Markets and Governments: The Reciprocal Dialectic of Failures

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NB: draft for conference discussion purposes only. The draft is entirely lacking in references, which would be provided in the event of a publication possibility.

(for conference on Constitutions and Markets, European University Institute, Florence, 14-15 June 2007)

***Abstract**: The current agenda in many countries for public service reform was provoked by certain widespread perceptions of public service failure. However, failures are now appearing with the reform agenda itself. In order to understand these, it is necessary to go back to the characteristics of the pure market, which is often in the minds of public-service reformers. It is therefore also necessary to understand the characteristic failures associated with the pure market, and the ways in which public services are to be understood as responses to those failures. This enables us to understand some of the weaknesses of the public service reform programme, and leads finally to some suggestions for a second wave of reforms. Questions are also raised concerning the rules for the separation of economy and polity that, in their very different ways, were fundamental to 20th century neo-liberalism and social democracy.*

Many current attempts at reforming public services include marketization and /or privatization as major components. As a result, market principle are increasingly coming to characterize the behaviour of governments, eroding some formerly widely accepted differences between political and economic modes of actions. The reforms are aimed at remedying identified public service failures. However, in appraising these it is necessary to remember that, at least in capitalist economies, public service provision often originated because of identification of a market failure. These failures can reappear in 'reformed' public services, reducing the extent to which marketization can be applied. These instances draw our attention to important, abiding differences between the private economy and public policy. They also put into question the rules for the separation of economy and polity that, in their very different ways, were fundamental to 20th century neo-liberalism and social democracy.

In this paper I shall tackle these issues by starting with the basic characteristics of a true market economy, followed by an identification of the principal potential failures associated in practice with each of these. This enables us next to relate typical traditional public service responses to each of these failures, and then to consider the typical public-service failures associated with these responses. From there we are able to generate a list of the characteristic public service reform responses of new public management to these; and therefore to consider in turn their own potential failures, particularly where they risk returning to a previously acknowledged market failure. Finally, we can examine some potential responses to these public service reform failures, which might lead on to a 'second generation' public service reform agenda. Table 1 summarizes the first parts of the argument by listing certain fundamental characteristics of the market, their associated potential market failures, typical public service remedies, and the failures often associated with them.

Table 1: Characteristics and failures of markets and public service responses

Market characteristic	**Market failure**	**Direct public service provision response**	**Public service failure**
I All prices are comparable	Failure of price to capture all values	Fiscally funded provision	Unwanted services, unresponsive to customers; dominance of producer interests; high taxation
II Everything is traded	1. Transaction costs	Removal of item from market into organizational hierarchy (as within firms)	Inadequate cost effectiveness; unwanted services
	2. Externalities incapable of being included in the price and trading system	Regulation to enforce recognition of externalities	Regulation imposes excessive burdens on market; or is formalistic and slow to adapt to new problems; also regulatory capture
III Market entry is without barriers, with multiple providers and purchasers	1. Major, virtually immovable, barriers to entry exist in many sectors	Direct state provision of goods and services where true market competition cannot be secured	As for I and II.1
	2. Inequalities of wealth and power exist as a result of accumulated entry barriers throughout the economy	Free or subsidized provision of goods and services where inequalities are considered unacceptable	As for I and II; also, public service provision subject to lobbying from interests privileged by existing inequalities

IV Market participants are perfectly informed	Major practical obstacles to fulfilment of this condition; inequalities in access to information	Decisions about service provision taken by well informed central policy elite	As I; also, excessive centralization and remoteness
V Economy and polity are separated	Powerful interests, created by inequalities generated by III.2 and IV, become insiders to political process	Public service codes of conduct stress separation of business and politico-administrative elites	Politico-administrative elites become out of touch with business approaches

1. Characteristics of the Pure Market

There are of course several forms that can be taken by the market: the neo-classical model of perfect competition is only one of these, and is found far less frequently than economic theory would like to believe. Indeed, current approaches to competition law have shifted to a more oligopolistic definition of the concept, being concerned mainly with whether some competition exists, not with the perfection of markets. This is not surprising, as the main actors in pushing this policy have been the US law and finance firms who are associated with large corporations engaged in global merger and acquisition activity that would often fall foul of competition protection rules that insisted on a neo-classical approach. However, there are good reasons for using the pure model when considering the role of marketization and privatization in public service reform. This is because, as I hope to show, many of the arguments used in favour of these reforms are valid only if the pure model is, if not fully realized, at least approached. Particularly important for a discussion located in the discussion of constitutions and markets, the depoliticization often claimed as a gain from marketization will not be realized if privatization programmes privilege a small number of politically favoured firms.

In its first column Table 1 lists the principal relevant characteristics of pure markets.

I All prices are comparable: In the original Walrasian model of the pure market, all economic transactions take place at a single auction, where an auctioneer balances bids for all items offered for sale in relationship to each other. Those bidding are not permitted to see the bids of others, because they must express their own pure preferences and not engage in gaming. The important point at the heart of this is that in the pure market all prices must be transitive: it must be possible to compare the prices of any two goods or services on a common scale. Where this is not possible and different criteria of exchange are being used, there is a blockage to the market.

II Everything must be traded: it follows from the first characteristics that all goods and services must be traded, that is must find their price within this universal market. If the allocation of any good is carried out by other criteria, then that good is not finding its true price in the market, its value in relation to other goods is not known, and there will be inefficiencies in its allocation.

III Market entry is without barriers, with multiple providers and purchasers: The market can operate only if increases in demand can be met rapidly by increases in supply. If this does not happen, excess profits and high prices develop. It is therefore essential that there are no barriers to entry into a market by new potential providers, who can quickly respond to the signals given by rising prices. By the same token, there should be ease of *exit* when demand declines; if not, wasted resources will remain trying to provide for a market that is in over-supply.

IV Market participants are perfectly informed: The market cannot work efficiently unless all individuals operating within it are able to compare prices for rival products, assess the value to them of alternative uses of their resources, and relate price and quality accurately and efficiently. If they cannot do this, then the market's signals are not operating efficiently.

V Economy and polity are separated: Contrary to the arguments of some currently popular ideologies, the pure market economy does not dispense altogether with the state. Both theoretically and historically, markets (except those where the participants know each other) need certain public authorities to maintain their own rules: to enable contracting parties to enforce contracts on each other; to maintain the value of currencies; to guarantee free trade from interference; to maintain a system of law courts and instruments for enforcement of their decisions on which contracts depend. What is essential to the pure market is that polity and economy do not interfere with each other. Government must not intervene in certain ways in the economy, or it will distort the market; and also individuals and firms in the economy must not interfere in politics, or they will induce the state to privilege them, leading to inefficiencies and market distortions.

2. Market Failures

The second column in Table 1 lists the failures characteristically associated with each of these core characteristics of the market.

I Failure of price to capture all values: There are serious practical obstacles to realization of the ideal of one market in which all prices are comparable, though it is possible to argue that in the long run all prices do become related through the mass of interlinked transactions. A more profound problem is that human beings cannot be prevented from believing that goods and services sometimes have a value that is not reflected in price, and that use value and exchange value are not synonymous, and from acting politically to have those beliefs expressed in public policy. This may be because condition II cannot be attained, or because inequalities prevent many people from expressing through price offers the values that they place on certain goods and services. Economists can try to solve this problem by definition, by saying that exchange value is the only meaning that can be given to use value; but in free societies it remains possible for people to reject this and to conceive of exchange value and use value as two analytically separate things, rendering unsuccessful economists' assertion of an identity.

To take the most prominent examples, it is likely for there to be widespread outrage if it is proposed that someone should have access to life-saving medicines, or basic education, only if they can afford to pay for it. The objection may be expressed in terms such as 'one cannot put a price on life', but that is unrealistic, as a price is routinely put on life: there are limits to the money that is spent on ensuring personal safety which stop short of providing as much certainty of protection as possible. What people are really saying is that the economy of providing certain fundamental goods and services should operate outside the framework of the mass of normal prices. In other words, not everything should be traded in the one single market. Ultimately the economists' argument is correct: at a certain point my desire to spend money on DVDs means that there is a limit to how much I am prepared to spend to allow children with cancer to receive effective treatment. But, as we shall see below, it is possible for certain intermediate barriers to protect the market for cancer treatments from that for DVDs.

II.1 Transaction costs can make the costs of trading unacceptably high: A practical problem occurs if every exchange has to take place in the market: it becomes very difficult to plan for the future or to accept on-going commitments, and considerable time and effort have to be spent in going to the market at very frequent points. This has long been recognized in the theory of the firm: why do firms exist as organizations, and not simply as nexuses of markets? Why do firms offer long-term, general employment contracts for labour services rather than renegotiate every new work task that needs to be performed? The answer is that it becomes inefficient if a mass of different transactions has to be performed rather than a small number of general ones. Of course, this does not mean that expansion of an organization rather than trading between it and others will always produce efficiency gains. Inefficiencies accumulate if long-term contracts are not subject to market testing; and there are diseconomies of scale at a certain point of organizational expansion. But the essential point is that there is a trade-off between these efficiencies and those of the transaction costs themselves. These arguments all exist at the level of the market economy itself, but they also have implications for government and public services.

II.2 Externalities prevent the trading of everything: Economic theory recognizes the existence of by-products of market activity which either impose costs that are not borne by those responsible for imposing them, or impart benefits that are not paid for by those gaining from them. The former loom particularly large in public debate, the main examples being pollution. In the normal course of events, a firm polluting the local environment does not have to pay for the burdens it imposes on the community, and may well in fact profit for so doing as dirty production methods are often cheaper than those that avoid pollution. Recent concerns over environmental damage extending far further than localized pollution to include damage to the environment of the planet itself have considerably enlarged the scope of the issue of externalities, once thought to be of limited application. Further enlargement has come from the history of multi-national corporations operating in developing societies, where the wealth, power and organizational capacity of the firms considerably exceeds those of local institutions, including state ones. Such firms can have an impact on the health and social customs of the people in the region and on the role of money within the conduct of public affairs which, whether it is evaluated positively or negatively (and both are possible), go well beyond the traded activities of the firms.

III.1 Some entry barriers remain unmovable: It may in practice be very difficult to fulfil the criterion of easy entry to markets. In some cases (for example, rail or air travel; or radio transmission before technological change massively expanded the number of wavebands available) it is simply impractical or physically impossible for more than a very small number of providers to exist within a market. In others (such as heavy industry, some forms of financial services) so much capital and/or know-how may be needed before a firm can enter the market concerned that only a small number of market participants is *de facto* feasible. There may also be limitations to the number of purchasers who can be present in a market, creating problems of monopsony rather than monopoly.

III.2 Entry barriers produce inequalities that distort markets: Pure markets do not generate extensive inequalities, as the appearance of considerably higher than average profits or occupational earnings serves as a signal that demand in the sector concerned is exceeding supply. This leads to an increase supply until earnings from the sector fall closer to the mean. For this reason, historically the growth of market economies has been associated with reductions of inequality compared with the feudally based economies that usually preceded them. However, the process of equalization remains limited, and in recent years the major historical association between market extension and inequality reduction has actually been reversed in most major economies. This indicates both the survival of old, and the emergence of new, barriers to entry in various markets. These inequalities in turn distort markets, as they distort the exercise of consumer choice. They also have further effects, to be considered under IV and V below.

IV The condition of perfect information acquisition is in practice very hard to fulfil: Acquiring enough information to make full rational price comparisons would often be so costly and time-consuming that individuals decide not to bother. Whether or not they lose out by doing this, they cannot know, as this knowledge is dependent on having the information that they have decided it is too costly to acquire. There will therefore be enduring inefficiencies. The impact of this problem varies from product to product, as the technical and other complexities of different products, and the importance of differences in capacities and qualities, vary widely. Most of us have enough information to compare the qualities of two apples offered for differing prices (unless they have been subject to different pesticide treatments of which we have little knowledge); few of us can compare the skills of two brain surgeons.

There are also considerable inequalities in the distribution of information access. Those who can afford to purchase skilled professional advice to assist their market choices are at a considerable advantage in certain markets, most notably those for complex financial products. This is one of the characteristics of late 20th and early 21st century markets that is generating an increase in inequalities. There is here a self-reinforcing process of inequality generation. A certain level of existing inequality enables some market participants to afford far more complete information about a financial market than others. This information gap then serves as an entry barrier (market failure III.2), reducing the number of participants in the market and therefore creating greater returns for those able to enter it, increasing further the inequalities in rewards, with further inequalities in capacity to acquire information about the market, and so on.

V the inevitability of political entanglement: In a market economy where government and law are neutrally maintaining the rules of the game, great gains may be had by those able to corrupt this neutrality and win political privileges. Separation of economy and polity is threatened whenever it is possible to exchange economic for political assets, and *vice versa*. Such exchange is often possible, because political influence costs money, particularly in a pure market economy where everything is measured in exchange values. The inequality of resources that some market failures (III.2 and IV) generate puts a capacity to influence policies into the hands of some firms and individuals and not others. They are likely to use this influence to secure certain kinds of market regulation that favour their own interests and increase their earnings. This will further increase inequalities and intensify the spiral identified in IV above, which in turn further intensifies the inequalities produced here in V. A market economy has little protection against this activity from within itself.

3. Public Service Responses to Market Failures, and their associated failures

Concern at several of these market failures leads to certain characteristic responses on the part of public authorities. This is to express the point theoretically; historically, the public institutions that have been involved in correcting market failures pre-date the market, being pressed into service to perform a market-correcting role at a certain historical moment. Sometimes these institutions have served particular interests. These characteristics have often weakened and distorted the operation of the market-correcting institutions concerned. These aspects need to be considered when discussing the weakness of public-service provision. We shall here examine the main public service responses alongside the market failures with which they are principally, though not solely concerned, as set out in Table 1. After a short discussion of each response we shall go on to consider the weaknesses with which it has itself come to be associated, here drawing on the final column in Table 1.

I Fiscally funded provision: The provision of goods and services by public agencies financing them through taxation and either not charging for them or subsidizing them is a means that people have found for coping with the apparent failure of exchange value to match use value. This kind of provision is therefore found most often in the case of goods and services, for the provision of which there is widespread reluctance to rely on competition within the general market, such as education, health, defence, certain cultural activities. Fiscally funded provision is also often used when the inequalities that result from market failure leave many people without the ability to buy goods and services that public consensus suggests are 'essential': health and education again, and a minimum level of security in adversity. This form of public response therefore also addresses concerns arising from market failure III.2. Markets are not abolished in any of these cases: public health services incur capital costs deriving ultimately from relative prices in capital markets; they have to pay for the land they occupy; they buy equipment and medicines; they employ waged labour. But the fiscal funding erects a frame around the provision, excluding consumer demand either completely or largely from the operation of the market, and rendering indirect the comparison of prices across the two sectors (the normal market sector and the fiscally funded sector).

Potential public service failure appears at a very clear point here. Who determines the consensus that decides that the market's provision is inadequate, or that a particular good or service is 'essential'? The political decision-making process is a very indirect and crude way of determining where a consensus lies, unless a society is particularly homogenous in its beliefs and values. It is notable that the major founding moments of most redistributive welfare states have occurred at times of unusual national solidarity, such as in the aftermath of major wars or emergence from dictatorships. Further, the Nordic countries, where welfare states have developed most strongly, have historically been culturally and ethnically homogeneous; greater demographic heterogeneity has threatened the strength of these welfare systems.

Also, the process of fiscal funding is itself vulnerable to the problems identified in V above: it cannot and must not be assumed that the politics of taxation and public expenditure always corresponds to some high-minded or functional logic. It is as subject to horse-trading and lobbying by privileged interests as anything else. If we consider the historical rather than the rationally theorized state, we see even more clearly how fiscal provision emerged from the capacity of rulers to exact taxes from populations in order to advance the life style of themselves and their courts. There is therefore a characteristic set of failures associated with this process. Some public services actually reinforce inequalities. Further, services may be provided that are not really wanted. Provision may be unresponsive to consumers themselves, because they have little access to the determination process; rather, the interests of producers, who can get closer to public authorities, can become dominant, taxation becoming high in the process. This can also mean the provision of unwanted supply.

II. 1 Organizations in place of markets: The means by which public service copes with high transaction costs in market exchanges is really just an extension of the theory of the firm: allocations are made by an administrative bureaucracy rather than by the market. This is particularly the case where a public authority allocates a good or service where there is considered to be little scope for bargaining in the market or for consumer choice, as was once for example considered to be the norm with the supply of gas, electricity and water to households.

Potential public service failures here are also shared by firms to the extent that they also replace markets with organizational hierarchies at certain points of their operation. Inefficiencies accumulate as allocation processes are not subjected to market testing, the goods and services concerned being removed for much of the time from the general market place within which prices can be compared. As a result there is a lack of cost effectiveness, and possibly also unwanted supply (as in I).

II. 2 Regulation: The classic public-service response to negative externalities is to impose regulations that prohibit or limit the offending behaviour. To take the pollution case, maximum levels for noxious emissions will be established, with enforcement by inspectorates with the power to impose fines or even the cessation of activities if the levels are exceeded.

Failure here can take a number of forms. It may be claimed that regulation is excessive, meaning that the gains achieved by reducing the pollution are outweighed by the losses to economic growth imposed. Since, by definition, the externality does not enter the market of transactions, it is however very difficult to verify this claim. A second problem, endemic to bureaucratic rule-enforcement, is that the process becomes rigid and formalistic, with following the rules being more important to the inspectors than achieving the substantive goals. Further, the regulation process is slow (usually requiring convincing government that an externality requires action, formulating legislation, and implementing it), while changes producing new externality problems can emerge very quickly; regulation is always likely to be behind the game. Finally, regulatory agencies are vulnerable to 'capture' by the interests they are supposed to be regulating. Most crudely this happens through simple corruption, or at least through unequal lobbying processes (see V below). Even without these elements, regulators and inspectors become heavily dependent on the firms they are regulating for information and for general co-operation. This involves compromises of various kinds, likely to vitiate the effects of the controls.

III. 1 Direct state provision: The classic response of public policy to 'natural' monopolies, and other circumstances where it was difficult for the private sector to make true markets with multiple providers, was to remove the service concerned from the market and provide it directly within the public sector. The main rationale for this has been that a public provider would be subject to more restraints on the tendency of monopoly to abuse its position than a private one.

The public service failures occurring here are the same as already discussed under I and II.1.

III. 2 Free and subsidized services: Whether or not they result from an economic interpretation of inequality as the result of market entry barriers, there are frequently widespread expressions of concern when inequality results in relatively poor people being unable to enjoy certain resources that are available to those higher up the scale. The strength of this concern varies directly with perception of the importance of the resource, and is liable to some variation over time and among societies. The main policy response has been for the resources in question to be provided free of charge at the point of use, and funded by general taxation. There may sometimes be a small charge, the rest of the cost being subsidized. Because these goods and services are being at least partially removed from the market, they have usually been provided directly by the public service rather than by firms who would have no market relationship with the users.

The likely failures of this form of provision are again the same as those in I and II.1. In addition, there is a problem that public service provision may not in fact reduce inequalities. Decisions that a good or service should be so provided are the results of an essentially political process; this is how agreement that its distribution is too important to be subject to the vagaries of inequalities is reached. But, as already pointed out, the political process is vulnerable to influence from influences already privileged in the market; it is therefore possible for public provision to reinforce rather than counteract inequalities.

IV Decision-making by well informed public service elite: In areas where consumers are likely to lack the information needed to make well informed judgements in the market (such as choices of medical treatment, forms of education, pensions provision), the problem is solved in classic public service provision by decisions being taken by expert public-service decision-makers. They determine the priorities of the health-care system, design education systems and the ways in which children are steered through them, and establish national pension schemes. These decision-makers have full access to relevant knowledge and can make well advised decisions as to best practice.

The disadvantages of this system are that the policy administrators may well be remote from the ordinary public, particularly perhaps when state traditions derive from the pre-democratic absolutist state. They may determine priorities on behalf of the public which the public itself (or at least parts of it) does not share. In democracies, the political component of government is supposed to compensate for this, but cannot be guaranteed to do so, particularly in highly technical areas. Further, the systems typically adopted for making these decisions are highly centralized, at the level of national or regional governments. There are efficiency and knowledge gains from doing this, but often at the price of increased remoteness.

V Public-service codes of separation of government and business: Here the aim of classic public service is to restore the relationship of separation between polity and economy envisaged in the neo-classical model itself. This separation becomes embodied in codes of conduct for public officials that establish the kinds of contact that there may be between them and businesspersons, including for example strict procedures for tendering for public contracts.

Apart from simple corruption, producing widespread breaches of the codes and returning to the original market failure position, the main defect of the classic public service model has been seen to be a remoteness of the politico-administrative elite from knowledge and understanding of the world of business. This is not only seen to impair the capacity of the public service to deal intelligently with business; it is also considered to reduce the efficiency of public service itself. It is argued that innovation and new ideas are likely to develop more quickly in the private sector, exposed to market pressures of competition, than in public service, which is typically monopolistic.

4. Marketized Public Services: the Response to Direct Provision Failure

The above discussion has identified a number of characteristic failures of direct public provision of goods and services. These do not necessarily correspond to specific market failures, but may be grouped into three general complaints, that public services are: A. unresponsive to consumers or users; B. produce excessive or unwanted quantities or qualities of service; and C. are out of touch with business and business practices.

The current reform movement within public service can be seen as attempting to tackle these problems by introducing some features of the market, but they rarely constitute a simple return of the services concerned 'back to the market', but rather a new hybrid between the pure market and classic public service. This is because public-service provision can, as we have seen, usually be interpreted as having been at least partly a response to market failure; a simple roll-back would bring about a return of these original failures. However, this does not prevent several of these new approaches from risking a return to certain typical market failures. The approaches of this new policy are related to the public service failures that they are designed to address in Table 2. The table also presents the failures that are coming to be associated with these approaches, both returns to market failure and some new ones. Finally, it considers potential new approaches to these failures in their turn. These last will be discussed in a later section, while the current section concentrates on presenting the marketized pubic service approach and its weaknesses.

Table 2: Marketization responses to public service failure; and new risks of failure

Public service failure	**Marketized service remedy**	**Possible new failures**	**New solutions?**
A. Unresponsive to consumers; dominated by special interests; centralized and remote	1. Privatization, with regulation where competition remains imperfect	Privatization does not guarantee perfect markets; regulators vulnerable to lobbying; market failures III.1 and V	Regulation, despite its weaknesses; reconsideration of role of direct public provision; limits to size of private franchises
	2. Market-making within public service, with direct consumer choice guided by performance data	Continued centralization in selection of performance data and in regulating demand; market failures II.1 and IV	Strong, hands-on inspectorates to monitor quality; decentralization of decision-making points; professional codes that prioritise consumer participation
	3. Private providers compete with public, but within publicly funded system	Private providers acquire privileged relation to monopsonist public purchaser; market failures II.1, III.1, IV, V	As above, with private providers limited to where true markets can be created without excessive transaction costs
B. Unwanted services; inadequate cost effectiveness; high taxes	1. Introduction of price element within subsidized provision	Absence of clear rules to determine balance of subsidy and market price; market failures II.1, III.2, IV	Constant scrutiny of effects of price component on access. Inspectorates to audit efficiency.
	2. Internal markets	Market failures II.1	Inspectorates for quality and efficiency
	3. Private sub-contracting	Monopsonist public purchaser; market failures II.1, III.1, V	Inspectorates; decentralization
C. Public service out of	1. Encouragement	Market failure V; also III.1 and 2.	Reassertion of public service

touch with business	of intensive interaction with, and learning from, private sector		codes; rigid division between advisory and contracting roles for business interests
	2. Adoption of business criteria in government practice	Market failures I, II.2	Clarity in policy-making and practice over areas of public service distinctiveness

A. Tackling unresponsiveness to consumers

Several of the public service failures identified in the previous discussion concerned various forms of unresponsiveness to consumers: classic public services often provide little choice; decisions about their provision are made at points that are both centralized (allowing for little diversity) and remote from the ultimate consumer; their provision is therefore dominated by producer interests, or by special interests within the public that have lobbied successfully. A number of measures has emerged to counter aspects of these perceived weaknesses.

A. 1. Privatization: The most radical approach of all has been the complete removal of the service concerned to the private sector. Privatization has not been solely motivated by a desire to respond to consumers; there have also been strong elements of problem B to be discussed below (which to some extent runs in the opposite direction from A.), as well as a simple problem of governments feeling unable to raise money for major projects themselves. Where prior natural monopoly or similar characteristics of the good or service concerned had been only coincidental or were in the process of radical technical change – as with telecommunications, both telephony and radio transmission bands – it was fairly unproblematic to produce real private markets.

However, in many cases problems of oligopoly, or artificial construction of markets, or difficulty for consumers in exercising choice, persist. Privatized industries are therefore frequently vulnerable to the original problems of market failure, and only rarely have the goods and services concerned become those of the normal market. They have therefore usually passed from public ownership to private ownership with regulation; this is even the case with telecommunications. Regulation is a classical public-service approach already discussed, so this really amounts to a shift within the realm of public service approaches to market failure. As such it is vulnerable to its own weaknesses of regulatory capture. On the other hand, regulation and regulators have been becoming increasingly sophisticated as privatization has brought a large increase in the number of oligopolistic services. The newly emerging forms of regulation therefore stand as a major approach to the twin problems of market and public service failures.

A. 2 Market-making within public service: Instead of the privatization of a service, governments are increasingly introducing competition within the public sector, by giving consumers choices among a number of supplying units. If consumers then pay a market price, a pure market has been created within the public sector; there is no necessary association between private or public ownership and the use of markets. Alternatively and at present more usually (mainly for reasons associated with market failure III.2) government continues to finance or at least subsidize the provision, reducing the exposure of consumers to the true market.

In some situations these approaches make it possible to combine consumer choice with universal public provision and funding in a way that was not possible with the original public provision mode. However, it is unlikely that all problems of centralization and remoteness can be resolved, for two main reasons. First, and particularly important, where government continues wholly or partially to finance provision, it will be unable to allow consumer choice to determine overall demand; there are therefore centralized decisions about rationing, both overall and for individual aspects of a service. Second, the construction of indicators to enable consumers to choose between alternative suppliers is usually controlled by the public authorities, who therefore decide what are relevant criteria for the public to use. Further, the use of markets, even in this controlled sense, renders the service vulnerable to two of the original market failures that direct public provision was intended to avoid: transaction costs, which have to replace organizational norms when internal markets are introduced; and the challenge of information costs for users (for which government-provided indicators are a solution that brings new problems). Paradoxically therefore these forms of marketization are usually associated with a rise of classic bureaucracy rather than its decline.

A. 3 Internal markets and private competitors: It is possible to combine privatization and the internal market, by having private firms compete with public providers, increasing the range of providers within A. II. It increases the variety available to consumers and may be particularly favourable to innovation.

This approach carries all the potential problems of A.II, with the additional one (to be encountered again in B.) that public authorities, rather than the ultimate consumer, are the monopsonist customers of the private producers. It is difficult for government to give consumers a complete free market choice where it is itself footing most or all of the bill. It therefore contracts with a small number of firms who then become privileged providers, with consequent entry barriers distorting the market. It is notable, particularly in the British case, where this process has gone furthest, to note how firms initially specializing in certain kinds of public contract expand into new markets. For example, firms originally based in road-building and defence contracts have recently extended their activities into education. Their original businesses gave them few insights into how to operate in these fields in terms of provision to ultimate consumers; they did however give them considerable help in the business of winning and managing government contracts.

This is logical: the customers of these firms are government officials, not school children and their parents. Their core business is knowing how to relate to and contract with these officials, rather than the provision of educational services. This does however raise questions about their capacity to fulfil the needs of the ultimate consumers. Entry barriers are also erected against outsider firms, who may have education expertise and make that their core business, but who have not acquired the skills of working with government. Further still, this aspect of contracting services to private providers introduces problems of inappropriate relations between government officials and these firms; that is, the introduction of a major new form of market failure V.

B. Unwanted, inefficient services

A second set of criticisms of public-service provision in the accounts above is almost the reverse of the first. Complaints in group A. are concerned with satisfying users, and may therefore imply finding means for increasing provision. Those in B. are more concerned with efficiency and waste, and tend towards reducing provision. It is argued that, because public provision is primarily driven by producer interests and financed by taxation, goods and services are provided at higher levels, both qualitatively and quantitatively, than had ultimate consumers been purchasing them in the market. As a result, taxes are higher than they would otherwise be the case. Linked with this argument is the claim that, because public provision is not being bought and sold in a market way, there will be inadequate cost controls and cost effectiveness.

B. 1 Introduction of price to publicly funded services: If consumers make their choices within marketized public services while also bearing part of the cost, it is argued, the conditions of a true market can be more completely approached. Such consumers may refuse to choose to consume certain public services, preferring to spend their money elsewhere in the market. They will also seek to reduce their expenditure on those services that they do choose, helping to drive costs down. In some cases governments may find a solution to this problem in simply withdrawing entirely from funding a service: for example, museums and art galleries may be required to survive in the pure market or close. (In practice, services of this kind usually depend on combinations of government funding, prices, and charitable donations. These last raise a whole new set of issues concerning the differences between public and private that go beyond the scope of the present discussion.) But of principal concern to us here are services where government fears the consequence of relying fully on the market. The most obvious case is education. Governments could save enormous sums of money, and considerable political debate, by ending compulsory education and declaring henceforth that children will only receive any education at all if their parents choose to buy it for them in the free market. They do not do this (except, ironically, in very poor countries), for reasons that we need not discuss here. The central point of these policy approaches that try to recognize both market and public service failure is that government seeks a combination of public subsidy and some element of market pricing.

Some advantages that accrue from this compromise between public provision and the market, but they cannot resolve the central problem of the balance between subsidy and consumer prices; this inherently political aspect of public provision can no more be avoided by marketized public provision than by direct public provision. These reform attempts are also vulnerable to a number of potential reversions to market failures: high transaction costs, and (in some circumstances) a return to inequality effects as a result of the use of price.

B. 2 Internal markets: These (already discussed under A.2) play a part in reducing both the level of services provided and their costs, as they give public-service providers incentives to save on costs in order to be effective within the internal market. Interestingly, this may lead to reductions in consumer choice, as some offered options become uneconomic, which is the reverse of the role anticipated for internal markets under A.2. Other potential disadvantages remain as discussed there.

B.3 Private sub-contracting: Again, this has been discussed in connection with consumer choice, but the use of private sub-contractors has also been greatly extended without reference to ultimate consumers. The aim is to bring existing public providers into price competition with potentially cheaper private firms. This again presents a situation of monopsonist markets, with a single government purchaser and usually a small number of preferred providers. It does mark an introduction of market forces in the sense of competitive pressure, but of the oligopolistic kind, not the pure market of neo-classical theory. It thus incorporates the market failures discussed under A.3, but more strongly so because the lack of reference to ultimate consumers.

C. Relations between public service and business

The issues discussed here, which arose largely under public-service failure V, are of a different order from A. and B. Here the argument is that the barriers erected between public officials and private business persons - in order to ensure the neo-classical requirement of an absence of entanglements between polity and economy - lead to public-service providers failing to keep up with changes in methods of production, management, service delivery, etc, which the private sector acquires as a result of competition.

C. 1 Encouragement of intensive interaction between public officials and businesspersons: The new approach simply reverses the requirement of both the neo-classical ideal and models of direct public-service provision: it advocates close and detailed interaction between politicians, public administrators, and firms. Consultants from the private sector become deep insiders within government departments, and it is not considered unacceptable for a firm simultaneously to advise government and to be a contractor to it in the fields where they have given advice. Similarly, policies for privatization and for contracting-out public services are determined in dialogue with potential contractors and with consultants linked to firms who will later bid for contracts. The rationale for this strategy is that the private sector is likely to be more efficient than the public, and that the latter will benefit from learning from the achievements of the former.

The principal problem posed by this approach is of course the return to the market failure of inability to hold the line required by former approaches between state and market. This risks a politicization of contracting decisions (and therefore a *weakening* of market forces), certain kinds of corruption, and the emergence of a privileged class of contractor firms, creating entry barriers and further strengthening inequalities, as already discussed above. The issue is a difficult one, since relations among private-sector firms themselves frequently generate these collaborative, network-like relations as opposed to those of strict contract. It is one of the ways in which transaction costs are reduced. Also, employees of both customer and contractor firm often generate joint working groups that do the actual work involved, achieving innovations and cost savings that would have eluded a strict principal/agent relationship.

Under most legal codes for contracting private firms are not required to abide by the formal requirements of the market contract: open competition, no privileged outsiders, level playing field….. They are deemed to want to seek the most efficient (and therefore the most market-conforming) means of action by virtue of the fact that they are having to compete in the market themselves. If in practice they choose to make cosy arrangements with long-established friendly suppliers, that is deemed to be something that will either prove to be as good a solution as the market could have provided (and the firm will thrive), or a bad decision (in which case the firm will enter a crisis that the market will resolve). Government contracting, on the other hand, is normally expected to follow legal procedures that replicate the conditions of pure markets, since governments are not themselves market actors and are not vulnerable to market discipline as firms are. However, governments, just as much as firms, can see the transaction cost inefficiencies of constant recourse to markets, and will seek similar approaches of building networks and special relationships. But these then give rise to political concern and fears of corruption. This is an issue that has not been confronted adequately by new public management reformers.

C. 2 Relations between public service and business: Adoption of business criteria: Government increasingly requires its services to model themselves on firms, with clearly stipulated goals and business plans. From this come gains in clarity and cost consciousness. The risks of this new model are that, in seeing little difference between themselves and firms, public agencies may forget two market failures that justifies much of the existence of the public sector in the first place: the failure of price to incorporate all value; and externalities. One of the easiest ways for a public agency to achieve clarity of business goals and sound income surpluses is by dropping all goals that are not formulated within its costed actions, and to ignore any externalities that it creates. But this only re-establishes market failure. Further, it is difficult for government departments to pursue a single maximand analogous to shareholder value maximization, unless it is the political reputation maximization of their ministers, which is itself problematic for service delivery.

In practice, government departments are usually being placed in contradictory positions by new public management reforms. On the one hand, they are compared unfavourably because they do not match the single-minded pursuit of simply defined efficiency goals of the private sector. On the other hand, they are not being relieved of their frequent basic responsibility to pick up precisely those tasks that cannot be subjected to pure efficiency criteria, and to pursue multiple goals. The solution that public policy has found to this dilemma is to leave public services poised on it, vulnerable to criticism whichever direction they move to resolve it.

5. New ways forward?

The final column of Table 2 indicates some possible ways forward for tackling the problems that are emerging with new public management. These will here be discussed as a group, and not as they appear in the table.

Privatization and the use of private sub-contractors are frequently producing markets that are far from perfect. The ultimate consumers have no customer relationship to the provider. The public service monopsonist being the purchaser; there is typically a small circle of insider firms, implying major entry barriers; and relations between firms and public administrators and politicians become questionable. Sub-contracting is often more problematic than privatization, as these relationships are enduring. At the same time, as noted above, a strict principal/ agent contract relationship may often not be the most effective or realistic way of providing a service. This conundrum leads to a number of considerations:

- In many cases there may be a need to reconsider a return to direct public provision, as no real market is being created. This can happen when, even after privatization, their remains a more or less monopolistic provider, or privileged group of insider provider firms, and a government monopsonist purchaser. It also occurs where the gains that come from service providers being able to enter into close relations with staff from the commissioning authority seem to outweigh the gains from a purer form of competition, but where correct and transparent public contracting procedures would thereby be compromised. It would remain possible and useful to continue with some market testing, provided the market is a true one, in order to ensure that a primarily public service has access to external knowledge of procedures and ideas. Internal markets may well continue to have a place in such services, up to the point where the bureaucracy needed to operate them becomes more of a costly hindrance than a help.
- Where private contractors are used for public service delivery, there often need to be limits to the size of individual franchises, to try to make better markets. The firms involved will always argue that they need large economies of scale; this may often be true, but it needs to be challenged. Why, for example, do British authorities accept a monopoly satellite television provider, while there is a more competitive situation in several continental European markets? Is this because of some features in the British market that require a particularly large franchise; or because the firm that owns the satellite monopoly, News International, has a particularly powerful position in press ownership and therefore the management of mass public political debate?
- New rules are needed that scrutinize public providers' relationships with firms. Particularly questionable is the ability of consultancy firms used to advise governments on policy implementation to try to sell the products of other branches of their firms to government. This is in fact also a problem *within* the private sector, as auditing firms sell other products to firms that they are supposed to be checking in the public interest – a major aspect of the Enron scandal. It is clearly valuable for public officials to learn from private firms, but this activity needs to be separated strictly from firms' commercial relationships with the same officials.
- Public service codes of conduct need to be revised to try to express this difficult balance between valuable mutual learning opportunities and exchanges that weaken and even corrupt markets.

- Public officials engaged in commissioning contracts with private firms need both to be permitted, and to be trained how, to drive hard bargains with firms and to formulate contracts that maximize true competitive opportunities. Frequently a combination of factors has inhibited this. First, governments have been so concerned to succeed in marketizing major parts of their public services that they have placed contract commissioners in a weak bargaining position. Second, whereas firms intending to bid for contracts have had a very strong incentive to learn techniques of smart bargaining, the public employees on the other side of the table have simply been doing a routine job. This has produced a large number of contracts where the public service has been a 'mug'. This has perhaps been particularly the case where private finance initiatives (PFI) and public-private partnerships (PPP) have been involved. Enough experience has now been gained to enable shared learning among public commissioners to offset this imbalance.
- Attempts to introduce internal markets and consumer choice accompanied by the use of indicators, whether accompanied by competition from the private sector or not, present a number of weaknesses. In particular, continuing centralization by government in the setting of indicators means that consumers' area of choice is in fact tightly controlled and determined. Also, in many cases transaction costs and continuing information problems make the use of the choice mechanism expensive and not very useful. These internal market and choice policies need to be accompanied, or to some extent replaced by, other means of solving the problem of remoteness and central direction often characteristic of traditional public service, for example:
  - ❖ Indicators, particularly in organizations with multiple maximands as is the case with much public service, lead to gaming behaviour and the distortion of performance. Despite its higher cost, there is no substitute for independent, professionally trained, hands-on inspectorates to monitor and to report prominently on quality, and to audit and develop the use of indicators and performance measures to ensure that these are not distorted by political opportunism;
  - ❖ The issue of remoteness of decision-makers can be partly tackled through decentralization of decision-making points in public service. The principle of subsidiarity needs to be employed in a thoroughgoing way to all services that involve delivery to ultimate consumers. Central governments should rely on good inspectorate services to achieve the necessary guarantee of minimum standards of quality, efficiency and probity, and beyond that to tolerate diversity and even disagreement about goals;
  - ❖ the codes that govern the work of public-service (and indeed private) professions, and in particular the training that members of these professions undergo, need to prioritize responsiveness to consumer participation. Professions have historically protected their economic and social positions by guarding their monopoly of knowledge, which has

involved keeping ‘secrets’ from clients and the public. As the extent of knowledge involved in professional practice becomes increasingly technical, professions both can and must risk sharing components of that knowledge with clients, engaging in dialogue with them and enabling them to make informed choices about how they use the professionals’ skills. This involves reshaping professional ethics so that they include client participation and knowledge-sharing as central values.

These recommendations for new practices in the next wave of public service reform do not yet constitute a coherent programme; they are a series of empirical responses to perceived weaknesses of the current wave. It is however notable that at several points they invoke the need for skilled and honest practice by groups of individuals: inspectorates and auditors, practitioners of public service professions, public administrators inevitably working closely with the private sector without frequent market testing. This approach runs in the opposite direction from the market concept. This latter is rooted in a belief in the fundamental selfishness and potential dishonesty of humans, one purpose of the perfect market being to render these bad qualities socially beneficial through the laws of supply and demand. If we cannot achieve perfect markets – and the argument of much of this paper is that we cannot – then we find ourselves again at the mercy of human self-interest. We then have no option but to try to make human beings behave better, through their training, through their mutual checks on each other, through codes of conduct supported by strong incentives and sanctions, by mechanisms of institutional trust.

Classical public service partly recognized this, through the elaboration of codes of conduct, but it sought to achieve something of the market’s automaticity through the rules of Napoleonic bureaucracy, as later analysed by Max Weber. The problem with this solution was that it produced the passive, rule-bound administrations lacking in a capacity for innovation, openness to public discussion and pro-active approaches that is part of the current critique of this model. New public management lifts some of these restraints, while establishing highly deformed markets. It also seeks to deal with the problem of human cupidity through targets and performance management. As we have seen, this brings further problems. It seems that we have little choice but to work at systems that use human means to monitor and control human weakness.

Finally, and most important, it is necessary to revisit yet again the dividing line between economy and polity in contemporary capitalism. This is a constantly shifting boundary, because it embodies fundamental instabilities:

- The capitalist market requires an absence of government interference in market rules, but the market order depends on a framework of law, which is produced and guaranteed by government. In principle this dilemma is met by the concept of a legal framework with which government does not interfere, which is best approached in common-law and contract-law regimes. But common law decisions are vulnerable to distortion by the capacity of powerful interests to hire the best lawyers. It has also not proven possible in practice for complex economic and technological systems to manage their market relations without statutory law, and rapidly changing economies and technologies are likely to require frequent adjustments of law, involving essentially political interventions. A major example of this is the way in which the law of intellectual property has evolved in the past two decades, led particularly by developments in the biopharmaceutical and information technology sectors.

- As noted in the above discussion, it is impossible to prevent economic resources from being converted into political ones, in a self-reinforcing and therefore accelerating manner.
- It is impossible to persuade citizens in free societies to accept that they may only pursue those goals that they can realize in the market. Given that by far the most important non-market means that citizens have for expressing their preferences is the polity, they will continue to seek political interventions into economy and market.

In practice there have been a number of attempts to re-define the barrier between economy and polity on a more realistic basis than that envisaged in pure neo-classical theory, of which the following are only examples:

- Social democracy, as it developed in northern Europe in the latter part of the 20th century, developed certainly discretely limited forms of intervention through welfare policy and certain specific economic policy concerns, beyond which it was content to have the market function;
- Overlapping, but not coterminous with, social democracy, Keynesian economics allotted a macro-level demand management role to government, beyond which it was content to have the market function;
- Neo-corporatism permitted firms to leave the market and influence political decision-making, but only by operating through representative organizations, which maintained a level playing field at least at branch level within which the market could operate.
- Pluralist political theory saw nothing amiss with firms engaging in heavy political lobbying, provided the polity itself resembled a market, with multiple actors, low entry barriers, and no monopolists or oligopolists.

- New public management and associated strategies have, as we have seen above, tried to steer a difficult path between statist approaches to market failures and market approaches to state failures.

All these approaches eventually developed vulnerabilities, which we can subject to analysis. The overall lesson that we would learn from such a study, as from the discussion above of the continuing dialectic between market and public service failures, is that there is no final resting place for that dialectic, no end of history. Each period needs to attend to the points of imbalance emerging from the last set of attempted remedies. At the present moment the most urgent issues appear to be those of the new imbalances in politicized economic power being produced by the last wave of marketizing reforms.