CMPO

Market and Public Organisation

Introducing CMPO

Issue 1
June 1999

Market and Public Organisation is a new bulletin which will be produced twice a year by the Centre for Market and Public Organisation – a new research centre based at the University of Bristol. Each issue will contain a series of short articles summarising the research of the Centre and assessing topical policy issues. In this first issue we take the opportunity to introduce the Centre and its research.

Private companies now provide many of the goods and services that have traditionally been the responsibility of the government. Important public services operate in market-like environments with consumer choice, price incentives and regulation. Public sector workers now commonly face incentive contracts and performance related pay much as their private sector counterparts do. In short, the balance between markets and the state has changed radically over the last two decades. This is set to continue with the recent White Paper on *Modernising Government* and new initiatives in health, pensions and education. The organisation of such activities on the 'boundaries of the state' is thus a key policy issue. It is also the focus of exciting new research. The objective of the *Centre for Market and Public Organisation* is to develop our understanding of the appropriate design of these activities and make a significant contribution to the policy debate.

Contents

The Centre for Market and Public Organisation is a new research centre based at the University of Bristol. Core funding for the Centre has been provided by the Leverhulme Trust, with a grant of approximately one million pounds over five years, to fund four research projects which together form their 'Public Sector, Regulation and Markets' programme. These projects concern competition and incentives in the welfare services, including health and education; regulation of newly privatised entities; principles of organisational design; and political imperatives in welfare services reform. In the first few months the Centre has received funding for further research projects from the ESRC. These look at the demand for private medical insurance, auditor reputation and effectiveness, and poverty dynamics in Britain.

We intend to make the Centre the first port of call for academics and policy-makers for information and analysis in these fields. We produce a working paper series along with hosting a programme of one-day workshops and also occasional larger conferences. Each issue of *Market and Public Organisation* will list recent working papers and advertise workshops and conferences (see back page). In addition, CMPO is developing a *Resource Centre* for policy makers, journalists, practitioners and academics.

The CMPO is uniquely placed to make a major contribution at the highest academic and policy levels with its mix of theoretical, applied and policy expertise. Those working within the CMPO have practical experience of the policy problems and have published extensively in the areas of health economics, regulation, privatisation, poverty and incentives in organisations. The research programme also benefits from the Centre's thriving visitor programme. First visitors include Hans Gersbach from the University of Heidelberg who visited the Centre in April and Professors Stephen Coate and Sharon Tennyson of Cornell University will both visit during July.

The Centre was officially launched at the beginning of the year by Clare Spottiswoode, former Director General of Ofgas and a member of the Home Office's Public Service Productivity Panel. In her address she emphasised that the research agenda for the CMPO could not be more timely: designing appropriate ways to reform and incentivise the wide range of traditional public sector activities, such as health, education and the utilities, is a major question for policy makers. She concluded that the Centre's mission to develop our understanding of what can be achieved and to make a significant contribution to the policy debate is extremely welcome.

To help promote the launch of the Centre we are also grateful to KPMG for funding a CMPO meeting in London at the end of last year. A discussion on public sector was led by Dame Sheila Masters and William Waldegrave. The guests included many leading figures in the public and private sectors with experience of public policy, such as the regulators Professor Stephen Littlechild (electricity) and Mr David Edmunds (telecommunications).

The Centre is currently undertaking seven research projects. These are:

Competition and incentives in the welfare services (funded by the Leverhulme Trust). The Thatcher reforms of the publicly provided welfare services introduced competition into the supply of public health care, education, rented housing and local government services with the aim of increasing efficiency. Similar reforms have been implemented elsewhere, but the extent to which competition brings increases in efficiency in the welfare sector is unproven. The research is examining the impact of competition in health and education markets. We will undertake both theoretical and empirical research, with the aim of establishing the conditions under which competition is welfare enhancing.

The regulation of newly privatised entities (funded by the Leverhulme Trust). At a general level the analysis of public and private sector provision focuses on two models: (i) public or quasi-public provision, and (ii) private provision with the emphasis on regulation. However, many of the regulatory problems that exist in the markets with newly privatised companies have arisen not because of private provision *per se* but directly or indirectly from the fact that the providers have been transferred from the public to the private sector. The development of regulation of this third category, newly privatised providers, is the central theme of this project.

Incentives in the public sector (funded by the Leverhulme Trust). Explicit incentives in the public sector are often inappropriate. Focusing on what is easily measurable might lead to agents merely manipulating the figures rather than serve faithfully their role in the organisation. For instance, there are real concerns that incentivisation of the National Health Service may prejudice doctor-patient relationships. For these, and other reasons, implicit incentives based on professional mores, and reinforced by career concerns, are very important. Exploring these issues is the subject of recent and ongoing research within the Centre.

Political imperatives in welfare services reform (funded by the Leverhulme Trust). The boundaries of the public sector are explained not only by how public sector organisations should best be organised, but also by considering the motives and

incentives faced by those who make political decisions. The research will explore these political imperatives and compare the UK experience to that of a number of OECD countries which have adopted a similar reform path.

The Demand for Private Medical Insurance (funded by the ESRC). This research is studying the impact of changes in the perceived quality of the NHS on the purchase of private health insurance. The aim is to further understanding of the growth of private welfare services in the UK.

Reputation and Audit Effectiveness (funded by the ESRC). The project will focus on investigating the creation and maintenance of auditor reputation and the relationship between the effectiveness of auditor reports and the environments in which auditing takes place.

Poverty Dynamics in Britain (funded by the ESRC). The research will commence in September 1999 and will analyse the impact of individuals' background, schooling, labour market and family histories on the incidence and duration of poverty. A model will be developed which will be used to explain dramatic changes in poverty in Britain over the last 20 years, and to assess policies to alleviate poverty.

The Centre currently has 17 staff and five associate members. These are:

Academic
Paul A. Grout (Director and Professor of Political Economy),
Carol Propper (Deputy Director and Professor of Economics of Public Policy),

Simon Burgess (Professor of Economics),
Paul Gregg (Senior Research Fellow),
Ian Jewitt (Professor of Economics),
Ian Tonks (Professor of Finance),

Maija Halonen (Lecturer in Economics)
In-Uck Park (Lecturer in Economics),

Research Assistants
Katherine Green, Andrew Jenkins, Paul Metcalfe, Arran Shearer and Mathew Stalker.

Research Students
Jennifer Ireland, Clare Leaver and Alison Thomas.

Co-ordinator
Clare Cox

Associate members:
Richard Hodder-Williams (Professor of Politics)
Hilary Land (Professor of Social Policy)
Aileen McHarg (Lecturer in Law)
Martin Partington (Professor of Law)
Nigel Thrift (Professor of Geography).

Incentive Pay for Teachers

The Government's recent proposal of performance-related pay for teachers is a key component of their drive to modernise government, but has been widely criticised. In this article **Simon Burgess** *and* **Paul Metcalfe** *suggest that incentive schemes do work, but have to be carefully designed to avoid undesirable side-effects. They point out some problems in the government's current plans and set out an alternative way of implementing incentives for teachers. This is based on school-level incentives. The idea is that this will foster co-operation and teamwork rather than being divisive, and that it will give Headteachers the incentive to make the right decisions regarding the pay of their teachers.*

The Government's recent proposal of performance-related pay for teachers is a key component of their drive for 'Modernising Government'. It is part of a programme extending such schemes throughout the public sector. The proposal has had a mixed reaction.

Public and teacher opinion is divided and the main teacher union is threatening strike action. Criticisms include that incentive schemes have no effect on work effort, that they are divisive and that they lead to bureaucratic confusion and inefficiency. In short, a common view is that they don't work.

We use recent economics research to offer a commentary on this debate. We set out some of the issues that need to be addressed in designing appropriate incentive schemes for teachers. We argue that the government's current plan has flaws, but more constructively we sketch out an alternative way of implementing performance-related pay that avoids some of the problems. This is based on school-level rather than teacher-level incentives.

Evidence suggests that incentive schemes do work

One response to the idea of incentive schemes is that they simply don't work – they have little influence on people's work effort. In fact, the bulk of the evidence available suggests that incentives do work. Studies on workers ranging from sports stars, sales staff, chief executives, skilled manual workers to doctors and civil servants all show that financial incentives do matter. Indeed, such schemes can have substantial effects on behaviour but unless carefully designed can lead to unintended and undesired outcomes. Typical cases involve people aiming to hit quantity targets regardless of quality. Another example is provided by the current promotion system in schools: while promotion brings higher pay it also brings a very different set of job tasks. This can create a set of counter-productive incentives: as the reward for excellence in teaching involves doing less teaching and more administration, this may not encourage people capable of excellence in teaching to demonstrate it. At present, good teachers are rewarded by making them give up teaching.

A classic case of the perverse effects of incentive schemes is when a job requires a number of tasks, all valuable but only some of which are easily measurable and rewarded. Unsurprisingly, people in such jobs will divert their time and effort to the rewarded tasks, to the detriment of the overall performance of their organisation. This is a problem that many people have with the idea of using incentive contracts in the public sector, and for teachers in particular. If helping colleagues or the school at large is not rewarded then much less of it will happen. A solution would be to reward co-operation, but this is hard for an outsider to measure objectively.

The government's proposal appears to be based on a recognition of this problem. A central element of the scheme is an annual appraisal which considers and rewards a teacher's performance as a rounded whole. However, there are a number of well-documented problems with this approach. Essentially, such schemes quickly become bureaucratised with assessors (in this case, Headteachers) reluctant to downgrade or dramatically upgrade individuals with whom they may expect a long term working relationship. This centrality bias or bunching reduces the effectiveness of the incentive scheme as it fails to truly distinguish and reward excellent performance. Eventually the scheme can become little more than an annual pay increment with some added flexibility. Typically the assessor has little incentive of her own to get the decision right.

However, the government's scheme does have an extra layer of external assessment. To advance beyond the national "threshold" and be eligible for further pay increases, a teacher's case is evaluated by an external assessor against a national standard of excellence. This certification scheme rewards teachers for ability and effort. Clearly, the scheme requires a great deal of detailed and rounded information on a teacher's performance. But we already collect similar information through OFSTED reports: the information requirements would not be that much more onerous than at present.

There remain a number of unresolved issues and problems. The first is the nature of the funding for the scheme. Are the salary increases to be met outside the school's budget? If so, why not advance all teachers in the school? The incentives for the Head to make the right decision depends on the impact of her decision on her budget. This is one of the key unresolved issues. The government's view on the appropriate funding mechanism is not yet decided. Second, the scheme is likely to fulfil predictions that it will be divisive. Teachers will see themselves as in direct competition with one another. Third, once past the threshold, teachers may have a much reduced incentive for good performance.

An alternative is to look at the best level at which to introduce incentives. In the UK and the US, the private sector is moving to a more flexible interpretation of 'variable' pay. Recent research at CMPO shows that in the UK private sector team-based incentives are common for white-collar workers; in the public sector they are almost absent. This is one of the most striking differences between the public and private sectors. The appropriate mix of individual-based and group-based schemes depends on the nature of the production process, on the ways in which the activities of one worker affect the output of her colleagues. While stand-alone work calls for individual-based incentives, these are unlikely to produce the best response when the value of the output is to a considerable extent collective. Group-based incentives suffer from the possibility of some individuals free-riding on their colleagues' effort. On the other hand, peer pressure to enforce group effort norms can be powerful. The evidence on this point is not yet conclusive. This is certainly one issue where new research would be valuable. Group-based incentives will also be much less divisive among workers and indeed can foster team spirit.

Turning to education, the core aim of putting children into schools is that they emerge better educated and better citizens. Since every child will be taught by many teachers, we can say that teaching is a team activity. One set of lessons builds on another and one style of teaching complements and enhances another. There are two reasons why a system of group- or school-based incentives may be helpful. First, it recognises the co-operative nature of much of teaching and applies the incentives to the team rather than a single individual. The Headteacher is in the best position to recognise and reward team performance. It will also be less divisive. The second key point to note is that having school-level incentives will produce implicit teacher-level incentives. The huge amount of money flowing into Premiership football teams has raised individual player salaries and provided a great incentive both to greater effort and also to attract talent in to the industry in the first place. In the public sector, the assessment of the research output of University Departments (team-based) has fostered a much more active market for academics (individual-based). Thus although the explicit incentives would be for schools' performance, this would lead to strong incentives for teachers to demonstrate their ability and effort in a full range of professional duties. Because Headteachers evaluate the impact of a teacher on the school as a whole, this forces them to make a balanced assessment unencumbered by centrality bias. This form of peer review more closely aligns the information and capacity for judgement with the incentives.

Thus one way to circumvent problems with the current scheme would be to radically re-balance the mix of incentives in favour of school-level incentives. These could be in the form of many private sector contracts and involve a threshold level of school performance with variable bonuses payable for performance above that threshold. The nature of these targets would depend on the government's educational aims: overall educational attainment or improvements for the less able or whatever. The bonus would be paid to the school; the Headteacher could decide to spend this on resources, pay increases for some or all teachers, or simply more teachers.

School-based incentive schemes may be useful

The government's current scheme and this alternative proposal both involve much greater responsibility for Headteachers and Governors in managing schools. This raises a number of issues which need careful consideration if these reforms are to succeed. For example, Headteachers will have to manage schools in a sense much closer to that in which managers operate in the private sector. They will have to be involved in personnel strategy (choosing appropriate pay structures, choosing who to hire), and in 'production' decisions (more versus better teachers, more teachers versus more resources). What are their incentives to be? Are they to have any financial incentive linked to the school's performance? Governors will also have considerable responsibility but some will have little direct interest in the success of the school while others may have a strong but partisan interest. What is the appropriate degree of accountability of Heads to Governors? Should Governors have the power to select and dismiss Heads? How should Governors be selected? Should Governors be given some incentive 'stake' in the school? These questions all need addressing before the implementation of any incentive scheme in the provision of education.

Responsibilities and incentives of Headteachers and Governors are crucial

Recent economics research can be very helpful in highlighting and addressing the issues that arise in designing good incentive schemes. The government's current proposal for incentive pay for teachers is vulnerable to the problem of bunching of assessments (centrality bias). The creeping bureaucratisation of the system would blunt its incentivising power. It would create a divisive atmosphere and reduce co-operation among teachers. An alternative proposal is sketched out above. There is considerable scope for adjusting the design of the scheme to take account of recent research. Postponing its introduction for one year gives a chance to address some of the issues involved.

We are grateful to our colleagues at CMPO for useful discussions on this topic, and in particular to Paul Grout, Gervas Huxley, Ian Jewitt, Carol Propper and David Winter for very helpful comments.

The 1998 Competition Act

The 1998 Competition Act will be fully in force within twelve months and represents the most important shake up in competition policy in the last twenty five years. In this note **Paul Grout** *provides a short primer on the Act and an assessment of the change in competition policy.*

The central provisions are welcome

A common and valid criticism levied by many EU companies is that they have to operate within two completely separate and different forms of competition policy, one for cross border trades within Europe and one for trade within their home country. Soon this will no longer be a problem for the UK corporate sector since we are now at the end of the process of rewriting our competition law and policy so that it will reflect and harmonise with the European Community. The new policy has had a long period of gestation having been proposed in the Green and White Papers of 1988 and 1989 but it has finally arrived. It becomes fully live in 2000 and will be the biggest shake-up of UK competition policy for at least twenty five years.

This note summarises the main features of the new policy and provides an assessment. The main conclusion is that the central provisions are to be welcomed and, if the opportunity to make real change is grasped by the Office of Fair Trading (OFT) and the Competition Commission, there should be a considerable improvement. Existing UK competition policy is criticised, amongst other things, for being too soft, lacking teeth, not consistent with EU policy, slow to act, too discretionary and insufficiently transparent. The new Act will go a long way to resolving some of these problems. The single biggest problem concerns the application of the new rules to regulated industries which are to be enforced concurrently by the Director General of Fair Trading (DGFT) and the industry regulator. Most regulators have left it almost too late if they intend to provide draft guidelines and from the evidence available from the sole existing draft it is far from clear that the concurrent application will be successful.

Consistency with Europe

European Competition Policy is centred around two articles of the Treaty of Rome, Articles 85 and 86, and the main thrust of the new policy is to create an Article 85/86 lookalike within the UK.[1] Articles 85 and 86 only apply to activities that affect cross border trade and have no jurisdiction over purely internal activities. This is the source of problems for the corporate sector whenever the home competition policy is not consistent with EC policy, particularly as a large area of overlap exists. A small but famous example of this effect is the impact of the Bosman ruling in soccer. This EC ruling ensured freedom of negotiation to soccer players at the

[1] Article 85 and 86 are renumbered 81 and 82 in the Treaty of Amsterdam. Although effective since last month few people are currently using the new terminology.

end of their contract but since the ruling can only apply to cross border trades, to take advantage players had to move between countries (i.e. become a cross border trade) if their home competition policy was not consistent with the EC. This effect, in combination with the influx of money into the UK game, is the main reason why the Premier League has been populated with famous foreign players.

Regardless of the superiority or otherwise of particular approaches, the drive to unification alone is to be welcomed since it minimises these kind of distortions in trade. Indeed, somewhat unusually, consistency of application between the EC and the new competition policy is directly built into the Competition Act in Section 60. Article 85 is recreated in the UK legislation as the Chapter I prohibition and Article 86 as the Chapter II prohibition. Both prohibitions import the EC law virtually word for word. Section 60 explicitly states that the UK authorities must ensure no inconsistency in the application of these Prohibitions with the principles of the EC Treaty and the decisions of the European Court although there are some ambiguities in the wording. This unusual provision is extremely helpful because it enables practitioners to lock onto the European case history. Although quite small in some areas, e.g. predation, the European history will help to minimise inconsistencies. This is particularly important since not all of the existing UK legislation (notably the 1973 Fair Trading Act) is being scrapped when the Competition Act comes into force.

The main provisions

One of the most important changes will be that companies found to be in breach of a Chapter I or II prohibition can be fined and third parties can seek compensation. This is a major shift and it is almost certain that the UK authorities will be seeking to establish their authority by the imposition of a very significant fine as soon as possible. The ceiling for a fine is 10% of UK turnover. While it is not expected that fines will reach this maximum, in Europe fines with equivalent current value of well over £100 million have been levied and there is no reason to suppose that they will be lower in the UK. The ability to impose fines is one of the most obvious benefits of the Act. UK Competition Policy has until now only been able to condemn activities and suggest structural changes. Punishments were extremely limited. The ability to fine brings flexibility and teeth. Appeals are heard by the Competition Commission which has an appeals tribunal and also takes over the role of the old Monopolies and Mergers Commission. The MMC has been dissolved although in practice for its traditional activities this has been a re-badging exercise with staff and chairman remaining unchanged.

Chapter I of the Competition Act prohibits agreements, decisions and practices which have as their object or effect the prevention, restriction or distortion of competition. Any agreement that is prohibited is automatically void. Some agreements, however, may be exempt; there is automatic parallel exemption with those in the EC. These three features are imported directly from Article 85. The most immediate thing for companies to note is that it is no longer the form of an agreement but the effect and intent that is central. Agreements that intend to restrict trade or do so unintentionally are prohibited and, save for the specific exemptions, there is no form of agreement that is safe from being declared void and bringing the risk of fines. Parallel exemptions brings with it all the problems that have arisen under Article 85 but fortunately the Commission is changing its exemption policy to make more economic sense and streamline procedures.

Effects and intent are central

Chapter II prohibits the abuse of a dominant position. The mechanism for implementing Chapter II is that the Office of Fair Trading first defines the market, then asks whether the firm is dominant in that market and finally asks if it is abusing its dominance. It is only the last stage, i.e., the abuse of a dominant position, that is prohibited and may result in prevention and fines. The formal assessment of markets and dominance following EC precedence is something new for the OFT (since cases were previously passed on to the MMC at an early stage). This will require an increase in input by the OFT and may be difficult to implement without a significant increase in staff. The problem facing the OFT is made more difficult because of the history of the European Commission in this area. A formal outline of how to define a market has only recently been published by the Commission and so there is limited history and transparency to draw on. Similarly the application of the definition of dominance is not always easy. Here there is a worrying

potential for deviance between the Community and UK which could then rein in the scope for real changes.

The new Chapter II prohibition imports the strong EC focus on competition rather than efficiency. Economists would tend to see the latter rather than the former as the primary consideration. This presents one of the main problems for the new Act since it only provides for 'guilty of damaging competition and hence fine' or not guilty. It has no scope for accepting the abuse if it is beneficial overall or for making structural changes when the abuse is damaging the public interest. The latter problem has been partly resolved in the UK by retaining the 1973 Fair Trading Act alongside the Competition Act. The 1973 Fair Trading Act uses the rather vague but still useful test of 'public interest' rather than damage to competition. This will allow companies with more than 25% market share to be considered by the Competition Commission on the grounds of its effect on public interest. The Competition Commission may then recommend changes that are structural rather than just punitive. The simultaneous running of the new Competition Act alongside the 1973 Fair Trading Act appears to resolve one of the main weaknesses of Article 86 and generally should be welcomed. It remains to be seen, however, whether this works well in practice. The notion of the 'public interest' has been criticised in the past as too vague and offering too broad a licence to the MMC. In the long run it is possible that this 'public interest' discretionary element becomes more and more at odds with the rest of the policy. The move within the Competition Commission towards greater transparency may limit this concern.

Regulatory overspill is a problem

Concurrency

In some industries covered by industry regulators (telecommunications, energy, water and railways) the Competition Act will be enforced concurrently by the industry regulator and the DGFT. This raises concerns about where the boundary of activity will be drawn in practice and how the concurrent application will develop since divergence in application is an unattractive but real possibility. The argument for the use of industry regulators as competition authorities is that they have the expertise in house that the OFT would have to develop or bring in for specific cases. While there is some sense to this argument it focuses only on one type of skill, namely industry knowledge. The regulatory bodies will not have the same depth or breadth of skill in conducting legal competition cases as the OFT and this is a strong argument for focusing all Competition Act cases on the OFT. An additional advantage of an OFT centred approach is that it avoids the divergence problem which is particularly acute where regulators have regulatory goals which differ from the goals of the Competition Act.

Under the new system each regulator can produce guidelines that indicate how the Competition Act will be applied. At present there is only one sector, Telecommunications, where draft guidelines have been produced. Guidelines ought to be exposed to a serious consultation process since there are difficult issues to be resolved. Given the limited time available it is worrying, if draft guidelines are to be produced for other sectors, that they are not available.

On the other hand, it is not obvious that there should be separate sector specific guidelines at all and there is a good case for arguing that this will make consistent application harder to achieve. It should not be the sector that determines the way that a problem is treated but the nature of the problem itself. By allowing each regulator to address the application in their sector it is possible that features that arise frequently in regulated sectors but are less common elsewhere will be the subject of a series of different interpretations. More generic additions to the existing OFT guidelines may have been a more consistent approach.

The difficulty facing a regulator is that the regulatory structure and the Competition Act concern different aspects of competition policy. The regulatory structure includes price cap setting and 'machinery' to promote competition where little or non existed whereas the Act is designed to protect competition, e.g. through preventing abuse of dominant positions. In many cases the regulator will be left with the choice of which to apply. What seems desirable for all concerned is consistency in how this is done and a rapid shift whenever possible towards the application of the Competition Act. However, in the one instance where Draft Guidelines have been produced by a sector regulator the application of the Competition

Act has been re-interpreted to be consistent with the regulatory structure at the expense of consistency with the overall guidelines and arguably the objectives of Section 60. One example is the application of very long run, forward looking approaches to predatory pricing which achieve inconsistency with both the overall OFT approach and with the EC access notice. Indeed, within these guidelines Oftel appear to be importing quite specific regulatory tests into their application of the Competition Act, e.g. the regulatory specific interpretation of incremental costs. The regulatory overspill into the application of competition law appears to kill off consistent application from the very start and does not auger well for the other guidelines to follow. Regulatory overspill is particularly worrying in telecommunications where competition is developing rapidly and the boundary of the sector is becoming increasingly blurred. Instead UK competition law should develop consistency with EC law, and UK competition policy should not promote sector specific goals.

Conclusion

Overall, the Competition Act is a welcome improvement. It offers the opportunity for a fundamental change and strengthening of competition policy in the UK. Concurrency as currently envisaged appears to be the clear exception. The overall approach to concurrency provided initial grounds for concern and the sole existing Draft Guidelines indicate that such concerns have been well founded. It appears there is a danger that we will end up with a situation where OFT guidelines and regulators will agree that one interpretation applies in one sector and another interpretation applies elsewhere. While this could be described as consistent, it is not the consistency that is required.

Concerns on concurrency are well founded

Do Doctors Respond to Financial Incentives?

The establishment of the NHS internal market represents a major policy by the Conservative Administration. Perhaps the most hotly debated aspect of these reforms was the creation of General Practitioner Fundholders (GPFHs). In this article **Carol Propper** *examines whether family doctors responded to financial incentives embodied within the fundholding scheme and the implications of their responses for patient care.*

In 1991 the NHS internal market reforms changed the incentives of participants in the UK health care market. The tax financed system was retained, but the functions of insurance and supply were separated. The reforms created a set of buyers of care, known as purchasers, who received budgets from general tax finance, and a set of hospital suppliers, known as providers. It was argued that separating the two roles would improve both productive and allocative efficiency in the NHS.

Perhaps the most contentious aspect of these reforms was allowing a subset of family doctors to act as purchasers under the GP fundholding scheme. Under the previous arrangements family doctors had been gatekeepers to all forms of medical care. They provided primary care in their surgeries, referred patients to hospital for further treatment or diagnostic tests and prescribed pharmaceuticals. But they were not responsible for the costs of either hospital treatment or their prescribing.

Under the reforms, the fundholder scheme gave family doctors budgets for these two activities. It was argued that the scheme would increase the efficiency of family doctors by making them responsible for the financial costs of their health care decisions

and that family doctors would be better purchasers of hospital care than third party purchasers who only bought but did not provide any health care. The outcome has been hotly debated.

On the one hand, it has been argued that fundholders have been better purchasers because they have better information on patients pre- and post-hospital treatment. They have been able to innovate, to change methods of treatment, and to improve the efficiency of hospital care suppliers. This has benefited their own patients but may also have had positive spillover effects for other patients.

On the other hand, it has been argued that the scheme has resulted in a two-tier service with more resources available to the patients of fundholders, leading to better treatment for this group at the expense of all other patients and possibly also higher incomes for fundholders.

The essence of the problem is that fundholders were given budgets based on their activity in the year before they became fundholders, and were subject to relatively little monitoring in how they used these funds. They therefore had unintended incentives to increase activity in the statutory waiting period before becoming a fundholder, and to decrease activity after becoming a fundholder to retain the surplus from the fund. The policy concern is whether they responded to these incentives.

To address this issue, we analysed information on every inpatient episode by patients in one health authority between 1993 and 1997. Our results show clearly that fundholders have responded to financial incentives. They have increased admissions to hospital in the year before joining the scheme and decreased them the year immediately after. But, in terms of welfare, does this matter?

Fundholders have responded to financial incentives

First, the size of the increase in elective admissions in the preparatory year is very similar to the fall in the year after. This suggests that the increase in referrals in the preparatory year represents a bringing forward of cases who would have otherwise had to wait for treatment. This is a once-off gain to the individuals who had to wait less long for their care.

Second, the rise in preparatory year referrals means that fundholders' budgets are inflated upwards for the whole of the period that they are fundholders. Since fundholders' budgets are deducted from the total allocation given to the health authority, larger budgets for fundholders means fewer funds available for non-fundholders. This represents a real shift of resources away from non-fundholding practices to fundholding practices.

Third, we observe a decline in admissions in the year of becoming a fundholder which means that fundholder patients get less hospital treatment in that year. But this does not necessarily mean fundholders' patients are getting poorer health care. As the rise in referrals in the preparatory year before is very similar to the fall the year after, fundholders may simply have brought forward those cases they could, and so they had a lower stock of electives to deal with in the first year of being a fundholder. More generally, decreases in hospital admissions are not necessarily welfare decreasing. GPFHs may be substituting treatment in their surgeries for hospital treatment. Or they may be substituting treatment in the private sector for NHS treatment.

The withdrawal of fundholders' business from NHS hospitals may have beneficial effects for all patients, including non-fundholders, if it forces the hospitals to become more efficient. Conversely, it may lead to a superior service for fundholders' patients compared with non-fundholders if the hospitals try to attract back the more mobile fundholder business.

Finally, fundholders might simply be retaining the financial surplus resulting from a higher budget and lower admissions for their own gain. In this case the only gain to patients is the once-off increase in admissions, and there has been a transfer from patients and non-funding doctors to fundholder GPs.

In summary, our analysis shows that GPs have responded to the financial incentives in the fundholding scheme. To some extent this may not be a problem: the scheme was designed to alter incentives in order to improve the efficiency with which health care is delivered. We cannot deduce from the fall in admissions to NHS hospitals after a GP practice becomes a fundholder that patient treatment is worse. However, the scheme

clearly has had unintended equity consequences. These are not in accord with the popular view – that fundholder patients get more hospital treatment – but that fundholding GPs have been able to increase their budgets for hospital care by bringing referrals forward. The cash constraints on the NHS means that this leaves less money for the hospital care of patients not in fundholder practices.

The scheme has had unintended equity consequences

Forthcoming Workshops

Pensions and Ageing – Thursday, 8th July

Speakers will include Dr David Blake (Birkbeck College), Professor Richard Disney (Nottingham University), Professor David Miles (Imperial College) and Dr Pasquale Scaramozzino (SOAS). As well as formal presentations, the conference will conclude with a discussion on pensions policy, led by Professor David Webb (London School of Economics) and Paul Johnson (Financial Services Agency).

Regulation and Broadcasting – Tuesday, 13th July

Speakers will include Professor Stephen Coate (Cornell University), Professor Martin Cave (Brunel University) and Professor Paul Grout (CMPO). There will be three formal presentations followed by a round table discussion led by Dr Chris Doyle (London Business School).

Further information about these workshops is available on our website. If you would like to participate please email the CMPO Co-ordinator, Clare Cox: cmpo-office@bristol.ac.uk

Recent Working Papers

98/001 Do Doctors Respond to Financial Incentives? UK Family Doctors and the GP Fundholder Scheme, B. Croxson, C. Propper and A. Perkins, November 1998

98/002 The Economics of Career Concerns, Part I: Comparing Information Structures, Mathias Dewatripont, Ian Jewitt and Jean Tirole, November 1998

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