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**Contracting-out  
and Governance Mechanisms  
in the Public Employment Service**

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## **ABSTRACT**

The contracting-out of job brokerage and case management services is a major international trend in the reform of the Public Employment Service. Instead of a public agency, private providers are contracted to deliver these services for the jobseekers. Australia and the Netherlands have contracted-out (almost) all of this formerly core public service. The U.K. has introduced so-called Employment Zones, in which private providers are responsible for long-term unemployed and thus replace the public Jobcentre Plus for this target-group. Based on agency theory, the paper analyses and compares the contract management in the three cases with respect to the risk of moral hazard. Differentiating between three distinct governance mechanisms (incentives, information and control), the paper shows the requirement of an integrated approach to contract management.

## **ZUSAMMENFASSUNG**

Das Contracting-out der öffentlichen Arbeitsvermittlung und des Fallmanagements für Langzeitarbeitslose ist eine der wesentlichen internationalen Entwicklungen in der Reform der öffentlichen Arbeitsverwaltung. Statt einer öffentlichen Behörde werden dabei private Anbieter vertraglich beauftragt, diese Dienstleistungen für Arbeitssuchende zu erbringen. Australien und die Niederlande sind bei dieser Auslagerung ehemals öffentlicher Dienstleistungen besonders weit gegangen. Großbritannien hat so genannte „Employment Zones“ eingerichtet, in denen private Anbieter für Langzeitarbeitslose zuständig sind und somit die Leistungen des Jobcentre Plus für diese Zielgruppe ersetzen. Ausgehend von der Prinzipal-Agent-Theorie analysiert und vergleicht der Aufsatz das Vertragsmanagement in den drei Ländern hinsichtlich des Moral Hazards. Ein effektives Governance-Konzept erfordert, dass die drei wesentlichen Steuerungsinstrumente (Anreiz-, Informations- und Kontrollmechanismen) zu einem integrierten Vertragsmanagement zusammengeführt werden.



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## 1. Introduction

Contracting out public services is not a new phenomenon (Kelman 2002; Savas 1987; Sclar 2000). However, whereas in the past contracting was very often input-related, the practice has shifted to performance contracting (Behn and Kant 1999). More recently, this new paradigm also has reached social services, which have become subject to public tendering and performance contracting (Ryan 1999; Smith and Lipsky 1993). One of the most recent new areas of public services in which contracting-out can be observed is the Public Employment Service (PES). The PES usually is organized as a large public bureaucracy with local offices that offer labor market information, placement services, and active labor market policy measures for the unemployed. In addition, in some countries the PES also administers the provision of income support for unemployed jobseekers (OECD 2001; Thuy, Hansen, and Price 2001). In the United States, the PES is less visible as a unified institution because states have a high degree of freedom to manage employment services. Moreover, large programs such as the Job Partnership Training Act (JPTA) have created their own nationwide implementation structure independent of any social security agencies (OECD 1999).

Expenditure for the PES constitutes a major item of the welfare budget in most Western welfare states. In the scope of this paper, employment services are defined in very broad terms, and include all services used to reintegrate a jobseeker into the labor market. These employment, placement, or reintegration services (the terms will be used interchangeably throughout the paper) comprise in particular intensive job counseling and case management for long-term unemployed jobseekers. In 2002, some countries, such as Germany, France, and the Scandinavian countries, spent more than 1% of their gross domestic product on active labor market policy measures (including the administration of these services and of public placement services) (OECD 2004a, 319). Whereas job placement services traditionally have been delivered in-house through the local PES offices, training programs usually have been outsourced to private training providers. In recent years, contracts have gained considerable importance internationally in steering public employment services (Mosley 2003; Sol and Westerveld 2005). On the one hand, Management by Objectives is used increasingly to guide the public administration itself (Mosley, Schütz, and Breyer 2001). On the other hand, governments increasingly rely on external service provision for placement services that in the past were delivered in-house by public servants (Sol and Westerveld 2005). This latter development has gained momentum through recent reforms in Australia, the Netherlands, and the U.K.

Following the contracting-out of employment services, the government has to search for appropriate contract management tools. The central question in this

paper will thus be which governance mechanisms are most suitable for the contracting-out of public employment services. The theoretical background of principal-agent theory will be used for the analysis. The governance mechanisms will be classified into three clusters: incentives, information, and control. Whereas incentives focus mainly on the optimal design of payment structures, information mechanisms usually make use of performance benchmarking and monitoring to increase the public purchaser's knowledge about the private providers. Finally, control mechanisms are defined as extensive rules and regulations that state in great detail how providers have to deliver their services.

For the United States, the analysis of the JPTA program has provided important insights into the weaknesses of performance-based training programs (Courty and Marschke 2003b, forthcoming; Heckman, Heinrich, and Smith 2002; Heinrich 1999). This paper will complement the findings from this research on training programs in two ways. First, a coherent framework of governance mechanisms is developed, which will show the need for the simultaneity and the interdependence of different mechanisms at any point in time. The paper is thus in line with current research that argues that traditional research primarily concentrated on the question of what services are suitable for contracting-out, rather than analyzing the contract management itself (Brown and Potoski 2003b; Kelman 2002; Mosley and Sol 2001; Romzek and Johnston 2002). Second, the empirical basis of research into the contracting-out of employment services is extended by including evidence from Australia, the Netherlands, and large-scale projects in the U.K. Some of the evidence presented in this paper was collected through expert interviews conducted in the three countries. With the notable exception of Struyven and Steurs (2005), Grubb (2003), and Sol and Westerveld (2005), this kind of comparative international approach has received little attention up to now. As could be seen with the JPTA program, governance mechanisms have been changed significantly over the last twenty years in order to respond to weaknesses of the system (Courty and Marschke 2003a). An international perspective can add further evidence to this research, enabling an active rather than a reactive design of governance systems.

The three countries used for analysis in this paper were selected because they have proceeded furthest with the contracting out of public employment services. Thus, they are the ones for which the most experience is available and trends over time can be observed. In the future, other countries such as Denmark and Belgium might also be included in comparative analysis.<sup>1</sup> Of course, comparisons may be made more difficult as, for instance, the scope (target groups as well as spatial coverage) of contracting-out differs or the public purchasing body is located at a different government level (federal level vs. municipalities). Nevertheless, governance instruments still can be compared, as the goal in each case is to support a public-private contracting arrangement.

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1 For an analysis of some minor programs in Germany that use contracting as well as vouchers to include private providers, see Bruttel (2005a).



The paper is organized as follows. The next two sections lay the foundation of the paper by presenting the theory used for the analysis as well as describing the institutional arrangements of the three countries. The main part of the paper then analyzes the design and implementation of the three governance mechanisms (section 4). Section 5 discusses the implications for contracting out employment-related services and provides some conclusions for possible directions of future research.

## **2. Neo-institutional economics, agency theory, and contracting**

In their analysis of contracting-out, researchers and scholars increasingly have made use of neo-institutional economics. In the last three decades, neo-institutional economics itself has become a standard tool in the analysis of different institutional arrangements. By the early 1990s, for example, Williamson's two major works (1975; 1985) on transaction cost economics had become the most frequently cited books in the social sciences (Ghemawat 2000). The range of theories included under the label "new institutional economics" is nevertheless very wide. In general, they share the aim of explaining the structure, behavior, efficiency, and change of economic institutions. Conventionally, the term neo-institutional economics comprises transaction cost economics, property rights theory, and principal-agent theory (Furubotn and Richter 1998; Picot and Wolff 1994). Transaction cost economics relates different institutional governance arrangements (hierarchy, hybrid, market) to different transaction characteristics (asset specificity, uncertainty, and frequency). The less specific a transaction is, the more efficiently a market mechanism works and the less efficient a hierarchical arrangement becomes. The property rights approach (De Alessi 1980; Furubotn and Pejovich 1972) argues that the efficiency of organizations depends on the direct assignment of property rights to an individual. Following this line of reasoning, firms in private ownership are expected to work more efficiently because efficiency gains are directly attributable to an individual. Thus, both theories are useful in evaluating the benefits of one institutional arrangement over another.<sup>2</sup>

Principal-agent theory is less concerned with whether to deliver a service through a public or a private organization. Its main focus is on the dilemma of how to make an agent (e.g. an employee or contractor) act in the interest of the principal (e.g. an employer or purchaser) (Eisenhardt 1989; Gibbons 1998; Sappington

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2 For a framework incorporating transaction cost economics, property rights theory and agency theory to evaluate private delivery arrangements in the field of public employment services see Bruttel (2005a). For research that uses transaction costs to explain the contracting of municipal services, see, for instance, Brown and Potoski (2002; 2003a).

1991). This conflict arises when one assumes asymmetric information between the two parties, risk aversion on the side of the agent, uncertainty, and a divergence of the agent's goals from those of the principal. The consequence is that a public purchaser is unable to observe the actions that a contracted private provider undertakes, and at the same time the public purchaser must assume that private providers maximize their own utility rather than work for the goals of the public purchaser. Agency theory aims at developing governance structures that allow for a solution or at least an attenuation of this trade-off. Private as well as public institutions share these conflicts.

Following these assumptions, the main risk of contracting is moral hazard (Picot and Wolff 1994). Moral hazard occurs after the contract has been signed and can be defined as those actions of the agents which maximize their own utility to the detriment of that of the principal in situations in which their actions cannot be fully observed. Classic examples are the situation of a landlord and a tenant farmer or that of an employer and an employee. In both cases, the agents have divergent interests from those of the principal. The tenant farmer and the employee will, given a fixed payment for their work, reduce their workload. At the same time, however, the principals are only able to observe results, which may be influenced by factors other than effort, making rewards based on results difficult. In the case of employment services, the government is unable to observe the effort of private providers to place participants into jobs. The only variable that usually is available is the number of placements achieved, though this outcome does not necessarily include any information on the contribution of an individual provider to this placement.

In general, three sets of governance mechanisms that solve or mitigate the principal-agent problem of moral hazard can be distinguished (Ebers and Gotsch 1999, 214): incentive mechanisms, information mechanisms, and control mechanisms. The intent behind incentive mechanisms is to align the interests of the agent to those of the principal through design. This can be achieved by designing payment structures in which the agent's maximization of its own profits also maximizes the utility of the government. Usually, this arrangement takes the form of performance-based payments. Information mechanisms aim directly at the information asymmetry by increasing the government's information about the providers' efforts. A widely used tool is performance benchmarking (Behn and Kant 1999; Courty and Marschke 2004). Another, more direct way is to monitor the provider's behavior directly through regular audits, for instance. Finally, control mechanisms implement extensive rules and regulations that state in great detail how providers have to deliver their services. However, this approach fundamentally works against the rationale of contracting-out, which is intended to increase rather than decrease the flexibility of service provision (Mulgan 1997).

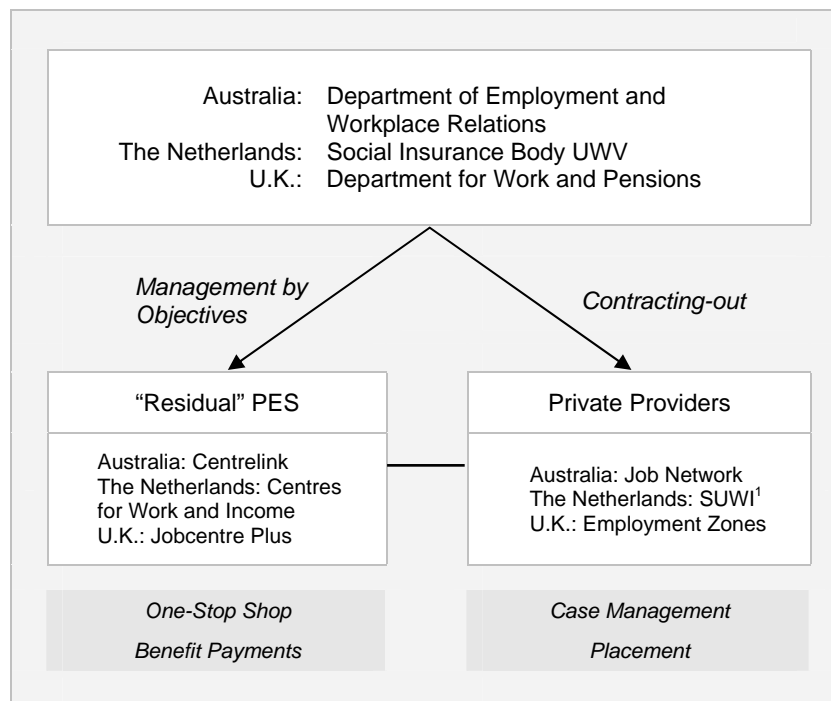
Most research focuses on only one of these mechanisms at a time. In particular, the design of performance-based payment structures and performance-evaluating benchmarking systems have attracted considerable interest. In the

case of employment services, and social services more generally, the deficiencies of past contracting arrangements often were due to a reliance on one mechanism and a failure to understand the interdependence of all three. It will be argued that only a coherent strategy that combines the three mechanisms satisfies the requirements for effective contract management.

### 3. The institutional set-up of contracting regimes in Australia, the Netherlands, and the U.K.

The following subsections describe the contracting regime for public employment services in Australia, the Netherlands, and the U.K. Even though the countries differ with respect to their institutional set-up, the principal design of the administration of public employment services in the three countries is presented in Figure 1. In general, we can observe a division of the responsibilities for benefit administration and payment on the one hand and job placement services on the other (in particular for jobseekers who are not job-ready). The “residual” PES is responsible for benefit administration, and often has a gateway function for further services (including the referral of jobseekers to private providers). This idea

Figure 1: Basic structure of privatized PES



<sup>1</sup> SUWI stands for *Structuur Uitvoeringsorganisatie Werk en Inkomen* which is the name of the Act introducing the new market-style regime for reintegration services.

of a one-stop shop is again an international trend (Clasen, Duncan, Eardley, Evans, Ughetto, van Oorschot, and Wright 2001). Although Centrelink in Australia does not offer any placement services (except self-help facilities, such as touch-screens displaying vacancies), the Dutch Centre for Work and Income is also in charge of short-term jobseekers. The Employment Zones in the U.K. are project regions in which private providers are contracted only for the case management of long-term jobseekers. Jobcentre Plus thus offers the full range of public employment services (including benefit administration and job counseling) for all mainstream jobseekers.

### 3.1 Australia

Australia introduced its contracting-out regime, called the *Job Network*, in 1998. The public one-stop shop for social benefits, Centrelink, takes care of the unemployment benefit payments, profiles the jobseekers using the *Job Seeker Classification Instrument* (JSCI), and refers them to a private provider. The Department of Employment and Workplace Relations (DEWR) contracts the private providers centrally, even though there are separate contracts for each of the 137 Employment Service Areas. Contract periods usually last about three years. The selection of providers is based on two criteria: the capacity to deliver services (40%) and the capacity to achieve outcomes (60%). The capacity to deliver services is mainly an input-related factor (e.g. staff qualifications, methods used, suitability of the office); the capacity to achieve outcome is mainly a quantitative factor that takes into account past performance. Prices are set administratively and thus are not a criterion for selection. The third Employment Services Contract has been running since July 2003 (referred to as ESC 3).<sup>3</sup>

In the first two contract periods there were three major services to jobseekers: *Job Matching*, *Job Search Training*, and *Intensive Assistance*. Depending on the barriers to employment identified during the profiling, jobseekers were eligible for one of the three services. Since the advent of the third contract, this distinction of services was abolished in favor of a continuum of services. All jobseekers follow the same track, starting with minor counseling and job search training. Only after 12 months does a period of *Intensive Support customised assistance* (ISca) begin. However, about 20% of newly registered jobseekers are classified as “highly disadvantaged” and referred directly to the ISca program. Besides the general services, to which most of the clients are referred, there are also specialist providers that have specialized in working with certain groups of clients (e.g. people with hearing impairments or AIDS).

The providers face a mixed funding model. Although they are paid up-front for the services they deliver, any other payments are made per outcome. An outcome is

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3 ESC = Employment Services Contract. ESC 1 lasted from May 1998 to February 2000, ESC 2 from March 2000 to June 2003.

principally defined in terms of acquiring a job for the client; the first payment is applicable after 13 weeks on the job, the second after 26 weeks on the job. The proportions between both components are discussed further below. Additionally, providers have a Job Seeker Account at their disposal, which is a budget that varies according to the status of “highly disadvantaged” and locational disadvantage and includes up to \$1,150 for the first ISca period and up to \$639 for the second ISca period, which starts after 24 months of unemployment.<sup>4</sup> The funds only can be used for expenditure for the jobseeker (e.g. training, clothes, mobile phones). Furthermore, there is a training account of up to \$584 which is available for older jobseekers and indigenous jobseekers. Because the public vacancy database depends exclusively on input from the providers (and employers), providers are paid a job placement fee (up to \$401) if a jobseeker is placed in a vacancy that was listed on the national vacancy database by the provider.

### 3.2 *The Netherlands*

On January 1, 2002, the Netherlands introduced a similar system with respect to the division of labor between the public and the private sector. In addition to the administration of public employment services, the reform also encompasses a more far-reaching reallocation of responsibilities between the public and the private sector (Sol 2001; Struyven and Steurs 2002). For instance, employers increasingly are being made responsible for incapacity benefits. The public Centres for Work and Income, which are the “residual” PES, are a one-stop shop that is responsible for profiling, insurance data collection, the placement of job-ready clients, and the administration of the vacancy database. The jobseekers are profiled using the *Kansmeter* and a more in-depth interview technique called *Kwint* (qualification intake). Jobseekers are classified into different streams, with Stream A containing jobseekers who are job ready and Stream B containing those who have multiple (often nonvocational) barriers to employment.<sup>5</sup> Stream A clients are expected to return to employment within six months and are serviced by the Centres for Work and Income, whereas the others are referred to either a case manager by the social insurance body (UWV) (if they are eligible for unemployment benefit or disability benefit) or a municipal case manager (if they are only eligible for social assistance). These case managers in turn refer them to private providers.<sup>6</sup> In 2002, 183,000 persons received unemployment benefit, 977,000 disability benefit, and 384,000 social assistance. In this paper the focus is solely on the UWV contracts, as only these contracts replace the PES.<sup>7</sup>

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4 To ease comparisons, all currencies have been converted into U.S. dollars through use of the 2003 Purchasing Power Parities quoted in OECD (2004b).

5 Before January 1, 2005, there were four streams, of which Stream 1 clients stayed with Centres for Work and Income and the others were referred to private providers.

6 For a description of the rather complex institutional set-up of the Dutch social security system, see Struyven and Steurs (2002).

7 For an analysis of the municipalities market, see Sol and Hoogtanders (2005), and De Koning (2004).

Private providers are selected in a one-stage tender (formerly a two-stage tender in 2002) on the grounds of experience, offered outcome rate, price, and method. Contracts are tendered in tranches within one of the six regions in which the country has been divided for labor market administration, based on target groups (e.g. there are five tranches with 150 clients each for jobseekers older than 50 in Region 1). There are five target groups for unemployment benefit clients (jobseekers with social/economic problems, jobseekers older than 50, jobseekers Phase 2, jobseekers Phases 3 and 4, and jobseekers from ethnic minorities), and up to 17 for disability benefit clients (of which some consist of only one hundred jobseekers nationwide).

In the first two contract periods (2001 and 2002), providers were contracted on the basis of product. Taking into consideration the perceived jobseeker's needs, a private provider suggested a range of products (e.g. diagnosis, agreement on an action plan, a training course, assessment center training, post-placement support) and was paid for these products partly at the time of delivery, partly at the time when an outcome was achieved. For most unemployment benefit clients, the rule was about a fifty-fifty split (i.e. 50% of the price was paid up-front, the other 50% when an outcome was achieved), although the more difficult-to-place target groups would give rise to a higher fixed component. This rather complex system, which involved a high degree of administration, was abolished in the contracts starting from 2003. Currently, providers offer a total price that consists of three parts: an action plan; a trajectory, which is the actual case management; and post-placement support. In the first stage, providers receive a (completely input-related) payment for the agreement of an action plan. The main part of the total payment is the price for the actual trajectory, of which the first half is paid after six months and the other half is paid after an outcome is achieved. Finally, there is a payment for post-placement support. Recently, the UWV has increased the proportion of "no cure, no pay" contracts, in particular for easier-to-place clients. In these contracts, providers only receive a payment after placement in a job lasting six months has been achieved. If they are not successful in placing a client, they do not receive a single cent.

### 3.3 *U.K. Employment Zones*<sup>8</sup>

Unlike Australia and the Netherlands, the Employment Zones in the U.K. cover only 13 (originally 15) generally very deprived areas with high unemployment rates, and focus on long-term unemployed persons only. Jobcentre Plus refers jobseekers who have been unemployed for more than 18 of the last 21 months to private providers. The current Employment Zone contracts, which started in October 2003 and April 2004, respectively, have contract durations of five to seven years. There are two kinds of Employment Zones. In Single Provider Zones, one provider is contracted exclusively to deliver the services for all jobseekers in that

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<sup>8</sup> For a more detailed analysis of the Employment Zones see Bruttel (2005b).

area. In Multiple Provider Zones up to four providers are awarded a fixed market share. The case management has three stages. In Stage 1, which lasts four weeks, the private case manager and the jobseeker agree on an action plan. In Stage 2, the private providers completely take over employment services for the jobseeker for 26 weeks (including benefit payments). After these 26 weeks, a jobseeker for whom no placement has been achieved returns to Jobcentre Plus and is eligible for another Employment Zone period only after another 18 months of unemployment. However, for a period of 22 weeks following Stage 2, providers can still work together with the jobseeker in a so-called *Follow-On* period. If they manage to place the jobseeker, they can still claim the outcome fees. The providers are paid \$470 for the first four weeks and receive an amount at the beginning of the 26-week period which is equal to the average unemployment benefit payment for 21 weeks. In turn, however, they must pay unemployment benefits to the jobseeker for a maximum of 26 weeks. Thus, if they do not manage to place the client within 26 weeks, they incur a loss for this individual client. All other payments are outcome-based (\$627 for a placement and \$3,762 or \$5,643 for a 13-week job outcome).<sup>9</sup>

#### **4. Governance mechanisms**

The last two sections introduced the theoretical framework for the analysis and outlined the institutional arrangements in the three countries. In this section, I analyze governance mechanisms intended to facilitate the principal-agent relationship. For this purpose, I use the categories discussed in the theory section, that is, incentives, information, and control.

However, before starting with the analysis, it is useful to recall some basic assumptions and parameters of contracting-out. One of the major reasons to contract out public employment services is the increased efficiency and flexibility associated with private providers. According to property rights theory, private providers are assumed to work more efficiently than public bureaucracy. At the same time, the new system emphasizes outcomes over processes. Hence, the government does not prescribe what private providers have to do but rather pays them for outcomes, and there is a high degree of flexibility for providers in how they want to organize their services. At the core of the principal-agent relationship is the difference between the objective function of private providers and that of the government. The private providers' goal is to maximize their (operational) profits, whereas the government can be thought of as applying a cost-benefit analysis in which (in its simplest form) it trades off unemployment benefits and

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<sup>9</sup> Figures refer to Single Provider Zones. In Multiple Provider Zones, the fees for 13-week outcomes are \$3,135 and \$4,702, respectively.

reintegration costs. Thus, the government needs to design mechanisms that simultaneously maximize both objective functions.

## 4.1 Incentive mechanisms

### 4.1.1 Outcome-related payments

For all countries, outcome-related payments are the single most important governance mechanism to align the interests of the private providers with those of the public purchaser. In general, fees are split into a fixed commencement component and an outcome-related component that is paid only after 13 and/or 26 weeks of sustained employment. Thus, providers face constant marginal incentives because the award function is linear, like that in a piece-rate compensation function. This contrasts with the situation in the JPTA program, in which most states paid performance bonuses only if a certain threshold was achieved (Courty and Marschke 2003b). Table 1 shows the payment structures of the first three contracts for Australia. For ESC 1, three levels of Intensive Assistance were distinguished, which corresponded to the severity of placement barriers for an individual jobseeker; for ESC 2 there were two such levels. In ESC 3, payments are now related to the duration of unemployment, which is taken as a proxy for employment barriers. Outcome payments increase with a longer unemployment duration. Only during the first twelve months is the proportion of the commence-

Table 1: Outcome payments in Australia, 1998-2006 (in U.S. dollars)

	ESC 1			ESC 2		ESC 3 (months of unemployment)			
	Level 1	Level 2	Level 3	A	B	3-12	13-24	25-36 <sup>a</sup>	36+
<i>Payment structure</i>									
Commencement fee	1,095	1,642	2,190	786	1,549	606	1,898	2,682	2,828
13-week outcome	1,095	1,642	2,336	1,835	3,615	401	1,204	2,409	3,212
26-week outcome	876	1,606	2,190	782	1,565	0	620	1,204	1,606
Total	3,066	4,891	6,715	3,404	6,729	1,007	3,723	6,296	7,646
<i>Distribution (in %)</i>									
Commencement fee	36	34	33	23	23	60	51	43	37
13 weeks	36	34	35	54	54	40	32	38	42
26 weeks	29	33	33	23	23	17	19	19	21

Source: For ESC 1 and 2, see Productivity Commission (2002, 10.18); for ESC 3, see DEWR (2002b, 53) and own calculations.

Note: For ESC 3, it was assumed that the jobseeker is placed at the end of a particular period of unemployment (e.g. after 3 months, 12 months, 24 months, or 36 months). The commencement fee for 25-36 months, for instance, also includes all payments made in the periods before. For 36+ a placement at 48 months is assumed. The commencement fee for ESC 3 also includes the Job Seeker Account.

<sup>a</sup> This category also includes highly disadvantaged jobseekers.



ment fee higher, which is due to the fact that there is hardly any outcome fee at this time. Furthermore, the 13-week outcome attracts the major proportion of payments. For twelve months of unemployment or less, it is actually only the 13-week outcome which is rewarded with an outcome fee at all.

Table 2 shows the payment structure in the U.K. Employment Zones. In order to understand the table, it is important to remember the system of Employment Zones, in which providers are paid the unemployment benefit for 21 weeks upfront in Stage 2 and in turn are responsible for payments to the client during a maximum of 26 weeks in this stage. If they place a client at any time in Stage 2 they can keep the remaining amount as profit. If they need more than 21 weeks, they have to deal with an extra burden. During that time, the Employment Zone providers also have the authority of the secretary of state to stop payments independently.<sup>10</sup> A system that makes the providers responsible for the payment of unemployment benefit is often seen as the one with the strongest and best incentives (Dykstra and De Koning 2004, 294)

*Table 2: Income for a provider in the U.K. Employment Zones, 2004 (in U.S. dollars)*

	Placement after one day in Stage 2		Placement after 21 weeks in Stage 2		Placement after 26 weeks in Stage 2	
	\$	%	\$	%	\$	%
Stage 1	470	6	470	8	470	9
Stage 2	2,371	29	0	0	-568	-11
Placement fee	627	8	627	11	627	12
13-week outcome fee	4,702	58	4,702	82	4,702	90
Total	8,171	100	5,799	100	5,232	100

*Source:* Department for Work and Pensions (2003), own calculations.

The fact that fixed and outcome-related payments are combined in all countries shows the trade-off between optimal incentive contracts and the risk aversion of the providers (Gibbons 1998; Sappington 1991). In the field of social services, the cooperation of the client is a major input factor, which the provider can only partially influence.<sup>11</sup> In addition, many (especially small) providers are exposed to serious cash-flow problems when faced with a pure outcome-payment system because the costs incur up-front whereas the payments lag by many months in some cases. The Netherlands tries to overcome this dilemma by paying 20% of the fees in the “no cure, no pay” contracts in advance. If a provider does not place a client, it has to repay this money. Whether these “no cure, no pay” con-

<sup>10</sup> In this case, jobseekers have to re-apply for Jobseeker Allowance at the local Jobcentre Plus. During this procedure, the validity of the ceasing of payment is controlled by Jobcentre Plus.

<sup>11</sup> See Fountain (2001) for the distinct characteristics of public services in contrast to private services.

tracts really are more efficient is doubtful. Many providers in the Netherlands have increased their prices in reaction to the new principle, in order to accommodate the higher risk. This response is in line with theory, if we assume that providers want to achieve a constant expected income. Instead of a “no cure, no pay” system, a structure that pays providers relatively small amounts at different stages is able to reduce this risk premium and thus reduce the total price, too.

Providers seem to pass on incentives to case managers and sometimes even to jobseekers. Performance-related salaries are the rule in all three countries. As a rule of thumb, one (sustainable) placement of a long-term unemployed person per week can be seen as the average performance target for most case managers. In the Employment Zones around 20% of clients have been promised a reward if they achieve sustainable employment (Hales, Taylor, Mandy, and Miller 2003). One expert interview revealed a systematic approach in which the provider paid clients \$627 if they found a job (and kept it for 13 weeks) within 4 weeks after starting Stage 2, \$549 within 8 weeks, \$470 within 12 weeks, and so on. An additional \$78 was paid if clients found the job themselves.

#### 4.1.2 Definition of successful outcomes and earmarked payments

In changing the focus from payments for inputs to pay for results, the contracting systems have changed from the paradigm of regulatory contracting to that of performance contracting (Behn and Kant 1999). Former indicators for controlling were often related to inputs (e.g. clients per staff member). This approach was followed by a period of output measures (e.g. placements), whereas recently outcome measures (e.g. placements into a job that lasts a minimum of 13 or 26 weeks) have become increasingly popular. This focus on sustainable employment outcomes counteracts the tendency to have placements into short-term jobs only. The definition of successful outcomes is similar in all three examples (see Table 3). In Australia and for Dutch jobseekers on unemployment benefits, the outcome payments are linked most consequently to the reduction in unemployment compensation. In the U.K. and for Dutch jobseekers on incapacity benefits, we find a minimum-hour requirement. Self-employment also is accepted as an outcome (and is proven through the discontinuation of benefit payments).

Employment durations of 13 and 26 weeks have emerged internationally as major milestones because they are useful indicators. In Australia, 65% of jobseekers who were in employment 13 weeks after their placement were still in employment after one year (DEWR 2004). In the Netherlands, even 86% of disability benefit recipients were still employed one year after their first placement (Algemene Rekenkamer 2001). The emphasis on employment reflects the Work First philosophy of the labor market policy in all three countries, a philosophy that favors employment outcomes over education outcomes, such as placement into a full-time training course (Bruttel and Sol 2006; Theodore and Peck 2001). In line with this policy approach, wage levels and considerations about the quality of place-

ments also are seen as secondary concerns at best. Obviously, such an approach does not suit all target groups. For benefit recipients for whom employment on the immediate labor market is not a realistic goal in the short term, other, less easy to define outcomes need to be specified. This is likely to increase the complexity of the contracts.

*Table 3: Definition of successful outcomes*

	Australia	The Netherlands	U.K.
<i>Kind of employment</i>	must be enough to reduce unemployment benefits by 100%	<i>unemployment benefit:</i> benefits stop <i>disability benefit:</i> at least half of the possible individual working time	minimum of 16 hours per week
<i>Duration of employment</i>	first payment after 13 weeks, second payment after 26 weeks	6 months	13 weeks
<i>Wage subsidies allowed</i>	yes <sup>a</sup>	yes	no <sup>b</sup>

<sup>a</sup> Payment comes from the Job Seeker Account.

<sup>b</sup> If public wage subsidies are used, the 13-week period only begins to accrue after the wage subsidy ends.

One of the aims of contracting out public employment services was to enable the increased flexibility that providers would have in using the funds available. In the Netherlands, this recently has been highlighted through the removal of product-based contracting and the use of lump-sum payments to providers for the whole reintegration process. Interestingly, Australia recalled such a policy after the first two contract periods because surveys showed that only 11% of Intensive Assistance customers took part in further training and a mere 3% were gaining work experience (DEWR 2001, 63). It is, however, less the contracting per se that should be blamed for this low investment in training. It is, rather, a political question of which kind of services are financed. Thus, the vehicle “contracting-out” should not be mistaken for the program content of active labor market policy. If the government appreciated training as an effective method for helping job-seekers, there would be ways to implement structures within these private delivery arrangements which would foster investments in training. One option would be a matched funding model in which the government would match private providers’ expenditure on vocational training for the jobseekers (Productivity Commission 2002). The Job Seeker Account may indeed be seen as a reaction to the problem of under-investment, as funds can be spent only on the jobseeker and are otherwise lost.

### 4.1.3 Creaming and parking

Quasi-markets for social services which use incentives in the form of outcome-based payments are often confronted with creaming and parking (Donahue 1989; Le Grand and Bartlett 1993; Smith and Lipsky 1993). This is particularly true for public employment services (Courty and Marschke 2003b; Dockery and Stromback 2001; Struyven and Steurs 2005). Because the whole idea of contracting-out is built around incentive-induced behavior, there are serious consequences if incentives are not designed well. An optimal contract would reward providers on the basis of their net impact on the situation of a jobseeker. Hence, the greater their contribution to the placement of a jobseeker; the higher their payment should be. However, it is very difficult to measure the net impact of treatment on an individual client. A measure of net impact would have to take into account the counterfactual situation of nontreatment, that is, what would have happened to the jobseeker if the private provider had not counseled him or her. Thus, real-world measures usually take only the gross results (i.e. total placements) as a proxy for the provider's impact. However, by only taking into account the gross results, the government implicitly assumes that the impact is constant for all jobseekers. Because providers are paid on the basis of crude placement results, they are encouraged to assist those who are easiest to place regardless of whether the provider's service actually makes any difference. This behavior is referred to as "creaming" (Heckman, Heinrich, and Smith 2002). On the other end, "parking" describes a situation in which jobseekers are not helped at all.

The contract management systems in the countries under consideration have developed different instruments to deal with these problems. A very common strategy is to differentiate payments according to target groups. Ideally, profiling instruments are used to classify jobseekers according to their needs with respect to the services that would be most useful in helping them find a new job (Hasluck 2004; OECD 1998). Within these groups the net impact on outcomes is assumed to be identical, which still creates problems. In Australia, the *Jobseeker Classification Instrument* is used for this profiling; in the Netherlands, the Centre for Work and Income uses the *Kansmeter*. Both are based on questionnaires. In the Netherlands, clients also may be profiled in more depth through a structured interview (*Kwint*). Both systems have been criticized in the past for their inaccuracy (Productivity Commission 2002; Vos, van den Berg, and Vroome 2003). For Australia, criticism also has focused on the way the profiling is done. Major problems are that clients do not reveal their true situation because benefit assessment and profiling are carried out in the same interview, and that the time frame is too limited (around 15 minutes on average) and the training of the staff insufficient. However, there is also a structural problem in that the target groups are defined very broadly and in many cases are not optimally linked to the profiling instruments. Client groups in Australia are defined only by the length of unemployment duration, and the profiling is only relevant for an extra group of highly disadvantaged persons. In the Netherlands the five target groups for unemployed jobseekers and up to 17 for jobseekers on incapacity benefits are rather one-

dimensional (e.g. ethnic minorities, older jobseekers). Finally, in the U.K. the allocation of jobseekers to private providers is subject to a threshold of 18 months of unemployment. It becomes obvious that target groups defined in these ways are not suitable for addressing the problems of quite heterogeneous groups.

#### 4.2 *Information mechanisms*

Information mechanisms are the second type of governance instrument used to tackle principal-agent problems. The design of information mechanisms should aim at an increased transparency of information for the government in order to overcome the asymmetric information between parties, which is one of the reasons for moral hazard. The two main instruments are benchmarking and monitoring. The first indirectly compares the impact of providers on the employment outcomes of clients, whereas the second directly observes the delivery process of the individual provider.

Benchmarking offers a way to measure the relative performance of providers. By using advanced econometric modeling, it enables a comparison of providers across different regions because the computations are able to control for external context variables (e.g. local labor market conditions) (Courty and Marschke 2004; Sappington 1991). Thus, even if providers are given a local or regional monopoly, their results can still be compared to providers in other regions. However, for benchmarking to work for employment services, it is also necessary to include variables on the personal characteristics of the jobseeker (e.g. duration of unemployment, age, educational background). Otherwise comparisons are biased. For instance, Provider A may have placed many more clients into jobs than Provider B, but, taking into consideration the clients' barriers to employment, Provider A actually added much less value to the job outcome of clients as they had a high probability of finding a job anyway (see the subsection "Creaming and Parking" above).

Australia has implemented a highly sophisticated benchmarking system. The so-called *Star Rating* compares the placement results of all providers by using a logit/probit regression model that controls for labor market conditions (i.e. regional employment growth, local unemployment level, major industries in a region, a dummy variable for the five largest cities, and the geographical size of the labor market) and for personal characteristics of the jobseekers (e.g. gender, age, educational attainment, duration of unemployment, status as an indigenous Australian, as a person with a disability, and/or as a lone parent) (Access Economics 2002; DEWR 2002a). Providers are ranked according to their controlled result and are awarded with stars. Five-star providers are at the top of the league, one-star providers perform significantly below average. In Australia, the Star Rating exercises a significant incentive for existing providers. In the transition from the second to the (current) third contract, the best 60% of existing providers on

the basis of the Star Rating were offered a contract renewal (without tender). From the point of view of game theory, the providers take part in a repeated game in which long-term considerations (such as reputation) are more relevant for business decisions than one-off profits (Axelrod 1984; Milward and Provan 2000).

In the Netherlands and the U.K., such econometric benchmarking models do not exist. Providers are compared on the basis of crude placement figures. The public purchasing bodies argue that the disparities arising from geographic differences are not that relevant. For the Netherlands, the six regions that form the basis for the tender of employment services are in a rather small and economically uniform country, whereas the U.K. Employment Zones are all in some of the most deprived areas in the country and thus share common economic conditions. For personal characteristics, in the Netherlands comparisons are made between the target groups. In the U.K. the results are only compared for all Employment Zone participants. Thus, there is a significant danger of creaming and parking, given the lack of information control for personal characteristics.

The second form of information mechanism is direct monitoring of the providers' behavior. The aim is to overcome the "black box" — that sphere where the government does not know what the individual provider does. In Australia, monitoring is done through a mix of desktop monitoring via an integrated computer system and visits to the individual providers. Every contact with the jobseeker is recorded in a Web-based database. The department can access the database at any time and hence observe the service provided for every jobseeker in the country in real time. Desktop monitoring means that monitoring takes the form of controlling the integrated database. A risk management tool in which providers and each of their sites are assessed according to the risk of failing to deliver the services properly accompanies the whole system of monitoring. Following this assessment, the number of monitoring visits is fixed and may vary from one per year to up to four and more if it is a new site from a new provider or if problems have occurred in the past. In the near future, this risk assessment will be enhanced by an electronic tool that alerts the contract manager whenever there are irregularities with a provider's site, for example if a client has not had an appointment with the provider for more than four weeks.

In the Netherlands, monitoring is still in its early stages. The government favors self-regulation by the industry. Borea, the industry's top organization, has developed a *Keurmerk* (quality certificate) which includes annual audits by external (but private) certification companies. Additionally, the UWV meets every three months to discuss written reports by the providers and to crosscheck the data from both sides. The latter is needed because there is no integrated system and most communication is carried out through paperwork or on floppy disk. An interesting approach can be seen in the involvement of clients in the monitoring process. The provider's three-month reports on each jobseeker on their register

need to be countersigned by the individual jobseeker, who thereby experiences empowerment in the provider-client relationship.

In the U.K., the monitoring also is done through visits to the providers. However, due to the small number of only three providers in the first contract round and seven providers in the current round, monitoring can still take place in a more informal and personal way than in the case of a country-wide system with hundreds of providers, like that in Australia. The monitoring, however, is focused on claimed outcomes. Thus, clients for whom no outcome has been claimed are not part of the monitoring.

### 4.3 Control mechanisms

The third form of governance mechanism discussed in the literature is control. Control mechanisms such as rules and regulations are the traditional tools of public bureaucracy. Control in the form of extensive rules and regulations thus contrasts with the rationale of increased flexibility and a focus on outcomes rather than processes, which motivated the introduction of private delivery arrangements (Mosley 2003; Mulgan 1997). For Australia, Considine (2001) indeed found evidence from surveys that private case managers are less guided in their daily work by central rules than are the staff of PES in other countries in which the PES is still a public bureaucracy. This in turn gives them more flexibility to find individually tailored solutions for jobseekers.

Reduced control in this context should not be misunderstood as a complete withdrawal of the government from the process of services delivery. Instead of distinct instructions, the contracts usually contain a quality management framework. In Australia, the contracts contain an *Employment Services Code of Practice* and a *Job Network Service Guarantee*, although their content may be described as rather “soft” (e.g. “acting with honesty, due care and diligence”). As mentioned above, in the Netherlands the government relies heavily on self-regulation of the industry, whereas in the U.K. the *Contractor’s Guide to Employment Zones* sets out the basic quality requirements. To check compliance with these rules, the government uses the monitoring mechanisms described in the previous section. In addition, it relies on the clients, who are given the opportunity to complain if they are not satisfied with a provider’s service.

Quality standards thus complement incentive mechanisms with their focus on achieving outcomes. The aim of control mechanisms can be seen as guaranteeing a minimum standard of service to all jobseekers, which is a key factor in delivering public services. The increased prescription of services in Australia should indeed be interpreted in this way. Because the former contract arrangements led to a lack of services for some jobseekers, in the new contract the government has defined standards (e.g. meetings every two weeks) that must be met for all jobseekers, although providers are free to choose a higher level of

service if this leads to better outcomes. Interestingly, there are two divergent tendencies at the moment. Whereas for Australia a stronger use of control instruments can be observed, the Netherlands seems to be reducing its regulations on private providers. Both countries seem to be evaluating the optimal extent of rules and have not yet found a definite answer. The basic trade-off is between the higher accountability of providers for their outcomes on the one hand and the freedom that they want to have in order to achieve these outcomes given their greater responsibilities (in particular financial responsibilities) on the other hand.

## **5. Discussion and conclusion**

This paper examined the mechanisms by which governments can manage contractual relationships in the field of public employment services. These contracting arrangements usually can be interpreted as principal-agent relations. The aim of this paper was to analyze in detail these principal-agent relations for three countries in which public employment services have been contracted out nationwide or, in the case of the U.K., in large-scale projects. I have identified three distinct governance mechanisms – incentive, information, and control mechanisms – which can serve as a useful tool for the analysis of other contract regimes as well. Incentive mechanisms using outcome-related payments are certainly the most widespread instrument. However, rather than paying completely outcome-based premiums, the purchaser and providers agree on a risk-sharing strategy that pays providers a fixed commencement fee. Although incentives are a big part of the story, which is reflected by the space devoted to them in this paper, efficient contract management also needs to take into account the information challenge for governments as principals. An increased transparency of information can be achieved either by (indirect) benchmarking or (direct) monitoring. The Australian Star Rating, in particular, is a very effective approach to benchmarking providers. Indeed, Australia shows how incentive and information mechanisms can complement each other. Monitoring, on the other hand, is a useful tool to increase information on the process of work rather than on job outcomes only. For both, benchmarking and monitoring, a sophisticated IT structure is essential. Finally, control mechanisms – in the form of rules and regulations – should not be used extensively because they do not square well with the rationale of service flexibility through contracting. Nevertheless, the example of quality control again shows that pure incentive mechanisms will not yield optimal outcomes in terms of equal services to all jobseekers.

What is needed is an integrated governance approach. This paper has shown that contracting for public employment services should not rely exclusively on incentive mechanisms, as it often has in the past. On the contrary, a coherent contract management approach should make use of information mechanisms



and control mechanisms in order to complement one-sided, outcome-related payments. The incomplete nature of contracts and the character of public employment services as social services require these instruments as safeguards in performance-related contracts. Thus, starting from outcome-based payments, benchmarking systems should be implemented and providers monitored by means of auditing visits and industry-wide quality standards.

The development of an integrated governance approach in practice is a challenging task; indeed, public purchasers have only started to develop a “contract management capacity” (Brown and Potoski 2003b) to govern private providers. Brown and Potoski (2003b, 155) distinguish three fields for which special expertise is required: first, the “feasibility assessment capacity,” which includes the make-or-buy decision about a good or service and thus also the suitability of a good or service to be procured from third parties; second, the “implementation capacity,” which includes the capacity to set up tenders, select providers, and design and negotiate contracts; and third, the “evaluation capacity,” used to evaluate and monitor the performance of private providers. Poor contract performance can result from insufficient management capacity in any one of these functional areas. The governance mechanisms that have been discussed in this paper can be subsumed under the latter two capacities: the implementation capacity of effective contracts (incentives) and the evaluation capacity (information and control). This focus is in line with the shift in research priorities. Whereas traditional research often has exclusively focused on the first capacity, the make-or-buy decision, second-generation scholarship (such as this paper) tends to emphasize the importance of how contracting-out is implemented and evaluated.

For employment services, the use of private providers in placement services (rather than training services) is a very recent development. Thus, further international comparisons of the positive (rather than the normative) design of these mechanisms in employment services would enhance our understanding of the strengths and pitfalls of contracting for this relevant area of social services, and at the same time allow for learning from best practices across countries.

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