

Competition and decentralisation in government bureaucracies

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Abstract

Recent reforms to the provision of welfare services by the public sector have transferred control rights in production from politicians to managers and simultaneously introduced competition between public sector suppliers. We derive conditions under which a self-interested politician will introduce either competition and/or managerial control for services where quality matters. We show that both competition and managerial control give incentives for greater managerial effort. However the cost of competition is higher taxes and the cost of decentralisation is a loss of political benefits. The politician will introduce these reforms if the political benefits from higher value service outweigh these costs.

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1. Introduction

Privatisation is not the only way governments have sought to increase the efficiency of the public sector. Politicians have also attempted reform within government, particularly of state-provided welfare services such as health care, housing and education. One model is the creation of a separate agency within government whose sole task is to administrate a single, clearly defined program. A more radical option, recently pursued by several governments, is the devolution of decision making to local level coupled with the creation of competing provider organisations *within* the public sector.

Analysis of reforms that allow competition *within* the state sector is of considerable interest. This type of reform has been widely adopted in the UK welfare state, where it known as ‘quasi-market’ reform (Le Grand, 1991), and it is not uncommon in the US, where it is referred to as an ‘internal market’ and is a model that has received considerable interest from other governments who both engage in the provision and funding of welfare services. Examples in UK include the quasi-market reforms in health care, education, social services, and social rented housing. Examples elsewhere are primarily reform of the provision of health care. These quasi-market reforms combine tax finance of (and in many cases, universal entitlement to) a service with competition between publicly financed suppliers.

Privatisation can be defined as a combination of the reallocation of control rights from politicians to managers (corporatisation) and an increase in cash-flow ownership of managers and private investors (Boycko et al., 1996; Shleifer and Vishny, 1994). Privatised enterprises may operate in markets with or without competition. The reforms of publicly provided welfare services such as health care and education can be similarly classified according to whether

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control rights are transferred from politicians to managers, whether there is change of ownership of cash flows, and whether there is competition in supply. In the cases of an agency or competition between suppliers who are within the public sector, managers are given greater control rights but ownership of cash flows remains with the government. These reforms are therefore the equivalent of corporatisation. The two cases differ in that in the latter multiple agencies are created to fulfill the task and are intended to compete with each other. Where government privatises the services (for example, in the case of prisons in some US states and in the UK) there is change in ownership of cash flows on top of transfer of control rights to managers and competition (either for the contract or in supply).

This paper analyses the conditions under which a self-interested politician would introduce competition within suppliers located in the public sector (i.e. would introduce quasi-market reforms). We separate the dimensions of control rights and competition in supply. Control rights may be given to managers or retained by politicians. Competition may or may not be introduced. We assume universal entitlement and focus on the impact of such reforms on the quality of the service.

We assume competition on the supply side is characterised by small numbers, reflecting the local nature of public services. We determine which form of production a self-interested politician would choose using an incomplete contracting approach. The politician designs the organisation of public services to maximise his own utility. He derives a political benefit from high-value service since voters like it, but has to raise taxes to pay for it, which voters do not like. We assume the manager derives private benefits from service production, but these are lower when she does not have control rights.

We show that the politician can use the instruments of managerial control and competition to elicit greater managerial effort and, hence, higher quality of public services. However, managerial control and higher quality come at a cost: the first brings a loss of political benefits, the second higher tax revenues. The politician will choose competition when he derives benefit from a high-value service and when cost of raising taxes is not too high. He will delegate control rights if the effort level that can be implemented under managerial control is sufficiently greater than under politician control, outweighing the loss of political benefit to him of being fully in charge of the service. In the choice of organisational form, there is a trade-off between popularity of the service being provided and the relative private benefit that the manager and politician get respectively from being seen as associated with the service. Our analysis also shows that delegation is not always optimal when the supplier gets more private benefit from service provision, and competition may be introduced even when managers have strong private incentives to supply high quality services.

Our paper follows the literature on privatisation by focusing on the issues of control rights and competition. Boycko et al., 1996, Hart et al., 1997, and Shleifer and Vishny, 1994 have used an incomplete contracting approach to analyse privatisation, and it has been suggested that this would be a fruitful way to look at government organisation (Tirole, 1994). We allow for an explicit role for the politician in choosing the form that service delivery should take. Recent literature on public services has examined the role of agent motivation (e.g. Besley and Ghatak, 2005; Francois, 2000) and in keeping with this literature we assume that both service providers and politicians get non-monetary benefits from service provision.

The organisation of this paper is as follows. In Section 2 we present the institutional details of one particular set of quasi-market reforms: those in the UK. In Section 3 we present the model. In Section 4 we analyse the various organisational forms. Section 5 examines the forces determining the optimal organisation. Section 6 examines the sensitivity of the results to a change in key parameters. The final section discusses the applicability of the model.

2. The institutional details: the UK quasi-market reforms

Prior to the late 1980s the in-kind benefits, health care, education, social services and social rented housing, of the UK (and other European welfare states) were funded through taxation and delivered by service providers who were part of either a central or a local government department. Each service provider was responsible for all services delivered in a local region. Service users had little choice of provider. Standards for provision (mainly in terms of inputs) were determined by the central government ministry responsible for provision of the service (sometimes with some local political control).

Such arrangements were criticised for being unresponsive to users, and inefficient and different models of service delivery were sought. One model was to contract out services completely to private providers (Szymanski and Bello, 1996). Another was to introduce competition on the supply side within the public sector whilst maintaining tax finance.

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