



City Research Online

City St George's, University of London

Citation: Dassiou, X., Langham, P., Nancarrow, C., Scharaschkin, A. & Ward, D. (2014). Public Service Markets: Their Economics, Oversight and Regulation. London: City University London.

This is the published version of the paper.

This version of the publication may differ from the final published version. To cite this item please consult the publisher's version.

Permanent repository link: <https://openaccess.city.ac.uk/id/eprint/7388/>

Copyright and Reuse: Copyright and Moral Rights remain with the author(s) and/or copyright holders. Copies of full items can be used for personal research or study, educational, or not-for-profit purposes without prior permission or charge, unless otherwise indicated, provided that the authors, title and full bibliographic details are credited, a hyperlink and/or URL is given for the original metadata page and the content is not changed in any way. For full details of reuse please refer to [City Research Online policy](#).



**CITY UNIVERSITY
LONDON**

CCRP Working Paper Series

Public Service Markets: Their Economics, Oversight and Regulation

Xeni Dassiou

Peter Langham

Charles Nancarrow

Alex Scharaschkin

Dan Ward

Centre for Competition and Regulatory Policy (CCRP)
City University London

CCRP Working Paper No 28
(December 2014)

Public service markets: their economics, oversight and regulation

Abstract

This paper has three aims.

Firstly, it aims to show that the language of markets can help to frame arguments about how effectively public services are achieving their intended outcomes. Using 'market' language and concepts may not always be comfortable for those from a traditional policy-making background. This paper suggests that thinking in these terms can nevertheless be very useful when designing investigations of the effectiveness of public services, whenever those services entail a degree of personalisation or user choice – as is currently the case, for example, in large parts of health, social care and education in England.

Secondly, the paper aims to show that public service markets (public services that involve choice on the part of service users) differ quite fundamentally from private markets. Hence the conditions for the success, or failure, of public service markets to achieve public policy intentions may be different from the conditions that are necessary to foster successful (well-functioning) markets in the private sector. Although there are analogies between private and public markets, some of which are discussed, the introduction of 'market mechanisms' into public service provision does not necessarily mean that the public service markets thus created will behave like private markets, or that policy intentions will be achieved simply by 'leaving it to the market'. This, of course, has implications for how public service markets are overseen, managed, and regulated.

In particular, the nature of the 'goods' that are 'traded' in public service markets is often very different from those in many private markets. This paper argues that not only are public services typically merit goods (characterised by positive externalities in their consumption), but that there is an important distinction between 'choice' merit goods, such as education or social care, and 'compulsory' merit goods, such as probation services or welfare-to-work programmes. Choice merit goods could in principle be provided through vouchers or direct payments to users, although doing so would not necessarily achieve other policy objectives such as universality or equity, even if all conditions were in place for the public market to operate efficiently (in practice, this latter requirement is also unlikely to be met). There may also be conflicts between how service users actually make choices, and how the state would 'like' them to (for example, hospital patients may value proximity of the hospital to their home more highly than its results on clinical performance measures).

The 'users' of compulsory merit goods, on the other hand, may not wish to consume them, but it may be welfare-enhancing for society to coerce them to do so. The commissioning or direct provision by the state of such goods may meet public policy objectives more effectively than the market mechanism alone, as users are not able to internalise the full social benefits of their actions.

Finally, building on these foundations, the paper discusses when public service markets are likely to be an effective method of achieving public policy objectives, and when they may not be. Issues that arise frequently in public service markets are discussed, such as principal-agent relationships; determining the quality of complex experience goods; the existence of local or regional monopolies of provision, and monopsonies of funding; the operation of competition law in the public sector; and how to deal with provider failure. The paper concludes with some suggestions for what this all means for those charged with overseeing public service markets in practice, based both on the preceding considerations, and on empirical evidence and experience to date.

1. Introduction & background

1. This paper sets out to test the assertion that public service markets are fundamentally different from regulated utilities markets [or consumer-funded public services] by exploring the extent to which genuine differences in market structure and product characteristics exist, as well as the extent to which similarities may be found. It then looks to develop thinking on whether there are certain types of public services where effective outcomes are unlikely to be achieved from a ‘competition in the market’ approach to delivery (‘competition in the market’ includes approaches such as personal budgets, direct payments, vouchers, free entitlements to services that can be ‘redeemed’ at a provider of choice etc.).

What are ‘public services’?

2. We use the term ‘public services’ 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. Arguably, in addition a reasonable quality internet connection and access to financial services such as a bank account also count as ‘public services’ under this broad definition but these are not the main focus of this paper. 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.

What is a public service market?

3. In markets for public services there is a transactional relationship between the (citizen) user and the provider of the service. 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’).

Who pays for public services?

4. It is a political and policy decision whether public services of this kind are funded by service users directly (for example, by paying their water bills), or by taxpayers (for example, in the UK access to the National Health Service is ‘free at the point of delivery’, the costs of running the NHS being picked up by the taxpayer). Of course these 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.

Who is responsible for ensuring public policy objectives are met?

5. Whatever model of paying for these essential public services is adopted, arrangements must be made to ensure that the market of service providers, and service purchasers (either users directly, or the state acting as each user's agent¹), functions as intended to achieve policy outcomes. In the UK, and for the case of services that are paid for by users directly such as water, energy, telecommunications and banking, the required market oversight arrangements are realised through the system of independent regulation that has developed over the last three decades, and is implemented through bodies such as the Office of Water Regulation (Ofwat), the Office of Gas and Energy Markets (Ofgem), the Office for Communications (Ofcom), and the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA—now part of the Bank of England).
6. In public service markets, such as early years, the market can be overseen by a variety of organisations. For example, the sponsoring department, a sector regulator, the local authority or other public body, or a combination of these may be responsible for ensuring the market delivers the intended public policy outcomes. When government policy is implemented by 'marketised' service provision it brings a combination of opportunities and risks. Markets present opportunities for services to become more personalised, responsive, efficient, diverse and innovative. They also present new challenges for government; specifically the risk that having established markets in public services, 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.
7. The characteristics and often complex nature of public services (discussed elsewhere in this paper), together with the vulnerability of many service users, requires government to establish independent regulatory frameworks for public services delivery. These comprise initial accreditation or licensing of providers, and a monitoring and inspection regime to ensure that quality standards are being upheld. An independent accreditation or licensing regime is intended to ensure that only providers that meet required national standards are allowed to enter the market, or stay in the market. Independent inspection regimes monitor, inspect and regulate providers to ensure their services continue to meet required standards, and take remedial action or withdraw the licence if a provider fails to do this. In education, Ofsted

¹ Of course the state also has an obligation to the taxpayer, that its purchasing decisions should represent 'good value for money'. We explore in section 4 some of the tensions entailed by this dual obligation for public servants such as commissioners of health services, who are supposed to represent the interests both of the service user and the taxpayer simultaneously.

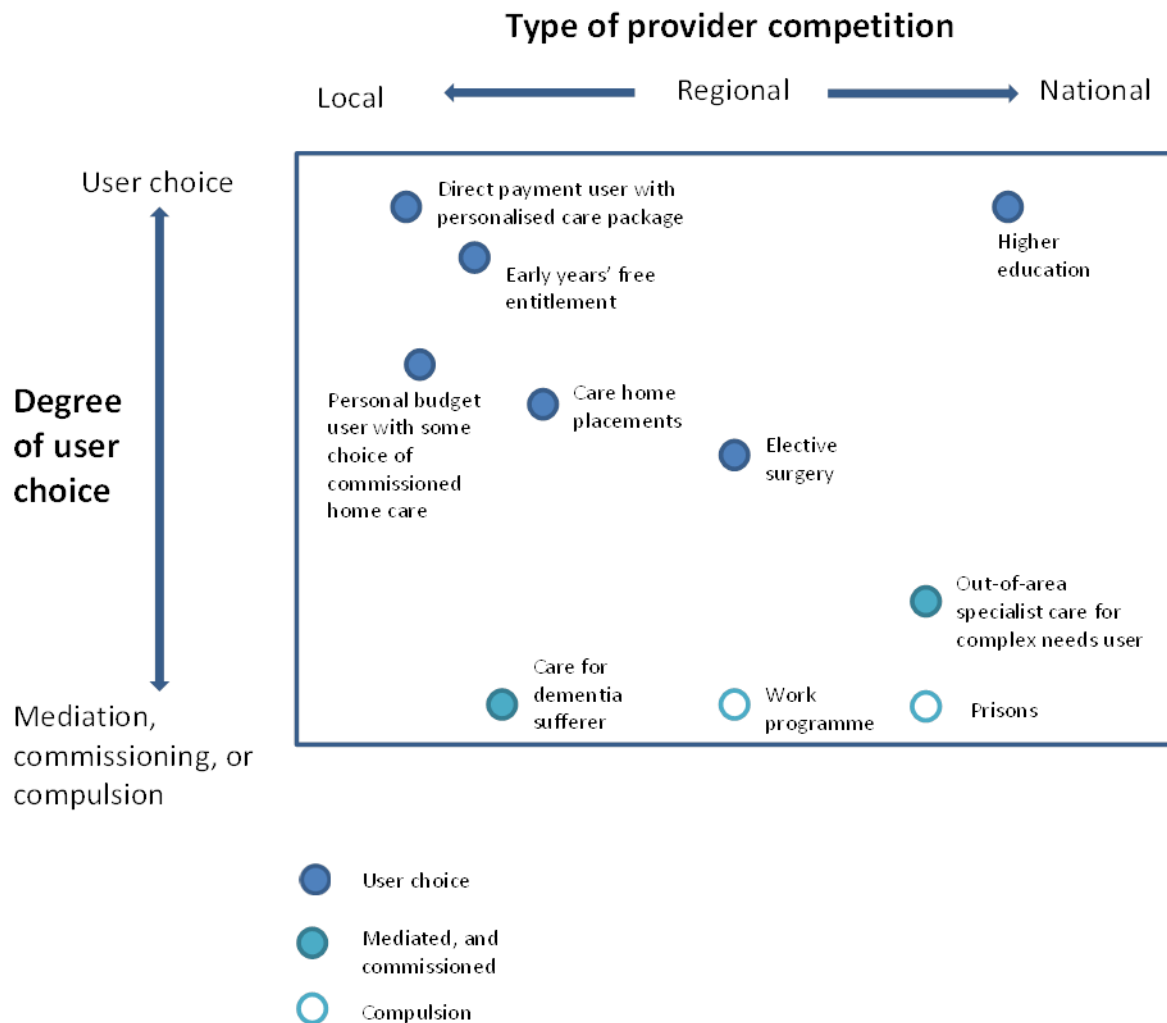
performs the role of independent quality regulator and in health and social care, this role is led by the Care Quality Commission.

What are the characteristics and main kinds of markets for taxpayer-funded public service markets?

8. There are different dimensions to markets for taxpayer-funded public service markets such as: user choice vs commissioner choice ('quasi-markets', in Le Grand's terminology). Put another way user choice can be characterised as 'competition in the market', whereas 'commissioned services' are where a commissioner buys public services on behalf of the public (this is sometimes called 'competition for the market'). The buyer side of public service markets can be represented by many individuals each with their own personal budget, or at the other end of the scale a single commissioner such as a local authority who buys services on behalf of their community. Variants that combine a 'competition for the market' approach with some element of user choice are also not uncommon, for example a local authority may commission domiciliary care services for the elderly in their area and deliberately contract with more than one provider, and allow service users to choose between a number providers. These arrangements may suit some users who are happy to leave commissioning of care provision to the authority and to retain a modicum of control by choosing between the commissioned social care providers.
9. Public service markets can be composed of one or typically a range of different types of provider:
 - Publicly-funded providers, such as schools and NHS-funded hospitals;
 - Private businesses (owned and funded by private capital); and
 - Third sector providers, common forms these take are charitable or voluntary bodies, social enterprises and mutuals.

What are the main product characteristics in public markets?

10. Public services are typically "merit goods", i.e. services characterised by large positive externalities in their consumption. It is worth drawing attention to the distinction between choice (those consumed willingly) and compulsory merit goods (consumed through compulsion). Merit goods such as education and healthcare are consumed by choice or out of need by service users. These are distinct from public services such as probation services, jail time, workplace programmes, which users may not wish to use (and have to be coerced to use) which are sometimes referred to as 'compulsory' merit goods. These are goods for which under provision or elective consumption can have seriously negative consequences for the non-users. Clearly user choice is not a feature of these types of services.



Market definition issues

11. The geographical market definition is an important feature to explore in defining a public service market: it can be local, regional, national or even international. In most utilities' markets, competition is conducted among private 'for profit' providers acting on a national market basis, with "unconventional" companies being the exception (Network Rail, Welsh Water). For example:

- In energy electrons and gas molecules makes it impossible to discriminate in terms of source, so end-users essentially choose a service provider rather than a product in energy. Hence location plays no role.
- In financial services, and higher education market definitions may extend beyond the national to the international.
- In rail the regional nature has been resolved by franchises ('competition for the market') or, in the case of electricity transmission and distribution continued price regulation in the face of regional or national infrastructure monopolies.

12. On the other hand, local competition seems to be a strong characteristic of many public service markets and there is a plurality of provider types ('not for profit' mutuals, social enterprises, charities, academies etc. as well as profit maximising owner-run firms and large shareholder companies). Providers also come in many shapes and sizes in the for-profit sector, from small (sometimes family-run) businesses in the care sector, right up to large-scale national chains that operate in many different areas. The 'not for profit' sector also has a diverse range of provider types.
13. Geographical constraints can be a key determinant in defining the local market from the perspective of consumers who live in an area, where typically there is a limit to the choice of local hospitals, schools (catchment areas) etc. However, some consumers are prepared to travel further afield for service (e.g. even travel abroad for treatment and charge the NHS afterwards), or even move to a different area in order to enter the catchment area of a highly-rated school. The "transaction" costs, however, will deter the majority from acting this way. Some users view proximity to a provider as their paramount "quality" criterion when exercising their choice. In addition, switching costs can be high and consumers may tend to stick with the local or regional dominant provider (a barrier to entry feature similar to the energy sector). This makes provider new entry difficult and dampens exit pressures on incumbents and helps to explain why seemingly poorly-performing schools, hospitals etc. nevertheless continue to experience demand for their services.
14. Interestingly the recent substantial fee increase in the case of universities suggests that such geographical limits can be broadened with students apparently now more ready to study abroad to avoid the tripling of the tuition fees in England. Regulatory constraints and institutional set ups also play a role: the market definition can also be broadened giving more choice to the consumers as mentioned in the case of vouchers for schools which effectively opens up the choice of Swedish parents to include private schools as well as state schools.
15. For the majority of network utilities, vertical unbundling ensured the introduction of effective competition at several stages of the value chain, while retaining the infrastructure components of networks separately in the form of price regulated monopolies (transmission and distribution networks, gas pipes, rail network, etc.) to deal with the natural monopoly characteristics of these segments.
16. In the case of some public service markets there is a reliance on efficiency in the performance of upstream and downstream services as the user receives services at each stage of the process (rather than just the final product), e.g. integrated care pathways in healthcare (lines of procedures), probation services (need for collaboration with local authorities to commission work and accommodation, health services etc.), social care (coordination with personal care and care in the community upstream and hospitals downstream). Again the issue that arises here is whether efficiency in such cases is achieved through competition or rather through integration and collaboration between state and providers, since the introduction of competition through vertical unbundling could potentially be counter-productive as integration of the delivery of substitutes may be problematic and ultimately economically inefficient.

2. Regulation, oversight and funding in PSMs

17. Utility regulation in the UK relies on a well developed system of independent sector regulators that over the last 30 years have accumulated a wealth of experience in promoting the interests of present and future consumers, promoting competition where possible and implementing price regulation in the absence of effective competition (Ofcom, Ofgem, Ofwat, ORR, CAA, FCA, etc.). The reasons behind the development of independent regulators were:
 - a) As a commitment device to enhance the credibility and predictability and assure companies and investors that current and future decisions would not to be governed by day to day politics; this was essential given the long term horizon of many infrastructure investments undertaken by privatised utilities as it provided assurance that they would get a reasonable rate of return on their investment and that the regulatory environment that they face would not depend on the political cycles of changing governments.
 - b) As a depository for accumulating & deepening expertise on a particular sector and thus promoting the interests of the consumers in an effective and consistent manner as well as promoting competition and choice where appropriate. The regulator itself is financially independent of the state as it is funded by the levies on the respective industry.
18. In the case of public service markets (referred to hereafter as 'PSMs'), NHS-funded healthcare does have 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.
19. It is important to stress that the idea of independent regulation in PSMs is limited by the fact that on the demand side unlike the case of utilities where customers are paying for the good, the funding for the public service comes from taxation; hence budget constraint considerations & allocation of resources by the state will always act as a constraint. On the other hand, this means that the PSMs do not suffer from the conflict of whether industry funding should come from the customers or from taxation as we have seen recently in water and energy (in energy some of the green levies have been shifted to general taxation). In rail, regulation decisions regarding industry funding and how this is to be split between customers and taxpayers stays with the government.
20. Funding in PSMs is typically from general and local taxation, unless the consumer is self-funded wholly or up to an initial capped sum as in the case of elderly social care in England. In Scandinavia vouchers are given to parents to use for the school of their choice to fully or partially pay for the tuition fees of their child by topping up if required. As the vouchers can be used to both state and private schools, this importantly implies that private schools are the recipients of government funding. This is not a trivial issue: it implies that users are given

discretion on how to use state funding rather than the typical standard approach where parents pay for state schools through taxation but then have to pay entirely from their own pocket if they wish to privately educate their child. Ideological issues aside, this implies an increase in choice for users, leading to competition between state and private schools for the parents' custom, thus broadening the market definition and placing the parent in the purchaser/commissioner seat. On the down side, it deprives the state of the savings it can make by parents that decide not to use the state system of education despite paying for it through taxation, as is the norm.

21. The legal context is worth considering and to what extent competition law applies in these markets. 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. Existing published legal advice from a trade association of UK care providers² suggests that the position is complex and turns on whether a local authority is classed as an 'undertaking' engaging in 'economic activity'. According to this source, public bodies which only engage in purchasing in a market and are not involved in the direct provision of goods and services in the same market are generally not 'engaged in economic activity', and therefore do not class as 'undertakings' for the purposes of the Competition Act. The presumption that public authorities in these circumstances are outside the scope of competition law was the basis of a Spanish healthcare case heard by the European Court of Justice.³ A trade association for Spanish medical technology providers attempted to sue the Spanish health system for abuse of a dominant position, because it was a near-monopsony purchaser of their services and was accused of taking advantage of its position for example taking many weeks to pay invoices. The court found that the Spanish health system was not acting as an undertaking in this case. The legal position, however, of public bodies in public service markets still needs further clarification, in particular for those that engage in a mixture of purchasing and the direct provision of goods or services of a commercial nature (i.e. for "economic purposes").
22. Public authorities may (knowingly or unwittingly) exert substantial buyer power in a local market and depress prices below competitive levels, and force providers to accept unsustainable prices. This may not only have undesirable effects for providers on their sustainability and severely limit market supply, but also it could inadvertently hamper the public authority in meeting its statutory duties to ensure adequate provision in its area. Whilst applying competition law is complex and public authorities acting solely as buyers may not necessarily be captured by its provisions, authorities still need to act with care. Courts may still judge that they have acted unfairly, even if their actions are not directly caught by the prohibition against abusing a dominant market position. For example, in a court case in 2012

² Guidance to UKHCA members on UK Competition law issues, UK Homecare Association Factsheet, December 2007.

³ A summary of the Fenin case can be found at: <http://www.reckon.co.uk/open/Fenin>

a group of local care providers challenged a local authority's decision to offer no increase in fees and took it for judicial review. The judge on this occasion quashed the local authority's decision on several counts including on the grounds that the judge considered that the authority was abusing its dominant position.

23. There is also neither a coherent institutional nor a legislative framework in most cases that determines who is responsible to ensure effective economic regulation and competition, VFM and quality standards into the market. While it is expected that the CMA will scrutinise such markets, it is unlikely that it would do so at a local level, if the latter is small. The investigation by the OFT (see February 2014 report) of the higher education sector on the Universities' Terms and Conditions is such an example, the market definition for the sector is national (124 universities as used by the OFT inquiry) but it is possibly becoming international (following a drastic increase in undergraduate tuition fees and the development of UK courses in English across Europe), which is atypical for the majority of quasi markets.

3. Why public service markets need oversight – market failures

24. Is there an economic justification for regulation in PSMs? In the case of utilities typically the goods are well defined in their characteristics, and hence price and output decisions are the result of demand and supply market forces. The companies in such industries have an interest to create artificial complexity in the hope of creating switching costs through the introduction of complex bundle tariffs as in energy, mobile telecoms, etc. which give rise to menu and search costs. Such moves are designed by companies to impede effective competition by creating consumer inertia and relying on loss aversion, framing and other consumer behavioural biases to restrict the consumers' ability to access, assess and act on information (3 As). In so far as this is the case, such strategies can be effectively dealt with by using the competition toolkit and it is not necessary to resort to regulation.
25. In the early years of deregulation in utilities, as the user is typically the payer, well established techniques of price cap setting (e.g. RPI-X) were in place in these market segments where competition was not yet effective in order to avoid monopoly power abuse of the customers by the sellers. The segments where this still applies today are the infrastructure segments with natural monopoly characteristics; typically the customers in such price regulated segments are not the end users, but upstream and downstream companies e.g. transmission or distribution pricing, etc. Price caps, and, more generally, ex ante regulation is considered as a temporary necessity before the forces of competition were fully developed in a market. Once this is the case, the customer is protected by competition, choice and the effective enforcement of competition law. Vertical unbundling and technological change have made possible the removal of natural monopoly characteristics in many segments of the value chain. Thus market failure in utilities was eliminated, and with it the main case for regulation. As effective competition flourished, price caps are no longer present in markets such as retail gas and electricity, generation, telecoms, etc., while the role of the regulator has evolved to one of providing information to the consumers to alleviate their information asymmetries and enable effective choices, as well as enforcing competition.

26. In the case of PSMs, there are a number of market failures that may justify state or regulatory intervention: some are features of the characteristics of the service or of the users i.e. the demand-side, whilst others are a product of the supply-side.

DEMAND-SIDE MARKET FAILURES

Merit goods

27. Services are typically merit goods i.e. characterised by large positive externalities in their consumption. Economic theory identifies this as a clear market failure that justifies government intervention.
28. Education, health and social care are typical examples of “choice” merit goods (case example – Figure 1) where while the good is not public (i.e. the service is both rival and excludable), the marginal social benefit of the service significantly exceeds the marginal private benefit. Of course, there are some distinct types of healthcare that may require some compulsion in their consumption (e.g. the need to inoculate the population to protect them from a dangerous communicative disease), or choice is impossible (ambulance and A&E services) or the need to make parents send their children to school.

Figure 1: Case example - social care

Social care is characterised by having 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, however left to the market alone care would be under-consumed leaving vulnerable people without financial means to fend for themselves, which explains why government funds social care. When users do not pay for a service there is 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.

29. These goods are such that while state funding is justified to avoid under consumption, in principle there is no reason why the state could not just hand vouchers to users and let them choose a supplier, if they are in a position to do so effectively. The reason why this does not happen even if we assume hypothetically that all the users had the ability to effectively choose in this manner (plurality of providers, free entry and exit in the market, ability to access, assess and act on information, etc.) is that 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.
30. The other main category of merit good are known as “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/services (e.g. are not the direct beneficiaries), but 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, workplace programmes, are merit goods for which under provision or elective consumption can have seriously negative consequences for the non users. The goods in

question are tax funded and the justification for this lies in the market failure caused by the considerable externalities of these goods to all people (the majority of which are non-users!), rather than the minority who are their direct users and who may not wish to use them, but may be welfare – enhancing to coerce them to do so.

31. While private markets may satisfy part of the demand for merit goods, in order for the society to reach the optimum level of output provision and avoid under consumption of the good what is required is either:

- subsidies (as already mentioned in principle the government could give vouchers or assign budgets to families to meet their health and/or education needs; personal budgets or user entitlements now exist in a number of public services). However, subsidies may be preferable if the state wants to prevent “undesirable” outcomes stemming from a mismatch between public policy objectives funded by taxpayers’ money and the preferences of the users), or
- commissioning, or state provision of the good, to ensure the wider social benefits of these services (e.g. probation services, work placement services, waste management services). The latter, alongside the existing private provision where it exists (as in health and education, care, etc.), should give an outcome closer to the socially optimum, that satisfies the wider public policy objectives that the market mechanism alone will not meet as the users are not able to internalise the full social benefits of their actions.

Complex, experience goods

32. While in the case of utilities the goods and services provided are usually standard products with well defined physical attributes, in the case of PSMs the goods can be complex and personalised services that are ‘experience’ (or even ‘credence’) goods with different quality attributes and features. For instance, across all types of care, quality is heavily reliant on individual relationships with care workers, and it is therefore difficult to determine the quality of the service before purchase. Figure 2 illustrates some of the characteristics of healthcare which contribute to the difficulty in assessing and measuring the quality of the treatment concerned with certainty.

Figure 2: Attributes of some types of healthcare

It is often difficult to measure the quality of healthcare. Many components of a health service that commissioners or patients value are difficult or impossible to measure. Some of the reasons for this can be:

* Time lags – e.g. a good indicator of the quality of a cancer service would be how many patients survive for ten years after treatment. But to find this out you have to wait ten years, by which point the service offered might have changed completely.

* Difficulty of establishing a counterfactual – for example, if a patient has an operation and is left in severe pain afterwards, it can be hard to tell if this is due to an unusually bad surgeon or to a good surgeon dealing with an unusually severe injury.

* Problems of attribution – the NHS is only one factor affecting a patient's life, and their long-term health outcomes are also affected by things like their lifestyle, their age and their genes. It is difficult to know to what extent a patient's health outcomes are attributable to the care they received.

33. Moreover by their nature some of these goods are major life decisions with little room for switching in the case of a poor choice (school, university, social care, health care) without significant inconvenience and disruption. In the case of a frail, elderly resident in a care home, their original choice of the care home may have been poor owing to it being made in a hurry and at a time of mental distress. The prospect however of switching homes may be too big a disruption for them to even contemplate and the individual effectively becomes 'locked in' to that provider. This means that the user / consumer is either:

a. not in a position to engage effectively in the market and exercise choice or switch in the normal way because of problems accessing, assessing and acting on information, given the asymmetry of information between providers and users; experiential/ credence characteristics of some types of public services, and / or the disruption and inconvenience of switching provider. Or,

b. for compulsory merit goods, it is not desirable that the consumer takes a decision as it is preferable that the state decides on the level of consumption and provision (jail services etc.).

34. In the asymmetry of information case, the PSMs share a market failure that makes them similar to financial services.

Principal – agent issue

35. Additionally, 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.

36. This again has similarities with consumers taking financial decisions with the advice of an intermediary/broker/adviser or more recently comparison websites, in choosing financial products, e.g. mortgages, personal pensions, ISAs, etc. The problem 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 position is further compounded by the dual role of the GP as a budget holder and a prescriber of the most appropriate treatment. The type of provider can also play a role as well: the *raison d'être* of a mutual company is the promotion of the customers' interests, thus alleviating problems of asymmetric information between users and providers. We discuss this further below.

37. Even in the cases where the user does exercise choice by purchasing the service directly and without an agent (this may take the form of an ear-marked budget or vouchers), the user's choice is restricted by the funding for the service from the relevant local authority (in fact for

example with school choice it would be more accurate to say that the user (the parent) can state a preference rather than being able to exercise the right to choose which school their child attends). Hence the choice of available school places are restricted by how many schools there are in the area, as well as the capacity of these schools. Also it is restricted by what the user considers as substitutes which may be:

- the result of geographical considerations (proximity),
- the way funding is provided as we have seen in the case of vouchers used in schools in Scandinavia which may broaden the market definition to include the private sector, or
- the result of substantial price changes as we have seen in the case of universities' market definition slowly evolving from national to international, or regulatory constraints (e.g. school catchment areas, GP registration restrictions, etc). We return to the market definition issues in PSMs below.

38. Similarly to the financial services regulation there is a lot of asymmetric information between the buyers and the sellers in such markets both in terms of adverse selection and moral hazard. A reflection of the latter can be seen in the spectacular collapse of many of the providers in the financial industry that had to be bailed out by the government during the economic crisis. In the case of PSMs, where assets are owned by independent organisations rather than government, there is a risk of moral hazard whereby failed organisations can exploit public demand for service continuity by demanding bail outs or excessive returns for investment.

Over-consumption

39. Given that unlike utilities markets, many of the quasi-markets are characterised by extensive tax funded provision, there is a need for gate keepers to avoid over-consumption when excludability is difficult to enforce and the user does not pay. Hence a GP is not only a provider of information (intermediary), but also a gatekeeper to the health system. This means that as an agent he may face conflicting incentives in his dual role, unless incentives are properly set to correct this.

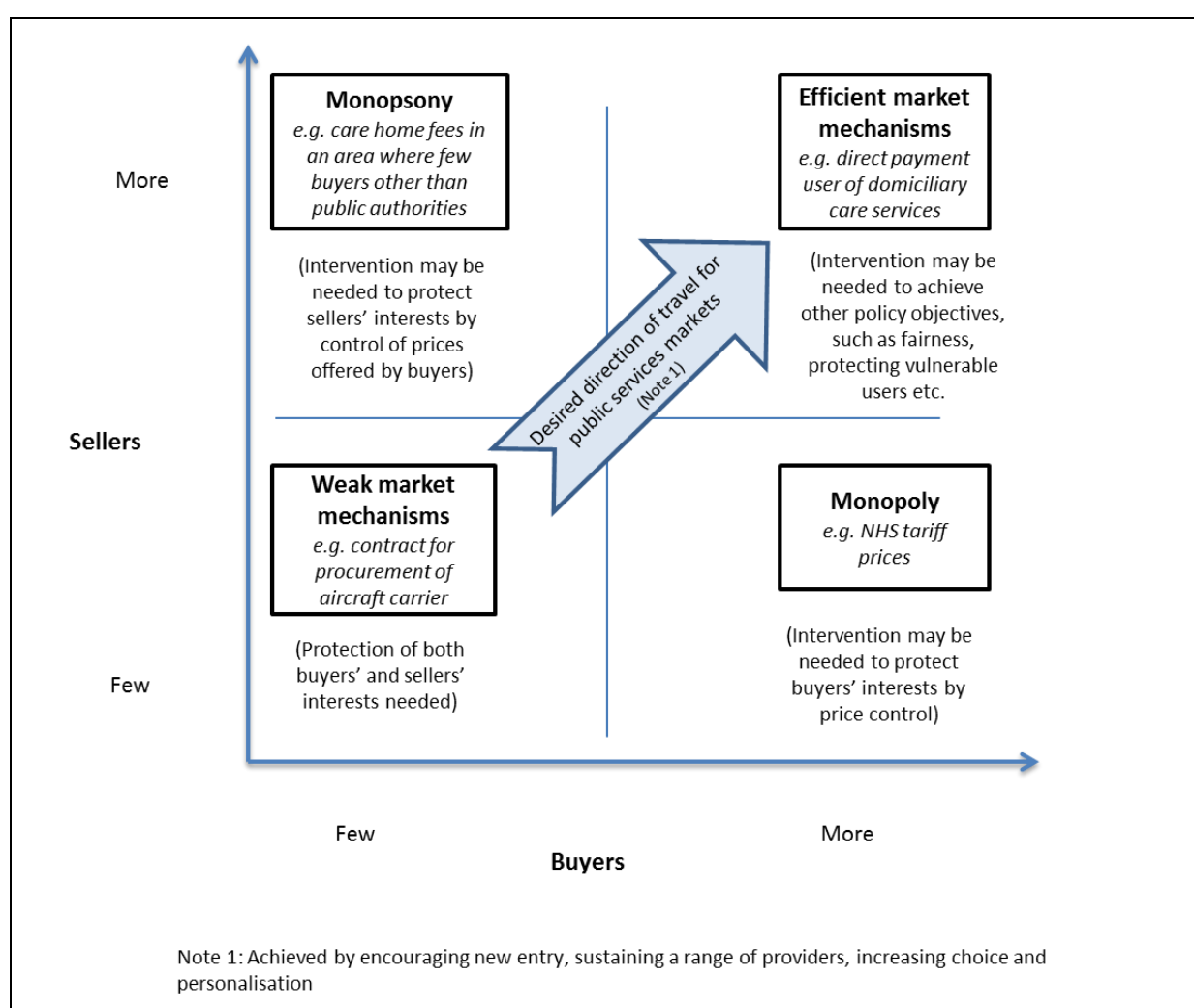
40. Interestingly, referral by a GP is necessary even in the case where the patient elects to go private. This is because private healthcare is not only provided by the 200 or so private hospitals, but also on private patient units in NHS hospitals. There is clearly some degree of competition for scarce resources as private health care providers rely to some extent on the infrastructure and resources of the state ones (and vice versa for less serious routine operations, with the NHS using private providers to alleviate waiting lists problems) resulting to a degree of complementarity as opposed to substitutability on the supply side. It should be noted that there have been state attempts to mimic this complementarity in secondary education, by asking private schools to share some of their human resources and infrastructure in the provision of state education.

SUPPLY-SIDE – MARKET FAILURES

Provider-purchaser separation and weak market mechanisms

41. Public service markets are often “thin” and can take the form of local or regional markets with a bilateral monopoly or a monopsony. 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. It is hoped that a movement from a bilateral monopoly to one where there is plurality of different types of providers will assist with cost discovery that will enable the government to set a fair price (tariff) for the service through benchmarking, as well as providing the market with comparators not only in terms of costs but also in terms quality. Figure 3 shows the different types of market situation that government may face in PSMs, and the type of interventions that may be necessary to ensure that policy objectives are met.

Figure 3: Different types of market situation in public service markets



42. In some PSMs competition is either set in terms of price and quality as in social care and work placement services, whereas in others the government sets a fixed price to providers and asks them to compete in terms of quality when the latter is more difficult to determine than the former in quality (school academies, hospitals, etc.). In both cases the replacement of a bilateral monopoly with that of a monopsony, by introducing plurality on the provision side, will raise issues of finance-ability of the providers as the price set by the commissioning

authority will need to sustain supply at acceptable levels as well as ensuring that it is reflective of the cost of provision without adversely affecting quality.

43. Separation of the providers from the commissioning side introduces coordination problems, transaction costs in contracting if the product is difficult to define or difficult to verify the value for money and quality of provision (for example where there is no public sector comparator). All this is compounded by the dearth of data or inconsistency in data collecting between different LAs. As an alternative the state can itself provide the service either exclusively (effectively eliminating the principal agent problem) or along with other providers thus retaining a public sector comparator to the mix by being one of the providers at least until the problem of asymmetry of information regarding costs is resolved (at which point the public sector firm can become a spin-off). To illustrate the problems, in the case of health, while there was initially hope that nearly all of the NHS contracts would be awarded through competitive bidding, there is now an acceptance that non-competitive contracting is sometimes the best choice if the process is transparent and clearly benefits the patients.
44. This is strikingly reminiscent of the Swedish healthcare experience where separation between purchasers-providers (p-p) was put in place in 2003. The split proved ineffective because of a lack of contracting know how by the purchasers which led to them being dominated by providers due to a greater knowledge and information by the latter. Contracts were insufficiently specific which led to a lack of clarity of organisational roles as purchasers eventually took additional roles on specifying inputs rather than just outputs/outcomes. In the end this led to either the p-p split being modified/ terminated or a shift of the emphasis over the years in achieving efficiency through collaboration and coordination between local authorities and providers rather than efficiency through competition contracting.

Barriers to entry and exit.

45. A lack of contracting capability can be problematic not only on the side of the commissioning authority, but also from the side of the suppliers which may lead to barriers to entry for smaller inexperienced suppliers. An example of this can be found in utilities regulation concerning the regulatory burden in the supply of electricity and gas. According to the State of the Market Assessment Report (OFT, OFGEM & CMA, March 2014, page 13) the industry is governed by a number of codes. The complexity and costs of compliance is burdensome and can place at a disadvantage smaller suppliers that can ill afford such costs. Similarly mutuals and other small suppliers may find it difficult to survive once their preferential treatment in being awarded contracts expires and complex licensing/ procurement/ regulatory structures develop. On the other hand, a continuing preferential setting for smaller firms/mutuals will create a disincentive to grow up, thus creating barriers to expansion (perverse incentives). This is not a novel concern; it features in the market for electricity and gas, where the existence of a size threshold below which a supplier is not required to meet social and environmental obligations may act as a barrier to expansion. We return to barriers to entry, supply competition and ownership structures below.

Natural monopoly characteristics

46. Natural monopoly characteristics as in the case of hospitals which can be viewed a little bit like distribution companies in energy: regional monopolists. Additionally, both are characterised by asset specificity. It should be noted that in other sectors, such as elderly care, asset specificity is less of a problem; for example care homes can be transformed in flats. On the other hand jails cannot. There are also parts of healthcare services such as diagnostic services that are characterised by very large capital costs. In such cases it may be appropriate for GPs to lease such services by a single provider who owns the equipment. Figure 4 illustrates some of these issues for healthcare services.

Figure 4: barriers to entry in healthcare markets

For many healthcare services, the provider side of the market is likely to be very 'thin' in many parts of the country. This happens for multiple reasons:

- * The geographic market for many healthcare services is quite narrow. Patients are unwilling to travel 500 miles for GP appointments (although they may be willing to do so for specialist treatment).
- * Many services have very high fixed costs (radiotherapy machines cost millions of pounds)
- * Many services (such as A&E Departments) have large economies of scale or scope, possibly even rising to the level of natural monopoly.
- * In rural areas demand is sparse, reducing the number of providers that can be supported.

47. If a market can only support one or two providers, 'competition in the market' is unlikely to work effectively. And the same factors which make these markets thin in the first place can often create significant barriers to entry, meaning competition for the market is not feasible either. In some cases you may in fact end up with a bilateral monopoly, with a single commissioner negotiating with a single provider. This leads to the usual inefficiencies which come with bargaining.
48. This is a bit like ROSCOs leasing engines and carriages to train companies or companies owning airplanes leasing aircraft to airlines. We can treat this as infrastructure bottleneck facilities and price regulate for fair access price to the use of such services by GPs. (the equivalent of transmission access prices).

Supply competition, ownership structures and exit

49. Exit in PSMs, creates the problem of who takes over (e.g. failing sixth form colleges). What happens to consumers facing failing providers if there are no other providers in the market? As mentioned this may give rise to moral hazard issues that can be exploited by a provider to demand a bail out or additional funding and removing damage efficiency incentives by removing the threat of exit from the market as a punishment for inefficiency. For example, in 2011 the UK social care sector only survived the potentially disorderly exit of the largest care

bed provider as a result of considerable effort by a number of organisations and individuals, without formal processes and powers to call upon to ensure an orderly exit.⁴

50. 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 must 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.
51. 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.
52. Does ownership structure matter in outcomes? The emergence of mutuals may deliver better outcomes for their customers as by the very nature of their ownership such firms overcome asymmetric information problems. In contrast, shareholder owned firms will promote the interests of their managers as well as the shareholders and will typically take advantage of the asymmetric information on the side of the users/purchasers. Similarly, owner managed companies will go for profit maximisation; if they know that their customers are unable to discern quality (in the short-term anyway) then again there is little prospect of the provider being punished for providing poor service, thus dampening exit pressures (e.g. barriers to exit). Reputation and competitive pressure may do the trick; comparators are required to make sharecropping less of a problem as they reduce the asymmetry of information.
53. Does ownership structure matter in order to survive? As we mentioned earlier, initially mutuals and other start-ups face a favourable climate in contracts awarding etc., but what happens as these are phased out and a complex licensing/procurement/regulatory structure develops. A continuing preferential setting for smaller firms/mutuals means that these will have a disincentive to grow up, in order to avoid facing a more hostile procurement environment (e.g. perverse incentives) once they do.

⁴ Oversight in Adult Social Care, The consultation response, Department of Health, May 2013, page 5.

4. Practical considerations for overseeing public service markets

Rules for ensuring a competitive market

54. Like private markets, PSMs need rules that govern competition in the market and these rules need to be enforced where appropriate. Competition law which prohibits anti-competitive behaviour (or practices) applies to all private sector providers operating in PSMs. It should also capture, in most circumstances, not-for-profit providers and publicly-funded providers that operate in similar markets. However, it is less clear whether it applies to public sector buyers (where they do not act as providers in the same market). Public bodies should also bear in mind that their conduct may also (or alternatively) be subject to other laws within the field of competition law, including public procurement, merger control and state aid laws.

Competition powers may be an imperfect tool for publicly-funded providers

55. As stated earlier, the Competition Act is largely un-tested in public service markets. It is unclear to what extent competition bodies would pursue the full force of enforcement action against publicly-funded providers that infringe competition law. Enforcement action that leads to financial penalties being imposed on a public body for a breach of competition law, are likely to have to be met from the budget of the public body; this could in turn impact adversely on the level of public services available to users. However if the competition body decides not to pursue enforcement action against a publicly-funded provider this could create tension with other priorities or principles that competition bodies pursue:

- **Equal treatment:** the competition authority risks being seen as treating providers unequally if, in similar circumstances, it proceeds against private providers with the full rigour of competition law but publicly-funded providers do not suffer similar sanctions. In addition, such a scenario could lead to a 'chilling effect' which makes private providers less willing to invest and engage in the market.
- **Deterrence:** similarly the deterrent effect will be lost if competition authorities do not take enforcement action against providers who infringe the law; which may risk giving misleading signals to other publicly-funded providers in the market that they too may not face enforcement action if they transgress.

56. However, in guidance issued by the Office of Fair Trading to public bodies on applying competition law, it emphasises that a level playing field and a similar commitment to compliance should exist in those markets, particularly in mixed markets in which public bodies engage in economic activities, alongside private firms and third sector organisations.⁵ It makes clear that where competition law does apply to a public body it could potentially expect to

⁵ *Public bodies and competition law, A guide to the application of the Competition Act 1998*; OFT 1389, 2011, paragraph 4.2.

face adverse consequences such as reputational impact; the possibility of financial penalties and or civil claims for damages.⁶

57. This gives an indication of some of the types of considerations that competition bodies are required to balance when they consider applying competition law in relation to public bodies acting as providers in PSMs. It is therefore important that government works with the competition authorities to help raise awareness of the conditions under which competition rules could apply to public bodies' involvement in the public services markets they oversee. This could include outlining and illustrating the types of behaviours and practices that should be avoided.
58. This still leaves the question however of how the government and competition authorities should deal with public sector buyers who are not captured by the provisions of competition law but potentially abuse their market position. The guidance suggests that in response to competition concerns in a PSM (which may or may not be captured by the provisions of the Competition Act) the competition authority may decide to use its tools flexibly and apply a range of measures; for example, advocacy work to help raise awareness, or a study to explore competition issues arising in that market such as the impact of public bodies' buyer power on the sustainability of provision (and where appropriate refer for a more detailed market investigation).⁷

Alternatives to competition powers to mitigate buyer power of public bodies: ombudsman and dispute resolution schemes

59. Where competition law is not deemed to apply to a public body that has buyer power (or it is unclear if the law applies), an alternative approach can be for the provider to invoke a dispute resolution clause in their contract with the public body, particularly if this refers to mediation or alternative dispute resolution. Both are generally far cheaper than going to court and should allow the parties to continue to engage in a commercial relationship. In various sectors of the economy statutory provision for a form of alternative dispute resolution already exists:
- In the communications markets covered by the Communications Act 2003, disputes on matters not covered by competition law or in the scope of other regulatory or legal powers, communications providers can raise a regulatory dispute which requires the regulator (Ofcom) to use its regulatory powers to resolve.
 - An adjudication scheme has also been set up to cover the groceries market, and in particular the buyer / supplier relationship. The job of the independent groceries code adjudicator is to judge disputes between the suppliers and supermarkets (i.e. buyers with market power) where unfair, or abusive treatment is alleged.
 - In financial services, provision is additionally made for smaller businesses (as well as consumers) to complain to the Financial Ombudsman Service if they feel they have been treated unfairly, and if upheld, they can order the complainant to be compensated for their loss.

⁶ *Public bodies and competition law*, OFT 1389, 2011, paragraph 4.8-4.9.

⁷ *Public bodies and competition law*, OFT 1389, 2011, paragraphs 4.10-4.11.

60. An EU directive on Alternative Dispute Resolution schemes that are available to help complainants resolve their dispute outside court is currently being consulted on by the UK Government. If parties to a dispute are unable to settle their differences, ADR offers a quicker and cheaper means of resolving that dispute. Ombudsman schemes already exist as a back-stop for service users of local government and the NHS where existing complaint-handling processes have not resolved the problem to the satisfaction of the user. Whilst public service markets are out of the scope of this EU directive, in principle consideration could be given to setting up similar dispute resolution schemes as an avenue of potential redress for providers of public services who are in dispute with commissioners, as a way of providing quick and cheap resolution (instead of having to take matters through the courts).

Other rules for effective public service markets

61. As public services are 'merit goods' the state requires these services are universally available to all those deemed eligible for them, as the benefits of mandating their provision on a free and universal basis for society as a whole is deemed to outweigh the costs of their provision to the taxpayer. To meet these public policy objectives, government also has in place rules and or financial incentives that sit alongside regulation of markets by competition law. These rules may, for example, be intended to ensure minimum standards or equity in provision, or to discourage certain types of discriminatory practice by market participants.
62. Alongside universality and equity, the protection of the vulnerable is another key concept in the provision of public services. The characteristics and often complex nature of public services (discussed elsewhere in this paper), together with the vulnerability of many service users, requires government to establish independent regulatory frameworks for public services delivery. These comprise initial accreditation or licensing of providers, and a monitoring and inspection regime to ensure that quality standards are being upheld. An independent accreditation or licensing regime is intended to ensure that only providers that meet required national standards are allowed to enter the market, or stay in the market. Independent inspection regimes monitor, inspect and regulate providers to ensure their services continue to meet required standards, and take remedial action or withdraw the licence if a provider fails to do this. In education, Ofsted performs the role of independent quality regulator and in healthcare and social care, this role is led by the Care Quality Commission.

Enabling users to participate actively in the market

63. As in other consumer markets, a lack of good information and advice can act as a barrier to an effectively-functioning market. In public service markets where user choice is the means of service allocation, government can help create the conditions for an efficient market by enabling users to participate actively in the market. Users need access to good quality information to inform their choice, as well as help to assess it. They also need to be able to feel they can act on their choice. This means enabling users to switch providers if they wish

(without causing them undue distress and inconvenience), as well as ensuring effective means of redress exist for users who experience poor quality or inadequate provision.

Dimensions of information for users

64. As explained earlier, public services have unusual characteristics which can inhibit the ability of users to make effective choices. These can be intrinsic to the type of service; in the case of 'experience' or 'credence' goods the outcomes for the user can be largely unknown in advance, making it difficult to make a well-informed choice. Some public services are by their nature complex and information on quality and outcomes may be unsatisfactory from a user's perspective for any number of reasons: incompleteness; difficulty in its interpretation, or in its comparability; not covering all aspects of relevance to the user.
65. The various ratings and user-experience feedback surveys in the higher education sector have developed and been refined over a number of years, and provide prospective students with a rich resource of information. Nevertheless such user information has to be managed, interpreted and presented properly if users are to benefit from it. The energy market is an example of where consumers can become easily confused by the plethora of information on different rates available which can reach a tipping point where the market is no longer working in the interests of consumers. Various market solutions have emerged to help consumers navigate the plethora of tariffs and find the best deals for their energy needs. In what is likely to reduce competitive pressures in the market, Government is acting to reduce drastically the number of tariffs available in an attempt to deal with the "confusopoly" problem that commentators had highlighted. In other areas, for example healthcare, attempts to create tools to inform user choice have been less systematic and are a lot less well developed to date. The recent Friends and Family test introduced post-Francis Report is an attempt to introduce a more systematic approach to provide potential users with a better idea of past users' experiences of the healthcare they received at a hospital.
66. Owing to its specialist nature, however, patients are likely to need to rely on the advice and support of healthcare professionals to ensure they receive appropriate treatment and can effectively navigate the system. Healthcare is not the only public service where users may require the advice and support of an intermediary. Social care users can benefit from the expert advice and support in tailoring a suitable package of care to meet their needs. However, the incentives on professionals in the 'system' may not always converge with the interests of the user. For example, a GP may have to balance the wishes of the user for an expensive course of treatment or package of care, with pressures on their Practice budget, and the wider interests of the taxpayer. For these reasons and others (such as fitting in with existing local commissioning arrangements), professionals may feel constrained in the choices they are prepared to offer patients, and more likely to default to existing care patterns and pathways unless otherwise prompted by the patient or their advocate.
67. However in some areas, for example social care, personal budget holders may have access to alternative sources of advice which can help support them in deciding how to meet their individual care needs. User-led organisations (some of these have been spun-off as social enterprises from the public sector), independent brokers and those who offer peer-support

can offer advice, support and advocacy to users which is independent of the 'system'. The OFT found in research it carried out on so-called 'choice tools' that qualitative feedback on consumer experience can help make complex decisions and comparisons easier for users.⁸

Consumer redress

68. Whilst the national quality regulators (such as Ofsted and CQC) provide service quality oversight, strong public service markets also need effective redress mechanisms that enable individual users who have experienced poor service, or are dissatisfied, to complain and obtain a satisfactory response. This is particularly so given the essential nature of these services and the inherently complex, experiential and personal features of some of these types of services (discussed earlier in this paper). These features make it more difficult for users to make well-informed decisions in the first place about which provider to choose, and also can present barriers to switching provider making it very inconvenient and disruptive for the individual to switch. Redress mechanisms are also an area where good information and advice can play a key role as it allows users to have a better idea of the standards they have a right to expect and how they can raise concerns.⁹
69. In addition, also discussed earlier, some public service markets have geographical constraints which can be a key determinant in defining the local market from the perspective of users who live in an area. Typically there may be a limit to the choice of local hospitals, schools etc., or, as in some areas and for some services, no effective choice. If the local market lacks real competitive pressures, genuine choice, and switching is not a realistic proposition for many users in an area, the accessibility of effective redress is vital. Otherwise users may have little prospect of proper redress if the services they receive are sub-standard and need improving.
70. Current research from the United Kingdom shows a general lack of understanding about the role or importance of redress mechanisms in public markets. For example, recent research by the UK consumer organisation Which? found that services are poorly organised leading to a 'complaints maze' which consumers find hard to navigate. Which?'s survey of consumers who had experienced a problem with public services found that over a third did not complain, and over half of those did not take their problem further following a first complaint. The main reasons cited were: scepticism that their complaint would have any impact; a lack of understanding of the complaints process; and, fear of repercussions for the quality of ongoing services where there was a personal relationship between complainant and provider. Clearly there are some significant impediments to this element of public service markets working effectively.

Promoting healthy competition between providers

Diversity of providers and a level playing field

71. PSMs typically have a range of different types of provider. In some sectors (for example, hospitals, schools, higher education institutions), the publicly-funded providers still represent

⁸ *Empowering consumers of public services through choice-tools*, OFT 1321, April 2011.

⁹ *The Care Maze: The challenges of navigating care for older people*; Which? April 2014, Section 3.

the norm, whilst 'not-for-profit' and 'for-profit' providers are largely marginal participants in such markets. In some markets such as social care, the situation is almost the opposite; publicly-funded providers are scarce (most local authorities are no longer involved in direct provision any more) and private or not-for-profit providers represent the bulk of provision in most areas. In other markets such as nursery and childcare education, the picture is mixed with a more even split between public and private providers.

72. Some of the factors that OFT guidance has identified as acting as barriers to a level playing field between providers are: differences in regulation, taxation and pensions treatment between different types of provider; incumbency advantages enjoyed by existing firms, such as access to information, pre-qualification and bid criteria, and transition costs; and a lack of clarity in the application of competition law (covered earlier in this paper). Where barriers do exist the position of incumbents may be strengthened and reduce the level of competition and choice in the market.

Entry, expansion and exit of providers

73. Research shows that in private markets at least half of the increase in productivity over time arises from the exit of less productive firms and the entry of new and more productive firms. New providers that enter the market may offer a different, innovative service, or provide a service that better meets particular needs. Competition from new entrants can also act as an incentive for existing providers to drive up the quality of their service or face exit.
74. In some public service markets, potential new entrants may face difficulties trying to enter the market. For example, small providers may be deterred by what they perceive as disproportionate requirements to meet existing accreditation and regulatory criteria. New entry and countering barriers to entry may be achieved however through a variety of means:
- spinning services out of the public sector to create new providers in the market, and
 - encouraging new entrant providers by setting prices for public services that are neither too high (wasting taxpayer's money), nor too low such that they would discourage providers from entering the market (and also potentially risk reducing the quality of existing provision).
75. Public service markets may also only offer weak financial incentives to expand that act as a break upon strongly-performing providers' willingness to take over failing providers, or create new capacity. Funding constraints can also lead to difficult trade-offs between creating supply-side flexibility (potentially important, for example, in making competition effective between schools in an area), and controlling public spending during periods of tight budgetary constraint.
76. The regulatory context itself, with its restrictions and incentive arrangements imposed on users' choices and providers respectively may act to restrict choice and competition in public service markets as has happened at times and for various reasons in the regulated utilities. For example, in the case of registration choices for patients of GP services, until recently users were

allowed only one choice from GPs close to their residence (and possibly close to their place of work). This precludes the ability of users to shop around for GP services (which in theory would equate to alternative providers competing for patients) in neighbouring boroughs. In addition, GPs are paid by the number of people registered with them, irrespective of how frequently patients are using the practice or the quality of the service that patients receive when they do. These arrangements lacked incentives for an efficient functioning market as choice and incentives for competition among GP practices were limited. Similarly, the establishment of catchment areas for schools may reduce competition between neighbouring schools once again restricting both choice by parents and competition among schools.

77. Competition in public services is more likely to be effective if the incentives for providers are strong, rewarding success and penalising poor performance. The risk of going out of business can act as a powerful incentive on providers to perform well. Certain types of public service such as social care, have a well-established private sector and third sector provider base which represent the vast majority of provision in the market. Most care providers in the market are small and individually they may exit their local market without causing significant disruption. In principle the closure of poorly-performing providers is possible and does sometimes occur in other public services like schools and hospitals, however in reality this is unlikely to happen if it leaves the needs of the local population in the area inadequately provided for.
78. Common approaches to dealing with poorly-performing state providers, particularly in health and education, is either to replace the existing management, or to allow another provider to merge with or take over its running. It is also necessary to bear in mind that the exit of a provider may not always be caused by poor management; it could be partially or wholly due to the need for a more fundamental service re-configuration, such as the consolidation or rationalisation of existing providers in the local area. In these circumstances, replacing the leadership of the school or hospital (etc.) is unlikely to provide an effective solution.

Service continuity

79. Public services such as health and social care are essential to many people's lives and well-being, similarly it is unacceptable from both an individual and societal perspective for other types of public services, such as education or probation services, to be disrupted for any length of time. Government has statutory duties that require it to ensure there is continuity of these services, and therefore to keep service disruption where it does occur to a bare minimum. Government however wishes to avoid providing explicit (or implicit) guarantees to support providers that fall into financial difficulties. If not, there is the risk of "moral hazard" that a government guarantee would weaken the incentives on providers to manage their own businesses effectively and maintain their financial viability, if they knew government would step in and bail them out if they got into financial trouble. Government therefore has to find a way to balance the need for poorly-performing providers to exit the market with its duty to ensure service continuity and protect users from service disruption. Both the financial crisis in 2008 that led to the UK's worst banking crisis (defining public services in the broadest sense to include bank accounts), and the Southern Cross Healthcare debacle in 2011 revealed an important feature of markets in public services, where service provision is in real danger of severe disruption the state has to step in and it becomes the "provider of last resort".

80. In many sectors of the economy there are formal mechanisms for oversight of a provider's financial "health" at the national level. These sectors include travel (aviation and tour operators), energy, rail and health. This oversight is necessary because it is unacceptable for individuals to be left without the services they need or have paid for, or because the removal of these services could have a negative impact on the well-being of that individual. In addition, the need for oversight may be particularly relevant where providers adopt high-risk business plans that make them vulnerable to economic downturns, credit squeezes etc. or where providers have a relatively high level of market penetration. The failure of Southern Cross demonstrated the risk a major business failure can pose to both the quality of care that people receive and to the continuity of those care services. It also led to significant concern and distress among the people receiving services, their families and carers. In the event the risk to the continuity of care was largely managed but this outcome was not a forgone conclusion and was the result of considerable effort by a number of organisations and individuals, without formal processes and powers to call upon. As a result it convinced Government that adult social care should also have formal mechanisms in place to ensure service continuity for all social care users.¹⁰
81. An oversight system to capture early warnings where a large or difficult-to-replace provider is facing financial difficulties, and to take action to stop the situation deteriorating, are an important feature of public service continuity regimes. Figure 5 provides an illustration of the oversight regime in social care at the local level, and the proposed national oversight regime.

Figure 5: Service continuity in social care

In the social care market there are many small providers, it is clear that when these providers exit or face closure, the local authority has a responsibility to talk to local providers and to work with them if they decide a service must close to ensure that people are given the necessary support to arrange alternative care. However in the social care market, there are a number of medium and large providers of care, operating across large parts of the UK, on a significant scale. The impact of such a provider failing would affect many parts of the country and it is not reasonable to expect individual local authorities to manage the situation. National coordination and oversight is needed. Keeping abreast of the commercial negotiations that occur if a major company has to be wound up cannot be done effectively at the local level. The Government's consultation in 2013 on oversight in adult social care recognised the strong need for a regulator to take on the role of overseeing those care providers whose services, for whatever reason, would be hard to replace if failure occurred.

Ensuring the market is delivering the public policy objectives

82. Using markets to deliver public services does not mean that government's responsibilities for achieving policy objectives cost-effectively are diluted. Yet market delivery involves provision by non-public-sector entities, which are not directly accountable to government or the

¹⁰ Oversight in Adult Social Care, The consultation response, Department of Health, May 2013, page 5.

taxpayer. This lack of influence means that government must design the legislative framework of rules for the market, monitor its overall financial sustainability and ensure that system-wide the provision of public services is effective, value for money, and achieving government's policy objectives.

83. To fulfil this systemic role government must be prepared to:

- monitor and intervene, where appropriate, to calibrate central funding, depending on the national balance of supply and demand, and taking account of the patterns of regional variation (and levels of spare capacity).
- assess the likely impact of policy reforms and possible future scenarios in terms of their likely impact on policy objectives.
- develop an understanding at the national level of the market structure, including market size and concentration levels; as well as the degree of exposure to publicly-funded users, price and quality variations and trends, rates of entry and exit, and significant merger and acquisition activity.
- work with the competition authorities and relevant quality and sector regulators, to raise awareness, standards and enforce rules and the right market behaviour.

84. Departments that have oversight responsibilities for market delivery of public services may also consider adopting a presumption that they should actively review the delivery of public services through market mechanisms on a periodic basis. Such a review could be undertaken by or in consultation with the Competition and Markets Authority, or in the case of NHS-funded healthcare, with Monitor. If the results of the review suggest that significant user detriment exists, government may need to decide on appropriate remedies or be prepared to consider referral of the market for more detailed investigation. Ultimately if a public service market fails, it will be the state who retains the role as 'provider of last resort'.