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Nicholas A. Barr

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REBALANCING THE ROLE OF THE STATE: TOWARDS A 'THIRD WAY'

Nicholas Barr

Department of Economics,
London School of Economics and Political Science,
Houghton Street,
London WC2A 2AE

Tel: 0171-955-7482; Fax: 0171-831-1840; Email: N.Barr@lse.ac.uk

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REBALANCING THE ROLE OF THE STATE: TOWARDS A 'THIRD WAY'

Nicholas Barr

The market versus the state: a political football

A major thrust of New Labour is to refocus public activity, with the state *doing* less and *regulating* more. The debate is central but not new. The 1980s saw a major debate over privatisation of state enterprises of which some (British Airways, British Telecom) are today taken for granted, while others (several public utilities) continue to provoke controversy. The early 1990s saw a similar debate on a much wider scale in the transition countries of CEE (for general discussion see World Bank (1996), for discussion of social policy, Barr (1994)).

The debate, historically, has been ideological. Depending on political perspective, markets were seen as 'good' and state intervention 'bad', or vice versa. The issue was thus a political football.

Political Punch and Judy is not, however, a good guide to policy design. Much better to learn more about when markets work well and when they do not. Fortunately, recent developments in economic theory — particularly the economics of information — tell us precisely that. This article summarises the central 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 for efficiency reasons, to provide services which the market would supply badly if at all, and, as such, serves the entire population.

For reasons of space, the argument is limited in two ways: it is sketched only in outline; and the article focuses on the demand side of the market (i.e. the usefulness 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 and important medical risks. 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, moreover, 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, since the actions of individuals do so. The free market, according to this view, is a highly efficient, self-adjusting information system; and 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.

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 (a) consumers and firms are well informed, (b) the industry is competitive and (c) 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 for policy makers 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 (e.g. 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. Their analysis, however, could not take account of subsequent writing. But that writing makes a fundamental difference to their conclusions. In a nutshell, consumer choice is more useful:

(a) the better is consumer information;
(b) the more cheaply and effectively it can be improved;
(c) the easier it is for consumers to understand available information;
(d) the lower are the costs 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, clothing and the like

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

- People generally know what constitutes a balanced diet; food prices are well known, not least because food items are bought frequently; 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 easily be 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. 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 (e.g. an adequate diet for everyone) is through income transfers (strategy 1, above), allowing people with low incomes to buy food of their choice.

Clothing, too, conforms with criteria (a) - (e) and is therefore best left to the market. It can, however, be argued that people are less-well-informed about the quality of clothing than about food, not least because they buy clothes less frequently. Yet there is virtually no regulation of the quality of clothing. One reason is that with food the costs of mistaken choice can be high (food poisoning and, in the extreme, death); with clothing such costs are much lower. The exceptions — for example safety clothing and crash helmets — precisely for that reason *are* heavily regulated.

Consumer goods like televisions, washing machines, kitchen appliances and personal computers fit into the same 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; and 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 the arguments are similar to those for consumer goods, a key feature being 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 (e.g. 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 (a) they are not sufficiently well-informed to protect themselves and (b) the costs of mistaken choice are high. Beyond that, however, matters should be left to the market.

Health care

The health care story 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 if her condition is acute (contrast the situation with a car repair, where the owner can take time to acquire information).

- 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. In that sense, medical care is more like an individually-tailored product (e.g. a made-to-measure suit) than like a standard, mass-produced product (e.g. a hi-fi).

- Much medical care is technically complex. In the extreme, it would be necessary to train everyone to be a doctor. Because of that complexity, 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 (discussed in detail in Barr, 1998, Chs 5 and 12), 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. To see the intuition of what is happening, compare behaviour in an 'all you can eat for £6.95' restaurant (or when drinks are free), with the way people behave when faced with a conventional menu.

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 (Barr, 1998, Ch. 12): 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 objectives by giving health care, including prescription drugs, free to the poor.

Though the complexities of the problems just discussed mean that 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 and extent 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. This is a strong message.

- *Delivery*. Here the message is less prescriptive. There are 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 is extensively involved in all systems as a regulator of quality *and* of expenditure. The incentives to increased medical spending discussed earlier are not restricted to private insurance, but arise in any fee-for-service system (i.e. where medical suppliers, like other suppliers, are paid on a per-item basis). 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 compatible package comprises public funding plus publicly organised delivery (e.g. the UK). An alternative package involves public funding plus private, fee-for-service delivery, *plus* regulation to contain expenditure. Policy design downplays the last component at its peril.

Education

The education story suggests another twist to the argument, with different answers for school education than 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. However, parents might themselves not be well-informed; in addition, they 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.

These problems all suggest that 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, in the sense that 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? As discussed earlier, a restaurant which provides bad service will go out of business; its former clientele will have suffered nothing worse than a bad meal, and can spend the rest of their lives going to better restaurants. School education, in contrast, 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 (changing friends, for example) in changing school. A more apt analogy is a restaurant whose food is so bad that it might cause permanent ill-health (hence the need for hygiene laws and a health-and-safety inspectorate).

All these arguments underpin the case for extensive regulation of school education; 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 education package (and hence the meaning 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. It should not be thought that there is a 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. For reasons of space, discussion here is limited to universities to illustrate the argument, which applies similarly to vocational training and to further education. First, information is available, and more can be made available. There are already 'good universities 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.

It should be noted, fourth, that students make choices already. Though the matter is controversial, it can be argued that the assumption of well-informed (or potentially well-informed) consumers holds for higher education. The many students I have met have generally been impressively well-informed — they were a savvy, streetwise consumer group.

Finally, consumer tastes are diverse, degrees are becoming more diverse, and change is increasingly rapid, and global. For all these reasons, students are more capable than central planners of making choices which conform with their own needs and those of the economy. In contrast, attempts at manpower planning are even more likely than in the past to be wrong,

largely (though not wholly) because of the increasing complexity of industrial and post-industrial society.

For these reasons, it is not inconsistent to support mechanisms (e.g. 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).

Conclusion

The key lesson is that ideology comes into the picture at the stage of setting the objectives of policy, e.g. how much redistribution should there be, how much weight should be given to promoting equal access to health care and education? Once the objectives are set, however, 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 exists also for efficiency reasons, and is therefore relevant to the population as a whole. The welfare state is much more than a safety net; it is justified not simply by redistributive goals, but because it does things which private markets for technical reasons either would not do at all, or would do inefficiently. We need a welfare state of some sort for efficiency reasons, and would continue to do so even if all distributional problems had been solved. Changes in the world about us, including 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, in conclusion, 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 for debate 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. *That* is the real route to any third way.

3660 words

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BIOGRAPHICAL INFORMATION

Nicholas Barr, Senior Lecturer in Economics at the LSE, has written extensively about the welfare state, has worked for the World Bank on social policy in Central and Eastern Europe, and is active in the debate on the reform of higher education finance.

SUMMARY

Recent developments in economic theory, particularly the economics of information, show that the welfare state exists not only for the poor but — because it does things which markets do either badly or not at all — for the entire population. The theory also opens the way to more sophisticated analysis of state intervention; policy might be more effective, for example, if the state's role in some areas changed from that of provider to that of regulating private providers.

BLURB: something like:

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

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