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## **BIAC Discussion Paper**

# ***Productivity to the Rescue of Social Protection***

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Applying the productivity concept could solve the universal break-down of thought and action in the area of social protection (health, insurance for the elderly, employment insurance and social protection programmes for the poor).

Our generation must resolve a number of concurrent issues:

- \* despite the growing resources allocated to it, social protection is losing its effectiveness
- \* burdensome social budgets are hindering the normal functioning of the market economy
- \* there has never been so much demand for social protection. In the history of OECD countries, there have never been so many sick, old, unemployed or poor people.

What have we done to respond to these needs? We have simply continued to create new services, build new facilities, train new social workers, without questioning their efficiency. An end to this headlong rush is inevitable.

Indeed, if we pursue the present course of action, only one solution will remain: rationing, i.e. a reduction in the amount and the quality of services on offer to each individual or a drastic cut in the number of beneficiaries of social services.<sup>1</sup> A “productivity “approach would enable the social services to benefit from the efficiency of market mechanisms and would keep social regression at bay.

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<sup>1</sup> See Paul Belien, “What Can Europe’s Health Care Systems Tell Us About the Market’s Role?”.

## I. Grafting the Productivity Concept into the Social Services Arena

The social protection system must be rethought in terms of productivity. A manifesto for social productivity would include the following imperatives:

1. In order to satisfy the greatest number of social needs, social services must be produced at a lower cost. Global productivity in the social protection system can be illustrated by the ratio “quantity of social demand satisfied/social protection budget”. This ratio must be ever-increasing. Social progress is directly dependent on the evolution of productivity in the social protection system. The increase in productivity not only depends on reducing costs, but also on the creation of more efficient services to satisfy existing and new needs. Global productivity depends on a combination of capital productivity, productivity of facilities and of labour. Capital productivity is affected by decisions of investment and funding in a social service or facility. Productivity of labour and facilities depend on the organisation of the system producing the social services.

2. There is no inherent difference between a social investment decision and a decision to invest in the market economy. With regard to the choice of their location, their facilities and the services they offer, a social protection office or an old age home are subject to the same principles of economics as a restaurant.

3. There is no inherent difference between the production of a social service and the production of a market economy service. For instance, once the decision to carry out an appendectomy is taken, the provision of this service would be governed by the same *production laws* as the manufacture of a racing bike.

4. There is no inherent difference between the purchase of a social service and the purchase of a product of the market economy. The purchase of an hour’s home help is subject to the same laws of supply and demand as the purchase of a ton of cement. Providers and buyers of social goods (the state or insurers) interrelate in the same way as producers and buyers on the market economy.

5. In order for the social sector to benefit from the productivity concept and its virtues, it must be exposed to competition. A social protection market must be created with regulatory mechanisms similar to any other economic market. However, for this, a number of key adjustments must be made:

- \* it should be possible for any social service to be supplied simultaneously by a private enterprise, profit-making or non-profit, and by a state-owned enterprise;
- \* regardless of the provider’s status, the remuneration of private and public enterprises must both be determined according to the interaction of supply and demand, as well as of the pursuit for the optimum cost/benefit ratio;
- \* there should be no discrimination against the private supply of social services;
- \* an independent authority must protect the social sector from monopolistic or oligopolistic practices (including those which emanate from the public sector).

6. In order for the social protection market to be open, there should be no barriers to, or discrimination against, entry. Productivity of the social protection system will increase if all citizens were to be covered regardless of their income level. The law of increasing returns to scale,

which governs large production lines, must be adopted. Markets must be created that are large enough to quickly offer outlets to social innovation. For this, the following adjustments are necessary:

- \* closed systems, in which the purchase of protection and services and their production are linked, should not be allowed. Such systems are economically inefficient, socially unfair and exclude the poor and the non-subscribers.
- \* different forms of remuneration for a same service (e.g. a medical treatment) should be illegal. A service should be paid for according to its inherent value and not according to the status of the provider.
- \* The functions of purchaser and provider of social services must be rendered incompatible and should not be performed by the same institution.

7. In order for the institution of competition to be efficient and socially equitable, it is necessary to:

- \* create information networks specific to the social protection market;
- \* inject dynamism in the public sector and initiate the necessary institutional change with a voluntary and ambitious restructuring programme of this sector.
- \* open the social protection market progressively, service by service. For each service, it is necessary to lift the barriers to entry, allowing a private supply.
- \* define competition laws for social protection services.

## **II. How Should Market And Competition Laws Be Adapted To The Specificities Of The Social Sector?**

Social Services consist rarely of transportable goods. They are produced in the vicinity of their beneficiaries: the covered sectors are local. The monopolistic or oligopolistic market structures are favoured by the weak size of the local market. Moreover, social services often have single buyers: the state or local social institutions. Consumers of social services are rarely given a choice between many different suppliers: they are only entitled beneficiaries of social services. Production of social services answers to stricter ethical and sanitary norms than those of the market economy.

In order to create markets large enough, so that competition replaces monopolies, there are various competing techniques that are capable of replacing the current impenetrability of the social protection system with transparency and information dissemination.

1. With regard to providers, different techniques are already being used, notably in the health care sector:

- \* the standardisation of provided services,

- \* the creation of open, international networks of information on the costs and prices of social services.
  - \* the creation of a standards system for providing services during a time-span sufficient for the depreciation of equipment,
  - \* the freedom to invest in the social sector with a guarantee of equitable treatment in terms of market access and remuneration.
2. Consumers should be able to choose among the services offered, notably:
- \* through a system of impartial public evaluation of the quality and efficiency of services offered,
  - \* by financial incentives to optimise their expenditures.<sup>2</sup>
3. Buyers of services, be it the state or insurers, should be able to evaluate the offers:
- \* by having access to complete information on the quality and content of the services,
  - \* by overcoming the opacity of the conditions under which services are provided, together with the opening of the market and the creation of information networks on comparative costs.
  - \* by having the ability to choose among various providers of social services.

### **III. How Will the Providers of Social Goods/Services Adapt?**

First of all, providers should improve the quality of their investment projects and make their organisation more efficient.

1. Implementation of the productivity concept should, first of all, improve the return on capital in the social sector. Indeed, capital, be it be public or private, has a cost, and must be paid for.<sup>3</sup> This is not a philosophical argument, it is an actual, physical need. An insufficient return reflects a poor allocation of resources. The public sector ignores the cost of the capital it uses because that is often hidden by recourse to taxes and subsidies. However, the state must consider the following two factors in order to determine the cost of the capital it invests:

- \* the impact of imposing taxes on the economy,
- \* the cost of capital borrowed by the state on financial markets.

For example, if the cost of public capital for the construction of a hospital is estimated around eight per cent, and if the investment fails to cover at least this cost, how could the state react?

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<sup>2</sup> See paper by Wilfried Prewé, "Efficiency and Equity in Social Insurance", mimeo, 1996.

<sup>3</sup> See paper by Henry Grabowski, "The Role of Governments in Creating Incentives for Innovation in Pharmaceuticals and Biotechnology", mimeo, 1996.

- \* it can either sell the hospital to the private sector, who, in return, would have to comply with strict operating procedures,
- \* or, if the state chooses to retain managerial control of the hospital, it can alter the investment project in order to earn a better remuneration of its capital.

In a true competitive system, the return on invested capital is an impartial indicator of the productivity of a social institution. If for different reasons (a high level of competition, low productivity or shrinkage of a market) providers of social services, public or private, fail to obtain sufficient return on their capital, how could they react?

- \* they can reallocate resources to other social services, or
- \* they can restructure their production tools, i.e., combine their efforts with other providers, or alter the range of services they supply, or seek a less expensive organisation.

In other words, if the state finances social protection operations which become unprofitable as a result of greater productivity of competitors, it must either cease to subsidise such operations altogether or improve their management. For a provider in a social market economy with efficient competition, the constant search for the best return on investment will constitute the most powerful stimulus for making judicious investment choices.

2. In the area of social protection, productivity essentially hinges upon human productivity. As a result of their legal status, public social protection institutions can often avoid the necessity to improve their organisational structures. This could easily be achieved however, if they were to model themselves on the private sector. They *are* in fact service enterprises, in which the organisation, motivation and training of employees determine the outcomes and the net profit. If the private sector example in terms of work organisation and employee motivation were to be followed in the day to day management of social protection institutions in the public sector (or, for that matter, of private non-profit institutions) the unit cost of each service would drop significantly.

Productivity also concerns facilities: practices such as optimal resource allocation, economies of scale, and subcontracting all reduce fixed costs. These strategies are the basis for any business endeavour in the market economy. The impact of improved use of facilities would be even greater in the social area, since there the capital intensity can be considerable.

The costs of social protection can be considerably lowered by a permanent rationalisation of work methods in this sector. Only competition can force institutions to optimise their work methods.

3. The attitude of providers towards the beneficiaries of social protection will be modified. Beneficiaries will cease to be entitled and will become clients. And, if they can choose among various services, the allocation of social protection resources will also be modified. If a patient chooses a public hospital because he believes he will be provided with better care there than at a private hospital, the consequences of his choice will be the following:

- \* he will participate in the allocation of social protection resources,
- \* this allocation will be made according to the best efficiency in terms of individual satisfaction,
- \* it will force the private hospital to re-organise itself.

This presupposes:

- \* the availability of substitutable services for the same need, made possible by the freedom of creating social services,
- \* the ability of all citizens to equally access all social services.

The aggregation of individual evaluations will result in an allocation of resources indicating the degree to which supply has adapted to demand. Only freedom of choice among competing providers would enable this.

An assessment by purchasers of the services, be they the state or insurers, is indispensable:

- \* for all services of technical nature implying a third-party prescriber (e.g., a physician)
- \* to estimate the macro-economic effect of choices concerning services.

Expression of preferences by the beneficiaries of social services is a powerful factor for optimising organisations. Even concerning the types of social services which cannot be easily substituted, such as direct income support, the beneficiaries can express their preferences. With equal income, the beneficiaries can choose among competing providers according to the quality of the service they receive.

#### **IV. In What Way is Striving for Productivity a Departure from Current Practice?**

1. Striving for increased productivity requires ending the confusion between the production and purchase of social goods. For example, the state often is both the provider and the purchaser of social goods, making it impossible an opposition of interests between buyers who want to lower their purchase price and sellers who want to maximise profits. The state fixes the prices of services it buys. Striving to achieve lower costs in order to maximise return on investment, which is common practice among private providers in a competitive system, will enable the state to reach its optimum production costs and thus lower prices.

2. This requires the modification of the process of identifying demand and creating social services. The level of satisfaction of social needs is often established by bureaucratic practices which can have little marketing sensibility. Social protection is no longer charity. It responds to a demand it is trying, itself, to create.

3. This puts an end to the “blind” allocation of resources. In the social protection sector, once a particular investment project has been formulated, its implementation is often neglected. For the same service, there is rarely any competition between different providers of social services.

For example, take the case of a housing project for elderly people. If the cost of housing per person in municipal institutions is higher, for the same service, than the cost of a decent hotel, it would make more sense to pay a housing allowance and let the beneficiaries “shop” for a service at a lower cost. This presupposes that social services can easily be substituted, and, indeed, very often they are.

This assumes that social services are substitutable; they are, for the most part. In this substitutability lies the basis for productivity search. There is no single best way to respond to demand; creative potential can be as strong in social services as it is in the market economy.

The idea that each citizen, insured or not, will be able to choose among suppliers in the market for social protection according to the best quality/price ratio is partially true. But this could be implemented gradually if an efficient social protection market were instituted.

4. The productivity concept would also put an end to the general remuneration of social institutions, as well as to the global budgets, as social protection providers will evolve towards a fee-for-service remuneration.

More often than not, the price of a social service is fixed by the state. The system is incoherent however: at best it aims to balance the accounts of social protection organisms. No steps are taken to sanction mismanagement of a social institution in the public sector. The purchase of a social service on the basis of free negotiation between the paying organism and the provider is unattainable, since the buyer will always be in a stronger position. However, competition between providers of services will give rise to greater economic efficiency in their relations with the buyers.

Once real competition exists between providers, management costs will drop because of the continual search for greater productivity. The public sector surplus thus released could then be reallocated to new social services, or will eventually allow lower mandatory social charges.

## **V. How can a strict assessment process prevent a decline in the quality of social protection caused by an increase in productivity?**

There will always be a risk that enterprises will provoke such a decline, not by poor management, but by trying to maximise their profits.

1. This brings up the question of standards in social policy. Clearly, the social partners and the state must be responsible for defining social protection policy and products. If efficient control and guidance exist, supply will have no other choice than to conform to the sectoral norms.

Assessment agencies can set qualitative and ethical standards of social services, and they can control the respect of sectoral norms. These same agencies can control the cost/benefit ratio of services supplied on the social sector market. Is it really that difficult to institute a system of evaluation? State has an immense experience with control. The transition from control to evaluation certainly demands a sizeable effort, but this must be the basis of a permanent quest for greater productivity.

2. Admittedly, the notion of profit has historically been banished from the social protection sector because it would be obtained at the expense of its beneficiaries. Profit is not necessarily harmful. It clearly signifies that expenses are inferior to revenue. What would be reprehensible however, would be to include a monopoly premium in the earning of capital invested in enterprises supplying the social services. This would reflect a lack of competition. On the other hand, if real competition were to exist, capital would earn a return only on the basis of a risk premium which the market itself would define. The profit would then be reflection of a satisfactory allocation of resources and of an optimal management of the enterprise. No social protection market may ever be able to institute pure and perfect competition. But if the competition mechanisms are efficient,

the existence of profit-seeking enterprises in these markets will be by far preferable to oligopolistic structures with weak financial balances.

## **VI. Does the Opening of Social Protection to Competition Implies Privatisation?**

1. First of all, privatisation is not an evil in itself; it facilitates a more efficient allocation of resources and improves the productivity of the privatised enterprises. But social protection cannot be left entirely in the hands of the private sector without putting social equity at risk. Even supposing one were to privatise all social services, it is unlikely that enough private capital could be found to replace the existing investments of the public sector.

2. Competition is generally the principle gain from privatisation. It is not a question here of privatising social services, but of opening them up to competition; liberalising access to the social production sector is not necessarily privatising social services. Non-profit organisations would not actually be privatising by entering the social production market.

Submitting public social services to competition, independently of privatisation, will force them to reform themselves. Opening the social sector to private enterprises, be they profit-oriented or not, does not entail privatisation. Rather, it entails submitting the providers of this sector to the constraints of efficient management.

3. Do market shares taken by non-state-owned participants create a process of rampant privatisations? Social protection markets are constantly evolving. If one provider of social services gains more market shares, it is because it offers more attractive services. The opening of social protection markets is not a zero-sum gain: there is a constant creation of new market segments and permanent formulation of new needs and new demand. Even in those sectors in apparent stagnation, the dynamics of innovation opens new markets.

## **VII. Is there a risk that social needs will not be satisfied if private intervention in social protection increases massively ?**

1. This is the case with the management methods currently in use. If the unit cost of each service could be reduced, an increased number of services could be supplied for the same cost. If the supply of social services could be liberated, these would become more efficient, less costly, and better adapted to new demands. But is the complete retreat of the state from social protection feasible?

2. It is the state which has primary responsibility for ensuring national solidarity. However, certain risks can only be covered by the public sector. When faced with the risk of sickness or unemployment, for instance, the most sophisticated private or mutual insurance system would be unable to provide universal coverage.<sup>4</sup> Citizens without resources cannot afford to buy a coverage; the state must pay for their social protection. No private insurance system could ever replace the state's role in solidarity, unless they were to include a solidarity premium in their premium calculations.

Moreover, various social protection programs, such as those for the disabled and the excluded, emanate essentially from the concept of national solidarity. The search for the greatest efficiency

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<sup>4</sup> See paper by Pharmaceutical Partners for Better Healthcare, *What Risk Adjustment can do*, 1996.

in meeting social demand is independent of the debate on the extent and the nature of national solidarity.

3. Certainly, private providers will prefer markets which are deemed profitable, to the detriment of those which are considered to be unprofitable. There is a major risk that “unprofitable” social services will be neglected and, ultimately, condemned to a downward spiral of diminishing productivity. Indeed, certain projects are not deemed worthwhile not only because they earn an insufficient return on investment, but also because their volumes of activity can be too unpredictable (e.g., local rural hospitals or new services targeting narrow market segments).

The state should never relinquish its role as provider:

- \* under conditions of monopoly, if competition is never achieved in some sectors, there could be social services having to use average national prices for reference, or cost calculations by benchmarking. Without these methods, the introduction of the productivity concept is pointless. In the absence of a price constraint which encourages the search for excellence through competition, this concept will only be applied to management techniques.
- \* the public sector can create or maintain a social service at an exorbitant cost. However, it can only maintain this position over time if it continually searches for alternative sources of supply. It will choose the project which, for the same service, maximises the return on public or private capital, given an equivalent cost/benefit ratio. (This by no means presumes that return on capital will be the supreme decision-making criterion for a public investment projects in the social services.)

Pockets of low productivity in the social sector can only be tolerated if the projects they represent are continually compared with alternative projects.

Development of comparative cost analyses, along with cost/benefit evaluations, will surely serve to make the production of social services no longer impenetrable to analysis.

### **VIII. Will the search for competition and productivity enable a better control of the cost of social protection?**

Are the costs of social services provided by the state really superior to those which would be provided by the private sector companies entering the market?

Numerous experiences as well as common sense are in favour of this hypothesis. However, there are counter arguments. For instance, in the United States, where private interests dominate, the share of GNP devoted to health care expenditures is highest in the world.

1. The goal of competition is to establish true costs and, therefore, true prices. If private providers are less efficient than the state, they would either improve themselves or they would leave the market. Competition is not privatisation and the reform of the state is not impossible.

2. There is a slight risk to have, first of all, a rapid increase in the supply of social services, provoking, in turn, a rapid increase in demand for such services.

If the concept of productivity is applied not only to the costs of production but also to the efficiency of services, providers who are not productive (in terms of having inefficient procedures

or offering ill-adapted services) will be eliminated. This will increase the profit of those providers which are productive, high-performing, and innovative. Competition influences not only costs, but also the cost/benefit ratio of services, as well as their adequacy for demand.

The most efficient and least expensive services will necessarily be the buyers' primary choice. The quantity and efficiency in social services whose scope is defined by the state (such as services for the handicapped or for senior citizens) will increase. The effect of competition will be immediate for these types of services: the efficiency of social protection will increase within the same budget.

For the social services characterised by an entitlement to receive an open-ended assistance (for example, medical services or aide programmes for the homeless) three factors will intervene, with contradictory effects:

- \* in all cases, their costs of production will decrease if market conditions are met in the social protection market,
- \* if final demand results from the aggregate of individual demands, programmes for assessment and adequacy control of entitled parties' demand should enable to restrain the effect of an increase in supply.
- \* if final demand results from current economic conditions (for example, aid for the homeless) competition would first lower the cost of existing services, and, moreover, favour the emergence of more efficient services.

3. Nevertheless, the risk of domination by private oligopolies is real. The presence of the state in an open, competitive system, is the best guarantee of establishing true prices. Oligopolies would have nefarious effects when the state is incapable of productivity and when the anti-competition measures remain dysfunctional.

## **IX. How To Establish Competition In Social Protection?**

Establishing a market requires the use of legislative techniques, as well as the reform of already existing institutions. Simultaneous evolution of the two are indispensable in order to avoid adverse effects.

1. States can very well decide to open a part of the social market; but without instruments of information, assessment, and control, the mechanisms of competition will be inefficient. Therefore, before any reforms take place, the following measures are needed

- \* creation of databases on the cost and efficiency of services,
- \* definition of service standards
- \* creation of assessment and accreditation institutions.

Competition on its own is not sufficient to lower costs. Buyers are often in micro-markets facing oligopolies. Without information on the average prices of other micro-markets, service buyers are at the mercy of providers. Without instruments for assessment, they will not be able to evaluate innovations.

The types of remuneration of public sector institutions can hinder the creation of databases on prices. But instead of focusing on prices, it is possible first to measure costs. This problematic already exists in the health care sector. The development of evaluation procedures and costs databases in this sector reflects this evolution.

2. The reform of state social institutions must begin even before the opening of new markets, even if their impact on public sector employment will weaken government's efforts towards reform. But, the opening of markets will be inefficient if there is too great a difference in productivity between public and private enterprises.

Providing favourable conditions for public providers represents a mis-allocation of social protection resources by the state.

The reform of state institutions should be conceived in the form of ambitious restructuring plans for the medium term. Without this, the reforms would be limited to restrictions which would deteriorate the performance of social institutions. Funding efforts will be important, since the cost of restructuring public services is greater than that of private enterprises. In a sector where the turn over rate of personnel is fairly high, a medium term plan will limit the magnitude of layoffs. Moreover, specific programmes for people unemployed as a direct result of the restructuring of a social institution, can limit social pains. It would be less expensive to have a system of early retirement with a restructuration fund than to maintain unproductive structures. Finally, the future re-organisation of social policy by the development of new supply will limit the scope of this measure.

If the reform of certain institutions would be too costly, the state could entrust their management to the private sector, which would then take it upon themselves to restructure the institution. In this case, the private sector intervention will essentially consist of preparing public institutions to face competition.

3. The opening of social protection assumes the adoption of a competition law specifically designed for the social sector which must include:

- \* a fight against discrimination of citizens in the access to social institutions,
- \* instituting universal coverage to fight against market segmentation,
- \* rules of equal treatment of providers of services in the production as well as in the purchase,
- \* rules against monopolies and oligopolies, especially taking into account specific constraints of the social sector: non-transportable goods (which necessitate national benchmarking) and strong capital intensity (which necessitates long-term contracts).

4. In many OECD countries, the health care sector is being revived by the emergence of private sector institutions in this area. This sector seems to be ready for this type of evolution.

In social policy systems providing services as opposed to direct income re-distribution (aid to the handicapped, to senior citizens, nurseries, fight against exclusion, etc.), competition already exists with for-profit and non-profit providers. However, some measures are still needed in order to sensibly increase these systems' efficiency:

- \* freeing completely the provision of these types of social services by ending the preferential treatment linking the state and public social service providers.
- \* permitting the purchase of social services equally from either private or public providers, with no discrimination. Discriminatory practices still persist.
- \* assessing and accrediting providers of these social services.

Two major issues seem relevant concerning direct income re-distribution:

- \* permanent assessment of income re-distributions,
- \* encourage the emergence of innovative services.

5. Establishing competition in social protection is a long and difficult process. It modifies management rules of social institutions and requires permanent attention in order to reach optimal market conditions. Without that, the adverse effects of competition can deviate all reform efforts from their goal and indirectly lower the efficiency of the social protection system.

## **X. Conclusion**

The private initiative is present in social protection systems in most OECD Member countries. However, in none of these countries the creation of a competition policy in the social sector has been systematised. For competition to be established, a comprehensive and systematic policy must be adopted. Scattered elements of competition do not make a market. Only with a strong political will, can the social protection system be transformed. This type of action would take time to set up and bear fruit. There is no quick remedy or miracle, but applying a thinking based on economic efficiency can stimulate social progress.

Our social protection system is at a cross-roads:

- \* the search for productivity is not its inevitable evolution. Without a clear political will, it may very well plunge into the vicious circle of low productivity / rationing / lower final demand / higher unemployment / low productivity.
- \* by transforming its operational mode, it can be galvanised into a development path comparable, in terms of productivity and innovation, to that of the market economy during this century.

The radical transformation of social protection can constitute a source of growth which will permit us to face the challenges confronting our societies, in the same way as industrial and marketing revolutions have already succeeded in doing.

The massive increase in the productivity of social protection, should allow us to satisfy the increasing, and ever changing, social needs which have to be met.

## LIST OF PAPERS ATTACHED<sup>5</sup>

Dr. Paul Belien “What Can Europe’s Health Care Systems Tell Us About the Market’s Role?”

Dr. Patricia M. Danzon, “Can Cost Control and Innovation Co-exist?”, The Wharton School, University of Pennsylvania, July 1995. Paper presented at the OECD Management Experts Meeting on “Health care Reforms in Light of Changing Funding, Incentives and Production patterns, 4-5 May 1995.

Dr. Henry Grabowski “The Role of Governments in Creating Incentives for Innovation in Pharmaceuticals and Biotechnology”, mimeo, 1996.

Pharmaceutical Partners for Better Healthcare, *What Risk Adjustment Can Do*, 1996.

Dr. Wilfried Prewé “Efficiency and Equity in Social Insurance”, mimeo, 1996.

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<sup>5</sup> The attached papers are annexed as recent examples of research on issues related various aspects of the question of reforming social protection. The papers represent the views of their respective authors.