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# Competition in public service provision: The role of not-for-profit providers<sup>☆</sup>

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## ABSTRACT

With public services such as health and education, it is not straightforward for consumers to assess the quality of provision. Many such services are provided by monopoly not-for-profit providers and there is concern that for-profit providers may increase profit at the expense of quality. This paper explores the implications of entry by for-profit providers when there is unobserved quality. The model generates three key policy-relevant insights. First, by developing a novel approach to competition between different organizational forms, it frames the relevant trade-offs precisely. Second, it shows the value of keeping an incumbent not-for-profit as an active provider. Third, it characterizes the optimal payment (or voucher value) to an entrant for each consumer who switches in a way that can be applied empirically.

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## 1. Introduction

When it comes to public services such as education and health care, much of the economy is run by not-for-profit providers. There is widespread suspicion that quality of public services (some aspects of which are not easily observed) will suffer if supplied by for-profit providers, even if they are more cost efficient, which can be avoided by having those services supplied by monopoly state-funded not-for-profit providers. This would be fine except that such providers can be problematic not least because, as monopoly providers, they have little incentive to be responsive to customer needs. There may, moreover, be potential entrants who can provide the service at lower cost. These concerns notwithstanding, allowing a greater role

for for-profit provision is among the most controversial proposals in public service reform.

This paper provides a window on this policy debate by exploring the implications of entry by for-profit providers in a world where the principal drawback from for-profit provision is a failure to provide an unobserved dimension of quality. Following Glaeser and Shleifer (2001), this drawback can be mitigated by using a not-for-profit provider even if the latter does not necessarily act in the best interest of consumers. Entry by a for-profit provider nevertheless guarantees that consumers are better off, despite the unobserved quality, provided that the not-for-profit incumbent is retained as an active provider – the for-profit provider supplies markedly (not just marginally) higher observed quality to offset lower unobserved quality. Keeping the not-for-profit incumbent active also ensures that consumers who do not switch to an entrant do not lose out. But a for-profit entrant competing with a not-for-profit incumbent needs a greater cost advantage for entry to be worthwhile than if the incumbent were for-profit. This creates a trade-off from retaining the not-for-profit incumbent: it ensures greater benefit to consumers if entry occurs but with a lower probability of benefit-increasing entry. Entry by another not-for-profit provider, however, can occur with a smaller cost advantage

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relative to the not-for-profit incumbent, which may be why much competition in education and health services is by not-for-profit providers.

Having explored the potential for for-profit provision to benefit consumers, we explore whether it is optimal for the government to set a capitation fee (in effect a voucher) that discriminates for or against the incumbent. In general, it is not optimal for there to be a “level playing field” with the same capitation fee for both because the probability of entry is endogenous to the fee that is set. We give conditions for the capitation fee for the entrant to be above or below that for the incumbent and also show that the factors that go into this formula can in principle be measured.

The analysis of this paper generates three key policy-relevant insights. First, by developing a novel approach to competition between different organizational forms, in particular what happens when a for-profit and a not-for-profit compete, it frames the relevant trade-offs precisely. Second, it shows that the value of keeping an incumbent not-for-profit active as a competitor is relevant for policy discussions about opening up public services to competition. Third, it characterizes the optimal level of the fee or voucher value to an entrant for each switching consumer in a way that can be applied empirically.

The rest of the paper is organized as follows. In the next section, we discuss related literature. Section 3 introduces the core modeling framework. It also sets up the monopoly benchmark and motivates the role for not-for-profit provision in that framework. Section 4 allows entry and studies competition with different provider objectives. Section 5 develops the analysis of optimal funding, including the optimal capitation fee or voucher that should be offered for consumers who move to an entrant. Section 6 concludes. Appendix A contains proofs of propositions. Appendix B shows that the main results are robust to allowing for a more general objective function for not-for-profit firms, a continuous distribution of switching costs/benefits for consumers and multiple quality dimensions.

## 2. Related literature

The model of not-for-profit provision we use draws on two established approaches. From Newhouse (1970), we use the idea that not-for-profit providers have a bias towards quality relative to for-profit providers and, following Hansmann (1980), we acknowledge the importance of the difficulties in monitoring performance in understanding why firms choose not-for-profit status. Glaeser and Shleifer (2001) have a formal model with non-contractible quality in which not-for-profit providers choose higher levels of quality than for-profit providers solely because of the non-distribution constraint that applies to not-for-profits, not because of an inherent preference for higher quality. They also briefly discuss competition between for-profit and not-for-profit providers but without two characteristics common to many public services, that consumers do not pay directly for them and that strategic interaction between providers plays a role when, as with schools and hospitals, location is important to consumers. Non-contractibility of quality also lies behind the core trade-offs uncovered by Hart et al. (1997) in their model of public versus private ownership of a public service facility. The literature has observed that the potential cost-quality trade-off can be mitigated by employing motivated agents who care directly about quality, as in Besley and Ghatak (2001), Francois (2000), Francois and Vlassopoulos (2008) and Ghatak and Mueller (2011).

There are obvious difficulties in comparing the extent to which for-profit and not-for-profit providers differ in delivery of quality dimensions unobserved by customers – as noted in Glaeser and Shleifer (2001) (footnote 10), such quality dimensions are typically unobserved by researchers too. Sloan (2000) assesses the reasons, including difficulties in measuring quality among others, why not-for-profit provision is dominant in US healthcare. More recently,

Herrera et al. (2014) provide an overview of the findings of numerous systematic reviews of differences between for-profit and not-for-profit hospitals in a variety of settings. While expressing concern about the methodological quality of many of those reviews, they still conclude that, among private providers, for-profits have significantly higher mortality rates than not-for-profits. While differences in mortality rates are observable *ex post*, they may well be something patients are unaware of at the time of choosing where to go for treatment.

The role of competition in public service provision has been discussed in Le Grand (2007). Hoxby (1999) has discussed some formal models of how competition can matter. Lakdawalla and Philipson (2006) also discusses competition with a not-for-profit provider. In that model, a not-for-profit differs from a for-profit only in having the quantity it provides as an argument in its objective function in addition to, and separate from, its role in generating profit. Only because charitable donations enable it to operate at a loss can it indulge its own preferences relative to a for-profit provider with the same cost function. Quality of service does not enter the model. More recently, Laine and Ma (2017) include quality of service in their model of competition between public and private firms. Their public firms, however, are assumed to maximize social surplus, which makes them very different from the not-for-profit providers in Newhouse (1970) and in Glaeser and Shleifer (2001) that have their own self interests.

The analysis of competition and entry in education is extensive. In its early incarnation, the focus was on competition between jurisdictions with population mobility. However, in recent years interest has been fuelled in large measure by the US charter school experiment allowing entry of schools to compete against public providers. The latter has been taken up in a range of countries including Sweden and the UK. There is now a large theoretical and empirical literature on the role of competition in improving the performance of schools. From the theoretical side, there are contributions by Barseghyan et al. (2014), Epple and Romano (1998) and McMillan (2005). Empirical studies of the impact of school competition include Card et al. (2010), Hoxby (2003), Lavy (2010) and Gibbons et al. (2008). However, as yet there is no canonical theoretical approach to entry in competition with public providers that takes into account of the possibility of strategic interaction between them.

The paper is also related to the large literature on school vouchers (see Ladd, 2002 and Neal, 2002 for reviews) following the early advocacy of the idea by Friedman (1962). Standard models, such as Nechyba (2000), look at the possibility that a citizen can carry their public funding to another provider. Böhlmark and Lindahl (2015) evaluate Sweden's school voucher system, arguing that increased school competition enhanced standards. The debate about the value of voucher systems has typically centred on changes in quality and/or the gains from competition. Here, we raise an additional issue – whether vouchers should be more or less generous than the capitation fee given to incumbents – and show that, because quality may not be optimal in the first place, there may be a case for either more or less generous funding of entrants relative to incumbents.

How to ensure service quality is also a major focus of the literature on health care, with significant implications for public provision of health services, see Chalkley and Malcomson (2000). The growing literature on the effects of competition on quality in provision of health services is reviewed in Gaynor et al. (2015). The models of quality determination by providers reviewed there focus on a single quality dimension observed by customers, so there is not the underlying rationale for not-for-profit providers emphasized in Hansmann (1980), and on monopolistic competition, in which there is no strategic interaction between providers. Absence of strategic interaction is appropriate when there is a large number of competitors, none of which impact more on one rival than on another. In our setting, which begins with a status quo of a monopoly state-funded

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