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**Citation:** Dassiou, X., Langham, P., Nancarrow, C., Scharaschkin, A. & Ward, D. (2016). New development: Exploring public service markets. *Public Money and Management*, 36(2), pp. 149-152. doi: 10.1080/09540962.2016.1118942

This is the accepted version of the paper.

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**Permanent repository link:** <https://openaccess.city.ac.uk/id/eprint/12465/>

**Link to published version:** <https://doi.org/10.1080/09540962.2016.1118942>

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# Public service markets: A comparative analysis

Authors:

Dassiou Xenia, Langham Peter, Nancarrow Charles,  
Scharaschkin Alex, Ward Dan

Centre for Competition and Regulatory Policy | Department of Economics |  
City University London | Northampton Square | London EC1V 0HB

## 1. Introduction

This article sets out to test the assertion that public service markets are fundamentally different from regulated utilities markets [or consumer-funded public services] by looking at the product characteristics, market structure, funding oversight and legal arrangements in such markets. It also asks whether there are certain types of public services where effective outcomes are unlikely to be achieved from a 'competition in the market' approach to delivery ('competition in the market' includes approaches such as personal budgets, direct payments, vouchers, free entitlements to services that can be 'redeemed' at a provider of choice etc.).

We use the term 'public services' to refer to services that are generally regarded as essential enablers of participation in society. For example, access to water and energy, as do access to education, health and social care. Another way to think about these services is that they are those for which government would have to act as "provider of last resort", or make arrangements that ensure their continuity, if their provision were to be put at risk.

In markets for public services there is a transactional relationship between the (citizen) user and the provider of the service. The user is funded at least in part by the public purse. This form of market is often termed 'user choice and provider competition' or 'competition in the market', and is distinct from contracting or commissioning where the public authority is buying services on behalf of the citizen user (or often termed 'competition for the market').

It is a political and policy decision whether public services of this kind are funded by service users directly (for example, by paying their water bills), or by taxpayers (for example, in the UK access to the National Health Service is 'free at the point of delivery', the costs of running the NHS being picked up by the taxpayer). Of course these two modes of paying for public services are not mutually exclusive, and public services may be funded by a mix of both. In the UK, for example, most of the costs of social care are born by users directly, with the taxpayer only subsidising provision for the poorest; and while people pay to use train services by means of fares, the taxpayer covers around half the total costs of maintaining and enhancing rail infrastructure. Of course private markets also often exist alongside public markets, such as for private education and private healthcare for those who choose and are sufficiently affluent to access them.

Whatever model of paying for these essential public services is adopted, arrangements must be made to ensure that the market of service providers, and service purchasers (either users directly, or the state acting as each user's agent), functions as intended to achieve public policy outcomes. In the UK, and for the case of services that are paid for by users directly such as in water, energy, telecommunications and banking, the required market oversight arrangements are realised through the system of independent regulation that has developed over the last three decades, and is implemented through bodies such as the Office of Water Regulation (Ofwat), the Office of Gas and Energy Markets (Ofgem), the Office for Communications (Ofcom), and the Financial Conduct Authority (FCA).

In public service markets, however these may be overseen by a variety of organisations. For example, the sponsoring department, a sector regulator, the local authority or other public body, or a combination of these may be responsible for ensuring the marketized system delivers the government's policy objectives. When government policy is implemented by 'marketized' service provision it brings a combination of opportunities and risks. Markets present opportunities for services to become more personalised, responsive, efficient, diverse and innovative. They also present new challenges for government; specifically the risk that having established markets in public services, departments and local authorities may lack the capability to ensure that they operate in the interests of the users and the taxpayer, rather than in the interests of the providers whose profits are funded by users and taxpayers.

The characteristics and often complex nature of public services, together with the vulnerability of many service users, requires government to establish independent regulatory frameworks for public service delivery. These typically comprise initial accreditation or licensing of service providers, and a monitoring and inspection regime to ensure that they meet required quality standards (see National Audit Office paper, Sept. 2011), and take remedial action or withdraw the licence if a provider fails to do this. In education, Ofsted performs the role of independent quality regulator for schools and for early years' education; and in health and social care, this role is the responsibility of the Care Quality Commission.

## **2. What are the product and market characteristics for taxpayer-funded public service markets?**

Demand for many public service markets is characterised by asymmetry of information from the side of the user. Many of these services, unlike utilities such as water, rail, energy etc., are experience goods, have large switching costs (social care, schools) and/or are credence goods (e.g. health). Hence, there are different dimensions to markets for taxpayer-funded public service markets such as: user choice vs commissioner choice ('quasi-markets', in Le Grand's terminology [1991]). User choice can be characterised as 'competition in the market', whereas 'commissioned services' are where a commissioner buys public services on behalf of the public (this is sometimes called 'competition for the market'). The buyer side of public service markets can be fragmented with many individuals each having their own personal budget, or at the other end of the scale a single commissioner such as a local authority who buys services on behalf of their community.

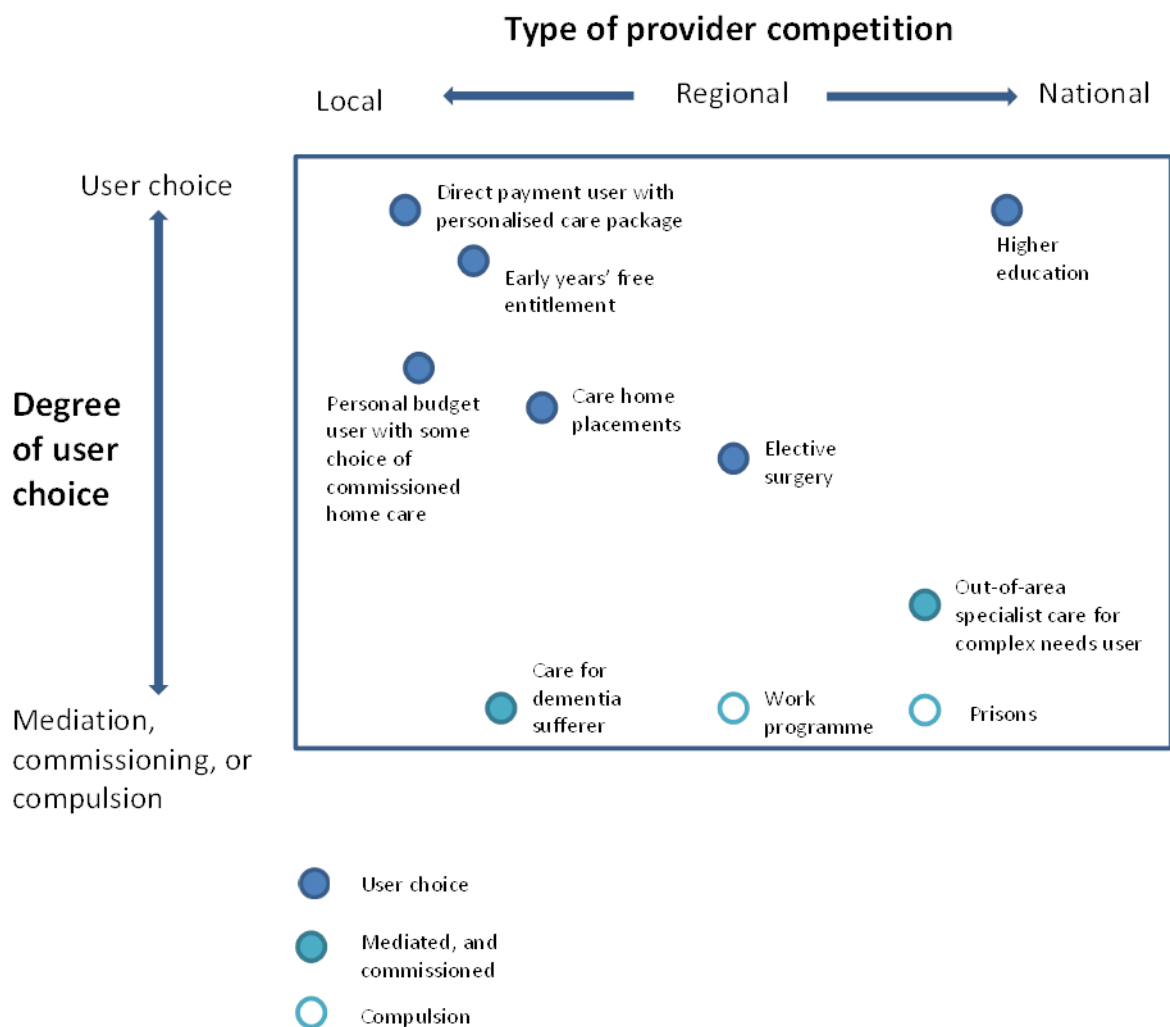
Variants that combine a 'competition for the market' approach with some element of user choice are also not uncommon, for example a local authority may commission domiciliary care services for the elderly in their area and deliberately contract with more than one provider, and allow service users to choose between a number of providers. These arrangements may suit some users who are happy to leave commissioning of care provision to the authority and to retain a modicum of control by choosing between the commissioned social care providers.

Public service markets can be composed of one or typically a range of different types of provider:

- publicly-funded providers, such as schools and NHS-funded hospitals;
- private businesses (owned and funded by private capital); and
- third sector providers, common forms these take are charitable or voluntary bodies, social enterprises and mutuals.

As mentioned earlier, private and third sector providers may typically participate in both the public and the private markets for the provision of services.

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



### 3. Market definition issues

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

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

On the other hand, local competition seems to be a strong characteristic of many public service markets as well as a plurality of provider types. Providers come in many shapes and sizes in the for-profit sector, from at one extreme the micro (sometimes family-run) business in the care sector, right up to large-scale national chains that operate in many different areas. The 'not for profit' sector also has a diverse range of provider types, though characteristically these tend to be small and based mainly in one area.

Geographical constraints can be a key determinant in defining the local market from the perspective of consumers who live in an area, where there is a limit to the choice of local hospitals, schools (catchment areas) etc. However, some consumers are prepared to travel further afield for service (e.g. even travel abroad for treatment and charge the NHS afterwards), or even move to a different area in order to enter the catchment area of a highly-rated school. The "transaction" costs, however, will deter the majority from acting this way. Some users view proximity to a provider as their paramount "quality" criterion when exercising their choice. In addition, switching costs can be high and consumers may tend to stick with the local or regional dominant provider (a barrier to entry feature similar to the energy sector). This makes provider new entry difficult and dampens exit pressures on incumbents and helps to explain why seemingly poorly-performing schools, hospitals etc. nevertheless continue to experience demand for their services.

Interestingly the recent substantial fee increase in the case of universities suggests that such geographical limits can be broadened with students apparently now more ready to study abroad to avoid the tripling of the tuition fees in England. Regulatory constraints and institutional set ups also play a role: the market definition can also be broadened giving more choice to the consumers as mentioned in the case of vouchers for schools which effectively opens up the choice of Swedish parents to include private schools as well as state schools.

For the majority of network utilities, vertical unbundling ensured the introduction of effective competition at several stages of the value chain, while retaining the infrastructure components of networks separately in the form of price regulated monopolies (transmission and distribution networks, gas pipes, rail network, etc.) to deal with the natural monopoly characteristics of these segments.

In the case of some public service markets there is a reliance on efficiency in the performance of upstream and downstream services as the user receives services at each stage of the process (rather than just the final product), e.g. integrated care pathways in healthcare (lines of procedures), probation services (need for collaboration with local authorities to commission work and accommodation, health services etc.), social care (coordination with personal care and care in the community upstream and hospitals downstream). This, combined with the increasing complexity of the outcomes-based commissioning model, raises the question as to whether efficiency in such cases is achieved through competition or rather through integration and collaboration between state and providers, or through a combination of competition and collaboration.

## **4. Regulation, funding and oversight in public service markets**

Utility regulation in the UK relies on a well-developed system of independent sector regulators that over the last 30 years have accumulated a wealth of experience in promoting the interests of present and future consumers, promoting competition where possible and implementing price regulation in the absence of effective competition (Ofcom, Ofgem, Ofwat, ORR, CAA, FCA, etc.). The reasons behind the development of independent regulators were:

- a) As a commitment device to enhance the credibility and predictability and assure companies and investors that current and future decisions would not to be governed by day to day politics; this was essential given the long term horizon of many infrastructure investments undertaken by privatised utilities as it provided assurance that they would get a reasonable rate of return on their investment and that the regulatory environment that they face would not depend on the political cycles of changing governments.
- b) As a depository for accumulating & deepening expertise on a particular sector and thus promoting the interests of the consumers in an effective and consistent manner as well as promoting competition and choice where appropriate. The regulator itself is financially independent of the state as it is funded by the levies on the respective industry.

In the case of public service markets, NHS-funded healthcare does have an independent economic regulator (Monitor), but other services are subjected to limited economic regulation with an unclear distribution of duties among different departments for stewardship, accountability, assessment of the providers' performance, standards appraisal and fulfilment of contractual obligations, user satisfaction feedback information, and ultimately information of the funding received by government to ensure that the value for money process can start to operate effectively.

It is important to stress that the idea of independent regulation in public service markets is limited by the fact that on the demand side unlike the case of utilities where customers are paying for the good, the funding for the public service comes from taxation; hence budget constraint considerations and allocation of resources by the state will always act as a constraint. On the other hand, this means that the public service markets do not suffer from the conflict of whether industry funding should come from the customers or from taxation as we have seen recently in water and energy (in energy some of the green levies have been shifted to general taxation). In rail, regulation decisions regarding industry funding and how this is to be split between customers and taxpayers stays with the government.

Funding in public service markets is typically from general and local taxation, unless the consumer is self-funded wholly or up to an initial capped sum as in the case of elderly social care in England. In Scandinavia vouchers are given to parents to use for the school of their choice to fully or partially pay

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

The legal context is worth considering together with the extent that competition law applies in public service markets.<sup>1</sup> Applying competition law to public markets is complex and largely untested. In principle its provisions would apply to non-public sector providers, however the Competition Act does not necessarily capture the activities of public authorities, in particular whether authorities are under an obligation not to abuse a potentially dominant position when they operate both as a provider in the market and as a purchaser of services in the same market. Existing published legal advice from a trade association for care providers suggests that the position is 'ambiguous' and 'cannot be definitively answered' with 'case law both in the UK and in the EU seemingly contradicting one another on this issue'. The former OFT (now the CMA) set out its policy relating to public bodies and the Competition Act and concluded that it turns on whether a local authority is classed as an 'undertaking' engaging in 'economic activity'. According to the trade association guidance, public bodies which only engage in purchasing in a market and are not involved in the direct provision of goods and services in the same market are unlikely to be 'engaged in economic activity', and therefore do not class as 'undertakings' for the purposes of the Competition Act. Nevertheless, the former OFT's guidance stresses that public authorities should not consider themselves immune from competition law, and should not assume that the Act does not apply to them at all.

The presumption that public authorities in these circumstances are outside the scope of competition law was the basis of a Spanish healthcare case heard by the European Court of Justice. A trade association for Spanish medical technology providers attempted to sue the Spanish health system for abuse of a dominant position, because it was a near-monopsony purchaser of their services and was accused of taking advantage of its position for example taking many weeks to pay invoices. The court found that the Spanish health system was not acting as an undertaking in this case. The legal position, however, of public bodies in public service markets still needs further clarification, in particular for those that engage in a mixture of purchasing and the direct provision of goods or services of a commercial nature (i.e. for "economic purposes") in the same market.

Public authorities may (knowingly or unwittingly) exert substantial buyer power in a local market and depress prices below competitive levels, and force providers to accept unsustainable prices. This may not only have undesirable effects for providers on their sustainability and severely limit market supply, but also it could inadvertently hamper the public authority in meeting its statutory duties to ensure adequate provision in its area. Whilst applying competition law is complex and public authorities acting solely as buyers may not necessarily be captured by its provisions, authorities still need to act with care. Courts may still judge that they have acted unfairly, even if their actions are not directly caught by the prohibition against abusing a dominant market position. For example, in a court case in 2012 a group of

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<sup>1</sup> This topic was the subject of the City University's Centre for Competition and Regulatory Policy's Roundtable in January 2015. Amongst the speakers were current leading figures in the UK competition regime. Slides from presentations at the Roundtable can be found at <http://www.city.ac.uk/arts-social-sciences/economics/research/centre-for-competition-and-regulatory-policy/presentations-from-the-19th-ccrp-roundtable-2015>.

local care providers challenged a local authority's decision to offer no increase in fees and took it for judicial review. The judge on this occasion quashed the local authority's decision on several counts including on the grounds that the judge considered that the authority was abusing its dominant position.<sup>2</sup>

In terms of the wider oversight of public service markets, the Competition and Markets Authority (CMA) has an important role in making markets work well for consumers and businesses and the economy. In the past the CMA (and its predecessor the OFT) has conducted studies of a number of public service markets including higher education, care homes and dentistry etc., and has made a number of recommendations to government to improve the market effectiveness in order to improve outcomes for consumers in these markets. The CMA's strategic assessment document has signalled its intention to do more work in the area of public service markets along with a number of other key areas of the economy.<sup>3</sup> In its assessment of these markets, market design problems, consumer information deficiencies and unequal outcomes were identified as potential risks.

## **5. Concluding remarks**

The aim of this article was to compare, contrast and highlight the areas where the public service markets differ from the markets for regulated utilities. To achieve this we have explored the definitions of public services, have highlighted the differences in the user side (who is in many cases separate from the buyer/commissioner) and types of user choice, the product characteristics of such services, the plurality in the forms of provision, the market definition. Finally, in section 4 we have analysed the regulatory and oversight arrangements in such markets and highlighted issues which will potentially assume growing importance as marketized delivery is likely to become increasingly mainstream in public services provision.

## **Acknowledgement**

This article is based on part of a working paper by Dassiou et al. (2014).

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<sup>2</sup> 'National Audit Office Principles Paper (2013), paragraph 3.36.

<sup>3</sup> 'CMA Strategic Assessment', CMA 35, November 2014.

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