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# Public providers: Making human service markets work

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## Introduction

This book is replete with examples of problems in the operation and outcomes of human service markets. Many of those problems are intrinsic, inevitable and essentially unremovable, given the nature of both markets and human services. Many, though, are the result of the poor design and/or management of specific markets. Whatever the drivers in each case, the result all too often has been that the net effects of marketisation for many human services have been counterproductive in achieving the key objectives of the services.

This chapter, however, is based on the proposition that this does not have to be so and that markets can be used to consistently improve human services. For that to happen, market mechanisms should only be used in a limited and strategic way, while certain elements that are not part of the neoclassical market model need to be in place. My purpose here is to outline how one such element—namely, a well-functioning public provider (that is, owned and operated by government)—can improve the operation and outcomes of human service markets. While the marketisation of human services is fundamentally directed at moving away from monopoly public providers, ironically, the managed (or quasi) markets thereby created often work best if a well-run public provider participates in the

market. Fundamental to enabling this—and indeed the raison d'être for public providers—is government and the boards and senior managers of public providers understanding that a public provider is not simply another competitor in the marketplace, but a *policy instrument that has unique capacities to effect broader systemic and societal change*.

Public providers have historically played an important social role in ensuring that human services are available on a more universal and equal basis across the population and have most commonly been justified in these terms. Here, however, the main focus is on an aspect rarely covered in modern writing, but which was the main reason public providers were used widely in the broader economy throughout the twentieth century—namely, to make the market work better in providing essential goods or services in sectors that have significant intrinsic market failure (Goot 2010).[1] This aspect was of little relevance to human service public providers before the 1980s, but it is now of central importance given the extensive marketisation of these services.

Importantly, the position taken here is based on the recognition that there are no simple prescriptions for the provision of human services, that no service system or approach is perfect and that the optimum system and approach will vary with each situation. The provision of human services and the design of markets for them are constantly a 'choice between imperfect alternatives' (Wolf 1988), in a world where the theory of the second best is ever-present (Lipsey and Lancaster 1956). Public providers have their limitations but are a key element in the good design of human service markets.

While the major focus of the chapter is on human services, much of the discussion also applies to public providers more broadly (for example, in the banking and energy sectors). Similarly, while the focus is on Australia, the issues raised here are relevant to many situations internationally (for example, in the United Kingdom, in relation to changes in the National Health Service and the changing role of local government in aged care over the past four decades).

The chapter, however, must be read with an important caveat in the contemporary context. The decades-long dominance of neoliberalism, exacerbated by long periods of governments philosophically opposed to

1 The term 'market failure' as used here is not restricted simply to when existing markets are not working well, but also includes when *no* market—or service—has been established.

and lacking understanding of the role of government, has taken many of the remaining public providers a long way from the principles and possibilities espoused in this chapter. There is much evidence of the remaining public providers being focused mainly on commercial success: senior managers parachuted into jobs without previous experience in any human service sector, let alone the one in which they are now working; large bonuses paid to senior staff simply for doing their job; politicised appointments; and operations ignoring many of the principles outlined later in this chapter. The result has been a loss of capability, performance and public faith in public providers that may take some time to recover even if the political and bureaucratic will to restore them was there. That does not, however, reduce the potential value that public providers have and the validity of the arguments contained in this chapter, even if, for the moment, some of them cannot achieve all the potential benefits.

The next section gives an overview of the historical and contemporary contexts in which public providers of human services have had to operate, focusing on the distinctive intrinsic features of both public providers and human services, and the major impacts of neoliberalism on each of them. Two sections then set out the key issues to be addressed in the design of effective public providers. Most fundamentally, there are preconditions that governments need to put in place in terms of the philosophical and policy frameworks in which public providers must operate and the operational principles that then guide their behaviour. Alongside this, it is necessary to address the common criticisms of public providers, especially in terms of their relative efficiency and cost, and the risk of residualisation. The chapter then moves on to explain how a human service public provider can be a powerful policy instrument, by outlining the broad roles it should play in the market and the specific mechanisms through which it can shape the market in ways that no non-government provider can fully duplicate across a large and complex service system.

## The context for the operation of public providers of human services

Three key elements form the context for this chapter: the role of public providers in general (that is, in the wider society as well as human services), the nature and provision of human services (regardless of whether markets are used) and the ever-expanding dominance of neoliberalism in most

nations since the early 1980s. More specifically, two major effects of neoliberalism are particularly relevant here: the reduced presence of public providers in general and the growth of human service markets.

## Public providers in general: A brief overview

### History and diversity

Public providers have played a major role in the development of many nations. In some form, they have existed for millennia, but it was from the nineteenth century that they became an integral part of the society and economy of many nations, including Australia (for example, public schools, hospitals, postal services). The presence of public providers grew substantially in the twentieth century, not just in human services, but also more broadly across the economy, although there were constant reforms at the margin in response to changes in the political complexion of national and state governments (Goot 2010).

Historically, public providers have been used in sectors that both produce essential goods or services and have experienced substantial market failure. This has included sectors in which users pay all or most of the cost (for example, electricity, banking) and sectors in which governments pay all or most of the cost (for example, most human services, public infrastructure). It has included sectors in which public providers have had a monopoly and sectors in which they have been only one of multiple suppliers competing for custom.

There has been—and remains—much diversity among public providers. They differ by the level of jurisdiction (national, state, local), by the type of organisational entity (for example, departmental unit, statutory authority, company limited by guarantee) and by operational factors (for example, form of executive control, employment of staff). There are also variants specific to a sector (as with comprehensive and selective public schools). There is insufficient space here to discuss the nature, features and implications of each of the various forms of public provider in relation to all the issues covered in this chapter. What is important, however, is to note that there will be much variation in how each of these issues plays out in practice in each situation.

## The traditional roles of public providers

Where they have been used, public providers have traditionally played *five key roles*. First, a core purpose of public providers has been at the level of individual users, to ensure essential services that are affordable and of reasonable quality are available to everyone who needs them, whatever their personal circumstances or location. A second core role has been to periodically provide a critical policy instrument to facilitate a rapid and effective response to, and recovery from, major social and economic disruption.[2] Both these roles involve directly providing assistance to many individual citizens, but in the course of giving this assistance, public providers have also significantly contributed to developing better overall service *systems* (in terms of the key system objectives outlined later, such as universality, quality, efficiency, equity and stability).

Traditionally, public providers have also been designed and operated to play three further roles that impact primarily at a broader systemic and societal level. These roles are:

- to improve the overall service system for the service being provided through their capacity to have a wider influence on other providers and sectoral norms
- to enhance the contribution of a service to broader social and economic goals (for example, the contribution of education to economic performance) by virtue of the government's capacity to direct a public provider to operate in certain ways
- to improve the operation and outcomes of markets in the sectors in which they operate.

Importantly, the systemic and societal benefits encompassed in all five roles represent the critical and unique contribution of public providers, rather than them simply being providers of services to individuals. It is a key contention of this chapter that the five roles are no less important and relevant today in marketised human service systems, that public providers are still uniquely best-suited to achieving them and that in sectors with significant intrinsic market failure, the overall service system will be more effective, efficient, equitable and stable when a public provider is present. The converse view is that the roles can be carried out as well, if not better

2 In Australia, the bushfire, flood and Covid-19 crises since 2020 have strikingly demonstrated this point.

and less problematically, by non-government providers—both non-profit organisations (NPOs) and for-profit organisations (FPOs). This broader debate is at the heart of the chapter, although the primary focus here is on improving the operation and outcomes of the *markets* for human services.

## The source of the unique potential contributions of public providers

The unique contribution public providers can make via the five roles outlined above derives primarily from a combination of their public ownership and size.[3] Public ownership enables public providers to draw on the unique legal and moral powers and responsibilities of government. More specifically, this encompasses: 1) the unique legal and coercive powers of government to direct and coordinate individuals, organisations and resources, including fiscal powers to tax and spend; 2) the resulting capacity to marshal (obtain and organise) substantial financial and physical resources that enable the development of organisations with the size needed to adequately address large and complex needs in society; 3) the greater guarantee of stability and continuity of basic services across a jurisdiction given government's longevity (albeit the form of services may change over time); 4) the capacity to maintain and develop linkages with other bodies, given both the longevity of government and its powers to require other bodies to work with its agencies; 5) the moral responsibility of government to use its powers in the public interest and the fact it will be subject to public criticism and possibly electoral consequences if it is seen to do otherwise; 6) the power of government to provide practical and moral leadership through its legal powers and the constant attention it receives; 7) a greater obligation, often based in law, to be more transparent and accountable than non-government bodies; and 8) each of the above factors reinforcing one another, creating synergies that cannot exist independently of public providers that have *all* these features. In summary, public providers have a moral responsibility to operate in the public interest, plus the legal powers and resources to do it in ways and to an extent that cannot be guaranteed by non-government providers.

3 In this chapter, the term 'size' for an organisation is used to encompass not just its scale (as measured by dollar turnover, number of employees, and so on), but also the scope of its services and its geographic spread. See Davidson (2015: 115–20) for a discussion of the nature and significance of each of these and other key structural dimensions of service providers.

However, these powers and moral imperatives are of limited value unless they are harnessed to substantial organisational power. Hence, the other important driver of the benefits of a public provider is its size, which also generates two major forms of power. There is the logistical power based on a capacity to operate on a large scale for a wide range of services across a large and diverse geographical area. This enables it, for example, to reach all regions and potential service users in a jurisdiction, to achieve a critical mass and economies of scale and scope in the delivery of services, to absorb major unplanned impacts without threatening its long-term operation or survival, to harness the synergies and interdependencies of a large organisation and to obtain efficiencies that also set up a platform for better services. Coupled with this, there is the power to influence others that comes with size. This can help set public norms, standards and expectations about services. This power to influence becomes market power where services are marketised and—as discussed later—enables a public provider to influence the behaviour of other providers, sectoral norms and government benchmarks for quality, equity, efficiency and price.[4]

Importantly, it is also because of the above factors that there is strong public support for public providers even after governments of both the left and the right have so often chosen to ignore that these are the first-choice providers for many citizens.

## The nature and provision of human services

As shown throughout this book, the terms 'human services' or 'social services' encompass a wide range of service types. While there is much diversity between the various service types, they also have a number of common features that distinguish them as a group from other products (goods and other services).[5] These distinctive features are in relation to: 1) demand (limited finances and/or limited personal agency of service users), 2) the production process (the centrality of human skills, attributes and relationships as inputs to production, and the consequent limited scope to increase productivity without reducing quality) and 3) the final

4 Size, of course, is a double-edged sword, in that it can lead to overly bureaucratic behaviour and lack of responsiveness to individual users.

5 I have elsewhere set out detailed analyses of human services and human service markets (for example, Davidson 2009, 2012, 2015, 2016). This and later sections briefly note key findings relevant to this chapter.

'product' (limited tangibility, measurability, observability, storability and homogeneity) (Davidson 2015). These features create issues for the provision of the services regardless of markets, but they are also the source of substantial intrinsic (and often unremovable) market failure that is generally deeper and more pervasive than for most other products (Arrow 1963; Le Grand and Bartlett 1993; Blank 2000; Davidson 2015).

A key implication of these distinctive features is that government must play a major role in human services to ensure the quantity and quality of services expected in a modern developed nation. At a minimum, government needs to provide substantial funding and some level of regulation. But it also often must have a role in policy, purchasing and delivery if the services are to be provided effectively, efficiently, equitably and reliably to all the people who need them.

Governments fund human services because of both their importance to the wellbeing of citizens and their contribution to broader social and economic goals (for example, the role of education in economic development). For these two core goals to be achieved, there are several widely agreed objectives for both the services and the systems that provide the services—notably, universality, effectiveness (which primarily derives from the quality, responsiveness and diversity of services), equity, efficiency, choice, stability, innovation, accountability and linkages with other sectors. From the perspective of individuals who need the services, there are three key requirements: availability, affordability and quality. These broad goals and service objectives are logically the criteria with which to assess a service and service system in each specific case, including the impact of both marketisation and public providers. They are a touchstone for the discussion throughout the chapter.

## Neoliberalism

The term 'neoliberalism' has been defined and applied in multiple ways by different writers (see the Introduction to this volume). Notwithstanding these differences, there are two points about neoliberalism that would be generally accepted—namely, that it is ostensibly based on a core belief in personal liberty, the power of markets and the need to limit the state (as opposed to collective action and state intervention); and that it is a movement that has been massively successful over the past 40 years in shaping public policy and transforming economic and social

life internationally along the lines of those core beliefs. It is primarily regarding these two broad points—its core beliefs and its overall impact—that neoliberalism is relevant to this chapter.

Within these broad parameters, however, neoliberalism has many dimensions. It variously represents, inter alia, a set of ideas; an array of specific changes to legislation, institutions and processes; an approach to statecraft and a set of political strategies to promote these ideas and achieve desired changes; and, perhaps most significantly, it represents a mindset and frame of reference through which to view and interpret the world that have become the default position for many decision-makers. Through all these means—often in *Gestalten* ways—neoliberalism has changed the world over the past four decades. When we speak here of the 'impact of neoliberalism', it refers to the possibility that any one or a combination of the above factors may be relevant in any situation.

Neoliberalism can be critiqued in terms of both the theoretical quality of the analysis and prescriptions emanating from this world view and the extent to which the above forces have promoted ends that are at odds with its stated ideas and goals. While claiming to be driven by objectivity and rationality devoid of special interests, neoliberalism has been driven substantially by ideology, politics and private interests, often without—or even in defiance of—evidence-based studies, while its notion of liberty involves ensuring the powerful can continue to exercise and grow their power (Mirowski and Plehwe 2009; Nik-Khah and Van Horn 2012). For example, drawing on both neoclassical economics and libertarian philosophy, neoliberalism promotes the idea of a minimal state, claiming government action distorts and reduces the preferences and freedoms of individuals (Hayek 2007; Friedman 1962), and the state will inevitably be captured by vested interests (Buchanan 1978). Such a view, however, ignores the positive impacts of much state action, as well as the actual motivation and practice of many public officials and institutions aimed at promoting the public interest and common good (Douglass 1980). Moreover, in practice, neoliberalism has often not reduced state intervention, but simply changed the nature of intervention and who exercises control over it.

There have undoubtedly been major economic and commercial gains from the changes driven by the many faces of neoliberalism, as reflected in the growth of gross domestic product and international trade over the past four decades, but these have not translated into a higher standard of

living for many people. Rather, they have led to greater inequality (which in turn has been shown to limit economic growth) and to questions about the adequacy of conventional economic statistics as indicators of national wellbeing (Cingano 2014; Monbiot 2017).

Similarly, markets have also indisputably played a central role in raising living standards over the past two centuries. But markets do not form naturally for some goods and services, and virtually all markets have some level of market failure.[6] While there is general agreement about the broad causes of market failure and the need for government intervention where such failure is extensive, there are major differences of opinion as to the extent and depth of market failure in any situation and the nature and extent of intervention required. Such differences lie at the heart of the central issues of this chapter, which is essentially about how best to address market failure.

We now consider two major effects of neoliberalism in human services that are relevant in this context: the reduced presence of public providers and the growth of human service markets.

## The reduced presence of public providers

By the early 1980s, public providers had a substantial presence in Australia. Some sectors had a mixed economy with a large and well-supported public provider as an option for users in a competitive market (for example, the Commonwealth Bank, Qantas); in other sectors, in which users paid their own costs, there was a monopoly public provider (for example, electricity, telecommunications); and in those sectors that were publicly funded, services were largely—sometimes totally—delivered by public providers (for example, many human services). As a result of the growing hegemony of neoliberalism, however, this has been substantially reversed over the past four decades, with a major reduction in the presence of public providers in most sectors via the processes of marketisation, marginalisation and—ultimately, in many cases—privatisation or abolition.

In Australia, *none* of the government research and policy papers in the past 30 years relevant to human services—most of which are very strong in promoting greater marketisation and contestability for public funds—

6 Formally, market failure exists where *any* of the conditions of perfect competition are violated.

argues that a public provider is either undesirable or unnecessary.[7] Moreover, when governments decide to downsize or dispose of public providers, it is often done quietly, sometimes with no public announcement beyond informing the users who are affected. The proponents of privatisation know it is not popular with most citizens (Quiggin 2018).

To the extent that reasons are given publicly for the downsizing or elimination of public providers, they have centred on (rarely substantiated) claims about: 1) alleged problems with public providers concerning operational limitations (especially in terms of efficiency, cost and responsiveness to user needs), misuse of monopoly and market power by large government agencies or decisions allegedly driven by the personal interests of politicians and officials;[8] 2) the lack of need for a public provider given non-government bodies can supposedly do the task as well, if not better; and 3) improvements to services that will supposedly be driven by new entrants and competition, such as greater quality, efficiency, diversity and choice for users. While such claims are often poorly based, anecdotal and/or politically driven, there is such a long history of tales of Kafkaesque and other poor behaviour by public agencies that one certainly cannot idealise public providers. In addition, critics claim that ending or reducing public providers will have broader benefits for government, such as: 4) reducing the operational overload on government (Rose 1979; Moran 2018), enabling it to be more strategic and to 'steer not row' (Osborne and Gaebler 1993); 5) reducing financial and operational risk for government; and 6) releasing limited public funds for other programs.

The real reasons for the reduced presence of public providers are more complex. In summary, we can identify six major factors that largely explain their reduced presence over the past four decades.[9] First, it was an inevitable consequence of marketisation that the 'market share' of public providers would fall. Second, and allied to this, government policy in this period commonly supported a greater use of non-government providers. Third, the operational shortcomings of public providers have clearly played a part in some sectors.

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7 This is the case from Hilmer (1993) through to Harper et al. (2015), the Aged Care Sector Committee (2016) and many Productivity Commission reports concerning human services over the past 25 years (for example, PC 2018).

8 These issues are discussed in more detail under 'Potential problems with the operation of public providers'.

9 Davidson (forthcoming) provides a more extensive discussion of these factors.

Fourth, the reduced presence has been substantially driven by ideology, politics and private interests. Ideologically, public providers have been a major target of the neoliberal goal for smaller government (Berg and Davidson 2018). There have also been more directly political motives to reduce the exposure of government to financial and political risk, to cripple public sector unions and to transfer much of the cost of services to service users—motives that are often opaque because they are considered by policymakers to be in the public interest but likely to be unpopular. Then, increasingly important over time, non-government providers, both FPOs and NPOs, aware of the dollars and power of being a major provider of government-funded services, have come to have substantial influence on policy and program design.[10] This influence commonly accelerates once some critical mass is reached, rising in some cases to such interests now effectively deciding policy in some fields (Gingrich 2011; Edwards 2020).

A closely related fifth factor is that the debate about the appropriate role of public providers is now framed by a set of concepts originally developed by proponents of smaller government—notably, competitive neutrality (Hilmer 1993; OECD 2012), commercial in confidence, soft budget constraints (Kornai 1986; Kornai et al. 2003), stewardship (Hamilton 2016; Carey et al. 2018) and risk. I argue elsewhere (Davidson, forthcoming) that these concepts are conceptually flawed, especially in the ways they have been applied to human service markets.[11] Finally, the cumulative impact of these five factors over time has created a self-perpetuating downward spiral in the capacity of, and public confidence in, government and its agencies.[12] Hence, as noted in the introduction to this chapter, there is now some difficulty in calling for a greater role for public providers because government may be less capable of operating them effectively and in the public interest.

10 An important aspect of this is a process that has been described as the 'game of mates' (Murray and Fritjers 2017), which includes, for example, the 'revolving door' for people moving between government and the private sector.

11 For example, competitive neutrality as it has been applied commonly: 1) prevents public agencies from adopting measures that simply reflect the unique and intrinsic advantages of the public sector; 2) prevents payments to public providers for activities aimed at improving the overall service system; and 3) is a one-way street with non-government agencies receiving government funding not being required to service more complex users and more remote or difficult areas, or meeting the same level of public accountability as public providers.

12 Indeed, Mazzucato (2018: 259) argues there has been a deliberate process of 'gaslighting' (or undermining) the public sector, such that the state and its officials have lost their confidence to achieve results.

In general, the reduced presence of public providers has *not* been a result of comprehensive, evidence-based assessments of their performance or outcomes. In fact, there is much evidence of good practice and good outcomes from public providers over many years. Cross-ownership studies consistently show the quality of services from public and NPO providers is likely to be higher than from FPOs (Weisbrod and Schlesinger 1986; Amirkhanyan et al. 2008)[13] and is often highest in public providers (Royal Commission into Aged Care Quality and Safety 2021; Yang et al. 2021). Moreover, public support for public providers remains high—favoured by most people for a number of services (Meagher and Wilson 2015). In summary, while public providers are not perfect, they have a history of achievement and much support from service users.

## Human service markets

From the late 1980s, neoliberalism led to the introduction of market mechanisms to varying extents in most human services in most nations. However, one result of the extensive market failure intrinsic in human services is that markets for these services do not form naturally and governments have had to construct managed (or quasi) markets, of which there are many forms (Davidson 2008, 2012, 2015; Gingrich 2011).[14] Then, within each of those managed markets, there is significant market failure, especially arising from the need for a third party to provide much of the purchasing power, the limited personal agency of many users (few of whom are *Homo economicus*) and extensive asymmetries of information.

Market mechanisms thus need to be used in more limited and strategic ways with human services. For example, more contestability should not mean unregulated entry or lower capability standards for providers, competition should be based mainly on the quality of services with limited price competition, choice is complex and may be reduced by too many options, while high co-payments exclude people who need a service (Davidson 2015). However, the many warning signs from theory about

13 Such findings are also reported in this volume in relation to the family day care sector (Chapter 1) and aged care (Chapter 6), while Chapter 5 notes the privatisation of public providers of disability services reduced the potential benefits of choice from the NDIS.

14 In Davidson (2008, 2012, 2015), I developed a schema identifying three major types of managed market: single contract, in which government contracts one provider to service a given group of users; quasi-voucher licensing or demand-side funding, in which funding follows the user, who is free to choose any licensed provider; and a hybrid form under which government selects a small number of providers from whom users can then choose.

excessive marketisation and the long empirical international experience of problems have commonly been overlooked by governments as they have tried to substantially replicate conventional markets in human services.

## Problems with service providers in human service markets

Consequently, the marketisation of human services has been very controversial, with frequent and recurring problems in service delivery across most service types. There are several problems directly related to service providers:

1. Providers can choose where and whom they service and thus gaps—often substantial—develop in service systems. No services may be available for some areas or people; services for others may be inadequate and some eligible people may in practice be excluded from available services through cream-skimming, parking or high co-payments.
2. There is much potential for poor or opportunistic behaviour by providers, especially through cutting costs by reducing the quality of staff and services under some acceptable minimum in ways that are difficult to detect. As discussed below, there are severe limits to the extent to which regulation and contracts can prevent or control such behaviour.
3. Human service markets are subject to the danger of providers setting prices either too low to cover the cost of quality services or too high to exploit their market power.
4. There are extensive expenditures by providers on items that are not part of delivering the service and exist only because of markets and commercial motives (for example, many transaction costs, marketing, information technology, advisory services, profits for FPOs) and represent an inefficient and wasteful leakage of public and user funds (Davidson 2018).
5. Most non-government providers (including NPOs) must necessarily be ultimately concerned with their own situation and their desire to thrive, or at least survive. Hence, the focus of many has now moved to their financial bottom line rather than the services and broader social goals.
6. All the above problems are especially likely when the large for-profit corporations that are increasingly taking over human services are involved.

A major source of these problems has been the relaxation of regulations constraining the entry of new providers, which has allowed poor and opportunistic providers to be let into most sectors. Nor has marketisation brought the efficiency gains it promised. In many cases, the unit cost of services may be less, but that is far too often a result of cuts to inputs by providers that lead to lower quality—and hence to lesser services.

Moreover, the operation of the markets has been suboptimal and they have commonly failed to deliver better service systems. The above list of problems shows that universality, equity and even efficiency in many respects are intrinsically curtailed by markets. Markets also impact negatively on the stability and continuity of services. While neoclassical theory about competitive markets posits that the process eventually leads to equilibrium, the theory also assumes that, over time, there will be a continuing process of less-efficient providers exiting the market and new providers entering, pointing to the fact that continuing instability is actually a *goal* of competitive markets.

The marketisation of human services has ostensibly been driven by the promise it will improve the outcomes of services for both direct users and society more broadly. What is evident both from theory and from the empirical experience of the past four decades, however, is that marketisation often cannot deliver on these goals, with a core source of the problem being the nature and behaviour of service providers. This is emphasised by the case studies in this book. Indeed, markets, left largely to themselves with relatively open entry for new providers and 'light-touch regulation' of provider behaviour—as is now a common basis for government policy—are most likely to substantially impede achieving the key objectives of human services.

## Alternative policy instruments in human service markets

Notwithstanding the problems associated with the marketisation of human services, it is clearly here to stay, at least for the foreseeable future. The value of having some market mechanisms, the current pervasiveness of marketisation in every sector, the current policy frameworks that have emerged from neoliberal perspectives and the realpolitik of powerful interests benefiting from it will ensure that. However, if the goals and objectives of human services are to be achieved and the operation and outcomes of human service markets are to be optimised, there is a need for substantial government intervention in these markets that goes beyond simply providing funds and light-touch regulation.

We have earlier pointed to the powers and responsibilities of government and the way they can be powerfully harnessed by public providers. Of course, governments do not have to use their powers by establishing public providers but have several other policy instruments to try to improve the operation and outcomes of any system or market that provides goods and services.

In summary, there are six other key policy instruments that can be used.

1. The first option in a neoliberal age is to consider measures to *increase competition* in the sector—for example, by reducing barriers to entry for new providers, reducing limits on the mobility of inputs and the spread of technology, improving public information about providers and the market and consumer education.
2. The approach most commonly supported by the critics of marketisation is greater *regulation of the service behaviour of providers* by more closely specifying and enforcing how the services are to be resourced, delivered and monitored.
3. Governments can also more tightly regulate the *initial entry of providers* into the sector and their *commercial behaviour* (for example, pricing, marketing).
4. Rather than invoking their coercive powers via regulation, governments can *influence the incentives* for providers' behaviour (in relation to services and commercially) through financial and nonfinancial incentives and disincentives. Moral suasion and 'nudge economics' can play a role here (Thaler and Sunstein 2008).
5. Governments can also reduce providers' costs by *establishing common infrastructure* that encourages good practice (for example, training programs, innovation clearing houses).
6. In a managed market, government has much scope to control or influence all aspects of the *design and operation of the market*.

Davidson (forthcoming) analyses in detail the roles and limitations of each of these instruments with human services. In summary, each has a role to play in the design and management of human service markets where there is significant market failure, but they are all limited in their effects; they often introduce additional costs for users, providers and governments; and they can even be counterproductive in some situations. It is in this context that a public provider can represent a powerful addition to the

policy armoury of government that can uniquely contribute to achieving the objectives of human services in a market environment in the ways outlined below.

## Preconditions for the effectiveness of public providers

The core argument of this chapter is that public providers have a unique capacity to improve the operation and outcomes of human service markets in the environment outlined above. This is most likely to happen where certain preconditions are in place in terms of the philosophical and policy frameworks set by government and the operational principles for public providers that guide their behaviour.

### The philosophical frameworks: The role of the state

A key tenet of neoliberalism is a belief in the need for a minimal state. This chapter, however, is grounded in a quite different conception of the role of the state—one that takes account of the strengths and limitations of both the state and the market. Hence, it recognises the substantial and demonstrated capacity of the state to play a positive proactive and productive role in improving the lives of its citizens by achieving better economic and social outcomes. This is in the tradition of writers such as Keynes (2004, 1973), Polanyi (2001) and, more recently, Hind (2010), McAuley and Lyons (2015), Raworth (2017) and Mazzucato (2015, 2018, 2021).

The role of the state envisaged here, however, also remains within tight limits, following the guiding dictum of Keynes (2004: 40): 'The important thing for government is not to do things which individuals are doing already, and to do them a little better or a little worse; but to do those things which at present are not done at all.' That is, to do what no-one else can or will do. However, it is also often the case that to do well what no-one else can do, the state may have to do some of what others do (as, for example, if it is to be a cost-efficient provider of last resort, as explained later).

## The policy frameworks

At the core of policy, there needs to be a recognition that programs of public funding for human services exist for public interest purposes; they are not business development programs for non-government bodies, as is too often the tenor of contemporary policy documents. Alongside this, it is important that there is some level of contestability for the services of a public provider such that it does not have a monopoly or excessive market power.

More specifically, it was noted earlier that the current policy environment for marketisation discriminates against public providers in terms of key concepts that frame policy. To address this, there needs to be: 1) a more sophisticated interpretation and implementation of the notion of competitive neutrality (for example, such that *all* service providers receiving public funds do their share of servicing more complex, more costly and higher-risk users and areas); 2) more transparency required of all funded bodies rather than them being able to hide behind notions such as commercial in confidence; 3) an acknowledgement of the need for government to have soft budget constraints when they are used in a limited way for clearly defined public interests; 4) an acceptance by government of the need to go beyond mere stewardship of the market to more direct management in setting its parameters; and 5) government accepting greater risk in supporting new developments aimed at enhancing the public interest.[15]

## Operating principles for public providers

Central to the case for public providers is the fact they are primarily a policy instrument, rather than simply another competitor in the marketplace. For this to occur, it is essential that public providers establish and adhere to a set of core principles that are based on pursuit of the public interest. These principles will vary with each situation, but they should, at a minimum, encompass: 1) a mission for the organisation that embodies a clear vision of the role of government in creating public value (rather than, for example, setting commercial and financial success as the

15 It is important here to distinguish between taking risks to open new areas of knowledge (Mazzucato 2015, 2018, 2021) and the undesirable forms of risk taken by some public agencies in moving into dubious entrepreneurial activities simply to increase their profits and/or market share. The latter occurred, for example, with the state banks of South Australia and Victoria in the 1980s, while Walker and Walker (2000: 71–74) recount Pacific Power's plans in 1998 to invest in offshore activity—plans it then used to try to justify privatising.

key goals); 2) a definition of its scope of activities that acknowledges both the limits of its mission and the range of activities essential to achieve the mission; 3) a core obligation to ensure services are available for all people and areas, with a particular focus on those who would not otherwise receive a service; 4) a core obligation to a minimum level of quality and responsiveness to individual needs for all of its services for all people, while, as far as resources allow, striving for excellence; 5) a preparedness to move into areas and activities where no-one else is willing to go if these have broader public interest benefits; 6) financial self-sufficiency, operating within the revenue obtained from its services, taking account of any additional explicit subsidies from government that would be payable to other providers in the absence of a public provider (for example, to support systemic improvements or 'community social obligations'); 7) a commitment to being a best-practice employer; 8) a commitment to transparency, such that detailed information on the operations, finances and outcomes of the organisation is publicly available;[16] and 9) limited commercial goals (for example, in terms of profit, sales, growth and the approach to service quality and pricing).[17]

Where in this chapter it is stated that a public provider can have various positive effects, this assumes the provider has the mission, structures, resources, personnel and incentives to enable it to operate in the above ways. This does not imply it will be perfect in all respects, but that it fundamentally operates along these lines.

A key issue for a public provider in relation to its role as a participant in the market is its approach to service quality and pricing. The public provider's commitment to the public interest should ensure the quantity, quality and organisation of its staff and other inputs are such as to produce good-quality services that are available to everyone who needs them at an affordable and efficient cost (possibly free, depending on the level of government subsidy). It should be able to produce these quality services relatively efficiently because its size will allow it to achieve the critical mass and economies of scale and scope that enable the most efficient use

16 There is a need for some limits on transparency, because of safety, privacy and to limit gaming of the system.

17 These principles are based on my reading of the theoretical and empirical literature on public and non-government providers and my extensive professional experience with providers of all kinds in market and non-market environments across many services. The principles are presented here as being indicative of what is possible and as a stimulus to other researchers, rather than purporting to be a final definitive statement of what is required.

of its inputs. At the same time, it should not be unnecessarily increasing its costs by leakages (such as extensive marketing). Then, its commitment to the public interest should ensure its prices reflect actual costs,[18] as it eschews the opportunity to use its market power for its own interests and ignores the opportunities available to commercial-maximising providers to obtain 'rent' (excess profit) that flows from its market power.[19]

This final principle requires that, as a market participant, a public provider should have limited commercial goals. For example, while it naturally wants to ensure people use it, it should not seek to maximise revenues or actively pursue increased market share per se. High demand may continue to generate substantial growth, but it does not need to actively seek to grow beyond the level necessary for the optimum critical mass and economies of scale and scope. While this does not preclude making users aware of the services available and taking steps to present them positively, it should not involve extensive marketing and use of other 'satellite' services (such as advisors) more than is necessary to operate efficiently and to give users genuine information about its services. Further, the organisation should not be getting into financially risky entrepreneurial activities simply to increase market share and revenue.

While the above principles should be expected of all providers, the fact is commercial and market pressures inevitably divert many non-government providers, both NPOs and FPOs, from these principles. However, with a well-run public provider, it will be the public interest and the wellbeing of citizens, not the wellbeing of the organisation, that are paramount. Notwithstanding this, clearly, there will be some non-government providers that are able to stick to the principles—but, as we shall see, even then the transaction costs of contracting make them more costly and uncertain than an efficient public provider.

As noted earlier, there is much diversity among public providers in the type of organisational entities and management structures that are put in place, and hence, there will be much variation in how these principles apply in individual situations. In all cases, however, the success of public

18 Formally, price will be equal to long-run average cost (P=LRAC), where the cost includes an allowance for future investment and unforeseen contingencies.

19 The argument in this paragraph assumes the level of government subsidy available to all providers or users is sufficient to enable the most efficient provider to offer a minimum-quality service. This is not always the case (Cortis et al. 2017). Moreover, it is not unknown for government to allocate a level of funding and other resources to public providers that is inadequate to carry out the additional tasks they have been asked to do.

providers in following these principles is dependent on the *selection of board members and senior managers*. It is imperative the organisations are controlled by people with a keen sense of the potential and responsibilities of public bodies and a motivation primarily focused on achieving better services, rather than simply the survival and/or growth of the organisation. This has been threatened in recent years by the politicisation and de-specialisation of senior management in many public providers.

One result of applying the above principles may be that, in some respects, a public provider may have greater costs (for example, from providing better wages, working conditions and organisational arrangements), but in other respects, it will have lower costs (by minimising marketing and other leakages of the service dollar). It is not evident from theory whether that will mean the total overall costs of a public provider in any specific case are higher or lower. This is an empirical question for each situation. What is clear is the factors that generate the higher cost elements in a well-run public provider are important in improving quality and equity and are socially more beneficial than many of the elements that generate higher costs for commercial maximisers.

Clearly, the model public provider set out above will work most effectively if it is established at the outset of a new managed market (Wilson 1989: 96), although it can still be a powerful force if used by a government wanting to substantially and positively reform a sector.

There will be criticism that the organisation sketched in this section is utopian. The fact, however, is many public providers broadly operated along these lines both before and since the onset of neoliberal dominance.[20] Moreover, the prospect of such an organisation is based much more on realistic assumptions and empirical experience than that propounded by the proponents of the minimal state and perfect competition.

20 For examples in Australia and elsewhere, both in and out of human services, see Denhardt and Denhardt (2007), Goot (2010), Hind (2010), McAuley and Lyons (2015), and Sitaraman and Alstott (2019).

## Potential problems in the operation of public providers

The previous section painted a positive picture of how a public provider, with adequate resources and good governance and management, can be effective and efficient. This section acknowledges the potential problems that can arise in the design and operation of public providers.

We have earlier noted the alleged operational shortcomings of public providers. The issues relating to risk, control by vested interests and the misuse of market power have all occurred, though nowhere to the extent claimed by promoters of privatisation. Moreover, those issues are largely addressed by the principles set out above. That does not mean such problems will not occur, but they will be much less likely to occur if these principles are established and followed, and then only occur in defiance of explicit rules against them. Of course, governments often see *political risk* in operating public providers, and it has been common for public providers to be eliminated for this reason, regardless of how well they have been working. However, the fact is if government is still paying the cost of a service and/or has regulatory responsibilities, it will not fully escape criticism for poor performance by providers of that service.

There are two major aspects in which there are genuine intrinsic potential problems for public providers: relative efficiency and cost, and the danger of residualisation.

### The relative efficiency and cost of public providers

The reason most commonly proffered for removing or downsizing public providers is that they are less efficient and more costly than alternative providers. In fact, it is far from clear that public providers are less efficient or more expensive than non-government providers for providing equivalent services to an equivalent set of users.

There are four major points to consider. The first two relate to the potential for public providers to have higher costs, while the last two relate to the potential for non-government providers to have higher costs. First, government agencies are potentially subject to several intrinsic pressures

for *X-inefficiencies* (Leibenstein 1966).[21] These can arise because there is little or no contestability for the goods/services produced by a public provider, more bureaucracy (partly a result of the greater requirements on government agencies for probity and accountability) (Wilson 1989), guaranteed tenure of employment for many public sector staff, a public union wage premium (Hart et al. 1997: 1147) and soft budget constraints that can result in less discipline and urgency. In this context, large size can obviously have negative effects. While these forces indisputably can adversely affect the relative efficiency and cost of public providers, history shows they do not necessarily have to and are substantially avoidable if the above preconditions are in place. It is also the case that many public employees have a strong 'internal motivation' to provide the most effective and efficient services, and that guaranteed employment tenure can both attract better workers and enable them to fully focus on achieving good services.

Second, to the extent that public providers have higher total costs in any service sector, this usually results from higher labour costs of the sort that both: 1) underpin more services (from acting as a provider of last resort) and/or higher-quality services (using staff who are better paid because they are more skilled and experienced);[22] and 2) have broader positive systemic and societal effects (for example, attracting a sufficient supply of quality staff for the sector, ensuring a decent living wage for low-paid workers, helping to stimulate stagnant macroeconomic growth).[23] Empirically, multiple studies of human services by ownership of providers show that in general both unit costs and quality are likely to be lowest in FPOs and highest in public providers.[24]

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21 X-inefficiencies occur when a firm lacks the incentive to tightly control costs, generally because of a lack of competitive pressures. They are manifested in poor attitudes and practices of managers and employees, especially complacency, lack of responsiveness, poor workplace cultures, overstaffing, poor use of inputs and general organisational 'slack'.

22 The other side of this coin is that contractors may substitute much cheaper (and less-capable) labour.

23 Covid-19 has also shown the public health impact of low wages in human services. One factor in the virus spreading was that many aged care staff worked in a number of facilities because low pay led to them taking more than one job.

24 The lower unit cost is often described as 'higher efficiency' but in such cases 'efficiency' is usually measured simply by lower unit costs with little analysis of whether that reflects better ways of using resources. Indeed, the normally linked finding of lower quality suggests that, to a significant extent, it does not.

Third, some costs of non-government providers are greater than those of public providers. This can occur with both labour costs (for example, at more senior levels and from higher wages in some sectors such as private schools and private hospitals) and non-labour costs (for example, government has lower borrowing costs for upfront investments such as buildings and information technology). More significantly, however, are the multiple leakages of the service dollar in non-government providers (both NPOs and FPOs) for functions that are not part of the actual service. Fourth, many empirical studies over a long period show that, flowing from these extra costs, outsourcing government functions is often much more expensive than using public providers (Walker and Walker 2000; Mazzucato 2021). For Mazzucato (2021: 37–49), the claim that 'outsourcing saves taxpayer money and lowers risk' is one of the major 'myths' about modern government.

In summary, as noted earlier, it is not clear from theory or empirical evidence whether the cost of a public provider following the desirable operating principles in any specific case will have higher or lower total costs than non-government providers.

## The danger of residualisation

The other major problem for a public provider is the risk of residualisation. This in large part stems from the fact that in any well-functioning service system, *someone* must be designated as a provider of last resort to handle the more difficult cases, and this should be the role of the public provider. Government can and should absorb more risk and, without a public provider, there is often no provider of last resort.

However, this is a fine line for a public provider. Over time, it can become identified in the minds of users as simply a safety net for 'hard cases' that is unable to provide quality services. In Australia, this has especially occurred with employment services and housing, and is currently a major issue in schooling, where parents avoid some public schools that are seen to be offering a limited curriculum and/or dominated by disadvantaged students. This is reflected on the provider side by the process of cream-skimming, whereby some providers appeal to and disproportionately choose low-cost, low-risk and/or more affluent users, while rejecting the less able and less affluent. It is a given that public providers will have a higher proportion of 'difficult' cases, but it is important they also keep

getting a good supply of more capable users, so they can maintain the quality of their services and avoid a downward spiral of 'middle-class opt-outs'.

It is not possible to eliminate cream-skimming by non-government providers, but steps can be taken to minimise it, including: 1) ensuring genuine competitive neutrality whereby all providers that receive government funding (either directly or via subsidies for users) are required to take some of the more complex and higher-cost users (as has occurred with residential aged care in Australia); 2) adjusting the level of subsidies to the user profile of the provider (as in case-mix funding models); 3) means testing of both the user and the provider (in relation to both their income and their assets) in those cases where a user wants to opt out of the public provider and put a public subsidy towards paying for deluxe services (for example, as in private schools and aged care); and 4) reducing other incentives and opportunities for commercial maximisers as part of the design of human service markets.

## Improving the operation and outcomes of human service markets

This section explains how well-run public providers can uniquely add to improving the operation and outcomes of human service markets in a context where there are multiple problems with these markets and the desirable preconditions for public providers are in place. We first outline the broad roles public providers should play and then describe some specific mechanisms by which they positively influence markets.

### The broad roles of public providers in human service markets

The positive impact of a well-functioning public provider in improving the operation and outcomes of markets substantially flows from the influence it can have on other providers by establishing industry norms and practices.

First, it should seek to operate as an exemplary provider—a model of good behaviour for other providers in both its services and its commercial actions. Far more powerfully, however, its role will be to lead the way in

setting standards and benchmarks for the sector, especially in relation to the quality of services, the efficiency and cost of production and the price of services, by generating market pressures of which all providers need to take account. In summary, it means there is a large socially maximising provider with sufficient market power to set norms for the sector that other providers must follow if they are to remain fully competitive. In this way, the case for how a public provider can enhance the operation and outcomes of human service markets is firmly grounded in neoclassical microeconomic market theory. In effect, the public provider acts as competitive market theory claims a provider will act, responding to user needs and preferences and basing its prices on the most efficient long-run average cost. It is financially self-sufficient, without exploiting market power to charge high prices or collect 'rent'. Nor does it cut its costs by reducing the quantity or quality of its resources to such an extent that services are below a minimum acceptable quality.

In these ways, it can willingly act within the market disciplines that competition theoretically should bring, but which are blurred or lost in the imperfections of real-world markets and market power. Then, by the logic of competitive market theory, other providers would need to match the quality and price of the public provider or risk losing business. A public provider can thus both limit the exercise of market power by other providers and use its own market power in the public interest, acting as a powerful countervailing force to the incentives that markets can generate for poor behaviour by providers. In turn, government should have less need to use its coercive powers (regulation), indirect incentives/disincentives or persuasion (all of which have their limitations, as noted earlier).

A well-run public provider will actively adopt an industry and market leadership role in its own practice to advance the public interest. It is a combination of the attributes of its public ownership, including a prime focus on the public interest, and its size that gives public providers a greater potential capacity to have this impact compared with other providers. There is a large body of theoretical and empirical evidence to show that in markets with significant market failure, the presence of a public provider as a competitor in the market, efficiently charging at

cost, can be a powerful force to reduce the growth and exploitation of market power by other providers, to maintain quality services and to control prices.[25]

At the same time, the presence of alternative providers is an important constraint on a public provider misusing its market power should there be a change in membership of the board or management to people less committed to the principles outlined earlier. Alternative providers make it less likely the public provider will fall into the natural traps of monopoly power with less responsiveness to user needs and determining output and price in the interest of the provider rather than users and the wider society.

## How public providers improve the operation and outcomes of markets

As part of the broad role outlined above, there is a range of specific ways in which a public provider can improve the operation and outcomes of human service markets. This section outlines four of the main possible improvements—limiting the negative effects of marketisation, increasing the efficiency of the market, reducing the total cost of services and facilitating other goals of marketisation—and the key mechanisms that underpin each of them. While these show the major impacts of a public provider in a market, they are indicative rather than exhaustive of all the possible effects.

### Limiting the negative effects of markets

We have seen that, notwithstanding the positive effects markets can have on human services, they intrinsically work against achieving objectives such as universality, a minimum-quality service for all, equity, stability, transparency and accountability. In the more volatile managed markets based on demand-side funding, these risks are even greater (Cortis et al. 2013). Some examples follow of how a well-run public provider can limit the negative effects of markets in relation to the universality, stability and quality of services.

A public provider ensures everyone can receive a quality and efficient service by acting as a provider of last resort for people and regions otherwise unable to obtain services. In principle, in any specific case, it should be

25 For example, see Evatt Research Centre (1988), Quiggin (2003), Denhardt and Denhardt (2007), and McAuley and Lyons (2015).

possible to obtain some provider at some price to carry out this role, but it is done most effectively and efficiently if there is a single designated provider with a wider presence that can be deployed rapidly, rather than applying successive bandaids for each episodic case.[26] A public provider also ensures a stable and continuous service for all users. In a market, there is likely to be a continuing flux of providers entering and exiting the sector, and the stability of services for any person or area over time cannot be guaranteed if they have to rely on non-government providers.

A further example of how a public provider can limit the negative effects of markets is by its capacity to exert competitive pressure to keep the bar higher for the overall quality of services in the sector, preventing the 'race to the bottom' that has occurred in some sectors. One critical aspect of how this is achieved is by building and maintaining a quality workforce in the face of competitive market pressures to cut costs. The public provider can lead the way in following a 'high road' offering good remuneration and working conditions that stimulate recruitment and retention, rather than a 'low road' on which less able people or migrant workers who are prepared to accept lower pay and conditions are used to fill the gaps (Folbre 2006).

## Increasing the efficiency of the market

Public providers, however, can go beyond merely acting as a safety net and bulwark against the negative impacts of marketisation and play a key role in making markets work more efficiently via several mechanisms that promote competition and reduce production costs.

Most fundamentally, a public provider can help create a more efficient market by improving the information available to all participants. The availability of perfect information is central to effective markets, but human service markets are characterised by major asymmetries of information, which are made far worse by the current capacity of providers to claim commercial in confidence about much critical information. However, when one large provider is transparent about its own financial and operational detail, it can have a wider effect in improving the amount and quality of information available more generally in the sector. In turn, this can facilitate the development of a set of detailed benchmarks that can be used by service users (to compare providers), by government funding and

26 The next section shows why a public provider can do this more cost-efficiently for government overall than a non-government provider.

regulatory bodies (to assist in the design and management of the market) and by other providers (to guide their behaviour). It also reduces the capacity of commercial-maximising providers to exploit the asymmetries of information. Importantly, it gives funding and regulatory authorities more detailed information to enable industry parameters (for example, subsidies, co-payment rules, mandatory staffing) to be set at levels that generate the best outcomes. It is commonly difficult for authorities to obtain that information from providers at the level of detail needed. The presence of a public provider can enable the detailed insider knowledge to be available to users and to funding and regulatory authorities.

A second major mechanism by which a public provider can increase efficiency across a sector is by contributing to setting a platform for more efficient production costs and prices for services. It can achieve these levels itself but, by being transparent with its own operational and financial data, it can help establish benchmarks for quality and prices to which other providers must respond, driving the cost of and prices for quality services to a more efficient level.

A well-run public provider further contributes to overall efficiency through being the most cost-efficient provider of last resort. Ultimately, in any specific case, it should be possible to obtain some provider at some price to carry out this role, but the price charged by an efficient, socially maximising non-government body is likely to be higher than an efficient public provider. As well as the transaction costs for both sides in establishing and monitoring the contract, the non-government body will reasonably add a risk premium to cover not just possible cost blowouts, but also operational and reputational risks. This is a financially and commercially logical—and almost inevitable—outcome. Moreover, the non-government provider will often have a degree of market power in this situation such that the government agency responsible for the welfare of the person(s) involved has no option but to pay the asking price. As a result, the risk premium can be very large in some instances. Simple market theory suggests competition among possible providers of last resort will compete away (or substantially reduce) the risk premium; but the reality in markets is the high premium rate becomes the 'market rate' below which no potential provider of last resort will go, knowing that over time they will also have opportunities to receive work at this rate.

Finally, an important point from contestability theory (Baumol 1982; Baumol et al. 1982) is that there does not have to be a new entrant to promote more competitive and efficient outcomes from a market, merely that there is the real potential of one. In this way, there can be implicit pressure on incumbent providers in a market to provide more information and to reduce their costs and prices. Hence, it is important that, at the very least, governments signal that a public provider remains an option, even if one may not be established in every case.

## Reducing the total cost of services

The discussion thus far has revealed some ways in which public providers can reduce the total cost of quality services for both government and users via the market. First, they can reduce the need for other policy instruments such as regulation, thereby reducing the often-high administration, transaction and compliance costs associated with those instruments. Second, the transparency of a public provider will provide better information about costs to funding and regulatory authorities, which in turn will enable a more accurate assessment of the 'efficient price' for quality services on which the government subsidy paid to all providers should be based. Over time, this should reduce the level of the subsidies government needs to pay all providers for a service over the longer term. This effect will be reinforced by the fact the public provider's own costs are more likely to demonstrate the real costs of providing services, as its expenditure will not include many of the 'leakages' that are present with more commercially focused providers.

## Facilitating other goals of marketisation

Public providers can also play a distinctive role in promoting three aspects of improving services and service systems that are particularly important for the proponents of marketisation: choice, innovation and diversity of services.

**Choice:** There is much evidence that many Australians want their essential services (including human services) to be provided by a public provider. For example, in a 2009 survey across a number of human services, the proportion of people who preferred a public provider ranged from 36 per cent in child care to 87 per cent for health services (Meagher and Wilson

2015).[27] Given that choice has now been established as an overarching policy goal in human services in Australia following the acceptance by the Council of Australian Governments of the recommendation by the Harper Review of competition policy that 'choice should be at the heart [of] human services' (Harper et al. 2015: 247), public providers should logically play a large role in the delivery of most human services. Certainly, removing a public provider means choice for many people will be substantially limited.

**Innovation:** The proponents of marketisation argue that markets and competitive pressures generate innovation. Two associated arguments are that private enterprise is more 'adventurous' and not stifled by the bureaucracy of government, and that competition allows for the entry of new, smaller enterprises that are engines of innovation. The evidence about each of these claims is, at best, mixed.

While some small organisations are very innovative, most new technological and organisational developments in today's world come from large bodies that have the capability and resources to bring together well-equipped and well-resourced multidisciplinary teams, and to achieve the critical mass, economies of scale and efficiencies necessary for continuing innovation. In these ways, the large size of a public provider can support innovation. Moreover, stringent service standards that limit the entry of new providers to those most capable can reduce the need for regulation of behaviour, thereby enabling more innovation by all providers (Davidson 2017).

It is also important to understand the nature of innovation, which Mazzucato (2018) summarises as being 'cumulative, collective, and uncertain'. In practice, most innovation in organisations involves incremental adaptation, drawing from existing, albeit often newly established, knowledge, rather than new, discrete breakthroughs by unconnected players. Hence, rapid and wide dissemination of new ideas, processes and technology is critical in generating a culture of innovation, but the dominant ethos of commercial in confidence means that, in practice, service providers in a competitive market try to keep new developments to themselves. A public provider, however, should have as part of its remit the responsibility to disseminate innovations, both its

27 The preference of many users for public providers is also revealed in international data. In the United Kingdom in 2013, 84 per cent of people believed the National Health Service 'should be run in the public sector' (YouGov survey, cited in Mazzucato 2018: 253).

own and others of which it is aware. There is little or no incentive for non-government providers to do this; on the contrary, there are strong incentives for them not to do so.

Public providers can also play an important role in stimulating and making breakthrough changes, as Mazzucato (2015) has demonstrated. She argues that, historically, public agencies have been prepared to enter areas considered far too risky by non-government bodies, and there is little evidence of 'crowding out' in highly innovative areas where private companies avoid large uncertainties. For Mazzucato, governments should embrace risk, not avoid it, and reducing the role of government can destroy a key dynamic that generates much of the innovation in the wider economy.

**Diversity:** A popular view of public providers is that they provide rigid, standardised, one-size-fits-all forms of services that are unresponsive to the distinctive needs and preferences of individual users. This can be—and often has been—the case, but equally there are many examples of public providers that provide diverse and responsive services. A well-run public provider with scale has a level of resources that allows greater flexibility to respond to the full range of needs among its users, including services for groups with vital niche needs that are not otherwise viable.[28]

It is often asserted that non-government bodies can be more responsive and diverse in their services. In practice, however, commercial (and survival) considerations mean they must also often focus on achieving economies of scale to lower cost, which leads to greater standardisation of services (Ritzer 2013), institutional isomorphism (Di Maggio and Powell 1983) and mission drift (Weisbrod 2004)—all strong forces to reduce the diversity of providers and services.

28 With human services, this particularly occurs at a community level where specialised services for a local subgroup (such as Indigenous people) become embedded in the day-to-day operation of local public schools, public hospitals, TAFE centres, and so on.

## The effect of residualisation on the value of public providers

We have looked at how the problem of residualisation can arise for public providers and broad approaches through which it can be best addressed and minimised. We now look at how it can affect the capacity of public providers to achieve their potential contribution.

Increasingly, public providers in many sectors have been marginalised and reduced to the role of a residual safety-net provider for only the most difficult users or regions. The size of a public provider, however, is at the core of the unique contributions it can make, and much of its value is dissipated if it is simply a residual safety-net provider.

First, it means the organisation will be unable to achieve the critical mass and economies of scale and scope that are necessary for maximum effectiveness and efficiency. Second, it can only carry out the safety-net role effectively and efficiently if it has a broader role and presence, and thus is able to respond rapidly in any area. Third, residualisation creates a continuing downward spiral in the appeal and capability of a public provider. Fourth, it can lead to tighter eligibility criteria for using a public provider, resulting in some people with real needs 'falling between the cracks', as is now clearly happening with public housing in Australia. Fifth, and most damagingly in the context of this chapter, it means public providers will be much less influential as a positive force in setting benchmarks for the market and acting as an industry leader to improve the service system and the market.

# Can other providers replace a public provider?

While the discussion thus far has been presented largely in terms of a publicly owned and operated provider, it has also made the broader case for there to be a large provider working in the public interest with the authority of government behind it. One implication of the arguments used for marketisation is that a government will better achieve its goals by paying a non-government body to do what its public providers have been

doing. This section considers the possibility of government contracting a single social-maximising NPO to carry out the roles and follow the principles expected of a public provider outlined above.[29]

## Frameworks for decision-making

A range of frameworks have been developed to guide governments as to whether there should be public providers in specific fields or whether services should be 'externalised'. Despite the simplistic nostrums encouraged by many neoliberal ideas, the reality is that deciding whether a public provider is required is a complex question, where determining what should happen depends very much on the circumstances of each situation.

The framework developed by Alford and O'Flynn (2012) to determine when and how a government-funded service should be externalised is a good example of the approach needed. It is based on three key considerations—namely: 1) the impact of externalisation on the services (for example, in terms of the objectives of human services outlined earlier); 2) the impact of externalisation on the broader strategic goals of government beyond the services; and 3) the relationship(s) between government and the external provider(s) required to effectively monitor an external provider and assess the two sets of impacts. There are, then, various frameworks to assess the three considerations, some examples of which follow.

Central to assessing each of the three considerations is the concept of 'incomplete contracts' whereby it is not possible *ex ante* to specify all the situations that may arise *ex post*. This is almost inevitably the case with human services given their distinctive characteristics. There are three major aspects of incomplete contracts of particular interest here: asymmetries of information, the impact of poor-quality services and the unavoidable incompleteness of such contracts.[30]

29 This is the alternative that is most favoured by the critics of public providers. The other major alternatives are to rely on the market, to contract an FPO or to contract multiple NPO and/or FPO bodies to jointly carry out the role of a public provider. Each of these alternatives simply introduces complexities that make the case for using non-government providers less attractive. Charter schools in the United States provide a good example of the multiple problems that can arise where a number of non-government bodies operate the 'public option' (Sitaraman and Alstott 2019: 115–17).

30 The term 'contract' here also applies to the basis for government approvals of providers to operate in quasi-voucher licensing (demand-side funding) systems (see note 14). Indeed, the problems discussed here are likely to be even greater in quasi-voucher licensing systems, which place much greater onus on individual users to detect and rectify problems.

First, asymmetries of information mean a purchaser (whether a user or government) cannot be fully aware of the quality of the production process or the final product. Blank (2000) developed a model to help determine the appropriate level of 'public–private interaction' in social services in any specific case. Essentially, she identifies the major sources of market failure in social services[31] and then argues that the nature and extent of government intervention in each situation should vary with the nature and extent of market failure. This is necessary given the greater the market failure in any situation, the greater are the transaction costs and uncertainty for government in ensuring the objectives of a service are being met by an external provider. Blank concludes that, given the extensive market failure in most social services, a public provider is often the best option, although she does have an important caveat that it is necessary to consider other factors in each situation, especially the efficiency of the current public option.

Hart et al. (1997) point to a second problem with incomplete contracts through the increased risk that a supplier seeking to minimise costs will compromise quality, given that incomplete contracts enable 'an agent with strong incentives to pursue one objective [that is, lower costs] … to shirk on other objectives' (Hart et al. 1997: 1131). The 'shirking', of course, is possible because of the asymmetries of information. Hart et al. (1997: 1130) argue that 'the bigger the adverse consequence of [non-contractable] cost cutting on [non-contractable] quality, the stronger is the case for in-house [government] provision'. In the language of risk-management theory, Blank focuses on the *likelihood* of problems, while Hart et al. focus on the *impact* of those problems.

Third, the uncertainty and risk arising from incomplete contracts can never be totally removed, for, as Williamson (2000: 599) has noted, 'all complex contracts are incomplete', given the intangibility of many of the factors and the extremely high transaction costs of trying to establish the full reality in such cases. Ultimately, this means a government considering outsourcing faces the classic 'make-or-buy' question that confronts any organisation needing to obtain inputs (Coase 1937).

31 The sources of market failure that Blank identifies are essentially the same as those derived from the distinctive characteristics of human services set out earlier in the chapter.

## The limits of external providers

It is clear many non-government providers can provide services for significant numbers of people that are as good, and sometimes better, than a public provider. However, there are a range of reasons why they cannot achieve the key *systemic* contributions of a well-run public provider, or at least cannot do so without significant extra cost and uncertainty.

First, there are extra costs associated with contracting compared with an efficient public provider. There are transition costs in moving to the external provider—costs that are repeated if the contractor is changed in the future. There are transaction costs in establishing and managing the contract, including disputes over what precisely is required under contracts—something that is very much the norm in such arrangements. Additionally, an NPO will inevitably (and sensibly) add a risk premium to the price given the financial, operational and reputational risks it faces, while government will have limited control over the various leakages of the service dollar (for example, marketing), especially where the contractor has a broader operation. After all these costs, there remains the inevitable uncertainty about the operations and performance of any contractor.

Second, an external provider generally will have less capability and motivation than a public provider to achieve systemic and broader strategic goals. It does not have the same institutional linkages, system leverage and capacity to coordinate resources and other bodies that come with being a government agency. Moreover, in many cases, the contractor will not be able to respond as quickly to urgent and emerging needs, as it must negotiate funding and the conditions of any changes to its contract. Then there is the issue of motivation. An external body, however well intentioned at the outset, will ultimately have to be concerned with its own survival and growth in ways that may conflict with the public interest.

Third, there will be developments during the contract that will generate more issues. Inevitably, there will be changes over time both in the environment in which the provider must work and in the provider itself that will challenge the sustainability and continuance of any initially agreed role and operating principles for the external provider. In addition, a contract to effectively operate as a public provider will enable the NPO to develop and use significant market power, which it can then use in its own interests rather than the public interest. Then, if the outsourcing

arrangement does not work out (as inevitably happens in some cases), it can be difficult—and costly—to revert to a public provider, especially given the leverage an incumbent contractor has in such a situation.

Fourth, it is commonly claimed that NPOs have positive features that cannot be replicated by public providers—in particular, that NPOs have greater flexibility because they are free of the restraints of government bureaucracy and closer to the communities they serve. These may or may not be the case in each situation, but there are many examples of public providers having greater flexibility and being closer to their communities than are non-government bodies.[32] Finally, an NPO cannot, by definition, give many people their first choice of a public provider.

This is not to say there is no case in which a non-government body can replace a public provider. After all, the reason for frameworks such as those of Alford and O'Flynn (2012) and Blank (2000) is to examine where that is possible. Rather, the point is that, in general, there are powerful arguments for retaining a public provider in a competitive human service market that are all too often ignored. Moreover, these are not all-or-nothing situations. It may be that after consideration of all the factors, government decides to have a mixed market, making services and funding more contestable, but still retaining a public provider to ensure that all the critical unique roles of public providers set out in this chapter are achieved.

## Conclusion

The core proposition in this chapter is that a public provider can be a powerful and unique policy instrument at a systemic level to improve the operation and outcomes of markets in sectors that provide an essential good or service, but which have substantial intrinsic market failure. The need for a public provider is especially strong where government must be a significant source of the purchasing power for the good or service, as with human services.

32 See Lyons (2001) and Dollery and Wallis (2003) for discussion of 'voluntary failure' and the problems associated with the delivery of services by NPOs.

Unfortunately, this valuable policy instrument has been progressively devalued and discarded over the past four decades under the weight of ideology, politics and private interests, with the extensive marketisation of human services leading to a major reduction in the presence of public providers in most human services. At the same time, however, marketisation also means that the capacity of public providers to improve the operation and outcomes of markets—of little relevance in human services before the 1980s—assumes some significance, especially in light of the multitude of problems with markets in many human service sectors, as revealed in this book.

Public providers are not perfect, but they have an important role to play, at both an individual and a systemic level, in human service markets. Governments have a range of other instruments with which to address the problems of human service markets, but too often these instruments are limited in their impact, costly and even counterproductive. The revitalisation of public providers is thus an important element in building future social infrastructure. They should not be the only or a privileged player in a market, but they should be used as an essential policy instrument to ensure a basic level of services for all and to assist the broader service systems and markets to work better. Moreover, the option of a public provider is central in considering how best to design a managed market in each situation. Even if the option is not taken up, the analysis can point to the inherent weaknesses of a proposed human service market that need to be addressed.

The benefits of public providers set out in this chapter presuppose a government that wants to optimise the public interest and user outcomes from the market—and not simply outcomes for large non-government providers (both NPOs and FPOs) closely aligned to the government. Critical to the success of public providers are the senior people responsible for them. Ministers, board members and executive staff must be totally committed to the operating principles outlined earlier. If they are not—and ideology, politics and private interests are allowed to dictate the design and management of the markets—it is hard to see *any* human service market working well.

Unfortunately, however, there are now many powerful forces inside or influencing government that are not focused on achieving the best possible public policy outcomes. This may extend to 'state capture', whereby narrow private interests have such access and influence they are

able to effectively determine and control policy and the distribution of public resources in a sector.[33] In such cases, one could argue that a public provider represents a worst-case scenario to be avoided.

Notwithstanding these extreme cases, surely if there is a single big lesson from the past two centuries, it is that successful economies and societies are based on the effective blending of markets and government intervention. While there are many possible variations of how this blend can be achieved (Esping-Anderson 1990; Gingrich 2011), neither monopoly public providers nor total reliance on non-government bodies and the market is the best way to provide human services. In this context, strong and active public providers as participants in competitive markets can play an important role.

Some of the above will be derided by some as outdated and ideological, but this is not some utopian view of public providers, nor a proposal to return to the monopoly public providers of the welfare state. Rather, it is a contemporary twenty-first century view that absorbs the lessons and failures of both the welfare state and neoliberalism and builds on the strengths and limits of markets and the state. It acknowledges the limitations and imperfections of public providers, but in a world of choosing between imperfect alternatives where the theory of the second-best is ever-present, the public provider remains an important policy instrument not just to improve human services and service systems, but also to make markets for these services work better.

Ironically, proponents of marketisation have become so fixated on dismantling the influence of the state that they have overlooked the one mechanism that may actually make human service markets work well.[34] In practice, the lack of a substantial socially maximising public provider is a major risk factor for both the operation of markets in human services and the overall provision of these services.

33 See Hellman et al. (2000) for a seminal paper by World Bank staff on the concept of state capture, Murray and Fritjers (2017) and Australian Democracy Network (2022) give recent Australian perspectives.

34 This is similar to the argument of Mazzucato (2015) that a reduced role for government in research undermines a core driver of innovation.

## Epilogue: Future prospects

This chapter is relevant at two levels for the future: to revitalise existing public providers and to support the establishment of new public providers. Despite a substantially reduced presence, public providers still play a significant role in the delivery of human services in Australia, especially through public schools, hospitals, housing and vocational education, as well as having a presence in fields such as aged care, primary health care, homelessness and child protection. This chapter shows how those services can be revitalised to achieve much more than they have been asked to in recent decades.

Insofar as establishing new public providers (or restoring former ones), this is only likely on a larger scale as part of a turnaround in the broader attitude to and understanding of the role of government. The recognition of the need for this turnaround is certainly occurring on many fronts as the perils of neoliberal ideas and excessive marketisation are revealed. To some extent, it has happened over the past decade with public providers in major new initiatives (such as the National Broadband Network), while the importance of public providers has been reinforced in Australia since 2019 through the bushfire, flood and Covid-19 crises.[35] Notwithstanding these developments, it may be some time before there is a more general revival of the belief in the value of government and the opportunity for a more substantial use of public providers.[36]

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35 The National Broadband Network is responsible for the core infrastructure of open-access data services (including the internet) in Australia.

36 However, even the most pessimistic view of the future for public providers should see the position presented in this chapter in the same light as the apparently dim prospects for success of the neoliberal ideas of the Mont Pelerin Society when it was established in 1947. Those ideas have now ruled the world for the past 40 years.

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