

# Perspectives on Public Sector Outsourcing: Quasi-markets and Prices

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## Abstract

Public sector outsourcing, in the form of private production of tax-financed services, is on the increase with economic and social consequences for consumers, taxpayers, and employees. The development has given rise to so-called quasi-markets with choice and competition between public, for-profit, and non-profit providers. By introducing the main characteristics of quasi-markets with a focus on prices, this article provides background perspectives. It sets the stage for the other six articles on public sector outsourcing in this special issue of the journal. (JEL codes: D23, H11, H44, L33).

**Key words:** outsourcing, quasi-markets, remuneration, pay for performance, privatization

## 1. Introduction

Can market forces improve public services without endangering equitable outcomes? To what extent are private production, choice, and for-profit firms conducive to political goals in education, care, and social work? Answers to such questions are crucial as western governments increasingly rely on private providers to deliver tax-financed services.

Public sector outsourcing—here in the form of private production of tax-financed services—has economic and social consequences for consumers, taxpayers, and employees. For each service, the effects of outsourcing need to be determined by theoretically grounded and careful empirical work.

The potential benefits of public sector outsourcing include efficient provision, lower costs, consumer choice, and innovation. The potential drawbacks include the risk of low quality due to cost minimization, segregation, and job loss among public sector employees (Poutvaara 2014).

This article gives background perspectives on public sector outsourcing and sets the stage for the articles in this special issue. The perspectives are focused on quasi-markets (Section 2) and the importance of prices (Section 3). Finally, Section 4 describes the need for comparative empirical work, such as can be found in the six other papers in this special issue.

## 2. Quasi-markets

Public sector outsourcing gives rise to so-called quasi-markets for services that are primarily tax-financed. The term quasi-market underscores the difference between markets for tax-financed services and ordinary markets; in particular that a third party—the government—pays for the consumed services. The normative reason for the government to pay is the existence of political goals that would not be fulfilled in an ordinary market. Most democratic governments prioritize equitable access to education and healthcare. Paternalism is also involved; the redistribution of resources is contingent on the consumption of certain services with a ‘public’ component.

Quasi-markets are characterized by a purchaser–provider split. The primary responsibility of the state—or local government—is to collect taxes and purchase the services in question. The purchase can be direct from a provider as in a public procurement or indirect as in a voucher system with user choice. Instead of a bureaucratic allocation process, there is competition between public and private service providers. The private providers may either be for-profit firms or non-profit organizations (Le Grand 1991). Quasi-markets and outsourcing thus imply the (partial) privatization of service production, while the financing remains (mostly) public.

The introduction of private providers may reduce costs and increase quality under competitive pressure. Disregarding political goals, private production is, in general, more efficient than public sector production (Sheshinski and López-Calva 2003; Megginson 2005). Moreover, users are more likely to find a service that suits their preferences when they have a choice between various providers. As argued by Lewis (2017), private providers will also be more informed about and responsive to users compared with traditional, more rigid, public sector production. Since people are driven by different motivations, having different providers also improves the matching of employers and employees.<sup>1</sup> Many employees will be reluctant to put in extra effort if they suspect that it will primarily result in higher profits (Glaeser and Shleifer 2001). Not-for-profit providers are more attractive to employees with a strong pro-social motivation and will be able to extract more effort from them than a for-profit firm would.<sup>2</sup> In markets where there is only room for one provider—which is the case in many small municipalities—one should avoid purchasing the services from a for-profit monopoly (Besley and Malcomson 2018).

On the other hand, private providers have different goals than public ones, including profit maximization and heterogeneous social goals. Therefore, it is only to be expected that the quasi-market outcomes will deviate towards private goals, away from political priorities. Depending on the remuneration of services, for-profit firms may deliver substandard quality to boost profits (more on this in Section 3). Other political goals, not least related to segregation and aspects of equity, also risk being neglected by private providers. The more weight placed on such goals, the less attractive are quasi-markets relative to pure public sector provision.

1 Gregg et al. (2011) show that workers in non-profit organizations do more unpaid overtime compared with employees in comparable for-profit firms. They also find that people do not change their amount of unpaid overtime when switching between non-profit and for-profit employers, implying that people sort themselves into the non-profit and for-profit sectors depending on their inner motivation.

2 See Francois and Vlassopoulos (2008) for different forms of pro-social motivation and their consequences.

The ideal stylized quasi-market should promote competition by providing a level playing field for private and public providers. For two reasons, the ideal has been difficult to achieve. First, the public sector has system-level responsibilities that blur the purchaser-provider distinction. While transaction costs are—at least in theory—easily separated from production costs, the need to guarantee service provision for everyone eligible is a different matter. As the provider of last resort, the public sector must be able to handle delivery problems in the private sector. The risk of market exit by private providers calls for contingency plans and motivates excess capacity. Second, the public sector faces a conflict of interest when its purchasing arm does business with its provider arm. The public purchaser has a lot of opportunities to tilt the playing field in favour of public providers and against their private competitors. A common critique has been that public providers are consistently allowed to have costs that exceed the payments to their private competitors. In this regard, there are reports of widespread loss-making among public providers of healthcare and eldercare in Swedish regions and municipalities ([The Swedish Competition Authority 2012, 2013](#)). This ‘soft budget constraint’ is a fundamental difference between the public and the private sector ([Kornai 1986](#)).

Ultimately, the performance of a quasi-market system and its private providers must be evaluated empirically. [Le Grand \(2007\)](#) gives five essential attributes that public services should be evaluated against: quality, efficiency, responsiveness to users, accountability to taxpayers, and equitable delivery. Along these lines, the articles in this special issue provide new pieces of evidence on the consequences of public sector outsourcing.

### 3. The Importance of Prices

The outcomes of public sector outsourcing depend on the contractual terms, of which prices are fundamentally important. Since prices cannot capture all desired aspects of complex services such as education or healthcare (the services are not perfectly contractible), there is great risk of committing ‘the folly of rewarding A, while hoping for B’ (as expressed by [Kerr, 1975](#)).

In all kinds of outsourcing, the contract can either be of the type ‘fixed-price’ or of the type ‘cost-plus’ (reimbursement for costs plus a mark-up). A fixed-price contract has the disadvantage of giving the provider incentives to shirk on quality if quality cannot be verified. A cost-plus contract instead provides every reason to deliver as high quality as possible and will, therefore, result in quality levels that are more expensive than their value for the buyer. The fundamental difference between the two main types of contracts is the same for public and private providers, although for-profit providers can be expected to react more strongly to pricing differences that affect their bottom line.

Among tax-financed services, fixed price is the more common contract. Cost-plus is used mostly in healthcare, together with fixed price for treatments, such as payment for treating someone from a diagnosis-related group, or for assuming responsibility for a person’s health (capitation). A fixed price for treatment, or fee-for-service, gives incentives to provide more treatments, whereas capitation gives incentives to provide less. In addition, there are pay-for-performance schemes that reward providers for meeting outcome or process targets and penalize them for undesirable outcomes such as medical errors. Healthcare stands out in that several remuneration models are often combined. Arguably, the scope and complexity of healthcare call for a composite remuneration model. As an example, problems of antibiotics subscription have been successfully handled by introducing pay-for-

performance components to the remuneration of Swedish primary care centres (Ellegård et al. 2018).

Another fundamental aspect of quasi-market prices is that consumers typically pay parts of them. While some services, such as healthcare within the British NHS, are ‘free at the point of use’, user fees are more common. User fees contribute to the financing of public services, give rise to redistribution and insurance, and introduce monetary incentives that provide signals of demand.

As mentioned, fixed-price contracts give incentives to reduce quality to cut costs. Depending on the costs and valuation of quality, we might get the undesirable practice of ‘quality shading’, especially in the absence of counteracting user choice. Formally, the problem is analysed by Hart et al. (1997). In their model, private for-profit production is preferable to public production when the value of cost reductions and quality-enhancing innovations are large relative to the adverse quality effects of reducing costs. Building on the model, Shleifer (1998, 139) lists ‘a rather narrow set of circumstances in which government production is likely to be superior’, i.e. situations in which all the following conditions apply:

1. Opportunities for cost reductions that lead to non-contractible deterioration of quality are significant.
2. Innovation is relatively unimportant.
3. Competition is weak, and consumer choice is ineffective.
4. Reputational mechanisms are also weak.

Two remarks on the list are in order. First, the importance of innovation is reduced under fixed-price contracting. With fixed prices, a provider cannot develop better services and charge a premium for them. Moreover, since the public sector is a large and powerful customer, price increases run the risk of disappearing after renegotiation. Second, reputational mechanisms require excess capacity to work. A shortage of beds in hospitals or nursing homes imply that providers will not lose much of their business if they deliver substandard quality (Bergman and Jordahl 2014; Bergman 2019). On the one hand, excess capacity drives up average costs, but on the other, it promotes service quality through mechanisms of competition, reputation, and choice.

Prices will also affect incentives for cream-skimming—the screening and selection of users to serve only the profitable ones. Fears of cream-skimming are pervasive in education, but the systematic evidence and consequences are less clear. Chile introduced a national voucher system in 1981, after which high achieving students were more likely to choose a private school (Hsieh and Urquiola 2006). In Sweden, which introduced a national voucher system in 1992, cream-skimming should be more difficult to carry out since compulsory schools are neither allowed to charge tuition fees nor select students on ability. While school choice has contributed to student segregation (Brandén and Bygren 2018), the location pattern of Sweden’s independent schools has if anything reversed segregation (Böhlmark et al. 2016).<sup>3</sup> New independent schools tend to locate in areas where a large share of parents are immigrants and have high education. Sweden’s unique tax-funded for-profit schools have not sought out municipalities with higher voucher revenues or lower renting costs (Angelov and Edmark 2016).

3 Also in England, school choice has increased segregation (Allen 2007).

A study by Altonji et al. (2015) on US schools decomposed the total ‘cream-skimming effect’ into three parts: the student heterogeneity within schools, the school choice take-up rate of strong students relative to weak students, and the strength of the peer effect. They found a small cream-skimming effect on the performance of students remaining in public schools. The size of the effect was smaller than the effects of competitive pressures and resources.

It should be clear that the prices of tax-financed services affect various quasi-market outcomes. Compared with the privatization of service production and the expansion of user choice, remuneration has received less attention in the literature. This is unfortunate since studies focusing on remuneration are needed to understand the effects of choice and privatization and for the public purchaser to determine appropriate prices.

#### 4. The Need for Comparative Empirical Studies

The six papers in this special issue illustrate that the pros and cons of public sector outsourcing should be evaluated on empirical grounds. When most arguments receive some support from theory, empirical studies are needed to identify the dominating effects. It would be unsatisfactory to claim that private providers will always underperform in unmeasured quality dimensions. The difficulty of measuring service quality in education and health care should not be taken to imply that quasi-market outcomes should be compared with theoretical ideals to arrive at policy conclusions. Neither the ideal of a benevolent and omnipotent government nor that of a free market with perfect competition provides much guidance to actual policymaking.

What is needed is comparative analyses of actual outcomes under different policy regimes. The six papers in this special issue provide such analysis by focusing on contracting problems, the profit motive and competition in health care, the effectiveness of private and public schools, differences between public procurement and laissez-faire in waste collection, and the effects of public sector outsourcing on public employment.

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