

COMPETITION IS GOOD FOR US - OR IS IT?

The 19th century French economist Bastiat was known for his essay "What is seen and what is unseen", in which he was speaking about the law of unintended consequences. His particular concern was those seeking advantage for themselves at the expense of others. But his concern extended to actions of government where, even with best of intentions to assist one group, intended outcomes were confounded by subsequent reactions.

It would be arrogant of an economist to claim any superior rights over the law of unintended consequences. In our personal lives, in our community interactions and in our observation of government, we are all familiar with St Bernard's proverb that the road to hell is paved with good intentions.

But when economists are putting policy prescriptions they have a particular obligation to discuss the knock on effects of their proposals. That is where their skill set is most valued, where they point out the less obvious consequences. So that is the theme of my contribution. When proposals for increasing competition in the Australian economy are focussed on human services, we have an obligation to discuss the knock on effects. In particular, what are the possible consequences of drawing the Community Welfare Sector further into the process of market competition?

My contribution follows the issues opened up by Tony Nicholson in his speech in May on the future of the Community Welfare Sector. He explained his concern for the erosion of what our voluntary organisations have stood for over a century. He wanted a rethink, but not a withdrawal of government. Paul Smyth's paper in this forum in August provided further insights.¹

I will first explore the competitive process and how it may affect the Community Welfare Sector. Then I discuss the possible incentives at work, together with impediments to competitive tendering that may frustrate intentions. A further section discusses some consequences. The last section offers tentative suggestions for progress.

¹ Both papers are available at www.bsl.org.au

Competition

While competition is ever present, regardless of government, the policy issues have been brought into current debate by the Competition Policy Review chaired by Prof Ian Harper. The draft report released in September covered a wide range of issues, but for my current purposes I can summarise relevant parts as follows.

- The context includes ageing of the population which will increase the need and significance of health and human services.
- Competition needs to be extended in these areas to improve choice, efficiency and outcomes.
- A diversity of suppliers of services is important, and the current mixed provision by for-profit and not-for-profit organisations is important and should be preserved.
- In recognising the importance of the voluntary sector, issues of diversity, innovation and choice are to the fore.

These sentiments are logical and laudable. But the question arises, how are they to be given effect? How are “diversity, innovation and choice” to be operationalised? How are impediments to them to be reduced?

For the ensuing discussion I take encouragement in the reflections of the same Ian Harper when he said in his 2003 Acton Lecture²

“..habits learned in the marketplace can be carried over inappropriately into community life, undermining a sense of mutual obligation.”

So what is this thing called competition? Most of us are familiar with the allegory of the lions and antelopes waking at dawn on the plains of Africa and how it helps to be the fastest lion but not the slowest antelope. The Business Council moved beyond this Darwinian expression of competition in its submission to the Harper Competition Policy Review

“Competition provides a strong incentive for businesses to improve quality, reduce costs and innovate to meet the needs of consumers.”

² The Centre for Independent Studies: 2003 Acton Lecture on Religion and Freedom. "Christian Morality and Market Capitalism", Ian Harper.

But while the Community Welfare Sector might be interested in quality, costs and innovation, we should not assume to start with that the Sector is just business without suits.

It is useful to decompose the ways in which economic competition works and then to consider the corresponding impacts on the Community Welfare Sector. Economic competition can be thought of as working in three ways.³

Compositional Effects of Competition

First competition favours more efficient firms at the expense of the less efficient. This is a compositional effect. Efficient firms prosper and grow while the less efficient wither and die, and average efficiency rises. For the Community Welfare Sector as a whole this is not a welcome prospect.

Those parts of the activities of each community welfare organisation which are in the marketplace may not constitute the whole of the organisation's purpose, and yet their ability to contribute to their mission across all of their activities may depend on the health of the whole.

In the case of some specialised community welfare organisations whose whole purpose is to fulfil government contracts, they might conceptually seem to be an extension of government, perhaps with less burdensome features of bureaucracy and with a lower cost structure. Life or death for them is not like the business sector, where entry and exit to a market is conducted by assembly of risk capital and purchase of assets, or liquidation of assets and write offs of shareholders' funds. For the Community Welfare Sector, a much more significant component of their asset base is goodwill, or social capital. This is an asset that is slow in the building, and one which does not offer some recovery of value on liquidation. (One sign of this is little merger and acquisition activity since their capital is not fungible as in business).

It seems unlikely that a thinning of the ranks of the Community Welfare Sector driven by the compositional effects of economic competition would be a good outcome for social welfare. It would not preserve the diversity that the Competition Policy Review says is important.

³ Concepts of Competition by John Vickers. Oxford Economic Papers 47 (1995).

On the other hand, Community Welfare organisations, in the absence of voluntary support and their own resources, do not have the right to a guaranteed existence at the expense of the government (actually the taxpayers). They already receive taxation concessions.

Trying Harder Effects of Competition

Second, competition encourages each firm to try harder to weed out inefficiencies by cutting costs and reallocating internal resources to improve productivity. The search for efficiency in the Community Welfare Sector is of course not a bad thing. However the focus of contracts with government and what gets measured from the point of view of efficiency may not capture the wider benefits (what economists call positive externalities) that the Community Welfare Sector brings to their mission. The narrower the contract the more the pressure for efficiency is likely to leave aside such wider benefits.

The scope for productivity gains resulting from 'trying harder' in the Community Welfare Sector is inhibited by two considerations. The first is a circumstantial one. In the private sector, all components of a business are expected to contribute to target rates of return. Laggard divisions are trimmed and resources shift to more productive areas. (Time may be taken to await returns from innovation). In the Community Welfare Sector, not all parts of activities are necessarily in the marketplace. Shifting resources has an opportunity cost that may be disguised by the non-market measurement of outcomes in the non-market sector. (Think of moving volunteer workers from where they were doing good to bolster resources serving the contract).

The second impediment to productivity gains is what economists call Baumol's cost disease.⁴ This is the insight that there are certain occupations, predominantly in human services, where the scope for productivity gains is inherently limited, (but wages must increase to compete with sectors where productivity gains induce higher wages). Think of hair dressers or nurses. The search for a faster or smaller orchestra confounds its very purpose. (Haydn's disappearing orchestra in his *Farewell Symphony* notwithstanding). Of course some gains are possible, and should be sought. The use of computers to manage data and communicate has not been off limits to the Community Welfare Sector. But then

⁴ Children of Performing Arts, the Economic Dilemma. William J Baumol. Journal of Cultural Economics 20 (1996).

many people with disadvantage may not themselves have the wherewithal to derive their part of the benefits: sending an email to offer an appointment may be feasible for the provider but if there is no email address?

Competition through Innovation

The third way competition works is to encourage firms to innovate to get a step ahead of their rivals, by producing products or services in different ways and by producing new products or services that they hope consumers will choose. (Indeed some economists think that innovation by temporary monopolies is the most important feature of markets and the key to rising living standards). For contracts the Community Welfare Sector has with governments it seems inherently likely that the contracts will be quite specific, inhibiting new ways of meeting needs, and certainly constraining the creation of new services in pursuit of an outcome.

Moreover, a key aspect of innovation in the private sector is the willingness to take risks in search of reward. I would argue that in the Community Welfare Sector risk is viewed differently: experiments are undertaken, but risks affecting outcomes for the disadvantaged are not sought and calculated in a dispassionate fashion. A business may draw a line under an unsuccessful trial and write off the costs (and claim a tax deduction), but the Community Welfare Sector has a higher goodwill component in its capital stock and the continuity of its community relationships does not envisage such an approach.

Economic competition Framework

Thinking broadly about the relevance of the economic competition framework to the Community Welfare Sector, it is worth appreciating the complexity of the circumstances of the disadvantaged. Economic theory suggests overall welfare is enhanced by competitive firms seeking to meet the needs of well informed consumers with price signals mediating supply and demand responses. But the disadvantaged are less able to participate in using the market, being less well resourced and less practised or positioned in making market decisions serving their long term interests. (The Harper Review draft report touches on this, and draws some tentative conclusions from the point).

In any case, for government service contracts with the Community Welfare Sector there is not likely to be a final price faced by consumers to signal choice and priorities. (The National Disability Insurance Scheme represents a departure from this, since people with disabilities will have a budget to exercise and they will be active in making choices). So while competitive contracting out looks like a market process, the market is not complete. The most important constituent of the market - the final consumer - is not playing an effective role.

These challenges are not to say that competitive tendering and other competitive pressures should not apply at all to the Community Welfare Sector. Governments should value both the capability of the Community Welfare Sector and the need for least cost social welfare outcomes. But there seem to be somewhat different complexities in this area which need exploration and management. There are things that are “unseen”.

What Motives Are At Work?

Economists like to think of the incentives that are at work when analysing issues. By this we mean much more than paying for results or saving money. Anyone who has worked in the public sector is well acquainted with the scope for institutions to look to their own interests and convenience. Empires are not confined to the history books. (The branch of economics that underscores these insights is public choice theory). Government motivations are seen and unseen.

Government Motives

In many ways government is distant from the circumstances of people it is trying to assist. It has little insight into local circumstances and community connections that underpin everyday life. Government therefore values the closer connection of the Community Welfare Sector with those in need. Service delivery through the Community Welfare Sector is thought to allow closer knowledge of circumstances of each case to be applied. The Community Welfare Sector is held to be better able to distinguish between those in genuine need and those who might seek to ‘game’ the system. And because the Sector has a culture of economy born out of limited resources, it is likely to be careful and abstemious in the distribution of benefits.

The Brotherhood of St Laurence captured these understandings in its submission to a recent Productivity Commission inquiry.

Community organisations which are embedded in and trusted by their local community are a key part of Australia's service delivery architecture. They play a valuable role in the development and delivery of innovative approaches to tackling complex social challenges. They are uniquely positioned to harness local skills, altruism and resources, and to strengthen the capacity of families and communities.

Moreover, government recognises that the Community Welfare Sector may be a source of innovation in services. For these reasons, government understandably would seek to join the Community Welfare Sector in service delivery of social welfare programs.

At the same time, government has responsibilities to the electorate to apply taxation revenues judiciously. Hence the ever present search for efficiency in programs. Further, government faces substantial reporting requirements on its activities, with a degree and type of scrutiny arguably well beyond that faced by the private sector.

The pressures for efficiency have led to increased contracting out with scale, often through competitive tendering. Over the past two decades, a recurring expectation has been that cost savings for government of around 20 per cent were available from contracting out. As far as I am aware, this guesstimate first appeared in a reform package suggested by the Industries Assistance Commission (predecessor to the Productivity Commission) in 1989. I am not sure in what way it might have been validated, other than by repetition. (In Victoria there was a period of compulsory competitive tendering by local government which sought such gains, with mixed results as I recall). But I did come across a recent example. A government agency was seeking tenders, but had stipulated that terms and conditions of existing staff should be maintained. The intending contractor had a direct comparison of employee costs between the public sector and itself. The cost difference was about 20 per cent. If that example is instructive, it suggests that circumventing the comparatively generous terms and conditions of employment in the public sector is the one off source of cost savings.

Government has never excelled at contracting out, as copious Auditors-General reports attest. It is not core business. It is hard to reflect a complex mix of government objectives in contractual form, and social welfare objectives are amongst the hardest to specify. (Sometimes those objectives are in tension with each other: think of the tension between transparency and commercial confidences). Nonetheless, setting out intended outcomes in a way that has meaning to the outside world has an upside.

Regulatory requirements, otherwise internally managed, become specific and externalised into contracts. It could be argued that such separation of regulation requires it to be more specific and transparent, and possibly more consistent (depending on how it is enforced). The costs of regulation become more evident. The Brotherhood attends to 44 standards in aged care delivery, and pays for the government audits. Some flexibility may be lost according to how the regulation is set out.

Continuity of services is subject to changes of mind and the Procrustean bed of the electoral cycle and budget timetables and horizons.

The bureaucrat's traditional liking for tidiness, supported by accountability requirements, gives rise to separation of services, and siloing of institutions, in the face of the confusing world of disadvantage. Timing is influenced by convenience. The Brotherhood's experience is that time allowed for tendering is typically two to four weeks, which inhibits proposed program development. And the forward schedule of tenders is often incomplete or out of date.

In my scan of Auditor General and Finance Department guidelines in the Commonwealth and Victoria governments I found plenty of guidance about grants, procurement and contracting, but I did not find any focus on contracts with the Community Welfare Sector as a distinct and different group. I would not judge that the door is closed to this issue. Rather, I think the approach is underdeveloped.

So, one Australian National Audit Office report⁵ noted:

The Commonwealth Grant Guidelines, while noting that several selection methods are open to Australian Government agencies, indicate the Australian Government's

⁵ Management of the Targeted Community Care (Mental Health) Program. ANAO Reports 2012-13.

preference for using open competitive merit-based selection processes when selecting grant recipients. (and...)

the Australian Government has committed to strengthening the contribution of the not-for-profit sectorStreamlining contracting and funding arrangements are part of the overall reform approach but the government is also seeking to improve the sector's accessibility to grant funding opportunities. Open competitive selection processes would be expected to help in this regard...

But the picture is not static. For example, here in Victoria the Victorian Auditor General reported material progress with a four year plan commenced in 2008 to strengthen the capacity and long-term sustainability of the community sector in Victoria, where there were 140,000 community organisations delivering \$3 billion in government programs. And from March 2013, Victorian Government departments have rolled out a service agreement aligned with a Whole-of-Victorian Government Common Funding agreement.

Motives of Community Welfare Organisations

Community Welfare Organisations, in pursuit of their various missions, understandably look to increase the good they can do by increasing available resources. Government (or rather, the taxpayer) offers substantial funds. Welfare organisation constituencies are less likely to weigh the direct tax consequences of raising the revenue to provide those funds. And while they may be aware that tax burdens affect economic growth and employment, a primary solution for much disadvantage, those longer term considerations are not necessarily front of mind when worrying about day to day needs.

To some in the Community Welfare Sector, the authority of government objectives may validate their choice of activity. And to be in good standing with government through a service delivery contract may also open up other opportunities to promote their mission, through contacts established and associations formed.

Some Consequences

Government contracting with the Community Welfare Sector runs the risk of degrading those very qualities that attracts government to the sector. This is a key insight to which

Tony Nicholson's paper draws attention. The pressure for efficiency leads to an incentive to look for scale in service delivery. It also serves a simplification objective of reducing the number of contracts and associated transaction costs. (The Brotherhood has more than 50 current contracts with State and Commonwealth governments).

This process draws the Community Welfare Sector away from the intimacy of feel for the circumstances of those in need. The broader the scale, the less room for localism. The pressure for programs to fit with the timing of budget cycles may bear little relationship to the continuity of needs. The pressure for reporting and accountability may cause program objectives to be narrowed and simplified, at the cost of attention to the more complex aspects of disadvantage. The cost/benefit framework underpinning government policy choices is inclined to leave in the 'too hard' basket the positive externalities that the Community Welfare Sector embodies – (as the traditional anecdote of the interpersonal benefits of meals on wheels reveals). Externalities from a long-term perspective in the form of community relationships, including in support of the spiritual element of peoples lives, are not to be found.

The concept of efficiency from the government perspective relates more to short term outcomes in an effort to solve problems that are too hard to ignore. But this discounts the merits of preventative community interventions at which the Community Welfare Sector has a comparative advantage, and lifetime outcomes. (An exception to this may emerge in the case of the National Disability Insurance Scheme, where the insurance model encourages a lifetime approach).

At the same time, the Community Welfare Sector is being drawn into being an extension of government, albeit with less bureaucratic cost. This may distort their priorities. Large scale contracts may undermine their attention to local circumstances and limit their flexibility. As Paul Smyth observed, the opportunity for choice by the disadvantaged may be constrained, and we economists regard choice as an economic good. Moreover, while economists usually think it adequate to consider the needs of consumers rather than producers, the nature of the Community Welfare Sector's relationships with communities does not offer such a straightforward separation.

The opportunity to experiment and innovate may be subdued under the weight of specific contracts. The managerial features of scale may disengage volunteers who may be hard to conscript to the routine or regulatory requirements of a government contract. The ethos of cooperation to be found throughout the Community Welfare Sector may be hard to reconcile with competitive behaviour. More subtly, these trends may feed an increased tendency to look to the State as the source of succour, with the “little platoons” of the voluntary sector disappearing into the government “army”. (I am told that an example of this in a completely different area is the way ‘landcare’ has been coopted into a branch of government, with a consequent loss of enthusiasm and effectiveness).

Some Tentative Suggestions

The incentives for government to contract with the Community Welfare Sector are strong, and not without merit. Government should not be insensitive to the problems that are emerging. It should be possible to discuss and develop rules and practices to try to address difficulties. The development of structures to guide institutional relationships need not crowd out trust and collaboration.⁶ Such rules or principles are to be distinguished from contractual regulations embedded in contracts.

One approach could be styled **consenting contracting adults**. This would adapt the status quo to a greater or lesser extent. Here government will read the risks for itself, perhaps making some adjustments. Community Welfare Organisations would do likewise, lessening the risks for themselves by limiting their participation in government contracts, and only choosing contracts that are fully consistent with their mission. For example, an organisation might decide to limit its dedication of resources to government contracts to one third, say, of its staff. It might further decide not to sweeten its contracting offer by un-costed resources, be they volunteers or paid staff, in recognition of the opportunity cost to its other activities.

Another idea would be to try to **incorporate externalities**. This would involve government recognising explicitly the ‘beyond contract’ benefits that an organisation could bring. Bearing in mind the limits of government knowledge, this might best be arranged so that the tendering organisation could nominate for itself what additional benefits it might bring.

⁶ Economizing on Virtue. Geoffrey Brennan and Alan Hamlin. Constitutional Political Economy, 6 (1995).

This would allow the different organisations in the Community Welfare Sector to give expression to their different missions. So a contract price could be loaded by, say, 10% to allow for extra benefits. Decisions would be made on a 'price and beauty' basis.

(The objective of value for money in government operations would not seem to prevent such an approach. Finance guidelines, and Auditor-General reports, describe rational decision making processes but do not prescribe a limiting definition of value for money).

Another option is **reverse tendering**. This would be to foster innovation. Government would specify a contract amount and broad objectives. Tendering organisations would indicate what they could do in pursuit of objectives and how they might innovate. They would nominate performance measures.

The problem of timing might be softened by some **longer term contracts**, with 'step up' and 'step down' clauses, with some design in progress components. This would be intended to share risks between government and the contracting organisation, akin to some engineering contracts.

Lastly, there could be efforts made to **bundle service contracts**. This would be intended to recognise that some disadvantages are multiple and best met in a coordinated fashion. If a single organisation did not want the scale of a bundled contract, then there should be an option to join with another. This would place the burden of coordination on the Community Welfare Organisations, who may be better equipped to manage that challenge.

These issues affect both federal and state governments. Matters are not static. For example, the Victorian Government has been working on a Community Sector approach . There could be scope to draw on the expertise of Auditors-General and Finance departments to draw up **model contract guidelines for not-for-profits**, with the assistance of the Community Welfare Sector. The guidelines I have found so far do not seem to adapt well to the circumstances under review here.

Conclusion

Some of my insights may not be new, either with respect to the value of the Community Welfare Sector, or the unsatisfactory features of its relationship with government. For example, in its 2010 review of the not-for-profit sector the Productivity Commission observed⁷:

NFP activities may generate benefits that go beyond the recipients of services and the direct impact of their outcomes. For example, involving families and the local community in the delivery of disability services can generate broader community benefits (spillovers) such as greater understanding and acceptance of all people with disabilities thereby enhancing social inclusion.

and

The efficiency and effectiveness of delivery of services by NFPs on behalf of governments is adversely affected by inadequate contracting processes. These include overly prescriptive requirements, increased micro management, requirements to return surplus funds, and inappropriately short-term contracts. Substantial reform of the ways in which governments engage with and contract NFPs is urgently needed.

But I am not sure that satisfactory progress has been made. And with more competition apparently in prospect it is worth looking to things that are "unseen" which may grow in significance.

Understandable incentives at work amongst governments and Community Welfare Organisations are leading to some unanticipated adverse consequences. The Harper Competition Policy Review is an opportunity to see if improvements can be instituted.

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⁷ Contribution of the Not-for-Profit Sector. Productivity Commission Research Report, January 2010.