National Audit Office

Public Service Markets

View from the National Audit Office

Charles Nancarrow

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My presentation is very much about setting out the key concepts and an understanding and of public service markets. It draws on years of work at the National Audit Office where we started some years ago evaluating economic regulation, then moving on to examining competition regulation in private markets, and most recently expanding our work to look at public service markets.

My presentation draws very heavily on the work that we have been doing with City University, and so I must first give credit to the authors of the joint paper, and in particular to Xeni Dassiou.

Overview

- What is a public service market?
- Where do we see markets in public services?
- What are the characteristics of public service markets?
- What are potential market failures in public service markets?
- NAO work in the area

Complex, so helpful to start from first principles

What is a public service market?

- Public service
- User-provider transactional relationship
- Often called user choice and competition
- Funding can be public or hybrid (and conceivably private)
- **Fundamentally different to direct delivery**
  - Opportunities: personalisation, devolution
  - Risks: User drives vfm, capability

Firstly we must define what we mean by a public service.

We use the term public service to refer to services that are generally regarded as essential enablers of participation in society. For example, access to water and energy, as do access to education, health and social care.

Another way to think about these services is that they are those for which government would have to act as “provider of last resort”, or make arrangements that ensure their continuity, if their provision were to be put at risk.

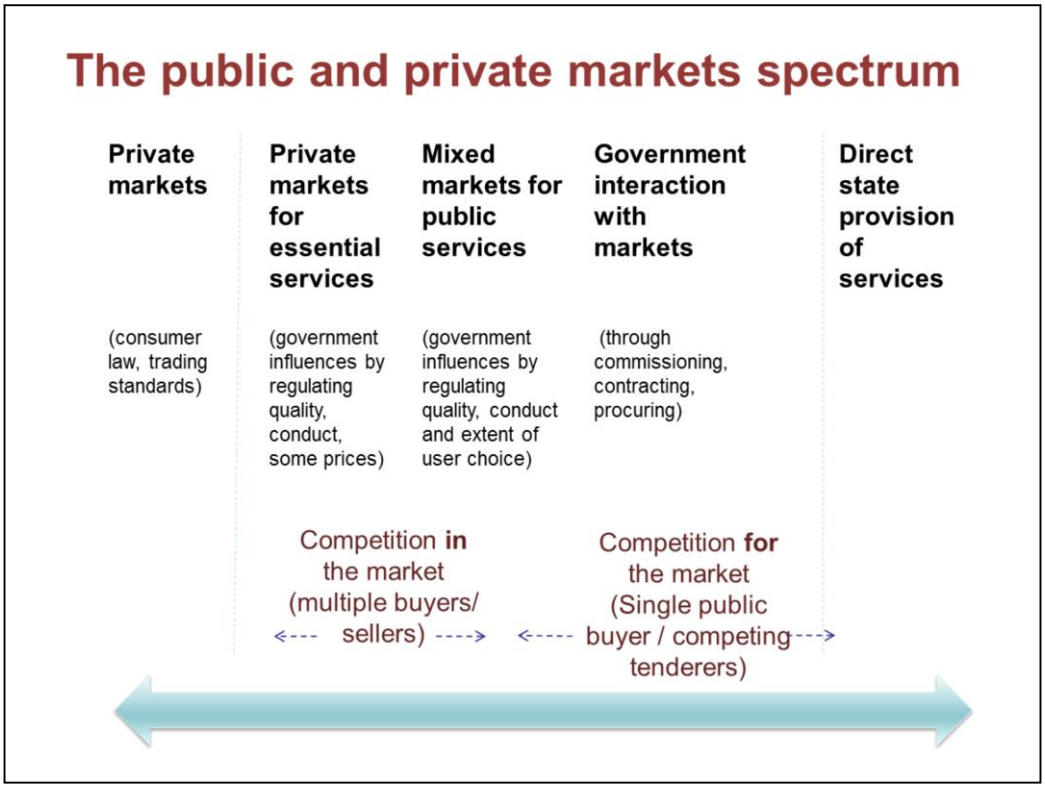
In markets for public services there is a **transactional relationship** between the citizen or user and the provider of the service. Also, the user is funded at least in part by the public purse. This form of market is often termed ‘**user choice and provider competition**’ or ‘competition in the market’, and is distinct from contracting or commissioning where the public authority is buying services on behalf of the citizen user (or often termed ‘competition for the market’).

Funding is a political and policy decision (private – eg. water bills; taxpayers eg. National Health Service). The two modes of paying for public services are not mutually exclusive, and public services may be funded by a mix of both.

In the UK, for example, most of the costs of social care are born by users directly, with the taxpayer only subsidising provision for the poorest; and while people pay to use train services by means of fares, the taxpayer covers around half the total costs of maintaining and enhancing rail infrastructure (through a grant from the government to the rail infrastructure company, Network Rail).

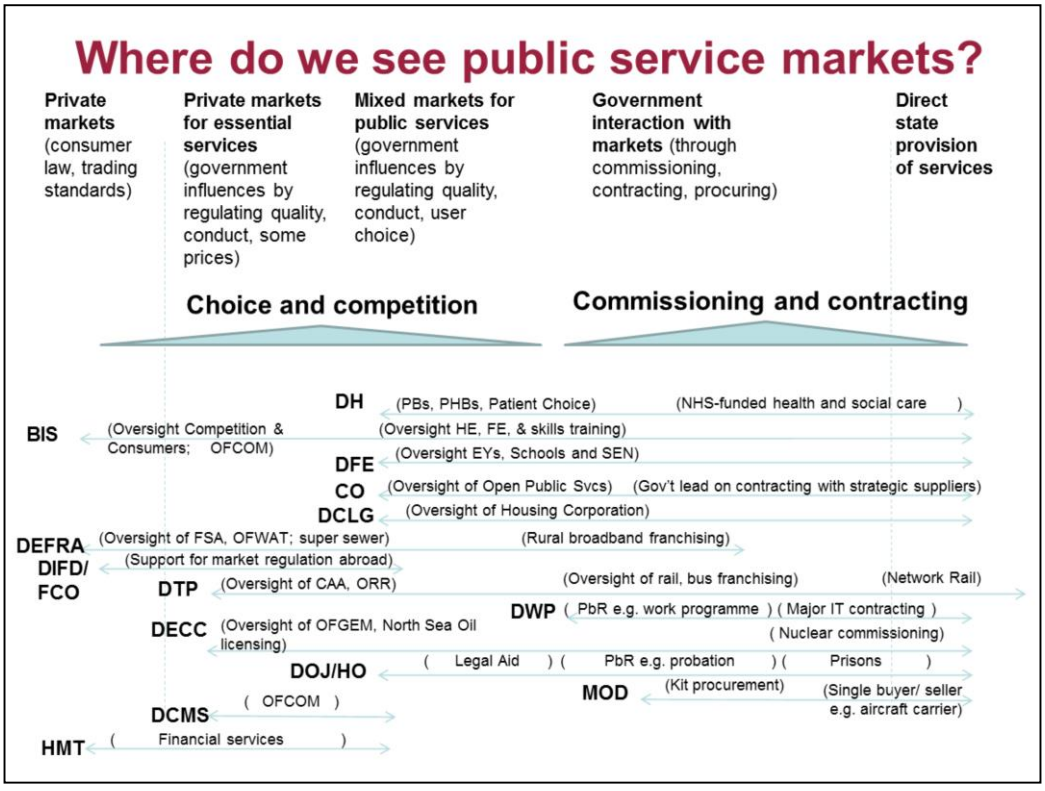
Of course even when government policy is to provide public services partly or wholly at the taxpayer's expense, private markets also often exist, such as private schools and hospital markets, for those who choose and are sufficiently affluent to access them.

Public markets are fundamentally different to direct delivery and there are a combination of opportunities and risks. Opportunities are for services to become more personalised, responsive, efficient, diverse and innovative. But there are major new challenges for government. For example, departments and local authorities may lack the capability to ensure that they operate in the interests of the users and the taxpayer, rather than in the interests of the providers whose profits are funded by users and taxpayers.



To understand public markets further we can view them as part of a spectrum. This is particularly important because public markets are not absolute in there nature, and many areas of delivery can have some or many market characteristics without being fully developed markets.

An example of this would be users who may choose from a range of LA commissioned providers.



This is work in progress and maps out various public services on this spectrum.

More developed public service markets are in DH, DFE, and MoJ (legal aid)

Private markets – very well developed

Other end of the spectrum is direct provision eg. Network Rail

Public and private markets are different with implications for oversight

- PSMs are fundamentally different to private markets
  - Complexity
  - Vulnerability of user
  - Taxpayer and user affordability
- Typically merit goods (ie. with a positive externality)
  - Choice merit goods – can be provided through vouchers or direct payments
    - May not achieve universality or equity
    - User choices may be inconsistent with policy objectives
  - Compulsory merit goods – probably best provided through commissioning arrangements
- Nevertheless, useful to frame arguments using 'market' language

It's very important to understand that private markets are fundamentally different to public markets. This means that public policy objectives are unlikely to be met by 'leaving it to the market'. We think that early Government experiments with public service markets did perhaps display some naivety around this issue.

Public markets are often highly complex. For example delivery chains and linkages in health and social care are highly complex and extended, as are the nature of goods and services. Users are often vulnerable (for example someone in care who has dementia), or they may have to make a distressed purchase, for example having to choose a care home at short notice when being discharged from hospital. Furthermore, public markets will often have affordability constraints associated with taxpayer funding which is not generally a feature of private markets.

Typically merit goods

Public services are also **typically merit goods** which means they are characterised by large positive externalities in their consumption. I'm going to talk briefly about market failures on the next slide, but I wanted to mention merit goods here because of their importance in understanding public

markets and because economic theory identifies merit goods as a clear market failure that justifies government intervention.

Social care is a typical example of a “choice” merit good as it has large positive externalities (a civilised society expects those people needing care and without sufficient financial means to have their care needs met). The private care market caters for those able to pay for their own care, but left to the market alone care would be under-consumed leaving vulnerable people without financial means to fend for themselves. This explains why government funds social care. However, when users do not pay for a service there is also a risk of over-consumption, so government needs a system of gate-keepers (e.g. GPs, care professionals) to ensure only eligible recipients receive publicly-funded care.

In principle there is no reason why the state could not just hand out vouchers for merit goods to users and let them choose a supplier, if they are in a position to make choices effectively. However the state may wish to pursue different objectives like equality, fairness as well as budget constraint considerations, which will not necessarily be achieved if users choose providers in an unconstrained manner. And user choices may be inconsistent with policy objectives.

The other main category of merit goods are “compulsory” merit goods. These are services where user choice is either not desirable and/or their consumption is not optional. Typically the majority does not consume these goods or services (meaning they are not the direct beneficiaries), but they are strongly affected by the negative externalities caused by their absence, or their underproduction in quantity and quality. For example, goods like probation services, jail services and workplace programmes are all merit goods for which under provision or user choice could have seriously negative consequences for the non-users. Commissioning, or state provision of these services is likely to give an outcome closer to the socially optimum than user choice as users are unlikely to internalise the full social benefits of these services – no-one is going to send themselves to jail!!

Market language

Although, as we have seen, public markets have different characteristics to private markets we believe it is still helpful to frame them using ‘market’ language. This helps define key concepts and understanding, and is particularly important because we have found that the key concepts and language of public service markets is not well developed or used coherently.

Potential market failures in public service markets

- Demand issues
  - Principal / Agent relationships
  - Determining quality of complex and / or experience goods
- Provider issues:
  - Thin market / monopsony of funding
  - USO
  - Purchaser provider split
  - Local / regional monopolies
  - Provider failure

As you will all know, regulation is well established in private markets for public goods, and RPI-x has, over time, given way to general competition law. In public service markets there are a number of market failures, in addition to merit goods, that may justify state or regulatory intervention.

Principal – agent issue

Whereas in utility markets the good is purchased by the user who pays the price and the providers meet this demand, in the case of PSMs this is different: the user is not necessarily the buyer of the service (as this may be commissioned on their behalf) and they typically do not pay for it. Choice and competition may exist; or choice may be exercised on behalf of the user by an agent or at least with the advice of an agent say, a GP.

This has similarities with consumers taking financial decisions with the advice of an intermediary such as a broker or adviser or more recently comparison websites. The problem here is whether the agent (say, the GP in healthcare) is incentivised in such a way so as to promote the interests of the principal (who is in this case the service user). The problem is compounded by the dual role of the GP as a budget holder and a prescriber of the most appropriate treatment.

Determining quality…

It is often very difficult for the user to determine the quality of public goods in advance of purchase, for example because the notion of quality is complex, or because the good is an experience good such as surgery.

Provider-purchaser separation and weak market mechanisms

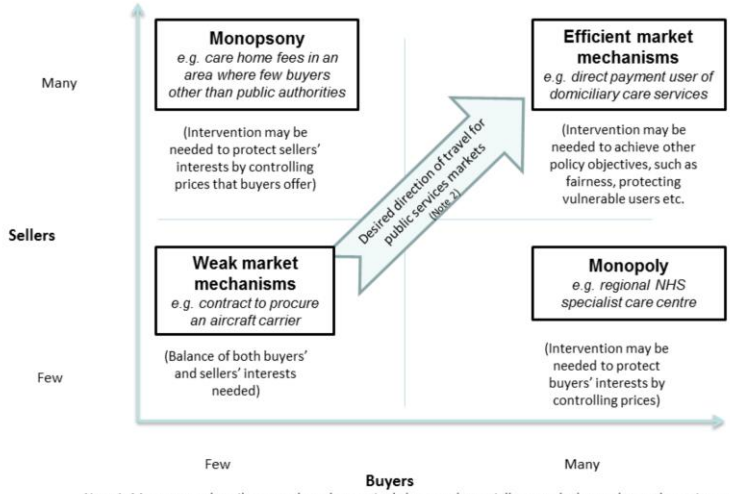
Public service markets are often “thin” and can take the form of highly local or regional markets with a bilateral monopoly or a monopsony. Users often make choices on the basis of proximity with the effect that the public service markets may be very small and local. Also, when a local authority commissions services it may face a single provider, or its buyer power may give it monopsonistic power in a local market.

Provider failure

Public services such as health, social care and education are essential to many people’s lives, which require government to ensure arrangements are in place to maintain continuity of service in order that harm or detriment to users is avoided (such as reduced educational outcomes, or physical harm or even death in the case of health or care), and policy objectives are met. Public authorities need to ensure that arrangements exist to guarantee service continuity in the event of provider failure or exit. For this reason, effective oversight in public services can require government to monitor the financial health of key providers in order to assess the degree of risk that exists in the market to service continuity for users.

Government has to avoid however providing explicit or implicit guarantees to support providers that fall into financial difficulties, for this could risk weakening the incentives on providers to manage their own businesses and maintain their financial viability. The government therefore has to balance the need for poorly-performing providers to exit the market with the need to protect users by ensuring continuity of service.

Potential market failures in public service markets



Note 1: Monopsony describes a market where a single buyer substantially controls the market as the major purchaser of goods or services.

Note 2: Achieved by encouraging new entry, sustaining a range of providers, increasing choice and personalisation.

Potential market failures in public service markets

- Demand issues
  - Principal / Agent relationships
  - Determining quality of complex and / or experience goods
- Provider issues:
  - Thin market / monopsony of funding
  - USO
  - Purchaser provider split
  - Local / regional monopolies
  - Provider failure
- Application of competition law in the public sector

Competition law

Applying competition law to public markets is complex and largely untested; the provisions do not necessarily capture activities of public authorities unless certain conditions are met. However, public authorities should not necessarily assume that competition law does not apply to them. A key issue for public service markets is whether the Competition Act applies to public authorities, in particular whether authorities are under an obligation not to abuse a potentially dominant position when they operate both as a provider in the market and as a purchaser of services in the same market.

Oversight arrangements vary reflecting the need to meet policy objectives

- Accreditation and licencing of providers
- Regulation / inspection
- Remedies
- Ante / post

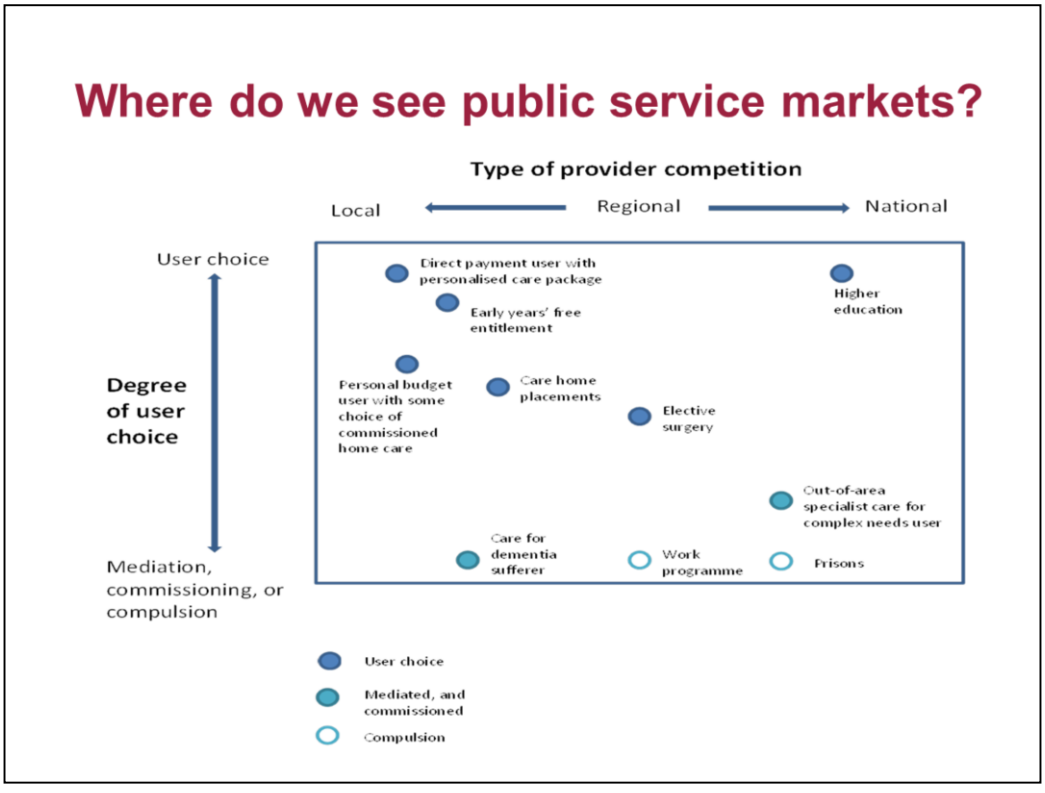
Our work so far has found that oversight arrangements vary enormously

In the UK, where services are paid for by users directly, such as water, energy, telecommunications and banking, market oversight is realised through the system of independent regulation that has developed over the last three decades. For example through Ofwat, Ofgem and the Prudential Regulation Authority (PRA—now part of the Bank of England).

These bodies regulate in a variety of different ways ranging from highly prescriptive and ex-ante to ex-post. So, for example, an ex-ante regulatory regime would see the initial accreditation or licensing of providers, with a monitoring and inspection regime to ensure that quality standards and price limits are being upheld. An ex-post regime will rely on the rules of the market, for example consumer or competition law, intervening only when these rules are breached. And there may well be other types of intervention, for example to provide users with better information so that they can make more informed choices.

In public service markets, such as early years or adult care, the market can be overseen by a variety of different organisations. You may have a

sponsoring department, a sector regulator, the local authority or other public body, or complaints organisations. In reality it is likely that a combination of these will have responsibility for ensuring the market delivers the intended public policy outcomes. For example, NHS-funded healthcare has an independent economic regulator (Monitor), but other services are subjected to limited economic regulation with an unclear distribution of duties among different departments for stewardship, accountability, assessment of the providers' performance, standards appraisal and fulfilment of contractual obligations, user satisfaction feedback information, and ultimately information of the funding received by government to ensure that the VFM process can start to operate effectively.



I've got here a slide of some public service markets which maps them out on a number of different dimensions. The purpose of this is to show how the different market characteristics of each public policy area have implications for value for money.

HE – In principle looks like an effective market, but are students making choices that are consistent with public policy objectives – how are choices framed?

DP - with personalised care package – Highly personalised care, but very local market, so is there enough competition (substitutability) to obtain a good price?

Care home placement – Looks like an effective market, but are there elements of distressed purchase?

Peter will be talking about the way we have brought these together in a coherent evaluative framework.

NAO work on public markets

- VFM studies:
  - Care markets
  - Early years
  - Looked after children
- VFM principles papers
- Overarching evaluative framework

VFM principles: Delivering services through markets

- Rules for ensuring a competitive market
  - 1: There are rules to ensure the effective operation of the market.
  - 2: The rules of the marketplace are enforced if necessary.
- Enabling users to participate actively in the market
  - 3: Users are empowered to make appropriate choices.
  - 4: Users have effective mechanisms for redress.
- Promoting healthy competition between providers
  - 5: There is a level playing field for all providers, whether public or private.
  - 6: Providers can easily enter the market, expand and exit.
  - 7: There are service continuity arrangements where provider failure could harm users.
- Ensuring the market is delivering the public policy objectives
  - 8: Market oversight is based on good quality financial monitoring and market intelligence.
  - 9: The oversight body has sufficient expertise to understand the market and will intervene, if appropriate, to remedy market failures.
  - 10: The body responsible for delivery of public policy regularly reviews whether public service outcomes are being delivered.

VFM principles: Deciding prices for marketised public services

- National principles – policy departments as 'system operators'
  - **1:** Department understands national supply and demand and intervenes to remedy problems
  - **2:** Department understands the national market structure and intervenes if market failure
  - **3:** Department should understand the role of, and work with, the competition authorities and relevant quality and sector regulators, to raise awareness, standards and enforce rules and the right market behaviour
- Local principles – local authorities as 'market stewards'
  - **4:** The local authority understands its impact on local public and private markets as a purchaser of services, and how to encourage the right market behaviour
  - **5:** The local authority knows the costs of service provision
  - **6:** The price sustains supply at acceptable levels
  - **7:** Quality is acceptable
  - **8:** Users are well informed about quality