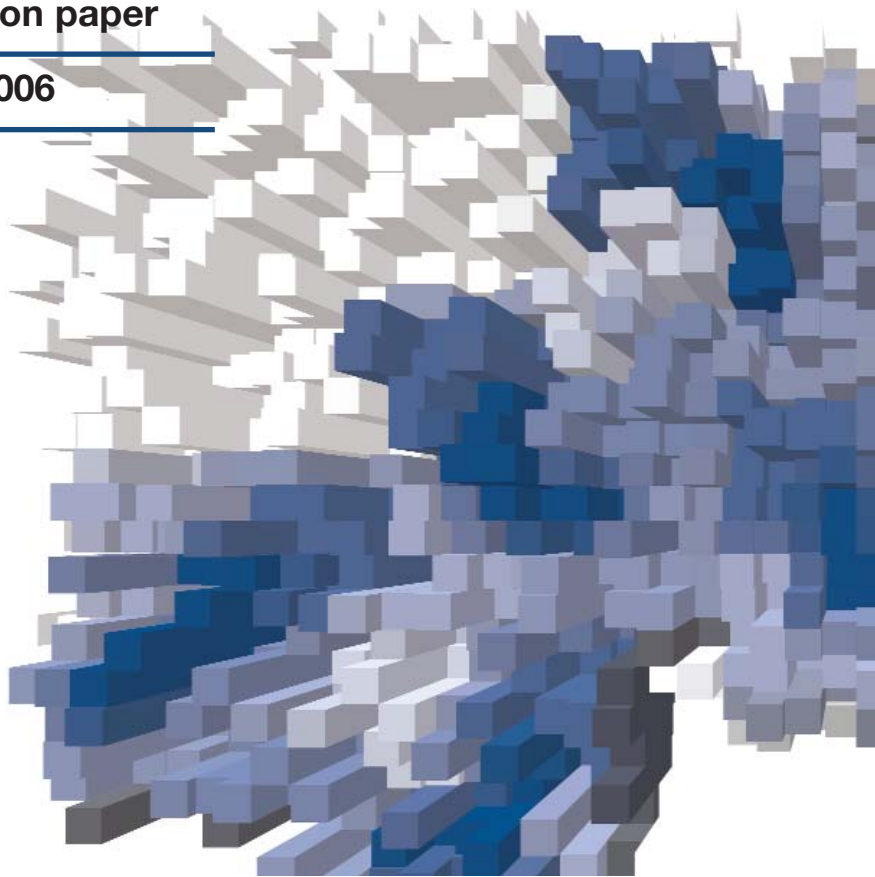


Corporate



Discussion paper

March 2006



The future of regulation in the public sector

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Introduction

1 Public services are changing. They are being delivered in new ways, through a wider range of providers which extend beyond traditional public sector bodies; and they are being increasingly tailored to the needs of individual users, with greater involvement by users in the specification of the services they receive. And as expectations about the services provided by public bodies change, so too do the roles that public bodies play and the requirements placed upon them. For example, the provision of high-quality public services is no longer simply a question of ensuring first rate delivery by public bodies. These public bodies are increasingly expected to be effective commissioners of services, to develop markets in the provision of services and to stimulate innovation through their commissioning decisions. They are also being challenged to a greater extent than at any time in the past decade to demonstrate that they are providing value for money through their decisions about service provision, whether directly as deliverers of public services or through their commissioning function. And these trends are accelerating.

2 Increasingly, it is being recognised that users of public services are taxpayers too, and that although taxpayers also use public services, the interests of taxpayers and service users are not identical.

A balance needs to be struck between them. Arguably, this balance has shifted in recent years in favour of those users who demand more and better public services, without adequate regard to the willingness or ability of taxpayers to fund them. The providers of public services have become more conscious of, and more responsive to, the voice of their customers while taxpayers have struggled to make their voice heard. The role that independent public audit can play in ensuring value for money in the provision of public services is therefore a vital part of public sector regulation. It makes a distinctive contribution in a part of the economy where market disciplines either do not apply or apply only in a weak form. And because of this, the role of public audit has recently been enhanced, for example by the introduction of auditor judgements on use of resources in local government.

3 At the same time, public services are improving. The benefits of recent increases in funding and increased attention to the quality of leadership and management in public bodies are being seen in better outcomes. These are reflected in improved performance indicators, although the extent to which public satisfaction is also increasing differs between sectors. But there are doubts expressed at all levels about whether the rate of recent improvement can be sustained by the continuation of the current approach to public service reform and regulation, and even greater doubts as to whether the current approach can secure the quantum leap in service quality that is believed to be both possible and necessary. Centrally imposed targets and the associated performance monitoring and intervention are perceived to stifle innovation, addressing the failures of the worst performers while holding back the majority. Likewise, regulation is perceived to be a burden which is subject to a law of diminishing returns and which must now be rolled back, in both the public and private sectors. In the public sector there is a growing demand from providers and commissioners alike for greater reliance on self-regulation and on market mechanisms to ensure high-quality services.

4 All of this has profound implications for the future regulation of public services. The expectations placed upon the regulators of public bodies must flow from the expectations placed upon the regulated bodies themselves. As the latter change, so must the former. It follows that the roles of regulators are changing and will continue to change over the next few years.

5 Although the overall shape of the government's agenda for the reform of public services is already apparent, elements of it will become much clearer during the course of 2006. The extension of user choice, the devolution of decision making and the promotion of a mixed economy of providers of public services have been established as key themes in the approach to reform right across the public sector. But in some sectors it is not yet fully clear how these themes will play out. In local government, for example, the full extent of devolution will not emerge until the publication of the government's White Paper, expected in June or July, or even until after the publication of the report of Sir Michael Lyons' review of local government which will come later in the year. The debate about the future regulation of local government will therefore need to take place alongside a debate about the future role, structure and funding of local government itself.

The need for further debate

6 In recognition of the changes in the way in which public services are provided and the need for regulation to reflect this, the government is remodelling the landscape of regulation in the public sector. Eleven existing public sector inspectorates will have been reduced to four by April 2008. These will be focused on police and criminal justice services, health and adult social care, children and learning, and local services. At the same time, the government has committed itself to reducing the overall amount spent on inspecting public services and to reducing the burdens that inspectors impose on those delivering public services, for example through often uncoordinated requests for data or other information. The Audit Commission has welcomed these developments but considers that, in the longer term, they will not go far enough.

7 Of themselves, they will not necessarily result in a consistent approach to inspection and other forms of regulation across the public sector and they will not necessarily enhance the importance attached to the interests of service users and taxpayers within the methodologies employed by different inspectorates. The government's

structural reforms are therefore underpinned by a clear policy framework within which inspectorates are expected to operate. This policy document (**Ref. 1**) defines ten principles of inspection which have been accepted by all inspectorates and are now being applied to specific inspection regimes. However, even these ten principles will not necessarily ensure that the various forms of public sector regulation adapt quickly to the further changes in the provision of public services that are in prospect beyond 2008, for example by permitting a more area-based focus on local services provided through partnerships of different public bodies. And nor will they necessarily create a lasting consensus about the different roles of government and of independent bodies within the overall regulatory framework.

8 A further debate is therefore needed about the future regulation of public services – one which takes the impending legislation to create four new public sector inspectorates as given, but which looks beyond that reform, and which seeks to define what will be needed over a longer time horizon. This paper attempts to stimulate that debate. It draws out some of the implications of changes now taking place in the provision of public services for the future regulation of public bodies in England, especially those within the current remit of the Audit Commission. And it reflects also the need to recognise in a more differentiated approach to regulation in the future, the emerging evidence of sustained improvement in the performance of many of our public bodies. Where appropriate, this paper also draws on lessons to be learned from examples of approaches to the regulation of bodies that are not currently within the Commission's remit.

9 The purpose of this paper, and of the debate it attempts to stimulate, is to equip policymakers to go beyond the decisions made so far about the future of regulation and to consider what further measures might be needed for the post-2008 period. The

Commission recognises that the future of regulation, including the number and shape of regulatory bodies and the roles they will be expected to play, is a matter for government and parliament to decide. Any significant changes to the present arrangements, or those that will result from the planned legislation already announced, are likely to require primary legislation and the Commission does not presume to know what is in the government's mind, or seek to deny the rights of ministers to come to their own conclusions and to legislate for their own policy decisions. But the Commission does wish to encourage wider debate about these issues, and to contribute some thoughts on key aspects of this debate – for example on how regulators might better assess their impact and ensure that their activities do not create unintended consequences. And we wish also to prompt other stakeholders to put forward their own views. To that end, we intend to follow up this paper with further discussions and publications on specific aspects of future public services regulation.

What is regulation for?

10 Much debate about regulation is confused by arguments over semantics. It is therefore helpful to begin with some broad definitions which should serve to clarify any ambiguities in the meaning of words used elsewhere in this paper. Thus:

- We refer to **regulation** in the wider sense adopted for example by Hood and Scott (**Ref. 2**) who hold that it is all or any part of the activity of a regulator, which is simply an office or organisation that seeks to shape the behaviour of another organisation in circumstances where there is formally an arm's length relationship between the overseeing organisation and that being overseen, and where the overseer has some sort of official mandate or authority for its oversight. This definition embraces inspection along with those forms of regulation which involve the granting of licences to trade. It also embraces public audit. Inspection and the granting of licences to trade are respectively examples of quality regulation and economic regulation, which are sub-sets of regulation in its wider sense.
- **Quality regulation** comprises activity aimed at improving services or at assuring service users and others that minimum

service standards are being achieved. Activities performed under the aegis of quality regulation may embrace adjudication of complaints and can include inspection and the publication of information about service quality and the experience of service users. It overlaps with economic regulation when an element of the role of the quality regulator is the granting of authority to provide the service in question, or to remove this authority in circumstances where minimum quality standards are not being met.

- i. **Inspection** is activity which involves the assessment against pre-determined criteria of the performance of a service or of the standards met by a service provider. It is both a sub-set of quality regulation and a tool used by quality regulators to fulfil their responsibilities. The purpose of inspection may vary from inspectorate to inspectorate and from time to time and will ultimately be determined by the government department with responsibility for the relevant inspectorate. It may serve to drive improvement in services, or to provide assurance that minimum standards of safety or service quality are being met, or to provide information to the public, but will typically seek to do all three. Inspectors are also normally required to have regard to value for money considerations, and as such there is an overlap with economic regulation.
- ii. **Performance assessment** is also a sub-set of quality regulation. Like inspection, it involves the publication of judgements about the quality of services, or the providers of them, against pre-determined criteria. It may be an output of inspection, but more typically inspection is only one contributory element of a wider performance assessment framework embracing key performance

indicators and other judgements of performance. The latter might include auditor judgements and government assessment of the plans prepared by public bodies. The Audit Commission's Comprehensive Performance Assessment (CPA) of local authorities is a form of performance assessment that embraces but is not confined to inspection.

- **Economic regulation** is a form of regulation applicable in the public sector to the sub-set of services which are provided through market mechanisms. We have adopted the definition of this activity set out, in the context of healthcare regulation, by Dixon (**Ref. 3**) who draws on the statutory functions of the Office of Fair Trading and emphasises the role of economic regulation in consumer protection. Economic regulation may include price setting and typically also involves financial monitoring, failure management and control or influence over market entry and exit with a view to ensuring a sustainable mixed economy of providers while maintaining fair competition. It occurs both in advance, through the creation of a set of rules to promote fair competition and eliminate perverse effects, and retrospectively, through enforcement action against alleged breaches of rules or alleged uncompetitive behaviour. As the purpose of economic regulation is to ensure that the benefits of competition are secured in markets that do not function efficiently, value for money is a key concern of economic regulators.
- **Public audit** in this paper refers to the audit of public bodies, or of bodies providing public services and funded wholly or largely from taxation, which is conducted in accordance with the principles of public audit promulgated by the Public Audit Forum (**Ref. 4**) and endorsed by the Sharman Report (**Ref. 5**) and the government's response to that report (**Ref. 6**). These hold that public audit is distinguished by:

- i. the independence of the auditor from the audited body, with bodies subject to public audit not being free to appoint or dismiss their own auditor;
- ii. the wider scope of public audit, which embraces regularity, probity, governance arrangements and consideration of value for money, or of the economy, efficiency and effectiveness of the public body in the provision of its services; and
- iii. the ability of the auditor to report in public without constraint.

Public audit supports both quality and economic regulation as it provides assurance about the accuracy of performance information and is central to improving value for money. But it is also a distinct and important form of regulation in its own right. It provides assurance that public money is being properly spent and accounted for and that decision making by public bodies is transparent and in conformity with the rules laid down for them. As such it promotes accountability and good governance, and encourages public bodies to recognise their responsibility for the proper stewardship of public money which is provided involuntarily by taxpayers.

11 It follows from the range of definitions which may be adopted in this area that regulation takes many forms and can serve several different purposes. This will remain the case in the future. It has many audiences, including government, service users, taxpayers, managers of public services, those who invest in private sector providers of these services and those who are in competition with them. Each group of stakeholders will have their own expectations of regulators and these may change over time. In any sector, the functions of economic and quality regulation may be combined within a single body or may be the responsibility of different bodies. We would nevertheless argue that a hierarchy exists among the many possible

purposes of regulation. Some stakeholders are more important to regulators than others, not least because they are more dependent than others on the activities of regulators to satisfy their needs. And some of the functions of regulation are more enduring than others. From this perspective it is possible to define a core purpose of regulation, at least in the public sector, and hence to articulate some abiding principles which can help shape the future of regulation as the future shape of public service provision changes.

12 The Prime Minister's Office of Public Services Reform (OPSR) in its review of inspection (**Ref. 7**) in 2003 found that 11 of the 13 public sector inspectorates it examined saw improving public services as part of their role. Discussion of the future of regulation must therefore have regard to this role, and be conducted in the light of other tools for driving improvement, including those available to service users. The greater the impact of external bottom-up pressures on public sector performance, the less likely it is that the regulatory regime will need to be the main engine for improvement. And since regulation is already seen by many as imposing a burden, which must be reduced, it is important that new improvement drivers are developed and that the design of future regulatory regimes reflects and is consistent with the existence of these new tools.

13 Fundamentally, however, the OPSR review found that the purpose of inspection was seen as providing assurance to the public. We believe this is essentially true of regulation more widely. We therefore see the core purpose of public sector regulation as that of providing assurance, with promoting accountability and driving improvement as complementary but discrete and subsidiary elements of this role. The weight that may be given to each element of the role will vary over time and between sectors, but all forms of regulation provide assurance, even where they do so by active intervention in market mechanisms through incentivising or penalising particular behaviours.

14 Beyond the provision of assurance, all forms of regulation also seek to promote accountability – to government, to taxpayers and to service users. In different parts of the public sector different models of accountability prevail, and hence different approaches to regulation are appropriate. For example, in local government a regulatory regime that did not acknowledge the democratic mandate of local councillors, accountable to a local electorate for articulating local needs and determining local priorities, would not be acceptable. Likewise in health, the form of regulation experienced by foundation trusts will necessarily differ from that confronting NHS trusts which are subject to direct performance management by the Department of Health. A key test of any approach to regulation will therefore be whether it is appropriate to the accountability framework facing the regulated body and whether, within this framework, it in fact enhances accountability – to the full range of stakeholders to which public bodies or public service providers may legitimately be held to account.

15 In promoting accountability, regulators may undertake a number of different tasks, including the provision of information. And they will go about these tasks in different ways which reflect the variety of stakeholders that regulation serves. For example, both commissioners of public services and the general public require information about providers of these services, but their needs differ and regulators must ensure that the information available to both is appropriate and reliable. In some instances they will choose to do so by publishing such information themselves; in others they will validate information published by providers.

16 In local government, promoting democratic accountability is an important and arguably underdeveloped purpose of regulation which could perhaps be enhanced by connecting regulatory activity more closely to the scrutiny work of local authority and neighbourhood bodies. And in all sectors, new opportunities for regulators to promote improvements in the quality and extent of information available to the public will arise as data management systems improve.

17 But what regulators do is less important than why they do it – to provide assurance, promote accountability, drive improvement, protect consumers and enhance the value provided for taxpayers' money.

Design principles for public sector regulation

18. From this understanding of the purposes of public sector regulation it is possible to construct a set of principles to aid the design of future approaches to regulation in the different parts of the public sector. In doing so a distinction must be made between first and second order principles. The former are primarily for government to address. We would describe five such **first order principles** as follows:

- i. The approach to the regulation of public services must sit easily within a reasonably stable, coherent framework describing how these services are to be funded, commissioned and delivered (including the role that private and voluntary sector providers are to play in the provision of services). This framework is for government to determine.
- ii. Within this framework, government must be clear about the role it wishes to play itself, and hence the functions that are to be reserved to government. The role of other regulators must be shaped around that.

- iii. It is likewise the responsibility of government to determine the overall size and shape of regulatory activity, including the number of regulatory bodies, their functions and the limits to the resources they may consume. The design of any particular regulatory regime must be consistent with this overall policy framework.
- iv. Changes to the framework of regulation should be infrequent, transparent and clearly explained, as should any necessary departures from core principles.
- v. At the operational level, regulation should be conducted independently of government, which should not override the professional judgements that regulators make about individual public bodies or services.

19 While, as principles i to iv of these first order principles imply, government has a vital role to play in the design of the overall framework for regulation, we believe, as principle v suggests, that at the operational level and in the design of particular regulatory regimes, government should remain at arm's length. This may present a difficult challenge to government, which is responsible for the funding of public services and may be held accountable by the public for serious service failure. Government has a duty to protect the public interest, for example by ensuring that public services meet the needs of vulnerable users and that publicly funded assets are well used. In doing so, it will need to rely to a large extent on the judgements of regulators and may therefore seek to shape their priorities. But the more it seeks to do so, the more it will risk undermining the credibility of the judgements that regulators provide.

20 This is especially true where these judgements may impact upon the reputation of politically led bodies or where government is itself the service provider and there is a clear danger of conflict of interest in

government regulation. But where there are markets for the provision of public services, it is also likely that the confidence of private sector providers will be undermined if ministers are seen to be able to interfere in these markets. And as the growth of market mechanisms is a key element of the agenda for public services reform, the success of this reform programme may ultimately be influenced by perceptions of the extent to which regulation is independent of government. Moreover, enhancing the accountability of public services to users and taxpayers is unlikely to be best served by a form of regulation which places decisions about assessment methodologies in the hands of ministers responsible for the provision of those services and the determination of tax levels.

21 Regulation must both serve, and be seen to serve, the purpose of providing assurance to public service users and taxpayers. So it must be delivered with unimpeachable integrity and authority, by a wholly disinterested party. Government has an important role to play in making strategic choices that will affect the extent to which regulation focuses on improvement or enhancing democratic accountability rather than relying on other mechanisms, including action by government itself, to deliver these objectives. But if, for example, in determining the role that government should reserve for itself in accordance with principle ii above, this role were to extend to deciding which specific public bodies should be assessed and when, perceptions of the independence of the regulator could be fatally undermined. In such a scenario the regulator would be seen to be acting as a direct agent of government and hence the credibility of the judgements or decisions reached could be seriously compromised.

22 There is a further reason why the independence of regulation from government is an important principle. While regulators act in some respects as agents of government they are also advisers to government where government has coercive powers to intervene in

the running of services that are managed by autonomous bodies. A good example of this is provided by the extensive powers of intervention in the affairs of a local authority that ministers are able to exercise on the recommendation of a corporate government inspection by the Commission. In such cases government relies on the regulator to direct it to take action but reserves the right to differ from the regulator's view, which requires the separation of government from regulation.

23 It is of course possible to conceive of a form of public sector regulation in which sanctions follow automatically from judgements about performance, for example one in which powers are removed from public bodies or in which services are subjected to competitive tendering if performance drops below a pre-ordained benchmark. This would require no separate decision making by government at the level of individual public bodies and arguably would prove a more powerful tool in motivating service providers to improve. This might also have closer parallels with some forms of regulation in the private sector, especially in relation to financial services.

24 However, where public bodies have their own democratic mandate there could be profound constitutional questions raised by the government subcontracting to regulators in this way the power to suspend or close functions if the necessary conditions prevail. It would remove an element of discretion which forms part of the hard decisions that ministers are required to make when choosing whether or not to exercise powers of intervention. And it would place these tough decisions in the hands of regulators who are less accountable than ministers for the decisions they make. Recent evidence of public unease about the ability of the Local Government Adjudication Panel to suspend or remove elected councillors from office on the recommendation of the Standards Board for England provides support for retaining the imposition of intervention penalties in the hands of ministers and confining the role of regulators to that of adviser.

25 The issues posed by the potential for conflict between principle v and the other first order principles raise questions about whether parliament rather than government should be the sponsor for regulatory bodies, once government has fulfilled its responsibility for ensuring that appropriate regulatory arrangements are in place. There are powerful arguments of principle in favour of such a reform, but there are also practical arguments in favour of the status quo and the Commission would not advocate such a significant change to existing arrangements without further debate. We do however note that at present there are some regulators that have accountability to parliament and others that do not. We therefore identify further below, at paragraph 37, some of the considerations which would need to feature in such a debate.

26 At the minimum, the potential conflict argues for restraint by ministers in the exercise of regulatory functions. There needs to be a clear distinction drawn between the proper performance management of services which are directly accountable to ministers and the regulation of these and other public services. And government should confine its own regulatory activities to the minimum necessary, within an overall framework which seeks to reduce the total volume of regulation.

27 There is also an apparent conflict between principles iii and v, especially in relation to the funding of regulation. Government must be free to require a reduction in the call that regulation makes on overall taxation, or to identify gaps in regulation that must be filled. But a too close control of the funds available to regulators may be seen to impose a threat to the independent judgement of the regulators concerned. This is a matter for government to resolve, but the conflict could be reduced by stronger accountability of regulators to parliament. Alternatively, the existence of this dilemma suggests that regulation is best funded through charges to regulated bodies, within

a policy framework determined by ministers. Funding regulation through charges, providing it is risk based and the charges reflect the degree of risk, may also have desirable behavioural effects on regulated bodies.

28 Core principle iv implies that it is the responsibility of government to ensure that the principles of public audit are applied to all bodies responsible for spending taxpayers' funds on the provision of public services, or to explain clearly why it would not be appropriate to do so. This will become increasingly important as new models of service provision, such as trust schools, emerge from the government's programme of reform across the public sector.

29 Since 2003 government has been paying particular attention to principles i and iii above, manifested by a radical programme for the reform of public services and by a review of regulation. In respect of the private sector this has been the responsibility of the Better Regulation Task Force (BRTF), and subsequently the Better Regulation Executive (BRE), which has been established within the Cabinet Office to give effect to the recommendations of the Hampton Report (**Ref. 8**). In the public sector, the process of rethinking regulation began with the publication in 2001 of a report (**Ref. 9**) for the Public Services Productivity Panel by Sir Ian Byatt and Sir Michael Lyons. Their report suggested that inspection can generate perverse outcomes, with the inspected bodies distracted from other key responsibilities, and argued for more systematic appraisal of the costs and benefits of inspection. They recommended that in local government, inspection of corporate capacity to deliver should provide a baseline assessment for a new, more risk-based and proportionate inspection regime and they emphasised also the need for better coordination and information sharing between different inspectorates. Within government the work to take forward these recommendations was initially led by OPSR but has now been transferred to BRE.

30 For both the public and private sector the process of streamlining regulation has been conducted under the direction of a Cabinet Sub-Committee. The outcomes of discussions within this Sub-Committee to date have been announced in a series of statements by ministers and their departments and provide a clear basis, looking forward, on which to articulate what may be described as the second order principles for the design of public sector regulation. We believe that there are five such **second order principles**. We would describe them as follows:

- i. Public sector regulation must be designed so as to enable it to support government in remedying any deficiency in the model of accountability appropriate to the sector in question, whether this is a centralised model, as in the NHS, or one placing greater reliance on local democracy or a market.
- ii. Public sector regulation must be flexible enough to enable the right balance to be struck, at different times and in different sectors, between providing assurance to service users and taxpayers; promoting better accountability to service users, taxpayers and government; driving improvement in service performance; and enhancing value for money.
- iii. The specific approach to regulation in each sector must reflect the views of public service users, through the focus and outputs of its assessments, and should meet the needs of both service users and taxpayers through the incentives inherent in the funding and design of regulatory regimes.
- iv. Where market mechanisms exist, regulation should distinguish between commissioning and provider functions and between public and non-public providers, but should not result in market distortion by imposing undue burdens on one type of provider.
- v. Regulators must themselves be accountable and must provide value for money. Regulation must be proportionate and cost-effective.

31 Implicit in these principles is the assumption that while the activities of regulators may be focused on service providers, they are not the principle customers for regulation. Nor is government. Instead the outcomes of regulation must be judged by the extent to which it meets the needs of service users and taxpayers and strikes an appropriate balance between them. This does not suggest that regulators must in all instances pursue improvement activity, but it may be legitimate for them to do so providing this does not create conflict with their other responsibilities. In practice, most regulators see driving improvement as part of their role and conflicts of interest are rare.

32 Principle i above raises specific issues about the shape of regulation of local government. If government resolves that a principal purpose of local authority inspection is to support more effective local democracy, then local citizens, both those who use council services and those who pay for them, need to be at centre stage in discussion of the design of any future inspection framework. Regulation can help empower citizens, and may be reinforced by rights for citizens that go beyond the periodic expression of public will through the ballot box. It should be expected to be a key element of an overall accountability framework designed by government, but government need not act as client for the regulatory activity on a routine basis.

33 Principle ii above also implies that over-reliance on self-regulation or self-assessment cannot be acceptable. Self-assessment is powerful and has a proper part to play in the overall performance management of public services. Properly and honestly employed, it compels managers to raise their self-awareness and encourages them to learn from others. But it also has limitations. It can result in a focus on the uniqueness of the body in question rather than the things it has in common with others, and hence the objective realities against which it should be compared with others. And if it forms too great a part of an overall system of regulation involving freedoms and

flexibilities or the possibility of external intervention, it is unlikely to be realistic. There must be at least an element of independent assessment to ensure consistency and provide the necessary assurance to the public.

34 Principle ii also assumes a complex model of accountability which recognises that service users are not a homogenous group and that public bodies are accountable to a wider group of stakeholders than service users and taxpayers.

35 Principles ii and iii above together imply a stronger role for the voice of users in future assessment regimes, but do not require this to take any particular form. For example, it may take the form of more frequent, or more influential, use of customer satisfaction measures in the routine performance management of public services by providers and a requirement on regulators of public services to play a role in establishing common frameworks for this, or in reporting on the effectiveness of the arrangements in place. Or it may involve regulators in redesigning their assessment frameworks to place stronger emphasis on the perceptions of users and/or taxpayers in the judgements they reach, which could in turn require regulators to undertake their own surveys of such perceptions. In practice, the form in which these principles would need to be applied would depend on the circumstances prevailing in the particular sector or service in question.

36 Principle iii also implies that funding must reward success and that the design of regulatory frameworks must be flexible and proportionate to risk. Regulation must recognise that providers or commissioners of public services will range from the poorly performing, through the unambitious but adequate performers, the improving but underperforming, to the strong performers. Regulatory regimes need to be both flexible enough to be appropriate to the

different stages of development of regulated bodies and dynamic enough to recognise that even the best performers can deteriorate over time.

37 Principle v above suggests that regulators must be made to be more accountable. One way of enhancing the accountability of regulators and ensuring that they are subject to the same degree of challenge as the bodies they regulate might be to subject them to direct parliamentary scrutiny rather than continuing the present practice of sponsorship by government departments. This would be similar to the model that has been adopted in practice in Scotland and Wales. But, as in those countries, it would be important if such an approach were to be followed in England for parliament, while exercising independent scrutiny of the regulator, to evaluate the work of regulators by reference to the objectives for them determined by government. Inspection is arguably a form of executive action which should rightly be accountable to the executive rather than the legislature, and without clarity of this kind in relation to the scope of any parliamentary scrutiny, regulators could be faced with conflicting requirements and regulated bodies confronted by the confusion that would necessarily arise. It should be noted also that in the model adopted in Scotland, care has been taken to respect the separate democratic mandate of local government by retaining the role of the Accounts Commission.

38 In any event, regulation must be transparent and regulators must be willing to justify their approach. They must understand not only the financial cost of their regimes but also any associated compliance costs and they must constantly strive to reduce these costs. They must in addition develop their understanding of the effects they have on regulated bodies and others, in order to be able to demonstrate the beneficial impact and hence the cost-effectiveness of the regulatory activities they undertake, if the public is to be assured that

the resources regulation consumes are commensurate with the value it provides. Delivering better value for money and minimising the risk of perverse consequences from regulation in this way will require improved cooperation between different regulators, for example to eliminate possible duplication and overlap, such as that which results from uncoordinated requirements imposed by regulators on public bodies to provide information or undertake self-assessment.

39 Byatt and Lyons (**Ref. 9**) identified five key risks associated with the overall impact of a multiplicity of external reviews:

- failure to get the most from the system, by not looking at the overall picture;
- duplication of effort;
- excessive cumulative burdens;
- creation of a compliance (rather than performance improvement) culture; and
- inconsistency.

Action taken by government since 2001, including the merger of inspectorates and creation of a gatekeeper role for lead inspectorates in each sector which have been announced but not yet implemented, should serve to address the first three of these concerns. The latter two, however, will require further consideration and may necessitate further regulatory reform.

40 Taken together, we believe that the principles set out in paragraphs 18 and 30 above embody, and indeed go beyond, what the Audit Commission has described as Strategic Regulation and which has been at the core of the Commission's approach since 2003. What the Commission means by Strategic Regulation was articulated in our Strategic Plan in 2004 and has again been set out in

our latest draft Strategic Plan (**Ref. 10**). We do not therefore repeat it here. We consider that the principles described above are also wholly consistent with the ten principles of inspection promulgated by the Cabinet Office in 2003 and the five principles of good regulation devised by BRTF (**Ref. 11**).

Future trends in public sector regulation

41 Applying these principles to the future shape of public service provision as it is emerging from the government's reform programme, some likely trends in the future regulation of public services may be discerned.

42 In the NHS, the creation of foundation trusts and changes in the method of funding providers, with the introduction of Payment by Results, and consequent exposure of hospitals to real competition, together with an enhanced role for private sector providers, will result in a stronger focus on commissioning. This may in turn result in a greater emphasis on the need for economic regulation and will prompt questions about where this function should lie. Arguably there may be a case for an independent economic regulator in the NHS, but equally this function could be performed by strategic health authorities or by the larger primary care trusts now in prospect.

43 There is an analogy to be drawn with local government where there has been a mixed economy of service providers for many years and where some services are already provided mostly by local

authorities contracting with the private sector. Although the role of the private sector is similarly growing in importance in local government, there is not yet the same degree of concern about the inability of markets in public services to deliver the theoretical benefits of competition or concern that these issues cannot be resolved within the sector itself.

44 This reflects the different nature of the two sectors, and in particular the more monolithic character of the NHS and the fact that local authorities commission services as well as provide them, if they choose to do so. There are also cultural and other differences deriving from the different functions and experiences of bodies in the health and local government sectors. For example, consumer protection is a statutory function of local government and local authorities do not therefore see the need for a new or reformed regulator with consumer protection as a principal focus of activity. Moreover market entry and exit currently results from the autonomous decisions of commissioners of services across hundreds of local authorities, which would be reluctant to surrender this power to a new form of regulatory activity imposed upon councils by central government.

45 Although it is likely that a shift of emphasis towards economic regulation within local government will be less of an issue than in the NHS, at least in the short term, there are factors that may nevertheless point to regulation of local government also moving in this direction within the foreseeable future. Principal among them is the importance of the government's drive for greater efficiency from public services and its desire, in pursuit of this objective, to strengthen market mechanisms where they are currently weak or non-existent. Despite the long history of a mixed economy of providers in local government, local authorities are to a very large extent still responsible for the direct provision of council services. The role of the third sector in the provision of council services is less pronounced than ministers

would like it to be and there are prominent examples of both success and failure in local authority contracting with the private sector. There may in future therefore be more demand for measures of what works effectively in this area, and a stronger desire to place obstacles in the way of approaches that have been found to be associated with failure. Moreover, where public bodies occupy the position of being both purchasers in monopsonistic markets and substantial providers, there may be increasing public interest in ensuring that barriers to entry are scrutinised and controlled by an independent body to ensure that markets are operating effectively.

46 But the more immediate regulatory issue for local government is how best to build on the success of the Audit Commission's CPA, while further increasing the voice of service users in the assessment framework, and at the same time reducing the overall cost of regulation. The Commission's approach to CPA has recently been refreshed and the new programme of assessments will continue until 2008. But beyond that, there will be a need to provide greater incentives for improvement through a more varied approach which recognises the different starting points of different local authorities, and which recognises too that local government is not just about the delivery of services. There will be a need also to strengthen the predictive power of the regulatory framework. Inspectorates must be expected to play a positive role in identifying councils at risk of losing competence before they do so, without this resulting in new or more intrusive forms of assessment. Our detailed thoughts on what a future regulatory regime for local government embodying these principles might look like in practice will be set out in a separate paper.

47 Central to our current thinking about the future regulation of local government is the belief that CPA will have provided by 2008 a clear baseline assessment from which it will be possible to differentiate between individual local authorities and to shape a regulatory regime

accordingly. A number of high-performing authorities will by then have demonstrated their ability to sustain this performance over a period of several years, while the direction of travel of authorities not yet performing at the highest levels will be clear. It should be possible therefore, and in our view it will also be desirable, to design a regulatory regime which excludes a large number of authorities from its more onerous provisions.

48 This will of course depend on the structure of local government remaining largely as it was when the current published assessments were undertaken. It will depend also on finding ways of ensuring that any significant deterioration in the performance of the best councils is identified and addressed. Experience teaches that the performance of even the best run and most successful organisations can deteriorate over time, and can even collapse quite rapidly, as private sector investors in the once mighty GEC would testify. Among the current best performers in local government are councils that were rightly held in very low regard a decade or two ago. So it cannot be assumed that present CPA ratings are necessarily a reliable indicator of future performance, especially as one looks further into the future.

49 But they provide a reliable starting point for a regime which seeks to combine less intrusive inspection and more strategic risk assessment with greater predictive power. Such a regime could draw on, and suitably adapt, the proposal put forward by Byatt and Lyons that:

‘Following the Base Line inspection, the authority would review both its plans and its capacity to achieve them. This would be expected to lead to a programme of organisational development, capacity building and specific proposals for the improvement of individual services... During each subsequent year of the cycle... the focus would shift radically towards progress made against

performance improvement plans, drawing on evidence from performance indicators... and other developmental activities. Local auditors would contribute from their own knowledge of the organisation.’ **(Ref. 9)**

50 We also recognise that beyond 2008, the regulation of individual local authorities or other public bodies operating at the local level is likely to be less important than the need to form a view about the experiences that residents in each locality have with the provision of public services as a whole. Few members of the public either know or care which particular public body is responsible for the services on which they rely. Development of an approach to area-based assessment of the overall performance of all public bodies at the local level is therefore likely to be required and the Commission is undertaking work, in collaboration with other regulators, which should make this possible. A key element of this work is the development of area profiles which provide a wide-ranging picture of the quality of life and public services in a local area by bringing together data, information and assessments for every local authority area in England. Further information about our work on area profiles can be found on the Commission’s website at www.areaprofiles.audit-commission.gov.uk.

51 For housing associations, the Housing Corporation already performs the functions of both an economic and a quality regulator, drawing on the Audit Commission’s inspection functions to support it, especially in the latter role. It combines these function with that of an investor, promoting housing development to secure government policy objectives. No fundamental change in the respective roles of the Corporation and the Commission in housing is currently proposed by government but the Corporation has been reviewing the regulation of the sector. The outcome of this review is likely to bring the regime more into line with the government’s wider policy objectives for a

reduction in regulation and with the principles outlined above. In particular, a more varied and risk-based approach, which more clearly recognises the differences between large and small housing associations, is anticipated. Beyond 2008, the performance of housing services provided by registered social landlords will also need to be capable of being brought within the scope of area-based assessment.

52 A review of regulation has also been conducted by the Department of Health, the terms of reference for which include consideration of the Commission's NHS audit function. The inclusion of audit within the scope of the review reflects the importance that the department and others quite properly attach to public audit within the overall framework of regulation of the public sector. The increased emphasis on value for money and governance issues in public services will further increase the importance of the audit function during the lifetime of the current parliament. It will be essential therefore to ensure that the outcome of the Department of Health review, while reducing where possible the overall cost of regulation, does not erode the scope or impact of the public audit regime.

53 In the period up to 2008 and beyond, and across all public services, more weight will need to be given in the design of regulatory regimes to the views of users. This will require better analysis of the different views of different groups of users and of how these might be reflected, for example, in performance assessment frameworks and inspection methodologies. At the same time, regulators and public bodies working in partnership will need to find ways of strengthening internal controls and performance management arrangements within public bodies and public service providers, so that regulators may place greater reliance on them in lieu of direct regulatory activity.

54 In conclusion, within any foreseeable model of a reinvigorated local and national democracy, citizens will require more than their access to the ballot box to ensure the accountability of public services for the spending of taxpayers' money. Regulation will therefore continue to have an important role to play. Assuming that the performance of public services continues to display the recent rapid rates of improvement, it will be possible for the overall scale of regulatory activity to be further reduced. But the nature of regulation and not just the extent of it must also move with the times. It must keep pace with the reform of public services, develop its predictive power, hone its ability to focus on the things that matter, strengthen its power to promote efficiency and better value for money, connect more clearly with the views of those who use public services and move beyond the narrow view of individual public body responsibilities that is largely irrelevant from the locality perspective. This paper attempts to open up a wider debate about how best to achieve these objectives. Other contributions to this debate will follow from the Commission at a later stage.

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