

THE CUSTOMER IS ALWAYS RIGHT

HOW TO REDUCE EXECUTIVE REWARDS
WITH PROCUREMENT CONTRACTS

About the High Pay Centre

The High Pay Centre is an independent non-party think tank established to monitor pay at the top of the income distribution and set out a road map towards better business and economic success.

We aim to produce high quality research and develop a greater understanding of top rewards, company accountability and business performance. We will communicate evidence for change to policymakers, companies and other interested parties to build a consensus for business renewal.

The High Pay Centre is resolutely independent and strictly non-partisan. It is increasingly clear that there has been a policy and market failure in relation to pay at the top of companies and the structures of business over a period of years under all governments. It is now essential to persuade all parties that there is a better way.

The High Pay Centre was formed following the findings of the High Pay Commission. The High Pay Commission was an independent inquiry into high pay and boardroom pay across the public and private sectors in the UK, launched in 2009.

For more information about our work go to **highpaycentre.org**

Follow us on Twitter **[@HighPayCentre](https://twitter.com/HighPayCentre)**

Like us on **Facebook**

Contents

- 4** Executive Summary
- 6** Introduction
- 9** How big is the outsourcing sector?
- 11** A short history of social clauses in procurement
- 12** Public support for social requirements
- 14** Private Providers of public services
- 16** Conclusion

Executive Summary

Outsourcing firms account for roughly 24% or £84 billion of public sector spending – nearly £3,000 per adult each year. Some estimates suggest this will increase to £140 billion by 2015. The outsourcing sector employs 1.2 million people or 4% of the workforce.

With the government such a big customer of private sector firms, we believe it should exercise its consumer power to influence pay policy at those companies.

According to a report by the National Audit Office, the four largest private sector providers of services to the public sector are Capita, Serco, Atos and G4S. Between them, the companies receive around £4 billion in public money. Their CEOs were paid around £2-2.5 million each.

All these companies make at least one third of their UK income from the public purse. For Serco and Atos, the figure is at least 50%.

Given that the companies covered by our research rely on the public

purse for such a large share of their revenue, it might well be argued that their executives have more in common with public sector managers (for whom the circa £140,000 pay of the Prime Minister is frequently cited as a benchmark) rather than the private sector, where the average pay for a FTSE 100 Director stood at £4.3 million in 2012.

To bring executive rewards in outsourced companies back in line with the public sector, and to ensure and encourage fairer pay practices, this report recommends that the Government use its power as purchaser to include fairer pay policies in any private sector provider contracts. These policies could include, but are not limited to:

- > Publication of a pay ratio, including the ratio of top pay to bottom pay.
- > A pay cap for any company receiving public contracts over a certain value, either in absolute terms or as a proportion of their revenue. This could be applied

table 1¹

| Company | UK Revenue/£bn | UK Public Sector Revenue/£bn | Percentage of UK revenue from public purse | CEO Pay/£m |
|---------|----------------|------------------------------|--|------------|
| Serco | 2.7 | 1.8 | 67 | 2.5 |
| Atos | 1.4 | 0.7 | 50 | 2.3 |
| G4S | 1.9 | 0.7 | 37 | 2.3 |
| Capita | 3.2 | 1.1 | 34 | 1.9 |

¹ Figures taken from National Audit Office, The role of major contractors in the delivery of public services, p5. CEO pay widely reported in the media

on the same principle that the US Government caps pay at federal companies.

> Imposition of a maximum pay ratio in any private sector company providing public services. This could initially be set at a rate of 90:1 but be decreased over a period of 10 years.

> Worker and consumer representatives to be included on the company board of directors.

By using their purchasing power to opt for goods and services that also deliver good social outcomes, Governments can make a major contribution to encourage ethical business, and fairer pay practices.

Introduction

While wages for ordinary workers have stagnated since 2008, the trend towards ever-increasing executive pay packages for business leaders was unaffected by the financial crisis. In 2012, the last full year for which data is available, FTSE 100 Chief Executives enjoyed a 14% pay rise, even as pay rates across the economy failed to keep up with inflation.²

This growth in executive pay is not the result of exceptional company performance; indeed there is scant evidence of any correlation between executive rewards and company performance. Rather it is the result of factors including:

- executive capture;
- rent seeking;
- failure on the part of government to take meaningful action;
- And the wider narrative of 'wealth creation' that attributes far greater responsibility for economic prosperity to a tiny pool of 'top talent' than is their due.

The 2013 Business Enterprise and Regulatory Reform Act empowered shareholders with the right to a binding vote over companies' executive pay policy. However, the average shareholder advisory vote against FTSE 100 remuneration reports remained below 6% for each year between 2006 and 2011. So it is doubtful whether a binding vote will help to curtail excessive and unwarranted pay awards.

This report looks at another way in which government could exert positive downward pressure on executive rewards, through its power as a purchaser.

The rise of outsourcing

Since the late 1970s we have seen successive Conservative, Labour and Coalition governments move towards a new model of public service provision, one intended to maximise efficiency through targeted use of the private sector. Services have been increasingly outsourced and purchased by the government through procurement processes, rather than managed and delivered by public servants employed directly by the Government.

The rhetoric coming from Government to explain this shift in provision has not always been clear. Enhanced business efficiency; the private sector's capacity to deliver investment; and growth in share ownership have all, at times, been cited as advantages of private sector provision of public services.

Despite these different objectives, the increasing use of outsourcing as a means of public service delivery has made the government one of the biggest purchasers of private services.

How big is the outsourcing sector?

Today, roughly £1 in every £3 that government spends on public services goes to independent providers.³ Oxford Economics

² Financial Times, Top Directors pay rises 14% over the last year, 17 November 2013 via <http://www.ft.com/cms/s/0/e884ac6a-4dee-11e3-b15d-00144feabdc0.html#axzz2tISUxOyf>

³ Julius, D., Public Services Industry Review, 2008, Retrieved 15 July 2013: <http://www.bis.gov.uk/files/file46965.pdf>. Note that this estimate includes services procured by government to support service delivery.

estimates the current outsourced market for public services has an annual turnover of £82 billion, representing around 24% of the total spend on goods and services by the public sector.⁴

It is widely understood that the market is only set to increase, Seymour Pierce, the City broker, estimates that the size of the public sector outsourcing market for support services could increase from its current level of £80 billion to £140 billion as a result of the new spending regime by 2015.

In addition the public services industry directly employs 1.2 million people, around 4% of the total work force.^{6,7}

The scale of public sector outsourcing in the UK is relatively unusual, by international standards. While outsourced public service provision is dominant in the US, most public services are still provided by the public sector in other countries.

According to one analysis by Information Services Group (ISG) the UK is second only to the US in terms of the size of its outsourcing market. The UK alone accounts for 84% of total public sector outsourcing in Europe, the Middle East and Africa (EMEA).⁸

In the fiscal year 2008–09 the UK government's total spending amounted to £618.6 billion, or 43.2% of the UK's national income. This translates into just over £10,100 for every person in the UK, or about £13,000 per adult.⁹ This means that

currently nearly £3,000 per person is being spent on the private provision of public services every year. Given this level of investment it seems only right that people have a say in how their money is spent.

Box 1: What is private provision?

Private provision of public service can be divided into 3 basic forms:

➤ **Privatisation**, where a goods or service is wholesale moved into the private sector. This can be seen in the privatisation of the utilities companies in the 1980s and 1990s.

➤ **Outsourcing**, where the government commissions the private sector to provide a service, or part of a service.

➤ **Public private partnerships**, where the government works with the private sector, for example Private Finance Initiative (PFI) used to build hospitals.

With the UK government now spending over £80 billion on private provision of public goods, it certainly begs the questions: isn't it right that it use its power as a consumer to encourage positive change in the companies it is buying services from? Over the last 30 years we have seen a growth in the private provision of public

⁴ The Size of the UK Outsourcing Market Across the Private and Public Sector, Oxford Economics, April 2011

⁵ <http://www.theguardian.com/business/2010/may/24/public-spending-cuts-hit-suppliers>

⁶ <http://www.cbi.org.uk/business-issues/public-services/public-services-and-business-the-role-of-business/>

⁷ <http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/june-2013/sty-uk-employment.html>

⁸ <http://www.computerweekly.com/news/2240179844/UK-public-sector-outsourcing-world-phenomenon>

⁹ IFS (2009) Public Spending

services. Over the same period, we have seen a dramatic increase in 'performance related pay', bonuses, and overall pay packages for executives in the private sector.

Those individuals running our companies, and increasingly our hospitals, prisons and care homes are predominantly 'incentivised' through a variety of performance-based awards. These awards have questionable efficacy when it comes to encouraging long-term performance, but are highly effective at obfuscating inflated pay packets.¹⁰

This report looks at these private providers of public services, their pay levels and their profits and asks could procurement requirements reduce executive reward packages? This report in particular focuses on the role that pay clauses could have in public procurement contracts.

¹⁰ High Pay Commission (2012) Cheques with Balances

A short history of social clauses in procurement

The economic significance of public procurement to companies gives local and national government a market power, which can be used not only for economic but also for wider social purposes.¹¹

Indeed there is a history of pay clauses in public procurement dating from the 19th century. In 1949 the International Labour Organisation (ILO) adopted a specific Convention on “Labour Clauses in Public Contracts” (Convention No. 94). The purpose was to ensure that workers hired by companies that were contracted in would not receive less favourable conditions than those in appropriate collective agreements or other forms of pay regulation.¹²

According to the European Commission a socially responsible procurement policy is about ‘setting an example and influencing the market’ in order to ‘give companies real incentives to develop socially responsible management.’¹³

In addition it is seen as an important instrument to “foster the European social model as a “vision of society that combines sustainable economic growth with improved living and working conditions.”¹⁴

As the European Commission has noted in its recent evaluation report there has even been ‘growing policy interest in re-orienting public expenditure towards solutions that are more compatible with environmental sustainability, promote social policy considerations, or support innovation.’¹⁵

Indeed according to Article 26 of the EU Directive (2004/18/EC) ‘contracting authorities may lay down special conditions relating to the performance of a contract. The conditions governing the performance of a contract may, in particular, concern social and environmental considerations.’ The inclusion of social considerations leaves the door open for clauses on executive pay.

It has also been confirmed by the European Court of Justice in a case against the Netherlands (C -368/10) ‘that contracting authorities are also authorised to choose the award criteria based on considerations of a social nature.’

In North America, the US even offers a limited international precedent for social clauses in public sector contracts relating specifically to executive pay. Contracted organisations can only bill the Federal Government for staff time equivalent to the President’s \$400,000 salary.¹⁶

In the UK, the Coalition Government’s own rhetoric on ‘localism’ has emphasised the importance of devolving power not just to subsidiary levels of government, but to directly involve local people in the design and delivery of public services. Introducing the 2011 Localism Act, Secretary of State for Communities and Local Government Eric Pickles stated his intention to allow people ‘to vote against excessive council tax rises, elect a mayor for their city, save a community treasure or take over running a local service.’¹⁷

¹¹ Schulten () Pay and other social clauses in european public procurement
¹² ibid
¹³ European Commission (2012) Buying Social : A Guide to taking account of social considerations in public procurement
¹⁴ European Commission (2010) Buying Social : A Guide to taking account of social considerations in public procurement
¹⁵ European Commission Evaluation Report (2011) Impact and Effectiveness of EU Public Procurement Legislation
¹⁶ Government Executive, Obama to Seek Much Lower Cap on Contractor Exec Pay, 30 May 2013 via <http://www.govexec.com/contracting/2013/05/obama-seek-much-lower-cap-contractor-exec-pay/64007/>
¹⁷ Eric Pickles, The Localism Bill reverses a century of centralisation, 18 November 2011 via <http://www.conservativehome.com/localgovernment/2011/11/in-pursuit-of-localism-restoring-a-100-year-democratic-deficit.html>

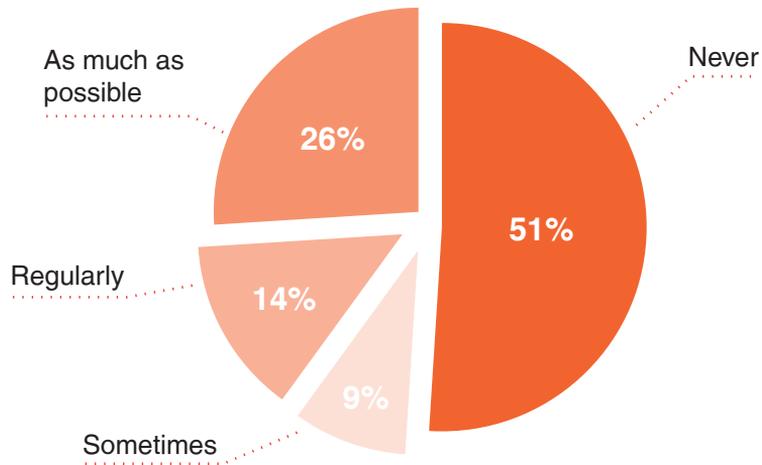
The 2012 Social Value Act enables contracting public authorities to take wider social and environmental considerations into account when awarding contracts for public services.

More generally, models of 'co-production' and 'service user engagement' in public service provision have become increasingly popular with policy experts, who

argue that service-users and taxpayers ought to play a more central role in shaping the way in which public services are designed and delivered.¹⁸

The concepts of localism, social value and co-production are all philosophically consistent with the idea of pay-related clauses in public sector contracts when supported by public consensus.

figure 1 Use of social requirements in tender documents by European contracting authorities



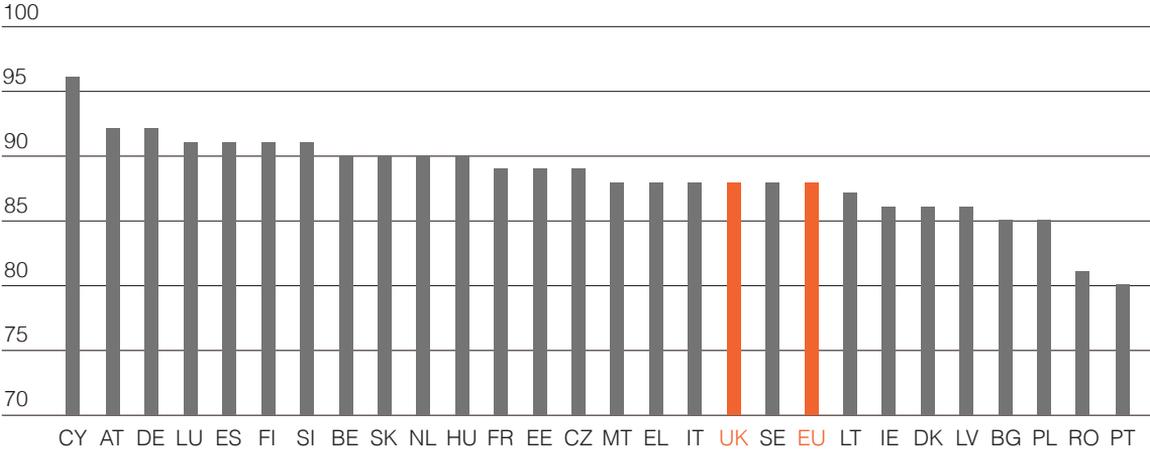
¹⁸ See, for example, Guardian, International focus: public service co-production around the world, 13 November 2012 via <http://www.theguardian.com/local-government-network/2012/nov/13/coproduction-public-services> ; or Institute for Government, Engaging Citizens in Policy Design – The Practicalities, July 21 2011 via <http://www.instituteforgovernment.org.uk/events/engaging-citizens-policy-design-practicalities>

Public support for social requirements

According to a survey of Eurobarometer only 13% of people in Europe think that that the cheapest price should be the most important factor for awarding public contracts. 88% of the EU population

supports the consideration of social aspects in public procurement contracts. This varies across the EU, but the UK has 88 % support rate (see figure 2).¹⁹

figure 2 Support for the consideration of social aspects in public procurement even if it makes public contracts more expensive (2011) in %



¹⁹ Eurobarometer statistics published on http://ec.europa.eu/public_opinion/index_en.htm

Private Providers of public services

In the 1980s, as some publicly-owned services were fully privatised, some provision was simply contracted out. The “internal market” in the health service, whereby the NHS contracted certain services from private healthcare providers, was the first, but since then we have seen security, welfare and care provision have all moved towards a model based on outsourcing. A report from the CBI demonstrates that 48% of hospital security spending is outsourced, compared to 47% of local government waste management services, 27% of schools catering, and 16% of police forensics.²⁰ This is an ever growing industry funded by the public purse.

This section of the report looks at a number of key providers and analyses their recent performance and pay levels.

According to a report by the National Audit Office, the four largest private sector providers of services to the public sector are Capita, Serco, Atos and G4S.

Between them, the companies receive around £4 billion in public money. Their CEOs were paid around £ 2-2.5 million each.

All these companies make at least one third of their UK income from the public purse. For Serco and Atos, the figure is at least 50%. At smaller outsourcing firms, the figures are even more striking. CareUK, which provides care services to the elderly and disabled, receives 91% of their revenue from the public sector.²² Their operating profit of 31% suggests that somewhere in the region of £150million is made in profit each year by CareUK from providing services to the public sector. While the government will not release details on expected profit margins for companies contracted to provide services in the public sector, these figures suggest that the margins can be very high.

What’s more while the public sector is experiencing pay restraint and senior public sector managers are subject to intense criticism over the size of their pay packages,

table 1²¹

| Company | UK Revenue/£bn | UK Public Sector Revenue/£bn | Percentage of UK revenue from public purse | CEO Pay/£m |
|---------|----------------|------------------------------|--|------------|
| Serco | 2.7 | 1.8 | 67 | 2.5 |
| Atos | 1.4 | 0.7 | 50 | 2.3 |
| G4S | 1.9 | 0.7 | 37 | 2.3 |
| Capita | 3.2 | 1.1 | 34 | 1.9 |

²⁰ Confederation of British Industries (CBI)

²¹ Figures taken from National Audit Office, The role of major contractors in the delivery of public services, p5. CEO pay widely reported in the media

²² Based on annual report 2011

executive pay in private providers remains high, with rewards of £1m or over remaining the norm. The CEO of Serco received total pay of £2.5m while the boss of Capita took home £1.9m. While these rewards may be standard for a private company, when compared to pay levels in the public sector, they are stratospheric. Given that the companies covered by our research rely on the public purse for such a large share of their revenue, it might well be argued that their executives have more in common with public sector managers (for

whom the circa £140,000 pay of the Prime Minister is frequently cited as a benchmark) rather than the private sector, where the average pay for a FTSE 100 Director stood at £4.3 million in 2012.

Though the government has stated that it wants to reduce executive pay, executive rewards remain more than a hundred times the pay of ordinary workers in companies that depend on the Government for a significant proportion of their revenue.

Box 2: Recent Outsourcing Scandals

As the scale of outsourcing has increased, so have the number of outsourcing scandals. It is arguable that as outsourcing moves into areas where performance is less easily measured, because of the human element, the likelihood of problems developing in the contracts will only increase. Indeed a report by the Institute for Government (IfG), concluded that the Government still did not have the skills to manage private sector contracts effectively. Here are just some examples of scandals to hit outsourcing firms in the UK:

- Audit of **G4S** suggested the firm had been charging to tag criminals who were either dead or in jail.²³
- **Serco** is being investigated by the Serious Fraud Office (SFO) after claims it had overcharged the government by “tens of millions” of pounds for electronic tags for criminals.²⁴
- Leaked documents show welfare-to-work firm **A4e** knew of widespread potential fraud and systemic failures by management to control it.²⁵
- **Serco** accused in House of Commons report of falsifying data on a contract for out-of-hours GP services, the report stated that national standards had not been met, there was a culture of “lying and cheating”, and the service offered to the public was simply “not good enough”.²⁶
- **Compass**, the major provider of outsourced food in public services admitted that its own tests had shown that some of its products contained “a minor amount of horse DNA”.²⁷
- Neglect stemming from “institutionalised abuse” at a care home directly contributed to the deaths of five of its elderly residents at **Southern Cross**, which was Britain’s largest care provider.²⁸

²³ <http://www.bbc.co.uk/news/uk-25001800>

²⁴ <http://www.bbc.co.uk/news/business-24672344>
²⁵ <http://www.bbc.co.uk/news/uk-17476415>

²⁶ <http://www.theguardian.com/society/2013/jul/11/serco-gp-out-of-hours-substandard?gclid=Article:in%20body%20link>

²⁷ <http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/9873300/Compass-and-Whitbread-caught-up-in-horse-meat-scandal.html>

²⁸ <http://www.independent.co.uk/news/uk/home-news/britains-cruellest-care-home-institutional-abuse-contributed-to-deaths-of-five-pensioners-8889770.html>

Policy Proposals

As outsourcing increases this opaque area of government spending and public service provision expands. This report has demonstrated how executive pay in these companies outstrips public sector pay, despite the fact that pay in both the public and outsourcing sector is funded, at least in part, from public money. It has also highlighted how these companies can often become mired in scandals, for poor quality service, which has created an intense debate about the true value of outsourcing.

When the executives, who are ultimately responsible for these scandals, receive multi-million pound pay packages, the public are understandably angry. This adds an unhelpful element to the debate about outsourcing, and could weaken faith in Government and business, with damaging wider consequences. The fact that a small tier of senior managers benefit so significantly from outsourced provision of public services creates the impression that advocates of an outsourcing model are acting in their own interests, rather than the public interest.

To bring executive rewards in outsourced companies back in line with the public sector, and to ensure and encourage fairer pay practices this report recommends that the Government use its power as purchaser to include fairer pay policies in any private sector provider contracts. These policies could include, but are not limited to:

- > Publication of a pay ratio, including the ratio of top pay to bottom pay.
- > A pay cap for any company receiving public contracts over a certain value, either in absolute terms or as a proportion of their revenue. This could be applied on the same principle that the US Government caps pay at federal companies.
- > Imposition of a maximum pay ratio in any private sector company providing public services. This could initially be set at a rate of 90:1 but be decreased over a period of 10 years.
- > Worker and consumer representatives to be included on the company board of directors.

These policies would ensure fairer pay policies within companies, they would encourage company bosses to increase pay at the bottom, and would ensure that workers and consumers had a say in the running of the company.

The government has shied away from imposing a pay cap or worker representation across the private sector as a whole, on the basis that it is the role of shareholders and customers to pass judgement on company stewardship. In the case of outsourcing firms, however, the Government is the customer. It has the leverage of around £80 billion worth of spending on private sector outsourcing.²⁹ In this context, regulations to contain the multi-million pound pay packages of outsourcing executives represent

²⁹ Oxford Economics, The Size of the UK Outsourcing Market Across the Private and Public Sector, Oxford Economics, 2011 via http://www.bsa-org.com/uploads/publication/file/98/BSA_OE_UK_outsourcing_across_the_private_and_public_sectors_Nov2012.pdf

not intrusive state regulation, but democratic consumer activism designed to ensure that public money is spent in a manner that is coherent with public values and the public interest.

Conclusion

£80 billion in public spending is going to the private sector every year. This is only set to increase, yet outsourcing remains a relatively opaque area of public spending.

What's more, the increasing outsourcing of public services has seen practices prevalent in the private sector trickle into the public sector, particularly ever escalating pay for top executives and huge gaps between the lowest and the highest paid. This creates the impression that the fashion for outsourcing results from the fact that it serves the interests of the rich and the powerful rather than the public as a whole.

As this report has shown, the top companies saw their executives receive enormous executive rewards this certainly begs the question, what are we paying for?

When nearly 50% and in some cases more of their income comes from the public purse, it is not clear why the lead executives of outsourcing firms enjoy packages in excess of ten or twenty times what might be considered reasonable for a leading civil servant. Performance-related pay is meant to encourage entrepreneurial activity and innovation, but when it comes to private provision of public goods the role is not so much entrepreneurial rather that of a competent public servant.

By using their purchasing power to opt for goods and services that also deliver good social outcomes, Governments can make a major contribution to encourage ethical

business, and fairer pay practices. Beyond this it is also right to ask, if the government has such influential buying power, why can it not use this influence for social and environmental aims? Put simply, the government is a major customer, and isn't the customer always right?

Annex 1: Outsourced companies³⁰

Construction and “hard” facilities management

Serco, Morrison, ISS, Rentokil Initial, Carillion, MITIE, Interserve, Mitie, Balfour Beatty, Integral, Laing, Amey, Caxton, Operon, GSL, Wates, Amec, Bovis, Costain, Skanska.

Support services and “soft” facilities management

Compass, Mitie, Spectrum, ISS, Rentokil Initial, Aramark.

ICT, business process and corporate services

Capita, BT, Serco, SBS, HBS, Vertex, Atos Origin, Liberata, IBM, Fujitsu, EDS, Xansa (part of Steria).

Long term care

Southern Cross, Four Seasons, BUPA, Craegmoor, Barchester, CareUK.

Schools

Amey, Costain, Skanska, Bovis, Capita, Mott Macdonald, Balfour Beatty.

Waste management

Veolia, Biffa, SITA, Shanks, FCC (Waste Recycling Group), Cory, Enterprise, May Gurney and Greenstar.

Consultancy

IBM, LogicaCMG, Accenture, PA, Capgemini, Mott MacDonald, PricewaterhouseCoopers (PwC), Atos Origin, KPMG, Deloitte, Xansa (Steria), Tribal, McKinsey, Booz Allen Hamilton, Hedra, Grant Thornton, Ernst and Young.

Key Service Sectors

Primary healthcare

Care UK, UnitedHealth, Humana, Atos Origin, Kaiser Permanente, Laing (through ExcellCare), GSL, Babcock & Brown, and Carillion.

Housing

Home Group, North British, Wakefield, Anchor, Sanctuary, London & Quadrant, AmicusHorizon, Genesis, Places for People, Circle Anglia, Synergy, Riverside.

Custodial services

GSL, Serco, Sodexo, GEO, Reliance, UKDS.

Tertiary education

INTO (part of Espalier), Kaplan, IBT, INSEARCH, A4E, Capita, Centre for British Teachers (a charity), VT (part of Vosper Thorneycroft), BPP, Cambridge Education.

Secondary healthcare

Alliance Medical, Capio, Tribal/ Mercury, Nations, Netcare, Care UK. LEA outsourcing Serco, Capita, Tribal, Amey, Nord Anglia, Cambridge. Leisure services DC Leisure Management, Esporta, Greenwich Leisure.

³⁰ SEUK (2012) The Shadow State: a report about outsourcing of public services

