

Choice and Competition in Public Services

A guide for policy makers

A report prepared for the OFT by Frontier
Economics

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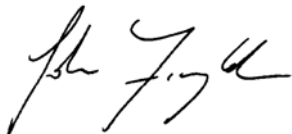
- Department for Children Schools and Families
- Department of Health
- Department for Business Innovation and Skills
- Department for Work and Pensions

PREFACE

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.

A handwritten signature in black ink, appearing to read 'John Fingleton', written in a cursive style.

John Fingleton
Chief Executive, Office of Fair Trading

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1 EXECUTIVE SUMMARY

- 1.1 Public services account for approximately 20 percent of economic activity in the UK¹ 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>

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:

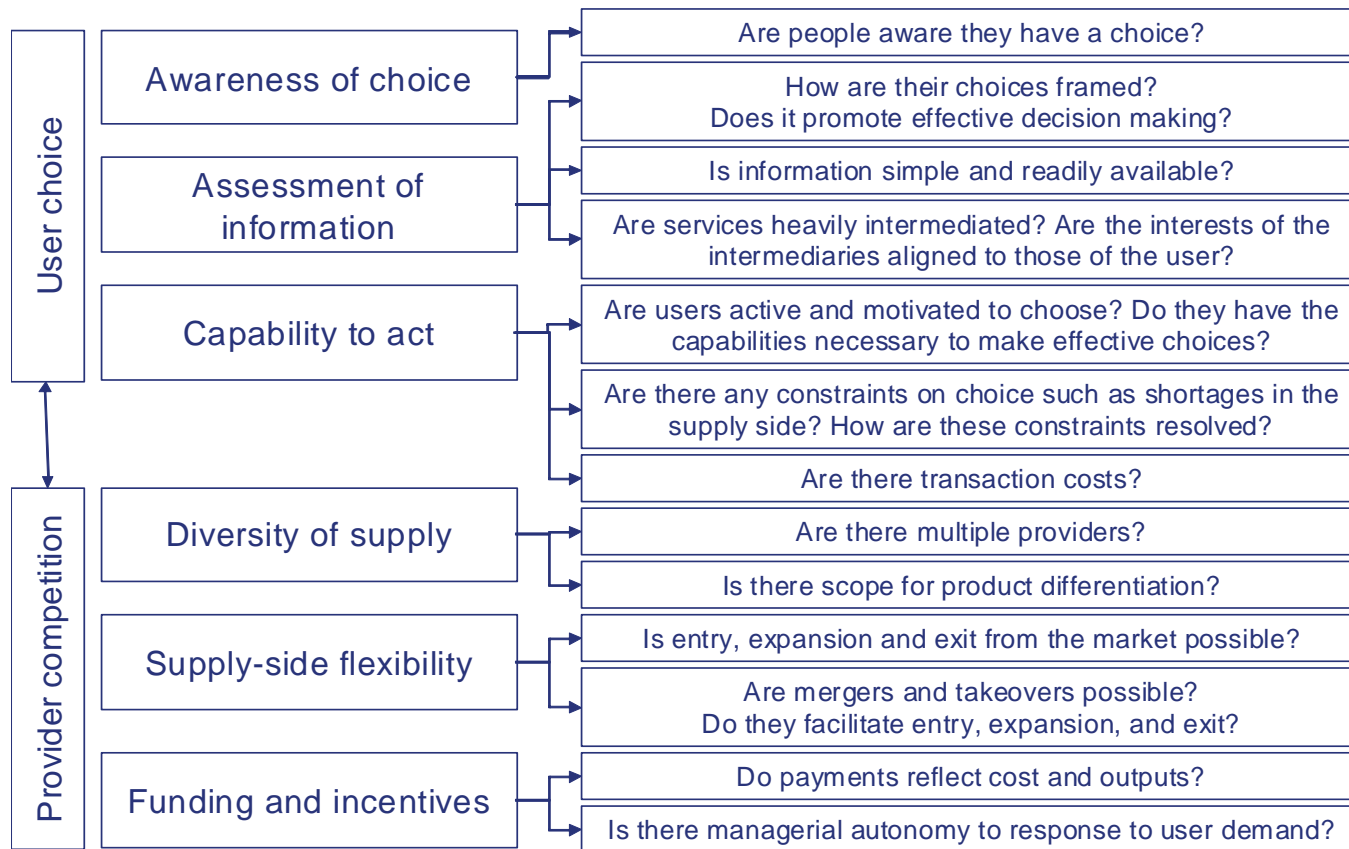
- **Diversity of supply** - This involves multiple providers or at least the potential for multiple providers that users have the opportunity to choose between.
- **Supply-side flexibility** around entry, exit, and expansion is critical. In public service markets a key issue is around the exit of poor 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



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.

