Choice and Competition in Public Services

A guide for policy makers

A report prepared for the OFT by Frontier Economics

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In our 2009 paper, Government in Markets, the Office of Fair Trading set out the rationale and some of the principles of government involvement in markets and sought to offer some key points for policy makers to consider when assessing interventions. This included brief consideration of the role of government as a 'market maker' and the potential role of user choice in the delivery of public services.

Successive governments in the UK and further afield have explored the possibilities for using choice and competition mechanisms to improve performance across a range of different public service markets. In commissioning this report from Frontier Economics, we hope to provide further insight into how these market mechanisms work – both their potential benefits and practical pitfalls. The report seeks to draw lessons from experience in the UK and abroad and present them as part of an overall framework that we hope will be useful for policy makers in assessing where and how competition and choice can be most effective, and how best to design systems that use market incentives to improve the performance of public services.

The role of competition and choice in the provision of public services is not a new subject, but it is likely to remain as contentious as ever in the next few years. In producing this report, neither the Office of Fair Trading nor Frontier Economics looks to pass judgement on decisions that have been made or indeed to push for further changes, but rather to contribute to improved policy-making into the future.

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1 EXECUTIVE SUMMARY

1.1 Public services account for approximately 20 percent of economic activity in the UK\(^1\) and cover some of the most important issues facing society—education, health, emergency services, defence, and care for the elderly and disabled. Many of these services are provided by public agencies and often the range of choice open to users has been limited in the past.

1.2 Successive governments have made moves to open up greater choice for users of public services. This report does not aim to comment on whether particular decisions to open up public service markets have been right or wrong, or provide a critique of government policies to date. Instead, the key aim is to identify general lessons that can be learnt from the experience so far. Drawing on these it then provides a framework for policy makers to help identify critical success factors when designing market mechanisms in public services.

1.3 The report draws on evidence from five case studies: elective healthcare, schools, further education, social care, and employment services for the long-term unemployed. These areas were chosen to illustrate a range of different types of public service, and hence provide evidence on which to base our framework. The case studies are not intended to provide a comprehensive picture of policy development in each of these areas, which would go well beyond the scope of this report.

The value of choice and competition

1.4 Competition usually works well in private markets in the absence of market failures. It places downwards pressure on costs, forces firms to focus on meeting customers' needs and leads to more efficient allocation of resources between firms. It also acts as a spur to innovation. In well functioning markets, strong competition is driven by consumer choice, with active consumers putting

\(^1\) Based on estimates from the Institute for Fiscal Studies 'The IFS Green Budget: February 2010' [http://www.ifs.org.uk/publications/4732](http://www.ifs.org.uk/publications/4732)
pressure on firms to improve their product offering, in part by looking for opportunities to switch.

1.5 Public service markets are different. They are typically subject to market failures, such as externalities or information asymmetries. Policy makers frequently have wider policy goals alongside pure efficiency, such as a desire for equitable outcomes. As a result, the usual market assumptions often do not apply. Consumers do not generally pay directly for services they receive. And providers are not generally driven by a profit motive, but by wider public service interests.

1.6 But competition and choice mechanisms can still play an important role in helping to deliver some public services, provided they are implemented in a way which recognises the unique features of these markets.

1.7 The existence of choice in public services is likely to have value in itself. There is evidence that users of these services, including disadvantaged groups, value being given a choice.

1.8 In addition, and as with private markets, choice and competition also has the potential to improve the overall quality of services, to tackle situations in which services are of an unacceptably low standard and to drive efficiency improvements. The choices that users of public services make, and the way that providers respond to incentives, all convey information. This is information that a central planner, however well intentioned, is unlikely to be able to replicate.

**Key findings**

1.9 The design of public services is highly complex. Increased choice and competition can often be effective, but it needs to be designed carefully and used alongside a range of other tools and policies.

1.10 Evidence from the case studies highlights a number of factors that influence how effective the introduction of competition and user choice is likely to be. Key findings include:
• Information is very important, but in practice people often do not use it directly or do not act on it. Making information simple and accessible, intermediation and ways of framing choice matter a great deal.

• There are difficult trade-offs between creating supply-side flexibility (potentially important, for example, to make competition in schools really effective), and controlling public spending over the short-term.

• Competition on price may be inferior to competition on quality (with a fixed price) as the former may lead to quality deterioration, particularly when quality is difficult to observe. This observation has driven much of the structure of competition in secondary health care.

• Excess demand requires some sort of 'rationing mechanism' (in social housing an allocation formula is used, in schools the distance lived from the school is often used). The mechanism chosen will be an important determinant of the outcome.

• Allowing mergers and takeovers between public sector bodies can be an important alternative to simple closure of less effective institutions. There is plenty of experience of this in Further Education.

• Failure to create supply side flexibility, particularly failure to allow providers to exit the market can create higher long-term cost by rewarding poor performing providers.

• In fact, closing down institutions as a direct result of poor performance is hard in public sector markets, as it will inevitably create short-term cost and disruption for users. Having an effective 'failure regime' is important.

• Funding has to be both activity-based to provide incentives for expansion and also cost-reflective to prevent 'cream-skimming'.

• Managerial incentives and behaviours can be made more responsive to competitive pressures by granting additional autonomy and changing institutional structures.
1.11 In practice, the detail of specific public service markets matters a great deal. Some key findings from the case studies are summarised at the end of this Executive Summary.

Framework for policy makers

1.12 These key findings form the basis of a framework that could be used by policy makers to consider when trying to facilitate choice and competition in public service markets.

1.13 First, the nature of the service matters. In some cases, choice will simply not be an appropriate mechanism for delivery. For example, choice makes little sense in delivering accident and emergency care.

1.14 Where choice and competition are feasible mechanisms, we can think of public markets as having:

- a demand side – the consumers or users of the service who exercise choice
- a supply side – the providers who compete to provide a service.

1.15 If there are serious constraints on either side then the choice mechanism is less likely to be effective. For this reason it is important not to overestimate the ability of user choice to drive better outcomes. Enabling choice in itself is not a guarantee of effective competition between providers – just as in private markets the fact that consumers are able to make choices does not always mean that the market works effectively or that desired outcomes are achieved.

1.16 The framework in this report looks at the demand side and supply side and sets out the key aspects of user behaviour and provider competition that should be taken into consideration when designing mechanisms for choice and competition.

1.17 On user choice (the demand side) key factors identified are:
• **Awareness of choice** – In many public service markets awareness of choice among users appears low. This is not surprising given that choice is relatively new in many of these services. Promoting choice in these instances may be valuable.

• **Assessment of information** – Users need to be able to assess information to make informed decisions. However, making information accessible can be difficult. Public services are complex. The presentation of information, the way choices are framed, and the role of intermediaries are all important in encouraging and assisting individuals to make choices.

• **Capability to act** – In practice there are a number of reasons why individuals may not exercise choice in the market. They may lack motivation or the capabilities to choose, there may be high transaction costs that discourage users from choosing, or there may be geographical or supply side constraints that prevent users from acting on their choice. Policy makers should consider whether any of these are likely to be present in the market.

1.18 On provider competition (the supply side), key factors identified are:

• **Diversity of supply** - This involves multiple providers or at least the potential for multiple providers that users have the opportunity to choose between.

• **Supply-side flexibility** around entry, exit, and expansion is critical. In public service markets a key issue is around the exit of poor performing providers. Exit and closure can have very real social costs. Mergers and takeovers can play a key role in increasing flexibility in the market.

• **Funding and incentives** - Providers need to have incentives to compete, and to compete on the right dimensions. Directly relating providers' income to the number of users they attract and/or the outcomes they achieve can be an important way of achieving this. Granting flexibility and managerial autonomy to providers also create incentives to innovate or seek efficiency gains.
1.19 This framework is summarised in Figure 1.1 below and explained in more detail in Chapter 2.

Conclusions

1.20 Not all public services will be suitable candidates for introducing direct user choice and provider competition. As shown in the case studies in this report, there are many practical difficulties in introducing choice-based policies. Sometimes these are around securing effective user engagement. At other times the role for markets is limited by supply side constraints, and in some cases public budget constraints.

1.21 But there are also good reasons for wanting to encourage choice in some public services. In particular, the choices that users of public services make and the way that providers respond to incentives all convey information – information that a central planner is unlikely to have. In a sense one of the central challenges of public service provision is over how to access and make use of this information.

1.22 The evidence of the case studies in this report shows that experience to date has been mixed. However, we hope that by identifying some of the cross-cutting issues that determine how effective different policy approaches have been, this report will help policymakers think through how choice in public services might work more effectively in practice.
Figure 1.1: Factors determining effectiveness of choice and competition in public services

- **User choice**
  - Awareness of choice
    - Are people aware they have a choice?
  - Assessment of information
    - Is information simple and readily available?
  - Capability to act
    - Are users active and motivated to choose? Do they have the capabilities necessary to make effective choices?
    - Are there any constraints on choice such as shortages in the supply side? How are these constraints resolved?
    - Are there transaction costs?
  - Diversity of supply
    - Are there multiple providers?
    - Is there scope for product differentiation?
    - Is entry, expansion and exit from the market possible?
    - Are mergers and takeovers possible? Do they facilitate entry, expansion, and exit?
  - Supply-side flexibility
    - Do payments reflect cost and outputs?
  - Funding and incentives
    - Is there managerial autonomy to respond to user demand?
Summary of case studies: lessons learned

Secondary healthcare

While there is strong evidence that patients value choice in healthcare, it appears that it is not yet fully embedded. In 2008, only half of the surveyed patients were aware that they could exercise choice over hospitals. Of those that were aware of choice they tended to rely on their GP, or friends and family for advice. Only 5 per cent of patients used the NHS Choice website when making their decisions. This is not surprising given the complexity of a choice which requires patients to be able to interpret a range of information on quality of hospitals.

GPs, when making recommendations, tend to rely on a combination of ‘soft informal’ evidence and statistics provided by the NHS. Going forward it is likely that GPs will continue to play their intermediary role; therefore, it is important to ensure that they consider a range of options when advising their patients rather than always choosing a ‘default option’ - the nearest hospital.

The supply side of the market appears to be fairly flexible, with the NHS trusts competing with private providers for patients under the Any Willing Provider scheme. This scheme requires the primary care trust (PCTs) (purchasers of healthcare) to buy care from any hospital willing to do a particular type of work. This helps create additional capacity into the system. Nevertheless, exit and contraction of the NHS hospitals is restricted.

The current Payment by Results funding formulae provide the incentives for hospitals to operate at full capacity while the foundation status gives them financial and managerial autonomy. Recent evaluation of NHS foundation trusts showed improvements in efficiency. Given this flexibility of supply, one would expect choice, when fully embedded, to have an impact on quality of care.
Schools

The current school system allows all parents to express a preference for the school they would most like their child to attend. Most parents exercise the choice and are offered a place at their first choice of school.

There is a wealth of information available to parents on a school’s performance, including test scores, value added measures and Ofsted reports. When choosing a school, the evidence suggests that parents care about three main factors – travel distance, academic performance and school’s socio-economic composition.

Some parents may have difficulties navigating the system. The introduction of Choice Advisors (in 2006/07) should help disadvantaged parents to exercise choice effectively.

One of the key challenges relates to supply side flexibility, that is the ability to expand good schools and to close down underperforming schools. Policies aimed at intervening in and supporting poorly performing schools, and closing them if need be, are an important part of the current policy framework. In part they can be seen as mechanisms designed to replicate market signals, leading to eventual exit, but in a more managed way.

We understand that the current Department for Children, Schools and Families vision is for the improvement of schools through cooperation, tackling underperformance through partnerships and accredited school groups. This is expected to improve flexibility by enabling schools to share resources and best practice.

Literature on the effectiveness of choice and competition in improving school performance is inconclusive. This may reflect that the details of what is meant by choice and competition matter a great deal.
Further education

Compared to primary or secondary education, the Further Education (FE) sector is more responsive to both excess demand and excess supply. Private training providers do go out of business, while FE Colleges can expand and contract relatively quickly. That said colleges tend to respond to incentives imposed by regulators as well as by customers (learners and employers).

The Government does not fund all activity within the Further Education sector: in some cases students and employers have to contribute to the costs of their training. In general, Government funding within the Further Education sector is linked to the attainment of specific qualifications – full level 2 and full level 3 qualifications, for example. This limits the set of effective choices available to individual students and employers.

Choosing between FE colleges is not easy, as information on quality of courses and colleges is not readily available. In particular, it is not clear which qualifications are considered to be more 'valuable' by employers.

'Train to Gain' is a programme which delivers training directly to employers. Private providers, as well as FE colleges, can access funding through this programme and form an important part of the supplier base. There are some concerns about how well procurement works. For some employers Train to Gain is intermediated by skills brokers who help to match employers and training providers. While there is some evidence that the skills brokers help to engage 'hard to reach' employers, it is not clear whether they offer enough choice of training providers to employers.
Direct payments for social care

Since their introduction in 1996, uptake of Direct Payments (DPs) for social care has been slow and variable. In 2007/08 only 5.6 per cent of people eligible for Direct Payments received them.

Low uptake appears to be due to several factors:

- Rates of DP are widely acknowledged to be below the market price for social care. This makes it a relatively unattractive option for users to take up as they may experience difficulties in finding suitably qualified people.

- Complexity in setting up and administering DP particularly if wishing to employ someone directly. While most regions now have agencies in place that support DP recipients with this kind of issue, complexity likely remains a barrier.

- Lack of good information on quality of providers, particularly non-regulated providers such as personal assistants. It is therefore difficult for individuals to assess whether they would be better off receiving DPs as opposed to their default option of social care arranged by the local authority.

- Lack of support. Variability in take up by regions has been explained by differences in attitude to DP by staff in Local Authorities and the effectiveness of support schemes they offer.

Despite the low take-up those who have opted to receive DP are happier with the service they receive.

This case study highlights one of the important lessons on choice in public markets, that is for choice to work (and to be used), the decision making process has to be simple, information on quality of providers needs to be readily available, and 'hassle costs' of exercising choice need to be low.
Employment services for the long term unemployed

The experience of the UK in allowing the long-term unemployed to choose their employment service provider has been limited to a few areas and client groups. The majority of unemployed people have been required to access support through Jobcentre Plus, the government funded employment agency.

In 2000 the government introduced employment zones (EZ). The aim of this programme was to test out the idea of choice and competition in employment services. While initially most individuals were allocated to a provider, as the programme progressed jobseekers were allowed to choose their provider.

Evidence from EZ shows the long term unemployed were strongly in favour of provider choice. Following its introduction clients reported to have had improved attendance, increased levels of engagement and less resentment about having to attend a provider.

For those individuals that were able to choose, location played an important role in their choice of provider, as did personal recommendation. Lack of clear information on providers’ performance limited the ability of jobseekers to make informed choices over their provider.

Motivation and skills play a key role in whether individuals exercise choice in this market. Unlike hospitals and schools where users actively seek these services, the long-term unemployed are required to access these services in return for benefits.

On the supply-side there is evidence to show that having multiple providers competing in an area is more beneficial than simply contracting out services to a single provider. The existence of multiple providers allows for benchmarking performance and driving up standards as well as facilitating the sharing of best practice.
2 CHOICE AND COMPETITION IN PUBLIC SERVICES

2.1 Choice and competition are increasingly being used in public service markets as a way of improving performance and increasing the degree of say that individuals have over the services they access.

2.2 In this report we address the question of when and how choice and competition may be effective in delivering government objectives. In doing that we draw on:

- an economic framework which considers the preconditions for choice and competition to be effective
- a wide range of experience in public service markets
- five specific case studies – schools, hospitals, further education, direct payments for social care and employment services for the long-term unemployed.

2.3 In this first chapter we briefly consider the basic arguments for opening up public service markets to choice and competition, and draw up a simple framework for assessing their likely relevance in public service markets. In chapters two and three we draw on evidence, primarily from the five case studies to illustrate some of the key issues in public service markets. We then devote a short chapter to each of these five case studies, drawing out the general lessons.

Benefits of choice and competition in private markets

2.4 Choice and competition usually works well in private markets in the absence of market failures (for example, externalities, asymmetry of information and natural
monopoly). The OFT\(^2\) has summarised the benefits of competition as a driver that can:

- place downward pressure on costs
- force firms to be more focused on meeting customer needs
- lead to more efficient allocations of resources between firms
- act as a spur to innovation.

2.5 Competition provides a strong incentive for providers to improve their offer to consumers, to become more efficient and, most importantly, it ensures that resources are efficiently allocated. It can do all this by providing appropriate incentives for organisations.

2.6 Competition works best when there is a well developed demand side, made up of confident and well informed consumers, and an efficient supply side, made up of a number of different suppliers all competing against one another to gain market share. In the context of public service markets, an active demand side means giving users a degree of choice over the services they consume. An efficient supply side means, in most cases, securing a degree of competition between different providers.

2.7 In an effective market, choice and competition should be mutually reinforcing. Confident and informed consumers activate competition by rewarding those providers that

deliver the best services that most suit their needs. Figure 2.1 illustrates the way in which well informed, active consumers can drive the competitive process between firms in a 'virtuous circle'.

Figure 2.1: 'The virtuous circle' - the role of firms and consumers in driving effective competition

Source: The Office of Fair Trading

Different motivations for encouraging choice in public services

2.8 It is worth distinguishing here between three different motivations for increasing choice in public services.

2.9 First, as we will see in some of the evidence presented in Chapter 3, one should not ignore the fact that choice has intrinsic value – people value choice even if it has no impact
on the average price or quality of any service. We do not focus on that in this report, but it should not be forgotten.

2.10 Second, choice may be used purely as a mechanism for allocating scarce resources. This is what happens in choice based lettings. Choice based letting does nothing to the quantity or quality of homes available, but it does ensure a better match between tenants and properties.

2.11 Third, choice can be used as a means to driving improved efficiency and better outcomes. This is certainly part of the role envisaged for choice of schools and hospitals.

Differences between private and public service markets

2.12 Public services, for example health and education, is a classic example of market failure where private, unregulated markets would fail to provide the goods and services that are demanded by consumers in the desired qualities. In such cases it is usually appropriate for government to intervene.

2.13 Government can regulate private providers, creating a market framework for them to operate that corrects the identified market failure. Alternatively, government can control the provision of services directly.

2.14 The decision of whether to regulate markets or directly deliver the service depends in large part on the magnitude of the market failure in question and also on society’s values and beliefs concerning the right of citizens to have access to some key basic services.

2.15 In this report, we will focus on the latter form of government intervention – public provision.

2.16 Public service markets differ from private markets in a number of respects:
• lack of price signals
• universal service obligation
• absence of profit motive within public sector organisations.³

Lack of price

2.17 In private markets, consumers make choices on the basis of price, quality and other individual characteristics of goods or services. Price is usually absent as a determinant in public service markets. Most public services, such as education, healthcare, and social care, are provided free of charge at the point of delivery.

2.18 So consumers do not usually face a budget constraint that restricts their ability to consume public goods or services. Subject to some restrictions on eligibility, for example through means testing, users of public services are free to consume as much of these services as they require.

2.19 Government, on the other hand, does face budget constraints and is restricted in the amount of services it can deliver before it has to raise taxes. This has implications for the providers' ability to meet user demand.

Public service obligations

2.20 Provision of public services often reflects a societal requirement for universal provision and a degree of equity in provision. We don’t want anyone to be left without good access to healthcare and education. Some choice and

competition is compatible with this desire for universal and equitable provision, but needs to be designed with that in mind.

Lack of profit motive

2.21 Unlike private providers who are accountable to shareholders who want a return on their investment, public sector providers are not motivated by profit and do not generally compete on price.

2.22 Motivations matter because they determine responses to incentives. Motivations in the public sector are likely to be complex and multi-faceted.

2.23 Even where those delivering services are wholly motivated by the public interest – and this is unlikely to be a common scenario – there is little chance that they will have a full appreciation of the scope and variety of demand. Perhaps the greatest value of choice and competition is that it allows demand to be expressed in ways which summarise information for providers in a way that is almost impossible to replicate through bureaucratic procedures.

Scope for choice and competition in public service markets

2.24 The question for policy makers is often how choice and competition can be introduced in a way which provides information and sharpens incentives, but does not damage wider benefits which may be fostered in the public sector.

2.25 Elements of choice and competition are present in many publicly provided services. For example:
• People can state preferences over which school they wish to send their children to. The hope is that the expression of choice will promote characteristics that parents value.

• Choice has recently been introduced into NHS secondary care, with patients being able to choose hospitals for their treatment. It is expected that better quality hospitals would attract more patients and those which are currently underperforming would need to improve.

• In the social housing market, choice-based letting (CBL) provides customers with a wider set of properties to choose from and, consequently, improves matching between available properties and eligible tenants.

2.26 The introduction of choice and competition in public service markets will not automatically improve outcomes. Whether it will work is an empirical question. The question is under what circumstances, and how, might additional choice and competition improve public service delivery in terms of quality, efficiency or equity?

Competition in the market

2.27 An important starting point is to distinguish between competition for the market, and competition in the market.

2.28 Competition for the market entails competition among providers for a monopoly contract to supply a market. Such competition is now common across central and local government services. Compulsory Competitive Tendering of local services such as refuse collection is one example of competition for the market. The system whereby companies bid for rail franchises is another.
2.29 Competition for the market in this way is important because of the benefits it can bring, and may be particularly so where competition in the market is not practicable, because for example there are economies of scale. Competition in the market occurs where suppliers compete directly for customers and is usually defined by the way in which customers exercise choice.

2.30 This report focuses on competition in the market.

Our framework

2.31 The effectiveness of choice and competition will depend on a range of demand and supply side characteristics of the market and the detail of the mechanisms introduced. The introduction of competition and choice where the characteristics are wrong, or the introduction of a poorly designed system can have unintended negative consequences – just as happens in private markets where regulations are insufficient or inappropriate.

2.32 Drawing from the lessons learnt from the examination of our case studies, the following framework sets out a series of considerations that could help assess how and where competition is likely to be effective, including questions on:

- the nature of the service to be provided
- user choice or demand side factors, and
- provider competition or supply side factors.

2.33 When considering the following questions it is important to bear in mind that more apparent competition in one dimension may not improve outcomes or lead to a process that is more competitive overall if there is limited competition in another dimension. Where, for example,
there are significant supply side constraints, an increase in user choice may have unintended consequences in the way in which supply and demand are matched.

The nature of service provided

2.34 The introduction of competition and choice is less likely to be effective in certain circumstances which have specific features. Policy makers should consider:

- Is the service very complex?

  If it is hard for customers to assess the service and obtain information on its quality then it is hard for them to exercise informed choice. This is a constraint in regulated markets such as financial services and in areas of public services including health care, and is indeed often part of the reason for public service provision. This is because even when complex markets are regulated extensively they can still fail to produce optimal outcomes.

- Is the service time critical?

  One would expect choice to be less effective for highly time critical services (for example, ambulance services), where customers genuinely do not have time to exercise informed choice.

- How often will the service be used?

  As in private markets, customers are more likely to exercise informed choice if they have had the chance to learn through repeated experience of the market. Public service markets with repeated service include primary health care (GPs) and dentistry, where customers interact with providers fairly regularly and can switch
providers if they are not happy with the service. This is less likely to be true for acute hospital care, for example.

- **Is the decision important?**

Motivation to exercise choice may be less if either the cost of 'getting it wrong' is small or if there is little differentiation between providers. In these circumstances consumers may be less likely to assess all the relevant information or they may choose on factors such as convenience.

Within many public service markets there is an element that these markets are highly regulated markets and that whatever service is chosen people will be offered a minimum service level. Even if they do not choose they will always be allocated to a service provider, for instance, in health. This can influence their motivation to exercise choice.

**Factors affecting user choice and provider competition**

2.35 Where the nature of the service allows for choice and competition, the framework in Figure 1.1 sets out a series of factors that policy makers need to take into account in designing market mechanisms. These relate in particular to how user exercise choice, and to how providers respond, in competition with one another.

2.36 These factors are explored in more detailed in the following two chapters.
3 USER CHOICE: DEMAND SIDE ISSUES

3.1 Competition only works if there is an effective demand side to the market, in which consumers are active and can actually make choices over the services they receive. In most private markets consumers are making choices on the basis of price, quality and other individual characteristics of goods or services. Price is usually absent as a determinant in public service markets.

3.2 Using examples and evidence from the five case studies, this chapter runs through the issues identified in our framework and draws key lessons that can be learnt. The key groups of factors identified in the framework are:

- awareness of choice
- assessment of information
- capability of public service users to act.

3.3 Before considering these issues, we briefly summarise some of the evidence on the value of choice to public service users.

The value of choice

3.4 An important element of introducing choice is that people often appear to value it for its own sake, independent of any impact it may have on the quality of service – that is it is valued intrinsically rather than instrumentally.4

3.5 One criticism often levelled at the use of choice in the public services, is that it is only the relatively well off and well educated who want it and will be motivated to use it. The evidence does not appear to support this contention. Figure 3.1 is a chart based on the British Social Attitudes Survey which asked people how much say they thought they should have over which hospital they should go to if they need treatment. A majority of all social groups thought they should have choice, and this majority was if anything greater among those that typically earn lower incomes.

**Figure 3.1. Desire for choice in the NHS by social class**

![Desire for choice in the NHS by social class](image)


3.6 An Audit Commission report from 2004 found if anything more striking results when surveying people’s reactions to
more choice for local government services. To quote directly from their report.\textsuperscript{5}

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

3.7 Initial pilots of the choice agenda in healthcare also indicated that poorer patients were as likely as the more affluent to exercise choice actively. Evidence prior to the introduction of the explicit choice agenda though did indicate that more deprived individuals travelled on average less far to access treatment, indicating a likely need to support access to more distant hospitals.\textsuperscript{6}

Key finding

In general choice appears to be valued by consumers of public services and by those with lower incomes as much as by others.

Awareness of Choice

3.8 Choice can be limited in any market by design or in practice: I don’t really have a choice to shop in places a long way from where I live, even if I could in principle do so. Equally, whilst I in principle have the option to use a hospital which is many miles away it is highly unlikely that I


will do so. There can be other barriers to the exercise of choice including lack of awareness that such choice exists and lack of confidence over ability to exercise it. This may be a particular concern for public policy where equitable access and outcomes are a key policy imperative.

3.9 Despite this, in many public service markets people actively and confidently exercise choice. This is clearly the case in, for example, choices that students make over which university course to apply for. Active choice is also a feature of the further education market. Prospective social tenants make good use of choice based letting where they are available. In each of these cases people are aware of the choices open to them, understand how to use the choice and, within supply side constraints, can exercise the choice effectively.

3.10 In some public service markets however, choice is exercised much less than it could be. Two examples of where this appears to be the case are in choice of hospital, and choice of employment service provider. Here the availability of choice may be less well understood and individuals appear to have less confidence in exercising that choice. In the case of hospitals there is some evidence that patients are not always informed of the availability of choice.

- **Hospitals**: Since January 2006, patients needing a hospital appointment should have been offered, at the point of referral, a choice of four or five providers, including local NHS trusts, foundation trusts, services provided by GPs with specialist interests and independent sector treatment centres. In practice a survey found that fewer than half of patients referred for treatment in December 2008 recalled being offered a choice by their GP, and only 5 per cent of patients say they use the NHS Choice website (www.nhs.uk), launched in June 2007 to
provide information on NHS and independent sector providers to help patients compare options.

- **Employment Services**: Evidence from UK employment zones suggests that the ability of the long-term unemployed to exercise choices confidently without any support may be limited. This may be due to a number of factors including low motivation, lack of basic skills, and lack of awareness of choice. Factors identified as contributing to the effectiveness of choice in this market included nature of information, time available to consider this information and ability of advisors to clarify and explain choice.

### Key finding

Key to any choice mechanism is that consumers are aware of their choices - people need to understand that they have a choice and what the nature of this choice is.

### Framing of choices

3.11 The way choices are presented or framed also influence whether and how individuals make choices. At a simple level supermarkets understand that how goods are laid out and presented will affect the choices people make about what to buy. This applies in public service markets in important ways.

3.12 The most salient example of its importance can be seen in the way that governments have made concerted efforts over many years to persuade people to save more in private pensions. Most efforts have been unsuccessful. The DWP ran a set of pilot schemes – known as the 'informed choice pilots' – which involved offering employees in participating firms' significant additional information about the benefits
of joining the firm’s pension scheme. These had no discernible effect. This is in line with much psychological research which casts doubt on the value of information alone as a means of ensuring that informed choice is actually exercised.

3.13 Evidence from the US, however, suggested that one change could influence behaviour dramatically – a change to the default option. Figure 3.2 illustrates findings comparing the behaviour of two groups of employees offered the same choice – whether or not to join an employer’s pension scheme. But one group were 'defaulted in', meaning that if they took no action they would be enrolled into the pension scheme by default. The other group were not, meaning that if they took no action they would not become pension scheme members. All were entirely free to make their own choice. As the chart makes clear, those who were defaulted in were much more likely to join the scheme. This is an important part of the evidence which underpins the government policy to default employees into their employer’s scheme if applicable, or a national scheme otherwise.

7 Leston, J. and Watmough, M. (2005) 'Providing pensions information and advice in the workplace where there is little or no employer contribution: pilot evaluation findings based on survey and qualitative research' DWP research report no.294.
Key finding

The way choices are presented, the ease with which action can be taken and in particular any ‘default’ option can matter enormously for how people actually exercise choice. This is important in defining and implementing choice in public sector markets.

Figure 3.2. Evidence from US on automatic enrolment and pension coverage levels

Source: Laibson (2008)\(^8\)

Access to information

3.14 Information is of course necessary in making any type of choice work. But simply providing more information may not always lead to better choices. It is about providing the right ‘type’ of information.

3.15 In public service markets it is rarely, if ever, that information on price that drives behaviour. For consumers price is almost always zero and even for institutional purchasers of services within the public sector, price is often fixed. For example, where PCTs pay for secondary care, that price is fixed. There are good reasons for that in the healthcare market. Evidence from both the UK and the US suggests that variation in the prices of health services purchased can lead to a deterioration of quality as providers compete on readily observable prices at the expense of quality which is often less readily observed.

3.16 Clearly in these circumstances it is particularly important that choice is based on the right measure of quality. If choice is made based on quality, but only some aspects of quality are reported, providers could have incentives to improve observable/reported components, but there is no guarantee that unobservable quality will also be improved by the competitive process. And, as has been shown by Rowena Jacobs and others, aggregating measures of quality into simple summary statistics is fraught with difficulties. They show, for example, that small changes to underlying indicators and aggregation rules could have large impacts on the 'star ratings' assigned to hospitals. Simplification of complex problems is important, but fraught with difficulties.

- **Hospitals**: Patients might care about both the clinical success of their treatment and about the quality of their experience (stay in hospital). While patients can easily

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judge the quality of their experience in hospital, the quality of the clinical services are more difficult to assess. Without adequate provision of information, competition may lead to oversupply of quality that is easy to observe and undersupply of that which is hard to observe.¹⁰

3.17 In fact, as illustrated in Figure 3.3, the use of this information directly by patients appears to be limited. The majority rely on advice from their GP and/or the views of family and friends.

Figure 3.3. Sources of information used for choosing a hospital

![Bar chart showing sources of information used for choosing a hospital]


• **Schools:** A wide range of quality measures are available, including Ofsted reports, scores in SATs, GCSE and A-level results, and value-added measures. Parents are also invited to attend open evenings where they can assess school facilities and other aspects they may consider to be important.

In practice raw exam results and league tables of actual results are easier to interpret than information on value added, which is itself only a summary measure in any case.

• **Further Education.** In contrast, the further education sector seems to lack standardised measures on which to compare different further education colleges and courses. This makes it difficult for students to make effective choices. While there are significant amounts of information available to students provided by the colleges themselves, there are no official measures that cut across the whole sector.
Key findings

- Choice in public markets is not based on price, rather on quality and convenience.

- Information on quality is crucial – but getting the balance between information that is both sufficiently comprehensive and sufficiently easy to digest is hard.

- Standardised performance measures that facilitate comparisons between providers can be helpful to users in making choices and can drive up standards.

- However, it can also have negative consequences. If people make choices on a limited set of information this can, for obvious reasons, lead providers to focus on improving in the dimensions on which information is available at the expense of other, potentially more important, dimensions.

- When prices are regulated and competition is based on quality alone, competition should drive up quality as long as those prices cover the cost of providing the service.

Assessing choices – the role of intermediaries

3.18 A key factor influencing whether individuals can make effective choices has to do with the nature of the decision. Many public service markets are characterised by asymmetric information. In healthcare, for example, the patient may not know what is best for their health and is unlikely to know as much as their GP about the quality of care available in different settings. The process of making choices can also be difficult to navigate, often involving complicated procedures and forms.
3.19 In such cases, intermediaries can play an important role in bridging this information gap and helping users navigate the system. They provide expert guidance and advice to help users make effective and informed choices. Intermediation becomes particularly important when users are required to make one-off decisions with significant long-term consequences. In these cases users do not have the opportunity to learn through repeated interactions with the system.

3.20 Intermediation is not unique to public service markets. Many retail financial services are intermediated by 'advisers' in a regulated market. This is because, like healthcare, financial services are complex, infrequently purchased, and their quality can often only be assessed after the event.

3.21 Where such advice is needed, the role of the intermediary is crucial. There is rigorous regulation of financial advisers because of concerns that their interests may not be aligned with those of their customers. It may be easy to assume that the interests of patients and GPs, for example, are more closely aligned, but this is not necessarily the case.

3.22 Research by the King’s Fund\textsuperscript{11} suggests that while GPs were broadly supportive of extending patient choice, they felt there were a range of constraints on such choice. To the extent that GPs took a different perspective to their patients, it appeared that GPs would particularly value 'soft' information about clinical quality. Interestingly it seems they rely on this soft information quite heavily when it comes to making choices over their own care or that of relatives and that they rather distrust official data. They are likely to be

feeding in quite different information and preferences to those available to patients.

3.23 Other examples of the use of intermediation include:

- **Direct Payments.** In almost all cases, Local Authorities are required to offer all users of social services the option of receiving Direct Payments instead of the care they receive.

  In practice, there is a very uneven pattern of usage of direct payments between Local Authorities (Figure 3.4). Care managers responsible for assessing the eligibility of prospective care users and planning their care, discuss their needs with users and it is likely that these discussions reflect the different attitudes of care managers about the suitability of Direct Payments. They have the capacity to influence the decisions of service users as to whether Direct Payments are appropriate in their case.
Personal pensions. Introduced in 1988 as an additional choice in competition with SERPS (State Earnings Related Pension Scheme), Personal Pensions were complex products sold (or intermediated) by financial advisers. In one sense this competition worked very well. Four million individuals took out personal pensions over a short period of time.

Those who benefited most from the generous subsidy available (the relatively young) were much the most likely to do so. But because these were complex products and those intermediating the sales had the opportunity to make money, there was also substantial mis-selling. Many were left worse off as a result of opting for personal pensions, a direct reflection of the incentives and complexities involved. Compensation was paid to over one and a half a million individuals costing nearly
£12 billion in total (not including an administrative cost of £2 billion).12

- **Further education.** In principle, further education students have a free choice as to where and what to study, and the government refers to the system as 'demand led'. In fact government and its agencies act, to a degree, as intermediaries of demand here. At a minimum they insist that only particular types of qualification are fully funded. They also collect and analyse information from employers and to some extent encourage individuals into particular areas.

There is logic behind this system to the extent that the government can collect and use information about demand for skills better than individuals can. Its cost is the very considerable bureaucracy that is created around collecting information and designing complex funding mechanisms that provide incentives to colleges to provide what is deemed necessary.

- **Employment services for the long-term unemployed.**

  Personal advisors in employment centres play a crucial role in helping the unemployed navigate through a wide range of choices, including options on education and training modules that might help them get back into work. Providing advisors with sufficient flexibility and autonomy over how they advise their clients is important. The introduction of advisor discretionary funds (ADF) allowed personal advisors to be more effective by allowing them to tailor their interventions more closely to the needs of their clients.

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Key findings

- The interests of the intermediary and the consumers need to be aligned. Where there are significant sums of money to be made from a particular course of action, the intermediary may have the incentive to distort the market.

- Intermediaries need to be 'on side' and supportive of the exercise of choice. Otherwise there is a risk they will block choice.

Acting on choices

3.24 Finally, users need to be motivated to act on their choices. Here transaction costs and motivation can play a significant role in whether individuals act and make choices. A good example where transaction costs may represent a barrier to choice is with direct payments for social care:

- **Direct Payments.** Although Direct Payments for care services offer consumers a very wide degree of choice, there can be insufficient information on quality for making these decisions in an informed manner, and there are often major 'hassle costs' involved in employing a carer or contracting with a private provider. Someone using Direct Payments to employ a carer needs to go through all the steps a conventional employer would need to go through if it was employing someone. Difficult and bureaucratic process means significant support may be needed to make active exercise of this choice an attractive option. As a result, take up of choice remains low and varies by region.

3.25 Similarly, effective competition relies on consumers being motivated and active in the market. Individuals' motivation
and incentives to take up choice depend on a variety of factors, including the consequences of not choosing. For example, users may attach greater weight to decisions where the consequences of not choosing or choosing badly can have a large impact on their lives. Some parents are very active in exercising choice because they know that the consequences of not choosing or choosing badly can have a lasting effect on the outcomes and future prospects of their children.

3.26 However, there will always be some consumers who will not choose. It is important that the system of allocation for these consumers is fair and drives the right incentives for providers.

**Excess demand**

3.27 Excess demand is a pervasive issue in public service markets. In some cases this is excess demand in total – for example, there is excess demand for social housing. In other cases there is, at least in the short to medium term, fixed total supply which meets total demand – as in schooling – but there may be an excess demand for the highest quality provision.

- **Social housing.** Choice based lettings explicitly recognise overall excess demand and provide a transparent method for allocating a scarce resource. Tenants are given points according to their status and can state a preference for properties which have a tariff expressed in points. There have been concerns about people’s ability to understand and negotiate the system. But the evidence is that this has been a successful example of the power of harnessing market mechanisms even in the face of serious supply constraints. The most comprehensive
evaluation to date of Choice Based Letting\textsuperscript{13} suggests that:

'\textit{CBL generates improved tenancy sustainment and this is testament to its effectiveness in better matching people to properties and improving service user satisfaction with letting outcomes.}'

The same study finds positive outcomes as well in various dimensions of equity including treatment of ethnic minorities and the homeless.

- **Schools.** Although there is no excess demand in total, there is excess demand for the 'best' schools. There is limited flexibility for such schools to respond by expanding. This can lead to the impact of competition appearing in another market. In this case there is competition for housing in catchment areas of good schools, driving house prices up. Gibbons and Machin (2001) looked at the premium paid for houses near good primary schools and found that a 10 per cent improvement in the proportion of children reaching the government’s expected level (Level 4) at Key Stage 2 translates in house price premium of 5.2 per cent to 8.4 per cent (depending on the region).\textsuperscript{14}

Note that this is not a consequence of competition as such – a catchment based system with no choice would have similar results. Expression of choice but with allocation by lottery would have different effects. But it is an example of how the demand side can respond and


\textsuperscript{14} Gibbons. S and Machin. S (2001) 'Valuing Primary Schools', Centre for the Economics of Education
rationing can occur by different market mechanisms to those intended.
4 PROVIDER COMPETITION: SUPPLY SIDE ISSUES

4.1 Effective competition requires a dynamic supply side of providers. Efficiency, innovation and customer-focus will all depend on rivalry between the providers driving up quality and reducing costs. As set out in the framework, there are three key ingredients required for competition on the supply side to be effective:

- diversity of supply
- supply-side flexibility
- funding and incentives.

Diversity of supply

4.2 Effective competition generally requires at least two potential providers to compete in the market.\(^{15}\)

4.3 In some public services there will not be multiple providers, at least within some geographic areas. While there may be several schools within plausible travelling distance in many urban areas, for example, that is not the case in many rural areas where there may be no effective choice of secondary school. In these cases supply side competition may be quite effective in some parts of the country but not in others.

4.4 Figure 4.1, for example, shows number of secondary schools within a 10 minute drive time of other secondary schools.

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\(^{15}\) Though it is worth noting that potential providers need not already be present in the market as a threat of entry may be sufficient for the outcome to be efficient (in terms of price and quality).
Key finding

Nationwide policies on competition may well be geographically quite different in their effects and this needs to be accounted for in policy formation.

Funding and incentives

4.5 Competition is only likely to be effective if there are appropriate incentives on providers – they are rewarded for success or punished for failure. It is clear how this works in the private sector. Successful firms make profits and expand. Unsuccessful ones make losses and eventually go out of business or are taken over by their rivals.
4.6 In the public sector such rewards or punishments need to be constructed through the funding and regulatory system.

4.7 Questions of funding are key, in particular how providers are rewarded either for having more customers, or more expensive customers, or for providing better quality services. The reality is often that funding incentives are blunt. Schools do get more money for each pupil they take on, but are often constrained as to how many they can take and most operate at, or close to, capacity.

4.8 In addition, few public institutions are at risk of having funding significantly cut in response to poor performance, not least because of concerns that this would lead to further poor performance, an outcome which is not consistent with equity in provision.

4.9 Very briefly, funding for schools, hospitals and further education work in the following ways:

- **Schools.** Schools get additional funding for each additional pupil, but as we have already seen, often find it impossible to expand to meet excess demand. They also attract additional funding for children with 'free school meal' status. The funding system, however, is somewhat slow to respond, so that when a child from a deprived background moves from one school to another, the school will need to wait some time for funding to 'catch up'.\(^\text{16}\) In addition these funding differentials are hard to get right and are blunt – adjusted only for free school

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\(^{16}\) This may happen because of the complexity of the school funding system. Although schools are supposed to receive additional funding with every additional FSM-eligible pupil (or a pupil with SEN), total additional funding may be constrained by the Minimum Funding Guarantee, which stipulates a lower bound on the growth rate of per-pupil funding and therefore inhibits LAs’ capacity to redistribute funding in line with social deprivation of pupils.
meal status. There remain very large differences in achievement between pupils from poorer backgrounds and better off pupils. So incentives for 'cream skimming' have had to be counteracted by strong national regulations over admissions criteria.

- **Hospitals.** With Payments by Results (PbR), hospital trusts are paid per unit of activity in accordance with a national set of tariffs. In that sense there is no price competition. Indeed, there is good evidence that price competition in health can drive down quality.

If payments are made based on customer numbers, but invariant to the types of customers (simple cases vs. complex cases), providers might take advantage of their knowledge to supply services to only the healthier, lower-cost patients ('cream-skimming'). This leads to less healthy patients getting less care than needed. It is important that price setting bodies (commissioners of healthcare in this case) have as much information as providers about the costs of providing a service to different groups of customers.

- **Further education.** FE colleges are in some sense funded in a similar way to hospitals. Amounts of funding are set for provision of particular courses, as hospitals are paid according to units of activity, with quantum of funding varied according to the nature of the course (medical procedure). In both cases this creates substantial complexity. In both cases this complexity is important but creates costs.

4.10 Linked to, but separate from, the issue of funding is that of incentives on managers. Where there is little impact of success or failure on pay, promotion or job security,
managers may be less likely to respond positively to competitive pressures than otherwise.

4.11 On the other hand excessively powerful incentives can lead to undesirable consequences. If managers are strongly rewarded for meeting particular targets then other valuable outputs may be neglected.

**Diversity and managerial autonomy**

4.12 Competition will work most effectively in improving outcomes if those in charge of the provider organisations have the ability to innovate and change the way services are delivered. The lower the level of autonomy, the less likely suppliers are able to respond effectively to expressed demand. Some autonomy in heavily regulated markets can, however, have adverse effects. For example, it is a well known result that certain types of autonomy over pay in public markets can drive up overall levels of pay at the expense of other inputs, as providers compete over a largely fixed pool of labour.

4.13 In addition, policy makers have concerns over minimum standards and equity in provision which inevitably lead to limits on autonomy. And autonomy cannot be allowed to result in 'cream skimming' to attract the 'best' pupils or the easiest to treat patients. How these competing demands are balanced can be crucial in determining the nature of competition.

4.14 In fact increases in diversity of supply and in autonomy for some classes of provider have formed a central plank of policy in the schools and hospital sectors in recent years. The intentions have been two-fold:
• To increase the diversity of supply, and hence choice available to users

• To increase the autonomy and control of managers, and also, importantly, to change the focus of their objectives.

4.15 However, the market has started to change with the introduction of Foundation Trusts which are expected to pay more attention to financial performance and efficiency, bringing managerial objectives closer to profit maximisation.

• Hospitals. Foundation Trusts were established by the Health and Social Care Act (2003). They are part of the NHS, but are not directed by the Secretary of State or by Strategic Health Authorities and so have greater freedom to decide their own strategy. They can also retain surpluses and borrow to invest. There are now over 120 NHS Foundation Trusts.

Importantly becoming a Foundation Trust involves assurance of high governance and financial standards. An evaluation for Monitor, the Foundation Trust regulator, suggested that going through the approval process for becoming a Foundation Trust resulted in increased efficiency, improved governance and greater financial awareness.¹⁷ These are all crucial elements in any organisation being able to operate effectively in a competitive market and prerequisites for competitive pressures to have a positive impact on efficiency and outcomes.

- **Schools.** There have been several phases leading to increased differentiation between schools. The majority of secondary schools are now 'Specialist Schools', meaning they have a designated specialist subject area for which they receive some funding and which allows some limited adjustments to admissions criteria. This has created more diversity in the maintained sector and was also intended to give each school a more individual sense of mission.\(^\text{18}\)

A rather different initiative has been the Academies programme. Academies are formally in the private sector, though funded by government. They are set up and managed by sponsors, independent of Local Authorities and are generally established in place of a previous failing school. The intention is that the new input, new management teams and greater autonomy will lead to better outcomes for students.

Key findings

• If policy makers want to promote strong competition, provider income should arguably be activity related (for example, determined by the number of customers served) and as nearly as possible cost reflective.

• In some public sector markets, in particular health, it is preferable for institutions to compete on quality with a given price, and not on price.

• The more elements of funding and demand that government tries to control, the more costly is likely to be the administration of the system.

Supply side flexibility

Expansion, contraction and excess capacity

4.16 Funding structures may incentivise performance, and lead to better outcomes, particularly where institutions can expand (or contract) in response to excess (or inadequate) demand.

4.17 Some public institutions, schools for example, in fact find it very hard to expand to meet increased demand and hence the usual impact of excess demand in a market – eliciting greater supply of the demanded product/institution – does not occur. Instead the demand is funnelled to other schools for which there was less initial demand.

4.18 Contraction is often difficult as well. A school with falling pupil numbers may find it hard to provide a good service to remaining pupils. There are often strong local and political objections to any local service contracting.
4.19 In the short run, effective competition also requires some excess capacity 'if there is no capacity to take me at any other school, college or hospital, then I have to go the one where there is capacity. If the best school or hospital cannot take any more pupils or patients then the fact that I know it is the best and want to go there carries little weight'.

4.20 But of course running a system with such excess capacity is more expensive, at least in the short run, than running a system at full capacity. For a fixed overall schools budget this may mean reduced resources per pupil.

- **Schools.** It is possible to compare capacity usage in schools performing well above the national average and in those performing significantly below the average\(^{19}\) (Figure 4.2). While best performing schools fill 96 per cent - 100 per cent of their places, worst performing schools still fill in 89 per cent - 93 per cent of their capacity. Given that poorly-performing schools are able to fill most of their places anyway, the impact of choice on their incentives to improve quality may be muted.

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Further education. FE providers, on the other hand, appear to be more flexible. There are numerous examples of successful colleges expanding their capacity by (i) constructing a new bigger building; (ii) adding another site (sometimes in a different location) or (iii) merging with other colleges.

There is also variation across FE colleges and training providers in the extent to which they grow and contract. For example, despite an overall decline in the number of adult learners between 1998/99 and 2006/07, 32 per cent of colleges experienced a rise change in their adult learner numbers.

There is evidence that, when considering relocation, colleges take into account customers' preferences. They expand their catchment area by locating in city centres or near public transport links, and attract new customers by improving sporting and other facilities. These strategies
prove to be successful, with colleges being able to attract learners from their neighbours.

Key findings

- For competition to be effective there needs to be flexibility to increase, reduce or change the mix of activity in the face of changing demand.

- In many public services this kind of flexibility is genuinely hard to achieve.

Entry, exit and mergers

4.21 Not only must providers be able to adjust levels of provision, but the effectiveness of competition as a driver of outcomes depends on freedom of entry and exit from the market. There is evidence that in the private sector most productivity growth is directly associated with closure and contraction of unproductive plants and opening and expansion of more productive ones. As Professor Jonathan Haskel has put it, on the basis of careful work looking at plant level productivity in the private sector:20

'The major insight from plant-level evidence is that at least half of productivity growth over a decade is due to changes in the market fortunes of good and bad firms, with entry and exit particularly important in this reallocation process. Thus policy has to let the market work. Hindrance of free entry, propping up firms who would otherwise exit and stopping firms from competing will all slow the reallocation process down that is crucial for raising productivity.'

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20 Matthew Barnes and Jonathan Haskell Productivity, competition and downsizing www.hm-treasury.gov.uk/d/254.pdf
4.22 Of course there is not necessarily direct read across from these findings for the private sector to public markets, but the message is stark. In the private sector half of increases in productivity over time arise from the exit of less productive firms and entry of new, and more productive, firms.

4.23 For many public services, including schools and hospitals, it is hard for successful providers to expand, there are limited incentives for expansion, new entry is very difficult and closure of existing facilities is difficult and controversial. This may well limit the potential benefits of the competitive process.

4.24 There are of course often very good reasons for these limitations. New entry and expansion of capacity is expensive and can sometimes be risky. Closure and contraction can lead to a short term diminution in quality which, when there are concerns about equity, may well be deemed unacceptable. There are often conflicts between an implicit or explicit 'universal service obligation' and the need to 'punish' poor providers. Finally, the process of entry, exit and expansion can create uncertainty and disruption for users. For example, in schools it could be argued that parents want to know that the school they are sending their pupils to in the first year will still exist by the time they come to complete their studies.

- **Schools.** The government’s 2005 White Paper set a vision for a system that ‘is dynamic, with weak schools replaced quickly by new ones…and opportunities for the best schools to expand’. The reality appears to be that threat to incumbents from new schools entering is small and closure rates are low. Fewer than two per cent of
schools (both primary and secondary) entered or exited the market annually between 2003-04 and 2005-06.21

There has been an attempt to manage the market for schools by monitoring performance through league tables of exam results and Ofsted inspections, with intervention and support in the first instance and closure in extreme circumstances. This is a managed process, decided administratively, rather than happening automatically through a collapse in demand. Closure has often been accompanied by opening of new schools, more recently academies with new leadership teams and often new buildings.

The most 2009 White Paper focuses on creating a system making it easier for successful schools effectively to take over less successful schools. This is a more common model in public sector markets, happening to some extent in both the hospital and FE sectors.

- **Further education.** Mergers are relatively common in the FE sector, sometimes as a way of dealing with failing institutions. Between 1993 and 2008 there have been 72 mergers of FE colleges resulting in 43 merged institutions (some colleges have gone through more than one merger). Evidence on the effect of these mergers is patchy, though there is good evidence to suggest that there are economies of scale in the provision of further education.

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21 Sibieta et al ibid
Key findings

- Relative freedom of entry and exit is crucial for effective competition in many private markets, but is hard to achieve in the public sector.

- Having procedures to intervene with poor performing organisations and close them down in at least some circumstance is likely to be important.

- There is some experience of mergers and take-overs in various parts of the public sector and, in both schools and hospitals, increasingly policies in place to allow more to happen in a managed fashion. The impact is uncertain but there is potential for this to help spread good practice.

Competition from private providers

4.25 Not all competition in the provision of public services is entirely within the public sector. Allowing private and third sector entry can be a way of introducing diversity and greater competition, and can also allow benchmarks against which to judge the public sector. On the other hand impacts on existing public providers and on wider policy objectives, particularly around equity and the universal service obligation, need to be understood.

4.26 Other examples of competition from private providers include: private dentists who are often in competition with NHS dentists, and privately provided nurseries, which compete with publicly provided ones. In these circumstances incentives on public providers may be sharp. Where the public sector is significantly cheaper than private providers (dentists) or of better quality (much childcare), the impact of private competition on public providers may be
limited. It is important, however, to understand the impacts on the private market.

- **Hospitals**: Despite limited opportunities for entry of public providers, the market has become more flexible because of its openness to competition from the private sector. Private sector entry has occurred through the Independent Sector Treatment Programme. The rationale was to 'create additional capacity within the NHS to reduce waiting times and introduce choice for patients'.

  The focus of this programme has been on the large waiting list backlog associated with fairly commoditised procedures such as hip replacements, cataract operations and MRI scans. This is the area where competition from the private sector is most likely to be effective. The use of the private sector both increased capacity and sharpened incentives facing public providers.

  Some criticism has been levelled at the way in which Independent Sector Treatment Centres (ISTCs) were guaranteed a revenue stream over a period of five years. This was seen as necessary to facilitate entry – the issue of uncertainty in heavily publicly managed markets is a serious one. In most public service markets that have been opened up to competition guaranteed revenues have been a feature, but it is important that as these markets develop and there is more information on the volume and costs that the pricing structure more accurately reflects these.

- **Further education**: While there are large differences between private training providers and FE colleges, there are areas where competition can occur between the two groups. Train to Gain is one area. In 2008-09 for example, 51 per cent of learners using Train to Gain did
Early experience of the programme is that the quality of Train to Gain provision by FE colleges appears to be higher than that from private training providers. This may reflect the relative inexperience of private providers operating in public markets and with associated accountability requirements. Figure 4.3 shows that FE colleges’ Train to Gain provision gained higher scores in quality inspections by Ofsted than that offered by private training providers. However, FE colleges’ Train to Gain provision did not score as highly as their general provision.

Private providers themselves have found negotiating some of the administrative hurdles difficult. Private providers need to be accepted onto frameworks to provide public services and some have found procurement processes challenging. The distributed nature of local Learning and Skills Councils and the limited availability of big national contracts have constrained some private providers. Getting the market working effectively requires careful construction of processes alongside appropriate quality assurance.

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22 NAO (2009), *Train to Gain: Developing the Skills of the Workforce*, p.12. The remaining seven per cent train with either voluntary organizations or their employer.
Key findings

- Private providers can add flexibility to the supply side. Some form of revenue and minimum work load may be needed to facilitate entry.

- The degree of competition between public and private providers may be limited if there is significant variation in price (dentists) or quality (childcare).

- Private providers will often find early challenges in entering heavily regulated and policed public markets.

- Getting procurement and contracting procedures right can be an important part of constructing an effective role for the private sector.

Source: NAO (2009), Train to Gain: Developing the Skills of the Workforce, p.32
5 ASSESSMENT – GENERAL LESSONS ON CHOICE AND COMPETITION

5.1 There are no simple lessons from theory, or indeed from available evidence, on the impacts of choice and competition on outcomes. Before we look at our case studies in more detail there is one conclusion that does not depend upon the effectiveness of choice and competition at promoting particular outcomes:

- In general people value choice in public services, and if anything those on lower incomes and with lower education are the most likely to value it.

5.2 And there is one very general conclusion about the use of choice and competition:

- The design of public services is highly complex. Increased choice and competition can often be effective, but it needs to be designed carefully and used alongside a range of other tools and policies.

5.3 Even the most apparently straightforward issue – that of making adequate information available – is of limited value as a general guide.

- Information is very important, but in practice people often do not use it directly or do not act on it. Ways of making information simple and accessible, intermediation and ways of framing choice matter a great deal.

5.4 With regard to our initial framework we have seen that all elements of the demand and supply side that we identified – information availability, ability to deal with excess demand, existence of multiple providers, funding structures, flexibility for providers to grow, shrink, enter and exit, and
provider autonomy – are important in different public markets.

5.5 Some conclusions are:

• There are very hard trade-offs to be made between flexibility on the supply side (vital for example to make competition in schools really effective), control of public funding, and delivering a universal service.

• Competition on price may be inferior to competition on quality (with fixed price) as the former may lead to significant quality deterioration, particularly when quality is difficult to observe.

• Excess demand requires some sort of 'rationing mechanism'. In social housing allocation this is an allocation formula, in schools it is usually a measure of distance lived from the school. The mechanism chosen will be an important determinant of the outcome.

• Allowing mergers and takeovers between public sector bodies can be an important alternative to simple closure of less effective institutions. There is plenty of experience of this in further education.

• Closing down institutions as a direct result of low demand is hard in public sector markets. Having an effective 'failure regime' is important.

• Funding has to be activity-based to provide incentives for expansion and cost-reflective to prevent 'cream skimming'.

• Managerial incentives and behaviours can be made more responsive to competitive pressures by granting
additional autonomy and changing institutional structures.

5.6 Private sector competition can be helpful in driving public sector performance. But most experience so far suggests it is more helpful in increasing capacity and providing additional choice. Getting regulatory and contracting mechanisms right is vital.

5.7 It is likely that well designed mechanisms for choice and competition, alongside a range of other appropriate funding and control mechanisms, will be important in driving performance in public sector provision. But the complexity of these delivery mechanisms means that definitive evidence on the impact of the introduction of choice and competition on outcomes is scarce.

5.8 In the UK outcomes in health and education have improved a lot in recent years. But alongside reforms to increase competition have been large funding increases, more centrally set targets and oversight and other new institutional arrangements. The academic literature does not yet provide clear evidence on the role of competition in driving performance in these sectors, though there is evidence of positive effects in some other countries where these mechanisms have been taken further.

5.9 In general, there is little evidence that choice and competition have adverse impacts on equity. Indeed less affluent people appear to feel particularly empowered by the ability to express choices. This does though depend on how the rationing mechanism works. There may be a particular issue in schools where there are limited places in the most desirable schools, there are 'peer effects' and rationing of places occurs through the housing market. But these are specific circumstances.
5.10 The second half of this document presents more detailed case studies, summarising some of the evidence that has been gathered on choice and competition in these sectors.