

Reforming Public Services

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As we have discussed today, one of the main challenges facing the new Government is ensuring the provision of high quality public services in a way that will deliver more with less. This will only be achieved if the service providers can succeed in two key aspects of delivery:

- They are focussed on being as efficient as they possibly can, bearing down on costs at all stages of the supply chain.
- They are focussed on being as innovative as possible. We live in an age of very rapid technological change – especially in relation to information technology. This opens up many new and exciting avenues by which consumers – the general public – could potentially interact with service deliverers.

Competition and choice can be very powerful tools in driving both efficiency and innovation, and the absence of these levers in many public service delivery areas is arguably a major factor in the lag we see in innovation and efficiency, despite any number of policy initiatives.

It would be too easy, however, to assume that simply swapping a public provider to a private provider will solve this problem. Instead, we need to ensure competitive, well-functioning markets are in place, which are capable of driving

the long-term productivity growth vital to meeting the Government's public services challenge.

There is also no shortage of evidence that consumers of public services want and expect some degree of choice, and that this demand comes from all segments of society. We are now seeing, from all sides in the coalition, a clearer political commitment to the increased use of choice and competition and the better quality and efficiency that can be achieved by aligning the incentives of the provider with those of the user.

Many of the major public services, such as education, health, welfare have until recently largely been delivered by public agencies directly funded by the State. While there have been some attempts in the past to open up these markets to competition from private and not-for-profit organisations, these have been partial, or restrictions on the scope of competition have not allowed the full potential benefits to flow through.

The OFT's recent publication 'Choice and competition in public services' drew lessons from experience in the UK and abroad on how market mechanisms work across a range of public sector markets. There are three key issues which are crucial to making reform of public services successful. These are:

- a) the importance of ensuring an **open supply side** in which restrictions on entry and exit from the market are minimised
- b) the key role active **consumer choice** plays in driving efficiency and innovation through competition, and
- c) the importance of ensuring a **level playing field** for providers.

Entry and exit

In any market entry and exit play a key role in creating a competitive environment. Entry from new providers is the life-blood of well functioning markets. New players are more likely to bring in new processes and new innovative ways of doing things. This creates competitive pressure to innovate, which in turn drives up standards and increases productivity.

Whilst barriers to entry are widely discussed and understood, it is too easy to overlook the importance of exit from the market. If exit costs are high and capital cannot easily be liquidated then entry into these markets is likely to be reduced. Of course it can be very difficult, practically and politically, to close down public

services such as individual schools and hospitals, even if they are performing badly.

But not being able to do so may, in many cases, be a fatal impediment to introducing successful market mechanisms. Experience has shown that commissioners cannot duck the issue of when and how to allow exit regimes when setting up markets. They must address up front questions such as what happens if a provider fails? Does the state bail it out? Would a state-owned enterprise be needed to purchase the assets? Is it credible to expect other providers in the market to take over the business? How would they do this?

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.

If competition is to work well, commissioners should seek ways to allow new entrants, or existing market participants with a strong track record, to take over the management of these services. One solution could be facilitating mergers and takeovers – thereby gaining the benefit of the transfer of efficient approaches to service delivery and innovation while avoiding the disruption of closure.

Consumer choice

Traditionally, economists have under-emphasised the role active consumers play in making markets deliver the wider benefits flowing from competition within markets.

A lack of clear information for consumers can mean that despite containing a plurality of competing providers, a market will not be working as well as it could. Information is very important, but in practice people do not always use it directly, nor do they act on it. Ways of making information simple and accessible, providing intermediation and ways of framing choice matter a great deal for the success of the market.

The issue is particularly important in public sector markets where services provided are commonly those which consumers cannot easily assess for value or quality. These are known to economists as credence services, as the consumer has no choice but to trust the service provided due to an imbalance of knowledge.

The service user therefore needs access to credible data or advice to make a sensible choice of service provider.

This is particularly true in health, where evidence shows choice is not fully embedded. The Department of Health's patient choice survey clearly demonstrates that the majority of patients rely on their GP or friends and family to make a choice over their hospital. Few consult the NHS Choices website and make a critical assessment of their options. 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.

There is also evidence to show that when implemented properly, choice can make a big difference to public services. For example, in 2000 the government introduced the initiative 'Employment Zones', which aimed to introduce choice into employment services. Results showed that allowing long-term unemployed people to choose their provider improved attendance, increased levels of engagement and reduced resentment.

Level playing field

The third factor that has proved to be a stumbling block is creating a level playing field, or ensuring 'competitive neutrality', between different providers. There is still much to be done to ensure that when competition takes place between the public and private sector it is on an equal footing.

Major obstacles to competitive neutrality include incumbency advantages enjoyed by existing providers, which have an inside track on the costs of doing business, unrivalled access to key decision makers and controlling access to key facilities. There are also often differences in regulation, taxation and pensions treatment between private, third sector and state-owned firms.

If we allow such incumbent advantage to go unchallenged there is a serious risk that potential new markets go unexploited, that service delivery processes ossify and efficiency and growth are damaged. As an aside, an OFT report a few years ago on the commercial use of public information found that more competition could benefit the UK economy by about £1 billion a year, and it is disappointing how little has been achieved since then to open up commercial access in some areas.

As it happens, the OFT is today publishing a paper on competitive neutrality in mixed public / private markets, looking at how this issue is being addressed in the UK. It generally found some good examples of different government departments implementing measures to try to achieve competitive neutrality. For example, some have separated commissioning, procurement and bidding functions into different departments to try and avoid conflicts of interest, or applied an uplift on payroll costs to all public sector bids to address differences in pensions treatment.

Given the ongoing difficulties we think there would be advantages in developing over-arching competitive neutrality principles that can be followed across the public sector and within which individual commissioners could then design sector specific approaches.

There also seems to be very little work done to evaluate the effectiveness of government departments' own initiatives to address competitive neutrality and whether they are delivering the intended outcomes. We think this is an important element of building a new competitive neutrality framework.

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So there are several lessons for policy makers here. But it is important we don't characterise this as a simplistic 'private good / public bad' argument. Replacing a public monopoly with a private monopoly will not change much, and many of the problems we have seen with private provision of public services has been where government procurers have found themselves becoming, effectively, locked in via long-term contracts and find it difficult in practice to switch supplier once the contract ends.

Competition also needs to be hard wired into commissioning and procurement to ensure the full benefits are gained. There is plenty of evidence around the world of the risk of collusion among tenderers for government contracts, and indeed the OFT recently issued its final decision against over 100 construction companies involved in bid rigging and cover pricing, in one of the largest national competition enforcement cases in world.

And a final warning: the unique character of public service markets means the benefits of choice and competition are by no means guaranteed, and there may be cases where it will simply not be an appropriate mechanism. In many others, careful design will be needed to deliver the beneficial incentives of competition. It is vital, therefore, that we achieve, and share, better understanding as to how

these mechanisms can be best applied to different public service markets, and the OFT will be playing an increasing role in the coming months and years in identifying and coordinating best practice.