

# **Markets and Hierarchies in Social Services:**

## **Incentives, Institutions, and Politics**

Armando Castelar Pinheiro  
Fundação Getulio Vargas

Ben Ross Schneider  
Department of Political Science  
Massachusetts Institute of Technology

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**Abstract.** By the 1990s a consensus emerged that traditional bureaucratic forms of service delivery were incapable of increasing efficiency and quality. Government reformers turned instead to a variety of new organizational innovations, quasi-markets central among them. Quasi markets raise a range of theoretical and empirical problems including: agency dilemmas, information costs, shifting incentives and motivations, partial implementation, unequal access, insufficient accountability, and policing and enforcement. Introducing market mechanisms in the delivery of social services is an institution-intensive reform best accompanied by complementary policies to enhance the collection and dissemination of information, to permit personnel flexibility, and to manage the entry and exit of private providers. Nonetheless, quasi markets often have negative side effects in narrowing employee incentives, aggravating social inequality, and providing additional incentives for opportunism, for which reforming governments have sought further compensatory measures. Politically, quasi markets strengthen the short route of accountability (from consumers to providers), but can weaken the already tenuous long route (from consumers to politicians to providers). Examples and illustrations are drawn from recent reform experiences in Latin America.

The state pays; parents choose; schools compete; standards rise; everybody gains.

*The Economist*, 3 May 2007

When faced with disappointing health and education outcomes, especially for poor people, it is tempting to recommend a technical solution that addresses the proximate cause of the problem. Why not give vitamin A supplements, de-worm schoolchildren, and train teachers better? Why not develop a “minimum package” of health interventions for everybody? Although each intervention is valuable, recommending them alone will not address the fundamental institutional problems that precluded their adoption in the first place. Lack of knowledge about the right technical solution is probably not the binding constraint. *What is needed is a set of institutional arrangements that will give policymakers, providers, and citizens the incentives to adopt the solution and adapt it to local conditions.*

World Bank (2004, pp. 10-11, emphasis added).

## **I. Introduction<sup>1</sup>**

Governments everywhere face a constant trade-off between providing better and more services to their citizens and keeping taxation and public debt at levels that do not harm economic growth and job creation. Not surprisingly, then, government reformers seek alternative means to provide social services with greater efficiency, better quality, and lower cost than through traditional publicly financed and operated facilities (Joumard et al., 2003). This search often included, since the 1980s, attempts to infuse public administration with the so-called ‘new public management’ (NPM), which tries to mimic private-sector management practices in the public sector. Examples include the introduction of improved budgeting techniques, results-oriented

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management, performance contracts and bonuses, etc. (for a recent review, see Gottschall 2015). But a number of governments went further: several OECD countries, Britain often in the lead, experimented with the adoption of a variety of alternative ‘techniques’ of service provision that incorporated market or quasi-market mechanisms, including contracting out of non-core activities, such as cleaning and security, using vouchers, relying on public-private partnerships to build and operate hospitals, and encouraging competition among schools. Although, these alternative mechanisms still account for a small part of the supply of publicly-financed social services around the world, their use has steadily expanded and market principles consistently come up in debates on public sector reform (see Le Grand 2007 and Gingrich 2011).

The inspiration for the use of such instruments stems from the same conceptual matrix that fed the reform of infrastructure, public utilities, state enterprises, and social security systems; in particular, the goal of separating policy, regulation, and commercial activities, which were previously bundled together under the responsibility of a single public organization. Advocates of this separation argue that, while there are good reasons for governments to be involved in dealing with market failures and pushing for distributive goals in the provision of social services, they do not need to be directly involved in service provision. Thus, reliance on quasi-market mechanisms in social services can be seen as a natural extension of the 1990s market reforms in the economy and the result of the discredit faced by the state as single provider of a wide range of goods and services. It has been this discredit of statist, bureaucratic, and centralized policy options that helped to put in power reformers more predisposed to consider market solutions even in formerly non-market environments, like social services. This continuity also extended to the support of multilateral banks, especially the World Bank and the Inter-American Development Bank (IDB),

which have backed the introduction of market mechanisms in sectors previously dominated by public sector providers.<sup>2</sup>

As was, sometimes belatedly, discovered with the introduction of market reforms in infrastructure, putting these policy recommendations into practice tends to be more difficult in developing than in developed countries. Governments in poor countries face a more complex challenge: they have fewer resources but face greater demands to expand the coverage and improve the quality of services. This means that the opportunity cost of public spending, measured, for instance, by the number of lives that may be saved or extended, is higher in poor than in rich countries, which in principle would make the use of efficiency boosting quasi-market mechanisms more attractive. Yet, because most poor countries have less consolidated institutional environments, contracting between the public sector and private parties becomes substantially more complicated and requires special governance structures to operate effectively. Put differently, creating quasi markets is paradoxically an institution-intensive reform. Furthermore, in developing countries politicians are often less accountable and poor citizens face greater obstacles to effective political participation. The weakness of this ‘long route’ of accountability may in fact increase the attractiveness of shorter, more direct routes of accountability through quasi markets, though it is not clear how much or how well shorter routes can substitute for the longer routes of formal political accountability.<sup>3</sup>

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<sup>2</sup> See, for example, Fiszbein (2005: 29): “In the limited areas in which it has been implemented, giving individuals choice over which organization they get services from has generated powerful pressures for results on front-line providers.”

<sup>3</sup> See World Bank (2004) and the introductory chapter by Perry and Angelescu for an elaboration of the differences between the short route of accountability (from consumers to providers) and the long route (from consumers to politicians to providers).

Latin America provides a revealing context in which to study the attractiveness and pitfalls of adopting quasi-markets in developing countries.<sup>4</sup> The ‘social deficit’ in Latin America, especially in health and education, is enormous, and governments over recent decades have increased spending on those areas. However, more resources alone are unlikely to solve the problem. Indeed, the World Bank (2004) observes that, on average, on health and education public spending is only weakly correlated with outcomes. Thus, without raising the efficiency of public spending and quality of social services, allocating more resources to these sectors will not necessarily translate into better indicators (see also Afonso, Schuknecht and Tanzi 2006).<sup>5</sup> The three empirical chapters to follow analyze a wide range of reforms Colombia, Peru, Chile, and Uruguay in service provision including decentralization and devolved authority, participatory decision making, voucher systems, and a variety of means intended to improve the flow of information and exercise of accountability. These cases are representative of the many reforms and experiments in government services across the whole region, and this ongoing quest suggests that quasi markets will remain as options on the reform agenda.

Despite some important exceptions, until recently research on the use of quasi-markets in the provision of social services in Latin America had been subject to relatively little systematic

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<sup>4</sup> Among developing countries, Latin American countries have ‘median’ experiences along many dimensions. Most of the region consists of middle-income countries, with democratic regimes that embarked on market reforms in infrastructure. Also, while countries in the region have weaker economic and political institutions than typical OECD countries, they are stronger than those in many other developing countries (Kaufmann, Kraay and Matruzzi, 2007).

<sup>5</sup> Most of our empirical examples come from basic services in health and education, by far the most costly areas of social service provision. In some countries, quasi-markets have been extended to other services. In Brazil, for example, private concessions have recently been granted to operate prisons (see World Bank 2012 and Rombach et al. 2014).

theoretical and comparative analysis.<sup>6</sup> In contrast, the literature on the regulation of public utilities, for example, offers more extensive theoretical elaboration as well as more policy relevant work on applying theory to different institutional contexts (Levy and Spiller 1996). As in the latter literature, our theoretical approach draws heavily on transaction cost economics, principal-agent theory, and the analysis of information asymmetries. In particular, we think there is much to be gained from thinking through problems of multiple principals, perverse or incompatible incentives, and variable costs and quality of information.

Market pressures can be introduced in social service delivery in three general ways: by subjecting providers to competition 1) for funding and contracts or 2) for consumers (e.g., vouchers and other fee for service arrangements), or 3) by promoting internal competition among employees of provider organizations (as in NPM).<sup>7</sup> Whereas in normal markets consumers pay directly for what they buy, in social services payment (by governments) and consumption (by citizens) are separate making these markets partial, constrained, or quasi.<sup>8</sup>

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<sup>6</sup> For exceptions, see Savedoff (1998a), Sojo (2000), and World Bank (2004). Kaufman and Nelson (2004b) offer systematic theoretical and comparative analysis, but their focus is more on political feasibility than best practices.

<sup>7</sup> These three areas can be further disaggregated. Patrinos (2006), for example, identifies six types of contracts between governments and private subcontractors. All contract types though promote competition among providers for contracts, rather than for students or among employees. Gingrich (2011: 11-18) also identifies six different types of markets in social services. Her typology revolves around only the first two of our three types of competitive (for consumers and for contracts) but excludes employee competition in NPM, and the six outcomes depend more on which actors – governments, consumers, or providers – end up with more control and whether public funding remains universal or not. Another means to introduce this kind of incentives is through reputational competition, using public rankings, as is common in education. These can be combined with voice mechanisms to strengthen the importance of client feedback.

<sup>8</sup> See Barr (2012: 260-1) for a discussion of why introducing competition in service delivery results in quasi markets. The term quasi market seems to have the most currency in Britain, where NPM also had the strongest run (Gottschall et al. forthcoming). Decentralization is

Each form of competition has distinctive advantages, disadvantages, and information problems. In the first form, competition among providers for funding helps primarily to lower costs. However, providers have incentives to skimp on quality, and the principal (government) has a more difficult time assessing the quality of the services provided, and consumers have difficulties conveying aggregate information on quality back to the government. To mitigate information problems, governments may institute extensive reporting requirements and establish regular testing and other assessment instruments.

In the second form, direct (e.g., vouchers) or indirect (e.g., fee for services) transfers to consumers, who can then choose providers, gives consumers (who may have better information on quality) greater leverage over providers, but often increase costs and require greater administrative oversight.<sup>9</sup> Since providers compete for consumers, governments may concentrate on generating information on quality and disseminating it to consumers. Voucher systems may also allow for a greater proportion of funds to reach service providers at the front line, rather than being consumed in intermediate administration. Lastly, in the third form, competition can be introduced in internal labor markets among healthcare and education professionals and staff. This competition is the mainstay of the new public management (NPM) generally, and in social

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intended to improve service delivery in the short run by allowing local implementation to conform to local constraints and preferences, to shorten the long route of accountability (see the chapters by Sánchez & Pachón and by Jaramillo & Alcázar). In Colombia's decentralized system, local capacity for taxation was particularly important in improving service outcomes. Over the longer term, in principle, decentralization creates a weak quasi market in that local jurisdictions compete with one another for mobile workers and businesses.

<sup>9</sup> Across the social services, there seems to be greater consensus among experts in healthcare that payment should follow patients (Nelson 1999: 22). In education, voucher systems, where payment follows pupils, are less common and more controversial. See Vaillant et al. in this volume on vouchers in Chile.

services usually takes the form of additional incentives, almost always financial, for better performing employees (pay for performance).<sup>10</sup>

The goal of this paper is not to assess whether or how much such market mechanisms can improve social services, but rather to develop a framework for analyzing the problems and challenges – in incentives, institutions, and politics – that arise in implementing market reforms. Section II summarizes arguments for and against the use of quasi-markets and contrasts markets and hierarchies in social services and public utilities. Section III examines complementary considerations – especially facilitating information flows, flexibility, and entry and exit – that impact how well quasi markets function. Section IV analyzes potential compensatory measures to redress problems (such as socioeconomic sorting, narrowing incentives, and exploiting information asymmetries) that typically arise in using market mechanisms. Section V returns to the long and short routes of accountability and considers how quasi-markets can change the politics of social service delivery.

## **II. Theoretical Issues: Markets, Hierarchies, and Quasi-Markets**

What is different about social services, especially education and health, that justifies the intense involvement of the public sector in their provision? Why are those sectors not treated like many others including public utilities in which state intervention is either absent or limited to some light forms of regulation? One reason is equity: the consensus in most societies is that everyone should have access to a minimum threshold of security, health care, and education, regardless of their income level. In this context, the state can play a unique role in taxing and

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<sup>10</sup> Many university reforms combine various types of quasi markets, including competition among universities for government funding, among units within universities for resources, among professors for salary increases, and across universities for students. For a review on Europe, see Enders et al., 2015.



redistributing resources to those who lack the funds to finance those services on their own. Another reason is market failure: because individuals do not appropriate all the benefits of consuming these services, if let alone they will under consume them. A typical case is immunization against contagious diseases. In the extreme, some of these services are public goods – that is, it is costly to prevent any individual to consume them once they have been produced – and will not be produced privately – for instance, the security provided by policing a certain city or neighborhood. The state may not only subsidize the consumption of services with positive externalities, but also enforce universal participation in consumption or finance of these services. A third reason is the lack of insurance mechanisms against income losses accruing from serious illness and old age. Problems of adverse selection -- in demand and/or supply -- usually complicate the existence of such schemes and the end result may be a large part of the population remaining unassisted. State intervention can not only enhance the scale of such schemes, in some circumstances lowering costs and allowing for greater risk-diversification, but also force universal participation and cross-subsidization.

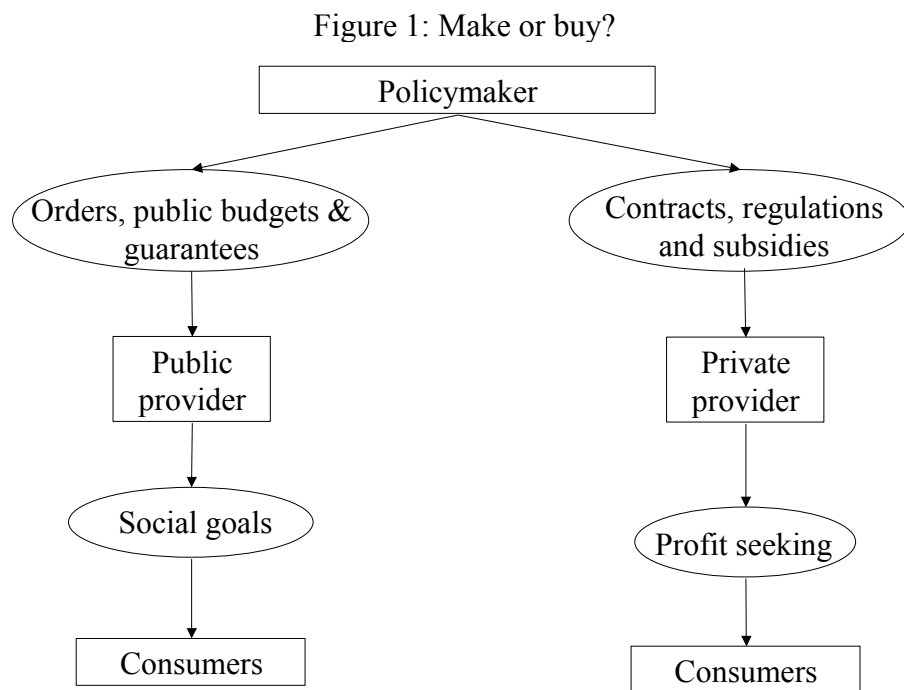
In developing countries all these problems tend to be more acute. Low and ill distributed income leads to low consumption of education, preventive care, and insurance instruments. Inefficient or absent institutions raise transaction costs and asymmetries of information, and weaken contract enforcement, making it difficult for markets for social services to expand beyond elite groups. Mistrust of private insurers discourages participation in voluntary insurance schemes, be they in health or pensions. In such circumstances, ‘consumers’ either lack the resources or are unwilling to spend as much as they should to directly reward service providers, and governments intervene to assure a proper consumption level.

These arguments are not, though, unique to social services. Indeed, most are also relevant in public utilities (electricity, telecom, water, sanitation, and transportation infrastructure) and the financial sector, and have been used to justify a similar degree of public sector participation in those sectors. Equity concerns justify policies geared to universalize the consumption of public utilities and access to the payments system, usually through some form of direct or cross-subsidization. There are also important positive externalities in the consumption of sanitation services and in connecting to networks, as in telecommunications, roads, and the payments system. In many institutional settings, savers' mistrust of private banks discourages financial intermediation and causes the state to establish its own banks. The construction of roads may demand state intervention to force all drivers to pay tolls. Finally, increasing returns to scale, asset specificity, asymmetry of information, high dependence on third-party contract enforcement and collective action problems, among other factors, may prevent the existence of financial markets and public utilities based exclusively on private service providers. Again, these problems are particularly acute in developing countries.

Historically, public intervention in both social services and public utilities occurred through hierarchical structures, in which a public provider subordinated to the sector minister was responsible for supplying these services. Hierarchies offer many advantages: they facilitate the transfer of subsidies to low-income consumers, they allow for the introduction of social goals to correct for the presence of market failures, and they overcome the problems stemming from weak institutions, in particular the risk of administrative expropriation of sunk private investment.

Consider, as in Figure 1, the alternative of public intervention through regulation of a private service provider. In hierarchy, the policymaker (e.g., a minister) can simply command the public provider to operate according to social objectives, directly transferring public subsidies

and having the Treasury implicitly guaranteeing insurance schemes. The alternative is to rely on subsidies and regulations that encourage the private provider, while trying to maximize its profit, to behave accordingly to the social goals. Whereas in hierarchy the policymaker could rely on good information on costs and demand to fix the volume of public subsidies, when contracting a private provider information would be incomplete, easier to manipulate, making it difficult for the policymaker to determine a fair value for the subsidies. The private provider would be the residual claimant of cost savings, and thus would have an incentive to cut on quality, a less likely problem with a public provider. Finally, in hierarchies operations can be easily adapted to reflect changes in technology or market conditions, whereas in a market type relation this would require renegotiating the contract.



Thus, the traditional approach in social welfare policy has been the direct provision of services by the public sector. The drawback of this alternative is that the public sector, and hierarchical administration in general, is usually less efficient than the private sector in delivering

services and less responsive to changes in technology, consumer needs and preferences, and other external conditions. For one, most public providers start with the perverse incentives of monopolists and face little pressure from service consumers, whose power to demand better service is weakened for they do not pay directly for it (and thus cannot threaten to reduce the provider's revenues by exit) and lack information and mechanisms to adequately voice their dissatisfaction (section V returns to these long and short routes of accountability). For another, administrators in typical bureaucracies lack the necessary degrees of freedom to operate efficiently, notably regarding labor management and the acquisition of consumables which often results in high levels of absenteeism and corruption. Other important problems are irregular and inflexible budget allocations, conflicting or unclear goals established by public sector principals (e.g., local politicians and the ministers of health and finance), and the difficulty of securing resources for new investment (and often also for maintenance).

Differently from what took place in public utilities and the financial sector, marked by outright privatization of state-owned enterprises and concessions to private investors, in social services the preferred options have been either to strengthen incentives -- through decentralization or NPM, for instance -- or to resort to more complex governance schemes that transfer some of the operational activities to the private sector, but with close regulation and oversight by the public sector. Complete privatization is usually a good option when service provision can be entirely financed by consumers and the government can withdraw to regulate markets from a distance to correct market failures, but is much more complicated when equity and other social objectives are higher priorities. Several factors contributed to this differentiation between social services (especially education and health care) and public utilities:

- In social services, the disjuncture between those who control resources and pay for the services, those who provide the services, and those who consume them complicates, at a minimum, the governance structure supporting these transactions. When governments have to pay for the services, public procurement problems change but do not necessarily diminish. There is still a need to select or accredit providers, define fair prices for a multitude of services (as in health) and situations (e.g., in large metropolis and small communities), and monitor providers. Moreover, depending on the means of finance adopted, the pressure applied by consumers may be weak, especially if they do not have a choice of provider, which may often be the case in small communities and when transportation costs are relatively high (Greener and Powell 2009).<sup>11</sup> These relations are less complicated in public utilities where consumers pay providers directly, but regulating prices can be a more complicated and contested process.
- For social services, the reliance on resources from the government budget introduces a number of uncertainties. There may be delays in public sector disbursements, difficulties in negotiating adaptations to non-contracted contingencies, and changes in priorities and policies that lead to a reduction in the scale of operation or simply cause a discontinuity in the transfer of resources altogether. Although private providers can count on a contract to demand payment, contract enforcement and actual collection of payment may take a long time and cost much when the public sector is the defendant. This may encourage private providers to shy away from certain types of contracts and use inefficient technologies that nonetheless minimize asset specificity and hence dependence on government. This

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<sup>11</sup> This may also be a problem with some utility services (e.g. water and sanitation), in which it is hard to bring in competition, and thus tend to be more heavily regulated -- or supplied directly by the state -- than, for instance, telecom services. On water, see the Jaramillo & Alcázar chapter.

uncertainty will also encourage private providers to mobilize for, and invest in, politics (see Section V). Resources for public utilities come more from consumers than government budgets, but the political incentives are similar because most prices are regulated.

- Although complex, it is relatively easier to assess efficiency and quality in the case of public utilities than in social services where pronounced asymmetry of information makes contracts more difficult to write and monitor. Moreover, social services more closely resemble the case of multi-task principal-agent relationships examined by Holmstrom and Milgrom (1991) in which strong incentives to save on costs and the difficulty to contract on service quality may result sacrifices on quality (Delbono and Lanzi 2012). To prevent service interruption and declines in quality the public sector may decide to forego much of the savings it could obtain as a result of the efficiency gains accomplished by the private provider.
- There is usually greater political and ideological opposition to bringing the private sector to operate public health and education facilities.<sup>12</sup> The efficiency gains derived by bringing the private sector in largely stem from its profit-orientation, which is anathema to many stakeholders in the health and education sectors. In contrast, the fact that public utilities were already provided by commercial companies (though state owned) greatly facilitated their privatization. Moreover, different from public utilities, which are capital intensive, social services are labor intensive, counting with more influential labor unions,

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<sup>12</sup> See, for instance, the discussion in Iriart and Waitskin (2006) about the reforms in Argentina's health sector. A central demand of the many student demonstrations in Chile since 2011 is to make all education public and eliminate private provision which accounts for a majority of enrollments at all levels (Vaillant et al. this volume).

which can more easily mobilize against reforms that reduce job security and penalize absenteeism.

To address these problems and complexities, and others, governments introducing quasi markets often pursue a range of complementary and compensatory measures, the focus of the next sections.

### **III. Complementary Issues in Quasi Market Design**

Even though quasi markets are not widespread, the record of reform to date suggests that it is not enough to create quasi markets and leave them to function on their own. Rather reforms need to take into account a series of complementary factors that help promote the optimal functioning of quasi markets. This section considers several factors – information flows, flexibility, and barriers to entry and exit -- that are crucial in basic design of quasi markets, the next section considers further issues in regulation, correction, and compensation.

1) Information. Regardless of the administrative model adopted, the provision of health care and education to millions of people in diverse conditions and across vast territories creates generic information problems. Problems of information cost and asymmetry are large even in hierarchical, bureaucratic service delivery, but they increase with the introduction of quasi-markets.<sup>13</sup> If competition is for consumers, then full, intelligible, timely information has to get to them (Greener and Powell 2009). If competition is for contracts, then information on the performance of contracted providers has to get to the government. Information collection and

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<sup>13</sup> The chapter by Perry and Angelescu provides an extensive discussion of information and overall accountability in service provision. Our focus here is on the narrower issue of information in quasi markets.

processing is costly for all parties and should be weighed against other cost reductions expected from quasi markets.

One of the major problems in the hierarchical, bureaucratic model is that central policy makers have a hard time collecting information on quality of services and designing policies to improve quality. For advocates of quasi markets, the consumers who exit particular schools or hospitals should, in principle, resolve much of this information cost by signaling directly which units have low quality services. However, the meaning of this signal is often ambiguous. Government regulators cannot know the meaning of, or reasons for, exits (many of which may have little to do with the overall quality of instruction) unless they conduct exit interviews (adding to the overall information burden and cost). Moreover, exit is costly, and families are likely to delay it until conditions get very bad. Generally, voice and complaints provide much more timely and specific information on problems, but, as discussed below, the exit option reduces incentives to invest in voice.

In voucher schemes or demand side subsidies, in which payment follows the patient or student, the government payer (monopsonist) sets the prices and providers compete for quantity, essentially on the basis of quality, cost of access (e.g., proximity), and advertising. For the most part, it is difficult to introduce price competition in these kinds of quasi-markets. To set prices at the optimal level, to get the maximum benefit for the minimum price (or cost to the government), policy makers need a great deal of information. For relatively homogenous services like prison incarceration, setting a price per prisoner is relatively simple. For educational services, a price per student is also relatively easy, though heterogeneity in the target population increases once learning disabilities, behavioral problems, ethnic and linguistic differences, and socio-economic background are factored in. In areas with relatively homogeneous services and hard budget



constraints, pricing becomes more simply a matter of dividing the fixed budget by the number of beneficiaries.

In health care, heterogeneity is vast because the service is not per patient but per treatment, and policy makers must first establish ‘commodities’ in terms of standardized health ‘goods.’ The issue for information processing is that governments need vast amounts of information (and capacity to process it) in order to set prices for a wide range of treatments. And, especially in healthcare, central price makers need new data constantly in order to keep abreast of rapidly changing medical technologies (on Chile, see Lenz 2005).

In outsourcing contracts (and infrastructure bidding) competition obviates the need to amass information on pricing; governments fix the quantity and providers compete on price. However, once the competition is over and contracts awarded, providers have incentives to lower quality, so government regulators face similar problems, and high information costs, in monitoring the quality. And, consumers cannot exit, so that source of information is lost.

Quasi markets thus greatly expand the quantity of information required as well as increasing the need to disseminate it widely. At a minimum, market mechanisms increase the costs of data collection, and require further institution building in the public sector as governments create entities and staff them with trained professionals who can establish reporting and testing requirements, collect and process data, and conduct regular onsite inspections. A good example is that of hospital services contracted out by state and municipal governments to not-for-profit organizations in Brazil. Supporting these contracts are very detailed reporting and supervision schemes, as well as annual consumer satisfaction surveys that partly define payment (see Quinhões, 2009). As the chapter by Vaillant et al. analyzes, lots of well disseminated

information is crucial to the functioning of educational vouchers in Chile, both in determining merit pay for teachers and in parent decisions on where to enroll their children.

Quasi markets also introduce new asymmetries and therefore incentives to manipulate information flows. Hierarchies are of course not without information asymmetries or opportunism as subordinates often massage the flow of information going up the chain of command. However, quasi markets can lengthen the distance between monitors and providers and add profit motives to the incentives to manipulate information, all in the context of new and more information and data that could be doctored (these perverse incentives are considered further in Section IV).

2) Flexibility and managerial autonomy. In order to maximize the benefits of competition and markets, economic agents need autonomy and flexibility in organizing the services they offer. Governments restrict most markets on the margins (child or slave labor, for example), but generally leave economic agents on their own to decide how to buy inputs and organize production. However, providers of social services are often severely constrained. In Chile, vouchers gave parents choice, but school managers in public schools had little autonomy to respond to market signals because they did not control their two major inputs: curriculum and personnel (hiring/firing and salaries)(Aedo 1998; Kubal 2006; Mizala and Schneider 2014b).<sup>14</sup> Outside of these core areas, school administrators have incentives to improve quality and

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<sup>14</sup> In Brazil health sector, the great operational autonomy enjoyed by the social organizations contracted to run the public hospitals were a key factor explaining the success of such schemes. See Matzuda, Rinne, Shephard and Wenceslau (2008).

efficiency, but the gains of quasi markets are likely to be modest if restricted to this small realm.<sup>15</sup>

The sorts of rigidities remaining in Chile are more common elsewhere in the region. Inflexibilities are the greatest in personnel management, due primarily to civil service statutes and unions (Stein et al. 2005, chapter 10). Teachers and health care workers in most countries are public employees, sometimes with their own special employment statutes and sometimes protected as tenured civil servants. Reformers in many cases preferred to proceed with quasi-market reforms before tackling the much more politically explosive issues of reducing employment rigidities or protections. However, if providers cannot adjust what is usually the main input – personnel – then the benefits of competition are likely to be quite modest.

3) Entry and exit. As in other markets, ease of entry and exit, by both consumers and providers, is crucial to harnessing the power of competition to generate efficiency and quality. However, in practice entry and exit may not be easy options. The costs of transportation limit the exit options of consumers, especially in education or regular health care visits, and in many isolated or rural areas exit options do not exist because the nearest alternative provider could be hours away. On the provider side, minimum scale requirements, especially for hospitals and secondary schools, make entry investments large, and the need to locate near target populations increases initial capital costs, especially in densely populated better off neighborhoods where the cost of property and construction are large.<sup>16</sup>

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<sup>15</sup> Vaillant et al (this volume) find positive effects of school autonomy and personnel management in Chile but this is largely capturing greater autonomy and flexibility in fully private schools (rather than the private and municipal schools supported by vouchers).

<sup>16</sup> In other kinds of markets open to private providers, where barriers to entry are low, the opposite problem of excessive entry has sometimes occurred. When the entry response is excessive, funds often ends up in wasteful advertising and administrative costs, as well as inefficiencies in terms of economies of scale (private insurers and pension funds in Chile).

Given sunk investments and high political costs, the barriers to exit are often higher than most advocates of quasi markets expect (Betts 2005; Greener and Powell 2009: 366). One of the fastest ways to increase average school quality is to close the worst ones and move students to better schools. By allowing families to vote with their feet, voucher programs should make clear to policy makers which schools are underperforming and ripe for closure. However, in practice the policy response is often the opposite, to increase funding and support for ‘problem schools.’ In Chile, municipal governments have stepped in to replace funding local schools lost through students (vouchers) who went elsewhere (Aedo 1998). If common, barriers to exit and soft budget constraints sap the energizing force of competition that quasi markets are designed to infuse into school management.

In higher education, constraints on the functioning of quasi markets are fewer where private provision is substantial because students are more mobile (at least within large cities if not among them) and entry and exit are easier. And, in practice, several countries in the region have introduced quasi-market reforms in universities.<sup>17</sup> For example, in the 2000s, Brazil began some initiatives in higher education that resemble voucher programs. In 2005, the government established ProUni (*Programa Universidade para Todos* -- University for All) – a program that consists on granting full and partial (50 percent) scholarships to low-income students in private colleges in exchange for tax exemptions for the university (World Economic Forum, 2014). The federal government also pays for tuition directly to private institutions through FIES (*Fundo de Financiamento Estudantil* -- Student Loan Fund), a student loan program that dates back to 1999, but which boomed only after a warranty fund financed by a fee on tuitions and government funds

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<sup>17</sup> Reforms in European higher education have also moved to introduce more quasi market types of competition. For a review, see Teixeira and Dill 2011.

was established in 2010. Currently over half a million students receive ProUni scholarships and more than a million receive FIES student loans.<sup>18</sup> It is estimated that, in present value terms, the students will pay back half of the real value of their loans to the government, similar to student funding programs in the United Kingdom (JP Morgan 2014).

#### IV. Mitigating Negative Consequences

A primary objective of reforms using quasi markets is to change incentives, especially to shift those of the staff and employees to align their interests with the goals of increasing efficiency and quality. However, in introducing these new incentives, quasi markets displace other traditional goals as well as introduce some new, perverse incentives that require subsequent monitoring, regulation, and corrective or compensatory policies.

1) Incentives and motivations. Quasi markets in personnel policies through various NPM measures are designed primarily to redress one core issue in motivation, shirking versus working, and tie rewards to a single financial motivation.<sup>19</sup> And, Holmstrom and Migrom (1991) show generally that stronger incentives for performing on measurable dimensions (e.g., costs and output) weaken incentives for doing well in other non-measurable dimensions (e.g., quality of services).<sup>20</sup> As such, quasi markets may displace or diminish other motivations employees have

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<sup>18</sup> See “Fies e Prouni já respondem por 31% de matrículas de universidades privadas”, *Valor Econômico*, 11/03/2014.

<sup>19</sup> Quasi markets in contracting for services or construction, in contrast, do not suffer from multiple, conflicting, or displaced incentives, because they are usually engaged from the start with profit seeking firms. In cases where the contracting parties are non-profit, charitable, or religious organizations (as in schools and hospitals), then quasi markets may have similar effects of privileging the bottom line over other organizational goals and motivations.

<sup>20</sup> In utility regulation, this is a well-known problem with price cap mechanisms, which are highly potent regarding productivity growth but often at the expense of service quality. As such

to provide efficient, high quality service. Other motivations may include loyalty, esprit de corps and teamwork, the inherent value of service (especially in the so-called ‘caring’ professions), professionalism, and career advancement (see Le Grand 2003 for a full theoretical analysis of motivations). Doctors, for example, may have strong ties to the profession, close bonds of collegiality, and other norms which may conflict with market incentives and individualized competition.<sup>21</sup>

Incentives are further complicated by the self-selection bias in the recruitment of health workers and teachers: those who chose these careers are often personally motivated to help other people and potentially less responsive to other incentives. Analysts often note the religious schools and hospitals provide better, lower cost care, and presumably religiously inspired employees are less likely to respond to market incentives.<sup>22</sup> Moreover, reforms that tie remuneration to individual performance (NPM measures such as pay for performance) can shift incentives and relations among employees in the same workplace. Competition among teachers, for example, can undermine teamwork and collaboration within schools, generate jealousies, and encourage teachers to offload problematic students onto unsuspecting colleagues (see also Le Grand et al. 2012).

As in other organizations and private companies, payment schemes can be adjusted to align a range of incentives. So, organizations can tie pay increases to some combination of

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is often preferable to retain direct public provision when the measurement of quality is extremely difficult, or when the trade-off between profitability and quality is significant.

<sup>21</sup> Bonus pay for teachers is becoming increasingly common in Brazil in part because it has less long term fiscal and pension impacts than increasing regular salaries (Brun and Luque 2015).

<sup>22</sup> The World Bank (2004) reports that in Uganda faith-based health care providers were found to work for “28% less than government or private for-profit staff and yet provide a significantly higher quality of care.”

individual performance on standardized quantitative measures (sales for example for sales personnel, or student scores for teachers), collective performance measures (profits or median school test scores), and more holistic evaluations (supervisor recommendations) (on the complex measures in Chile, see Mizala and Schneider 2014a, Vaillant et al. this volume). However, even as providers design ever more sophisticated performance rewards, it is important to remember that some of the world's best school systems such as Finland and South Korea (as measured in international tests like PISA (Programme for International Student Assessment)) offer few or no special short-term pay incentives (see OECD 2009).

For parents, policies that encourage them to shop around for the best schools also discourage them from exercising voice. Where families are obliged to send their children to a particular local school, then pro-active parents have incentives to invest more in getting to know the school, learning how to voice their concerns, and developing parent networks and associations, rather than researching the comparative strengths of other schools they might decide to send their children to. More generally, of course, voice is central to the sorts of overall accountability mechanisms analyzed in Chapter 1.

2) Equity. While competition and consumer choice strengthen incentives for efficiency and possibly limit the ability to skim on quality, they raise equity (adverse selection) concerns. When payment follows consumers, as in voucher programs (equity is rarely an issue in contract competition), then various mechanisms – both discrimination by providers and self-sorting by families – tends to sort consumers by class or socio-economic status (Betts 2005; Delbono and Lanzi 2012). Notably in schemes that pay a flat-price per person serviced, suppliers have incentives to discriminate against those with greater difficulty to learn (in schools), with poorer health (in hospitals), or that pose a greater risk (in insurance schemes). Consumers will also try to

select, avoiding schools with poor students or insurers that take more risky participants, tending to cluster with similar class peers.

Critics of quasi markets often argue that poor people are least able to take advantage of complex markets (see for example Carnoy 1998: 311). Choice in education and health care are meant to benefit consumers who can leave low quality providers and move to better ones. However, making such choices requires lots of costly information, time to evaluate it, and the ability to make costly moves (e.g., sending students to a school farther away). Moreover, market reforms sometimes allow providers to refuse service, giving them incentives for adverse selection – selecting only patients and pupils who are easy to treat – and the poor are likely to suffer disproportionately from adverse selection. In quasi markets in Chile, private schools and private health insurers were allowed to turn students and patients away (Mora 2005). Even where private providers are legally required to accept any applicant, they can find informal means of discriminating. Anecdotes are common of administrators of richer schools making poor families feel uncomfortable and suggesting that their children might suffer socially because of their clothes or lack of cultural capital (Veleda 2006).

Advocates of vouchers in education argue that, even if poor families do not exercise choice, competition generates improvements even in the worst schools (Betts and Loveless 2005). This effect is more likely to obtain where there are fewer barriers to exit for underperforming schools which in effect forces passive families to opt for better schools. However, critics note that this process is often protracted and that political barriers to closing local schools are enormous. And, if low quality schools are kept open and the better students leave, then performance is likely to fall even further due to a negative or absent ‘peer effect.’



Reforms thus often include explicit corrective or compensatory policies to favor the poor and enhance equity, such as increasing subsidies for services offered to poor families or in poor areas. In Sweden, and more recently Chile, for example, governments pay schools more (increase the value of the voucher) for students from poorer families. Whether or not such compensatory policies effectively redress inequalities introduced by quasi-markets, they certainly add another layer of complexity and need for more information and closer monitoring.<sup>23</sup>

3) Auditing, policing, and enforcing. Given the multiple information asymmetries noted above, market mechanisms introduce myriad opportunities for manipulating information. In schools, officials and teachers have incentives to ‘adjust’ information for parents and government monitoring agencies, distort the curriculum by ‘teaching to the test,’ and at an extreme even cheat on testing instruments designed to monitor quality (Levitt and Dubner 2005). If quasi markets are based on per capita affiliation, then providers have incentive is to exclude unhealthy patients or difficult students (both of which are allowed under Chile system). And, providers have more information to facilitate discrimination and ‘cream skimming’ than do regulators trying to prevent these practices. If payment is per service, as is often the case in health care, the incentive is to provide unnecessary services. As chapter 1 emphasizes generally, monitoring and accountability are crucial.

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<sup>23</sup> In some cases, quasi-market reforms may target poorer populations directly. For example, a public school concession program began in Bogota in 2000. Fully funded by the state, it aimed to deliver quality education to socioeconomic disadvantaged children and teenagers. In order to expand the provision of educational services, the state built new schools in marginalized areas and communities. Afterwards, it contracted out to reputed non-profit private institutions to manage each of them by tender. Capacity and quality were monitored through previously established indicators. Admission was based on household proximity to school, as in all public education, and costs could surpass average spending per student in the public system. However, institutions were given autonomy over the distribution of funds and hiring teachers. In 2013, almost fifty concession schools were in operation (World Economic Forum, 2014). Bonilla-Angel (2010) provides robust evidence that students in these schools performed better than students in regular schools in math and verbal tests.

Even if information is not a problem, enforcement can be. Weak legal systems make contracts and sanctions hard to enforce. Contract enforcement is a major issue in quasi markets that promote competition for government contracts, especially where there are few providers and high barriers to entry. Moreover, reforms may specify certain payments from autonomous or private insurers, but not spell out the penalties in the event of delayed or no payment (as in Argentine hospitals).

In the beginning of the 1990's, the Costa Rican health sector went through a series of reforms. Public funding and universal coverage were kept in place, but some non-profit cooperatives were contracted out to provide primary health care. In the 2000's, the model was extended to for-profit institutions as well. However, conditions faced by cooperatives and private providers differ in many aspects: from the responsibility over facilities to the authorization to retain profits. To prevent management flexibility from reducing service quality, contracts were very specific regarding the population to be covered, types of services to be delivered, and attainment indicators. Also, a system to monitor and evaluate activities was established, so that private providers could be effectively penalized for underperforming. Cercone *et al* (2005) present evidence that cooperatives were able to meet quality and coverage standards, while diminishing costs, thus performing better than traditional providers.

Outright corruption has contributed to the low efficacy of public spending in traditional social services. Some forms of decentralized competitive service provision may remove funds from the reach of politicians who would divert them to other uses. However, decentralization and greater autonomy of front-line providers, in the absence of transparency and adequate monitoring, can open up new opportunities for corruption. Critics of bureaucracy and red-tape often forget that many of the measures that create so much bureaucracy and paperwork were

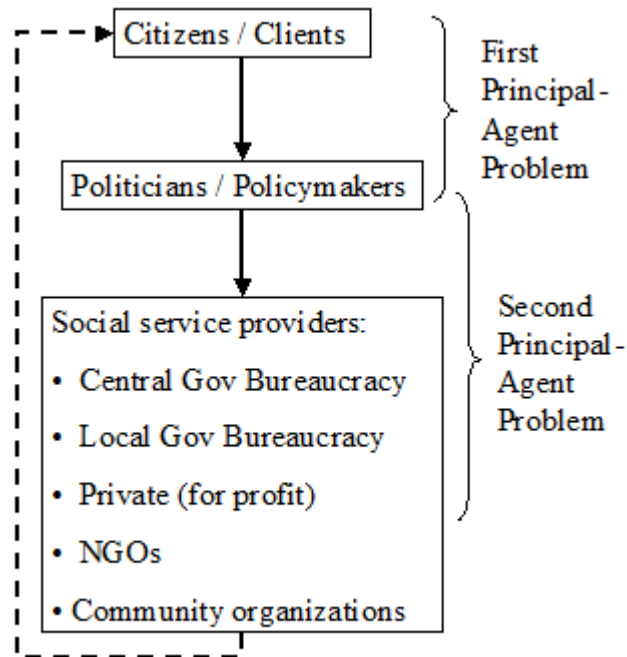
precisely designed to detect and deter patronage and corruption (Heredia and Schneider 2003). So, as additional measures are adopted to require additional information, monitoring, and closer regulation, quasi markets may come to resemble more the bureaucracies they were intended to replace.

## **V. Politics and Quasi Markets**

In political terms, the ‘easy phase’ of expanding provision and coverage of basic social services drew to a close in the 2000s in many middle income countries (Stein 2005; Corrales 2005). Extending the provision of health care and education to new areas and target populations generally confronted a congenial task in coalition building. For example, everyone can support the building of a new school: builders get contracts, local and national politicians get credit, unions get additional members, and constituents get new services. However, shifting reform from quantity to quality requires government intervention into management and rewarding and punishing employees. The benefits are few (and the beneficiaries do not always see them, certainly in the short run), while the losers are politically well positioned (unions).

As a general framework, it is useful to represent the triangular relationship not only by looking at the flow of funds and services – from policymakers to providers, and from these to clients -- but also at relations of political accountability, between providers and policymakers and between governments and voters. These relations highlight the existence of two superimposed principal-agent problems that complicate the provision of social services (Figure 2). On the first level, the service provider is the agent and the policymaker the principal, on the second, the policymaker is the agent and the client/citizen the principal.

Figure 2: Agency problems in publicly financed social service provision



If voters could force politicians to act according to their preferences, and if policymakers could guarantee that providers would do as instructed – the long route of accountability – then hierarchical public provision would work fine. But, a number of problems compromise accountability at each stage. For various reasons, many political systems fail to hold politicians accountable to voters regarding the quality of services. In principle, in a well-functioning democracy a majority of voters who are poor and/or poorly served by existing social welfare systems should be able to vote in new politicians who will improve service delivery. In practice, in most political systems several factors weaken this long route. For one, many poor voters are effectively disenfranchised by low voter turnout, lack of information, or manipulation through vote buying and clientelism (Stokes et al. 2013).

At the high end of the income distribution, many families have exited the public system and rely exclusively on private schools and health care (as well as private security and sometimes even water and electricity). These more politically active voters then have little interest in supporting parties and politicians that prioritize improving the public provision of social services (Rothstein 1998). Moreover, systemic features of the political system such as weak parties and overrepresented rural areas weaken the accountability of the legislature to all voters.

Broadening the analysis to include other power resources besides votes such as campaign financing, lobbying, collective action, and strikes and street demonstrations suggests further reasons for politicians to discount poorer citizens. There are two groups in particular that attract politicians' attention away from the long route of accountability, namely unions and lobbies of private providers. Unions in health and education are often among the largest in developing countries, especially after the contraction of the manufacturing sector in recent decades. In some polities, these unions are closely allied with particular parties, in others they can elect 'their' legislators (who are subsequently in a position to logroll and bargain with other legislators). In other words, union organization can amplify the voices of providers relative to other voters.<sup>24</sup> In more immediate terms, unions in Latin America have often used their disruptive power to pressure governments through strikes, street demonstrations, work to rule operations, and so forth (see Stein et al 2005; Mizala and Schneider 2014a).

Private providers, because of their dependence on public funds, usually conform to standard Olsonian expectations, and organize to guarantee the flow of resources. Even if they do not seek rents, private providers have strong incentives to invest in politics to defend their interests. These incentives are especially strong because the assets are specific and cannot be

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<sup>24</sup> See Elizondo (2011) on the extreme political power of the teachers union in Mexico.

easily deployed to other uses; schools, hospitals, electric grids, sanitation systems, and other public utilities cannot be converted to alternative uses if governments end or reduce payments. The assets of construction companies are less dedicated to public works, but they have high fixed costs and are subject to volatile shifts in public spending. So, firms should be expected to invest in collective action to build strong associations and lobbying operations. They are also likely to set aside funds for electoral campaigns. As with large unions, large firms in PR (proportional representation) electoral systems of the sort that predominate in Latin America can invest in funding ‘their’ deputies whose power in national legislatures is again amplified by their ability to negotiate votes (Schneider 2013).

The overall point is that numerous additional political factors weaken or distort the long route of accountability from consumers of social services to their elected representatives. Much of this is standard Olsonian fare and hardly surprising, but it rarely comes up in discussions of quasi markets and expanding the scope of private provision.<sup>25</sup> However, the collateral damage to politics of creating new private lobbies is quite predictable and should be part of any basic cost/benefit analysis of quasi market reforms.

In response, some compensatory political measures can work to improve both long and short routes of accountability. Decentralization considerably shortens the long route of accountability. Decentralization cannot by itself redress endemic problems of disenfranchisement of poorer voters or political mobilization by providers, but it can eliminate some of the problems of mal apportionment and weak parties at the national level, and provide consumers with greater incentives to participate, especially if decentralization is pursued all the

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<sup>25</sup> See Gingrich (2011) for a systematic analysis of how various types of market reform strengthen, alternatively, providers, consumers, or the state, and why left and right parties therefore use different quasi markets to build or bolster their support coalitions.

way to the municipal level. In general, decentralization in Latin America increases the likelihood that citizens will make demands on local governments (Montalvo 2009), though Sánchez and Pachón (in this volume) provide a cautionary tale of how national politics (especially national patrons of local politicians) can disrupt the shortened, local route of accountability.

Organized groups of consumers may enhance both long and short routes of accountability. Such associations can partially counter lobbies of providers and unions, or work with them when interests coincide. Moreover, they can provide governments with essential information. Associations of parents, doctors, and patients are much better positioned to collect information on the quality of educational and health care services, especially if they have support from, or access to, policy makers. Such support and access, as in putting association representatives on oversight boards, is a further policy measure that can ‘artificially’ strengthen consumer associations. On the short route, many reform proposals seek to elicit greater participation by organized groups that can serve as additional sources of monitoring and accountability for independent service providers. For example, giving schools and/or parent associations more control over their budgets might increase parent involvement.

## **VI. Conclusions**

In many respects, the overall goal of advocates of quasi-markets is to make the public sector look more like the private sector, to subject public employees to the same sorts of market pressures, incentives, and sanctions as those encountered everyday by employees in the private sector. However, after analyzing the myriad problems in markets, agency, information asymmetries, contracting, and transaction costs, it is worth returning, at least theoretically, to what private sector managers might do if confronted with agency and information problems as

complex as those found in quasi markets in social services.<sup>26</sup> For a basic Coasian, social services would seem to be a classic case where contracts are too hard to specify and enforce, and the rational private sector firms would therefore adopt hierarchy, make rather than buy. Of course, private sector managers would assume the prior existence of clear goals (the bottom line), single principals, and the prerogative of firing hierarchical subordinates if performance lagged. One interesting hypothesis is that it is precisely the absence of these assumed features of private sector management that make quasi markets such an attractive option for policy reformers. If teachers and doctors cannot be fired, are subject to political interference (multiple principals), and serve multiple goals, then perhaps one of the few possible reforms to encourage better performance is through quasi markets, even if highly constrained.

The central focus in this paper has been on introducing competitive market pressures into the provision of social services. However, in a more general vein, many of the issues here would come up in other reforms intended to enhance the quality of social services. As such, some of the methodological implications of this analysis may have broader application. The central focus on information flows, variable incentives, principal-agent dilemmas, and various routes of accountability are likely to figure in the analysis of most types of reform. The crucial analytical task is to identify how these factors vary across the wide range of stakeholders, from a variety of political actors (legislators, interest groups, executive branch reformers, and officials of subnational governments), to different providers (public, private, religious, non-profit, etc.), to various employees (directors and administrators, staff, and front line employees), and consumers

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<sup>26</sup> Savedoff (1998b) notes that the idea of quasi markets is similar to the management reforms undertaken by General Motors, where they created independent divisions and subjected each to market pressures and evaluations.



of varying capacities and interests. Simplifications in reform proposals or analysis are not likely to improve matters.

Another central conclusion from a survey of attempts to introduce quasi-markets is that each reform is partial and particular, as are reforms more generally in social services. Chile's voucher program was very extensive, yet left other parts of the educational system (such as personnel policy and curriculum) unreformed. In Mexico, governments introduced stronger teacher incentives, but without changing other institutions. In other countries, school choice was available only to certain groups of families: poorer students in Bogotá, or students with access to religious schools in Argentina and Venezuela. In other countries such as Brazil and Peru, families had little choice of providers, but some provincial governments opened up opportunities for private firms to compete for school management contracts (see Vegas 2005). For observers, it then becomes more difficult to isolate the net impact of the reform compared with other changes in the institutional or broader political environment. Given that there are so many 'moving parts' in any education system or other mass social service, isolating variables is complex at best. Although not a panacea, one methodological aid is comparative analysis, over time, across jurisdictions (where subnational governments adopt different reforms), or across countries. If variables have similar effects in different configurations of reform and different institutional contexts, then the grounds are stronger for confidence in the conclusions.

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