For-profit organisations in managed markets for human services

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The provision of human services, including paid care, relies substantially on government funding. Increasingly over the last 25 years, in Australia and elsewhere, that funding has been distributed using ‘competitive’ market mechanisms. The result has been a widespread development of managed markets, also known as ‘quasi-markets’, in human services. There are many variants of managed markets, but they are all distinguished from conventional markets1 primarily by the fact that government is the source of much, if not all, of the purchasing power of the users of services. This enables government to dictate how these markets operate in ways that go well beyond the powers of government in most conventional markets. In turn, government action in shaping the particular form of each managed market will substantially influence the types of service provider organisations that operate in that market, including the extent to which for-profit organisations (FPOs) are present.

This chapter reviews some key characteristics of human services, managed markets, and FPOs, as a basis for examining the type of service providers that should and do operate in these markets, particularly in terms of the growing role of FPOs. This analysis can assist in establishing whether there may be justification for limiting or encouraging the participation of some types of providers in these markets.

1 We use the term ‘conventional markets’ to refer to markets where there is no or minimal government funds to purchase the product; that is, the type of market assumed in standard economic theory.
markets—and if so, under what circumstances and on what terms. There are, of course, more fundamental concerns about the validity of marketising human services, but the chapter assumes that, in the foreseeable future, governments will continue to use managed markets to support the provision of these services. Thus the focus is on how these markets work and how they might be made to work to maximise the achievement of social objectives, rather than examining the broader concerns.

The chapter draws on developments from a range of services and market types. Its findings should be regarded as an attempt to identify general trends and issues that then need to be tested in sector-specific or cross-sector studies, rather than as a claim to lay down a theory or prescription that fits all situations. Two key points emerge from the chapter. First is the importance of ensuring that the initial entry of all service providers is closely monitored given the inherent tension between profit maximisation and service quality, coupled with the lack of perfect information for service users and their agents in these markets. Second is the blurring of the boundaries between non-profit organisations (NPOs) and FPOs in these markets, such that we need to go beyond this simple dichotomy to establish which types of organisation can best provide services in each situation.

Human services

Zins (2001, pp. 6–7) defines human services as ‘institutionalised systematic services’ aimed at ‘meeting human needs ... required for maintaining or promoting the overall quality of life’ of service users. While this covers a diverse range of fields and programs, including education, health, child care, residential and at-home care for the aged, disability, family support, early intervention, homelessness, and job search assistance for the disadvantaged, most share common features that can make their provision via a ‘market’ somewhat problematic. That said, it is important not to overstate the distinct features of human services and to recognise that some of these
features have traditionally been ascribed to all services, including services provided through conventional markets.

Economic analysts (for example, Productivity Commission 2002a; Miles & Boden 2000; Miles 1995; Bureau of Industry Economics 1980; Akehurst & Gadrey 1987; Baumol 1967) have identified that services are more likely to have the following core characteristics:

(i) **Simultaneity of production and consumption**, as shown, for example, in the way that the assistance given by a carer in bathing an aged person is ‘consumed’ at the same time it is ‘produced’.

(ii) **Intangibility**, in that ‘the output tends to disappear at the point of delivery, leaving no lasting physical manifestation’ (Saunders 1999, p. 40).

(iii) **The central importance of labour in production**, so that, for example, the capacity of each individual carer largely determines the quality of care provided.

(iv) **The consumer as an active agent in determining the final product**, as shown by the way a teacher adapts a lesson to suit the individual students in a class.

In turn, these factors mean that with services there is more likely to be:

(v) **Heterogeneity in a given ‘product’**, such that there is variation both between different suppliers and by a single supplier over time. For example each doctor’s consultation, carer’s act of bathing an aged person, and lesson by a teacher will be distinct in some way.

(vi) **Limits to improving labour productivity**, in that there is limited scope to reduce the amount of labour needed for a given level of output.

(vii) **Complexities with measurement** of output, quality, and productivity.

(viii) **Asymmetry of information** whereby one player or set of players
in a market, usually the suppliers, has more information about the production process and the final product.

(ix) Buyer uncertainty about the product before purchase, given that there is likely to be nothing tangible to inspect before buying.

Early economists regarded labour used in services as ‘unproductive’ (Smith 1991, pp. 294–96), and thus the foundations of modern micro-economics were largely developed on the basis of the production and distribution of goods, and in denial of the characteristics and economic value of services based on labour (Tucker 1977, pp. 13–16; Channon 1978, p. 1). Hence, the gap between the standard core assumptions of micro-economic theory, such as homogenous products and full information for all buyers and sellers, and the complexity of economic reality is even more pronounced in relation to services. While developments in computerised technology and integrated systems over the last 25 years have transformed some service industries, including communications and retail (Triplett & Bosworth 2003), the distinct characteristics set out above all remain very relevant—and accentuated—in human services where the ‘product’ being supplied is largely dependent on the quality of the human interaction. Nowhere is this clearer than in the care sectors, and England and Folbre (2003), Fine (2007), and Himmelweit (2007) provide an insight into the special features of caring and paid care that illustrate a number of the points made in this section.

We now consider what factors distinguish human services from other services, especially in terms of why greater government intervention is necessary. First, because human services aim to meet basic develop-

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2 Of course, subsequent developments in mainstream economics (from Coase (1937) onwards) have recognised these issues. However, the use of the term ‘cost disease’ to describe Baumol’s argument that the inherent nature of services limits productivity improvements illustrates a common view among economists that labour-intensive services are aberrant problems rather than simply different forms of economic activity. It must be noted, however, that Baumol himself actually said that many of these services are ones ‘that do so much to enrich our existence’ (Baumol 1967, p. 422).
opment and care needs of people, there are strong moral and public policy imperatives to ensure at least some minimum level of service for everyone and to avoid poor service to anyone. A wide range of quality from Armani to Target may be acceptable in consumer items, but not in human services. Second, the effective delivery of human services is more likely to require an extended set of individual service transactions over time. This has major cost implications for each user, while also making it more difficult to assess the quality and outcomes of a service, especially in the shorter term. Third, on the demand side, the end users of human services generally have vulnerability or limited capacity in some respect and thus agents who make decisions on behalf of users are an important feature of human services. Agents may be family members, personal associates, government agencies, or paid brokers. For example, parents make decisions about child care for their children, and adult children may make decisions about aged care for their parents. Importantly, however, agents are rarely able to observe the service being provided. Fourth, many of the end users of human services, and their family agents, have limited, if any, funds to buy the services they need.

Having identified core differences between services and goods, and then between human services and other services, our next step is to identify the main sources of difference between various types of human services. Propper (1993, p. 40), writing about health and social care services, noted that those services differ in ‘the technology of production, the nature of demand, and the information of actors in these industries’, and this observation can be applied more generally across all human services. Thus, for example, residential aged care differs from at-home community care for the aged because it requires substantially more capital and buildings, because it has to provide service for longer periods each day and for less able users, and because buyers of residential care are less likely to have information about the full production process.

The above analysis has implications for the way in which human services are provided and the organisations—and types of organi-
sations—that become service providers in each market. First, given that many services are largely unobserved by buyers—who are buying on behalf of others—and the quality and outcomes are difficult to measure, there is much potential for opportunistic behaviour both through adverse selection and moral hazard.\(^3\) Hence there is a greater need for trust between the buyer (service user or agent) and seller (service provider), with the motivation, values and commitment to client needs of the provider being critically important.

Second, to the extent that trust is lacking, there will be transaction costs for all parties, both *ex ante* (prior to approval of a provider) and *ex post* (monitoring and assessing the services)—and these costs can be large. Indeed, Williamson (1975; 1998; 2000), a seminal writer in the field of contracting, points out that the limits on an individual’s capacity to gather and process all relevant information, which economists called ‘bounded rationality’, make it impossible to specify all the contingencies that may arise in the future, and hence ‘all complex contracts are unavoidably incomplete’ (Williamson 2000, p. 599).

Third, because *people* are central to the production and delivery of human services, a provider is limited in the extent to which it can genuinely increase measured productivity (Baumol 1967; Himmelweit 2007). The quality of a service is critically dependent on the personal and professional skills of staff and the relationships they develop with users, and thus significantly reducing the number or quality of staff or the time they spend with clients can fundamentally alter the nature of the service that is provided. Larger organisations have been able to effect economies of scale and scope in human services, but these often arise from strategies in management, marketing, and ‘back-office’ functions rather than enhancing the direct production of the service.

Fourth, there are limits to standardisation of a service, since too

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\(^3\) *Adverse selection* is where the buyer makes a wrong choice because the provider does not reveal everything about itself. *Moral hazard* is where the provider puts in less resources and produces lower quality products than has been agreed.
close a specification of processes and outputs may reduce the quality of service for each user by ignoring his/her individuality. Fifth, it is likely that the ‘provider profile’, that is, the mix of different types of provider organisations, will vary between different human services.

An important implication of the above analysis is the inherent tension between commercial imperatives and the quality of human services, especially in relation to staff. A common lesson from studies of specific human services is that the major drivers of quality are lower user-staff ratios (variously described as case load, class size, et cetera), higher staff qualifications, an overall staff profile that has a high proportion of people who have significant qualifications and experience, and adequate remuneration to ensure the attraction and retention of good staff. However, these are precisely the major cost drivers for human service providers, for whom staff can represent over 80 per cent of total costs in some sectors. Thus there will be continuing pressure to control these staff costs (Wade 2007). FPOs will rightly argue that they will lose ‘customers’ or their contract if quality is perceived to fall, but a fine balance between limiting costs and an acceptable level of quality can be maintained, especially where information to customers can be restricted and marketing techniques used to shape customer expectations (Press & Woodrow 2005, pp. 282–83). This does not mean that there is no role for FPOs and the profit motive, but it does suggest that profit maximisation does not sit easily with ensuring high quality services.

**Managed markets**

Managed markets are distinguished from most other forms of public funding because they require external bodies that provide direct services for the public to directly compete against each other to obtain the funds. Managed markets are distinguished from conventional markets primarily because government provides much of the purchasing power for users.
From an economic perspective, government involvement is necessary in human services because of the prevalence of market failure—the ‘provision by a competitive market of an output quantity which is not socially optimal’ (Maddala & Miller 1989, p. 619)—or, more precisely in some cases, because no market has formed given the limited finances of the people who need the services. It is thus somewhat ironic that market mechanisms are now being used to fund services in sectors where historically the market has not worked.

The concept of contestability is central to the establishment and operation of managed markets. Formally, contestability is about the ease of entry into and exit from a market. In a perfectly contestable market, entry and exit are ‘costless’, in the sense that there are no additional costs for new entrants or ‘departees’ above the normal costs of establishing and operating the enterprise (Baumol 1982; Baumol et al. 1982). The core premise of contestability is that by making service providers subject to merely the threat of competition (and thus to the threat of loss of revenue), the overall quality and efficiency of all providers will be improved, both by attracting new providers and by driving improved performance by incumbents. Whether this logic is valid for managed markets in human services and whether it varies by the type of service, the form of the market or the type of provider are empirical questions to be answered in each situation.

Managed markets as a means of distributing government funds are not unique to human services nor are they a recent innovation (for example, tendering for public infrastructure has long been used). Further, governments can and do shape all markets, through policy statements, through general laws on corporations, competition, taxation and fair trading, and through the regulation of specific industries. However, because it provides a high proportion of the ‘consumer purchasing power’ in managed markets, government has greater power to shape these markets.

Bartlett and Le Grand (1993, pp. 13–19) identify the core objectives that governments have in establishing managed markets in social
policy, namely to promote greater effectiveness, efficiency, choice, responsiveness to client needs, and equity.\textsuperscript{4} There will be trade-offs in achieving these objectives; for example, increasing choice can mean a loss of efficiency. Bartlett and Le Grand (1993, pp. 19–34) also identify five key prerequisites of managed markets if these objectives are to be achieved: some level of competition between providers; appropriate motivations and incentives for both buyer (whose focus should be the welfare of the users) and provider (who should in part be motivated by financial considerations so that they respond to market signals); symmetry in the information available to buyers and providers; minimal transaction costs; and avoidance of ‘creaming’.\textsuperscript{5}

In a managed market, government can substantially dictate the way that the market functions, by making decisions about key features of the four core elements of a market:

(i) \textit{Product}: What is the service to be funded? What aspects of the service will be funded?

(ii) \textit{Buyer (users or agents)}: Who is eligible to use the subsidised product? How much is the subsidy? Do some users get a higher subsidy than others? Is any additional payment by the buyer required or possible? Can the subsidy cover all costs or is an additional co-payment by the buyer required or possible? Are there limits on the total dollars (or places) available to the whole population?

(iii) \textit{Sellers, or service providers}: Who can sell to those buyers supported by government funds? On what basis do they have to operate? What, if any, minimum standards are mandated for

\textsuperscript{4} Bartlett and Le Grand (1993) only list four objectives, conflating effectiveness and efficiency into efficiency.

\textsuperscript{5} ‘Creaming’ involves limiting services to ‘less difficult’ clients rather than assisting those with more complex needs who require more resources and represent a greater operational risk. The term ‘residualisation’ is also used to describe this process (Press & Woodrow 2005, p. 284).
providers to enable entry to the market? What mechanism determines who can service clients: tender or licensing? How often is the market ‘opened’ to new providers and is it open periodically or continuously? Is the right to operate tradeable? What performance targets and requirements are in place, and how are performance standards monitored and enforced?

(iv) Means of exchange: How do buyers and sellers interact? How do providers obtain individual clients? What is the basis of payment of the government funds: inputs, outputs, or outcomes, and how are these measured? Are payments made to providers or to users? What method of payment does the government use?

In an unregulated conventional market, most of these factors are irrelevant or not directly the business of government, with buyers and sellers subject only to general laws. Even in a regulated conventional market, government action in any single market will usually be limited to only some aspects of the four elements. In a managed market, however, government may have at least five distinct roles: policy-maker, regulator, banker, direct buyer, and service provider. Different agencies or even jurisdictions may take on each of these five roles in a specific market, but it is not uncommon for all roles to be administered from within the same agency.

**Forms of managed markets**

There are many potential variants of managed markets, each emerging as the outcome of government decisions on the factors listed above in specific cases. Governments, however, do not necessarily make explicit decisions about all of these factors. Indeed, in some cases, the ad hoc and implicit nature of some ‘decisions’ can mean that some elements of a program are inconsistent with other elements, or even with the overall objectives of the program. Further, ‘In practice, the way a service is delivered … may be more a product of
political dogma than of an assessment of relative efficiency or equity’ (Burchardt 1997, p. 5).

Three major forms of managed markets using non-government providers, both FPO and NPO, can be identified:

- **Competitive tendering and contracting (CTC):** A government agency chooses who will be the service provider(s) for a designated group of users.

- **Licence-subsidy (LS):** Entry is possible for any provider who meets a set of minimum requirements and standards (*licence*). Licensed providers then ‘compete for customers’ with the government substantially meeting much, possibly all, the costs of service for approved users (*subsidy*). Subsidies may be paid either to users or providers. If paid to users, they may be paid by cash, ‘vouchers’, tax deductions or tax credits.

- **Hybrids of CTC and LS models:** A limited number of providers are chosen via a CTC process, and then these providers ‘compete for customers’, with various possible limitations placed on the buyer-seller interaction and/or the use of mechanisms that ensure a minimum level of activity for all providers.

There are two main advantages of using CTC instead of a LS system. First, CTC better facilitates the planning of limited resources to ensure coverage of all areas and groups, greater stability in the overall supply of services, and greater stability for individual providers (which in turn can promote more investment in resources to improve the quality of services). Second, CTC allows closer monitoring of the quality of services. Against this, CTC is a costly and time-consuming process for both government and providers, offers little opportunity for users to select or have a choice of providers, and gives only limited signals from users as to which organisations provide the best service. Users generally have no exit option and very limited voice options to influence how a service operates (Hirschmann 1970). Thus LS is likely to be used where there is a desire to increase market signals, consumer sovereignty, choice, and provider responsiveness,
and to reduce administration costs. In practice, however, there is much variation in LS systems between service types, regions, and individual providers in the extent to which users can actually influence the form and operation of the service they receive (Press & Woodrow 2005, pp. 281–82).

Hybrid systems have emerged in response to the disadvantages of CTC. They aim to draw on the best aspects of both systems by limiting providers to the best ones, ensuring better planning of limited resources, and giving a greater guarantee of quality, while giving users some greater choice and generating market signals. The major disadvantage of the hybrids is that they retain the complexities and costs of the CTC process.

One argument for the introduction of managed markets has been that they will give users more information and make the allocation of public funding more transparent. But in practice, under all three forms, the notion of ‘commercial-in-confidence’ has often been used to restrict the information available to users.

For both the users and providers of services, LS markets operate more like a conventional market, although governments still make most of the critical decisions about the features of a market listed above. There is no clear-cut boundary between a LS managed market and a conventional market, but even where a high proportion of the providers’ revenue comes from user contributions, government licensing and funding can still drive the involvement and operation of major providers in the market.6 LS systems are also referred to as ‘quasi-vouchers’ (Lyons 2001, p. 186), ‘demand-side subsidies’, or ‘consumer-directed payments’, but it is important to use a term that also acknowledges the critical supply-side licensing element, which limits the organisations to which service users can present their ‘subsidies’ and requires providers to comply with regulations that are continuously monitored and enforced.

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6 For example, the corporate FPO, ABC Learning Centres, stated that a key element of its ‘successful child care model’ is to ‘maximise government funding [to] underwrite income sources’ (ABC Learning Centres 2005).
Under a LS system, any organisation that meets the minimum licensing requirements can provide services that attract government funds, whereas under CTC an organisation may meet the minimum service standards required of all tenderers, but still not be able to service approved users if it is not selected in the tender process. Under CTC, the competition between providers is to gain *entry* to the market and the user typically has no direct say about who the providers will be. Under LS, the competition between providers is to *attract consumers*. In other words, under CTC providers compete *for* markets, while under LS they compete *within* markets. Both forms of competition exist under hybrid systems. Under both CTC and hybrids, generally no new provider can enter in the shorter term to respond to emerging client needs. Two observed effects in some CTC markets (for example, the Job Network)\(^7\) are that after an influx of new providers with the initial introduction of contestability, the market becomes more closed over time with fewer providers and the larger ones increasingly dominant.

The type of managed market used has no necessary connection, theoretically or empirically, with the type of service. A given service may be supported by any of the managed market variants, depending on the jurisdiction. For example, the use of various LS systems to support ‘consumer-directed’ at-home personal care for aged people has been widespread in western nations for some years (Evers et al. 1994; Keigher 1999; Ungerson & Yeandle 2007), but this approach has had limited use in Australia where CTC continues to be primarily used. On the other hand, LS systems have been supported by proponents of markets in Australia for the last quarter of a century and are used for child care and residential aged care, while there is currently strong support from some users for voucher-type systems for disability programs (Hughes 2006). The Productivity Commission (2002b, pp. 11.1–11.6) has also argued for the introduction of

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\(^7\) This national program was established in 1998 to replace a service system formerly provided by the government’s Commonwealth Employment Service (CES).
a licence system for the Job Network; in response, van Dyke (2002) argues that this would lead to wasted resources in marketing and more providers than are needed or efficient.

In practice, CTC is used more for services that focus on a limited group of disadvantaged people, while LS systems are used for more universal services. The larger the target group, the greater the pressure for a more decentralised approach, while universality is more likely to involve more informed and affluent users who want greater choice. Services may begin as a grant or CTC system and evolve to a hybrid or LS system, as has happened with the Job Network and child care in Australia. Once the Rubicon is crossed to a LS system for any service, history shows that such a change can lead to a major shift in the profile and behaviour of providers, including the increased presence of FPOs.

For-profit organisations

Historically, human services have largely been provided by government or by non-profit organisations (NPOs) motivated primarily by social and altruistic objectives seeking to fill gaps in service systems. With the growth of managed markets, however, there has been increasing involvement of FPOs in human services. In Australia, this change has been particularly evident in fields such as child care, at-home community care, and job search assistance for the disadvantaged unemployed.

There is diversity among the FPOs involved in human services. At one level, there is diversity of legal structure and size, with public companies (that is, those traded on the stock exchange), transnational companies (both Australian- and overseas-based), large private equity firms, other incorporated firms with single owners or multiple shareholders, and unincorporated sole traders all now having a presence in one or more of the various services types. All of these forms are present in the at-home community care sector in Australia.

More importantly, there is also diversity in motivation and objectives.
A core assumption of micro-economic theory and most models of the behaviour of the firm is that FPOs are organised around maximising profit or the personal benefits of the people who own or manage the organisation. However, this can paint an overly simplistic picture, even for conventional markets. Some firms become involved in activities with altruistic or broader social aims as strategies to increase benefits in the long-term. Fligstein’s sociological analysis of markets (2001) assumes that suppliers fundamentally want stability in the market as the basis for ensuring their continuing prosperity. Other FPOs have owners or managers who aim for some threshold of financial surplus but are then prepared to forsake extra profit in order to increase the social contribution of what they produce.

Marceau (1990) also identified a group in mainstream business (in manufacturing) that she described as the ‘dwarves of capitalism’. These are people who own small operations, including many whose core objective is to be independent rather than wealthy. The ‘dwarves of capitalism’ have a very strong presence in human services, and include people who have left employment with large NPOs or government because of their concern about the constraints of the bureaucratic and increasingly commercial culture in these organisations. Further, in an age of outsourcing, FPOs (including self-employment) ‘may offer the only alternative to professionals seeking to continue to practice their face-to-face-support skills’ (Taylor & Hoggett 1994, p. 191). Some of these ‘dwarves’ represent a distinct and positive feature of FPOs, enabling experienced and capable people to provide services in ways, often very innovative, that focus on social and human objectives rather than organisational and commercial imperatives. While many very effective operators prefer to remain small, a number of major enterprises in human services that operate at national and international level began as ‘dwarves’.

Thus one needs to be cautious in generalising about FPOs that provide human services, as Rush (2006) showed in distinguishing between large corporates and small FPOs in the quality of child care each provides. Nor is there a straightforward association between motivation
and size—large FPOs may be more likely to be focused on profitability, but large FPOs can also have objectives other than to maximise profits (Martin et al. 1998) and small FPOs can have owners who see them as cash cows and the first step to a commercial empire.

This chapter is not seeking to systematically assess the advantages and disadvantages of FPOs, and whether they do in fact achieve greater efficiency, innovation, choice, responsiveness, and better outcomes as proponents claim (for which, see Meagher & Cortis 2009). The evidence on this is mixed and varies with each case. However, some situations highlight the intrinsic potential for a clash of interests between clients and profit-maximising FPOs in human services. First, the board and management of public companies are required by law to ensure that the interests of shareholders are pre-eminent (Bakan 2004). Second, with regard to license-subsidy systems, basic micro-economic theory shows that part of any subsidy for consumers is likely to be captured by suppliers in the form of a price increase (albeit generally less than the subsidy).8 This has occurred with child care in Australia (Hill 2007), but such price increases are avoidable in the absence of increased costs, and simply represent the capacity of a profit-maximiser to take advantage of an increase in demand.

For-profit organisations in managed markets for human services

In this section, we consider the economic and other factors that determine the entry and the potential market power of FPOs in managed markets for human services.

Incentives for entry

FPOs can have a range of motivations, but the major incentive for many to enter any sector is the potential level of profitability.

8 This assumes no increase in supply, while the proportion captured by suppliers depends largely on the elasticities of demand and supply for the product.
In managed markets this is substantially affected by government decisions about the design of the managed market.

On the revenue side, a major driver is the *scale of the market*, which will be largely determined by policy and budgetary decisions about the universality of the service, the number of places available, and the size of the subsidy. FPOs will also be more present where there is the *scope to build market share*, which, in turn, depends on three design features of a managed market. First, there needs to be scope to attract more ‘customers’, as is possible under hybrid and LS systems. Second, licences and contracts need to be tradeable, for example through the sale of a licence or by a takeover. Third, the level of revenue in a managed market will be affected by whether providers are allowed to charge a co-payment if the subsidy does not meet the full cost of the service, or users want more or higher quality service. For some human services, the contribution by clients is negligible, for example, in programs for homeless people. But for others, such as child care and residential aged care, there can be substantial scope for an additional payment, particularly where the users/agents are more affluent and/or can draw on other sources of government support, such as family allowances or the aged pension.

Two factors that impact on profitability will vary with each case depending on the decisions by government about the structure of payments. First, higher need clients involve higher costs and risk for providers and usually attract higher payments. Where the payments are relatively high, this is an important niche for some FPOs; in other sectors, providers do not consider the extra payment justifies the extra costs or risk, and ‘creaming’ occurs. Second, the way subsidies are paid under a LS system can affect the relative presence of FPOs via a range of possible mechanisms. For example, in child care, a change from tax deductions to direct payment to providers could have a number of possible effects on the relative use of NPOs and FPOs, and the viability of individual providers.9

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9 For example, tax deductions require parents to wait for reimbursement. This will constrain the demand for child care from some less affluent families, leading some
Barriers to entry

A number of the possible barriers to entry in conventional markets (Bain 1956; Carlton & Perloff 2005, pp. 73–82), such as patents or exclusive access to key inputs, have limited relevance in human services. On the other hand, the use of franchises is much more central to managed markets, because government is effectively issuing a franchise to some providers such that only they can access government funds. Indeed, for some programs, whole classes of providers, for example FPOs or government, are formally excluded. These barriers are less severe in LS systems because, while the need to meet licensing regulations can delay entry of a provider, it cannot ultimately prevent entry as can occur under a CTC or hybrid system.

Another difference between managed markets in human services and conventional markets involves access to capital. The need for capital in any sector depends substantially on the nature of the product; where economies of scale exist, size matters and the inability to obtain investment capital for buildings or management systems and technology is a barrier for some organisations. With managed markets, the significant share of revenue provided by government may be perceived by investors as either ‘government-guaranteed’, which is more likely if the program is well established; or as less secure because it ultimately depends on decisions by very few people in government rather than on decisions by many individual customers. The significant involvement of NPOs in managed markets for human services is a further difference in relation to access to capital. In general, FPOs have an advantage in obtaining capital (Krashinsky 1986, p. 116; Weisbrod & Schlesinger 1986, p. 146), although this can be offset by tax concessions available to NPOs (Gjems-Onstad 1994). As well, the removal of direct capital assistance to NPOs in some sectors and the expectation that providers will incorporate to seek to switch to lower cost NPOs and reducing the incentive for FPOs to set up in some communities.
capital costs in their overall ‘price’ has worked against the growth of community-based NPOs and to the advantage of FPOs.

An important perspective on barriers to entry into any market—but especially valuable here—comes from Demsetz (1982), who argued that underlying most standard barriers to entry is imperfect information, which can affect decisions by all participants, including producers, consumers, and providers of capital. In the absence of perfect information, which is more likely to occur where the product is a human service, the reputation of incumbent providers and the trust they have developed is central in giving them an advantage with both investors and buyers. The notion of ‘commercial-in-confidence’ can be used to further restrict the information available to competitors and consumers, and a means by which incumbents can entrench their advantage.

Finally, for any industry, entry is also partly determined by whether there are barriers or incentives to exit. Hence, for example, an organisation is less likely to enter if there is a high level of asset-specificity in production (that is, they cannot easily transfer the assets to another product or industry) or if the contract/licence to operate is not tradeable. While asset-specificity is clearly important with physical plant (for example, specialised machinery), it can also be very relevant in human services in determining the extent to which a provider will invest in obtaining and training quality staff.

**Entry and market type**

A key determinant of the presence of FPOs in a sector is the type of managed market, that is, whether a CTC, LS, or hybrid system is used. FPOs are more common under LS systems, a result of fewer barriers to entry, higher potential profitability, and greater opportunity for FPOs to use their relative advantages (in, for example, marketing and capital-raising) to expand and increase market share. However, while a LS system may give greater scope for small operators to enter the market, ultimately it may also lead to a smaller number of large
FPOs, since a LS system allows greater scope for takeovers and amalgamations.\textsuperscript{10} Thus, while aimed at increasing choice for users, a LS system may end up reducing the choice—as indeed has happened in the child care sector in a number of Australian communities.

While FPOs are likely to be more common in LS systems, they may also be significant in those sectors using CTC and hybrid systems, where more of the key contracted outcomes are stated in quantifiable and observable terms. This is the case in the Job Network, where the number of jobs obtained by disadvantaged clients is a key outcome required of providers.

\textbf{Market power}

Once an organisation is in a market, it is potentially in a position to exercise market power to improve its position relative to other providers and to limit the entry of new providers. The theory of conventional markets is that the market power of an incumbent derives from the extent to which there are barriers to entry. Its power will be a function of its size and market share and will be reflected in its capacity to set price above marginal cost and limit the total quantity of output so as to maximise profit.

In CTC and hybrid markets, a provider’s power over price and quantity will be substantially constrained given that the government agency offering the contract may have the power of a monopsonist (that is, a single buyer) to force down price and require greater output and accountability from providers. Hence, competition between providers is likely to be focused more on quality and costs. However, the buyer’s power will be more limited where there are large multi-service providers, such as nation-wide religious NPOs, which always have the option of transferring resources to another program and type of service.

\textsuperscript{10} For example, the Productivity Commission (2002b, p. 11.5) noted that the introduction of a LS system in the Job Network would be ‘likely to lead to some consolidation in the industry’.
There is more potential in LS markets for providers to exert power over price and quantity, but the nature of human services noted earlier means that these markets will tend to have two characteristics that limit this power. First, differentiated (or monopolistic) competition will be common, whereby there is a number of suppliers (many quite small), each with a slightly different version of a core product (Chamberlin 1933; Robinson 1933). Second, competition between suppliers will tend to be centred on a local area or a segment of customers (Hotelling 1929).

There are two other major sources of power for suppliers in conventional markets, namely that a supplier has the capacity to shape the expectations of consumers (Galbraith 1958) and to use ‘political’ power to shape the market by influencing government decisions on regulation and incentives. These two sources of power are potentially even more important in managed markets for human services. Governments have great power to shape managed markets, and suppliers have ample opportunity to shape consumer expectations by exploiting the asymmetry of information and the lack of observable outputs prevalent in human services.

The effect of history, politics, and place

The impact of the design of a managed market on the type of providers and the presence of FPOs in that market is limited by other factors related to history, politics, and place. In sectors where large NPOs are long established, inevitably there will initially be fewer opportunities for FPOs when funding for any service becomes contestable. This situation is likely to be exacerbated by the contracting decisions made by government agencies wishing to minimise early problems and choosing larger NPOs as major providers. Politics is important and every sector has its stories of lobbying government at both the political and bureaucratic levels, to open up opportunities and close off competitors. Thus in some cases, causality may be in the opposite direction from that generally assumed, if the market has been shaped
to favour certain players, rather than the players responding to the market.

The differing effects of history, politics and place on the profile of providers of a service are very evident in paid care in Australia. Tables 3.1 and 3.2 show the profiles of providers in each state in child care and residential aged care. While the data in the tables must be approached with caution,¹¹ they suggest some significant differences in the presence of FPOs between states and service types. Both nationally and in every state and territory, FPOs are more prevalent in child care, a sector where government funding was not available for FPOs twenty years ago. There are also major differences between jurisdictions for each service, with the proportion of places provided by FPOs in aged residential care ranging from 11.8 per cent (Tasmania) to 43.5 per cent (Victoria), and the proportion of FPO providers in child care ranging from 26.2 per cent (Northern Territory) to 82.5 per cent (Queensland). There are also differences in the type of NPOs in each sector: over 30 per cent of aged care places nationally are provided by religious organisations, a group that has a negligible presence in child care. In part, these differences in the provider profiles are driven by local circumstances including the size, structure, and location of the target group and the history of NPOs in the state, and by the development strategies of major providers. But they also reflect differing policy and practice of state and territory governments, with for example, the licensing function in child care being carried out by state authorities.

**Contract failure theory**

The theory of contract failure,¹² initially developed by Henry Hansmann (1980; 1987; 1996), is the theory most often cited

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¹¹ See notes on Tables 3.1 and 3.2. There is also a different base for each table, with Table 3.1 showing the number of places managed by each type of provider and Table 3.2 showing the number of providers of each type.

¹² The term ‘contract failure’ has the potential to create some confusion. The meaning of ‘contract’ here is not restricted to formal agreements as in CTC, but includes implicit understandings between buyers and sellers.
Table 3.1: Aged care residential places in Australia and each state/territory, proportion of places by type of provider, June 2005*

<table>
<thead>
<tr>
<th>Type of Provider</th>
<th>NSW</th>
<th>VIC</th>
<th>QLD</th>
<th>WA</th>
<th>SA</th>
<th>TAS</th>
<th>ACT</th>
<th>NT</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Religious</td>
<td>32.5</td>
<td>17.2</td>
<td>43.7</td>
<td>33.6</td>
<td>28.6</td>
<td>38.4</td>
<td>23.5</td>
<td>55.6</td>
<td>30.4</td>
</tr>
<tr>
<td>Community-based</td>
<td>15.6</td>
<td>16.0</td>
<td>12.3</td>
<td>12.1</td>
<td>13.0</td>
<td>25.1</td>
<td>6.7</td>
<td>15.3</td>
<td>14.7</td>
</tr>
<tr>
<td>Charitable</td>
<td>19.8</td>
<td>6.0</td>
<td>14.1</td>
<td>15.5</td>
<td>26.2</td>
<td>21.8</td>
<td>47.9</td>
<td>17.4</td>
<td>15.8</td>
</tr>
<tr>
<td>Private-for profit</td>
<td>29.3</td>
<td>43.5</td>
<td>23.8</td>
<td>34.1</td>
<td>23.4</td>
<td>11.8</td>
<td>21.9</td>
<td>11.6</td>
<td>31.2</td>
</tr>
<tr>
<td>State/territory govt</td>
<td>1.4</td>
<td>14.6</td>
<td>5.3</td>
<td>0.6</td>
<td>6.6</td>
<td>2.6</td>
<td>-</td>
<td>-</td>
<td>5.9</td>
</tr>
<tr>
<td>Local government</td>
<td>1.3</td>
<td>2.7</td>
<td>0.8</td>
<td>4.1</td>
<td>2.2</td>
<td>0.4</td>
<td>-</td>
<td>-</td>
<td>1.9</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total places</td>
<td>55,027</td>
<td>40,708</td>
<td>28,173</td>
<td>13,418</td>
<td>15,319</td>
<td>4,270</td>
<td>1,556</td>
<td>430</td>
<td>158,901</td>
</tr>
</tbody>
</table>

* Excludes multi-purpose services and flexibly funded services.

Source: Steering Committee for the Review of Government Service Provision (2006, Table 12A.4)
Table 3.2: Centre-based long day care child care providers in Australia and each state/territory, proportion of providers by type of provider, 2004-05*

<table>
<thead>
<tr>
<th>Type of Provider</th>
<th>NSW</th>
<th>VIC</th>
<th>QLD</th>
<th>WA</th>
<th>SA</th>
<th>TAS</th>
<th>ACT</th>
<th>NT</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Community-managed</td>
<td>22.4</td>
<td>23.7</td>
<td>15.5</td>
<td>34.8</td>
<td>51.2</td>
<td>48.7</td>
<td>68.4</td>
<td>73.8</td>
<td>25.7</td>
</tr>
<tr>
<td>Private-for profit</td>
<td>77.6</td>
<td>64.6</td>
<td>82.5</td>
<td>62.5</td>
<td>46.5</td>
<td>29.5</td>
<td>31.6</td>
<td>26.2</td>
<td>71.0</td>
</tr>
<tr>
<td>Government **</td>
<td>na</td>
<td>11.7</td>
<td>2.0</td>
<td>2.6</td>
<td>2.3</td>
<td>21.8</td>
<td>-</td>
<td>na</td>
<td>3.3</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total providers</td>
<td>1,938</td>
<td>913</td>
<td>1,197</td>
<td>531</td>
<td>258</td>
<td>78</td>
<td>98</td>
<td>65</td>
<td>5,078</td>
</tr>
</tbody>
</table>

*The Steering Committee for the Review of Government Service Provision notes that its data on child care services by provider type 'needs to be interpreted with care because the scope of data collection varies across jurisdictions' (2006, p. 14.13).

** Includes local government owned services, but excludes Australian government supported services.

to explain the relative presence of NPOs and FPOs in any field. Essentially, Hansmann argues that where there is asymmetry of information between seller and buyer because the delivery of the service is largely unobservable by the buyer and/or the outcomes are largely unmeasurable, there is a need for buyers to put great trust in the service provider. In such situations, Hansmann argues, NPOs will be more prevalent because they are more trusted, and they are more trusted because they face a non-distributional constraint (that is, their financial surplus does not get distributed to shareholders). In brief, the argument is that where trust is required, NPOs are chosen because they are not ‘in it for the money’. Hansmann further argues that ‘The distinction between the for-profit and the non-profit form becomes blurred when the organisations in question are small in scale. The non-distributional constraint … has real meaning only when an enterprise is of sufficient scale to develop large earnings’ (1980, pp. 870–871).

In the context of this theory, how do we explain the growing (and in some cases dominant) presence of FPOs, especially large ones, in human services? Under CTC and hybrid systems, why do government agencies choose FPOs; and under hybrid and LS systems, why do individual users (or their agents) choose FPOs? Let us examine the two major premises of Hansmann’s theory.13

Hansmann’s first major premise is that where outcomes cannot be easily observed or measured, a buyer’s decision is based on the trust they have in the seller. However, this will be less of a concern for those buyers who believe they can accurately assess the quality and outcomes of a service. Thus, a government agency may put great faith in ‘objective’ performance indicators, or users/agents trust their own judgement. This confidence may or may not be justified, especially if the assessment is based on only on a partial view of the

13 Note that Hansmann’s original article (Hansmann 1980) focused largely on overseas aid, where donors (or ‘buyers of aid services’) have few means of checking on the supplier. He explicitly noted that his analysis needs further development to cover ‘mixed market’ situations where NPOs directly compete with FPOs.
service—but we are here trying to explain ‘buying decisions’, not the objective reality of the service. Press and Woodrow (2005, p. 282) note that several studies have found that parents tend to overestimate the quality of child care.

Another caveat to the first premise rests on the way that many decisions are made, which is not by a simultaneous balancing of all the variables in a single function, but a series of filter decisions (Man- nion & Smith 1998, pp. 128–29). Buyers may first seek to ensure a minimum threshold level of quality, after which locality, price, efficiency, and other factors will be successively taken into account in the calculus of decision-making about human services to determine the ‘best value-for-money’. In these ways, the commercial advantage of large organisations and FPOs can come into play, especially in more capital-intensive sectors, providing there is an acceptable base level of quality.

Hansmann’s second major premise is that NPOs are trusted more because of the non-distributional constraint. In practice, however, this needs to be qualified by considerations as to how trust is gained—or lost. On the one hand, FPOs can gain greater trust in a number of ways. They can employ well-qualified, experienced staff with good reputations. They can provide a better level of service than the minimum required by a contract or regulations. They can undertake non-profit maximising activities, such as building local social capital. They can also use their marketing efforts to mould the attitudes and expectations of buyers. On the other hand, NPOs as a group can lose some of their ‘trust advantage’ when some adopt corporate strategies and processes aimed at maximising financial surplus, organisational growth, and the ‘market-based’ remuneration of senior employees,14

14 Note that the non-distribution constraint does not normally apply to remuneration for employees in defining an organisation as ‘non-profit’. However, this has been an issue in the United States, where some states have sought to limit the level of remuneration payable to NPO employees if the organisation is to retain its tax exemptions.
while reducing the conditions and rights of staff (Horin 2007). This is associated with mission drift (Weisbrod 2004) and institutional isomorphism as NPOs move away from their original purpose and are perceived to operate more like FPOs or their funders (Taylor & Hoggett 1994, p. 193; Di Maggio & Powell 1983; Smith & Lipsky 1993). This ‘blurring of the boundaries’ between NPOs and FPOs means that one cannot predict organisational behaviour simply on the basis of ownership, but that subtler and more complex models are needed (Austin et al. 2006; Crossan et al. 2005) to identify how well each provider balances its social and commercial objectives in a market environment.

Relational approaches in regulating entry

Given the difficulty of observing performance and the potential for opportunism where human services have been marketised, two major focuses of action are to ensure more rigorous government and self-regulation of provider behaviour, and to continually improve instruments to assess performance, especially for service quality and client outcomes. These are clearly important strategies and action on these fronts needs to be sustained.

However, in establishing the processes and requirements for contracting, licensing, and regulation, rigorous requirements relating to the initial entry of providers into a managed market are also necessary. Such requirements are not incompatible with contestability, and can lead to gains in both efficiency and service quality. Baumol (1982) and Baumol and colleagues (1982) point out that the assumption of perfect competition requiring many sellers is not essential for maximum efficiency, providing that there is at least one potential efficient entrant that can enter and exit costlessly. Indeed, an excess number of suppliers can lead to a loss of efficiency even if it might be argued that some users are overall better off because they have wider choice. Further, we can look to the theory of the second best (Lipsey & Lancaster 1957), which essentially holds
that where all of the conditions for an efficient market cannot be met, the most efficient outcome may be achieved by ensuring that one or more of the other conditions is not met. Thus Le Grand and Bartlett note that if ‘purchasers have inadequate information, it may be preferable to have providers that are not motivated by financial considerations’ (1993, p. 34).

Dyer (1997, cited in Horton 2005) provides an interesting lesson from the private sector for the operation of managed markets in human services. He examined different approaches to contracting for the supply of parts for the manufacture of cars, and showed that Japanese manufacturers essentially used relational contracting, by which they chose suppliers based on common values, and then used longer-term contracting and less detailed checking of production processes. By contrast, US manufacturers used competitive transactional contracting, which involved micro-management of the supplier’s processes and intermediate outputs. Even in this most tangible and commercial activity, the relational approach produced significantly superior results in productivity, reliability, sales and profit.

With the expansion of managed markets, governments in Australia and elsewhere have often moved much more towards competitive transactional approaches in working with external bodies. Yet given the nature of human services, a stronger relational approach, with a closer focus on the overall organisation in determining who can gain entry to a managed market seems more appropriate. A relational approach, of course, is not without its dangers—for example, corruption, a ‘closed shop’, or monopoly power for incumbents—especially where ‘public money’ is used. Accordingly, the case for and against a relational contracting approach, and how it might be operationalised, needs close examination in each case. Such an approach, however, can increase effectiveness and produce better outcomes, as well as saving substantial resources that would otherwise be applied to monitoring and enforcement.

While it is unlikely to be politically feasible to retrace the steps in
well-established managed markets, there are other fields still to be opened up and in which there may be significant expansion in coming years. The next section takes a brief look at how one type of paid care service might develop without adequate regulation of the initial entry of providers.

A future scenario?

The major program under which home-based care for older people and people with disabilities is currently provided in Australia is the Home and Community Care (HACC) program. HACC is funded by both national and state governments and administered by the states through a CTC system, with providers winning contracts for specific areas or groups of clients. While government providers are still very significant and most non-government providers are NPOs, FPOs have been contracted under HACC. In addition, a range of other FPOs, including specialist employment agencies (Perrett 2005) and US corporates (Horin 2006), either work with HACC providers or provide home-based care outside HACC through other government programs or on an unsubsidised basis.

Home-based care is very likely to expand in the future, given the ageing of the population and policy support for this type of care as a much more cost-effective alternative to residential care (Fine 2007, p. 102–68). If significant extra money starts flowing, it is also very likely that there will then be much greater interest from FPOs and strong pressures to introduce a LS system, which (as noted earlier) operates in a number of Western nations. In this event, we might also see the use within HACC and other government-funded home care programs of the standard FPO franchising models for home-based services. Under this model, a large corporate would gain a licence, and sell a ‘franchise’ to individuals operating their own business—that is, a variant of Jim’s Mowing or XYZ Cleaning Services. The individual would pay a significant fee in return for the benefits of the corporate brand, marketing and back-office support;
the corporate could earn substantial revenue, while having shifted much of the risk, responsibility, and costs to the individual service provider and the service user. This model is already being used for home care that is not funded by government.

We can presume that franchisees will be required to meet all of the conditions of the licence—staff qualifications, work processes, and so on—and that the corporate franchisers will need to provide training and back-up. It will undoubtedly produce some very good services, enabling skilled and experienced people dedicated to good caring to operate their service independently of the bureaucratic constraints of larger organisations; and enabling many users and their agents to have a greater influence on the service. How it will work across all providers and the whole population is not so clear, especially in ensuring consistent quality. Issues of privity of contract, which are already intrinsic to CTC systems, may also arise, whereby ‘service recipients, who are not parties to the contract, are unable to take steps to enforce it even though they may be clearly affected by the contractor’s breach’ (Administrative Review Council 1998, pp. 87–89). The corporate franchise approach may not be allowed initially, but it could gradually evolve and become accepted, just as many previously ‘unthinkable’ approaches for providing public services are now mainstream.

Conclusion

Governments have the power to substantially shape managed markets. If they propose to continue—or extend—the use of managed markets in human services, they need to use this power strategically to maximise the achievement of social objectives. Two key points emerge from this chapter to guide to how this might be done.

First, it is important to ensure that the initial entry of all service providers to these markets is closely monitored, given the distinct features of human services, the inherent tension between profit
maximisation and service quality, and the lack of perfect information for service users and their agents in these markets. Further, the requirements set should include an assessment of the overall objectives, values and behaviour of the organisation, to ensure that all providers have a fundamental concern with the welfare of users rather than with maximising the personal benefits of the owners or managers of the provider organisations. This also implies a greater use of relational approaches in admitting providers to the market.

Second, there has been a blurring of the boundaries between NPOs and FPOs in the provision of human services, which in part helps to explain the growth of FPOs in this field. While it still remains more likely that NPOs will have strong social motivation and FPOs will have a strong focus on commercial objectives, the situation is now far more complex than a simple dichotomy in those terms. While there may be a need to limit the entry of certain providers in some situations, it is necessary to recognise that different forms of FPOs operate, and to focus on the behaviour of providers rather than simply on their ownership in determining these limits.

Finally, it is important to emphasise that the most appropriate form of managed market and entry requirements, and the type of providers that should be admitted, will vary in each case, depending on the factors outlined in this chapter.

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