

CONTESTABILITY IN HUMAN SERVICES MARKETS

Bob Davidson

Over the last thirty years in Australia and elsewhere, there has been a substantial marketisation of human services¹ funded by government. A major justification used for this process has been the concept of contestability. Neo-liberal critics saw the traditional provision of government-funded human services as a series of either government monopolies or protected ‘in-groups’ of favoured non-profit organisations (NPOs) able to retain funding with little scrutiny of performance. Making government funding more contestable, it was argued, would not merely enable the entry of good new providers and lead to exit of poorer ones, but would also create incentives that would change the behaviour of all providers, increasing the quality, equity of access, efficiency, responsiveness, and diversity of services, while making providers more accountable to both users and government (Bartlett & Le Grand 1993, Le Grand 2007).

In more recent years, the goal of maximising consumer choice has also increasingly been used to justify and frame the use of market mechanisms in government-funded human services. This involves enabling users of services (or the user’s personal agents²) to decide for

1 ‘Human services’ encompasses a diverse range of activities, including education, health, child care, aged care, support for people with disabilities, support for vulnerable individuals and families, homelessness programs, and assistance for unemployed people. For a discussion of the scope and distinguishing features of human services, see Davidson 2009; Zins 2001; Hasenfeld 1992; and Eriksen 1977. The major ways in which human services have been marketised is discussed in Section 6.

2 ‘Personal agents’ are family members or friends who make decisions on behalf of users. For example, parents make decisions about child care for their children, and adult children may make decisions about aged care for their parents.

themselves what services they get and who will provide those services, rather than having government officials make these decisions for them. The two concepts of contestability and consumer choice are closely linked, although it is important to note, as is illustrated later, that there can be contestability without consumer choice, but not vice versa.

The two concepts are cornerstones of the conventional theory of markets, but there is an obvious tension between them and the reality of human services. In particular, an important implication of the substantial 'market failure' intrinsic in human services is the need to limit contestability by closely regulating the entry and behaviour of service providers, both to protect vulnerable people and to ensure high quality services that make the best use of limited public resources. This article seeks to identify how this tension has been addressed in the ways that contestability and consumer choice have been applied in managed markets³ for human services; that is, markets in which government is the source of much, if not all, of the purchasing power for services.

Of course, the idea of marketising human services is itself contestable. The growth of human services markets over recent decades has emerged in large part from the *political* dominance of neo-liberalism, but the theoretical and empirical validity of its core tenets are widely challenged and the reality of markets is far from the idealised version presented in neo-classical economics (Stilwell 2005). Human services present a number of examples of major limitations to neo-classical assumptions, especially the notion of a rational fully-informed 'sovereign' consumer. Moreover, there are clear alternatives to the market for organising the production and delivery of human services, and market failure need not be the only justification for government involvement (Donahue & Nye, 2002; Denhardt & Denhardt 2007).

The aim here, however, is not to present an alternative paradigm for delivering human services, but rather to examine marketisation on its own terms, to consider the implications of the approach in the context of the reality of products that are human services. This perspective does not

3 They are also called 'quasi-markets', but the use of 'managed markets' is preferred here because it emphasises that they are created by government and can be managed to assist in achieving a range of policy objectives; and that (for providers at least) they are *real* markets, albeit different to 'conventional markets' (the term used here to refer to markets where there is no or minimal government funds to purchase the product).

imply acceptance, even implicitly, of a neo-classical world-view. Rather, the need for such analysis is especially important in light of the ever-increasing significance of marketisation in human services, and the widely-held concern that many of the arguments justifying these developments may be 'social philosophy masquerading as economic science' (Nevile 1998:169).⁴ A key implication of the article is that, even on its own terms, there are substantial qualifications to claims about the efficacy of marketisation.

The next three sections provide necessary background in regard to contestability theory, the distinctive features of human services, and the profile of human service providers. The following sections then consider the appropriate balance between controlling initial entry and regulating the behaviour of providers; how the competing pressures of contestability and the need to control the entry of providers have been addressed in the various forms of managed markets that have emerged in human services; and how the community aged care industry provides an example of these processes. There are then some concluding comments.

The Meaning of 'Contestability'

The core idea behind the term 'contestability' is a principle in economics that goes back to Adam Smith (1776), namely that suppliers will only maximise their efficiency and the quality of their product if they are continually subject to the possibility of competitors taking over part or all of their business. Competition can only occur if a market is contestable.

However, the terms appear to have been first used formally in the context of market theory by Baumol and colleagues in the early 1980s in their development of Contestability Theory (Baumol 1982; Baumol, Panzar, and Willig, 1982). They defined a contestable market as 'one into which entry is absolutely free and exit is absolutely costless' (Baumol, 1982:3),⁵ and where 'an entrant has access to all production techniques available to the incumbents, is not prohibited from wooing the

4 Nevile's comment was actually directed at economic rationalism in general, but it is very relevant in this instance..

5 'Entry costs' are defined as any costs that a new entrant must incur *in addition* to the 'normal' costs of establishing and operating the business (e.g. advertising and legal costs to overcome the advantages of incumbents).

incumbent's customers, and entry decisions can be reversed without cost.' (Baumol 1986:xxv). They described such a market with *zero* entry and exit costs as *perfectly contestable*. In such a situation, the theory argues, the actual entry of a new supplier is not essential, since incumbents will recognise and respond to the fact that it is an ever-present possibility that a new supplier may enter in response to any monopoly profits. Thus *potential* entrants can be as effective in achieving a competitively efficient outcome as actual entrants.

In effect, Contestability Theory relaxes one of the conditions of the theory of perfect competition, by arguing that optimum efficiency outcomes do not require many sellers, but can be achieved providing there is at least one potential new entrant and there are zero entry and exit costs. While the theory was subject to much criticism on the grounds that it is both theoretically and empirically flawed (Shepherd 1984, 1990, 1995),⁶ it was developed at the same time as neo-liberalism was gaining dominance and thus gained wide currency, being used to support the conventional theory of markets while claiming to remove one of its unreal assumptions.

In practice, however, the common usage of 'contestable' is much less restrictive than perfect contestability. A market is generally considered 'contestable' if there are *no insurmountable* barriers to prevent at least one new supplier from challenging for the business of another, even if there may still be some barriers and costs to entry and/or exit. This less restrictive meaning makes possible the notion of a market becoming *more* contestable by reducing specific entry and exit costs, without necessarily eliminating them. Hilmer (1993), in the report that set the basis for government policy on competition in Australia in the last two decades, uses this less restrictive meaning, with a number of references to 'poorly contestable', 'less contestable', 'more contestable' or 'highly contestable' markets (Hilmer 1993: 33, 43, 227, 259, 267, 298, 309, 311).

The use of 'contestability' to justify the marketisation of human services also rests on this less restrictive meaning of the term. The literature on human services markets contains little or no formal analysis of the

6 The theory was also criticised by Shepherd and others as seeking to justify monopolies and to reduce scrutiny and regulation of those large corporations that were the incumbent firms in major industries.

applicability or implications of Contestability Theory, while discussions about increasing contestability in actual sectors focus on the need to encourage more competitors and reduce the role of incumbents rather than achieving zero entry and exit costs.⁷

The term ‘contestability’ is also commonly used to refer not just to the initial entry into an industry, but to the extent to which competition for all consumers in the industry is possible. Thus some markets effectively closed to new entrants may be regarded as contestable if there is vigorous competition between the incumbents for customers and sources of revenue within the market. This approach was part of the post-WW2 strategy in Japan to develop its export industries around the keiretsu (Gilson & Roe 1993), and it is implicit in the approach used in health with the Casemix model. Alternatively, there may be no barriers to initial entry to an industry, but very limited access to more prized segments⁸ of the market.

While increasing contestability is ostensibly aimed at enhancing efficiency and consumer choice, it can have the opposite effect. For example, relatively free entry is a characteristic of differentiated (or monopolistic) competition, whereby competing firms have slightly differentiated products; but it has long been established that one likely consequence of such a market is excess supply with its resulting inefficiencies as many firms are unable to achieve the most efficient size or have unused capacity (Robinson 1933; Chamberlin 1933). Further, efficiency may come at the cost of choice, such as when deregulation reduces legal barriers to entry and lead, perversely, to greater concentration of ownership as large firms use their market power to reduce the number of smaller ones and limit new entry, as has occurred in various retail sectors (Jacenko & Gunasekera 2005).

Limits on Contestability

A full analysis of contestability in any market involves many factors and potential barriers to entry. These include the capital and labour

7 For example, Baumol’s theory is not discussed in the seminal book by Le Grand and Bartlett (eds) (1993) on quasi-markets, which was written only a decade later.

8 In the context of this paper, a ‘segment’ of a market or industry is generally defined by a specific type of service, group of users, and/or specific location.

requirements for each type of service, the use of market power by incumbents, barriers to exit that may deter potential entrants (*e.g.* ‘asset specificity’ of equipment that has no alternative use), broader government policy (*e.g.* taxation, or fair trading legislation), and decisions by government that create opportunities, incentives, and barriers to entry for providers in each specific market.

The subject of this article, however, is much narrower, focusing on the potential for governments to exclude some organisations from a human service market, and why and how this may be done. This is most likely to be done by one of the following five approaches, which can be used for any product and market. However, they are particularly relevant for human services.

First, a supplier may need to obtain a ‘licence’ through a non-competitive process whereby a ‘licence’ is granted to anyone that meets set requirements regardless of the number and quality of other suppliers. The requirements may range from simply paying a fee, through to a rigorous process whereby the supplier must demonstrate that it can meet minimum standards (*e.g.* product quality or staff).⁹ *Second*, there may be a competitive process, such as a tender or auction, that limits the number of suppliers that can enter. This may be done to ensure all suppliers are high quality, to avoid oversupply in the industry, or to ensure that the overall society receives some return on scarce public resources. *Third*, certain types of suppliers (*e.g.* foreign firms or for-profit organisations (FPOs)) may be considered problematic and explicitly excluded from the market or from segments of the market. *Fourth*, one provider may be given a monopoly for the whole market or for a segment. *Finally*, only government agencies may be allowed to provide a service; and within that, there may only be one government agency able to provide the services.

Human Services

Human services are characterised by a number of features that distinguish them as ‘products’ in a market, although ‘it is important not

9 The ‘licence’ may be provided on various bases, for example, prior qualifications of people delivering the service (as with medical practitioners), a formal accreditation assessment, or as part of a tender process (Davidson 2008).

to overstate the distinct features of human services and to recognise that some of these features are ones that have traditionally been ascribed to all services, including services provided through conventional markets' (Davidson 2009:44).¹⁰ These differences have major implications for the way in which human services are organized, and, in the context of a market analysis, represent the source of substantial 'market failure'. In turn this underpins both why historically the 'market' has not been able to provide many of these services, and the form of the managed markets that have been established.

A model by Blank (2000) links the types of market failure that arise from the distinctive features of human services with an optimum form of 'public-private interaction' in situations where they arise. She identifies four types of market failure - externalities, distributional inequities (i.e. incapacity of many users to pay for services), limited personal agency of many users, and the difficulty of observing or measuring the quality of services after it has been provided. The first and last of these sources relate to the product; the other two relate to the user.

Blank notes that externalities and distributional inequities exist for most human services, and underpin the basic involvement of government in a regulatory and funding role. However, the other two sources - limited personal agency and limited measurability/observability - are more substantial problems involving significant asymmetries of information between the buyers and providers of services (Stiglitz & Weiss, 1983; Weisbrod & Schlesinger, 1986). This creates significant potential for opportunist and other poor providers to go undetected. Hence there needs to be greater involvement by government, either in providing services or in deciding who can provide them.

Blank then identifies four major forms of 'public-private interaction', which represent an increasing level of government involvement and responsibility. She argues that the nature and extent of this involvement and the appropriate interaction vary on a case-by-case basis depending on the types of market failure that are present. Thus (1) regulation would suffice where externalities are the only source of market failure; (2) government subsidies are also needed if there are both externalities and distributional inequities; (3) government should pay for and control the

10 For an analysis of how human services differ from goods and other services, see Davidson (2009:44-49).

service, but contract out the right to operate it if users also have limited agency; and finally (4) government itself should organise and deliver the service if all four types of market failure are present. This schema is set out in Table 1.

**TABLE 1: Blank's Model of Public-Private Interaction
by Type of Market Failure**

Type of Interaction		Type of Market Failure			
		Externalities	Distributional Concerns	Agency problems	Unobservable Output Quality
1	Private Sector Owns and Manages, with Regulation	Yes	No	No	No
2	Private Sector Owns and Manages, with Regulation and Vouchers	Yes	Yes	No	No
3	Public Sector Owns and Private Sector Manages	Yes	Yes	Yes	No
4	Public Sector Owns and Manages	Yes	Yes	Yes	Yes

Source: Blank (2000:C40, Table 1).

Blank (2000:C43-C48) notes that in practice in each specific case, the 'ideal' approach proposed by this model is very dependent on the capacity of government to fulfill its role. Thus, other criteria concerning quality assurance, trust, and efficiency become relevant in determining which approach is actually used. However, the schema shown in Table 1 is a useful starting point in indicating where and why the entry of providers needs to be more closely controlled, and is drawn on in later sections.

Human Service Providers

The previous section has outlined differences in the nature of the product and the buyer in human service markets. There are also important differences in the types of organisations that are the sellers, or service providers, in these markets.

A core assumption of orthodox micro-economic theory is that the suppliers in any market are motivated by maximising the profit of the organisation or the personal benefits of the people who own or manage it. However, this can paint an overly simplistic picture, even for conventional markets (Davidson 2009:57-58) and is even less relevant in human services where many providers are *not profit-maximisers, but social maximisers* that contend that they have an intrinsic motivation to provide the best possible services (Smith & Lipsky 1993, Wistow *et al* 1996; Lyons 2001). Competition, many of them argue, is not only unnecessary as a motivation for them to provide good services, but is often counter-productive by diverting them from their broader social mission, a process described as ‘mission drift’ (Taylor & Hoggett 1994, Weisbrod 2004).

Historically, human services have largely been provided by government agencies or by NPOs, encompassing the large religious and charity bodies set up in the nineteenth century and smaller local community-based bodies, many originating in the 1960s and 1970s. In the more marketised world of the last thirty years, these bodies have remained major suppliers of most types of human services, although there has been a growing presence of FPOs (Meagher & King 2009).

While it is still commonly assumed that NPOs and government providers are social maximisers and FPOs are profit-maximisers, there has in fact been a substantial ‘blurring of the boundaries’ between the different types of providers in recent years (Ott 2001:355). Some smaller FPOs have been established by people with a strong commitment to altruism and quality services who believe they cannot achieve these objectives within larger, more bureaucratic bodies (e.g. nurses setting up companies to provide at-home care for older people). On the other hand, many larger NPOs have become more corporate in their structure, personnel, and operations and increasingly there is criticism of some for being too commercialised (Horin 2007, Schneiders 2011).¹¹

11 Formally (as embodied in legislation in many nations), NPOs and FPOs are distinguished not by motivation or whether they make a surplus (or ‘profit’), but by the fact that NPOs have a *non-distribution constraint* (Hansmann 1980) whereby dividends from a surplus (or ‘profit’) cannot be paid to individuals. While ‘soft budget constraints’ (Maskin 1999) may apply in some cases, in general, a non-government body, whether NPO or FPO, must achieve at least break-even over the longer term across its overall operation. Beyond that there is no necessary

While the overall message from the evidence across service types and nations is that NPOs are most likely to provide higher quality service and FPOs most likely to be more efficient, this is by no means true across the board. Thus a simple dichotomy of FPOs as profit-maximisers and NPOs as social-maximisers is not valid and one can no longer assume the motivation or *modus operandi* of a provider from its legal structure (Davidson 2009).

Regulation of Providers - Entry and Behaviour

Given the discussion thus far, it is generally acknowledged (even by most neo-liberals) that there is a need for greater regulation of providers in human services than applies in most other industries, especially where government is providing funding for the services. This can be achieved by both regulation of *entry* to the industry or to segments of the industry, and regulation of provider *behaviour* within the industry by setting rules for conduct and monitoring these.

For the broader economy, a recurring theme in the industrial organisation literature has been the relative value of action aimed at ensuring freedom of entry *vis-à-vis* action focusing on how suppliers compete within the market, in obtaining the benefits of competition (such as lower prices and reduced market power of large incumbents). On the one hand are those (*e.g.* Baumol, 1982, 1986) who argue that low barriers to entry will ensure firms cannot exploit their market power and thus there is less need to regulate the behaviour of firms within the market. Against this, however, others (*e.g.* Shepherd 1984, 1990, 1995) argue that regulation of behaviour is essential because it is not possible to remove all barriers to entry, and large incumbent suppliers can exercise substantial market power however low the barriers are.

Determining the relative importance of controlling the entry of providers *vis-à-vis* ongoing regulation of their behaviour is also significant in human services markets, albeit with some different arguments. The proponents of contestability claim that subsequent regulation of behaviour can prevent opportunism; that too restrictive entry will keep good providers out and reduce the pressure on incumbents to maintain

legal or economic requirement for either to have a surplus on their overall operation or any of their specific activities.

and improve the quality and efficiency of their services; and that ‘the market’ will ultimately weed out the poor performers.

Conversely, there are strong arguments for having higher entry barriers to minimise opportunism and try to ensure that all providers are aiming to maximise the quality, equity, and efficiency of their services. In particular, there are the relative *transaction costs*, the costs incurred by all parties when there is asymmetry of information and limited trust between buyers and sellers (Williamson 1998; Krashinsky 1986; Davidson 2009). There is a trade-off between *ex ante* and *ex post* transaction costs, such that the more scrutiny by a buyer before purchase results in less need for monitoring performance; conversely, the less ‘due diligence’ beforehand, the greater the costs of subsequent monitoring. Up-front control of entry does not preclude the need for ongoing monitoring but it can reduce the costs and risks.

Given that ‘bounded rationality’ (Simon 1991) makes it impossible to specify all the contingencies that may arise in the future, and hence ‘all complex contracts are unavoidably incomplete’ (Williamson 2000:599), only limited faith can be put in any processes aimed at regulating behaviour in situations where there are substantial asymmetries and measurement/observability is low. Inadequate initial scrutiny can have a major impact. For example, cases of medical malpractice show the cost of one poor entrant, while political problems from a small number of poor providers can end a government program, as shown by the ‘pink batts’ program (Berkovic & Vasic, 2010).

From the perspective of government as the source of funds, the problem is similar to the ‘make-or-buy’ decision faced by a conventional firm in determining how to best undertake each part of production (Coase, 1937, Williamson 1998). The more difficult it is for a buyer to observe and/or measure output, the more likely it is that a buyer should ‘make’ the input or provide the service itself. Indeed, Blank’s model rests on the premise that the transaction costs in monitoring providers increase as the limits on personal agency and measurability/observability increase, to the point where government should provide the service itself.

A further important concern is the dynamic effect over time in the ways that easier entry can ultimately result in a weakening of the regulation of behaviour. For example, profit-maximisers may gradually accumulate both market power and political influence, and use it to dilute service and quality standards, as occurred with child care in Australia (Press &

Woodrow 2009). Hence, it is important to be careful who is allowed into the industry in the first place.

Managed Markets

While marketisation aims to encourage the entry of new providers into human services, there are powerful reasons for closely controlling entry. How is this tension resolved in the way that managed markets are structured and operate in order to achieve the ‘optimum contestability’?

Table 2 presents a schema of six possible market regimes in which human services can be delivered, in terms of the two variables of control of entry and availability of government funding.¹² The six regimes are shown in increasing order of the barriers to entry for a provider. The table also shows the extent to which users are able to choose their own provider. The last four of these regimes are managed markets (as defined in Section 1). It is important to note that these are broad types and there is a wide range of variants within each type.

The six types in Table 2 (with examples from Australia shown for each) are:

- **Unregulated:** No government funding and no industry-specific regulation. This is unusual in human services, but an example is the private purchase of at-home care for older people (see later).
- **Regulated:** No government funding but industry-specific regulation. While frequently found in conventional markets where there is a public interest concern (e.g. safety or competition), again it is less common in human services, but examples can be found with alternative health services for which no public (Medicare) rebate is available.

12 Note that two major non-market regimes are *not* included here, namely the Planning Model (where providers and the funding agency jointly decide how to allocate funding) and the model whereby a single government agency is the sole provider and decisions are made on a hierarchical basis within the agency.

Table 2: Market Regimes for the Delivery of Human Services

	Regulation of Entry				Gov't \$	User Choice of Provider		
	Nil	Licence	Tender	Mono poly (*)		Gov't Only	High	Limited
<i>Unregulated</i>	X					X		
<i>Regulated - Privately paid</i>		X				X		
<i>QVL</i>		X			X	X		
<i>Hybrid</i>		Usually	X		X		X	
<i>CTC</i>		Possibly	X	X	X			X
<i>Gov't Internal Markets</i>					X	X		X

* Commonly monopoly will take the form of a series of monopolies for different market segments (e.g. by location, type of service, or group of users) rather than a single provider for the whole market.

- **Quasi-Voucher Licensing (QVL):**¹³ Government funding is directly or effectively allocated to users, who are then able to choose between providers licensed to provide the service. Payment may be by cash or voucher to the user, a tax deduction for the user, or direct reimbursement to the provider, but all three approaches have the ultimate effect of enabling the user to choose who provides them with services as the subsidy follows the user (Davidson 2008). The subsidy may or may not meet the full cost that is charged by the provider. Two examples are general practitioner (GP) services under Medicare and child care.
- **Hybrid:** As with QVL, except that a government agency first conducts a competitive process to limit the providers that users

13 The seminal paper proposing the use of vouchers for government programs was Friedman (1962). QVL includes other mechanisms with a similar purpose. Some versions of QVL systems are described as 'demand-side funding'. The term 'quasi-voucher' appears to have been introduced by Lyons (1995).

can choose from. The Job Network and Commonwealth aged care funding (for residential care and community aged care Packages) are examples.

- **Competitive Tendering and Contracting (CTC):** There is government funding, which is allocated via a competitive process to choose a provider that is then given a monopoly for a segment of the market. The Home and Community Care (HACC) program is an example.
- **Government Internal Markets:** Only government agencies can provide services to subsidised users, but the funding for each 'outlet' (e.g. school or hospital) is based on the number of users that choose that outlet. Casemix funding for public health in Victoria is an example.

Blank's first three forms of public-private interaction can be equated, respectively, with the Regulated, QVL, and CTC regimes; her final form could include the Government Internal Market regime, but her main focus was on the traditional (non-market) government provision of services.

The main interest here is on the three regimes that have both government funding and non-government providers (i.e. the shaded ones in Table 2). In terms of the form of contestability in each one:

- **CTC:** The government chooses the provider and there is no consumer choice. Commonly, user preferences have no formal influence on the decision, and the only market is between the funder and the provider. The contract may be put up for re-tender periodically, but in the interim the funding and access to approved consumers is not contestable.
- **QVL:** Providers are licensed via a non-competitive process, and users choose from these. The only market is between the provider and user, and there is potentially continuing contestability for each user's custom. This system is more akin to a conventional market.
- **Hybrid:** This is a blend of CTC and QVL systems, where providers must face *two* contestable markets. Providers must first be chosen by government through a competitive tender process to be part of a limited group or 'panel of approved providers' allowed to service approved users who are eligible

for assistance. Users still have choice, but they must choose from the more limited set of providers that are (or should be) higher quality. There are thus two sets of markets, one between the funder and providers, the other between users and providers.

Table 3 summarises the above in terms of how providers face contestability.

Table 3: Managed Markets and Contestability

Managed Market	Government Choice	Consumer Choice
CTC	X	
Hybrid	X	X
QVL		X

It is also common for a Hybrid system to further limit contestability and consumer choice in some way. For example, the decision as to which provider is chosen for each user from a panel of approved providers may not be made by the user but by the funding agency or some other body (as in Veterans Homecare). A second approach is where the provider is allocated a certain number of places (as in residential and community aged care) or a specified share of approved providers (as in the Job Network). In such cases users may not be able to get a place with their provider of choice, while providers are limited in how much they can expand. A third approach (also true of CTC systems) is for contestability to be limited to new ('growth') funding, whereby a provider's existing places or funds are explicitly not subject to re-tendering as long as it meets its contract requirements; thus contestability is only at the margin of the market.

Hybrid or QVL?

The choice of the managed market regime is a major threshold question for government in determining how to marketise any service.¹⁴ In the

14 Beyond that, there are a myriad of decisions for government and its agencies about the design and administration of the regulation and funding systems that underpin a managed market, affecting the four major elements of a market - product, buyers, sellers, and the forum of exchange (Davidson 2009:51-52). These can affect

early years of marketisation, CTC was most often used, but many government agencies now seek to give users more say in the selection of their provider. As a result, the Hybrid model is increasingly used and is now possibly the most common form of managed market, although there has been little acknowledgement or direct study of its properties and effects. In a number of sectors, however, there are calls to move further down the marketisation path to 'more open competition' by introducing a QVL system.

The main arguments used for adopting a QVL system essentially derive from neo-classical theory based on consumer sovereignty, whereby, it is claimed, that the most powerful incentives for providers to maximise the quality, efficiency, and responsiveness of their services is by responding to the wishes of consumers.¹⁵ Only in this way, it is argued, can a provider survive and grow. This of course rests on the assumptions that all consumers are rational and fully-informed; and, to the extent that this isn't true, initial accreditation and ongoing monitoring by government will adequately ensure the quality of all providers. Two further arguments used in support of QVL system are the 'moral' right of users to have a provider of their choice that they believe best fits their needs, and the elimination of the significant *ex ante* transaction costs incurred by all parties in a tendering process.

We have noted earlier how high initial barriers to entry can help ensure the quality of individual service providers. This section briefly notes some *systemic* advantages of a Hybrid system compared to QVL, especially in terms of avoiding the problems inherent in a large of number of providers.

Firstly, a Hybrid system allows more *effective equitable, and efficient planning of services*, especially where rationing is needed when total funding is less than required to meet demand. Places or funds can be allocated at a regional level to ensure an equitable geographical allocation¹⁶; and within each region, places or funds are then allocated to individual providers. Otherwise, in a situation of limited funds, 'open competition' would generate incentives for some providers to try to

contestability and what providers and types of providers ultimately enter a market, but those effects will not be explored here.

15 See Stilwell (2005:Ch 19) for a critique of this theory.

16 Davies (1968) describes the equitable allocation of funds between regions as 'territorial justice'.

attract as many users as possible as quickly as possible, leading to misallocation of resources and recurring crises as funds run out. Further, this helps limit the impact of distributional inequities at a regional level, by reducing the extent to which profit-maximising providers are able to concentrate on more affluent areas from which they can obtain greater co-payments.¹⁷

Second, a QVL system runs the risk of failing to achieve its most fundamental stated objective, namely to increase the *power of users*. In any market, when multiple sellers are combined with differentiated products, there is the possibility of ‘too much choice’.¹⁸ Thus ‘many people find the growing obligation to choose is difficult, bewildering and paralysing’ and ‘more choice may not mean more control’ (McKnight, 2010:193-4, citing the work of Schwartz (2004)). The assumption of the rational consumer collapses under the weight of the information that has to be processed. This is exacerbated in human services, by the lack of agency of many users to be able to make an informed and accurate assessment of the quality of each provider. Nor does the use of a family agent overcome the problem, as Press and Woodrow (2005:282), for example, point to studies that found that parents tend to overestimate the quality of their own children’s child care.

Thus a QVL system that allows freer entry may give more providers, but it is not clear that it gives service users more control or real alternatives (Perri 6, 2003). Dowding & John (2009) argue that real choice and diversity is more likely to be enhanced by ‘a smaller set of better or more diverse alternatives’ where there are real differences between and within a limited number of options, than by a multitude of separate options. This would reduce search costs and risk for users, while also allowing for the exercise of voice as well as exit options by users in influencing the development of services (Hirschmann 1970).¹⁹

Third, there are good reasons for expecting that the *quality of services across the overall service system* will be higher under a Hybrid system

17 A co-payments is the user contribution that is obtained for most human services..

18 Humorously described by Adams (1997) as a ‘confusopoly’.

19 One suggestion that has been made in the context of proposing QVL systems for aged and disability services is the appointment of advisers, or brokers, to assist individual users, but this is likely to be a major drain on limited funding that may well lead to massive costs such as those generated by the army of advisors in the superannuation industry.

than under QVL. New entrants must have first not only met the minimum standards required to get a licence, but be among the best providers in order to be chosen. Further, the ongoing task for government of assessing and monitoring quality, given the intrinsic limits on measurability and observability in human services, becomes more difficult the more providers there are in the market, especially if (as is more likely in a QVL system) many providers are small scale and working on the fringe of the market. This implies (given the earlier discussion), one or more of a higher incidence of undesirable behaviour, higher *ex ante* transaction costs if initial accreditation is to become more rigorous, and/or higher *ex post* transaction costs to cover the monitoring.

A fourth important systemic consideration is that a Hybrid system is likely to mean greater *stability* of the service system. Freer entry under a QVL system will lead to more ongoing ‘churn’ of providers, inevitably with more marginal and more entrepreneurial providers, and the strong prospect of some providers with good services but poor marketing falling below a critical mass and having to close. Human services are about meeting people’s core development and support needs, and the instability of a conventional consumer market is not desirable. Stability is essential to help ensure the continuity of services (at both community and individual level) and to ensure the best investment of resources over the longer term. Proponents of the market will argue that ‘the market’ will sort out who will be the best longer-term providers, but, as shown earlier, there are many questions as to whether this process will produce better service outcomes than a more managed process - and it will certainly be a more disruptive process.

Finally, arising in part from the above factors, are the *efficiency* costs of a QVL system that can offset, and potentially exceed, any efficiency gains that may arise from greater contestability and consumer power. A differentiated competition model is most likely to emerge from a QVL system, and the likely outcome of enduring excess supply capacity (*e.g.* unused beds in a nursing home) means a loss in allocative efficiency. Second, the instability and resulting transition costs for all parties is a significant efficiency cost. Further, while the costs of tendering will be avoided, a QVL system may have significant additional *ex ante* and *ex post* transaction costs for all parties as noted above.

Thus a Hybrid system, based on limiting the entry of providers to a smaller group of proven performers, can have a number of significant

advantages over a QVL system. It represents a medium position, providing strong controls on entry, while giving users choice and enabling government to limit and structure competition in ways that both maintain the stability of the service system and give incentives for good providers to increase their quality and efficiency. The next section has examples of how this can occur for a specific service.

Community Aged Care

This section provides a snapshot of the community aged care industry in Australia as an example of how the processes described above play out in practice. In part, it is based on my own as yet unpublished research into the industry, which has included 44 interviews with senior representatives of funding agencies, industry bodies, and providers²⁰ together with analysis of documents and funding data about the industry and its service providers.

This industry provides a range of services for older people who choose to remain at home rather than go to a nursing home (residential care). These include where a care-worker assists in the person's house, such as with personal care and domestic assistance, as well as home maintenance and modification, transport, and allied health services. It is a substantial industry, the value of which is approaching \$4 billion annually, primarily based on a range of government funding programs. In 2009-10, some \$3.2 billion was allocated through nine of these programs (compared to \$7.3 billion for residential care) (SCRGSP, 2011:Table 13A.5). Moreover, it is a major growth industry for the future given both the ageing of the population and the increasing desire of people to remain in their own home as long as possible (ageing-in-place) (PC 2008; PC 2011).

The industry is distinctive amongst human services in the range of potential sources of revenue for providers. These include various government programs, substantial sub-contracting by FPOs of their direct care workers, insurance-funded users, and unsubsidised (and

20 This includes 30 interviews with CEOs, owners or senior managers of 22 community aged care providers in NSW, including the six major providers in NSW and providers receiving over half the Package and HACC funds in NSW.

unregulated) privately-paid services.²¹ This leads to a number of market segments each with their own form of market in terms of Table 2. It is an example of the type of industry noted earlier where there are few barriers to initial entry to the overall industry, but access to more prized segments is limited.

The core of the industry is based on two programs, namely the Home and Community Care Program (HACC), which uses a CTC regime; and the DoHA²² Packages, which use a Hybrid regime where providers are allocated a specific number of places for individual users. While the total funds from HACC (\$1.9 billion annually) is much larger than for the Packages (\$0.8 billion), winning Packages is the major goal of most providers. This is primarily because of the high per client payments (i.e. ranging from \$15,000 to \$49,000 annually in 2009-10 compared to the mean cost of just over \$2000 for each HACC recipient (PC 2011, Appendix E, p.3)). The remaining discussion focuses primarily on the Packages.

Contestability for the Packages is limited in a number of ways. First, to tender for places, providers must be obtain the status of an Approved Provider. Second, places previously allocated to each provider are never put up for re-tender as long as the provider maintains its accredited standards and contractual requirements. Third, the number of places funded is less than the number of people approved for assistance, so that the consumer choice inherent in a Hybrid regime is rarely evident, with long waiting lists in most areas, and providers effectively able to choose whom they wish to take. Interestingly, however, in some areas, additional community care places have at times become available at short notice²³, resulting in a short-term excess supply and subsequent action by providers to win consumers. Fourth, there is no price competition in the tender process, with price and outputs being set by the funding agency. Quality, the scope of a provider's services, and local

21 These are people who either have a level of frailty or disability that does not qualify them for government-funded assistance; or who have been approved for assistance but are on waiting lists or want extra ('top-up') services above their subsidised entitlement (e.g extra hours); or who would qualify, but are wealthy and want to avoid government.

22 DoHA is the Commonwealth Department of Health and Ageing.

23 This arises from under-subscription of residential care places, with numbers of providers (including NPOs) considering further growth to not be viable given current funding and regulations (Access Economics 2009).

appropriateness are the major criteria for selection, with the funding agency explicitly opposed to any offers by providers to squeeze more people into the available funding (based on personal interviews with DoHA senior staff, 2011).

Nevertheless, within these various constraints on contestability, providers still regard the Packages market segment as ‘very competitive’. Applications for community care places are almost always hugely over-subscribed, in some years by as much as ten to one. Larger providers use considerable resources in seeking to win tenders. Notwithstanding this, however, in its recent report on aged care, the Productivity Commission (2011:xxv) has claimed that under ‘the current system of aged care... providers have reduced incentives to become more efficient, improve quality, innovate, or respond to consumer demand’. It has thus recommended that both community and residential aged care be funded under a QVL system.

There are certainly substantial problems in the funding and delivery of community aged care services in Australia that require change, but most of these are not necessarily generated by the form of the current market. Rather they are problems that could, and often do, arise in a non-market service system,²⁴ notably (i) insufficient funds from government to fully cater for the number and needs of older people who have been approved to receive government-funded care (ii) chronic staff shortages, a function of both limited funding and the status of care work; and (iii) equity of access for more complex individuals, for providers servicing specific ethnic groups, and for rural areas. There are also many complaints by providers about the tendering process (an inherent feature of a Hybrid system unlike QVL) in terms of transaction costs and uncertainty over precisely why some are picked over others in decisions on tenders, but in large part these could be resolved by changes in administrative procedures rather than changing the funding and market regime. Indeed there appears to be no substantial evidence in the Productivity Commission’s report for either its claim about current incentives or for the recommendation to change to a QVL system, with the justification based essentially on the dictates of conventional economic theory outlined earlier.

24 There is a separate debate as to the extent to which these problems are exacerbated by market-based approaches. That is not the focus here, but to the extent that it is true, it strengthens the case for using a Hybrid system.

On the other hand, despite the above problems, it is widely agreed that virtually all providers selected to receive Package places do provide quality care; that there is substantial innovation occurring both in the way that care is provided and in seeking efficiencies that do not reduce quality; and that there have been limited reports of client abuse in community aged care, even in the unregulated, unsubsidised market segment.²⁵ *That this is the case can be traced back in no small way to the limited form of contestability that exists.*

First, with no price competition in the tender process and quality as the main determinant of success, providers can best get a competitive advantage in the tender by showing how they can achieve genuine efficiencies, through better work organisation and practices, improvements in their inputs (e.g. training of staff), and achieving economies of scale in their support and back office functions. Simply cutting costs that reduce quality will reduce their chances of success in tendering. Thus, contrary to conventional market theory,²⁶ the lack of flexibility in price and output can be a strong incentive for both efficiency and quality improvements.

There is evidence (from the interviews and provider submissions noted above) that the current system has had positive impacts with a number of providers improving the scope and quality of their services (e.g. by improving the training of their staff) in order to win specific tenders or in response to missing out. While the proposed improvements and innovations that a provider includes in each new tender directly relates only to the extra places each year, these service changes are then fed back through the provider's whole operation, including for services that are not subject to current or future challenge.

Second, the practice of allowing providers to retain previous places without re-tendering (subject to continuing good performance as assessed by the funding agency) has been important in maintaining the stability and development of the system. Thus the continued operation of well-

25 These three positive features reflect findings from my own interviews, while there is much supporting evidence for that in the 925 submission made to the PC inquiry (<http://www.pc.gov.au/projects/inquiry/aged-care/submissions>)

26 It should be noted, however, that this is not contrary to the reality of conventional markets, where non-price competition based on quality is not uncommon in many industries.

established providers is not disrupted and they can confidently plan and invest to bed down their continuing improvements.

Third, the scope for sub-contracting of direct care workers has an important positive spill-over effect since FPOs who do this - and most aim to - are expected to meet the service standards required for the Packages. For those concerned about the potential negative effects of profit-maximising, cost-cutting FPOs, this can be seen as an important 'civilising influence' in the industry. Moreover, this potentially enables users to get any provider they wish, but under the control of an organisation that has cleared a higher bar. In these ways, the positive effects of limited competition feed-back through the industry and other market segments.

Thus the community aged care industry is an example of how a Hybrid scheme, with its limits on contestability and consumer choice, may be more effective than the more open competition of a QVL system in generating incentives for providers to increase, or at least maintain, the quality and efficiency of their services.

Conclusion

This article has set out a basic schema for analysing managed markets and identified some of the key considerations in determining which managed market regime to use. Amidst the current widespread support for maximising consumer choice across a number of services, the focus here has been on noting some of the problems with regimes that maximise the number of possible providers from which consumers can choose. In summary, there may be significant gains, in quality, efficiency, and - perhaps counter-intuitively - in consumer control, if government limits the number of organisations that are directly funded to provide services in each market segment. If in fact, the recommendations of the Productivity Commission (2011) for a QVL system in aged care are accepted and implemented by the government, it will be an interesting opportunity for a 'controlled experiment' in the relative effects of Hybrids, QVL, and CTC regimes.

One of the interesting features of the above discussion is the relevance of some of the broad principles from Contestability Theory in seeking to obtain an optimum contestability in managed markets - but with the opposite policy implications. Thus, the thrust of the article is aligned

with the proposition of Contestability Theory about the importance of the conditions of entry for providers relative to regulation of the behaviour of providers in the market. But whereas Baumol and colleagues (Baumol 1982, Baumol *et al* 1982) use this to propose the removal of all barriers, here it is used to show the importance of maintaining strong barriers to entry. Further, Contestability Theory argues that it is not necessary to have many firms in a market in order to obtain the most efficient and socially beneficial outcomes, but rather the potential of a new entrant can achieve these outcomes. In a similar vein, it is argued here that it is not necessary for there to be large numbers of providers to achieve the desired outcomes. But whereas Baumol *et al* see this as providing the platform for less regulation, here it is proposed as a basis for enabling a more effective *managed* market that best aligns with the distinctive features of human services.

It is important to note that this article is not primarily aiming to compare marketised systems against non-market systems, nor to claim that the positive features outlined above in a Hybrid system are superior to what may be achieved in a non-marketised system of service delivery. Rather, it simply aims to show some of the key concerns about marketisation, given the reality of human services, and that, if market mechanisms are to be used, the goals of marketisation as articulated at the beginning may be better achieved by markets forms that limit contestability.

Bob Davidson is a private consultant undertaking PhD research in the Social Policy Research Centre at the University of New South Wales.

danett@ozemail.com.au

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