

## **Regulating private welfare**

**The causes and consequences of failures in the provision of private welfare**

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### **Abstract**

The welfare state is undergoing profound changes. In most Western countries private elements are introduced in formerly public welfare systems. These processes of privatisation mark the transformation from the conventional welfare state, in which the government fulfils the role of a public provider, into what is labelled a regulatory welfare state, a state in which the government becomes the regulator of the private market. The transformation towards a regulatory welfare state marks a change in emphasis that is given to the three general principles of ordering society: the state, the market, and the civil society. Within this ordering triangle, the market receives a more prominent role. The privatisation of the reintegration market forms an interesting example of the transformation towards a regulatory welfare state. Until now, the private reintegration market has, however, not lived up to its expectations. In this paper the causes and consequences of failures in the provision of private reintegration services are analysed. Analysis of the failures in the provision of reintegration services in the Dutch reintegration market shows that the causes for the failures originate from the ordering principles market, as well as state and civil society. In the course of the existence of the Dutch private reintegration market, some initial steps have been made in order to receive a better balance between the ordering principles state, market, and civil society. However, further improvements in the functioning of the private reintegration market can and need to be made.

### **1. Introduction**

The Western welfare states are under reform (Pierson 1998; Gilbert 2002; Taylor-Gooby 2004; Henman and Fenger 2006). An important element of the reforms concerns the introduction of processes of privatisation. Over the last decade, in most Western countries private elements are introduced in former public sectors such as health care, public transport, and social security. One of the elements of the welfare state that has been subjected to privatisation is the provision of public services. Over the years, many countries have chosen to contract out public service delivery (Domberger and Jensen 1997; Majone 1997; Scott 2000). By contracting out public services, the role of the government transforms from the role of a public provider to the role of the regulator of the private market, transforming the welfare

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state into a state-regulated welfare market: the regulatory welfare state (Braithwaite 2000; Moran 2002; Leisering 2003; Jordana and Levi-Faur 2004).

The transformation to a regulatory welfare state involves a shift in the orderings principles state and market. Since the foundation of Western welfare states in the nineteenth century, the distinction between the different ordering principles has been an object of discussion. In the first welfare arrangements, the role of the state was subsidiary to that of private initiatives. The so-called Nightwatchman state was characterised by both steering and rowing on the level of civil society (Osborne and Gaebler 1992; Braithwaite 2000; Jordana and Levi-Faur 2004). The churches looked after the poor and the employers and employees developed funds to cover employment related risks. The main idea was that state regulation should not stand in the way of these private initiatives. During the twentieth century the government increased its role in the provision of welfare by taking over both steering and rowing. This Postwar (Jordana and Levi-Faur 2004) or Keynesian (Braithwaite 2000) state reached its peak at the end of the twentieth century. With the current transformation to the regulatory welfare state, the responsibility for the provision of services is handed over from the state to the market separating steering from rowing. However, this time there is no withdrawal on the part of the state. The state retains its active role in the safeguarding of public values.

The transformation to a regulatory welfare state thus involves more market, but not less state. It is the role of the state that changes. Instead of providing public services, the government regulates private service delivery. Government regulation therefore does not decrease, but rather increases (Vogel 1996; Leisering 2003). As a consequence, the regulatory welfare state goes hand in hand with a tension between market forces on the one hand and the safeguarding of public values through government regulation on the other hand. While the market may, on the one hand, promote efficiency and effectiveness in service delivery, this may be realised at the expense of public values such as equality of rights and legal certainty. Government regulation, on the other hand, may be implemented to safeguard public values. However, such regulation may have detrimental effects on the efficiency and effectiveness of service delivery.

The tension that is inherent in the regulatory welfare state raises many questions. Moreover, it can be regarded as one of the important reasons why private welfare provision in practice does not always live up to its expectations. In this paper, the causes and consequences of failures in the provision of private welfare will be central. By analysing a concrete example of contracting out of public services, the privatisation of the Dutch reintegration market, we hope to receive a better understanding of the underlying problems that go together with regulating private welfare.

The focus on the Dutch reintegration market is interesting since contracting out is spreading especially rapidly in employment services (Sol and Westerveld 2005). The Dutch reintegration market is regarded as a prototype of this reform (Struyven and Steurs 2003). Since the implementation of the Work and Income Implementation Structure (SUWI) Act in 2002, reintegration services are contracted out in the Netherlands. Until now, the private reintegration market has, however, not lived up to its expectations (Bredgaard and Larsen 2007). The tender procedures have proven to be problematic and costly, the reintegration market is subject to negative selection processes like creaming and parking, and the net impact of reintegration services seems to be modest. Interesting for the Dutch case is further that the role of the government is twofold. On the one hand, the government fulfils the role of the regulator of the reintegration market. While, on the other hand, the government itself is

part of the reintegration market due to its function as buyer of reintegration services. As we will show in our paper, this second role may stand in the way of the regulatory role. The Dutch reintegration market therefore offers a good example to analyse the causes and consequences of failures in the provision of private welfare.

This paper is structured as follows. In section two a theoretical analysis of mechanisms for safeguarding public values will be given. In section three, the process of privatisation in the reintegration market will be central. Section four describes the failures in the provision of private reintegration services, and section five analyses the causes and consequences of these failures. Finally, section six concludes.

## **2. Safeguarding public values**

### *2.1. The safeguarding triangle: state, market, and civil society*

The concept of public value(s) has received more and more attention lately (WRR 2000, Bozeman 2002; Jørgensen and Bozeman 2002; Teuling, Bovenberg and Van Dalen 2003; Jørgensen and Bozeman 2007). Much can be said about the definition and identification of public values. Defining public values is, however, not the focus of this paper. Rather, we will focus on the safeguarding of public values. In our opinion, the analysis of mechanisms for safeguarding public values can be undertaken independent from the precise definition of public values that is chosen. In fact, safeguarding public values frequently implies a trade-off between realising or safeguarding different competing public values, or at least it necessitates a trade-off between efficiency and the costs related to safeguarding certain public values (De Bruijn and Dicke 2006). Therefore, an important element in the process of safeguarding public values is making choices involving trade-offs to balance different public values.

The literature distinguishes several mechanisms for safeguarding public values, which can be classified into three general principles of ordering society: the state, the market, and civil society (Zijderveld 1999). Each ordering principle is characterised by a different set of coordination mechanisms with its own strengths and weaknesses (Centraal Planbureau 1997). The state, with hierarchy as its main coordination mechanism (De Bruijn and Dicke 2006; Van Gestel *et al.* 2007; Charles *et al.* 2007), can safeguard public values by fulfilling the role of the public provider of goods or services, or by regulating the behaviour in society through government regulation and the use of financial incentives. In the market, exchange processes based on competition and the price mechanism form important mechanisms for safeguarding public values. Finally, in civil society the interaction about norms within networks functions as the main coordination mechanism (De Bruijn and Dicke 2006; Van Gestel *et al.* 2007; Charles *et al.* 2007).

Because state, market, and civil society are no separate entities, but rather intertwining principles, in practice, coordination mechanisms of the three ordering principles can be observed simultaneously. During the history of the welfare state the coordination mechanisms from all three ordering principles have to some extent been present. It is also argued that for the safeguarding of public values a combination of coordination mechanisms from different ordering principles is desirable (Zijderveld 1999; De Bruijn and Dicke 2006). The underlying argumentation is that each ordering has its own advantages and disadvantages, which makes it more or less appropriate for the safeguarding of certain public values. By combining several ordering principles, weak aspects of one principle can be compensated by mechanisms of the

other ordering principles (Lijesen, Kolkman and Halbesma 2007). However, combining different mechanisms is not without problems (Kirkpatrick 1999). Coordination mechanisms can be complementary, but also conflicting. Moreover, one should take into consideration the costs involved. When an extensive set of safeguarding instruments is applied, the costs may outweigh the benefits (Mitnick 1981).

All in all, a priori it is not clear which division between ordering principles is best suitable for safeguarding public values. Dependent on the type of public values that needs to be safeguarded and the institutional setting in which safeguarding takes place, a different set of mechanisms may be required. In the welfare state, different combinations of ordering principles have been present. The emphasis that has been given to the three ordering principles has not remained unchanged. Over the years, a shift in coordination from civil society, to state, and finally to market can be observed. Characteristic of the transformation towards a regulatory welfare state is the increased emphasis on the market within the ordering triangle. The consequence of this shift for the safeguarding of public values is the focus of this paper.

## *2.2. Safeguarding public values in a regulatory welfare state*

During the past decades, the market has received a more prominent position in the design of most Western welfare states through the introduction of processes of privatisation. Underlying notion for granting a more prominent role to the market principle is the belief that the introduction of private elements increases the efficiency of the system and therewith decreases public spending (Walsh 1995; Bredgaard and Larsen 2007). That the introduction of processes of privatisation will actually increase efficiency is, however, not given. Rather, it depends on the extent to which the structure of the market meets the requirements of perfect competition (Barr 2004).

The perfect competition model assumes that the players in the market will negotiate and trade until they reach an outcome that satisfies all players. In such as case the outcome will be Pareto efficient, that is, the resources are allocated in such a way that 'it is not possible (through further reallocations) to make one person better off without making someone else worse off' (Nicholson 1995, p. 547). In order to realise a Pareto efficient allocation of resources the structure of the market needs to meet certain assumptions. All players in the market need to be involved in the negotiations and have equal market power in order to enhance competition. Market players further need to have perfect information free of charge in order to be able to make informed decisions based solely on individual preferences and uninfluenced by transaction costs; the costs that go together with trade (Williamson 1985). Only under these assumptions can the prices on the market reflect individual preferences and performances and can the process of competition and the working of the price mechanism result in a Pareto efficient allocation of resources. Since in such a situation private interests run parallel to public values, all private interests and therewith public values will be safeguarded (Bijkerk, Poort and Schuurman 2003).

Given that markets are characterised by transaction costs, it is inconceivable that in practice markets will meet the requirements of perfect competition (De Mooij 2006). Acquiring information entails costs and there is hardly any situation imaginable in which players on the market have similar sources of information at one's disposal. Due to these market failures, in practice, markets are characterised by inefficiencies. However, because states are also characterised by inefficiencies (Walsh 1995), granting a more prominent role to

the market in the design of welfare states may nevertheless go hand in hand with an increase in efficiency. By introducing market mechanisms such as competition in the welfare state, efficiency might increase. Cost efficiency might increase because competition forces providers to produce against as low as possible costs. Competition further encourages providers to look for product improvements and innovations, which increases dynamic efficiency (Bijkerk, Poort and Schuurman 2003). Efficiency can therefore be regarded as an important advantage of the market principle. Possible efficiency gains should, however, be offset against potential detrimental effects of privatisation and the costs that go together with preventing or correcting such effects.

In order to prevent and correct potential detrimental effects of privatisation, processes of privatisation in welfare states nearly always go hand in hand with government regulation. Processes of privatisation therefore mark the transformation from the conventional welfare state, in which the government fulfils the role of a public provider, into a regulatory welfare state, a state in which the government becomes the regulator of the private market (Majone 1997; Braithwaite 2000; Scott 2000; Moran 2002; Jordana and Levi-Faur 2004). Contrary to what is often believed, the introduction of private elements in a formerly public welfare system, therefore, does not go hand in hand with less, but rather with more regulation (Vogel 1996; Leisering 2003). Although the market receives the freedom to do its work, the government stays in control by correcting perverse effects of the market.

The functioning of the market is addressed in two respects by government regulation. In the first place, government regulation is geared towards creating a competitive market. By creating the conditions for competitiveness, for example through the use of competition law or the installation of a competition authority, government regulation may prevent monopoly power and enhance efficiency. Another way of creating a competitive market is the contracting out of public services through the use of tender procedures. Contracting out is practiced more and more throughout the world (Domberger and Jensen 1997; Brown and Potoski 2003; Sol and Westerveld 2005). In the Netherlands contracting out is, for example, required for regional public transport since 2001, for reintegration services since 2002, and for home care since 2007. With the mandatory contracting out of these services, quasi-markets are created (Le Grand and Bartlett 1993). Once competitive markets are created, the second role of government regulation regarding the safeguarding of public values comes into play. Government regulation may increase the functioning of markets by preventing or correcting market failures.

In the case of private welfare provision, market failure due to asymmetrical information forms an important issue, for asymmetrical information may result in adverse selection and moral hazard. Adverse selection occurs on a private insurance market when risks are spread widely within a group of insurants and the information regarding these risks differs between insurer and insurant. On the one hand, when the risks are not known to the insurer, no insurance market will be established, because the insurer will have to create an insurance based on average risks, which will only attract the people with high risks and will therefore not be profitable for the insurer. On the other hand, when the insurer does know the risks, not the insurant but the insurer will apply adverse selection. The insurer may select insurants on the basis of the risks they are bearing, which means that sick people can be refused or offered insurance under less favourable conditions than healthy people. In this case, public values such as equality of rights and the provision of a fair income distribution will be harmed.

In a situation of private welfare provision, asymmetrical information may also result in moral hazard. On a private insurance market, all persons insured may be inclined to run more risks than they would have done without the insurance, because they are not confronted with the costs of insurance claims. In the same respect, having an insurance covering illness may result in unintentional use of the insurance, since it makes it attractive for employees to call in sick when they are in fact capable of working. Moral hazard may, however, not only appear on the level of the insured but also on the level of the provider. In a private reintegration market, the providers of reintegration services may, for example, display moral hazard. Since the quality of reintegration services is difficult to measure, suppliers of reintegration services do not have an incentive to offer high quality and therefore may not provide the tasks they are paid for.

Market failures can be addressed by government regulation. Adverse selection may, for example, be prevented by introducing a compulsory insurance. The Dutch health care market is characterised by a mandatory basic health insurance. Insureds are obliged to insure themselves and the insurers have the duty to accept all insureds. By introducing a mandatory basic health insurance, the government sets the boundaries in which the private insurance market may operate, which induces insureds and insurers to behave according to the interest of the public. To guarantee that market players display such behaviour it is, however, important that government regulation is enforced. Enforcement, for example through forms of supervision, does not mean that the responsibility is handed over to the government. Supervision is always supplementary to the primary responsibility of the agent that is under supervision and is focused on supervising whether the agents under supervision fulfil their responsibility and act according to the rules (De Ridder 2004).

Enforcement of government regulation is necessary when it is not likely that the agents under supervision will spontaneously comply with the rules, which is the case when it is not in the private interest of the agents to behave according to the interest of the public. When the behaviour of market players does not result in an outcome that is in accordance with the interest of the public, one is confronted with external effects which the market is not capable of internalising. Government regulation, when enforced, forces market players to internalise the external effects, therewith correcting the perverse effects of the market and resulting in a public interest outcome (Teulings, Bovenberg and Van Dalen 2003).<sup>2</sup>

Perverse effects of the market can, however, not only be corrected for by government regulation, but also through the use of financial incentives. Unintentional use of insurances can, for example, be discouraged by introducing financial contributions like the 250-euro excess in the Dutch healthcare insurance system. An important advantage of the use of financial incentives is that supervision is not necessary, since the financial incentives create a situation in which it is in the private interest of the market players to behave in accordance with the interest of the public. Due to the financial incentives the market players will thus spontaneously internalise external effects.<sup>3</sup>

In a regulatory welfare state, the ordering principles state and market thus play an important role in safeguarding public values. Norms and trust are, however, also important

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<sup>2</sup> We do acknowledge that, due to possible adverse effects of government regulation, in practice the realization of a public interest outcome is not always that clear cut. See Van den Bergh 2000 for adverse effects of government regulation.

<sup>3</sup> It is important to realise that financial incentives also have a drawback: that is, the possibility of crowding-out intrinsic norms or motivation. See Frey 1997 for examples of crowding-out effects.

coordination mechanisms. In fact, norms and trust, inherent to the ordering principle civil society, can be regarded as an important precondition for the functioning of the coordination mechanisms of the orderings principles state and market (Zijderveld 1999). The reason is that norms may contribute to a decrease in transaction costs (Ouchi 1980; Dyer and Chu 2003). Disadvantage of the use of government regulation, is the transaction costs that go together with the compliance with and enforcement of government regulation. The more the rules that need to be enforced coincide with the norms upheld in society, the lower these transaction costs may be (WRR 2000). Moreover, in contracting relationships between market parties, norms and trust are also important instruments for decreasing transaction costs. For if there is no trust, market parties are forced to lay down all agreements in formal contracts. As a consequence, transactions will go together with very high transaction costs (Zijderveld 1999) and the advantages of the market, in terms of efficiency, will be mitigated or may even disappear. Norms and trust make it possible to replace expensive explicit contracts with cheaper implicit contracts based on trust (Dyer and Chu 2003; Van Slyke 2007).

The coordination mechanisms of the ordering principle civil society may thus increase the efficiency of private service delivery and therefore form an important instrument in the safeguarding of public values in a regulatory welfare state. Moreover, by emphasising the coordination mechanisms of civil society, not the state nor the market, but citizens become more central. The empowerment of citizens is advocated by the New Public Service philosophy (Denhardt and Denhardt 2000). Instead of focusing on steering, which is argued for by New Public Management, the government should be serving: the role of the government is to 'help citizens articulate and meet their shared interests rather than to attempt to control or steer society' (Denhardt and Denhardt 2000, p. 549). Although the empowerment of citizens and reliance on trust is important for safeguarding public values, it is important to realise that too much reliance on this mechanism has drawbacks too: 'the downside to excessive trust may be just as steep as the downside of excessive competition and control (Entwistle and Martin 2005).

All in all, the transformation towards a regulatory welfare state and the accompanying change in emphasis that is given to the different ordering principles may have important consequences for the safeguarding of public values. On the one hand, the emphasis given to the market principle increases the focus on the efficiency of private service delivery. On the other hand, the market may be characterised by market failures and therefore warrants government regulation which may, in turn, decrease efficiency. Finally, the coordination mechanisms of civil society affect both efficiency and the safeguarding of other public values. For the safeguarding of public values in private service delivery continuous reconsiderations therefore have to be made. The tension that is inherent in regulating private service delivery forms one of the important reasons why, in practice, the provision of private welfare does not always work out as it is intended. One such example is the reintegration market. By analysing the coordination mechanisms of the ordering triangle state, market, and civil society present in the Dutch reintegration market, we try to receive a better understanding of the causes of the failures in the provision of private reintegration services and the consequences that can be drawn from these failures.

### 3. Privatisation of the reintegration market

From the foregoing it is clear that, in theory, a welfare state that exhibits both state and market elements is capable of safeguarding public values. It is this idea, which has prompted many to introduce private elements in a formerly public welfare system (Considine 2001; Taylor-Gooby 2001; Taylor-Gooby 2004). In the Dutch welfare state, two types of privatisation can be distinguished. With regard to the risks of illness and disability, a substantive form of privatisation is realised, by handing over the responsibility for the coverage of these risks to the employers. Since the employers have the opportunity to choose for reinsurance of these risks, the shift in responsibility goes together with the coming about of a private insurance market. In addition, the process of privatisation in the Dutch welfare state contains a form of formal privatisation, with regard to the provision of reintegration services. It is this form of privatisation that is the focus of this paper.

A private reintegration market is introduced in the Dutch welfare state through the implementation of the Work and Income Implementation Structure (SUWI) Act in 2002.<sup>4</sup> This reform introduced a prominent role for private actors within the previously public domain of employment reintegration services. With this reform and the mandatory contracting out for these types of services, a quasi-market (Le Grand and Bartlett 1993) for the delivery of employment reintegration services is created within the Dutch context. Since the implementation of the SUWI Act, municipalities and the Employee Insurance Agency (UWV) are obliged to purchase reintegration services for their clients on the market through the use of tender procedures (Sol and Westerveld 2005). From 2006 onwards, the contracting out for service delivery is no longer mandatory for Dutch municipalities. Both UWV and municipalities do, however, still need to act according to the European tendering rules.

Moreover, the privatisation of the reintegration market can not be regarded as an isolated decision. Rather, it is only one element of the transformation towards a more activating welfare state. For long the primary goal of the Dutch welfare state used to be the provision of income protection, which resulted in a substantial number of people depending on social assistance, and changed the focus in the Dutch welfare state from a system of passive income support towards a system of activating social assistance claimants. Where welfare states used to be primarily aimed at the provision of income protection, we currently witness the transformation of the welfare state into a more activating enabling (Deakin and Waksh 1996; Gilbert 2002) or workfare (Considine 2001; Wacquant 2004) state, where the promotion of labour participation is the principal aim. Characteristic for the transformation towards a more activating welfare state in the Netherlands is the implementation of the Work and Social Assistance Act (WWB) in 2004.<sup>5</sup> With the introduction of the WWB, the municipalities are fully financially responsible for the provision of social assistance and the re-integration of social assistance claimants. By introducing financial incentives, it is expected that the municipalities become more aware of the costs involved with inactivity, which induces them to introduce an active reintegration policy.

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<sup>4</sup> Wet Structuur Uitvoeringsorganisatie Werk en Inkomen, SUWI (29-11-2001), Stb. 2001, 624.

<sup>5</sup> Wet Werk en Bijstand, WWB (9-10-2003), Stb. 2003, 375.

#### **4. Failures in the provision of private reintegration services**

Underlying notion of the privatisation of the reintegration market is the belief that the introduction of a process of privatisation increases the effectiveness and efficiency of the system (Raad voor Werk en Inkomen 2003; Van Berkel and Van der Aa 2005). However, up until today little is known about the functioning of the private reintegration market regarding these two elements. Although many social assistance claimants are involved in reintegration tracks, results show that the effectiveness and efficiency of the tracks is modest at most (Van Berkel and Van der Aa 2005; Struyven and Steurs 2005). Especially the net impact of reintegration tracks is difficult to assess, since it greatly depends on external factors such as processes of economic development (Ministerie van Sociale Zaken en Werkgelegenheid 2008). Due to the disappointing results, the privatisation of the reintegration market is criticised (Struyven and Steurs 2005).

Another aspect, in which the private reintegration market has said to have failed, is the presence of opportunistic behaviour. In a privatised reintegration market two forms of opportunistic behaviour can be expected: providers of reintegration services can be expected to do less than they are contracted for (moral hazard) and can be expected to focus on those clients that are easiest to reintegrate (adverse selection). Both types of opportunistic behaviour are present on the Dutch reintegration market. Clients of reintegration services complain that the providers of reintegration services show little effort in helping them to get a job (De Wit, Ulenbelt and Visser 2004), and research shows that providers of reintegration services do indeed focus on those clients that are easiest to reintegrate, which results in little attention for the reintegration of social assistance claimants with a large distance to the labour market (due to creaming and parking) (Van Berkel and Van der Aa 2005; Struyven and Steurs 2005).

#### **5. Analysing the failures in the provision of private reintegration services**

##### *5.1. Underlying causes for failures in the provision of private welfare*

Until now, the private reintegration market, like many other privatisation processes, has not lived up to its expectations (Bredgaard and Larsen 2007). In reaction to failures in the provision of private welfare, suggestions have been done to bring the privatisation process to a halt or even to reverse it (Baarsma and Theeuwes 2008). Before opting for changes in the institutional design of the reintegration market it is, however, necessary to have a good understanding of the underlying causes regarding the failures in the provision of private welfare. Especially for the reintegration market this understanding is pressing, since the privatisation of the reintegration market can not be regarded as an isolated decision, but as one element of the transformation towards a more activating welfare state.

Moreover, as mentioned in section 2.2., processes of privatisation in this context usually do not just involve a shift from state to market, but mark the transformation from a conventional welfare state into a regulatory welfare state. In the regulatory welfare state, not only the market plays an important role, but also the ordering principles of state and civil society. As a consequence, failures in the provision of private welfare may not be caused by failures in the market only. The underlying causes for failures in the provision of private welfare might also be attributed to the other two principles of the ordering triangle, the state and civil society. Government regulation may, for example, be inadequate, the enforcement of

government regulation may not be effective, or there may be too little reliance on norms and trust. In analysing the failures in the provision of reintegration services we will therefore focus on the working of the coordination mechanisms of all three elements of this triangle. We do this by focusing on the failures regarding the effectiveness and efficiency of private reintegration services, on the one hand, and the presence of opportunistic behaviour on the other hand.

### *5.2. Flaws in the effectiveness and efficiency of private reintegration services*

Results show that the effectiveness and efficiency of private reintegration services is modest at most (Van Berkel and Van der Aa 2005; Struyven and Steurs 2005). Because comparisons with the pre-SUWI period are hard to make, and public reintegration tracks were also characterised by inefficiencies and ineffectiveness it is, however, very difficult to evaluate the privatisation of the reintegration market in terms of an improvement or worsening of the effectiveness and efficiency of the system (Wielers and De Beer 2007). To claim that the process of privatisation has been unsuccessful is therefore premature. Moreover, a comparison with pre-SUWI period is also not needed in order to receive a better understanding of flaws in the effectiveness and efficiency of private reintegration services. Without claiming that the private reintegration market performs worse than a public reintegration market, it is clear that the functioning of the reintegration market could improve in terms of effectiveness and efficiency.

Important cause for the lack of effectiveness and efficiency in private social service delivery, such as private reintegration services, is its lack of competition (Van Slyke 2003). As mentioned in section 2.2, efficiency can be regarded as an important advantage of the market principle. However, in order for the market to result in an efficient outcome, competition is required. Without competition, providers of reintegration services may not produce against as low as possible costs (cost efficiency), product improvements and innovations (dynamic efficiency) may be undeveloped, and services may not correspond to the needs of reintegration clients (allocative efficiency). The Dutch private reintegration market is characterised by all three forms of inefficiencies (Struyven and Steurs 2003; Van Berkel and Van der Aa 2005).

Due to a lack of allocative efficiency, the effectiveness of reintegration services is also not flawless. The problem is that cost efficiency and allocative efficiency are, to some extent, conflicting. In the case of reintegration services there is a trade-off between buying large packages of reintegration services for large groups of reintegration clients (cost efficiency) and buying the reintegration services that correspond best to the needs of each individual client (allocative efficiency). Especially in the beginning, cost efficiency has received much attention. As a consequence, reintegration services often were not tailored to the needs of the clients and cost efficiency was realised at the expense of the effectiveness of reintegration services. Over the years, reintegration services have, however, become more tailor-made (Raad voor Werk en Inkomen 2006b).

One of the instruments applied in the more tailor-made approach, is the use of personalised reintegration budgets. Characteristic of the quasi-market structure of the reintegration market is that there is no direct relationship between the provider and consumer of reintegration services. Public governments decide which reintegration services to buy for their clients. As a result, reintegration services may not be in accordance with the needs of the clients and clients may not be motivated to participate in a reintegration track they do not believe to be

appropriate. Moreover, due to the lack of tailor-made services and client motivation, reintegration services may lose out on effectiveness. By increasing the involvement and therewith the motivation of reintegration clients, the effectiveness of reintegration services may therefore be improved. Since 2004 the Dutch Employee Insurance Agency (UWV) offers clients the possibility to opt for individualised reintegration agreements (IRO), and municipalities have experimented with personalised reintegration budgets (PRB). The first results indicate that personalised reintegration services are more effective (Inspectie Werk en Inkomen 2006; Borghi and Van Berkel 2007a; Sol and Westerveld 2007). Placing more emphasis on the coordination mechanisms of civil society, argued for by the New Public Service philosophy (Denhardt and Denhardt 2000), may therefore improve the functioning of the reintegration market.

Although the example of personalised reintegration budget shows that public governments have some influence on the effectiveness of reintegration services, competition between providers of reintegration services is important too. Problematic aspect of the reintegration market is, however, that competition does not exist *in* the market. Instead, European tender procedures and the mandatory contracting out of reintegration services laid down in the SUWI Act, promote competition *for* the market. Although tendering is desirable for reasons of promoting competition, the tender procedures have drawbacks too. Dutch municipalities bring forward that the tender procedures are a bothersome factor as these consume many administrative resources. Transaction costs of tendering are therefore high (Bredgaard and Larsen 2007). Moreover, the European procurement requirements entail constraints with regard to contracting contractors that have provided good service delivery in the past (Raad voor Werk en Inkomen 2008a; Corra and Plantinga 2008). Due to the problematic measurability of reintegration services, by constraining contracting on the basis of past performance competition is hampered.

Reintegration services encompass quite a wide variety of services. These include services related to social activation (getting individuals in touch with society again), improving employee competences (improving basic employee competences such as being on time), offering specific training to enhance work related skills and experience (strengthening human capital), improving job interview and letter writing skills, and also job placement services. Not all of these services have easily specifiable requirements or have easily measurable outcomes. Moreover, contracting out for more complex services, such as reintegration services, can also bring difficulties with regard to disentangling long-term and short-term results. In some cases outcomes may not be clear or measurable until contracts have long expired (Deakin and Walsh 1996; Van Slyke 2007). Because reintegration services may be lengthy processes and the net impact of reintegration tracks depends greatly on external factors such as processes of economic development, the quality of reintegration services is hard to observe.

For services that are difficult to measure, the reputation regarding the past performance forms an important competition mechanism. For these services, competition between providers may not be based on the quality of the services that are delivered, but on the reputations of the service providers. As a consequence, in a competitive market, providers of reintegration services that function poorly will be punished by not receiving a contract renewal. Due to the constraints in the tender procedures, in the Dutch reintegration market this mechanism does not function properly (De Graaf-Zijl *et al.* 2005; Groot *et al.* 2006; Raad voor Werk en Inkomen 2006b). Due to a failing reputation mechanism, in the tender

procedures the price of reintegration services has become the most important factor. In fact, in the first rounds of tender procedures prices were set too low (Raad voor Werk en Inkomen 2004). Consequently, reintegration providers were not able to deliver sufficient quality and reintegration services did not have the desired effect (Groot *et al.* 2006, Raad voor Werk en Inkomen 2006b).

A possibility to improve the functioning of the reputation mechanism in the Dutch reintegration market, and therewith enhance competition and promote effectiveness and efficiency, is to include the opportunity of re-offering providers of reintegration services with good performance ratings their contract without competitive tender. Presently, only a limited extension of existing contracts is possible. New contracts are always subjected to tender regulations. The tender procedures in Australia do, however, offer the opportunity to renew contracts without competitive tender (Zwinkels, Van Genabeek and Groot 2004; Sol and Westerveld 2005). However, in Australia this possibility is combined with the inclusion of quality criteria in the tender procedure, which has increased the instability of the market (Struyven 2004). In order to improve the working of the market, government regulation should therefore be applied with great care.

Another way of improving the functioning of the reputation mechanism in the Dutch reintegration market is to apply social regulation. Social regulation involves the application of instruments geared towards supplying information based on voluntariness and persuasion, such as the provision of advice and the use of naming and shaming. Social regulation differs in an important way from the other forms of government intervention, because in the case of social regulation government intervention is not based on coercion (government or direct regulation) or financial incentives (also called economic regulation), but forms a facilitating role promoting forms of self-steering (Baarsma and Janssen 2007). By applying social regulation, the government fulfils a serving and not a steering role (Denhardt and Denhardt 2000).

An example of social regulation that is applied in the Dutch reintegration market, are the initiatives developed to increase the transparency of the reintegration sector. To this aim, information about the working of the reintegration market is collected and published through research reports and via websites. Also, the coming about of a quality mark for the reintegration market is promoted. By providing information regarding the functioning of reintegration providers, competition between providers is encouraged. The provision of such information is important given that Dutch municipalities perceive difficulties in monitoring results and effects of reintegration services due to lack of information regarding the performance of the contractors (Raad voor Werk en Inkomen 2008a; Raad voor Werk en Inkomen 2008b).

The difficulties in monitoring are related to the difficulties associated with the measurability of the service and the lack of a well-developed set of common performance indicators. As a response to previous contracting experiences, many Dutch municipalities start adopting modular buying strategies (Raad voor Werk en Inkomen 2008a, Raad voor Werk en Inkomen 2008b). Municipalities no longer buy complete tracks or packages of reintegration services. The reason is that these long tracks entail considerable difficulties regarding the measurement of results, for example, with regard to the long time span before results will be visible and the type of outcomes these types of tracks aim to achieve. Instead, municipalities buy shorter tracks with more measurable results. The modular buying strategy adopted by the

Dutch municipalities shows that one can think of innovative ways of reducing the complexity of service characteristics.

However, for the encouragement of competition between providers the monitoring capacities of municipalities play a role too. Until now, the promotion of competition is hampered by the poor monitoring capacity of public governments (Van Slyke 2003). Municipalities feel that steering based on tendering documents and contracts only, is too limited and inflexible. A close steering relation encompassing frequent contact and consultation between contracting parties is considered vital for keeping sufficient control over the service delivery (Raad voor Werk en Inkomen 2008a). The preference for closer steering relations is accompanied by an inclination to use more informal tools instead of formal sanctioning tools to achieve contract compliance. Municipalities indicate that they do not want to damage the trust and close relationship with their contractors by being too rigid and formal in relation to contractual specifications (Corra and Plantinga 2008). Because much time, effort, and resources have been invested in the selecting of contractors, only as a last resort option formal penalties or contract termination will be used to achieve contract compliance. Instead, informal tools are applied to maintain a strong and active role in the day-to-day operation of case management. Municipalities thus replace expensive explicit contracts with cheaper implicit contracts based on trust, introducing the coordination mechanisms inherent to the ordering principle civil society.

### 5.3. *Opportunistic behaviour*

The quasi-market structure, failing reputation mechanism, and problematic measurability of reintegration services not only have consequences for the effectiveness and efficiency of reintegration services, but also induce opportunistic behaviour (Groot *et al.* 2006). In markets characterised by asymmetrical information, such as the quasi-market in which information differs between principal and agent, it is profitable for market players to display opportunistic behaviour such as adverse selection (Faure 2005).

In a private reintegration market, it is profitable for providers to focus on those clients that are easiest to reintegrate. If tendering is based on large packages of reintegration services for a large group of reintegration clients, providers of reintegration services will have the opportunity to apply such adverse selection through processes of creaming and parking (Struyven 2002). Opportunistic behaviour of providers of reintegration services should therefore be tackled through the use of contracting. One possibility to prevent adverse selection is to buy small packages of reintegration services in order to give reintegration providers less possibilities to apply adverse selection. A trade-off with cost efficiency is, however, at stake here. The larger the package of reintegration services that is contracted for, the lower the average price of reintegration services. However, the more creaming and parking may take place. Another possibility to tackle opportunistic behaviour is to include conditions in the contract with regard to, for example, differentiation in target groups and the financing of both input and result (Struyven 2002). Although these options are being applied, research shows that creaming and parking takes place in the Dutch reintegration market (Van Berkel and Van der Aa 2005; Struyven and Steurs 2005).

Part of the adverse selection in the Dutch reintegration market may be solved by better contracting. However, poor contracting is not the only explanation for the presence of adverse selection. Adverse selection is no exclusive attribute of a private welfare state. In a public welfare state this drawbacks exist too (Struyven 2004). The Public Employment Service also

focused on those groups that were easiest to reintegrate (Engbersen 2006). Moreover, in the present reintegration market adverse selection is not only applied by providers of reintegration services, but also by municipalities. As mentioned in section 3, since the introduction of the WWB in 2004, the Dutch municipalities are fully financially responsible for the provision of social assistance and the re-integration of social assistance claimants. Because Dutch municipalities bear the full financial responsibility for the provision of social assistance, it is profitable for them to focus in their reintegration policy on those groups that are easiest to reintegrate (Raad voor Werk en Inkomen 2006a). Not only the capability of Dutch municipalities, but also the willingness to address adverse selection thus plays a role. It is striking at the very least, that what the private service providers are criticised for seems to be an accepted practice for public governments (Bosselaar *et al.* 2007).

As long as it is profitable for municipalities to focus on those groups that are easiest to reintegrate, and this form of adverse selection is not tackled by central government, adverse selection will be present in the Dutch reintegration market. Preventing adverse selection on the level of municipalities is, however, possible. An example is the possibility of valuing social participation as an outflow instrument and compensate municipalities in this case for the costs of social assistance (Raad voor Werk en Inkomen 2006a). Moreover, addressing adverse selection does require a trade-off with the costs of the provision of reintegration services. The lower the focus on those that are easiest to reintegrate, that is, the lower the level of adverse selection, the higher the costs of reintegration services will be. This trade-off should be made on state level, the providers of reintegration services in the market will simply operate within the boundaries they are given.

A second form of opportunistic behaviour that can be observed in markets characterised by asymmetrical information, is moral hazard. If it is difficult to evaluate the performance of providers in the market, providers will be inclined to do as little as possible. Given that the net impact of reintegration tracks is difficult to assess, providers of reintegration services can be expected to do less than they are contracted for. Moral hazard on the level of reintegration client may, however, exist too. Social assistance claimants may not undertake efforts to find a job, because they can rely on their social security payments. With the implementation of the WWB and the accompanying transformation from welfare to workfare, Dutch municipalities have tackled this form of moral hazard. Social assistance is no longer given without demanding something in return. The Dutch municipalities have also received more authority for providing sanctions. Social assistance claimants run the risk of being sanctioned when they do not participate in the reintegration track that is offered to them. Although in practice sanctioning is not widely spread, the use of sanctions is increasing. Moreover, the threat of sanctioning has large effects on reintegration clients (WRR 2007).

While the moral hazard of reintegration clients is addressed intensively, the moral hazard of providers of reintegration services and public governments has received far less attention. What are the sanctions when providers of reintegration services do not deliver what they are contracted for (Knijn 2005) or whether the case managers or reintegration coaches of public governments do not live up to their obligations? In a competitive market, the reintegration client would switch to a different provider. However, in the reintegration market the client does not have the exit-option. In fact, given the threat of sanctioning, reintegration clients are forced to participate even though the reintegration track that is offered to them might not fit their needs. The position of reintegration clients is therefore weak (Sol and Westerveld 2005; Van Berkel 2006).

While government regulation addresses the moral hazard of reintegration clients, it thus increases the possibility of moral hazard on the side of the reintegration provider. Although moral hazard of service providers is addressed by public governments through contracting, moral hazard on the side of the public governments is not addressed at all except for the general provisions of administrative law. This is striking given that the Dutch welfare state is well known for its example of moral hazard in a public setting, that is, the misuse of the disability status by the social partners during the 1980s (De Gier, Henke and Vijgen 2003). In order to prevent moral hazard of providers of reintegration services and public governments, the position of reintegration clients needs additional safeguards, for example, by giving them more possibilities to file complaints and the option to change reintegration providers in the case of malfunctioning of the reintegration provider.

## **6. Conclusion**

In this paper we have analysed the causes and consequences of failures in the provision of private reintegration services. In doing this, we have focused on the coordination mechanisms inherent in the three general principles of ordering society: the state, the market, and the civil society. The transformation towards a regulatory welfare state marks a change in emphasis that is given to the different ordering principles. An example of this transformation is the contracting out of public service delivery. By contracting out public services, the role of the government transforms from the role of a public provider to the role of the regulator of the private market. In this paper we have analysed an interesting example of contracting out of public services, the privatisation of the Dutch reintegration market. The focus on the Dutch reintegration market is interesting since contracting out is spreading especially rapidly in employment services. The Dutch reintegration market is regarded as a prototype of this reform. Interesting for the Dutch case is further that the government fulfils two roles. On the one hand, the role of the regulator of the reintegration market, on the other hand, the role as buyer of reintegration services. This second role may stand in the way of the regulatory role.

A private reintegration market is introduced in the Dutch welfare state through the implementation of the Work and Income Implementation Structure (SUWI) Act in 2002. Underlying notion of the privatisation of the reintegration market is the belief that the introduction of a process of privatisation will increase the effectiveness and efficiency of the system. Although many social assistance claimants are involved in reintegration tracks, results do, however, show that the effectiveness and efficiency of the tracks is modest at most. Moreover, clients of reintegration services complain that the providers of reintegration services show little effort in helping them to get a job and research shows that providers of reintegration services focus on those clients that are easiest to reintegrate, which results in little attention for the reintegration of social assistance claimants with a large distance to the labour market (due to creaming and parking).

Analysis of the failures in the provision of reintegration services shows that the causes for the failures originate from the ordering principles market, as well as state and civil society. With the implementation of the SUWI Act and the mandatory contracting out, a quasi-market for the delivery of employment reintegration services is created within the Dutch context. Until now a competitive market is, however, not realised. The failure to realise a competitive market may not be surprising, since over the years quasi-markets are widely investigated and

the associated problems are well known. The privatisation of the Dutch reintegration market shows once again that it is not a matter of course that the creation of a quasi-market will automatically result in successful outcomes. Especially given the complexity of reintegration services, the contracting out of reintegration services is not an easy task.

However, failures in the provision of private reintegration services can not be ascribed to the market principle alone. The other two elements of the ordering triangle, state and civil society, are in this respect important too. In fact, important underlying cause for the failures in the provision of private reintegration services forms the institutional context and the capabilities of the public governments to monitor private service providers. The institutional context may support or undermine efforts of contracting out and successful strategies for delivering services. In the Dutch case, most public governments evaluate the tender procedures as bothersome. The promotion of competition is further hampered by the poor monitoring capacity of public governments. Public governments need to develop capabilities with regard to being a good contractor, which takes time. Even though contracting out is ubiquitous nowadays it seems difficult to learn from previous experiences. What is known from previous experiences is that contracting often involves high transaction costs and that norms and trust form important factors for decreasing these costs. Dutch municipalities also feel that steering based on tendering documents and contracts only, is too limited and inflexible. They are therefore replacing expensive explicit contracts with cheaper implicit contracts based on trust, introducing the coordination mechanisms inherent to the ordering principle civil society.

Not only the capability of Dutch municipalities to monitor contractors, but also the changing role in which they do so is important. Since the implementation of the WWB in 2004, Dutch municipalities bear the full financial responsibility for the provision of social assistance. By introducing financial incentives, municipalities should become more aware of the costs involved with inactivity, which would induce them to introduce an active reintegration policy. The financial incentives have, however, also encouraged municipalities to apply adverse selection. Not only private service providers therefore display opportunistic behaviour, but also public governments. It is striking at the very least, that what the private service providers are criticised for seems to be an accepted practice for Dutch municipalities. Moreover, the disproportionate way in which adverse selection is addressed, also applies to the approach taken to handle another form of opportunistic behaviour, that of moral hazard.

With the implementation of the WWB and the accompanying transformation towards a more activating welfare state, Dutch municipalities have tackled the moral hazard of reintegration clients. Social assistance is no longer given without demanding something in return. Social assistance claimants further run the risk of being sanctioned when they do not participate in the reintegration track that is offered to them. While the moral hazard of reintegration clients is addressed intensively, the moral hazard of providers of reintegration services and public governments has received far less attention. What are the sanctions when providers of reintegration services do not deliver what they are contracted for or whether the case managers or reintegration coaches of public governments do not live up to their obligations? In a competitive market, the reintegration client would switch to a different provider. However, in the reintegration market the client does not have the exit-option. In fact, given the threat of sanctioning, reintegration clients are forced to participate even though the reintegration track that is offered to them might not fit their needs. In order to realise a long-lasting participation in society, it may therefore be wise to shift the focal point of

attention from punishment to the development of the capabilities of reintegration clients. In order to realise this, the position of reintegration clients needs additional safeguards. Participation of reintegration clients in the track they will be following can be encouraged and reintegration clients can be given more opportunities to force reintegration providers to do a good job, for example, by giving them the option to file complaints and the possibility to change reintegration providers in the case of malfunctioning of the reintegration provider.

All in all, for the provision of private reintegration services a good functioning market is required as well as coordination mechanisms of the ordering principles state and civil society. In the course of the existence of the Dutch private reintegration market, some initial steps have been made in order to receive a good balance between the different elements of the ordering triangle. However, further improvements in the functioning of the private reintegration market can and need to be made.

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