

Towards a 'third way'?

Rebalancing the role of the state

New
Economy

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A major thrust of New Labour is to refocus public activity, with the state *doing* less and *regulating* more. The debate is not a new one – many of the privatisations of the 1980s still provoke controversy – but it has, up until now, been an ideological one. Depending on political perspective, markets were seen as 'good' or 'bad' – hardly a good guide to policy design.

Recent developments in the economics of information, however, allow us to better evaluate when markets work well and when they do not. This article summarises the core of that theory and uses it to explain why Britain is right to have a national health service but not a national food service, and right to have free school education but to be introducing market forces into higher education. The theory underpins an important conclusion – that the welfare state exists not *only* to help the poor. It also exists because it is efficient at providing services which the market would supply badly if at all. The Welfare State is therefore relevant to the whole population.

For reasons of space, the article focuses on the demand side of the market (ie the use-

fulness of consumer choice), with little discussion of possible supply-side problems – for example the fact that private insurers face major technical problems in covering risks like unemployment. All the arguments are set out in detail in Barr (1998).

A more useful approach

Two classic statements of the virtues of the free market are Milton Friedman's *Capitalism and Freedom* (1962) and Friedrich von Hayek's *The Constitution of Liberty* (1960).

The core of their argument is that markets automatically allocate resources efficiently and do so at little cost, since outcomes are the result of individual actions based on individual information. Thus there is no need for the expensive information gathering and complex paperwork which characterise central planning.

In addition, there is no need for government to prioritise activities. Individuals do it for themselves. The free market, according to this view, is a highly efficient, self-adjusting information system. The state has not as much information, nor an ability to acquire it as cheaply, nor a capacity to respond to it as quickly or effectively.

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Over the 1970s and 1980s, a new body of literature stressed the importance of information as a key underpinning of the market's ability to allocate efficiently. If consumers and firms are well informed, the industry is competitive and a number of other technical conditions hold, markets will, indeed, allocate efficiently. Where any of those conditions fail, markets might systematically be inefficient, in which case the question is whether government intervention — for example through regulation — would improve matters. Where the condition fails badly and where government is effective, intervention can increase efficiency. Where government is incompetent or corrupt, the least bad solution might be not to intervene.

The issue for policy design is then usefully posed as follows. Suppose that our objectives are efficiency (including economic growth) and equity (including protection of the poor). There are then two ways of helping the poor:

- **Strategy 1:** give poor people income transfers, so that they can buy goods at market prices (eg pensions, which allow pensioners to buy food);
- **Strategy 2:** give poor people the commodity free or subsidised, for example health care under the NHS.

The question is: which approach better achieves the twin objectives?

To Friedman and Hayek the first strategy is self-evidently better. But recent analysis of consumer choice would seem to challenge their conclusions. In a nutshell, consumer choice is more useful:

- a the better consumer information is;
- b the more cheaply and effectively it can be improved;
- c the easier it is for consumers to understand available information;
- d the lower the costs are of choosing badly;
- e the more diverse are consumer tastes.

The rest of this article applies these conditions to food, health care and education.

Food and consumer goods

Food, by and large, conforms with all five conditions.

- People generally know what constitutes a balanced diet; food prices are well known; and people know roughly how much food they will need today, tomorrow and next week.
- Knowledge about food can be improved reasonably cheaply, for example through public information campaigns about healthy diet. It is no accident that the incidence of cigarette smoking has fallen dramatically among large sections of the adult population.
- Such information — for example 'you can increase your life expectancy by eating more fruit and vegetables and fewer animal fats' — can be easily understood.
- The costs of mistaken choice are often low: if a new local restaurant produces soggy chips or wilting salad, customers go elsewhere.
- Finally, tastes in food are enormously diverse, making allocation by a central planner impossibly complex.

This, however, is not the whole story. There are some things consumers do not know. Has the food been produced hygienically? What are the ingredients in products like breakfast cereals? Are milk, cheese and the like fresh? The state therefore has a critically important role as regulator: hygiene laws relating to the production and sale of food; regulations requiring ingredients to be listed; and the requirement to put 'sell by' dates on packaging. Food is a good illustration of how private markets can be helped by effective state intervention. A national food service would be enormously inefficient and would fail to satisfy consumer demand, but the other extreme — complete deregulation — is equally unpalatable. Problems with salmonella, E coli, BSE, and the like illustrate graphically the problems which arise if the state does not take its regulatory role sufficiently seriously.

Economic theory, borne out by practical experience, thus shows that consumer choice, assisted by quality regulation and public information, is useful so far as food is concerned. Two implications follow:

- In the absence of problems on the supply side, markets will be more efficient than central planning.
- The way to achieve equity objectives (eg an adequate diet for everyone) is through income transfers (strategy 1, above), allowing people with low incomes to buy food of their choice.

Other consumer goods can be analysed in the same way. Clothing conforms with criteria a-e and is therefore best left to the market. It can be argued that people are less-well-informed about the quality of clothing than about food but the costs of mistaken choice are generally much lower than with food. The exceptions – for example safety clothing and crash helmets – are heavily regulated.

Televisions, washing machines, kitchen appliances and personal computers fit into a similar pattern. The market supplies considerable amounts of information through consumer magazines, newspaper articles and consumer programmes on radio and television; such information is cheap, and consumers can understand it. Aggrieved individuals can seek legal redress. Minor consumer ignorance is ignored where the costs of mistaken choice are small. Regulation of quality concentrates on situations where the potential costs of poor quality are higher, for example electrical appliances which might catch fire.

Cars raise two sets of issues: their production, and their use. On the production side, a key feature is the extent of consumer information about quality. In particular, consumers cannot easily check that a car's brakes and steering are safe, and its tyres well-designed. Given the high costs of mistaken choice, regulation of such safety features is stringent and continually evolving. So far as the use of cars is concerned, regulation mainly addresses the

costs my driving might impose on others if I drive unsafely (eg drink-drive laws), or if I operate a car in unsafe mechanical condition (worn tyres, faulty brakes), or if it is unacceptably noisy or polluting.

In such cases, for theoretically precise reasons, the state's role is to regulate to protect consumers where they are not sufficiently well-informed to protect themselves and the costs of mistaken choice are high. Beyond that, however, matters should be left to the market.

Health care

Health care is very different. There are problems with the delivery of health care and with its finance.

Organising health care

Medical care conforms badly with the key conditions.

- Consumers are often badly-informed. People can be unknowingly ill. Diagnosis is often complex and technical; people are frequently poorly-informed about what types of remedy are available; and there is uncertainty about the effectiveness of different treatments. Nor does an individual generally have time to shop around.
- Some knowledge, such as first aid, can be improved cheaply. However, a person with a medical problem generally requires information based on individual consultation with a medical expert, which is inherently more costly than provision of information which is more generally applicable. Medical care is more like an individually-tailored product (eg a made-to-measure suit) than a standard mass-produced product.
- Much medical care is technically complex. People do not necessarily understand information even where it is offered.
- Mistaken choice is costlier and less reversible than with most other commodities.

To a considerable extent, therefore, consumers are poorly-informed both about the quantity of treatment they need and the quality of

the care they receive; and even if information were available, health care is inherently a technical subject, so that there is a limit to what consumers can understand without themselves becoming doctors. The problem is exacerbated by the existence of groups who would not be able to make use of information even if they had it, such as victims of road accidents. All these causes of poor information create an overwhelming case for wide-ranging regulation, including medical qualifications, the testing, production and sale of pharmaceutical drugs, and the quality of medical treatment.

Paying for health care

In addition to all these problems, nobody knows how much health care they will need. In principle, the solution is medical insurance. However, private, actuarial medical insurance faces major technical problems leading to two sorts of policy problem – gaps in coverage and exploding costs.

Gaps in coverage arise for some medical risks and for some types of people, important examples being the elderly and people with pre-existing medical conditions such as diabetes. For both groups the probability of requiring treatment is too high for insurance to operate. Insurance is based on risk pooling, and can therefore cover people who *might* need treatment but not those who *will*. The latter group, of course, needs care most.

Cost explosions (known as the ‘third-party payment problem’) arise with private insurance for two reasons: if an individual’s insurance pays all medical costs, treatment is ‘free’ to the patient; and similarly, on the supply side, the doctor knows that the insurance company will pay her charges. Thus neither patient nor doctor faces any incentive to economise: both can act as though the cost of health care were zero. Thus there are incentives to excessive treatment, and hence to uncontrolled increases in medical spending.

The USA is a clear example of both sets of problems.

The role of the state in health care

The case for the National Health Service thus rests on two planks: major problems of consumer information justify extensive regulation; and major problems with private medical insurance both explain and justify the fact that in all industrial countries except the USA medical care is mainly publicly funded (in 1995, averaged across the OECD countries, three-quarters of all medical spending came from public sources). Thus the NHS strategy is to pursue efficiency through publicly organised delivery and equity by giving health care, including prescription drugs, free to the poor.

Though there is no single, simple solution which is clearly superior to all other solutions, both theory and international experience point to a major role for the state. Though the form of that involvement can differ, the following generalisations are possible, at least for industrialised countries.

- *Funding* should rely mainly on public sources – taxation, social insurance, or a mixture – to prevent gaps in coverage.
- *Delivery*. There are diverse successful systems with publicly-organised health care (the UK, the Nordic countries), with mainly private doctors and hospitals (Canada) and with mixed public and private provision (Germany).
- *Regulation*. Government should be extensively involved as a regulator of quality and of expenditure. The cost explosion problem arises in any fee-for-service system. Many countries experienced rapid increases in medical spending in the 1970s. They responded by imposing a budget cap at a national or subnational level (Canada), or at the level of the individual hospital (the Netherlands). The effect of such regulation is to control medical incomes without interfering with medical practice.

Different strategies use different mixes of these ingredients. A key message for policy design, however, is that the ingredients need

to be mixed with great care. One way is to combine public funding and publicly-organised delivery (as in the UK). Another approach involves public funding and private, fee-for-service delivery, regulated to contain expenditure.

Education

Education suggests another twist to the argument, with different answers for school education compared to those for many training programmes and for further and higher education.

Compulsory education

Are consumers well-informed? Can information be improved cost-effectively? Will any such information be understood? Children (the immediate consumers) are not well informed. Decisions are therefore generally left to parents who may not be well-informed either and are likely to differ in the extent of their confidence and articulateness. Parental information can and should be improved – which for all their problems was one of the ideas behind 'league tables'. However the cost of improving information and its effectiveness in aiding choice will vary considerably across parents.

So market allocation at a school level is likely to be inefficient. At least as important, all these problems disproportionately affect people from lower socioeconomic groups. Thus the case for intervention also rests strongly on equity grounds. We might contemplate a very different school system in a world in which all parents were well-informed, articulate and deeply concerned about their children's education.

How high are the costs of choosing badly? A restaurant which provides bad service will go out of business and its former clientele will have suffered nothing worse than a bad meal. School education is largely a once-and-for-all experience. A child who has had a year of bad education may never recover. In addition, a child may face high emotional costs (chang-

ing friends, for example) in changing school.

All these arguments underpin the case for extensive regulation of school education and the case for public provision is completed if one believes that an important task of the school system is to help develop social cohesion – a process which is enhanced if children go through a common educational experience.

Going in the opposite direction, however, is the last of the five criteria. There is considerable diversity in consumer tastes. Families will have different views about subject matter, the role of discipline, and the place of religion. Thus, the definition of a 'good' education will depend on the economic, political and social structure of the country concerned, and will vary far more than the definition of good health. Thus there is an inescapable tension between (a) public provision aimed at providing a relatively homogeneous package of school education for reasons of efficiency, equity and social cohesion and (b) parental choice, given diversity of educational preferences. There is no complete solution to this dilemma.

Notwithstanding an uneasy relationship with diverse consumer choice, the strategy for compulsory education, like that of the National Health Service, is to pursue efficiency through public provision and equity objectives by providing education for the most part free.

Postsecondary education

The same criteria give a very different result when applied to postsecondary education. Take universities for example. First, information is available, and more can be made available. There are already 'good university guides'; and universities increasingly publish detailed information on the internet. Second, the information, for the most part, is sufficiently simple for the student to understand and evaluate. This process is easier because going to university can be anticipated (contrast finding a doctor to deal with

injury after a road accident) so that the student has time to acquire the information she needs, and time to seek advice. Third, though it is true that the costs of mistaken choice can be significant, it is not clear that a central planner would make fewer mistakes; moreover, the move towards modular degrees, allowing students to change subjects and, increasingly, institutions, reduces those costs.

Students are well-informed consumers already. The many students I have met have generally been impressively well-informed – they were a savvy, streetwise consumer group.

Degrees are becoming more diverse, and change is increasingly rapid, and global. Students are more capable than central planners of making choices which conform with their own needs and those of the economy. Attempts at manpower planning are even more likely than in the past to be wrong, largely because of the increasing complexity of industrial and post-industrial society.

For these reasons, it is not inconsistent to support mechanisms (eg vouchers and income-contingent loans) empowering consumers in higher education but to oppose them for school education. The strategy for higher education – more like that of food than health care – is to pursue efficiency through markets, and equity objectives through income transfers (scholarships, etc.) to targeted groups, for example on the basis of income, gender and ethnic background. Put another way, subsidies for higher education should not be *general* (hence largely grabbed by the middle class), but *specific*, carefully targeted on those groups for whom access is most fragile (for fuller discussion, see Barr and Crawford, 1998).

Mapping the third way

The key lesson is that ideology should come into the picture at the stage of setting the objectives of policy – how much redistribution should there be, how much weight

should be given to promoting equal access to health care and education? But once the objectives are set the *method* should be chosen mainly on the *technical* grounds discussed above. Nutrition and health are equally important, yet food and medical care are organised very differently: those differences rest on their technical characteristics, not on ideology.

The welfare state has always been seen as a device for helping the poor. However, the arguments above suggest that it also exists because it is efficient and is therefore relevant to the population as a whole. The welfare state is much more than a safety net. It does things which private markets for technical reasons either would not do at all, or would do inefficiently. We need a welfare state and would continue to do so even if all distributional problems had been solved. Changed patterns of work and changes in family structure, mean that the design of welfare-state institutions has to change; but its underlying justification remains.

Markets are neither good nor bad; they are enormously useful in well-known and widely applicable circumstances, less useful in others. Where the necessary conditions fail, carefully designed intervention, for example through regulation, may improve matters. The real issue is the design of that intervention. For example, policy might be more effective in some areas if the state's role changed from that of provision to that of regulating private providers. Policy is assisted by open and clear-minded discussion and *that* is the real route to any third way ●

A third edition of Nicholas Barr's The Economics of the Welfare State (OUP, 1998) setting out much more fully the arguments in this article, has just been published.