prison design and age, and prison location. He considers that it is not possible to directly compare prison performance without adjusting for these factors...The ERA agrees with submitters that cost per prisoner per day is an inappropriate measure of prison performance, particularly in Western Australia where few, if any, prisons are directly comparable... this measure has been removed from the ERA's list of recommended performance measures' (ERA 2015: 140-141).[18]

Despite this limitation 'ERA does consider that per prisoner per day (on both a system wide and individual prison basis) provides important information to both management and stakeholders as to cost drivers, and the outcomes of investment and policy decisions' (ERA 2015: 141). ERA classifies 'cost per prisoner per day' as 'management information' but retains the other three core objectives (*safety and security; rehabilitation; and prisoner quality of life*) as benchmarks with their associated performance measures. Thus the prison management category is 'designed to measure productivity in prisons [and] the other three categories are designed to measure quality of service' (ERA 2015: 141).

The second problem is solved by applying four independent variables which ERA claims account for the bulk of variation in the capacity of different prisons to achieve performance

[18] 'Cost per prisoner per day simply describes the Department's use of funds. It provides no information on the appropriateness of the use of those funds. For example, a prison with a very low cost per prisoner per day but very poor rehabilitation outcomes may be inefficient, but a prison with a high cost per prisoner and very low re-offending rates may be using those funds well to deliver an efficient outcome for the State' (ERA 2015: 54).

benchmarks. [19] 'Under this approach, the ERA has proposed that benchmark targets be adjusted to reflect differences in the composition of each prison's population. In particular, the ERA has proposed that the Department adjust benchmark targets to reflect differences in the security classification (that is, maximum, medium and minimum-security), sentence status (that is, remand or sentenced) and gender of the populations of individual prisons (ERA 2015: 134).

3.3.1 Cost per prisoner per day

Admitting that is not possible to derive a method for accurately comparing per prisoner per day cost across prisons is inconsistent with the demand that DoCS calculate an 'efficient cost'. ERA's design specification for what an efficient cost is meant to measure logically contains the means to make valid cost comparisons across prisons.

In response to the WAPOU submission to the *Draft Report* ERA (2015: 134) concedes that benchmarking requires all of the following be solved and quantified:

' ☐ the definition of prison services;
☐ inputs to, and outcomes, of prison services;
☐ the cost and quality of these services; and
☐ the contribution of each of these services to achieving the objectives set for individual prisons and the wider prison system... Dr Toner further submits that benchmarks must also control for differences in prison characteristics that cause differences in the type of service, their cost and achievement of the objectives set for individual prisons and the wider prison system...The ERA considers, based on consultations with the Department, that the recommended approach to benchmarking is both feasible and useful. The ERA agrees with Dr Toner that the Department needs to undergo a process of defining the services delivered in prisons that contribute to achieving objectives *and the price and quantity of those services in each prison*' (ERA 2015: 134 *italics added*). In theory this data is sufficient in itself to enable cost comparisons across prisons. Demanding the use of 'efficient cost' but denying the comparability of costs across prisons introduces a fundamental ambiguity into ERA's analysis and recommendations.

Expressed differently, if it is not possible to adjust for all the factors that give rise to cost differences across prisons what is being measured is a not an 'efficient cost' it is simply cost. The whole idea of calculating an efficient cost is that it permits not only accounting for changes within a prison that lead to cost changes, say in response to a change in the classification of prisoners or the introduction of new technology, but critically to explain why there has been a change in costs. Remember, an 'efficient cost' is not a bookkeeping identity; it is an analytical device to measure the long-run marginal opportunity cost of an individual service, and all services combined to optimise performance measures. In addition, it explicitly entails controlling for all the variables within a prison, such as those identified above, that lead to cost variations in meeting performance targets. This creates the basis for valid cost comparisons across prisons.

Secondly, ERA is inconsistent in its statements about this issue. 'The Department does not have robust information on how much it currently costs individual prisons to deliver specific

[19] Applying weights to these performance measures to control for the different priorities DoCS may have for different prisons is just a complexity to the calculations and is not dealt with here.

prison services or the *efficient cost* of delivering those services. Developing this understanding is a foundation step in ensuring that Service Level Agreements are realistic and achievable. Reflecting this, the ERA recommends that the Department engage in a specification, costing and benchmarking program (as detailed in Box 4)' (ERA 2015: 124 *italics added*). One of the benefits identified from introducing a specification, costing and benchmarking program in Box 4 is that 'access to robust cost information allows the Department *to compare the cost of individual prisons* and better compare the cost of operating the more expensive (and presumably older) prisons with the cost of replacing them with new facilities that have lower operating costs'(ERA 2015: 125 *italics added*).' This introduces a fundamental ambiguity into ERA's analysis and recommendations.

Thirdly, having 'solved' the problem that in reality it is not possible to compare cost per prisoner per day across prisons ERA has created an even larger problem. Without this basic metric there is no method for DoCS to rationally and equitably allocate resources across prisons. On the one hand, ERA says it can compare the performance of prisons through its benchmarking and target system, but it is impossible to compare how efficiently resources are used across prisons to produce these outcomes since it is invalid to compare the costs of running prisons. There is therefore, no system to allocate resources across prisons on the basis of efficiency. ERA's edifice of specification, benchmarking and costings, SLA's and contracting-out cannot therefore, achieve its central goal of lifting efficiency and productivity, since they cannot be measured.

Finally, an obvious critical problem with denying that cost variations across prisons are commensurable is that there is no basis for comparing the efficiency, or more specifically the rate of productivity change, of different prisons.[20] This latter issue creates numerous problems such as how is DoCS to set equitable financial incentives for Superintendents to reward improved productivity within and across a prison when there is no basis for comparing the rate of change of productivity. It may well be the case that it is easier for one prison to improve its productivity compared to other prisons. In fact, this is the whole basis for ERA's recommendation to adjust performance benchmarks for different characteristics of prisons that affect the capacity of prisons to achieve these benchmarks. It is to this issue we now turn.

3.3.2 Selection of the four independent variables to adjust benchmark targets

To adjust for the differing propensity of prisons to convert inputs into outputs or outcomes, ERA recommends, as essential to its specification, benchmarking and costing programme, that three control or independent variables be used to enable the valid comparison of prison performance. 'The main factor that is likely to affect a prison's performance is the composition of its population. These factors should be adjusted for in setting a prison's benchmark targets... the ERA considers that the factors that have the most influence on prison performance are security level, sentence status (that is, remand or sentenced) and gender' (ERA 2015: 147).

There are prodigious problems, identical really in nature to those applying to ERA's demand that DoCS establish 'causal' linkages between prison interventions and outcomes to allocate

[20] Efficiency is measured by reductions in the quantity of inputs to achieve a given output. The quantity of inputs is given by their volume and their price. It also requires adjusting both inputs and outputs for quality differences.

funds and also controlling for all the variables entering into the calculation of an 'efficient cost'.

ERA provides no rigorous quantitative basis for selecting these three control variables for its 'population-adjusted' approach to weighting each prison's benchmark targets. Rather they are based on ease of calculation and some assumed statistical reasons. ERA (2015: 151) even admits that a 'number of other population and prison characteristics may have some effect on prison performance. These factors include the location of the prison, the age and offence profile of prisoners, the proportion of prisoners who are Aboriginal, and the sentence length of prisoners. While the ERA appreciates these factors may have some effect on prison performance against benchmark targets, it has sought to limit the complexity of the process by restricting the factors considered to those likely to have the greatest effect.' This 'near enough is good enough' attitude to the allocation of scarce public resources simply 'not good enough'.

This criticism is not, however, a call for more expensive research to improve the quality of the independent variables. This call cannot be made since, as noted previously, there is no rigorous cost-benefit analysis concussively demonstrating the value of ERA's approach. This is an unsound basis for public policy.

To conclude, because of these fundamental flaws in the model proposed by ERA, it cannot be implemented and the forecast efficiency gains cannot be achieved both for practical reasons and simply, as they cannot be measured they cannot be established to exist.

Bad ideas are, nonetheless, tenacious. A possible scenario is the following. A government committed to neoliberal views will be highly attracted to a policy that promises it can deliver more for less. The fact that it cannot actually be implemented could well be part of its appeal. Not only would its implementation be monstrously expensive but ERA raised the possibility that an actual increase in cost per prisoner could well be justified on 'efficiency' grounds. What can actually be implemented is a replica of the UK specification, benchmarking and costing programme. Specified service standards and their 'efficient cost' will be equated to minimum standards and the lowest price. This is precisely what happened in the UK. NOMS publishes an annual *Costs per place and costs per prisoner* report, in which 'cost per prisoner is the average cost of holding one prisoner for the year. It is the Direct resource expenditure or Overall resource expenditure divided by the average prison population' (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/471625/costs-per-place.pdf . There is no adjustment for any independent variables that affect cost, because as argued above, the task is simply impossible to do rigorously. This leads to stark comparisons such as the following where NOMS extols the 'efficiency' gains from its latest round of commissioning:

'HMP Oakwood, a 1,605-place prison, will provide places at the lowest operational unit cost in the estate at around £13,000 per prisoner per year. This compares with an average of £27,400 per prisoner per year...this results in the lowest direct establishment unit cost in the prison estate' Ministry of Justice (2012) *Offender Services Competitions Annual Update 2012* (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/217274/competition-strategy-offender-services-2012.pdf) [21]

[21] ERA tries to disassociate itself from any adverse effects on the working lives of prison staff should its policy be actually realised. 'Under the ERA's recommended benchmarking approach, the ERA does not advocate for or expect any change to the number of prison staff or the way that they undertake their jobs as a consequence of

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the Department collecting more information on the costs of running prisons. Operational matters of this nature are for the Department and Superintendents to determine' (ERA 2015: 112).

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