

## THE CREATION AND EVOLUTION OF QUASI MARKETS IN THE PUBLIC SECTOR: A PROBLEM FOR STRATEGIC MANAGEMENT

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*The public sector has been unjustly neglected by the strategic management field as an object of study. In Britain we now see significant changes in public sector management, notably the introduction of an 'internal market' in the National Health Service. This paper reviews three theoretical perspectives on these developments and develops propositions for empirical enquiry based on the economic sociology perspective.*

### INTRODUCTION

These are exciting times to be working in the field of strategic management research. Empirically, new phenomena are appearing. Nowhere does this sense of a new age appearing have greater resonance than in public sector services. Who would have predicted in the mid 1970s—when all the talk was of immobilism, government overload and the power of staff at the periphery—the top down and politically driven pressure for restructuring apparent throughout Britain and many other countries in the 1980s?

Theoretically, too, old approaches seem to have lost validity (e.g., the incrementalist view of decision making in the public sector) and quite new fields are emerging as branches of economics move towards sociology and branches of sociology move towards economics. The discipline of law—with its emphasis on agency theory and contracting—also has to be taken into account. The debate between the three may be vigorous, but it is now proceeding at a much more sophisticated level than 10 years ago. Any

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empirical research has now to engage with these new theories.

This article attempts to map some of this new landscape from the perspective of those concerned with the strategic management of a transformed public sector. Most of the examples are here taken from a U.K. context, but they may well have resonance in other countries where public sectors have also come under increasing pressure to change. This piece seeks to review the field, and to move some of the developing literature into the domain of strategic management.

### **The neglect of public sector organizations within strategic management**

A major theme concerns the neglect by strategic management of the public sector (this weakness is indicated in Lyles' review of the field, 1990). A recent working definition of the strategic management field (Rumelt, Schendel, and Teece, 1991) is that it consists of the study of the direction of organizations, usually business firms. Often the focus in practice has been limited to the study of the competitive strategy of the firm. This is curious because other branches of organization theory have often called upon public sector organizations as research sites, if only

pragmatically because of their relative transparency. For example, hospitals have provided research settings for both contingency theorists (de Kervasdoue, 1981) and institutionalists (Di Maggio and Powell, 1983).

Why should strategic management academics be interested in the public sector? Surely—one might argue—it has withered away to insignificance under the sustained assault of radical right regimes in the 1980s.

#### No withering away

The picture is much more complex than this perspective might suggest. The public sector continues to exert major significance as an item of expenditure in many OECD countries, indeed marginally growing as a proportion of GDP in the 1980s across the OECD as a whole.

The most recent data from Britain indicate public expenditure is now rising as a percentage of GDP, and is projected to reapproach 1979/80 levels (the year when Mrs Thatcher assumed office).

Secondly the public sector continues to produce core goods and services that are of major significance to society as a whole: health, education, social security, defence and criminal justice. Rising expenditure in sectors such as health and education is often seen as a hallmark of an advanced post industrial society. So the core of the public sector has not withered away, and delivers goods and services of—if anything—increasing significance.

At the same time, the public sector of the 1990s is going to be very different from the old

Table 1. Trends in public expenditure as a percentage of GDP in the 1980s

	Total Outlays of govt as % of GDP				
	1970	1975	1980	1985	1989
U.S.A.	31.7	34.7	33.7	36.7	36.1
Germany	38.6	48.9	48.3	42.5	45.1
U.K.	38.8	46.4	44.7	46.1	40.9
Japan	19.4	27.3	32.6	32.7	32.9*
Sweden	43.3	48.9	61.6	64.7	60.1
Total OECD	32.3	38.0	39.3	40.7	41.6

\* 1988 data. Source: OECD (1991) 'Economic Outlook', 49, Table R. 15, Paris: OECD

Table 2. U.K. data on public expenditure as a percentage of GDP

Real gross government expenditure as percentage of GDP	
<i>Out turn</i>	
1979/80	43.3%
1984/85	46.1%
1989/90	39.3%
1990/91	39.9%
<i>Projected</i>	
1991/92	41.5%
1992/93	41.9%

Source: House of Commons Select Committee on The Treasury and Civil Service (1992) 'First Report on the 1991 Autumn Statement', Appendix 3, Table 1. London, House of Commons, HCP 58.

style public sector spawned by the 1940s. Over the last 10 years there has been in Britain an increasing managerialization of the public sector, and a (still ambiguous) shift away from traditional professional power. There has been an increasing emphasis on securing organizational change as opposed to organizational maintenance. There has been increasing downward pressure on costs. There has been talk of senior public sector managers behaving as 'strategists' from the mid 1980s onwards (Parston, 1986). A team at the Centre for Corporate Strategy and Change at the University of Warwick used comparative and longitudinal case study methodology to track the management of major service change in the restructured NHS of the 1980s (Pettigrew, Ferlie, and McKee, 1992). It was clear that at least in some localities and in some issues significant restructuring was occurring. We are now aware that the research agenda of the 1990s may be very different from that of the 1980s. For instance, we see the emergence of hybrid forms of organization, of substantial 'delaying' and of regrouping of professionals as they learn about management.

#### The 'quasi market' phenomenon

Most dramatically of all, we now see in the U.K. the introduction through politically driven legislation of 'internal' or 'quasi' markets in an array of key public services such as health and education. Other countries (e.g., Sweden) are also examining this model with interest. The

State is to become primarily a funder, purchasing services from a variety of private, public and voluntary providers, in competition with each other. Funding is no longer to be allocated solely through planning or formula funding, but instead through such devices as competitive bidding, or an earmarked budget which can be given to users, or agents acting on their behalf, who can allocate the budget between competing providers (Le Grand, 1991). There is thus a split between 'purchasers' and 'providers' of services.

This may well represent a fundamental move away from traditional planning based methods for the allocation of resources. It also has profound implications for the preferred organizational form at the level of the individual institution. Organizations such as hospitals and schools are now under pressure to adopt many of the characteristics of a 'quasi firm' they have to attract business in order to maximize revenue; they may need to market their services to consumers or their proxies; they may be pressured to reduce costs and raise quality; they may even have to determine their own competitive strategy in response to local 'market' conditions. Of course, like firms, they may also collude with other providers or seek to find ways of reducing purchaser pressure on them.

But there remain within the quasi market important differences from a pure market model as it is still unclear as to whether the U.K. Government would allow any poorly performing hospital or school to go bankrupt. The Government also retains formidable regulatory powers over the quasi markets that it has set up, for example, setting a formula for calculating price levels.

We are elsewhere engaged in a large scale empirical project tracking the implementation of these reforms, in particular focussing on changes to the corporate governance arrangements (Pettigrew *et al.*, 1991). Because of the observational techniques used, this project gives us a fantastic opportunity to study NHS Boards in action. We are also aware that we need to integrate this empirical material with more theoretical work on the nature of the quasi market.

The underlying issues signaled in this section will be addressed in the rest of the paper. Substantive literature relating to quasi markets by disciplinary base is reviewed. There is thus

reengagement with a range of developing and alternative theories which are outlined and discussed in turn. In the final section we begin to develop a research agenda in this area, considering questions of theory and of method.

## THE DISCIPLINE OF ECONOMICS AND THE STUDY OF QUASI MARKETS

In this and the following sections, some of the substantive literature on markets is reviewed. In the 1980s, the economists had a good decade and expanded their influence in both policy making and academic debate. The notion of a 'quasi market' derives intellectually from economics and much of the debate has indeed so far taken place within the realm of economics.

Three different perspectives from within economics are introduced: standard microeconomic theory has been influential but has virtually no account of market process; transaction costs analysis has also been influential and does contain a (controversial and some would argue limited) account of market process and there is also the work of the Austrian School which has not been influential in the policy debate but which contains a sophisticated account of market process.

### Microeconomic theory

It is fair to say that orthodox microeconomic theory has influenced—perhaps over influenced—the debate about quasi markets so far. Sometimes explicit theory is evident, although on other occasions implicit assumptions are made. Authors are drawn from University health economics research units (e.g., Brazier, Hutton, and Jeavons, 1990) or right wing think tanks (e.g., Goldsmith and Willetts, 1988). This domination is contrary to Rumelt *et al.*'s (1991) conclusion that the newer branches of economics were now proving more influential in the strategy field than traditional neo classical theory.

Indeed the model of a 'quasi market' in health care was first developed by Enthoven (1985) in an attempt to introduce greater efficiency, competition and incentives for performance into the system. This vividly contrasted with earlier accounts from other economists such as Arrow (1963) which argued that it would be unwise to introduce market principles in the health care

sector because of the consequent dangers posed by high levels of uncertainty, consumer risk aversion, and producer opportunism. In the new world, the American Health Maintenance Organization was taken as an exemplar. 'Quasi markets' could not only ensure value for money (technical efficiency), but also had the potential to improve consumer choice (allocative efficiency) (Le Grand, 1991).

As long as there was contestability in the market (Baumol, 1982), the new quasi market forces could exert important effects:

If market contestability can be created and sustained, substantial welfare gains may be achieved. The pace of this process is uncertain but its effects may be significant, obliging managers to restructure the supply side in a fashion which reflects current market demand rather than past history. (Maynard, 1991).

Presumably, managers in producer units here respond to increased pressures for performance as signaled by the market, and if they did not, they would pay the penalty.

Behavior is here seen as determined crudely by a mix of information regarding product price and quality and of a new structure of incentives rather than of strategic choice, government regulation, social norms or historic interpersonal networks. A major weakness lies in the failure of this approach to consider decision making inside the organization. As Rumelt *et al.* (1991:19) argue:

Economics has been chiefly concerned with the performance of markets in the allocation and coordination of resources. By contrast, strategic management is about coordination and resource allocation *inside the firm*. This distinction is crucial and explains why so much of economics is not readily applicable to the study of strategy and why strategy can inform economics as much as economics can inform strategy.

So standard micro economic theory primarily directs our attention to questions of efficiency, incentives and of market structure rather than to the internal organization of the producing unit or the question of how markets evolve through time. Its static force does not therefore handle the question of market process (Nelson and Winter, 1982). The firm is too often narrowly seen as a production function, and the prime

focus of innovation as technological. The actual strategic behavior of the firm remains largely unexplored as the neoclassical assumption of hyperrationality sees the firm as making optimal choice from a sharply defined set of possibilities. This schematic approach is unlikely to prove fruitful in any analysis of how quasi markets really operate or of how strategic decision makers in individual organizations effect choice.

There are of course other branches of economics not examined in this brief paper which could shed light on the evolution of 'quasi markets' in a way in which static microeconomic analysis cannot. Schumpeter's (1966) analysis of markets focuses on how they develop through time rather than static analysis. There is great interest here in the social, political, legal and institutional setting, as witnessed in his discussion of the role of the entrepreneur and the rationalization of market society. Social institutions arise more than being planned, and action is seen as often being characterized by unintended consequences. The notion of 'market process' has further been developed by Krizner (1973) as an iterative, learning, process.

#### **The new institutional economics: Transaction costs**

However, we now focus on an important development in economic theory over the last 20 years which has been the emergence of the so-called 'new institutional economics', or transaction costs perspective, closely associated with the work of Williamson (1975, 1985; also in Aoki, Gustafsson, and Williamson, 1990). The prime focus is on the efficiency properties of a range of different ways of organizing transactions. The transaction is seen as the prime unit of economic analysis, rather than (say) a traditional focus on the development of technology.

Here is a rich, sophisticated and influential attempt to link imaginative forms of economic analysis with other disciplines such as contract law and organization theory, even if the question of 'efficiency' continues to hold center stage. A central question within this literature is whether it is more 'efficient' for transactions to proceed through the market or to be internalized within an organization. Here the decision rule may depend on the nature of the transaction being considered: where transactions are highly specific,

then the balance of advantage may lie in internalization.

Social institutions are here seen as being shaped by efficiency considerations more than as a result of social or political action or power.

Within a transaction costs perspective, the public sector can be seen as an extreme case of the large vertically integrated organization. Originally, Williamson's analysis considered why it was that firms replaced markets. However, it is also possible to ask why it is that markets replace firms. At some point, bureaucratic failure is likely—particularly in the handling of routine transactions—and these transactions can be more efficiently organized through the market. Williamson outlines a number of criteria which are likely to determine whether or not the market will be a more efficient allocator of resources.

The transaction costs model has proved influential, and has been adopted as a theoretical base by a number of those seeking to understand the nature of 'quasi markets' (Bartlett, 1991), including critics of the U.K. NHS reforms (Burke and Goddard, 1990).

However, the transaction costs perspective has also come under attack from a number of quarters. Organizational sociologists see the approach as overemphasising the role of 'efficiency' at the expense of 'power' (Perrow, 1981; Bauer and Cohen, 1983), not to mention the question of ideology or the hegemonic culture. Granovetter (1985) also argues that, like many economists, Williamson operates with an undersocialized conception of human action. For instance, it is social relations, rather than governance structures or contracting, that ensure the interpersonal trust necessary in economic life. The transaction costs approach assumes that the natural state of man is opportunism rather than trust and finds it difficult to model behavior in 'trustworthy' institutions. Unlike Schumpeterian economics, neither does it offer a convincing account of how markets evolve and operate.

McGuinness (1991) also suggests that the theory is a confusing mixture of dynamic and static elements, analyzed in a loose way that does not make clear which things are endogenous and which exogenous. Furthermore, McGuinness argues that Williamson is far too sanguine about the efficiency effects of the alternative models of organizing transactions presented. Certainly an important contribution those working in this

tradition could make would be to undertake empirical efficiency studies comparing the old and new organizational forms in the public sector: have the new organizational forms really arisen because they are more efficient? Surely any realistic account of the creation of the internal market has to accord a far more central role to the influence of a changing political economy.

#### Transaction costs and the evolution of new organizational forms

So how are we to account for the transition to new organizational forms within the quasi markets? We here focus on a hitherto relatively neglected area within Williamson's work, that is his account of an earlier process of historical evolution between organizational forms.

Often Williamson at first glance appears more interested in generating context free axioms than exploring concrete historical processes. However, this is deceptive as Williamson (1985) addresses how it is that new forms of industrial organization which led to the modern corporation arose. Here he draws on the work of business historians such as Chandler (1962; 1977). The historical trend seemed to be away from the market and towards even more complex forms of industrial enterprise. Examples would be:

- the development of line and staff organization by the railroads from the 1840s onwards;
- the development of the divisionalized corporate form from the 1920s onwards;
- the evolution of the conglomerate;
- the appearance of the multinational enterprise.

Williamson (1985:404) clearly recognizes the need for more research into this field of organizational innovations. In his own account he essentially sees new organizational forms arising as a way of economizing on transaction costs.

Let us take the example of the emergence of the divisionalized company ('the M form') from the 1920s onwards. This was clearly a major innovation in patterns of industrial organization. In Chandler's (1962) account, the ability of managers in the old functionally departmentalized or unitary structure ('the U form') to handle the volume and complexity of demands on them was seen as badly eroded. Indeed, departmental

managers often maximized local rather than corporate objectives. The M form could be seen as more 'efficient' because it freed up the center to concentrate on corporate strategy, free of vested departmental interests. In the inelegant language of transaction costs economics, bounds on rationality were reached as the U form structure labored under a communication overload, while the pursuit of subgoals by the functional parts was partly a manifestation of opportunism (Williamson, 1986:152).

#### Weak historical analysis

There are a number of problems with this account. The first is the weak analysis of historical process. Faced with the need to retrench or to negotiate new forms of internal contract, 'organizational innovators' arise who devise a new structure. Presumably there is a slow, organic, switch to the most efficient form, led by entrepreneurs. But there is no sustained analysis, for example, of how these organizational innovations diffuse out. Why was it that the M form was so slow to diffuse, if it were so clearly efficient?

Fligstein (1985) indeed challenges Chandler's interpretation, and suggests that his theory alone cannot explain the pattern of spread and that consideration also had to be given to diffusion as well as efficiency processes and the role of the intraorganizational balance of power within firms. This reformulation brings in concepts of mimicry and of strong 'fads and fashion' from the institutionalists (see Hinings and Greenwood, 1988, for an account of such processes in the organization of local government) as well as the question of relations of power and domination from mainstream organizational sociology.

Palmer, Jennings and Zhou's (1991) empirical study of the adoption of the multidivisional form by large U.S. corporations provides mixed results, in which some of the propositions of the transactions costs perspective were sustained, as were some of the propositions of the institutionalist perspective, such as the operation of coercive and normative pressures in shaping adoption decisions.

#### Primitive efficiency analyses

Secondly, there is the question as to whether the new M form was indeed unambiguously more

efficient, as the long running dispute over interdivisional transfer pricing within such divisionalized companies bears witness (Eccles and White, 1988). We certainly need far more sustained analyses of the efficiency properties of these new organizational forms.

#### Neglect of power and ideology

Thirdly, the question of the relationship between organizational innovation on the one hand and power and ideology on the other is left unexplored. Did a specific social grouping (e.g., rising management cadres) push for the adoption of a new organizational form and how did they present their case? Cultural sociologists (Keat, 1991) would argue that one result of the 'enterprise culture' of the 1980s has been that the commercial enterprise has taken on a paradigmatic status as the preferred model for any form of institutional organization. In this sense, the emergence of new organizational forms can be seen as an act of cultural and ideological conformity.

#### Why do markets replace firms?

Fourthly, Williamson's analysis initially concentrated on the transition from markets to increasingly complex forms of economic organization. However, this long run historical trend now seems to have gone into reverse, in both public and private sectors. The public sector is moving from 1940s style planning to quasi markets. The private sector's desire to retain flexibility and to accelerate the pace of product development has been seen as functional ('efficient' in transaction costs terms) for the emergence of 'post Fordist' forms of production in which large corporations typically downsize, contract functions out and split up internally into more autonomous strategic business units (Kanter, 1989).

Williamson's most recent work (1991) indeed includes a discussion of how—in principle—the equilibrium distributions of transactions change in response to disturbances in the environment. However, the main focus of his applied analysis within this article is on moves from hierarchies to markets in Eastern Europe rather than in Western Europe or America. As a result, such culturally specific factors as changes in property rights

and the history of government expropriation loom much larger in the analysis.

### Transaction costs and empirical studies of health care settings

We now have two empirical studies trying to apply the transaction costs approach to actual health care settings.

Rehnberg's (1990) study of the organization of the Swedish health care system initially predicted that the production of asset specific and uncertain services would be internalized, while the production of standardized services would be externalized. In fact an integration pattern was found in which not only were asset specific transactions internalized, but also transactions of standardized services offered by a large number of sellers. The degree of asset specificity and of uncertainty were poor predictors of the degree of externalization.

Moving now to the American health care system, Arnold (1991) examines the rise of new organizational forms such as Health Maintenance Organizations, contract management arrangements, nonprofit hospital systems or for profit conglomerates. Her analysis of this governance transformation evident since the 1960s argues that economic efficiency theories which do not take account of the role of the state in shaping institutional arrangements at the sectoral level cannot explain these transitions. Institutional change in the health care sector must be seen as a profoundly political process.

We conclude that—while stimulating—the transaction costs approach to the study of quasi markets suffers from a number of serious theoretical and empirical flaws and that we need to look elsewhere for guidance.

## SOCIOLEGAL STUDIES AND THE PRIMACY OF THE CONTRACT

### Contracts and contracting

Another major area arises from the introduction of a much more formal and elaborate contracting process within quasi markets. There has thus been an important move from management by hierarchy to management by contract. Indeed, the modernization process has sometimes been seen in terms of a shift from status to contract

(Maine, 1861, quoted in Hughes and Dingwall, 1990), and this model has also been applied by some commentators (Klein, 1990) to the emergence of more formalized systems of contract within the public sector, particularly in relation to control over professional work flow.

Some scholars of contract law have become increasingly interested in the social relations and occupational roles which lie behind contracting. The empirical observation was made that often legal sanctions were not used to settle business disputes (Macaulay, 1963). Others have used a broad definition of contract, even referring to unwritten or 'implicit' contracts (Jensen, 1983).

MacNeil (1974, 1978) distinguishes between classical, neoclassical and relational categories of contract law. In his account, classical contract law attempts to enhance 'presentation', whereby a range of possible future events are dealt with in the contract. The identity of the parties to the contract is not seen as relevant. There are market alternatives available, and efforts to sustain the relationship are not seen as important. The emphasis is on legal rules, formal documents, self liquidating transactions and recourse to litigation as a means of resolving contractual disputes.

However, the alternative form of 'neoclassical contracting' has arisen to deal with certain types of transaction, notably long-term contracts executed under conditions of uncertainty or occasional transactions of the mixed and idiosyncratic kind (Williamson, 1979). As market relief is unsatisfactory, there is greater pressure on the principals to maintain a social relationship. There may also be the problem of long-term uncertainty. Aware of the inability to predict every contingency, contract planners may here use techniques to create flexibility in the contract.

As a result, there is typically recourse to arbitration rather than litigation as a means of settling contractual disputes. This scenario has *prima facie* validity in the arbitration mechanisms emerging in quasi markets, where disputes between parties are not referred to the Courts but go to higher governmental tiers for arbitration. However, these higher tiers have more autonomy than suggested in the neoclassical model as they not only respond to requests for arbitration but continue to shape the behavior of providers and purchasers through the production of quasi legal initiatives, rules and regulations.

The further development of 'relational contracting' is seen as resulting from the increasing duration and complexity of contracts. Multiturn contracts may replace 'spot exchanges' as a dominant mode of transactions. The contract is increasingly embedded in a social relation with its own history and norms (there is a clear crossover to sociology here). The reference point may not be the initial contract document, but rather the history of the relation as it has developed through time. Sanctions for nonperformance are more informal than formal. It might however be argued by sociologists that the term 'relational contract' is almost a contradiction of terms, because in close relationships diffuse social norms of trust and reciprocity replace contracting as a means for structuring recurring transactions.

#### Some implications for the study of quasi markets

Much more so than either economics or sociology, the sociolegal perspective also alerts us to the potential importance of the type of legislation which has been enacted to create quasi markets. Like the Marxist State, the Thatcherite State proclaims in the long run its desire to reduce the role of government, but in the short run increases it. Indeed Hughes and Dingwall (1990) take the problems of agreeing contracts in the old style Socialist command economies as an interesting, if extreme, comparator.

It could be argued that any real shift from a planned to a market based health care system would require that health care should undergo depoliticization as an issue. If this is not the case, the politicians will continue to need to exercise substantial control through the regulatory machinery in order to contain political embarrassment. So their proclamation of market based models becomes more rhetorical than real. Government circulars, directives and initiatives (e.g., junior doctors' hours) have continued to cascade out of the Department of Health. NHS contracts are not enforceable in courts, and must in reality be seen as pseudo contracts.

Some have drawn attention here to the important shift from primary legislation in favor of quasi legislative and administrative rules.

The 1990 NHS and Community Care Act which enacted the quasi market is a good example::

The 1990 Act is a case par excellence of open ended legislation: it is drafted in very broad terms and much of the detail will depend on delegated legislation in the form of orders and instruments prepared by the Health Secretary (Hughes 1991).

We need to know much more about the role and functioning of this regulatory apparatus. Laughlin (1991) uses theory ultimately derived from Habermas to analyze the reform process (to simplify grossly) as either an evolutionary social process or as imposed on a society by a group attempting to 'colonize' societal institutions. Part of this line of enquiry can be expressed in the field of regulation (Laughlin, 1991):

What is happening in the NHS is arguably what radical lawyers call a process of 'juridification', involving regulatory laws being enacted which go beyond acceptable levels of political behavior from the perspective of both society and the social systems being regulated.

We also need to know much more about the properties of different types of contracts used within the quasi market. While most contracts between producers and providers are currently in the form of relatively insensitive block contracts, there is an intention over time to move to more sensitive cost and volume contracts which increase the level of risk for providers. How are producers and providers learning about contracting and acquiring new skills? Will certain groups of actors in the quasi market attempt to exploit certain contract forms?

Finally, the sociolegal approach could usefully undertake work on the impact of the introduction of contracting on the pattern of social relations. The introduction of contract led and market life forces might, *prima facie*, be expected to shift transactions away from the relational and towards the discrete. Yet MacNeil's work points to the rarity of nonrelational exchange, particularly in complex organizational settings. Do inherited relationships really wither away, to be replaced by an atomized contract culture in settings as complex as health care organizations?



## SOCIOLOGICAL PERSPECTIVES

Grossly neglected by the discipline of sociology itself, as well as cognate fields in the recent past (despite classic work such as Polanyi, 1957), the sociological analysis of markets has been an expanding area throughout the 1980s. Essentially sociological concepts of social relations, of trust, of reputation and of obligation are seen as central to the understanding of how markets really work.

White's (1981) article led the revival in signaling a need to build a sociological view of markets. His own view was that markets should be seen as self-reproducing social structures established among specific cliques of firms which evolved roles and niches from observation of each other's behavior. A historically shaped structure of roles emerges among a stable set of producer firms. However, this early emphasis on reproducibility does not handle situations well in which new markets are created, nor does it consider the role changes apparent even after a market is established (Podolny, 1992) as firms may seek to renegotiate their position in the market.

One problem is how sociologists handle the question of individual and organizational choice. While neoclassical economic models assume hyper-rationality and frictionless choice, the opposite, but equally stylized assumption in at least functionalist sociology, is that of oversocialization, whereby man is seen as overwhelmingly sensitive to the opinions of others and obedient to social norms (this fault is recognized by some sociologists such as Granovetter, 1985). A strategic management perspective, by contrast, would place more stress than many sociologists on the capacity of organizational elites to affect strategic choice, most notably in the literature on corporate 'turnarounds'.

This is a complex and rapidly developing literature. However, there are a number of strands in the sociological approach which may have clear relevance to the study of public sector quasi markets:

### Social embeddedness

An attack on the assumptions of the 'New Institutional Economics' was apparent in Granovetter (1985). Economic transactions needed to be seen as much more socially embedded than in the transaction costs frame-

work. The focal unit of analysis was less the transaction and more the social relationship. From Williamson's perspective, a potential problem with opportunist economic actors lay in the excessive pursuit of self interest, so that one function of the firm was to act as a regulating governance structure.

Against this view, Granovetter (1985) argues that Williamson overstates the role of governance and hierarchy in regulating transactions, rather the trust so necessary for economic life to continue is generated through long run social networks. The problem becomes one of tracing the actual, concrete, interactions of individuals and groups and considering how these networks influence trading and the formation of prices within the market (Granovetter and Swedberg, 1992). We also need to consider how such trust may be produced (Zucker, 1986), for example, through professional solidarity.

A further question is whether such embeddedness of economic behavior is changing over time. One view might be that economic behavior was heavily embedded in social relations in premarket societies, but becomes much more autonomous with modernization. Indeed instead of economic life being submerged in the market; these relations become an epiphenomenon of the market. Modernization is thus associated with marketization and the reduction of social ties (Polanyi, 1957). This view has been questioned by Granovetter and Swedberg (1992), who argue that even in modern markets patterns of social relations still matter in shaping the pattern of trade. It could be argued that in the field of professional services (such as medicine) information on reputation which is primarily transmitted through organizational and occupational networks is crucial in shaping market position.

It is however worth considering in the case of the public sector quasi market whether—over time—inherited and dense patterns of social relations eventually break down in the face of economic signals and the move to 'contract culture' or whether they continue to influence trading decisions.

### Social network analysis

Clearly this social embeddedness perspective has close affinities with the literature on relational

markets developed by the Scandinavians (Ford, 1990). It was here felt that the conventional view of an active marketeer, passive consumers and an atomistic market restricted understanding of what really happened in markets.

Where economic life was dominated by a small number of large firms, corporate buyers (unlike individual consumers) would often interact with sellers. The relationship between companies and corporate consumers might be complex, including a mixed history of adaptation, commitments, trust and conflict. Such buyer/seller relationships are but one example of a much wider group of relationships in which a company might operate: seller-seller relationships should be considered alongside buyer-seller relationships which have as their primary focus product or technology development rather than the conventional sale.

Are these observations somewhat abstract in nature or can they be used as a platform for empirical research? At a small group level, Baker (1984) provides an analysis of the social structure of two securities markets using a social network perspective. He particularly focused on the impact of size on the nature of the market. Both marketplaces studied were found to exhibit substantial social structural patterns that influenced the degree of price volatility. Contrary to microeconomic theory, the larger marketplace was found to be less competitive than the smaller marketplace because large size and differentiation impeded the efficient flow of information among all actors.

Other sociologists would focus on questions of culture and power as shapers of markets rather than the more microlevel concept of a social network. Even those who are attracted by the prospect of social network analysis might argue that this social network perspective as evident in the field of economic sociology is as yet rather static and vague in nature. How can a typology of social networks be developed? (e.g., density of ties, core or peripheral role of actors in the network) What are the characteristic functions of the different types of ties? For example, Granovetter (1973) paradoxically highlights the role of weak rather than strong ties in diffusing information across conventional social boundaries. How is leadership apparent in a network? How are networks created and how do they evolve?

### **Institutional embeddedness**

Another point is that markets may not only be socially embedded, but also institutionally embedded. This shifts us away from the microlevel analysis of social networks and towards the macro level analysis of economic (and indeed social and legal) institutions. While in his most recent work Granovetter (1992) retains his network perspective, there is now more focus at an institutional level. However, he argues that existing networks of personal and political relations in turn shape economic institutions which act in effect as 'congealed social networks'. Institutions are to be seen as socially constructed by cliques of actors.

This view still has its roots in social network theory and is very different from the views of institutionalists who see institutions more as forces in their own right, independent of individuals' motives and actions. It can also be compared with Foucault's account of the emergence of new medical institutions (1973) which stresses the role of a background medical 'discourse' which links knowledge with power, quite independent of individual actors.

From the point of view of the public sector, however, a view of institutions derived from social network theory pays too little attention to the top-down role of the State in forming and imprinting institutions. Top-down restructuring plays as big a role as bottom-up networking in determining the character of the quasi market. Nor does it consider the role of national level professional associations in shaping the rules of the game. We need therefore to consider alternative ways of analyzing institutional forms.

So there may also be a need to link much more explicitly with emerging institutional theories of organizations than has hitherto been apparent. (Di Maggio and Powell, 1983). Within this perspective, new organizational forms arise not because of efficiency considerations but because of strong fads and fashions in organizational design and strong pressures to conform to centrally mandated templates. The State and the professions are seen as particularly important sources for structuring such organizational fields, with such pressures being particularly strong in public sector organizations which relate to powerful professions or which are dependent on state finance.

### The nature of competition

It has often been remarked that fields such as health care seem to be characterized by status competition rather than price competition. Non-price competition in American health care has produced a pattern whereby hospital costs per admission are significantly higher in competitive than in concentrated hospital markets (Robinson, 1991), thus giving rise to current attempts to deregulate health care.

For example, Fennell (1980) noted that hospitals represented a 'poor' market system because of consumer ignorance and that competition among hospitals is based on attracting the key physicians through, for example, providing state of the art technology. These physicians will in turn of course bring their patients to the hospital.

The question which then arises is whether such nonprice competition is status or quality based. Consumers may use status as a proxy measure for quality (Podolny, 1992), although the link between the two may be unproven. Some elements of status may be only very indirectly connected with product quality. For instance, ties to high status actors may well increase the prestige with which one is viewed.

Status orderings within markets may be difficult to change. Higher status producers may possess a number of important advantages in the market: they do not need to advertise; promises about quality are more likely to be believed; there is easier access to capital markets. As a result, lower status producers may find that their attempts to reduce the degree of market inequality or to renegotiate the pecking order face a number of obstacles.

Here is a conception of the market in which the constructed and maintained reputations of producers provide a tangible basis for decision making and for price setting. We need to examine further the relationship between status and quality. Will the growth of performance indicators and of quality measures expose the disjunction between status and quality? What will be the fate of high status but low quality producers?

### New organizational forms

An important thread within the new economic sociology has been an interest in the study of new organizational forms. So Eccles (1981) has

developed the notion of the 'quasi firm' which can be characterized by stable relationships between a general contractor and subcontractors. Powell (1985) has complicated the sharp distinction made by Williamson between market and hierarchically based forms of organization, looking at hybrid forms such as stable networks.

A number of organizational forms are arising within the British quasi market in health care, however, they are mandated by the top as well as emerging organically. The shift from management by hierarchy to management by contract is creating a new type of purchasing organization in health care, with a quite different set of objectives, requisite skill mix, pattern of staffing, ideology and timeframes. Provider organizations, such as NHS Trusts, are also being pushed towards a private sector model and a stronger set of economic incentives.

There is an attempt to make them much more 'business like' organizations with a stronger awareness of the 'bottom line'. The reorganization of British health care may be intended to build organizational forms which sit more easily with a market society. However, the dominant ideology emerging in these provider organizations seems to relate more to local autonomy than an embrace of the values of the market.

### The parallel problem of interprofit center transactions

Some of the problems likely to characterize quasi markets have parallels in multidivisional firms which are made up of profit centers. Here price is combined with authority within a mixed method for allocating resources. Within the transaction costs framework, the multidivisional form was seen as emerging because it was more 'efficient'. However, exchanges between profit centers within the multidivisional firm have often proved difficult to organize, and while economists recommend that transfer should take place at marginal cost, this rarely happens. Prices are indeed not taken as given but rather socially constructed through a process of bargaining. Contrary to the predictions of new institutional economics, Eccles and White's (1988) empirical study found that such internal transactions were fraught with more difficulty than external transactions.

While some American health care researchers

are now beginning to tap into aspects of this sociological literature (Clarke and Estes, 1992), it remains underdeveloped and underapplied in the British context. This is particularly surprising given the relatively easy passage of the transaction costs perspective across the Atlantic. Even this brief and very selective review suggests the fruitful avenues of enquiry being opened up by this literature.

### **SOME IMPLICATIONS AND A RESEARCH AGENDA**

In this final section, the review of the substantive literatures already presented is used to help flesh out a possible agenda for research in this field over the next 5 or so years.

#### **The study of public sector management matters**

The first point is that the public sector still matters (perhaps matters more than ever) for students of strategic management, as it has not withered away. Despite the radical right rhetoric evident on both sides of the Atlantic during the last 10 years, the proportion of GDP spent within the public sector indeed showed a slight rise across the OECD in the 1980s. Even in Thatcherite Britain, this proportion plateaued rather than fell over the decade. Although the U.K. industrial public sector has indeed been substantially privatized as part of the shock of the Thatcher experiment, core and indeed expanding services such as health, education and criminal justice are still delivered by the public sector.

Yet often the public sector seems to be invisible in the strategic management literature, except perhaps as a residual 'problem' which will eventually be solved through privatization. However, the privatization cycle now seems to have run much of its course at least in the U.K. and the emphasis is now on improving the quality of services retained within the public sector. No doubt this lacuna reflects the origins of the discipline of strategic management in business policy, yet such a gap constitutes an important narrowing of its field. It misses much of what is indeed strategic in modern postindustrial societies.

Perhaps studies of health care and education based organizations can be picked out as having

the greatest strategic significance. At least in Britain, these services are still largely delivered by agencies located in the public sector. How will the needs of an aging society be met? How does government respond to the HIV/AIDS epidemic? How will the expansion of higher education and of life long learning be organized? How can the training base be improved? Strategic management neglects the study of such societally and indeed economically important questions at its peril: the discipline thus needs to study strategy making in 'organizations' and not just 'firms'.

Moreover the public sector is changing rapidly so that stereotypes derived from the 1960s and 1970s no longer apply. We now badly need studies of the new order. There are a number of features of the new style public sector which throw up interesting problems for analysis, for example, the impact of culture change programs.

However, we now see the rapid introduction of quasi markets into the public sector. No more than the gleam in an economist's eye in 1985 (Enthoven, 1985), the quasi market was 'policy' in British health care by 1989 and subsequently exported to cognate fields such as education and criminal justice. Here indeed is a key area for future enquiry where studies of the new style public sector will need to draw on theories of markets developed elsewhere.

So not only hybrid forms of organization but also hybrid fields of enquiry may now be emerging: strategic management needs to broaden its base from its business policy inheritance; public sector management needs to move out of its public administration tradition to engage with quite different questions of market structure and process.

#### **A measured turn to theory**

We now also need to generate more and novel theory within the field of strategic management. This debate between basic and applied work is long standing (Lyles, 1990). Thus Chakravarthy and Doz (1992) contend that the field must now develop its applied component, recommending that strategy process research should become more relevant to practice and that methods of research such as action research should gain increased legitimacy. Bettis (1991) recommends the consideration of realistic and prescriptive

implications as a normal part of the research process.

Others—and this argument is well illustrated in the case of the study of quasi-markets—contend that the origins of strategic management in practice represent a major weakness and call for the development of more formal theory (Rumelt *et al.*, 1991; Bower, 1991). They call for predictive theory rather than the descriptive or inductive theory characteristic of strategic management in the past.

### The development of middle range propositions

Much of the literature reviewed in this paper operates at a relatively high level of abstraction; hence there is a need for the development of some theoretically informed but middle range propositions which can be used in empirical enquiry to distinguish between the relative validity of the very different theoretical perspectives on offer. My own theoretic interest lies in the development and application of the insights of the new economic and institutional sociology, but empirically there is also a need to test its validity.

*Proposition 1: The new organizational forms emerging in the quasi market can demonstrate legitimacy but not efficiency advantages.*

This proposition in effect tests the relative validity of the transaction costs and institutionalist perspectives. Both these schools of thought might agree that the quasi market is characterized by the emergence of new organizational forms which are in some senses qualitatively different from what went before, and which cannot be understood simply as a product of a 'relabeling' exercise so characteristic of many other public sector reorganizations. This most recent reorganization has bitten deeper and there are now new forms of organization emerging which exhibit signs and symptoms of a new 'business like' culture.

However, the two schools would disagree about the nature of these new organizational forms. The transaction costs school would see them as characterized by greater efficiency; while institutionalists would see them as characterized by greater legitimacy.

One approach would be to compare the efficiency and legitimacy characteristics of old

and of new organizational forms. This is possible as a diffusion based model for change has been adopted for this reorganization with the result that the two forms coexist. One would, however, need to take care to match for confounding variables such as strength of management: because the new forms of organization are seen as high status, they have often attracted the ablest managers.

Technical efficiency characteristics could be inferred from the raft of performance indicators that are now routinely generated and which give cost and activity information. One would need to consider measures of allocative as well as technical efficiency. Legitimacy characteristics, on the other hand, would require a more processual mode of investigation. Are the new forms of organization distinctively closer to centers of political, governmental, cultural and intellectual authority? Note that while institutionalists argue that the professions also act as sources of legitimacy, we do not here suppose that they exerted great influence in the creation of quasi markets. Of greater interest is the closeness of the relationship with the Party/State apparatus apparent at the highest levels of health care decision making and with Universities, think tanks or leading high status management consultancies.

*Proposition 2: In the quasi market, relations are in the end more important than contracts.*

Noordershaven's (1992) review of the problems of contract enforcement as viewed from transaction costs economics and agency theory suggests that there are many problems left unresolved. The nature of the obligation that binds parties together needs to become the object of investigation, rather than assumed to consist of formal contracts.

This proposition essentially tests the relative strength of the legal and the sociological perspectives. Clearly 'contracts' in the quasi market lack many of the features of the classical contract as they are not enforceable in the courts; they are not always entered into willingly; and they are subject to a special regulatory regime. While contracts in the quasi market demonstrate some of the features of a relational contract, they are unlikely for instance, to lead to the formation of specially negotiated local governance structures, dispute resolution mechanisms and incentive systems characteristic of bilateral relational con-

tracting (Ring and Van de Ven, 1992). What they do demonstrate are many of the signs and symptoms of a regulatory regime designed and imposed by a third party on parties engaged in forming pseudo contracts.

The question then arises whether within 'relational contracting' will the relation prove stronger or weaker than the contract? Sociologists would indeed argue that diffuse norms may prove more important in regulating behavior than purpose designed governance systems. Here there is a particular interest in the role of process-based trust emerging from recurrent transactions and of character-based trust resting on social similarity rather than the institution based trust produced by formal social structures (Zucker, 1986).

Thus Bradach and Eccles (1989) focus on norms of trust, obligation, cooperation and (it should be added) solidarity as mechanisms for controlling techniques and generating trust. The process norm of reciprocity may also be important: parties are aware that one bad turn deserves another. These macrolevel norms are subsequently embedded and developed in more microlevel personal networks: a local civic culture; a professional community; an organizational/political elite.

A number of questions arise. How are disputes between parties settled? There could be recourse to the formal national arbitration machinery, the designing of special local arbitration machinery or a much less focused process of bargaining between the parties. What, in particular, happens when there are allegations of nonperformance of contract? If, for instance, this is felt to be a result of force majeure and the relationship of trust is not violated, then one would expect recontracting to take place despite nonperformance of contract.

*Proposition 3: The quasi market will continue to be both socially and institutionally embedded and will resist atomization.*

It is here asserted that the quasi market will remain highly socially and institutionally embedded and will resist market based pressures for atomization. There are underlying reasons for supposing that professional networks in particular will prove resilient. Classically the uncertainty facing consumers in health care and their need to trust the producer will result in a

continuing willingness to hand over responsibility to professionals who speak with great authority in decision making. The social standing of medical professionals will remain high, and they will thus exert cultural and intellectual authority in shaping health care policy. It is also asserted that the managerial bloc in health care policy making—although increasing in importance and more willing to confront professionals in some areas—will continue in general to work in alliance with professionals. Most managers continue to be recruited from within the NHS, and attempts to break the mold by bringing in managers from the private sector have generally failed.

In addition proxy consumers (themselves often medical personnel) will have more power as purchasers than individual consumers. As a result professional and to a lesser extent managerial control will continue to prove more powerful than radical consumerism, and will work to restrain any market based solutions.

So well established local cliques and networks will continue to dominate decision making. Within the quasi market, there will be continuing barriers to market exit and entry; inherited contracting patterns will be rolled forward; and there will be little reletting of contracts. Even where new actors are superficially emerging (such as purchasers), they are still likely to have had career histories in the NHS and to be embedded in their own past. Given these underlying and resilient social structures, any atomization strategy is unlikely to succeed.

In part, we need to chart the ways in which such concrete social networks emerge and change and also to analyze their characteristics (Granovetter, 1985). Intensive case study analysis is here a highly appropriate methodology as this kind of information is more likely to be accessed through informal conversation, prolonged observation or 'canteen chat' than postal questionnaire. A fruitful focus of analysis is likely to be the individual health authority, and its small health care management elite is likely to consist of senior clinicians, managers and nonexecutive members. How are new appointments to this elite grouping made? What is the strength of interlocking or interpersonal ties between members of this elite? This echoes some of the corporate governance debate apparent in the private sector recently reviewed in Pettigrew (1992).

However, we do need to focus on the role of institutions as well as networks and it is not enough to conceive of institutions as 'congealed social networks.' This is too micro a view and neglects more societal considerations. The role of national professional associations is one issue. The role of government, and behind that the impact of the changing political economy, also has to be taken into account. In particular, the bureaucratic state represents a key institutional form in contemporary Western society which has its own logic. This logic may indeed be very different from that of the market form (Friedland and Alford, 1991) which we see now arising within bureaucracies, raising the possibility of institutional contradictions.

*Proposition 4: Competition in the quasi market will be status based more than quality or price based.*

The strategic management literature has long wrestled with the deceptively simple question: what is the basis of competition? This old conundrum has been given new life by the competitive advantage literature of the 1980s (Porter, 1980) which represents an alignment between the fields of economics and of strategy. The neoclassical notion of price-based competition is only one way of defining the basis of competition, and some of the Schumpeterian argument reviewed earlier in this paper illustrates that competitive advantage may also lie in the mastery of the new technology or even a new mode of organization. The whole quality boom (e.g., Total Quality Management programs) now apparent in both private and public sector organizations is also based on the argument that sophisticated customers will increasingly choose products and services on the grounds of quality as well as price.

Of course, these formulations are not necessarily mutually exclusive. Thus Pettigrew and Whipp's (1991) analysis of the nature of competition in the private sector suggested both that there were multiple bases of competition and that these in turn shifted over time.

However, it is here asserted that price is unlikely to play a dominant role in health care competition within the quasi market. Such is the level of uncertainty and of risk, that consumers and their proxies are willing to pay more to reduce the perceived risk of poor quality: they

are heavily risk averse. They are in effect searching for a high quality option. However, quality measures in health care are extremely underdeveloped and likely to remain so. Hospitals compete by investing in 'state of the art' technology—independent on the findings of any cost effectiveness evaluation—to attract clinicians and their patients. Process information (who is 'good' with patients) is as important as data on clinical outcomes. Such 'soft' information on personal and institutional reputation will be transmitted through the social networks already referred to and is likely to play a key role within the formulation of implicit quality judgements.

However, the link between status and measured quality may be loose (Podolny, 1992): a producer may be high status but low quality, at least as measured in formal quality indicators. Nor is the relationship between status, quality and price always clear as Podolny (1992) even suggests that higher status producers are able to make a given quality good at lower prices as they (for instance) bear lower advertising and marketing costs. This proposition asserts that as long as producers maintain a reputation for high status (e.g., teaching hospitals), they are unlikely to lose market share even in the face of price and quality (as formally measured) disadvantages. The dominance of status-based competition will survive regulators' attempts to shift towards price-based competition.

*Proposition 5: In the studying of quasi markets, market process is at least as important as market structure.*

This final proposition focuses on the question of methodology as well as theoretic orientation. No doubt a number of methodologies will prove useful in the study of quasi markets: analysis of market structures, for instance, are of course needed to assess the intensity of competition or market contestability, and concrete analyses of the efficiency properties of alternative organizational forms would also be central in testing Proposition 1.

However, the final proposition represents a plea for the study of market process as well as market structure. This choice of methodology is of course linked to the implications of the sociological theory already considered. Both organizations and markets are seen as embedded in a societal setting. For process analysts, there

is always great concern with contextual realism and the uncovering of the meanings that actors attach to their actions. If markets are indeed societally and institutionally embedded, there is a need for methodologies which can uncover these underlying social structures and institutional links. Some of these methodological themes are rehearsed in Pettigrew (1985a, 1985b, 1990). Along with an emphasis on embeddedness, there is also seen to be a requirement for the handling of temporal interconnectedness.

The point is made that quasi markets do not emerge fully formed but undergo processes of creation and evolution. There is indeed a distinct and deliberate creation phase which must be seen as an exercise in top-down restructuring, rather than as an organic, bottom up process. After the 'big bang' of creation, local 'rules of the game', learning, typifications and bargaining styles may then build up incrementally over the first years of operation. New roles only slowly crystallize. Outcomes in particular localities may show sharp divergence.

The relative interest in process distinguishes between different theoretic schools. As Pettigrew and Whipp (1991:19–20) put it in another context; 'one of the sharpest differences between the institutionalists and the neo-classicists arises over the issue of competition. The former see competition as a process, the latter regard it as a state.'

So how should we seek to understand the creation and evolution of quasi markets as a process? While there are as yet no developed accounts, there are a number of potential leads, sometimes using life cycle or 'stages' models.

Institutionalists such as Di Maggio and Powell (1983) use a life cycle model of organizational fields. They in essence conceive of a first stage which consists of the emergence and structuration of an organization field, followed by a second stage characterized by the homogenization of organizations within that field. Organizations in a field become more similar rather than more different.

By the notion of 'structuration' of an organizational field, they refer to four specific processes: (i) an increase in the extent of interaction among organizations in the field, (ii) the emergence of sharply defined interorganizational structures of domination and coalition, (iii) an increase in the information load with which organizations in a

field must contend, and (iv) the development of a mutual awareness among participants in a set of organizations that they are involved in a common enterprise. (DiMaggio and Powell, 1983).

This formulation may well model the joining together of organizations into a new field; it may have less validity in explaining the transition from one already structured field to another. Such a population ecology model—like the industrial economics view of industrial change whereby firms cluster within 'strategic groups' (Porter, 1980)—also plays down the ability of organizations to adapt and make strategic choice. Rather they become more homogeneous over time and their fate is seen as determined by market or selection pressures.

Van de Ven and Garud (1989) argue that population ecology may well fit mature fields saturated with competitors. However, it finds greater difficulty in explaining change in new or radically transformed sectors. Rather these authors analyze new industries as an emergent social system. They use Etzioni's accumulation theory of change both at the level of the individual entrepreneur and at the level of the collectivity of actors who socially construct the new industry. They propose another 'stages' model, suggesting there may well be overlapping periods of initiation, startup and take off in the emergence of a new industry.

McGuire, Granovetter, and Schwartz (1992) apply Granovetter's theoretical arguments about 'embeddedness' to the concrete and historical analysis of the formation of the electric utility industry (1880/1930). They argue that the way in which the utility industry developed was not the most technologically practical, nor the most efficient, but arose because a set of powerful actors accessed and applied certain techniques. They highlight the role of social networks in the creation of new economic institutions. They analyze the historic process of industry formation in care and detail, and consider the factors which led to one particular decision being taken, rather than potential alternatives.

These five propositions represent one way of fruitfully structuring future enquiry. Clearly the study of quasi markets in the public sector is not only important at a substantive policy or managerial level, but is academically challenging as it forces us to reengage with questions both of theory and of methodology.



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