

# WHAT IS THE SCOPE FOR CHOICE AND COMPETITION IN EDUCATION?



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## I. INTRODUCTION

Is there scope for greater reliance on competitive market forces in the provision of education services?<sup>2</sup> We argue that whilst there appears to be much scope for choice and competition in education, and certainly greater scope than exists at present in many countries, there are also some significant, often ignored, limitations on the scope for choice and competition if a major goal of education policy is to promote “equality of opportunity.”

## II. CHOICE AND COMPETITION IN THE EDUCATION SECTOR

Most governments are heavily involved in funding education services, especially in primary and secondary education. In addition, in most countries the government is not merely the primary funder of education, but the primary *provider* of education services. Furthermore, in many countries competition is not actively encouraged. In fact, in many cases, competition between government education providers is often deliberately and strictly limited, particularly by granting each education provider a limited geographic monopoly over the provision of education services to children within each school’s zone.

Why? Is there something about the provision of education services which *requires* a restriction on competition? Is conventional in-the-market competition somehow in opposition to the objectives the government is trying to achieve?

To answer this question we need to look at the underlying economic problem (or “market failure”) which gives rise to a need for government intervention in the first place. As we will see, that underlying economic problem gives rise to a motivation for substantial government subsidies for the education sector. We will proceed by exploring the scope for reliance on choice and competition in education in the context of government subsidies

### A. Why are Governments Involved in Education?

Three common rationales are offered for government involvement in education:

1. There are economic and political **spillover effects**:
  - A tax dividend effect – if education results in higher income in the future, individuals are not able to capture all of the benefits due to the effect of taxes. A government subsidy upfront may offset the distorting impact of taxes;

<sup>2</sup> This paper draws on two wider papers by Professor Allan Fels & Dr. Darryl Biggar, “The Role of Choice and Competition in Education,” CRESSE (2018) Conference, Greece and “The Role of Choice and Competition in Public Markets,” OECD Global Forum on Competition, December 7-8, 2018. See: [https://one.oecd.org/document/DAF/COMP/GF\(2017\)7/en/pdf](https://one.oecd.org/document/DAF/COMP/GF(2017)7/en/pdf).

- A productivity spillover – according to this theory, education increases the productivity of the individual, but also increases the productivity of individuals with whom that person interacts;
- A democratic spillover – having an educated citizenry allows the population to understand and participate in public decision-making and democratic processes, which leads to better democratic outcomes overall. As Stiglitz (1988) observes: “A society in which everyone can read can function far more smoothly in which few can read.”<sup>3</sup>

Stiglitz (1988) expresses some skepticism about the magnitude of these spillover effects especially compared to the size of the benefit the individual receives from education:

There is a large private return to being able to read, and even in the absence of government support, almost all individuals would learn this and other basic skills. Indeed, most individuals would go far beyond that. The question is: given the level of education that individuals would privately choose to undertake were there no government subsidy, would further increases in education generate any significant externalities? There is no agreement concerning the answer, but the case for government support based on these kinds of externalities seems, at best, unproved.

2. **Capital market imperfections.** Although it is theoretically possible for citizens to borrow to invest in education against their future lifetime income, in practice (due to moral hazard and asymmetric information) such contracts are difficult to enforce. As Stiglitz (1988) notes: “Private lenders are not, for the most part, willing to lend to finance education, and hence those without funds of their own (or their parents’) would be denied access to higher education without some assistance from the government.”

Governments may have a comparative advantage in using the tax system to compel students to repay loans. But this is an argument for government provision of educational loans as opposed to subsidies. Many countries have a system of government-backed lending for education services, particularly for higher (tertiary) education. But such systems typically operate alongside, instead of in place of, direct government funding and provision of primary and secondary education services.

3. The desire to promote **equality of opportunity**.

Stiglitz explains this last concept as follows:

The primary justification for public support of education arises from concern about the distributional implications of the private financing of education. Richer individuals will want to spend more on the education of their young, just as they spend more on cars, homes, and clothes. There is a widespread belief that the life-chances of a child should not depend on the wealth of his parents or the happenstance of the community in which his parents live.

We note in passing that promoting equality-of-opportunity may be more than a fairness or equity issue; it may also promote economic growth but we will not pursue this issue here.

For the purposes of this paper we will assume that a primary motivation for government involvement in education is to promote a degree of equality of opportunity. This motivation gives rise to government subsidization of at least the core primary and secondary education services – to ensure that all citizens have access to a certain quantity and quality of education services regardless of their background or income.

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<sup>3</sup> Stiglitz, Joseph E., *Economics of the Public Sector*, 2<sup>nd</sup> edition, Norton & Company Inc, New York, 1988. For more extensive references see Fels & Biggar, opus cit, 2017. In this paper we rely heavily on Stiglitz.

## ***B. Is Competition between Educational Institutions even Feasible?***

In principle, if it were possible to harness the forces of competition in education without compromising the objectives above, education might be delivered like many other services. We would expect a wide range of competing educational institutions meeting the needs of a wide range of students, and innovating to develop new educational techniques, making efficient use of new technology and other inputs, responding to the changing desires of parents and the needs of the broader community, and doing so with the minimal claim on government resources. But to what extent is this vision in conflict with the objectives identified above? To what extent can we rely on choice and competition to deliver desirable outcomes in the education sector?

First let's address the question whether effective competition between education service providers is even feasible. In principle, an assessment of the scope for competition in education services requires a formal competition analysis – that is, an analysis of the product and geographic dimensions of the market, barriers to entry and exit, and other factors such as transparency of prices and quality, vertical integration, and barriers to customer choice. However, to keep this discussions brief we merely make the following observations.

There do not appear to be inherent structural barriers to achieving effective competition between educational institutions in most large towns and cities. In particular, there do not seem to be overwhelming economies of scale or scope in the provision of traditional primary and secondary education within a reasonable geographic market. Most urban areas are able to sustain many traditional educational institutions within any given 5-10 kilometer radius. But even this radius is too far to walk; if competition is to be effective, consideration may need to be given to how students who make a choice of school will be able to travel to that school, perhaps by ensuring access to public transport.

The range of sizes of different schools which we can observe in operation suggests that relatively small schools (with less than, say, 200 students) are able to co-exist and compete with quite large schools (with more than, say, 1000 students). It appears, therefore, that, with the exception of relatively small towns, most urban areas should be able to sustain active competition in education services in most areas, even without students having to travel very long distances.

In order for choice and competition to be effective in improving overall outcomes, schools must have the incentive and ability to respond to market conditions, and to adapt and innovate in response to financial incentives. Historically, in countries where the education sector has been dominated by government providers, the scope for individual schools to exercise autonomy, independence and innovation has often been strictly limited. Government schools have historically not had the incentive nor the ability to respond to market conditions.

In other sectors, of course, private, for-profit firms typically have strong incentives to adapt and innovate where doing so will increase the overall stream of profits. We do not see any particular reason why private for-profit firms would not have the same incentive in the education sector. Across the OECD, of the 12 percent of students who are enrolled in private government-dependent schools, around 8 percent are educated in for-profit schools.

But for-profit schools remain the minority and in many OECD countries do not exist at all. Across the OECD, the majority of students enrolled in private government-dependent schools attend not-for-profit institutions – either religious not-for-profit schools or other non-religious, but not-for-profit schools. There may be good reasons why not-for-profit institutions survive and thrive in the provision of public services. For example, where quality is difficult for customers to measure, a commitment to a not-for-profit structure may provide an assurance and implicit commitment to customers that quality will not be cut *ex-post*.

The effectiveness of both for-profit and not-for-profit structures depends on the quality of the governance and oversight. High-quality governance is typically easier to ensure in the case of a for-profit structure where the owners have a direct financial incentive in the performance. But some of these incentives for high-quality governance could, in principle, be reproduced where the members of the Board of the school have a direct personal interest in its success, such as parents who have children at the school.

A full discussion of the merits of for-profit and not-for-profit firm structures in the education sector is beyond the scope of this paper. We merely note that, whatever structure is chosen, for competition to be effective, education service providers must be willing and able to adapt and respond to market conditions, to meet the needs of customers, and to compete to attract students. Both for-profit and not-for profit providers seem capable of meeting this condition.

For choice and competition to be effective it is essential that schools have the incentive and ability to adapt. In addition, underperforming schools must be allowed – and indeed must be required – to exit the market. No matter how profitable and innovative their product offering, new entrant education providers will be deterred from entering the market if incumbents are able to persistently earn a below-market cost of capital. Failing schools must be allowed to exit the market. There is a question as to how this applies to not-for-profit schools. Not-for-profit institutions (which are typically not subject to the threat of takeover) may be immune from the normal capital market disciplines. Among other things, not-for-profit institutions may be able to persistently earn below-market return on invested capital. This could in principle act as a barrier to entry. These questions remain to be explored.

Of course, competition does not deliver desirable results unless the customers are willing and able to make choices in their own or their children's best interests. In our view, the majority of parents are willing and able to make an effective choice of schooling on behalf of their children. However, some parents do not have the capacity or the desire to do so and, in these cases, special support is required. In particular, parents with limited education or ability to make an effective choice may require assistance or support in the choice of school for their children. Otherwise, there is a risk that disadvantage may become entrenched from one generation to the next, undermining equal opportunity objectives.

It is likely that consumers of education services will face something of an information problem. Consumers are likely to have difficulty in observing the quality of the education provided – even for those consumers who have attended a particular school, it can be hard to judge the relative quality of education (i.e. the counterfactual – how would the outcomes be different if I had attended a different school?). In any case, the quality of the education may be a personal or idiosyncratic experience (would the outcome be different if I attended the same school but was assigned different teachers, or met different classmates?). It can be even harder assessing the quality of education at a school without any direct personal experience.

The results obtained by students in standardized testing are relatively easily obtained. But such measures are only, at best, imperfect measures of the quality of education, since such results depend in part on the *ex-ante* or intrinsic ability of the students and not solely on the quality of the teaching.

This information asymmetry problem gives rise to the need for independent objective review, assessment, and accreditation services. These services could perhaps be provided by the market or, alternatively, could be provided by the government.

In 2006, the British government concluded that for choice-based systems to be successful in raising educational standards for all, the following conditions were required:

- Parents – particularly, parents of disadvantaged children – need to be provided with high quality information, guidance and advice about the options open to them;
- Help with the costs of making choices, such as covering the costs of transport to alternative schools, should be provided by those who need it; ... and
- Above all, early effective action should be taken to tackle failing or poorly performing schools and increase the supply of good schools. Ultimately, the greatest safeguard against adverse effects on social inequalities and segregation is to make sure there are more good schools ... Evidence ... suggests that where schools face no financial implications from not attracting pupils there is only a limited behavioural response to choice.<sup>4</sup>

In summary, achieving effective competition between schools may require specific government action, such as the provision of comparator information on school quality, provision of transportation services for students so that they can travel to the school of their choice, and mechanisms to ensure that schools have the ability to respond to financial incentives, and action to ensure that underperforming schools are able to (and indeed required to) exit the market. Provided that these issues are addressed there do not seem to arise insurmountable barriers to competition between schools. But can this choice and competition be made compatible with government subsidies and the government objectives for education set out above?

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<sup>4</sup> UK Government (2006), page 5. Another condition was a prohibition on cream-skimming: "Schools should be prevented from 'cream skimming' ... by putting in place funding regimes that reflect the higher costs of teaching some groups and by using regulation and statutory guidance to prevent unfair selection." This issue is discussed further below.

### ***C. Making Competition Compatible with Subsidization of Education***

The scope for choice and competition depends on how the government subsidies are paid.

Many countries have considered, trialed, or adopted **school voucher** schemes under which customers have a choice of school and the government educational subsidy is paid directly to the educational institution chosen by the end-user.

School voucher schemes are an example of a fee-for-service subsidy payment. Provided the revenue associated with the voucher exceeds the marginal cost of taking an additional child, the voucher scheme, coupled with choice, gives rise to a high-powered incentive on schools to attract students and therefore to achieve high levels of productivity, innovation, and responsiveness to the needs of customers.

But, there are also problems with the fixed-fee-per-service model.

## **III. THE TOPPING-UP PROBLEM**

It is widely believed that access to education is a fundamental component of promoting equality of opportunity. It follows that education services should not be allocated on the basis of parental income or wealth. As noted earlier, Stiglitz comments that “the life-chances of a child should not depend on the wealth of his parents or the happenstance of the community in which his parents live.”

However, where choice and competition between schools is permitted, it is highly likely that some schools will be in demand. These schools may choose to, or be forced to, limit enrolments. The natural mechanism to balance supply and demand in this context is to increase the price – in this case, the tuition fee. This implies charging an additional fee to the end-customer over-and-above the government subsidy. We refer to this as “topping up.” In fact, under a system of unrestricted competition between schools, many schools will seek to, or be forced to, ration entry through the price system. Some schools will be considerably more expensive than others. These may be the schools which provide the greatest life-opportunities.

In this world, the outcome of competition is likely to be – at least to some extent – an allocation of places at the schools which offer the most opportunity to those with the greatest ability to pay. In fact, for schools which choose to limit enrolment, the supply curve is, in effect inelastic. An increase in the government subsidy would be expected to result in an equivalent dollar-for-dollar increase in the price for education. In the absence of further intervention, the provision of a government subsidy coupled with the right to choose the educational institution undermines the objective of equality of opportunity.

Can we retain the benefits of competition while preserving the objective of equality of opportunity?

Many countries which have chosen to implement a voucher system for school choice (such as Chile or Sweden) have explicitly sought to prohibit “top up” funding.

But prohibitions on parental contributions are not easy to enforce. Schools which seek to ration entry can request a range of supplementary inputs that parents are expected to provide. The simplest approach is to ask parents to make a “voluntary” contribution to the school. Parents can also be expected to volunteer their time to the school. Although not as obviously discriminatory, such rules can have a discriminatory effect where low-income families have less leisure time to devote to volunteering at the school and where well-educated parents can offer more highly-valued inputs (such as tutoring students).

If rationing through price is explicitly prohibited, how are schools to balance supply and demand? One possible approach is to ration through waiting lists or through lottery. In our view, neither of these approaches is satisfactory. In some countries over-subscribed schools are allowed to ration through waiting lists. However, in one study it was found that the children who attended the school were overwhelmingly born in the first half of the year since children could be entered on the waiting list as soon as they were born. It does not seem satisfactory to ration access to education (and life-opportunities) by the happenstance of birthdate.

Some countries with school voucher systems (such as Chile) explicitly prohibit rationing by schools which participate in the voucher program. Schools which participate in the voucher program are required to accept all applicants. This is a fairly drastic intervention, but in our view is worth considering.<sup>5</sup>

To summarize, if equality-of-opportunity goals are to be achieved, access to educational opportunities should not be allocated on the basis of parental income or wealth. Although we have no objection to some, modest level of school fees, the ability of schools to ration access by charging above a minimum threshold would be expected to result in allocation of educational opportunities on the basis of parental income and therefore must be restricted. This will likely require active enforcement. We do not support allowing rationing by queuing or by lottery. Instead, we prefer a mechanism in which all participating schools are required to accept all applicants (perhaps with some notice period, to mitigate problems from large swings in numbers).

## IV. THE CREAM-SKIMMING PROBLEM

The other primary concern with encouraging school competition using vouchers is that of cream-skimming: the incentive for schools to identify and deny entry to high-cost-to-educate students.

As we noted earlier, potential students differ widely in how much it will cost for the school to achieve its desired objectives with that student. As long as the voucher is for a fixed fee, independent of the characteristics of the student, each school has a strong incentive to compete vigorously for students which can achieve their desired objectives at the lowest possible cost; and to actively resist taking students for which achieving the desired objectives will be very high-cost.

But what are the objectives that each school wishes to achieve? In a world of school choice and competition, the objectives of each school presumably reflect the desires of customers. What do prospective customers (students or their parents) look for in a school?

Where schools are assessed primarily on the basis of the academic performance of graduating students on standardized exams, the cheapest way for a school to achieve good outcomes is to select entering students with high innate ability. This results in quite strong competition for the very best students. Students of average ability may find the range of schools willing to accept them is limited, while students of low ability may find no opportunities at all. This system tends to favor parents who have well prepared their children, perhaps through tutoring, at an early age. It therefore seems to conflict with the objective of equality of opportunity.

How can this problem of cream-skimming be addressed? One possible approach is to carefully differentiate students into different groups *ex-ante*, and to match the funding revenue to the likely cost of educating each student. This has its own challenges and takes us beyond the scope of this brief discussion.

## V. ENHANCING CHOICE AND COMPETITION IN THE EDUCATION SECTOR

In short: we believe that effective competition in education services is possible, despite the presence of government subsidies and the need to pursue the basic government objectives identified above. However, perhaps unsurprisingly, specific and relatively strong controls on that competition are essential. Specifically, in our view, schools which receive government subsidies must not be allowed to compete on price, and probably should not be allowed to deny entry to any applicant. These are relatively severe interventions. In addition, the government must pay careful attention to differences in costs of educating different groups of students. Such differentiation may be tricky. Although we consider that this is not inevitable, there remains a risk that promoting competition between schools will enhance social segregation and undermine, rather than promote, social cohesion. We remain hopeful that these problems can be overcome.

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<sup>5</sup> The primary argument against an obligation to take all applicants is that doing so would lead to a dilution of quality. But why is this the case? Do the key inputs necessary for the provision of a high-quality education exhibit decreasing returns to scale? Presumably good teachers can be trained and good management and governance practices extended over multiple schools. If there are diminishing returns to scale in school size, then new schools can be created. Indeed, it is plausible that there are economies of scale in education, with larger institutions able to deliver higher-quality services more efficiently. A requirement to accept all applicants would eliminate any premium for exclusivity but exclusivity is unrelated to quality of education. On balance we consider an obligation to take all applicants worth considering.

At the same time there are large potential benefits. In our view there remains significant scope for school choice to significantly enhance the incentives on schools to provide educational services as efficiently as possible, and to innovate, to provide the variety of services that parents and students desire, and to respond to changing market demands. Although the flame of competition between schools must be tightly circumscribed, it is by no means necessary to extinguish it entirely.





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