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Briefing 10-21

## **Choice and competition in public services: A guide for policy makers**

To all APSE contacts in the UK, and with particular interest for those service managers and directors responsible for service delivery, planning and performance.

### Key issues:

- The OFT commissioned a report prepared by Frontier Economics to explore market mechanisms in public services
- The report does not endeavour to comment on whether decisions to open up public services to the markets have been right or wrong but to identify critical success factors
- APSE comments within the report seek to further explore the issues of choice but apply the principles of competitiveness

### **1. Introduction**

Public services account for approximately 20% of economic activity in the UK covering health, education, emergency services, defence and care for the elderly and disabled.

The Office of Fair Trading (OFT) in a 2009 paper 'Government in Markets' set out some of the rationale for considering the role of government as a 'market maker' and the potential role of user choice in the delivery of public services. In this latest report 'Choice and Competition in Public Services' the OFT seeks to explore the lessons from experience, in the UK and abroad, and present them as part of an overall framework when assessing where, and how, competition and choice can be most effective, and how to design systems that use market incentives to improve the performance of public services.

### **2. Choice and competition**

The OFT report comments that choice and competition works well in private markets (in the absence of market failures) for example through looking at externalities, asymmetry of information and natural monopoly. It is seen within private markets as a driver that can:-

- Place downward pressure on costs
- Force firms to be more focused on meeting customers' needs
- Lead to more efficient allocation of resources between companies and
- Act as a spur to innovation

Interestingly the OFT report readily acknowledges that competition works best where there is a well developed demand side, made up of well informed and confident consumers and an efficient supply side, made up of a number of different providers, all competing against one another. In a public service market it would mean giving consumers a degree of choice over the services they consume (individual personal budgets for example). An efficient 'supply side' would mean in most cases securing a degree of competition between different providers.

The report also makes the point that in an effective market 'choice and competition' should be mutually reinforcing. Confident and informed consumers activate competition by rewarding those providers that deliver the best services that most suit their needs.

The report does however draw the distinction between private sector motivations for encouraging choice and those within public services.

### **3. Different motivations for encouraging choice in public services.**

The report identifies three motivations for encouraging choice in public services.

- Within the public sector choice may still retain an intrinsic value even if it has little or no impact on the average price or quality of any service.
- Choice may be used as a mechanism for allocating scarce resources. For example choice based lettings do nothing to the quantity or quality of homes available but provide a better match between tenants and properties.
- Choice can also be used as a means to drive improved efficiency and better outcomes. For example the choice of a school or a hospital.

### **4. Difference between private and public service markets.**

A classic example of market failure would be where private, unregulated markets would fail to provide the goods or services in the quantities or at the quality needed; for example in health and education. In such cases it would be appropriate for the government to intervene.

Governments can also regulate to provide a framework to 'correct the identified market failures' creating a framework in which to operate to correct identified

market failures or alternately the government can control the provision of services directly.

The decision whether to regulate the markets directly depends, in large parts, on the magnitude of the failure, society's values and beliefs concerning the right of the citizen to have at least some basic access to services.

The report identifies differences between public and private markets as being:-

**A lack of price:** Public services are not restrained by charge as they are generally free at the point of delivery. Whilst there are hidden charges in terms of taxation or some charges for some services, such as leisure, price is not a key determinant in the way in which it is within the private markets.

**Public service obligations:** Public services reflect a societal requirement for universal provision of services and a degree of equity in that provision. Therefore 'choice' within public services needs to be designed with that in mind.

**Lack of profit motive:** Unlike private providers who are accountable to shareholders the public sector is not motivated by profit. Therefore whilst motivations matter, because they determine responses or incentives, they are likely, within a public sector environment to be complex and multi-faceted.

## **5. Scope for choice and competition in public service markets**

The report asks the question of policy makers how, or if, choice and competition can be introduced into public services in a way which provides information, and sharpens incentives, but does not damage wider benefits which may be fostered in the public sector. However the authors do note that the introduction of choice and competition in public services will not automatically produce improved outcomes.

The report distinguishes between competition '**for**' the market and competition '**in**' the market. For example in the past the use of compulsory competitive tendering for refuse collection services or currently rail franchise operations.

Competition '**in**' the market occurs where suppliers compete directly for customers and is usually defined by the way in which customers exercise choice. The OFT report focused on competition 'in the market'.

The report also explains a number of factors in assessing success or failure in the introduction of competition and choice in public services including:

**Is the service very complex?** If it is hard for customers to assess the service and obtain information on quality it is hard to make informed choice.

**Is the service time critical?** An example would be the ambulance service where customers do not have the time to exercise choice.

**How often will the service be used?** Customers learn through repeated exercise of choice so where there is fairly regular interaction they can make an informed choice. It is less likely that an informed choice would be made in service that is not frequently accessed.

**Is the decision important?** The motivation to make a choice may be less if the cost of getting it wrong is small or there is little differentiation between providers.

## 6. User choice and demand side issues

Price, quality and other determinants are usually factors in 'demand side' issues within private markets but in the public sector price is usually absent. Key factors in public sector choice are:

- Awareness of choice
- Assessment of information
- Capability of public service users to act

The report emphasises that there is a 'value of choice' in that even if it has little impact on service quality it is non-the-less valued. There is also a focus on the criticism of choice being a perception that only the relatively well off are motivated to use it and actively want choice. The report in response specifically references a study on the British Social Attitudes survey which asked people how much choice they thought they should have over which hospital they should go to. A majority of the social groups thought that they should have a choice over which hospital that they should go to and, if anything, this was greater among those that typically earn lower incomes.

Similarly in the case of local government services an Audit Commission report found *'Generally the least privileged people (social classes D, E,) were most in favour of choice as 'absolutely essential' in all of the service areas we tested in our survey – these are the people who have the least spending power to secure choice at present and depend more on council services to a greater degree than other people'*.

Choice in any market is also limited by barriers: For example, restrictions on the ability of individuals to travel, or a lack of confidence or awareness, that choice exists. Such barriers are, it is noted a concern for public policy makers where equitable access and outcomes are the driver.

The **framing of choice** is also a useful indicator and will affect what choices are made. For example defaulting employees into a pension scheme with an option to opt out resulted in more employees taking out company pensions schemes. Therefore how choices are framed will influence the exercising of choice.

## 7. Supply side competition

Effective competition requires a dynamic supply-side and for this to be effective it requires:-

- **Diversity of supply:** effective competition would generally require at least two potential providers to compete in the market place. Within the public sector markets, or at least within some geographic areas, there might not be adequate providers to produce competition
- **Supply-side flexibility:** to meet the needs of the service users it would need to allow for expansion , contraction and excess capacity
- **Funding and incentives:** Competition will need to provide incentives on providers. How within the public sector could rewards and incentives be structured into regulated arrangements?

The report references that the public sector is not 'at risk' of having funding cuts due to poor performance as this would militate against performance improvement. This to APSE is a flawed example (see our comments below). However the constraints within the public sector are recognised. Contraction, for example, is difficult within a school with falling pupils numbers where there will still be a need to have core teaching staff. Capacity is also explored and the report suggests that if there is no spare capacity then choice cannot effectively operate – if the hospital or school is full then the service user would have to go where the capacity is rather than there being capacity at the hospital or school of their choice.

## 8. General lessons on choice and competition

Some conclusions from the report are as follows:-

- There are very hard trade-offs to be made between flexibility on the supply side (vital for example to make competition in schools really effective), control of public funding, and delivering a universal service.
- Competition on price may be inferior to competition on quality (with fixed price) as the former may lead to significant quality deterioration, particularly when quality is difficult to observe.
- Excess demand requires some sort of 'rationing mechanism'. In social housing allocation this is an allocation formula, in schools it is usually a measure of distance lived from the school. The mechanism chosen will be an important determinant of the outcome.
- Allowing mergers and takeovers between public sector bodies can be an important alternative to simple closure of less effective institutions. There is plenty of experience of this in further education.
- Closing down institutions as a direct result of low demand is hard in public sector markets. Having an effective 'failure regime' is important.
- Funding has to be activity-based to provide incentives for expansion and cost-reflective to prevent 'cream skimming'.
- Managerial incentives and behaviours can be made more responsive to competitive pressures by granting additional autonomy and changing institutional structures.
- Private sector competition can be helpful in driving public sector performance. But most experience so far suggests it is more helpful in increasing capacity and providing additional choice. Getting regulatory and contracting mechanisms right is vital.

- It is likely that well designed mechanisms for choice and competition, alongside a range of other appropriate funding and control mechanisms, will be important in driving performance in public sector provision. But the complexity of these delivery mechanisms means that definitive evidence on the impact of the introduction of choice and competition on outcomes is scarce.
- In the UK outcomes in health and education have improved a lot in recent years. But alongside reforms to increase competition have been large funding increases, more centrally set targets and oversight and other new institutional arrangements. The academic literature does not yet provide clear evidence on the role of competition in driving performance in these sectors, though there is evidence of positive effects in some other countries where these mechanisms have been taken further.
- In general, there is little evidence that choice and competition have adverse impacts on equity. Indeed less affluent people appear to feel particularly empowered by the ability to express choices. This does though depend on how the rationing mechanism works. There may be a particular issue in schools where there are limited places in the most desirable schools, there are 'peer effects' and rationing of places occurs through the housing market. But these are specific circumstances.

### **APSE conclusion**

The report is fairly balanced and in some ways should be welcomed as it usefully does not fall into the accepted wisdom of suggesting that 'choice and competition' will deliver improvements in public services. It provides a reasonable analysis of the barriers.

The report is flawed however in some areas in that it is weak in its relationship to the dynamic of the current fiscal situation on public services. Whilst price may not be a factor in driving choice and competition for consumers, 'cost' is a factor in driving the rationale for service improvement and may be an issue in limiting the development of greater choice to service users.

The likelihood of large scale public sector cutbacks on funding will be a determinant in delivering service improvement. Alongside this there is policy support, across political parties, for increasing choice to end users in the delivery of public services. APSE has argued that choice will potentially impact in local government as economies of scale are lost. Equally moves to larger economies of scale (such as shared services) may impact upon choices for users and for councils in policy terms (procurement choices for example meaning goods are sourced outside of the local area limiting the choice on the council to procure locally or include community benefits in procurement).

The report is also limited to an exploration of 'choice and competition'. For reasons that the report itself acknowledges competition is not a particularly effective mechanism where there are demand and supply side limitations to the operation of 'competition' within the public sector. It is recognised that the mechanisms which otherwise help drive competition in the private sector do not readily apply

themselves to the public sector. Equally the report usefully recognises that whilst there is an intrinsic value in choice the need to balance this with spare capacity to effectuate choice is a barrier within public services.

APSE has long been of the view that whilst the public sector ought to be 'competitive' on cost and quality issues there needs to be a more discerning measure than a crude market testing exercise. For in-house local government services the challenge will be to balance the delivery of greater choice in public services against the need to drive down costs to meet the fiscal challenges.

In APSE's e-publication '[The Competitiveness Continuum](#)' we argue that competition, along with the profit imperative, throws up clear incentives to minimise the cost of producing goods and services. It is a serious flaw in attempting to deliver public services, which are on a not-for-profit basis within a framework designed for private sector services, which are by their nature driven by profit motive.

Whilst failing to minimise cost might not make a council service 'go out of business' there are nevertheless stringent drivers for cost controls and quality improvement with inspections, service user satisfaction / perception measures and the on-going requirements of best value. Best value requires a balance to be struck between economy, efficiency and effectiveness. Continuous improvement requires each one to relate to the other. Increasingly however it is recognised that 'effectiveness' may need to include the element of choice for users within that. This may however have an adverse impact on 'efficiency' since there may be a need to build additional capacity into systems and services that might otherwise be considered to be an inefficient use of resources, in order to meet the 'choice offering' to public service users.

As an alternative to the driver towards 'competition' in a market testing sense or indeed in a 'market maker' sense APSE's free to download e-publication (click on the title), [The Competitiveness Continuum](#), explores the differences between the private sector ability to develop market based mechanisms and the flaws of this approach within public sector services.

On the issues of choice perhaps one of the important phases within the APSE model is '*stakeholder consultation, involvement and participation*' since the ability to explore the choices, that users would like to make within a service, will influence how that service can be designed and delivered to accommodate choice.

Choice should not be bolted onto a service delivery plan but should be an integral part to the delivery of services planned around the needs of the user. This is not to say that the delivery of choice will be entirely reconciled with cost and quality barriers but it is an approach consistent with continuous improvement in public services. A graphical illustration of the competitiveness continuum is included in the appendix to this briefing.

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## APSE's improvement model

