

Limitations to creating and options for maintaining local quasi-markets

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The focus of this article is to explore the limitations to creating and options for maintaining quasi-markets in local government services. The article structures the quasi-market critique summarising the literature on quasi-market failure, problems of classic market failure and institutional aspects. The entry and exit possibilities set different prerequisites claims to the policy of a purchaser - which is decisive in maintaining quasi-markets in practice. The article seeks to find the options and identify the key elements for maintaining them. The article concludes that the limitations of quasi-markets are due to the nature of the service and the opportunities on the markets and institutional limitations of different providers. The options for maintaining quasi-markets created depend heavily on the policy of the purchaser.

Introduction

Why do quasi-markets fail and how could quasi-markets be maintained? The question is internationally interesting and may be applied to quasi-market discussion worldwide. In Scandinavia, the topic has arisen between the crisis of local government finance and responsibilities in the first decade

of the new millennium, when again, marketisation is hoped to solve the efficiency problems of tax-financed services. This article provides local government actors with a practical instrument to address the question of quasi-markets by summarising the limitations and pointing to the means of maintaining competition. Simul-

taneously, it structures the quasi-market theory critics further.

Quasi-markets are created when the public sector opens its service production to other providers by abandoning its monopoly and hierarchical way of producing services. The aim of market orientation is to expand customers' choice and, by implementing competition, to improve the economic efficiency of service production. However, the research results from quasi-markets are extensive and heterogeneous and they have yielded a selection of different quasi-market failures¹ and a critic towards quasi-markets even from the quasi-market theorists themselves.

Successful quasi-markets should function more efficiently than hierarchy. In practice, imperfect markets and the nature of the service may cause a situation when efficiency does not improve or even on the contrary deteriorates². One of the essential elements of quasi-market efficiency is what role the public purchaser takes in maintaining market situation and competition.

One of the tendencies of neo-classical microeconomics is the so-called new institutional economics which provides an opportunity to examine the theme through transaction cost theory³. According to the theory, companies are entities which are associated with each other through transactions. Transaction costs are likely to grow because of the asset specificity of transactions, bounded rationality of the actors and when opportunism is possible. From a company (or organisation) point of view, transaction costs can be understood either narrowly (trading or business activity)

or broadly (total costs of existence and business activity).

The theoretical literature on transaction costs concentrates on opportunism and trust (for example Oulasvirta 1994, Coulson 1997 or Marsh 1998). The theory has been used or at least tried out to solve problems of vertical integration (hierarchy vs. outsourcing). The theory does not offer methods to calculate transaction costs in practice, because costs are not given an exact definition (see for example Marsh 1998, 15). I have applied the concept of transaction costs in my earlier research and article (Kähkönen, 2001 and 2005). The results suggest that the influences of quasi-market reforms are comprehensive, so the evaluation should be broader than institutional measurement. They also indicate that own production and using conventional markets may be more efficient than quasi-market solutions. This aspect is one basis for of the limitations of quasi-markets.

This article combines the theoretical discussion of quasi-market limitations and the empirical experiences to find options, even means, to maintain local quasi-markets. The practical examples describe the quasi-market development in different types of services. The examples are from Finland⁴ where, as in Scandinavia in general, the role of local government services is significant, their variety is wide and their nature and attributes differ from each other. Still, although the examples are from a few services and from one country, the conclusions are interesting and could be applicable to any local public service worldwide.

The main aim of this article is explore:

1. *What are the limitations for the creation of quasi-markets?*
2. *What are the options and means to maintain quasi-markets?*

The concept of quasi-markets

In the background, there is the theory of quasi-markets developed mainly by British researchers in the early 1990's (see Le Grand and Bartlett, 1993). Quasi-markets come into being when the public sector opens services previously provided through hierarchy to other providers. The fundamental objective of such service production is usually social welfare and such services are usually financed by taxes and to fulfil certain tasks that have been assigned to the public sector.

The theorists define quasi-markets with the help of certain criteria that distinguish them from conventional markets (see Le Grand and Bartlett, 1993, 1994; Cutler and Waine, 1994, page 65; Bailey, 1999, page 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 providers 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 the service at the point of consumption; money flows between the (public sector) purchaser and provider.⁵

In practice the applications of quasi-markets are purchaser-provider split, public tendering or voucher⁶. The public sector sustains quasi-markets and works as a purchaser and director of the service.

The exact borderline between quasi-markets and markets is unclear, but the main characteristic for both is the (even potential) existence of *competition*. Competition in markets means several sellers and buyers, free entrance/exit to markets, enough (perfect) information and prices which are prescribed by demand and supply. Competition is expected to solve the inefficiency problems of the earlier public sector hierarchy. The public sector uses competitive bidding to create competition. Then, quasi-markets may be described as a market-like situation where there are different kinds of providers competing with each other but which are under the close control of the public sector.

Whether to implement quasi-markets is 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 different phenomena. The empirical evidence of quasi-market experiences from the UK is extensive. The main research on quasi-markets has been dominated by the evaluative approach (Cutler and Waine, 1997), without questioning the opportunities and limitations of such markets or the marketisation process itself.

Limitations to creating quasi-markets

Quasi-market failure according to Lowery

Concluding the wide experience of quasi-markets, Lowery (1998) classifies criticism of quasi-markets such as vouchers, contracting and the Tiebout model in his article. He divides his quasi-market failure critiques into three different subjects:

1. Failure in quasi-market formation. This refers to the fact that market formation in quasi-markets may fail because it is not possible to break monopolies in practice; for example, when demand is insufficient (rural settings), or when one provider captures all the available consumers.
2. Failure in preference error 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 real consumer preferences.

3. Failure by preference substitution 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 regarding what service is to be produced or what values should be weighted in choosing the service.

Lowery's main theme is consumer sovereignty. However, Lowery's criticism may be seen in a broader framework, namely that of traditional market failure (see Kähkönen, 2004). Quasi-markets fail because markets fail. Many local government services are reminiscent of private utilities (or only partly collective⁷), local service markets are rarely competitive. In addition to quasi-market problems in professional services (difficulties in defining and measuring outputs)⁸, general problems at the local level are imperfect competition and lack of markets.

Traditional market failures as quasi-market failures

Another question is classic market failure problems. I have discussed this theme more closely in my earlier articles (Kähkönen, 2004, 2005). Despite the way in which the public sector chooses to produce services (decision), there may be different market structures (condi-

tions) and different opportunities for competition.

*Reasons for market failures*⁹

1. Imperfect competition is a general problem. More or less imperfect competition is a predominant situation in practice throughout the whole economy.
2. Externalities are a main reason for public financing and local government services, which from the very beginning have arisen from the absence of other providers. Externalities may rise if production causes broader positive or negative effects: a provider has no incentive to produce more positive effects than it is paid for (preventive health care) or tends to produce more if it is not responsible for negative effects (pollution).
3. Public goods may not be a problem in quasi-markets in partly collective services, if public regulation and financial support are to solve consumption and exclusion problems.
4. Merit goods are private goods with a wider social objective, which may be too expensive for consumers to consume enough or for providers to produce, so public support and regulation is needed. The merit goods problem may be resolved with public regulation and financial support to consumers¹⁰.
5. Increasing returns of scale is a general problem, which may be resolved with sufficient monopoly regulation, if possible.

6. Imperfect consumer information (about quality and/or price). Quasi-markets may be a reasonable choice for markets when offering the essential, impartial information of providers on behalf of different providers.

7. Adverse selection is a problem when information asymmetry exists between purchaser and provider. If there are no ways to monitor the output, quasi-markets may face the same problems as conventional markets: products may be poor. Adverse selection problems set requirements to contracts and risk sharing.

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.

Another question is that although quasi-market ideas are a response to the public-choice theorist idea of government failure, quasi-markets may face the same failure, because the status of the purchaser may remain unchanged. Government failure may exist because of self-interest among both politicians and civil servants, manifesting itself in different ways: civil servants some-

times maximising their budgets to achieve more power (known as budget maximising); electoral pressures on politicians may lead to "the best" choice not being made because of a trade for votes or because the politicians want to secure their position at 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.

Institutional limitations to competition

Quasi-market theory allows different providers to act as providers. The only limitation to providers is that motives and incentives are economical and for-profit. On the other hand, the theory includes market criteria, which are the same as in conventional markets (entry-exit, information, prices). However, the institutional differences are so significant that it may be impossible to pursue a market-like situation. In his doctoral thesis, Valkama gives a profound picture of the implementation of competitive neutrality in quasi-markets (Valkama, 2004).

The status of the providers in quasi-markets may vary. For a private provider, exit is possible. For a public provider its existence is a politically taken public decision. Competitive tendering in quasi-markets has brought out the basic differences between these two, usually in the form of non-neutrality in competition. May quasi-markets where public and private providers

compete with each other ultimately be doomed as non-functioning?

Institutional limitations to quasi-markets are

1. Entry and exit conditions are different in the public and private sectors. The entry conditions (both entry and exit markets) between public and private providers differ fundamentally from each other: the public provider usually has no option to decide on its own existence or expand its ability on markets. A private provider may - at least in theory (see required investments in Section 3). A local public provider is also not allowed to expand into larger markets - in size, geographically or some other branch, because it is tied up to local government field of operations.

2. Public providers are more regulated, which affects activities and operations (publicity, compulsory announcements, compulsory budgeting, restricted or non-existing option to obtain loan or capital, legal requirement, equality requirements, public procurement regulations).

Behind quasi-market failure and institutional limitations are basic questions of the behavioural elements, from economic man to irrational behaviour. One of the original quasi-market theorists, Julian Le Grand, explored this question in the 2000's. His arguments are that individual citizens may not be

regarded as passive recipients of public service nor sovereign queens with unrestricted choices, and that professionals in the public sector are not always public-spirited altruists ("knights") nor are they self-interested egoists ("knaves"). This is also why quasi-markets may not remove government failure problems. The balance between motivation and action of agency should be resolved by different policies (Le Grand, 2003).

basic properties, which sets different entry and exit options. The figures presented are more or less illustrative, describing only the observed direction in a certain type of service.

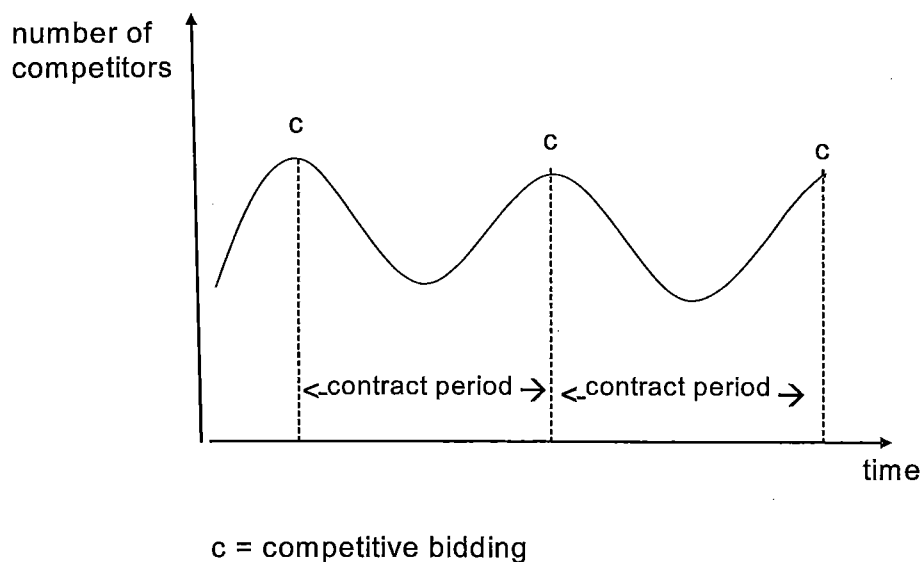
The question of maintaining quasi-markets may be described as follows:

Experiences of local quasi-market development in three service types

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. British quasi-market research is mainly concentrated on welfare services¹¹. The evidence of Sweden (mainly Stockholm) is evaluated largely and in more detail in street maintenance and care of the elderly¹². This article excludes such highly regulated services as health and education, but also technical services, in which buying services from existing markets is familiar.

The article uses a few different examples of existing quasi-market research in few services. Services are divided into three types according to their quasi-market development and

Quasi-market development as a result of contract period – an illustration



In maintaining quasi-markets the question is how to raise and maintain the line high enough but still restrain and soften the fluctuation. How sharp the angle will be is more or less dependent on the existing and potential market situation:

- required investments and/or sunk costs and
- how dependent the providers are on one purchaser (the number of other providers and purchasers).

Bus transport

Public transport is a capital intensive service. The required investments include buses and probably a depot. These constitute large sunk costs making it difficult or even impossible to enter or exit markets. The Danish, Swedish and Finnish experience of bus services shows

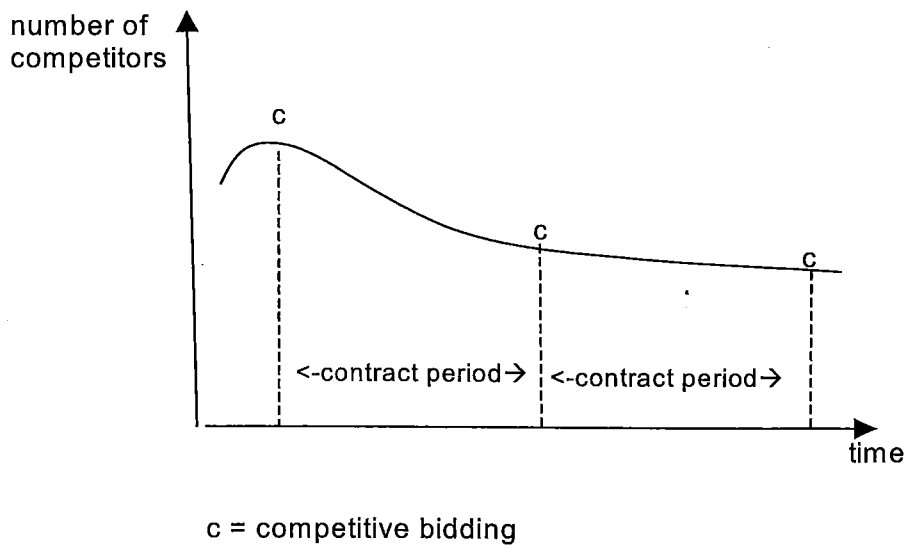
that markets are, after 10 years of competitive bidding, concentrated and international (Anttila, 1996), although in Denmark the call for tenders has purposely lower volumes. In the study of Helsinki Metropolitan Area the number of companies was 23 at first, but, after the fourth competition, the number of competitors had fallen to 11. The number of offers was 112 at first, after the fourth competition, number diminished to 63. The first competition was crucial. Companies bought each other out gradually to increase their size and smaller companies withdrew from the markets (Valkama and Flinkkilä, 2003). Two of the providers had no option to exit the markets, because they were owned by the City of Helsinki (later they were merged into a single public company). Competition has moulded the quasi-markets but does not seem to affect them at the very moment of

competitive bidding. Competitive bidding happens annually (for different routes) and the contract period has been

4-5 years (Kähkönen, 2001). The quasi-market development curve seems to be the following:

Figure 1 Development of quasi-markets in bus transport - an illustration

Development of quasi-markets in bus transportation – an illustration



It was seen that competitive bidding was occasional, although it happened in stages in different areas. In the first place, markets did exist. At the first stage, quasi-markets were opened and the number of potential providers increased. Volumes were high, which led to mergers and company buyouts.

As a result of the quasi-market development, competitive bidding has substantially increased the technical effectiveness of the branch, which has, however, occurred at the expense of the profitability of the branch. All companies at the metropolitan level suffered financially. The operating margin (of the four companies the study covered)

decreased as much as 40% between the years 1998 and 2001. Also, the equity ratio diminished almost 10%. One problem is whether regional markets are competitive enough. The markets also seem to be unstable because of the distrust between employees and employers. The price is tending to rise in the 2010's. The quality of passenger services has fallen dramatically and new quality criteria for providers have been designed.

Cleaning services

Entering and exiting markets in cleaning services is quite easy. Large

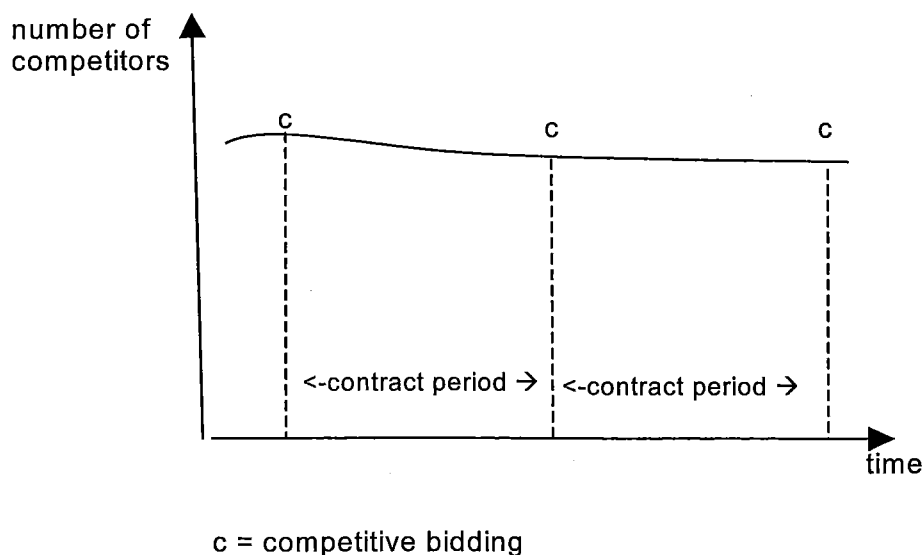
investments of capital are not required, nor are there legislative barriers. The results of the studies¹³ on cleaning services show that missing competition is not the problem in the cleaning service markets - there are numerous providers in the cleaning service markets, at least in densely populated areas. Still, use of private cleaning services is quite rare in the Finnish municipalities. Almost 10 companies participated in the competition almost every year in the Helsinki school cleaning case in the 1990's. The procurement was usually restricted: the call for tenders has been sent to known providers. The contract period has been one year. It seems that competitive bidding of a public purchaser does not affect the markets. The shape of the line is gently sloping - if there is any curve at all. The situation is most likely similar in some services in the technical sector.

Adverse selection problems are most typical in quasi-markets in the cleaning sector. Municipalities had difficulties with low-price companies' reliability and desired quality (Kähkönen 2000, 2001). Potential providers are numerous but the quality of markets is variable.

Social services (non-institutional)

The possibility to create quasi-markets in social sector services may vary. In sparsely populated municipalities where there are only few (or no) companies and distances are great, competition does not develop and individual providers 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. In *Institutional services*

Figure 2 Development of quasi-markets in cleaning services - an illustration



(accommodation as in institutional care, sheltered housing) the market area is large. *Non-institutional* social services are usually local (home help services, day care of children and the elderly). Institutional services require large capital investments in property. Non-institutional services require human capital. Although entry and exit to markets are difficult in institutional services, they may be not easy at least in non-institutional services because of investments in human capital.

In the city of Stockholm, the opening quasi-markets led to re-organising to fewer providers, including the care of elderly. The status of one purchaser is decisive: the investigation of the entrepreneurs showed that the city purchases as much as 75 - 100 % of the total markets¹⁴ (Utvärdering av upphandling...2001, page 279).

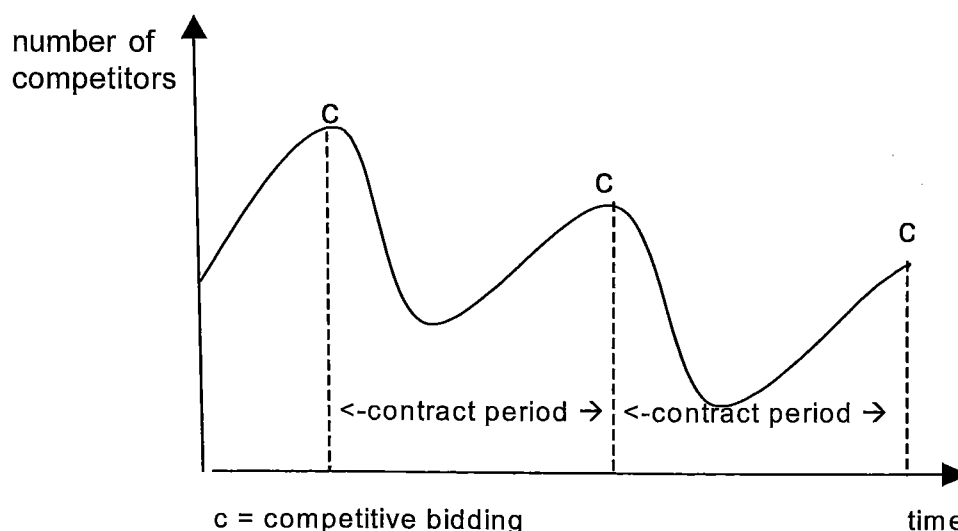
In Finland, the turnover of providers in social services trebled between the years 1995 and 2000. New provi-

ders have emerged mostly in densely populated areas (in Uusimaa and Tampere Region). Most of the new companies produce local services like day care for children or social non-institutional care. The most significant is that 3/4 of the total sales is to the public sector. The majority, as much as 80% of the companies, are small (fewer than 5 employees (Partanen, 2002).

Human capital, trust and tacit knowledge are the main significant costs in delivering the service. These should also be seen as possible sunk costs¹⁵. Short contract periods are considered problematic because of the large investment to organise services, especially in the social sector¹⁶. Even in support services (meals provision in home help services) a two-year period was considered too short (Kähkönen, 2001).

When dependence on one purchaser is high, the quasi-market development curve may vary sharply with the contract period:

Figur 3 Development of quasi-markets in non-institutional social services an illustration



Co-operation, partnership and long-term contracts between purchaser and provider, especially in the social sector, have more or less replaced competition. Creating and maintaining quasi-markets in decidedly local services, when the size of providers is small, is a mission impossible, because the negotiating power of one purchaser is practically a monopoly. The situation resembles small subcontractors and large firms, without the option of searching for other purchasers (unless by changing the place of business).

Summary

Using three types of services, it seems that the options and means to create and maintain local quasi-markets are limited for a public purchaser. Bus transport, as an example of large capital investments, is far ahead in developing quasi-markets, but markets seem to concentrate more and more in a long run. As the study of Helsinki Metropolitan Area bus transportation points out, competition may also lead to a decline of markets because the competitive bidding has allowed predatory behaviour to continue far too long. At the level of strategic behaviour, this may be called "predatory" competitive bidding. Too much competition does not seem to raise efficiency in a broad sense.

Cleaning services were an example of services where the entry to and exit from markets are easy. In these services, quasi-markets may not be needed because of existing markets, at least in densely populated areas. The question of creating and maintaining quasi-

markets seems to be secondary. Still, the status of public companies is problematic. Adjusting to the market situation may not be possible and the market area, both physical and functional, is restricted.

Social non-institutional services are an example of services requiring less physical but more human capital investment. These services seem to be heavily dependent on one purchaser and the number rises and falls with competitive bidding. Still, human capital and trust are especially important in these services, thus changing providers may be more disastrous than in situations where the capital is purely physical. These services require a long contract period and different means to maintain quasi-markets - if there is any competitive bidding at all. Suitable means for some services may be vouchers, if the purchaser is able to build an information system for consumers and the monitoring systems of providers.

Options for maintaining quasi-markets

The situation in markets is not stable but evolving. Different actors in markets make decisions which affect others. The theory of Industrial Organisation uses the term strategic behaviour to describe this. On the other hand, quasi-markets are a result of public decision and require a certain policy to be maintained.

Strategic behaviour

Identifying strategic behaviour: cartels, entry deterrence and predatory pricing are examples of the behaviour of a potential provider in different market situations¹⁷. If the main objective in quasi-markets is to reach economically efficient production through competition, the objective of a company is not to maintain competition but to achieve a monopoly. If this is not possible, the company specializes and the market situation leads to monopolistic competition, where attempts are made to differentiate products from each other.

The *negotiating power* of a buyer may be "too" strong towards companies at local level, or on the contrary, too weak towards large multinational companies. These may also be a consequence of lacking competition; in the first case there are not enough buyers and in the second case not enough sellers. In sparsely populated areas, functioning markets are often not attainable, even in support services like catering. The reason for this is that international companies control the national private markets (Kähkönen, 2000).

In many sectors markets are diminishing and the providers are large international enterprises that are definitely in a monopoly position in relation to small purchasers. In the opposite situation, local government may be the only client for a company. In this situation a service is heavily dependent on the purchaser, which can not only prescribe the prices but also affect the very existence of a provider. Also, if markets are purely local and companies are

small-sized and dependent on one purchaser (typical in non-institutional social service markets), the situation remains monopsony (one buyer in markets), not quasi-markets.

Mixed-form markets, where both non-profit and for-profit providers may co-exist, may develop in a particular way. Marwell and McIerney propose a framework to achieve three different situations between the dynamics of non-profit and for-profit: *stratified, displaced and defended* markets. Markets are stratified if the non-profit actors concentrate on functions which are desirable but not produced by markets. A for-profit organisation may also replace non-profit organisations but if the non-profit sector fights back, markets become defended (Marwell and McIerney, 2005). If the purchaser is to obtain the benefits of quasi-markets, how should it act?

The policy of the purchaser

The main characteristic of quasi-markets is the purchaser-provider split: the end user is not usually the purchaser. In practice this means that the number of buyers differs from conventional markets. There are usually only one or a few buyers of local government services - depending on the service. Then, one specific question will be the status of the purchaser. One of the thresholds to creating and entering markets is investment requirements and/or sunk costs: how large investments are needed to begin operations or how large is the existing, bound capital to an operation.

Investment requirements

Investments/sunk costs may be physical capital investments (buildings, machinery, high technology) and intangible assets (human capital). Energy supply, water and sewage treatment and public transportation are a good example of services which need capital investments - and which normally attain a natural monopoly position at the local level. Investments are also needed when a service includes property (for example sheltered accommodation for the elderly or other groups), expensive machinery (in health care services or the technical sector, even in catering services). In these services, one of the proposed solutions to creating and maintaining competition is the public, centralised ownership and competitive bidding of pure services.

In labour and knowledge intensive services capital may also be human capital or human resources¹⁸. Intellectual capital also consists of knowledge of client relations (customer capital) and stakeholders (relational capital) or other so-called tacit knowledge. These are essential in social services for children, the elderly etc., where well-being is more or less dependent on the provider and where long-term human relationships are extremely important. When creating quasi-markets, all these should be accommodated in the evaluation.

Investments already made become sunk costs in markets, and create entry barriers to other potential providers. The more sunk costs, the longer the contract period will be if the providers

are dependent on the purchaser. Existing market structure governs strategic behaviour in markets.

High capital investments may also turn into such sunk costs which again makes it difficult to change providers or for a provider to exit the markets without selling the whole company (for example bus equipment in bus transportation or manufacturing production kitchens in catering services). The value of human capital is not easy to measure but its significance may be crucial in some social services. The sunk costs may be tacit knowledge - which is likewise not measurable.

Length of the contract period

The contract period is related to investment requirements and is a key concept in maintaining quasi-markets. From the competition point of view, the contract period should be quite short. From the services point of view, the contract period may be as long as the value of the required investment depreciates and what is reasonable for the functioning of services. As in private service industry sectors, co-operation and long contract periods have replaced the continuous competitive bidding, which is considered expensive to both buyer and seller. From the viewpoint of maintaining quasi-markets, this may lead to a vicious circle: even if a service is thrown open to competition, the longer the contract period, the fewer potential providers are left in the markets (imperfect competition, again). If the contract period is brief, the costs of

competitive bidding may be rise higher than the achieved saving (Kähkönen, 2005).

Continuing competitive bidding increases efficiency in the short term, but the commitment of purchasers and providers may remain weak when the provider changes frequently. In the long run, efficiency may suffer because there is no time to develop for labour confidence. Short terms of employment cause insecurity in the labour markets. This has especially weakened the position of women, who traditionally work in the service sector.

Purchaser-provider split and voucher

Competitive bidding in local sector services in the 1990's was mainly occasional, leading to a situation in which one provider wins and the other loses and exits the markets. The situation, at first, may have reflected quasi-markets, but while other newborn providers lose, the situation turns into a monopoly - again. The objective of the public purchaser may have been to test the price level of the markets or may even have been to externalise a service.

In the situation of a purchaser-provider split, competitive tendering happens periodically and the client may choose between one or a few accepted providers. Vouchers may affect competition differently than the purchaser-provider split. In a situation of vouchers, the client chooses the provider, these cases occur repeatedly and competition is continuous. Voucher has been a means

to maintain quasi-markets, especially in social services.

Conclusions

In order to respond to the question posed on limitations and options of quasi-markets:

1. The limitations for the creation of quasi-markets

The nature of a service and the option for local markets constitute the first limitation or option quasi-markets: 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 and maintained¹⁹. If markets are purely local and companies are small-sized, the situation remains a monopsony - which leads to failure in quasi-market formation. Marketisation puts more pressure on public regulation, contracts and procedures than service delivery through hierarchy. It may also require financial support and information and advisory systems for consumers. A purchaser should also be aware of strategic behaviour in markets and possible adverse selection risks. Local government's room to manoeuvre is far more restricted than that of central government (legal control, income transfers) regarding market failures. Local government's role is to *open the quasi-markets if they are to arise*.

Institutional limitations are underestimated in the quasi-market discussion. The solution has been to form independent (public) companies, but still the basic problems persist. The position of public and private providers in competition is not neutral, which makes the whole quasi-market questionable in the first place. Instead of creating quasi-markets, local government may use markets by sourcing the service by direct procurement or putting it out to tender. *Maintaining a public provider* may secure competition or curb rising prices: comparison is always possible. Potential competition gives an incentive for a public provider to pursue efficiency if the obstacles to entering markets are not significant.

In order to respond to the question

2. *The options to maintain quasi-markets*

The policy of the purchaser is the key in maintaining quasi-markets. In some services (like institutional care) a purchaser may lower the threshold to enter markets by public ownership of the property. *Public ownership* may be the only means to maintain markets (Valkama, 2004), although municipal monopsony is not the objective of quasi-markets. Other means to maintain quasi-markets may be adjusted contract periods, competitive tendering in stages and the use of vouchers. *Adjusted contract periods* for different service

types may be a key to functioning quasi-markets. Short contract periods are suitable for services which require less physical capital and human capital. Also, short contract periods may work if markets are already competitive and the providers are not dependent on one purchaser. *Competitive bidding in stages* (different objects, areas or volumes). To avoid an on-off situation in markets, a purchaser may arrange the tenders in stages to different extents. For example, in bus services, different bus routes are thrown open to competition at different stages. Another means of continuing competition is vouchers, although it seems to function satisfactorily only in densely populated areas where there is sufficient demand for a certain service (Högberg, 2001, page 132).

The concept of quasi-markets is appropriate for a situation in which the public sector uses purchaser-provider split or voucher to stimulate competition in delivering services. Lessons for policy-makers may be yet that quasi-markets may never be competitively neutral due to institutional reasons (see Valkama, 2004). This means that quasi-markets are always a political solution. Sometimes quasi-market is a more practical means to solve market failure problems because of greater ability to control, collect information or support customers or providers (Kähkönen, 2004). The situation should be appraised before decisions are made. A purchaser

should also mention that its policy affects markets. Otherwise, in the light of empirical research (Kähkönen, 2005), utilising markets is more efficient than quasi-markets, because of transaction and other costs of quasi-markets.

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¹ see Bartlett et al. (Eds) (1998), Lowery (1998), Kähkönen (2004). Lowery classifies criticism of quasi-markets into three different subjects: 1) Failure in quasi-market formation, 2) Failure in preference error and 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 (Lowery, 1998).

² I have considered this problem in my earlier article Kähkönen, L. (2004). Quasi-markets, Competition and Market Failures in Local Government Services. *Kommunal Ekonomi och Politik*, Volym 8, Nummer 3, September.

³ Oliver Williamson developed transaction cost theory from 1970's. The theory examines decision making in large companies, transaction costs between different entities and uncertainty in contracting.

⁴ I have studied quasi-market experiences and costs effects in cleaning, catering, bus transportation, street maintenance in Finnish large municipalities and Helsinki (2000, 2001).

⁵ Kähkönen (2004).

⁶ I have defined and described the theory and experiences of quasi-market in my earlier work (2000-2005). Quasi-markets face the same criteria, problems and failures as markets. In addition to the quasi-market failures studied mostly in the welfare sector, my articles show that organisational changes cause both costs and inefficiencies to organisation(s).

⁷ Kähkönen (2004)

⁸ See for example Bartlett et al. (Eds) 1998 or Kähkönen, 2004.

⁹ Kähkönen, (2004).

¹⁰ Insufficient or overconsumption; Part of Lowery's failure in preference substitution (1998)

¹¹ see for example Bartlett et al. 1998.

¹² Institutet för Kommunal Ekonomi (IKE), for example Högberg and Almqvist, have studied Stockholm in 1990's. The evaluation of competition program 1997-2000 was given to consults (Ramboll Management, PLS).

¹³ see Kähkönen, 1999 and 2001.

¹⁴ this covers all entrepreneurs, also in other branches.

¹⁵ When, for example, the city of Helsinki tendered out meal provision in home services for the elderly, the costs diminished but clients felt insecure when the person who delivered the meal changed. Changing provider had negative effects on the clients, weakening the quality of the service 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 (Kähkönen, 2001; *Utvärdering av konkurrensutsättning...*, 2002).

¹⁶ Experiences both in Finland (Kähkönen, 2001, 45) and Sweden (*Utvärdering...2001*, 45)

¹⁷ See for example Martin, 1993 or Cabral, L (2000).

¹⁸ Concepts are from the "MERITUM -handbook": Guidelines for managing and reporting on intangibles (Intellectual Capital Report).

¹⁹ Kähkönen, (2004)