Market design for Tax-Free Childcare voucher accounts

The Government announced the introduction of Tax-Free Childcare (TFC) for working families at Budget 2013. As part of this, the Government had to decide whether it should deliver the voucher accounts service using its in-house team, or use the private sector instead. We advised HM Treasury on this issue and this Insight explores the advantages and disadvantages of the different options.

Background

At Budget 2013 the Government announced the introduction of Tax-Free Childcare (TFC) for working families. This new scheme is intended to assist working families by giving support equivalent to basic rate tax relief on money spent on childcare. Under TFC, parents will register with a voucher provider and open an online account. The Government will then make 'top up' payments into the parents' account up to 20% of the total value of childcare costs (subject to an annual limit of a £2,000 contribution for each child). TFC replaces the existing Employer Supported Childcare (ESC) scheme, and will be phased in from autumn 2015.[1] It affects nearly 2 million families, and a working family with 2 children under 12 can save up to £4,000 a year.[2]

A key issue in relation to the deployment of TFC was how to design the new market for the supply of voucher accounts. Government was seeking advice on which of the following models would best meet the needs of parents and taxpayers:

- single public sector provision (voucher accounts provided by Government, either through National Savings and Investments (NS&I), or within HMRC);
- single private sector provision (provider of voucher accounts selected through Government run competitive tender process);
- multiple, small number of private fixed contracts (small, fixed number of private sector providers, say 2-5, of voucher accounts, again selected through a Government run competitive tender process); or
- an open market (no direct limit on the number of providers that could offer voucher accounts, where account providers would enter into arrangements with HMRC through a framework procurement process, and account fees would be paid by Government, not parents).

In all of these options, Government decided that parents would not pay for childcare accounts, and instead it would pay the provider(s) directly.

In short, there were two high level questions to answer. First, should the Government should use its in-house team or the private sector to deliver voucher accounts? Second, if the latter, how should private sector provision be organised?

The obvious obstacle to answering these questions is that the market for TFC voucher accounts did not exist.

[1] *https://www.gov.uk/government/policies/helping-people-to-find-and-stay-in-work/supporting-pages/introducing-a-tax-free-childcare-scheme*

[2] *https://www.flickr.com/photos/hmtreasury/13237890915/in/set-72157642531417054*

Therefore, we used information from 'comparator' services, which have some characteristics in common with the new TFC voucher accounts.

In-house team or the private sector?

To help shape the answer to this question we considered how any buyer, irrespective of whether it was publically or privately owned, would decide between outsourcing and in-house provision of an input.

The main advantages of in-house provision over outsourcing is that it can (a) reduce the transactions costs of going to market and (b) mitigate the risk and consequences of performance failure. That is, under in-house provision, the interests of the 'buyer' and the 'provider' are more closely aligned (at one end of the spectrum, they are the same), reducing any incentives for opportunistic behaviour. Also, the buyer could have greater visibility and control over the performance of the provider, improving provider performance management.

Set against these advantages is the potential loss of consumer choice and the on-going pressure to innovate and reduce costs that could be delivered by outsourcing to a competitive market (i.e. dynamic efficiency).

The scale of these advantages and disadvantages are, of course, highly contingent upon the specifics of the product or service in question. For example, in relation to the loss of the on-going pressure to reduce costs, there are various pressures within in-house provision to encourage cost control – including the use of budget controls and the 'threat' that the Government could outsource in future. Similarly, it is unclear how much service differentiation might be expected to emerge in the supply of voucher accounts.

To help gauge the scale of these advantages and disadvantages, the Government conducted a survey of parents. The results of the survey suggested that parents valued 'simplicity' over 'choice', and this evidence contributed to the Government's decision to deliver the service in-house rather than outsourcing it.

How to organise private sector provision?

As indicated above, the Government identified a number of potential models of private sector provision, which primarily varied by the number of suppliers that could compete for parents' business at any one time. At one end of the spectrum, there could be a single private sector provider – i.e. the winner of a competitive tender process – a 'closed market'. At the other end of the spectrum, an unlimited number of private sector providers could be compete for parents' business – an 'open market'.

The table below shows that an open market would usually be favoured over a closed market, provided that there are no supply or demand-side barriers to competition in an open market working effectively.

Benefits of an open market	Benefits of a closed market
It is well established in economic theory (and regulatory best practice) that open market competition has the potential to yield greater dynamic efficiencies and product / service innovation. The intuition for this is straightforward: that intra-firm rivalry provides a strong commercial incentive for firms to continually re-invest in driving down cost and providing the services that customers want.	Where there is the need to make large sunk investments, firms are exposed to the risk of their assets being stranded. In such cases, a closed market model could mitigate the risk by providing security that the limited number of players in the market can earn a return on the investment required to enter. In an open market, however, there is no such mitigating factor – and thus this risk could stunt the scope for competition and the benefits it would bring.
In an open market model, competition has the potential to reveal the 'true' efficient cost of supply over time, and the nature of services customers want over time. In contrast, under a closed market model the Government is, to an extent, effectively second guessing: (i) what customers want today and in the future; and (ii) the future efficient costs of supply.	Where there are large economies of scale, a closed market model may result in a more efficient outcome. This is because, in such instances, one might expect there to be only limited competition under the open market model.
There are also transactional costs associated with any Government managed procurement or bidding process under a closed market model; some of which would, by definition, be avoided under the open market model.	Where the scope for product differentiation is limited, the potential 'dynamic' benefits of an open market model may be less relevant.
	Government may be better able to guarantee that all customers would be served by suppliers.

However, as noted above, a complication is that the Government decided that parents would not pay for the voucher accounts, and instead it would pay the provider(s) directly. The implication is that it reduces the benefits of an open market model relative to a closed market model (and in-house provision).

- First, without facing a price for voucher accounts, parents may put less competitive pressure on providers as there is not a financial incentive to do so. Relatedly, the decision eliminates one dimension of competition – the price of the childcare account.
- Second, the implication of the decision is that government will need to determine the price that it should pay providers for voucher accounts. It could do this by setting prices administratively (i.e. estimating prices using cost information) or by orchestrating a competition to reveal the market price (i.e. a competitive tender process).
  - The former approach creates a risk that does not exist under a pure open market model where providers could charge parents directly – that is, that government could inadvertently set the price too high or too low for the service, leading to costly over supply or harmful under supply. This is less likely to arise under a closed market model, where competition reveals the price.
  - The latter approach (i.e. orchestrating a competition) is effectively equivalent to a closed market model, and so has the same advantages and disadvantages.
  - Clearly, both models create transaction costs that would not exist under a pure open market model.
- Third, in determining the price it should pay providers for childcare accounts, government will also need to specify the level of service it wishes to pay for. This has a number of related consequences.
  - The level of service chosen by the government could be higher or lower than determined in a pure open market (possibly appropriately so, given that the government has to consider taxpayers' interests as well as parents').
  - It may be difficult to enforce the requirement that parents should not pay for childcare accounts and, at the same time, allow providers to differentiate themselves by offering differing levels of service quality.
- Finally, there is a possibility that government involvement in relation to service standards could encourage providers to focus on delivering a 'vanilla low cost' service, rather than a differentiated service.

Conclusion

After consulting with stakeholders, the Government decided on the 29th July 2014 that it would provide TFC voucher accounts 'in-house' through National Savings and Investments.

This Insight highlights that the choice between the four options listed above is a finely balanced one – it rests on the evaluating a trade-off between the scope for dynamic efficiency on the one hand, and minimising the scope for performance failure and transaction costs on the other.

It also highlights the value of using economic principles to help understand how features of a potential service (e.g. the decision that parents would not pay for voucher accounts) could affect competition, particularly where information is scarce.

Economic Insight advises the Government and firms on market design.

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