

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
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How and when consumer choice drives efficient competition in publicly funded services – Note by Mats. A Bergman

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1. Introduction

1. Private providers, in particular for-profit operations, are typically more cost-efficient than public providers. Meanwhile, public providers are better positioned to attract and benefit from the professional staff's public service motivation, and they have weaker incentives to engage in cost savings that may simultaneously degrade quality. Private provision, hence, potentially offers more services at a lower cost, but also comes with the risk that quality may suffer. In some circumstances, a well-designed consumer-choice system can result in both cost-efficient (private) provision *and* high quality.

2. Consumer choice is the norm in regular markets

2. In regular markets, the buyer evaluates the options on offer and, in principle, chooses the alternative that offers the best combination of price and quality. The seller, in turn, optimizes the combination of features and quality that yields the highest surplus, i.e., the largest difference between the consumer's valuation and the production cost. In a monopoly position, the producer could potentially extract all of the surplus, but if competition is reasonably effective, much of the surplus must be passed on to the consumer.

3. Consumer choice is a key driver of this virtuous circle. Producers need to accommodate the buyers' preferences and, in many markets, they need to continuously improve their offers in order to remain competitive. Even consumers that do not actively choose will benefit, as other consumers' efforts will often weed out deficient or sub-standard products.

4. Obviously, cognitive limitations and asymmetric information make it unlikely that the consumer in a given situation is actually able to select the overall optimum product; more realistically the consumer will make choices based on habits and convenience and will satisfice, rather than optimize. It can be argued, however, that over time learning and competitive processes will bring the outcome closer to the optimum. Also, as will be discussed below, mechanisms have been introduced that can reduce problems due to asymmetric information.

5. The conclusion remains: consumer choice is not only the norm in regular markets, it is an indispensable part of the market economy. Furthermore, consumer choice accords with the principles of self-determination, empowerment and general liberal freedoms; notwithstanding complaints about consumers having to make supposedly unnecessary choices from excessively wide assortments of products such as toothpastes and breakfast cereals.

3. The Swedish choice revolution

6. In the 1980s, not only was Sweden a country with exceptionally low income inequality, generous provision of welfare services and, at the time, exceptionally high tax revenues as a fraction of GDP. It was also a country where welfare services, to an unusually high degree, were *produced* in-house by the government. Child care services, education at all levels, health care and elderly care services were all predominately produced by the government, with a market share of around 98 % for education and elderly care, around 90 % for child care and health care, but only around half for dental care.

7. Genuine consumer choice existed only for dental care for adults and for higher education, although in the latter case with choice mainly restricted to government-owned universities. Since around 1990, however, a veritable choice revolution has swept through the Swedish welfare system, although the government has retained the financial responsibility, with free education at all levels, nominal fees for health care and heavily subsidized fees for child care, dental care and elderly care. Perhaps surprisingly, the private providers have to an unusually high degree been for-profit rather than non-profit. For example, Sweden stands out among rich countries in allowing for-profit education at all levels except universities, from kindergarten through primary to secondary education¹ and is one of a small number of countries with an extensive voucher system for schools.²

8. For elderly care, private provision was introduced around 1990, mainly through public procurement, but this opened the door for choice systems. In 1992 the Free School Reform in one stroke opened up for user choice in the markets for day care (kindergarten) and primary and secondary schools – although in practice the establishment of schools was necessarily protracted. In 2009 the Free Choice Act made it possible to more systematically introduce user choice for nursing homes and home care (for the elderly). One year later, the same act opened the primary-care market by mandating user choice, while allowing user choice in specialized care.

9. The fraction of welfare services provided by non-government entities has risen to 20 % or more for elderly care and child care, to 25-30 % for secondary education, to 40 % for primary care, and to about 15 % for primary education. Bergman and Jordahl (2014) survey empirical studies of the effect of outsourcing elderly care in Sweden on quality and Holmlund et al (2014) survey empirical studies of the effect of private for-profit schools on learning outcomes in Sweden. Overall, the studies report no effects on quality or small to moderate positive effects. However, grade inflation seems to be somewhat stronger in private schools. (Vlachos, 2010.)

10. The effect of school choice on segregation along ethnic or socio-economic lines is highly contested in Sweden, but an academic consensus appears to be establishing that school choice increases segregation slightly, although the main driver of school segregation is residential segregation. (Brandén & Bygren, 2018; Holmlund et al, 2014; Edberg, 2018.) Schools in Sweden are not allowed to require co-payments or to use admission tests. However, they can prioritize among applicants on the basis of residential proximity or older siblings already attending the school. They can also use waiting lists, they can establish in more affluent areas or choose profiles that attract children from socio-economically privileged families. In practice, waiting lists are used extensively, but there seems to be no bias towards establishing in affluent areas. Also, schools are under no obligation to meet composition quotas, although municipalities are required to accept recent refugees; a policy that indirectly yields some such effects.

4. Mechanisms for maintaining non-verifiable quality

11. As mentioned above, many markets suffer from asymmetric information. Consumers that buy technically advanced goods and services may be at the mercy of the

¹ Sweden does not allow for-profit universities. Chile allows for-profit companies to operate schools.

² Voucher systems are also used in Denmark, the Netherlands, New Zealand and Chile, as well as in many US states.

sellers and may end up with low-quality or even deficient products. The problem is particularly severe when key quality characteristics are non-verifiable, in advance of the purchase and sometimes not even after purchase, as may be the case with such diverse products as medical services or washing powder. If quality is verifiable, in the sense that the quality level can be ascertained according to some reasonable legal standard, the consumer is in a much better position, since such quality characteristics may be written into a contract.

12. However, multiple mechanisms have been introduced that ameliorate the problems of adverse selection when quality is non-verifiable. Generous guarantees will convince consumers that a product is durable – and will shift the cost of sub-standard durability back to the producer. Consumer-protection legislation and mandatory product standards strengthen the position of consumers. A clever mechanism that has sprung up in the market economies, generally beneficent for the buyer as well as the seller, is the brand. A firm that invests in a brand name and in its reputation can charge premium prices. It can still shirk on quality in order to reap short-term benefits, but it will then suffer in the long run.

13. Even the proverbially vulnerable tourist looking for dinner, at a resort or at some other tourist destination, now stands a decent chance of finding a decent meal, with the help of rating services available on the Internet. Common for all these mechanisms is that the consumer is at liberty to act on signals, or on a whim, without having to justify him- or herself with verifiable reasons. The consumer can act with full discretion, in response to any kind of signal.

5. Third-party payer markets and non-verifiable quality

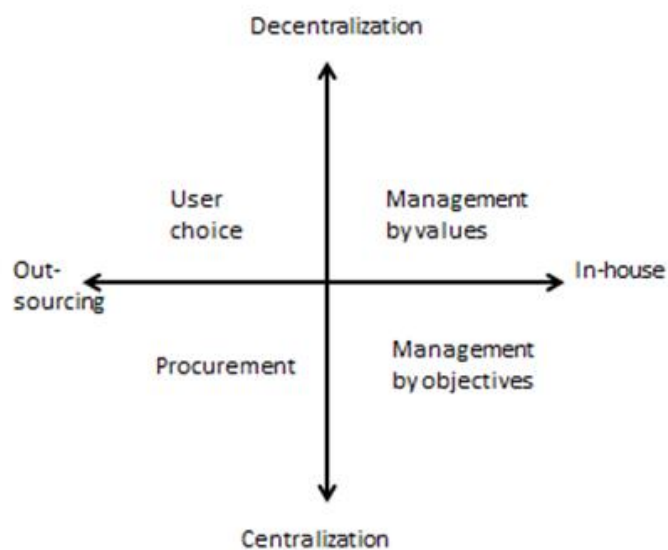
14. Welfare services are typically paid by, or heavily subsidized by, a third party; either the government or an insurance system. Compared to a private consumer in a regular market, this third-party payer is much more constrained in how it can select among providers, especially if the third party is the government. On top, the asymmetric-information problem is often worse for a third-party payer, who is not present when the service is delivered. The consumer of the welfare service and the producer often have a joint interest in selecting a quality level that, from the third-party payer's perspective, is excessive.

15. Even if the third-party payer observes the same signals as the consumer, it has less discretion to act on them. For legal reasons, it must typically restrict itself to relying on verifiable information. There are good reasons for this, notably that the government's coffers would otherwise be open to corruption, but this makes it much more difficult for the government to maintain quality in non-verifiable dimensions. For welfare services, such dimensions are often very important. Teachers, for example, should not only be qualified, but they should also be engaging and ambitious. Staff working with elderly care should be loving or at least respectful and caring; physicians should exercise good judgement, but also be respectful.

6. Maintaining quality in publicly funded services – four ideal-typical models

16. According to one classification, there are four ideal-typical models that can be used to manage welfare services and to safeguard a sufficient quality level.³ These four models can be illustrated in a two-by-two chart, with the degree of centralization or decentralization along one axis and the extent of in-house production versus contracting out on the other.

Figure 1. Management models for welfare services



17. The government can manage its in-house units under a centralized bureaucratic system, here called Management by objectives. Alternatively, it can give the professional staff a large amount of freedom to manage themselves, relying on their intrinsic motivation and their internalized norms. This model is here called Management by values.

18. If the government relies on outsourcing, it can either try to set strict quality standards and then procure provision on the basis of price, quality or a combination thereof. I call this Procurement. Finally, while still outsourcing to private providers, it can decentralize the selection of providers to the users, under a User-choice system.

19. In practice, there will always be elements of Management by values, as long as professional staff is employed. Similarly, the government will want to set up some goals, even when all service-production is outsourced, so there will be some Management by objectives also under Procurement and User choice.

³ Le Grand, 2007; Bergman, 2013.

7. Quasi-markets

20. A quasi-market is the institutional structure in which a user-choice system, e.g., for welfare services, can be established. The government retains overall control and responsibility for funding, while private and often also public entities compete for consumers, typically under fixed-price contracts. The choice between providers is typically made by the consumer, but sometimes by a better-informed third party, such as a physician.

21. Early discussions of quasi-markets are found in Le Grand (1991, 2002); a recent survey and discussion is Lewis (2017), with a particular focus on schools and the National Health System in the UK. Quasi-markets were expected to deliver high quality at relatively low cost, to offer consumers (or users) choice, while imposing hard budget constraints in sectors that had previously faced soft budget constraints.

22. According to Lewis, the effect of introducing user choice is mixed. Some evidence suggest that efficiency has increased, while there appears to have been only modest effect on quality; in some instances quality has improved marginally, in others there is evidence of some quality degradation. There is also some evidence of the producers shifting effort towards more easily observable quality aspects, such as narrowing the school curriculum or focusing effort on “borderline children”, i.e., those that may just past the national target level.

8. Combining consumer choice with centralized management and quality control

23. From an efficiency perspective, a major advantage of user choice is that users can react on non-verifiable quality that the government (or some other third-party payer) cannot observe or, even if it can, is prevented from acting on, due to legislation mandating transparency and equal treatment.⁴ Furthermore, user choice accords with the fundamental ethical principle of respect for autonomy, often emphasized in medical ethics, but with a less prominent place in the ethics of education.

24. Returning to the efficiency perspective, users can safeguard quality in certain dimensions, those that are easily observable while highly non-verifiable, while the government can retain control of other, more technical, dimensions. With user choice, consumers of welfare services can react on signals such as the reputation of a school, a dentist or a nursing home for the elderly. The reputation will often reflect values that are not easily verifiable, such as “being treated with respect” or “feeling safe”. As discussed above, it will be difficult for the government to observe and react on such vague notions, even though they are clearly important for welfare services.

25. Users – and their relatives – *can* react to non-verifiable information. In principle, users “vote with their feet”, i.e., they exercise their control through “exit”. (And often also through “voice”.) In practice, however, it is often difficult to switch provider. A pupil that moves to another school will often have to bear a significant, although in most cases transitory, social cost. Hence, the level of dis-satisfaction has be relatively high; the pupil will be locked-in, due to these switching costs, when quality differences are perceived as

⁴ For example, EU procurement law is based on the principles of non-discrimination, equal treatment, transparency, proportionality, and mutual recognition.

only low or moderate. Similarly for nursing homes for the elderly, few elderly will actually switch, as their health is fragile.

26. Instead of outright switching, which tends to be rare, reputation is the main feedback mechanism through which users discipline providers. A school or a nursing home that gets a bad reputation will have difficulties in attracting pupils or elderly in need of care, respectively. However, it must also be the case that a bad reputation results in lower capacity utilization. If the government off-sets the welfare provider's economic costs or directs new pupils to schools with low capacity utilization and the elderly to half-empty nursing homes, so that a reputation for low quality has few or no economic consequences for the provider, user choice will be ineffective in safe-guarding quality. It follows that there must be some slack in capacity; otherwise it will cost nothing to neglect quality.

27. While user choice can safe-guard some quality aspects, the government should retain responsibility for other quality dimensions, those that will be difficult for school children and their parents, for patients and their relatives, and so on, to verify. The government may want to verify that the curriculum is up to standard, that children and youngsters are given sufficient time with the teachers and that grading is fair. Also, the government is in a better position to monitor medical safety, that best-practice treatments are used and to evaluate long-term morbidity and mortality.

28. Furthermore, the consumers' interests will sometimes diverge from those of the government and, more generally, society at large. Pupils and students will want to have high grades, while it is in the public interest that grading reflects ability and performance. As discussed above, patients and physicians have a joint interest in choosing the best treatment, irrespective of cost, but the government will sometimes restrict eligible treatments in order to rein in costs.

29. In principle, the above objectives can be achieved by regulating and vetting private operators that wish to participate in a user-choice system. Only those that meet and follow certain quality standards will be allowed to compete for users.

30. Practical considerations will sometimes not permit outright privatization of publicly owned facilities, such as schools, hospitals and nursing homes – or at least make such sales difficult. It may, for example, be convenient to sell such facilities when they need large refurbishments or for other reasons are empty; selling a running operation may be more difficult and result in competitive concerns, as well as opposition from parents and relatives.

31. Instead, the management of a particular facility (a school, a nursing home, a hospital) may be procured within a user-choice system that encompasses that facility and many others. This more or less necessitates a fixed-price highest-quality model for bid evaluation. The fixed price would typically be the per-user cost allowed to the in-house

producer. (With standard adjustments for variation in facilities costs and for cost variations due to users having different needs.)⁵

32. Maintaining some production in-house may also have the beneficial effect of providing the government with information that allows it to improve the management of the system, such as more accurate information about the cost structure.

33. To summarize, a user-choice system will often respond faster and more strongly to deficient quality in non-verifiable dimensions. This is otherwise a fundamental problem to be managed when welfare services are outsourced, as private providers will have stronger incentives to cut costs also when this may impair quality. However, the government must realize that it still has the responsibility for safeguarding quality in other dimensions, where users have limited ability to perceive quality deficiencies or to respond to them, or where the interests of the users and society at large diverge (e.g., school grades).

9. Problems associated with user choice

34. The most fundamental problem with outsourcing welfare services is that many quality dimensions are non-verifiable and that this, in combination with a third-party payer setup, makes it difficult to set up a quality control system that prevents unscrupulous providers from shirking on quality, without becoming too onerous for honest providers.

35. As discussed above, user choice is one mechanism that does provide incentives for providing good quality. However, there are also problems that must be taken into account. Providers may want to “cream skim”. That is, they may want to use mechanisms that give them a more favourable mix of users, for example high-ability pupils or elderly in relatively good health.

36. Some such mechanisms have been mentioned in the context of primary and secondary education. Schools may use co-payments that are easier to pay for high-income families; they may prioritize on the basis of a waiting list, which benefits the families that can plan ahead, an ability that correlates with income and education. Similarly, an emphasis on science and demanding curricula will attract high-ability pupils.

37. In order to promote equal opportunities, the government will probably need to restrict the use of such practices. However, if users’ ability to choose is too restricted, it may be difficult to maintain the beneficial effect of user choice on quality, via the reputation effect. Also, for the sake of diversity, differences in pedagogic methods and in the focus of the teaching and the curricula should reasonably be permitted.

38. Another type of problem occurs when the interest of the individual diverges from the interest of the society. Most students will want high grades, but a more appropriate social objective is fair grading. There is a risk that struggling or entrant schools try to attract students by establishing a reputation for easy grading; other schools may then feel a competitive pressure to follow suit. More subtly, schools may engage in so-called teaching-to-the test or narrow curricula to mainly such skills as will be measured. In the context of health provision, competition may result in excessive medical testing or, if this comes at no cost to the patient, excessive quality provision.

⁵ An alternative is to allow top-ups. The government would then remunerate the providers with the same per-user amount, but the users could pay more for (perceived) better service.

39. User choice can increase as well as decrease segregation. Compared to an admissions system based on geographical proximity, admissions based on grades or waiting time will tend to counteract the effect of residential segregation, but it will tend to increase segregation based on ability, which in turn correlates with the parents' income and education.

40. Yet another problem stem from the complexity of choice. Users, similarly to regular consumers and perhaps even more so, have cognitive limitations. It is well-known that when consumers are presented with too much choice and are given too much information, the quality of their decision-making deteriorates. Therefore, the branch of government responsible for the user-choice system needs to carefully consider how to present an appropriate amount of relevant information. Many consider report cards a good way to provide easily accessible information to consumers or users that need to make a choice. Quality aspects can be presented with symbols, so that for example one to three stars represent successively higher quality. Several underlying quality aspects may also be weighed together to a composite index, so as to reduce the dimensionality of the quality presentation.

41. Which quality characteristics to emphasize, how to weigh them together and how to present them will have strategic consequences for providers with different strengths and weaknesses, so they will have incentives to lobby for a report-card design that make them appear good. Once the design is in place, they will still have incentives to manipulate the underlying results. For example, schools can engage in "teaching-to-the-test" or discourage low-achieving students from taking tests and in order to inflate the school's apparent learning achievement.

10. The need for bespoke solutions – and for intermediately high entry barriers

42. The example of elderly care shows how idiosyncracies have large effects. The market for nursing homes and the seemingly quite similar market for home assistance exhibited drastically different dynamics following the introduction of the Free Choice Act in Sweden in 2009.

43. In the market for home assistance, entry barriers were drastically reduced. Minimum standards for being allowed to compete within the system resulted in entry costs that were significantly lower than those under a procurement-driven system. In large cities, this resulted in a huge number of providers, many of which operated on a small scale, at low capacity utilization, and that employed competitive methods such as choosing a company name that appeared close to the top of an alphabetic list. More usefully, these firms began advertising their staff's ability to speak minority languages.

44. Meanwhile, entry barriers in the market for nursing homes were drastically *raised*. A firm that want to compete in the market for nursing homes needs to sink investments that vastly exceeded those necessary to participate in a public-procurement contest. It needs a facility of at least minimum-efficient scale – and the staff to operate it. Even if the firm could rent the facility, it needs to negotiate a multi-year lease contract. For a median-sized facility, it needs to recruit tens of employees. In contrast, when competing for a procured management contract for an already established facility, it suffices to hire a manager and perhaps a deputy manager, with the skills needed to submit a competitive bid. In a procurement situation, the nursing home is typically fully or almost fully occupied, while

a new entrant in a user-choice system needs to recruit elderly. This has resulted in competitive methods that bear some resemblance to those used by real-estate agents, as the relatives of elderly in need of care naturally will want to have the facility demonstrated. In some places, this has resulted in lobbies that, similarly to hotels, are built to a higher standard than the rest of the facility.

45. While the differential evolution in the two segments of the market is easy to explain after the facts, this sequence of events was not easily foreseen beforehand. Large cities may more usefully be served by a lower number of home-assistance providers, something that may be achieved in a combined procurement and user-choice system. In small cities, user choice may not be sufficient for even for the first entrant to break even, given that market shares build up slowly, even though the market would in principle be big enough for two or three rivals. In cities of intermediate size, a simple user-choice system may be the perfect solution.

46. It is sometimes argued that it should be as easy as possible to participate in public procurements. This is a misconception. When non-verifiable qualities are important, there must be mechanisms that make the producers take a long-term view. The propagating mechanism will often be the reputation of the establishment or the provider, but there must be a reward for good achievement and a penalty for poor achievement. If entry barriers are set at the right level, sufficient but not excessive, they serve both as penalties for non-serious entrants and as protection, for the serious providers, against hit-and-run competition from the non-serious ones.

11. Conclusions

47. User-choice may serve as a complement to other mechanisms for quality control when welfare services are provided competitively. It empowers users and it allows them to react on non-verifiable quality aspects, including, e.g., a school's reputation. Since non-verifiable quality often is critical in welfare services, user choice can help providing incentives for high quality in dimensions where government regulation and supervision often fail.

48. In most cases, however, user choice is only one mechanism among many that needs to work in tandem, in order to safe-guard good quality in as many dimensions as possible. The fact that social and private interests sometimes diverge (e.g., for school grades) adds to the need to complement user choice with other quality-control measures.

49. There are possible problems associated with user choice, such as a risk for cream skimming (the targeting of users associated with low costs or high revenues), increased segregation, and strategic manipulation of (reported) outcomes, such as teaching-to-the-test. A well-designed user-choice system and appropriate regulation and oversight that address these concerns are key elements of any user-choice system.

50. Despite the above concern, a beneficial aspect of user choice is that it provides incentives for high quality in a way that is relatively robust against strategic manipulation and that also tends to be perceived as legitimate by the profession as well as by the users. If users actively choose to patronize or not to patronize a particular provider, that provider will or will not, respectively, receive the corresponding payment. Bonuses or penalties

directly linked to measured quality will often be more susceptible to manipulation and, perhaps because of this, be perceived as less legitimate.

51. The link between performance and reward is broken, however, if the user-choice system does not allow for low capacity utilization among low-performing providers. Obviously, an overall excess capacity comes at a cost. Therefore, the link between performance and reward is best protected if the system is designed so that entry barriers are sufficiently high, but not too high. Too low entry barriers make a user-choice market vulnerable to hit-and-run competition from low-quality-low-cost providers. Too high entry barriers leaves too much profit with the incumbents. Hence, bureaucracy and oversight costs should not be minimized, they should be optimized.

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