

Quasi-markets, competition and market failures in local government services

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This article focuses on quasi-markets and their relationship to hierarchy, markets and competition. Using some examples from empirical experience, the article discusses why quasi-markets may fail in the light of classical market failure theory. Article concludes that quasi-market failures may exist as in conventional markets. In many cases, market failures can be avoided by public regulation. Although quasi-markets in highly professional services are problematic in general, the most typical quasi-market failure in other services is imperfect competition and a lack of markets.

Introduction

The conservative social policy revolution of the 1990s was based on ideological commitments to market principles. In the UK, the government implemented market-oriented reforms, such as competitive tendering in the public sector, which was termed quasi-market development. The aim of quasi-market reforms was to produce more efficient production of services without endangering social welfare.

Quasi-markets have no exact definition but could be characterised as an intermediate form of hierarchy and conventional markets¹. Quasi-markets are created when the public sector opens its own service production to other producers by abandoning its monopoly and hierarchical way of producing services. In practice this happens in the purchaser-provider split, public tendering or voucher. *Competition* becomes a central concept. The main purpose of quasi-

markets is to raise competition between existing or potential providers, which may be private or public, for profit or non-profit organisations. In a quasi-market situation the public production of services is thrown open to competition to obtain more efficient production.

The main research on quasi-markets has been dominated by the evaluative approach (Cutler - Waine, 1997), without questioning the possibilities of markets or the marketisation process itself. Quasi-market ideas are a response to the public-choice theorist idea of *government failure*. Government failure may exist because of self-interest amongst both politicians and civil servants manifesting itself in different ways: civil servants sometimes maximising their budgets to achieve more power (known as budget maximising); electoral pressures on politicians may lead to "the best" choice not being taken because of a trade for votes or because the politicians want to secure their position in the next elections; and both sorts of self-interest tend to raise costs, ignore the consumer, and lead to short term considerations taking precedence over long term considerations. Quasi-markets are established to promote efficiency and freedom of choice for consumers. However, sometimes, the result has been a *failure of quasi-markets* (Lowery, 1998, see chapter on quasi-market conditions and failure).

The main aim of this article is

1. To describe the substance of quasi-markets and their relationship to hierarchy, conventional markets and competition
2. To discuss why quasi-markets sometimes fail by looking at classical market failure problems.

The methods used are the evaluation of quasi-markets through economic market theories, which are illustrated with empirical findings from quasi-market research. In the background there are the classical theories of markets and competition and their application, the theory of quasi-markets developed by British researchers (see Le Grand - Bartlett (eds) 1993) in the early 1990s. The empirical research results are partly conclusions on quasi-market experiences in the welfare sector in the UK, partly experiences in the Nordic countries' local government sector (Stockholm, Helsinki, case studies), and partly debate in the USA. The research results from quasi-markets are extensive and heterogeneous. This article can only present a few, but significant examples of the development of quasi-markets and competition in (local) public services.

The concept and substance of quasi-markets

Quasi-markets are understood in different ways in the research literature. In the broadest sense, quasi-markets may be defined as almost anything having some resemblance to (conventional) markets. But should the term quasi-market be used every time the situation is only something like markets? Do quasi-markets develop and exist themselves, or are they something one has

to establish? Is the existence of quasi-markets tied to the public sector? What is the aim of quasi-markets – or do they just ‘exist’? American theorists understand the concept more broadly than Europeans. Feiock (1998) and Lowery (1998), for example, study ‘quasi-markets’ formed by local authorities competing with each other for vacancies and tax revenues. The form of quasi-markets is then the Tiebout model, with the possibility of companies and citizens moving to some other local authority (voting with their feet). This article applies the more limited European conception of quasi-markets; voucher, purchaser-provider split, and competitive tendering of the public sector services. Briefly, the form of service production public sector decides; hierarchy, quasi-market, or market.

Quasi-markets are ‘markets’ because they are intended to replace a monopolistic public provider. Quasi-markets are ‘quasi’ because both the supply and demand sides differ fundamentally from conventional markets. Theorists define quasi-markets with the help of certain criteria that distinguish them from conventional markets (see Le Grand - Bartlett 1993 and 1994; Cutler - Waine 1994, p. 65; Bailey 1999, p. 288). These criteria include:

1. Quasi-markets are established and maintained by the public sector
2. Services produced in quasi-markets usually implement the objectives of social profitability and welfare

3. The public sector is usually the subscriber, regulator, and purchaser of the service

4. There may be different kinds of producers in quasi-markets competing with each other (for-profit and non-profit organisations, public and private)

5. The user of the service does not normally pay for service at the point of consumption; money flows between the (public sector) purchaser and provider.

There are grounds for separating quasi-markets from situations in which the public sector uses markets by buying services from private companies. The service may be sourced by direct procurement or put out to tender. Quasi-markets may arise in any situation where public production is thrown open to competition. Other competitors may be private companies (or non-profit organisations) but quasi-markets may exist also ‘inside’ the public sector where all competitors are public units (for example the NHS in the UK). Quasi-markets can be understood either as an end in themselves or as an experimental stage to genuine markets.

Quasi-markets and competition

Despite the way in which the public sector chooses to produce services (decision), there may be different market structures (conditions) and different possibilities for competition.

		SERVICE PRODUCTION (DECISION)		
		(Public sector) Hierarchy	Quasi-markets	Markets
MARKET STRUCTURE (CONDITIONS)	No producers (no markets)	0	0*	0*
	Monopoly	1	3	5
	Competition	2	4	6

0-2 Public sector produces service whether there are other producers in the markets or no markets at all

(* public sector supports public or private units to create competition)

3-4 Quasi-markets are created, but market structure may range from monopoly to competition

5-6 Service is produced in the markets, market structure may range from monopoly to competition

Figure 1. *Service production in different market structures*

Figure 1 connects the public sector's decision on the way of producing certain services and the opportunities for competition in different market structures. In quasi-markets, as well as in conventional markets, the market situations may be variable. Hierarchy means that a service is produced by the public sector's own unit without any competition (public monopoly) whether there are other producers in the markets or no markets at all. A service may be thrown open to competition (quasi-market) due to cost-cutting, either by using existing markets or by creating them. The aim is then to move from a monopoly situation to competitive

markets (from 3 to 4). The objective may also be externalisation (from 1 to 5 or 6). Using existing markets may also be a consequence of quasi-markets if a private company wins the competition and a public unit is abolished (from 3 or 4 to 5 or 6), which may also create more competition in the markets. The 'markets' column in figure 1 may mean both that the service is bought from the markets and that the whole production of the service is left to the markets.

The public sector controls the markets and competition and may therefore influence the competition by legal means. In practice this possibility is in the hands of central government, not the local

authorities. Since local government – especially in the Nordic countries – produces a variety of services financed through taxes, the market situation concerning these services varies greatly depending on, for example, the nature of the service, customers, and physical distance. Functioning quasi-markets may come into being only if the situation 4 (as shown in Figure 1) is possible. In situations 3 and 5 effective control of a monopoly is mostly possible. In *Situation 0* private markets do not exist, and are difficult or impossible to establish (*market failures*). The public sector is then responsible for production of required service. It is possible to produce the service through one unit (situation 0) or subsidise several potential production units to create competition (situation 0*). For a local government, the latter option may become too costly or not be viable for some other reason.

Quasi-market conditions and failure

Quasi-market theory sets certain conditions for success for the market applying the competitive tendering procedure for public services, and certain criteria for evaluation (Le Grand - Bartlett, 1993, Bartlett et al., 1994). The theoretical preconditions are the same as for any markets. Actually, quasi-markets should resemble conventional markets in that market structure is competitive²: These preconditions are:

1. Sufficient information is available
2. There is free entrance to, and exit from, markets without extra costs
3. Prices must be determined by the competition in markets, i.e., they must not be bound by law or determined by a single producer monopoly.

Quasi-market theorists specify more conditions and criteria for success. The first criterion for evaluation is *efficiency*: production in quasi-markets should be more efficient than in a hierarchy³. This implies that transaction costs are lower than costs savings within the hierarchy. Le Grand and Bartlett (1993) state that the purchaser's motive must concern *social welfare* or the customer's well-being, and the provider's motive must involve financial incentives. It should not be possible just to take the lucrative transactions ('cream-skimming'). Responsiveness and choice should increase in quasi-markets: services should still lead to equity, meaning services are related to need (Le Grand - Bartlett, 1993). If some of these criteria are not fulfilled, quasi-markets may be unsuccessful.

The concept of quasi-markets remains inexact. Quasi-markets may include different kinds of planning, financing, control, and steering mechanisms. Actually, quasi-market criteria are connected to classical market conditions *and* the social objectives and allocative role of the public sector. Generally, despite the theoretical demands, markets are hardly ever (perfectly) competitive. Thus, quasi-markets, like conventional markets, may lead to imperfect competition and market failures.

Lowery (1998) classifies criticism of quasi-markets such as voucher, contrac-

ting and Tiebout model in his article. He divides his *quasi-market failure* critiques into three different subjects:

1. Failure in quasi-market formation
2. Failure in preference error
3. Failure by preference substitution.

Critique 1 covers the fact that market formation in quasi-markets may fail because it is not possible to break down monopolies in practice; for example when demand is insufficient (rural settings), or when one provider captures all the available consumers. The second case is where consumer sovereignty does not arise because the consumers lack sufficient information about the service – especially in the case of vouchers. Different external factors and difficulties in charging cause problems in ascertaining the real consumer preferences. The final critique is the preference substitution problem, which is a particular problem for quasi-markets. The two different consumer roles – the providing consumer who makes the decision about what is produced, and the production consumer who actually gets the service – may have different preferences on what service is to be produced or what values should be weighted in choosing the service. However, Lowery's criticism may be seen in a broader frame, namely traditional market failure problems, as we shall do next.

Classical market failures as quasi-market failures

Market failures are part of classical welfare theorems. The nature of the service as a reason for market failure include public goods (group of goods⁴), externalities, merit goods, increasing returns of scale, information problems (between purchaser and consumer, provider and consumer), and adverse selection (information asymmetry between purchaser and provider). Theories explain why markets do not come into being or do not function properly in the production of certain types of services. The theory of public service refers to problems in consumption (private or collective) and whether it is easy to exclude consumers from consumption (free rider problem) and charge for consumption⁵. The theory of externalities refers to the positive or negative effect of services on a larger group (than a producer or client). The theory of merit goods refers to paternalism: people will not always understand what is best for them, thus the public sector encourages them to consume more of some services. This is what Lowery (1998) means by the preference substitution problem as a reason for quasi-market failure. Adverse selection refers to market imperfections, which are caused by information problems: the provider could cheat the purchaser because he knows more than the purchaser (Atkinson - Stiglitz 1980, p.8, Barr 1992, Walsh 1995, p. 6-12).⁶

Local government in the Nordic countries is responsible for a wide range

of services. Services may be classified into functional groups: education and culture, health care, social welfare, basic infrastructure, and public transport. Almost all local government services belong to partly collective goods, where consumption is collective but exclusion possible though undesirable (externalities, merit goods). This refers to the fact that it would be socially desirable for the public sector to take care of provi-

ding and supporting such services. Also, local government services usually have positive externalities. In addition to this, there are many merit goods in public services like health, education and social services. Figure 2 describes the different types of market failure in each form of service production.

To simplify Figure 2, the markets option means that service production is left to the markets without any public

<i>Type of market failure</i>	<i>(Public sector) hierarchy</i>	<i>Quasi-markets</i>	<i>Markets</i>
Imperfect competition	Suitable	Monopoly or other market structure problem ⁷	Monopoly or other market structure problem
Externalities	Suitable	Insufficient or overproduction Problem ⁸	Insufficient or overproduction problem
Public goods	Suitable (financed by taxes)	Suitable in partly collective services; public regulation and financial support to solve consumption and exclusion problems	Consumption and exclusion problems, free-rider problem
Merit goods	Suitable	Suitable under public regulation and financial support to solve consumption problems ⁹	Insufficient consumption problem
Increasing returns of scale	Suitable	Suitable if monopoly regulation is easy and sufficient	Suitable if monopoly regulation is easy and sufficient
Imperfect consumer information (about quality and/or price)	Suitable	Suitable if information problems not involved in purchaser's decision making; In other cases: imperfect markets problem ¹⁰	Imperfect markets problem, moral hazard problem
Adverse selection	Suitable	Suitable under public regulation and financial support to solve adverse selection problem	Imperfect markets problem

Figure 2: *Ways of producing services and market failures in local government services*

regulation. In all of the given situations, quasi-markets may be developed because the main problem of market failure due to the nature of the service is avoided by public regulation, control, and financial support of potential service users. Quasi-markets are never a solution if the situation leads to imperfect competition, and, if production has externalities, the problem of insufficient or overproduction is usually in the hands of central government. At the national level, some market failures may be avoided by public regulation and financial support systems, but the tools of local government for market regulation are MORE limited (state grants to private and public schools, for example).

Quasi-market conditions and criteria for success indicate consumption and exclusion problems and potential cream-skimming in conventional markets (Le Grand - Bartlett, 1993, Bartlett et al. 1994). But are these reasons also the cause of the quasi-market failures of the social, educational and health sectors? The aim is to raise competition to promote efficiency, but if the nature of the service is such that markets do not come into being or endure easily, and if they do not solve the basic problems of consumption and exclusion, are they worth it?

Empirical experiences of quasi-markets

The main research on quasi-markets has been the evaluative approach of the welfare sector; education and health. In the UK *education* sector, quasi-market has meant a highly regulated system, where there is little entry or exit of providers. In Belgium, pupils are segregated because of the market concentration of schools within an education district. Experiences from other countries also seem to be more negative than positive (Bartlett et al. 1998, p. 6). The roots of these problems are in imperfect competition because of the positive *externalities* of the service and unsolved *adverse selection problems*.

The administration of the *health sector* varies between countries. Producers are mainly quite large, the service is highly professional and, in most cases, difficult to monitor. Pure private markets lead to 'overconsumption' in the UK (Le Grand, 2000, p. 15). Experience from the USA shows that competition also leads to 'oversupply' and higher total costs, because health markets are a typical form of quality competition rather than price competition (Koivusalo, 2002, Pekurinen, 2002). Market failures, and quasi-market failures, in health services are mainly due to *imperfect information problems*. In both the education and health sectors, *quasi-markets* may exist on a *national scale* rather than a local scale because of the nature of the service (in that it resembles the public service).

Technical infrastructure services are usually produced at a local governmental level. These include electricity sup-

ply, water management and sewer networks, which – due to the scale of the production and high initial investment – lead to the formation of a natural monopoly (Varian, 1987, Gravelle - Rees, 1992)¹¹. If there have been problems in the quasi-markets of technical or infrastructure services, the main problems have been due to *increasing returns of scale* or – in local government services – to the *inadequate number of competitors*. For example, the competition programme of the city of Stockholm led to market concentration and fewer producers within 4-5 years (mainly in the technical sector). Only the smallest and the largest companies remain.

The development has been similar in *public transport*, but also in some *support services* in Helsinki (Kähkönen, 2001). When the public sector first puts its services out for tender, one objective may be to increase the number of producers on the markets. However, the empirical findings show that, in the long run, markets do concentrate and the number of producers diminishes. It also seems that not all services are as clear and easy to measure as was expected – which has led to information and adverse selection problems between purchaser and provider. In densely populated areas, functioning markets are attainable and the problems are either insignificant or non-existent.

Quasi-markets in *social sector services* are a separate question (Utvärdering av konkurrensutsättning, 2002). In sparsely populated municipalities where there are only few (or no) companies and distances are great, competition does not

arise and individual producers easily achieve a monopoly. In the social sector, the markets may be very variable in different services, from small to large profit and non-profit organisations. Markets may be characterised as unbalanced because the producers may not be at the 'same level' in providing services or competition. Also, it is doubtful if there is only one market and if the services are really substitutes for each other. The main problem in social markets is the difficulty in monitoring efforts, so trust and co-operation has replaced markets where they are missing, and where there are no price signals or they are ignored (Bartlett et al. 1998, 8).

In many sectors, international companies control the private markets. One of the problems, especially for local authorities, is therefore the lack of negotiating power. In many sectors markets diminish and the producers are big international enterprises that are definitely in a monopoly position in relation to small purchasers.

To summarize, both education and health services are, on the whole, highly professional and regulated sectors where market-like solutions are more or less problematic. The question of imperfect competition as a quasi-market failure seems to be particularly crucial in other local government services. Even such services that are assumed to be homogenous and easy to put out for tender, may not be so in practice.

Quasi-markets and different kinds of services

For further analysis, we may divide services, like products, into end products (to the final user of the service) and intermediate products. The difference between these two is that an intermediate product is something the end user of the service rarely sees (administra-

tive tasks, phone and mail services, etc.). Many of these services are produced in conventional markets and are therefore quite easy to externalise if they are not already bought from the outside. Another way – popular in practice – is to distinguish between main (or ‘basic’ or ‘key’) services and support services. Services may be divided into standard, professional and technical (high-tech), and human (high-touch) services.

<p><i>Standard services</i></p> <p>* Technical services: * Human services:</p>	<p>Quite simple to measure, resemble or tied to products</p> <p>cleaning, street maintenance some customer service tasks</p>
<p><i>Professional services</i></p> <p>* Technical services: * Human services:</p>	<p>Services which demand professional skills, difficult to measure</p> <p>ADP-programmes, medical equipment purchases, education, home care for the elderly</p>

Figure 3: *Groups of services*¹²

Usually services have to be split to open them up to competition, but it is still difficult to make distinctions and divide services into groups. Some standard or technical services are closely linked to professional, or professional human, services. Thus, even if the service is categorised as ‘standard’ or more ‘technical’, it may still have a strong human service element.

When, for example, the city of Helsinki tendered out meal provision in home help services for the elderly, the costs diminished but clients felt insecure

when the person who delivered the meal changed (Kähkönen, 2001). *Changing provider* had negative effects on the clients, *weakening the quality of the service* (Kähkönen, 2001; *Utvärdering av konkurrensutsättning*, 2002), because the most essential factor of quality was the safety and trust that the client experiences. Even in cleaning services, when clients are institutions such as schools, day-care centres, and hospitals, the same person may perform both the technical cleaning service and human service at the same time. Some services

may be so closely connected to each other that they cannot be separated. In fact, *the end product the client experiences is the service as a whole*. In these cases, quasi-markets may be a worse solution than hierarchy.

Co-operation and long-term contracts between purchaser and provider, especially in the social sector, have more or less replaced competition. A circle has developed: even if the service is thrown open to competition, longer contract periods decrease the number of potential providers in the markets, which leads once again to imperfect competition.

Conclusion

Finally, in response to the questions posed regarding the concept of quasi-markets and its relationship to hierarchy, markets and competition:

1. A quasi-market may be described as a market-like situation where there are different kinds of producers competing with each other and which are under the close control of the public sector. The fundamental objective of such service production is usually social welfare. Although the quasi-market concept is a loose one, it is especially suitable for welfare and other services that are traditionally publicly provided, where conventional markets and competition will not arise, or where their creation would not be rational. Whether to implement quasi-markets is then a political decision, depending

on which services should be financed by taxes and what role the public sector should play (production, administration, delivery, and so on). Despite the means of production chosen for the service (hierarchy, quasi-markets, markets), the success of the solution depends on what the existing market structure is, and whether it is possible to create competition. Market structure and the nature of the service determine how genuine a market situation can be achieved.

2. Quasi-markets may fail due to government failure, due to the self-interest of public servants or politicians (see introduction), or classic market failure problems. This article examined the latter, concluding that, in addition to quasi-market problems in professional services, general problems at the local level are imperfect competition and lack of markets. Lowery called this "a failure in quasi-market formation", but the problem seems to emerge only in the long run in some services. Quasi-markets may also function at the national level, where government does not have enough power and tools (or even interest in) to regulate market failures. Quasi-market success at the local level is then heavily dependent on national politics and market control.¹³ Local government services also have other characteristics that may lead to market failure; the most significant of these being information problems connected to services. One notable

problem is with services that are intermixed: while the conditions for creating markets suggest splitting services to make it possible to throw them open to competition, the end product – the service which the user gets – is more likely to be a single entity than parts of services. Split services therefore put greater pressure on co-ordination.

Despite market concentration, there are services in different sectors that do have functioning markets. These services are tied to a number of products and are quite simple and easy to measure (as in Figure 3). On the contrary, neither the quasi-market theory – nor this article – have paid attention to different forms of market-like renewals, such as incentive systems, *inside* hierarchy, or other forms of co-operation with different actors such as partnership, which may be options for pure markets as a means of achieving more effective production.

Further issues for consideration include whether quasi-markets have solved the problems of government failure. It may also be interesting to examine more closely the spatial effects of markets and the development of marketplaces with respect to local government services. The next step in analysing market conditions, services, and producer motivations could also be transaction cost theory as Coulson (1997), Lapsley - Llewellyn (in Bartlett et al., 1998) and Marsh (1998) have done. The theory concerns the relationship between the principal and the agent from the viewpoint of hierarchy versus markets: information problems and

presumed opportunistic behaviour of an agent lead to high transaction costs (Williamson 1975 and 1985).

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¹ Quasi=having some resemblance

Quasi=is used to form adjectives and nouns that describe something as being in many ways like something else, without actually being that thing (Collins Cobuild English Dictionary, Harper Collins Publishers, 1995, Great Britain)

Quasi=1 in some ways; partly: the chairman's quasi-judicial role (=acting in some ways like a judge) 2 false or pretendent: quasi-scientific ideas (Longman Dictionary of Contemporary English:

Longman Group Ltd, 1978, Great Britain)

Quasi= 1 to a certain extent: a quasi-official body 2. seemingly but not really: a quasi-scientific explanation, a quasi-scholar (Oxford Advanced Learner's Dictionary of Current English / A S Hornby. Fourth edition. Oxford University Press, 1989)

² see also for example Varian (1987) or Gravelle - Rees (1992)

³ transaction and other marketisation costs have been investigated in, for example, Swedish and Finnish research (Nurmis, 1996, Högberg, 1996, Almqvist, 1999, Kähkönen 2001, 2002).

⁴ Public choice theory divides goods into public and private, toll goods, and common-pool goods. The distinction is made on the basis of exclusion and consumption, see Savas (1987, 2000), applied to the Finnish context, see Salminen - Viinamäki (2001, 18). The classic article on public expenditure was written by Samuelson (1954), and the article on publicly produced private expenditure was written by Arrow (1971).

⁵ If a service is collective, it may be impossible to exclude consumers or charge for consumption (like clean air).

⁶ Barr (1992) wrote a profound description of economic theories and welfare state in his article.

⁷ This is what Lowery sees as a failure in quasi-market formation (1998)

⁸ Lowery defines this as a part of the consumer sovereignty problem (1998)

⁹ Insufficient or overconsumption; Part of Lowery's failure in preference substitution (1998)

¹⁰ Part of Lowery's consumer sovereignty problem (1998)

¹¹ The concept and status of natural monopolies are questioned, for example, by detaching functions from them and by creating markets for these functions (for example railway markets in Britain and electricity markets in Finland).

¹² In the early publications on service marketing, services were classified in different ways. Wiley - Sons defines two groups: 1. high-touch services and high-tech services and 2. continuous services and occasional services. For more see Wiley - Sons (2000) or its Finnish translation, (which is used in this article) Grönroos (2001).

¹³ Problematics of fiscal federalism, see, for example, Bailey 1999, p.1-17.