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# LECTURE

## GOVERNMENT BY VOUCHER\*

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## INTRODUCTION

A. *The Context*

A central theme of the “reinventing government” literature is the extent to which substituting competition for monopoly provision in the delivery of public goods can produce demonstrable improvements in social welfare in a wide range of policy contexts.<sup>1</sup> Because government provision is seen to be beset by endemic efficiency and accountability problems, competition proponents claim that social welfare is enhanced by having governments either finance citizens directly, or finance (in whole or in part) private suppliers (profit or non-profit) who compete to earn the patronage of governments and community organizations acting on behalf of citizens. Through such decentralized delivery, the government can achieve its policy objectives at lower cost and in a more innovative and responsive fashion. In a central aphorism from this literature, governments are better at “steering” rather than “rowing.”<sup>2</sup>

The voucher instrument is one of the most frequently endorsed mechanisms for achieving the promise of decentralized delivery of government-supported goods and services. We will adopt a functional rather than formal definition of the voucher concept, including within the voucher concept any form of tied demand-side subsidy activated by consumer choice, whether in the form of tax deductions, tax credits, or universal or means-tested consumer entitlements reimbursable by government, irrespective of accounting details as to how payments are made to suppliers. While all of these mechanism seeks to subsidize targeted forms of consumer choice, they are not equivalent in other respects, particularly their distributional implications, which tend to become more progressive as one proceeds down this list of voucher instruments. These differences aside, the argument in favor of vouchers is simple: once governments decided to intervene in a given policy area, for a host of different rationales, including equity or distributional rationales, by conferring explicit, targeted subsidies on individual citizens, decisions regarding the consumption and production of publicly supported goods and services will be made more efficiently. Vouchers place resources directly into the hands of citizens, where they, rather than a governmental agent, will determine which goods and services to consume from a number of competing suppliers, thereby increasing the likelihood that citizen preferences in the consumption of publicly supported

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<sup>1</sup> See e.g., DAVID OSBORNE & TED GAEBLER, *REINVENTING GOVERNMENT: HOW THE ENTREPRENEURIAL SPIRIT IS TRANSFORMING THE PUBLIC SECTOR* 76-107 (1993) (describing how competition can unlock the bureaucratic gridlock that hampers many public agencies); VICE PRESIDENT AL GORE, *FROM RED TAPE TO RESULTS: CREATING A GOVERNMENT THAT WORKS BETTER AND COSTS LESS* 43-64 (1993) (discussing ways to break up government monopolies in favor of competition).

<sup>2</sup> See OSBORNE & GAEBLER, *supra* note 1, at 25-48 (elaborating on the distinction between steering and rowing).

goods and services will be vindicated. Specifically, the voucher concept introduces the prospect of economic exit, and hence failure, on the supply-side (e.g., bankruptcy) for institutions that are unable to attract and retain sufficient numbers of voucher-assisted consumers to ensure their survival. Thus, supply-sided institutions face a discipline that is absent from many current government programs that depend exclusively or primarily on political voice to ensure accountability.<sup>3</sup> In this respect, vouchers demonstrate considerable promise in terms of their ability to realize public goals, without distorting the efficient operation of markets. Indeed, given this capacity, the adoption of voucher programs may be able to mute, or even obviate, the great efficiency-equity trade-off of which Arthur Okun wrote so eloquently in his celebrated essay by that title.<sup>4</sup>

In light of the apparent benefits of the voucher system, it is not surprising that many commentators on the right and the left support the adoption of vouchers in a wide range of different policy contexts, including education, job training, health care, child care, low-income housing, long-term care for the aged, pensions and legal aid. Indeed, excluding those publicly supported goods and services that implicate concerns over natural monopoly or unacceptable exercises of the government's coercive powers by non-governmental suppliers, it is worth contemplating whether growing recognition of the putative strengths of the voucher system might dictate its emergence as the dominant instrument for providing social services in the next century — hence the title of this essay, *Government by Voucher*. Around the world, privatization of government-owned enterprises, economic deregulation, and contracting-out of government functions were the privatization issues of the past two decades. Voucher reform in providing social services, where the consumer empowered with public resources is the contractor, may be the next and most controversial privatization frontier.

Nevertheless, the thesis of this essay is that despite the superficial attractions of the voucher instrument, its wholesale adoption is neither as straightforward nor as obvious as its proponents have claimed. It is true that vouchers permit citizens to make decentralized choices in consuming public goods and services, but careful analysis reveals that citizens cannot make these choices without a very significant, and sometimes centralizing, role for governments in establishing, supporting and monitoring the voucher systems to ensure congruence with public goals. We argue in this essay that the degree of congruence between efficiency and equity that government by voucher promises depends critically on a number of central design issues that arise in

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<sup>3</sup> See ALBERT HIRSHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES 3-4 (1970) (articulating the differences between exit and voice).

<sup>4</sup> See ARTHUR OKUN, EQUALITY AND EFFICIENCY: THE BIG TRADE-OFF 1(1975) (discussing how the American economy encourages personal effort but, in doing so, creates inequalities).

any voucher program, the resolution of which is likely to prove both technically complex and politically and normatively highly contentious. This explains, in large part, why government by voucher has not yet proven to be the panacea to important policy concerns that proponents of "reinventing government" often represent it to be. More specifically, we argue that voucher systems cannot eliminate the tension between efficiency and equity; they only change the nature of the trade-offs. We argue, as well, that moving from a system of direct governmental provision to one in which private suppliers compete to earn citizen patronage turns out not to be an unalloyed triumph of markets over politics, but rather a more complex policy shift. Markets are substituted for politics in only certain dimensions, and politics assume a larger role in other dimensions, in particular in the financing and regulatory roles of government even where it has withdrawn from its role as direct provider.

This argument is developed in several stages. In the Introduction, we address the normative case for the voucher instrument by evaluating the specific claims made for the instrument. We also identify the various design challenges entailed in developing and operating an effective voucher system. Resolving these design challenges effectively is likely to require detailed governmental intervention. In Part I, we pursue the technical and normative complexities raised by these central design issues by examining them in the context of primary and secondary education. In Part II, we sketch briefly other applications of the voucher concept in the provision of social services. Finally, we conclude the essay.

### *B. The Benefits and Costs of Vouchers*

Although the case for vouchers is predicated on the desirability of allocating publicly favored goods and services through markets rather than political institutions, in this section we seek to render more explicit the arguments that are typically arrayed for and against voucher systems in general.

#### *1. The Benefits of Vouchers*

Several demand and supply-side features make voucher schemes attractive. First, vouchers allow citizens to consume publicly desired goods and services that are more closely tailored to their individual preferences than is typically possible in the case of monopoly government provision. The magnitude of this benefit will turn on how well monopoly governmental providers can satisfy citizen preferences. This, in turn, is based on the dispersion and intensity of preferences of citizens residing within the government's jurisdiction and on the capacity of governments to supply differentiated goods and services to its citizens. If citizens residing in a given political jurisdiction have homogeneous preferences for the mix of publicly desired goods and services supplied by a monopoly government (perhaps as the result of a Tiebout-inspired selection process), then the gains in terms of enhanced citizen preference satisfaction from unbundled delivery of publicly desired goods and services from voucher schemes may be relatively small. However, even if citizen preferences within

a given political jurisdiction are heterogeneous, the citizen preference satisfaction gains from adopting of a voucher scheme may not be large if governments are able to supply differentiated goods and services in a way that is responsive to citizen preferences.

A second claim in favor of vouchers is that they promote supply-side competition, which will have desirable consequences in terms of static and dynamic efficiency. Specifically, voucher supporters argue that because vouchers allow citizens to patronize or, alternatively, to terminate a supplier, and because these decisions have an immediate impact on the revenue stream of suppliers, the threat of exit will induce suppliers to produce goods and services that are highly responsive to citizen preferences and to do so in the most efficient manner. This claim turns on several critical assumptions. First, that there is sufficient information to allow citizens to make informed consumption choices. Second, that there are no significant barriers to entry, including economies of scale that limit supply-side competition. Third, that the objective function of at least some suppliers will be profit maximization, although non-profit suppliers will have more complex objective functions that are more difficult to model.<sup>5</sup> Finally, that government suppliers are incapable of being as responsive to citizen preferences as private suppliers are due to inherent frailties in bureaucratic and political decision-making structures. However, even if these assumptions hold, adopting a voucher system will not necessarily entail a reduction in overall governmental expenditures in comparison to the case of government monopoly supply and may indeed entail an increase in public expenditures. This is in part because some of the gains of more efficient supply through vouchers will accrue to private suppliers, not to government. Further, although governments could appropriate some of the efficiency gains through *ex post* voucher price re-sets, the prospect of such intervention has the undesirable efficiency consequence of diminishing *ex ante* incentives to establish efficient supply. Increases in public expenditures may result if vouchers are intended to increase the supply of some publicly desired good or service, rather than merely alter its composition.

A third claim in favor of vouchers is that adopting these schemes permits greater levels of supply-side specialization than is possible in a setting of monopoly government provision. This claim follows from the previous two. Monopoly government suppliers must produce a complex menu of only partially related goods and services, thus the scope for specialization is less extensive than in a voucher scheme where the provision of publicly desired goods and services is unbundled and different providers are able to compete to supply the market. However, the claim in favor of specialization benefits from vouchers should not be overstated. Presently, governments can, and do, contract out their responsibilities to private suppliers, thereby permitting the

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<sup>5</sup> See DAVID BRADFORD AND DANIEL SHAVIRO, THE ECONOMICS OF VOUCHERS 45-50 (National Bureau of Econ. Research Working Paper No. 7092, 1999) (describing the differences in incentives faced by private and public suppliers).

realization of gains from specialization.<sup>6</sup> Further, although vouchers allow for the emergence of specialized providers, there may be economies of scope that accrue to government when they supply a number of complementary goods and services.

A fourth claim in favor of voucher provision is that developing these schemes enhances political accountability by defining government entitlements more explicitly. As the monopoly supplier of goods and services, governments seldom make explicit decisions respecting the nature, scope and magnitude of government entitlements. Indeed from a public choice perspective, one of the significant political attractions of government supply is that it allows governments to obscure differential entitlements that are predicated on politically contentious cross-subsidies. In contrast, because vouchers place government subsidies directly in the hands of citizens, there is a need for government to be more explicit in defining the precise nature of the benefit conferred. Although government need not go as far as imputing a precise monetary value to the voucher, it must express the relative levels of voucher entitlements. In this way, conferring vouchers provides citizens with more information about the distribution of government benefits, and, in particular, facilitates critical evaluation of whether the distribution of benefits accords with legitimate normative principles or is simply the outcome of unprincipled political rent-seeking.

## 2. The Costs of Vouchers

Were vouchers only associated with the benefits enumerated above, the implications for public policy would be clear: save for cases where the production of publicly desired goods and services is characterized by significant economies of scale or scope, perhaps resulting in natural monopolies, the government should remit the supply of most publicly desired goods and services to vouchers. However, voucher systems also raise a number of objections and concerns.

The first concern relates to the quality and quantity of information that citizens have in making consumption choices with their assigned vouchers. Many critics of voucher systems argue that consumers lack the information necessary to make fully informed decisions, and, as a result, it is unrealistic to assume that individual citizens will make informed decisions when consuming services. To support this claim, the critics of voucher systems argue that it is difficult to make robust *ex ante* determinations of the quality of many of the goods and services typically provided by government which are "experience" or "credence" rather than "search" goods; indeed, this may be an argument for

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<sup>6</sup> However, while government contracting out permits specialized provision, it does not provide any assurance that the preference satisfaction benefits associated with vouchers will be realized. Here, government decision-makers are making consumption decisions on behalf of the public; in the case of vouchers, citizens make these consumption decisions directly.

government provision in the first place.<sup>7</sup> In addition, voucher critics argue that uninformed consumers are likely to make systematic and severe mistakes in consumption. This argument is strengthened when governments distribute vouchers on a means-tested basis, and the voucher recipients tend to be the least educated and sophisticated members of society.

However, while accepting the potential for information deficiencies in a voucher market, it is important not to overstate their significance. Although consumers may not possess perfect or even good information respecting the quality of services provided within the voucher market, there are a number of different ways to mitigate these information problems. First, as in the case of markets for other goods and services, suppliers will have strong incentives to develop credible *ex post* bonding mechanisms, such as brand names and guarantees, that ameliorate *ex ante* information deficiencies. Second, for citizens to spend their vouchers rationally, they do not need perfect information about the goods and service in question. Citizens simply need the capacity to observe the decisions of other more informed citizens and to be able to secure the good or service in question on the same terms. Third, if these two conditions do not hold, governments can reduce information asymmetries through tailored consumer protection requirements such as mandatory certification, information disclosure, and warranties, or by explicit monitoring and evaluation programs that would provide meaningful information to citizens. However, designing programs to ameliorate information asymmetries is complex, and the scope and character of government intervention necessary to support the arrangements may subvert many of the efficiency gains related to vouchers. For instance, an ill-designed supplier certification or accreditation regime could create a formidable barrier to entry that impedes competition and choice in the market for the good or service in question.

Even if citizens could ascertain the nature and quality of the good or service subject to voucher provision, there may still be residual concerns with the specific choices that well informed citizens might make with their voucher. For example, these concerns would arise if voucher recipients were to purchase goods or services regarded as inimical to some external conception of personal welfare. To some extent, paternalistic concerns explain why voucher schemes are targeted at specific types of goods and services. That is, instead of conferring a broad discretionary grant that citizens could exercise across a wide range of publicly desired goods and services, such as health, education,

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<sup>7</sup> Experience goods are goods whose full attributes are only revealed by usage. Search goods are goods whose attributes are fully observable on prior inspection. See Phillip Nelson, *Advertising and Information*, 82 J. POL. ECON. 729, 738 (1974) (distinguishing between search goods and experience goods); Phillip Nelson, *Information and Consumer Behavior*, 78 J. POL. ECON. 311, 312 (1970) (same). Credence goods are goods whose attributes are never fully observable by the user and entail reliance on the suppliers' claims about them. See Richard A. Posner, *An Economic Approach to the Law of Evidence*, 51 STAN. L. REV. 1477, 1489 (1999) (defining credence goods).

and housing, or at the limit provides untied cash transfers, most voucher proponents argue for narrowly defined schemes that would limit the scope for flexibility in consumption.

A second concern with vouchers, unrelated to and independent of paternalism, relates to negative social externalities in consumption. The concern is that privately rational consumption decisions may produce adverse social effects. For example, if recipients apply education vouchers to schools with a professed ideology that is deeply inimical to the survival of the state or to maintaining civil harmony and cohesion, these views could be successfully imbued in students. This would likely result in forms of conduct that would undermine social welfare.

To address these concerns, governments will be required to place some constraints on the supply and consumption of goods and services financed by the voucher system. Thus, the case for vouchers based on enhanced citizen choice should not be overstated. Compared to monopoly government provision, vouchers enhance consumer choice, subject to certain constraints. This results in intermediate levels of choice.<sup>8</sup> To address legitimate public concerns relating to paternalism and social externalities, government will be required to play a critical role in defining the scope of citizen choice, and in screening out suppliers of goods and services that fall outside the bounds of socially acceptable choices.

A third concern with vouchers relates to the innate tendency for private suppliers to engage in opportunistic behavior such as cream skimming and chiselling.<sup>9</sup> Cream skimming results when suppliers seek to reduce their costs by declining to provide goods and services to "high cost" voucher recipients. For example, in the case of health care, suppliers may seek to increase their profits by refusing to enroll individuals with existing medical conditions in their programs. Similarly, in the case of educational voucher programs, suppliers may have incentives to screen out special needs students with intellectual or physical disabilities, or perhaps simply language problems (i.e., children of recent immigrants). Chiselling relates to the information problems noted above, and arises when suppliers seek to exploit endemic information asymmetries on non-readily observable margins by reducing the quality of the good or service actually supplied in comparison to what was promised. The magnitude of cream skimming and chiselling problems relates to the intensity of the profit motivation. To the extent that non-profit suppliers are able to compete for vouchers, these problems may be reduced in importance, at the

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<sup>8</sup> See BRADFORD AND SHAVIRO, *supra* note 5, at 31-33 (illustrating the effects of vouchers on consumer choice).

<sup>9</sup> However, these problems are not necessarily related to the voucher system *per se*, as much as they are to provision of public goods and services through private suppliers. That is, these problems would still remain if government contracted out its monopoly responsibilities to private suppliers. However, the monitoring problems for government to control this propensity would be less severe under a sole supply contract.



cost, however, of attenuated incentives for static and dynamic efficiency. Alternatively, rather than suppressing the profit motive, governments can intervene in a number of targeted ways to control the incentive for cream skimming and chiselling by increasing the value of vouchers allocated to “high cost” citizens and by standard setting and monitoring.

However, even if governments were prepared to address the propensity for cream skimming by suppliers by conferring differentially valued vouchers, critics will be concerned with the impact that these arrangements may have on the values of human dignity and self-worth. Specifically, critics may argue that differentially valued vouchers will commodify or debase the citizen needs that are the very subject of the voucher entitlement. Here, the concern is not with the fact that governments must make difficult choices in the level of entitlements that different classes of similarly situated citizens will receive in a host of policy contexts, but rather with the pressure imposed by the voucher instrument to make the value of these differential benefits explicit and publicly transparent (“pricing the priceless”). Health and primary education can serve as examples. When government is the monopoly supplier of these services, there is no need for it to specify precisely the supplementary benefits that citizens with prior health conditions (in the case of health care) or children with special needs (in the case of education) should receive. These determinations cannot be avoided in the voucher system, though they can be muted by assigning different, non-quantifiable weights or values to the vouchers. The commodification concern is the converse of the political accountability benefits that proponents of the voucher system claim.

A fourth concern of many voucher critics is a skepticism about the likely adequacy of supply-side market responses, especially in small communities and thinly-populated rural areas, rendering vouchers of little relevance or value to residents of such areas. While there may be some force to this concern, in the sense that small communities typically possess fewer commercial suppliers of most goods and services than more densely populated areas, it is important not to overstate the impediments to new entry presented by economies of scale regarding most of the social services that are the focus of this essay. For example, one might readily imagine alternative schools to the local community school opening up in unconventional facilities, such as church halls, basements or community centers. In addition, broadening the relevant geographic market may enhance choice, although this may require that vouchers be set and financed at higher levels of government rather than at the local government level. This may enhance the exit option, but it may simultaneously weaken the local voice option in exchange for arguably less effective political voice at higher and more distant levels of government.

A final concern expressed by critics of the voucher system relates to the alleged erosion of citizenship values that results from extending market mechanisms into the delivery of public goods and services. Bonds of citizenship and community, which are allegedly nurtured and reinforced when government is a monopoly supplier of publicly favored goods and services,

erode when the same goods and services are allocated through vouchers. Consuming basic goods and services is no longer viewed as a shared act that reaffirms basic citizenship, but rather is regarded as a solitary act of market consumption that is indistinguishable from any of a number of market interactions that individuals conduct on a daily basis. As in the case of commodification concerns, the critics' disagreement with voucher advocates turns not on contestable positive claims—both agree that vouchers facilitate greater individual choice—but rather on the normative meaning that is attached to these observed changes in behavior. Voucher critics emphasize the losses to collective preference satisfaction in respect of the values of social solidarity and citizenship; voucher proponents emphasize the gains to individual preference satisfaction in terms of more responsive and dynamic delivery of publicly desired goods and services.

Careful enumeration of the benefits and costs of voucher schemes reveals considerable complexity in the case for vouchers. In part, this complexity is a function of different values that each side attaches to certain aspects of personhood, such as individual autonomy versus social solidarity or community. However, a considerable part of the complexity is related to the actual design of voucher programs, and the extent to which government can implement voucher programs to mediate the various concerns enumerated above. In the next section, we discuss some critical over-arching voucher design issues before exploring their salience in specific programmatic contexts in the next two parts of the essay.

### *C. Challenges in the Design of Voucher Programs*

In this section, we address several crucial design issues that implicate the extent to which the adoption of a voucher scheme is likely to enhance societal welfare in contrast to a starting point in which government is a significant, or perhaps monopoly, supplier of the goods or services in question.

These central design issues can be stated quite shortly:

#### *1. Is there a case for redistribution and, if so, in tied form?*

First, in designing any voucher system, the threshold question is whether there is a case for any form of public subsidies on either the supply or demand-side. A related question, assuming that there is a case for some form of redistribution, is why it should take the form of a targeted demand-side subsidy rather than a more general untied cash redistribution through the tax and transfer system. That is, if the general distribution of wealth were, for example, Rawlsian fair, would there ever be a case for vouchers or indeed any form of government provision?

In the problematic areas of interest to us, the case for some form of redistribution and the case specifically for tied, in effect in-kind, demand-side subsidies are likely to rest on some or all of the following factors: (a) a concern that in the absence of some form of redistribution, some members of the community, because of inadequate endowments, are likely to be denied access

to opportunities or facilities essential to their basic participation in civil society, which may violate notions of equal concern and respect (distributive justice) that all members of humanity, simply by virtue of being human, are arguably entitled to; (b) positive social externalities arising from individual participation in such opportunities or facilities that may be inadequately internalized in individual decision-making, even if individuals possess adequate resources to so participate (a form of economic market failure); (c) negative political externalities arising from individual decisions to opt-out wholly or partly from publicly-supported activities, attenuating political voice in sustaining the quality of these activities (a form of political market failure); and (d) paternalism, which views a significant number of individuals, even if they possess the resources and even in the absence of social externalities, as unlikely to make privately optimal decisions for themselves in the absence of collective inducements to do so, which tied demand-side subsidies provide. As Bradford and Shaviro point out,<sup>10</sup> a voucher is cash equivalent if the allocation between commodities that the recipient chooses at her budget line is identical to that which she would have chosen if given cash instead in the amount of a voucher. The more a recipient prefers the commodities that the voucher can be used to purchase, and the smaller the amount of the voucher relative to her other resources, the greater the likelihood of cash equivalence. Since non-cash equivalent vouchers are inferior to cash from the standpoint of a recipient with stable and well-defined preferences, replacing them with cash would be a Pareto improvement in the absence of other considerations, such as paternalism, externalities (including donative preferences for inducing a particular commodity choice), and the distributional aim of measuring need when it cannot be observed directly.

## 2. Who should qualify for a voucher?

Assuming that a case has been made for some form of state redistribution and, in particular, for a tied form of demand-side redistribution, a second threshold question arises regarding who should qualify for the entitlement on the demand-side. Here the central issue is likely to be whether the entitlement should be a universal entitlement, such as primary and secondary education, or basic health care, and if so whether opting-out of such entitlements is permissible, or whether the entitlement should be means-tested, as are most legal aid schemes. Inadequacy of endowments as a rationale for intervention will tend to favor the latter, while positive social externalities, negative political externalities and paternalism may favor the former. Thus, resolution of this question will, in large part, depend upon the normative concerns that

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<sup>10</sup> See BRADFORD AND SHAVIRO, *supra* note 5, at 18 ("It is natural to think of vouchers as inherently non-cash-equivalent from the recipient's standpoint, because they can only be used to purchase earmarked commodities. In fact, however, a voucher is equivalent to a cash grant unless the earmarking alters the recipient's overall budget allocation between commodities.").

motivate some form of collective intervention in the first place (the first threshold question). If means testing is thought desirable, the testing criteria are likely to prove contentious as well. Should they entail a static measure of ability to pay or should they also encompass past circumstances that explain present inability to pay or future prospects of ability to pay? Should means be tested at the individual or household level? Should means be extended to non-financial disabilities such as race and gender, for example, viewing quota-based affirmative action programs as in effect a form of voucher system?

Even conventional income or asset tests raise significant incentive problems. As Bradford and Shaviro point out,<sup>11</sup> an income test creates moral hazard problems due to the incentive effect of conditioning the grant on income when earning effort cannot be well-observed, although income is presumably a signal of some distributionally important underlying attribute such as low wage or bad luck. Income conditioned vouchers may exacerbate the resulting incentive problems when they are layered on top of each other and coupled with other income conditioned aspects of the overall tax system. The combined effective marginal tax rate in some cases may approach, or even exceed, one hundred percent. With respect to asset tests, liquid asset tests such as those used in the U.S. food stamps program distort consumers' savings decisions and asset choices. For example, since homes are not included in liquid assets, food stamps provide an incentive to own a home rather than hold liquid assets and pay rent, even though this choice has a weak relationship if any to the distributional purpose of measuring need. These kinds of problems raise concerns of poverty traps that deprive low income households of the reward of work and saving.

With respect to household composition, the treatment of household status presents another dilemma in distribution policy. One's personal income or assets may significantly increase the well-being of others in the same household, but determining tax or transfer consequences at the household level may distort decisions as to whether to form a household, or at least one that is observable. Often the incentive effect is to discourage forming households, despite policy aims that may lie in the opposite direction.

### 3. Who can compete for voucher-assisted customers?

A third central design question is who should qualify to compete on the supply-side for voucher-supported consumer demands. The virtues of vigorously competitive markets often depend on relatively unrestricted entry. However, in many contexts, the normative concerns that motivate some form of intervention in the first place, such as paternalism or social externalities, are likely to yield some skepticism as to the ability of consumers to make both privately and socially optimal choices in a totally unregulated market. Responding to these concerns will likely draw the government back into an active role in managing the supply-side of the market.

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<sup>11</sup> *See id.*

4. What should be the value of voucher entitlements?

A fourth central design issue relates to the structure of the entitlement: what exactly does a voucher entitle a holder to? If a voucher provides an unlimited claim to the cost of goods or services to which it relates (a marginal rate of reimbursement of one hundred percent), then major moral hazard problems are likely to arise on both the supply- and demand-sides of the market in terms of running up bills at taxpayers' expense, an effect which neither suppliers nor demanders have any incentives to resist. Marginal rates of reimbursement of less than one hundred percent, in effect, a form of co-payment system, may induce a higher level of cost consciousness on the part of consumers, but at the risk of being regressive in its impacts on low-income consumers.<sup>12</sup> In addition, capped or fixed sum vouchers may create incentives for under-provision of needed services to many consumers, depending on the value and calibration of vouchers and supply-side elasticities.

5. Should extra-billing be permitted?

A fifth central design issue that is particularly likely to arise with fixed sum or capped voucher systems, is whether suppliers should be permitted to "extra bill" consumers on top of the value of the voucher. If permitted, this will likely raise serious equity concerns if it allows individuals with greater private resources to acquire a larger quantity or better quality of the goods or services in question than individuals with fewer private endowments, perhaps also attenuating political voice in maintaining the value of voucher entitlements. On the other hand, it may be argued that fixed value or capped vouchers are designed only to ensure that all citizens receive some basic or core level and quality of the goods or services in question and that it is inappropriate to prevent other individuals with the resources or inclination to choose to augment their spending beyond the value of a voucher on the activities to which the vouchers relate. Moreover, some may argue that prohibiting extra-billing undermines the role of the price system as a signal of, and reward for, superior quality.

6. Should "cream-skimming" be permitted?

While the issue of extra billing raises the question of whether competitors on the supply-side of a market should be permitted to maximize their revenues through extra billing, a final central design issue relates to whether competitors should be able to minimize their costs by screening voucher-supported consumers to whom they choose to supply services, more specifically by "cream skimming," "cherry picking" or "discriminating," so that they service only those consumers who entail fewer costs or present lower risks for them. To the extent that this form of screening or supply-side selective servicing is permitted, equity concerns will arise with respect to citizens who are screened

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<sup>12</sup> See *id.*

or selected out in this process, who may be among the most disadvantaged or needy members of the constituency at which the voucher system is targeted. On the other hand, if the government not only regulates entry on the supply-side into the class of activities in question, and constrains or prohibits extra billing, but also imposes constraints on whom among the voucher-supported population suppliers may choose to do business with, it will have taken on major roles in managing the supply-side of these voucher-supported markets. This is both at variance with the simple, stylized virtues of voucher systems advanced by "reinventing government" proponents and, at the limit, may also raise questions as to whether an intensively government-managed form of competition is likely, in practice, to yield the efficiency properties that economists often claim on behalf of unconstrained competitive markets.

### I. SCHOOL VOUCHERS

Despite its vigorous articulation by Milton Friedman in his 1962 book, *Capitalism and Freedom*,<sup>13</sup> and by many subsequent proponents, widespread adoption of vouchers in the United States or elsewhere has not occurred in the intervening years. Friedman and others ascribe non-adoption of the voucher concept to the political influence of special interests, particularly the educational bureaucracy and teachers' unions, both of whose interests would be threatened by more competitive provision of educational services.<sup>14</sup> Although resistance from these interests may partly explain the non-adoption of the school voucher concept, the complex and contentious normative issues that accompany the design of a school voucher system also play a significant role. Resolving these issues is unlikely to lead to the claimed happy congruence between efficiency and equity.

In order to evaluate the virtues of a school voucher system relative to public monopoly provision of schooling, it is necessary to be clear on what the ends of primary and secondary education are. The skills model of primary and secondary education emphasizes the development of marketable skills, which requires a flexible, entrepreneurial and diverse school system in order to serve both the diversity of skills, abilities and preferences of students, and the changing needs of labor markets. In contrast, the citizenship model emphasizes the positive social externalities of primary and secondary education. In this model, many of the benefits of primary and secondary education accrue not to the individual directly, but to society as a whole through reduced dependence on social services, reduced crime rates, a common moral development, cultural sophistication and sensitivity, capacity for interaction with members of the community of diverse social and economic

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<sup>13</sup> MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 85-107 (1962) (outlining the role of the government in education).

<sup>14</sup> See MILTON & ROSE FRIEDMAN, *FREE TO CHOOSE* 157 (1980) (describing how the interests of teachers and administrators are served by consolidating control of the educational system in the hands of the government).

backgrounds, and informed participation in democratic institutions and community life.

With respect to the skills model, many parents, at least in North America, are disaffected with the current public education system and point to major international surveys that have shown that Canadian and American children consistently under-perform students in many other developed countries in core subjects such as mathematics, science and geography. With respect to the citizenship model, some elements on the right demand a return to Christian education encompassing strict discipline and family values, while partisans on the left urge a strengthening of the values of cultural diversity, community and tolerance. How one weights these various objectives of the educational system is likely to have a significant influence on one's view of the virtues of decentralized voucher systems versus centralized public education systems.

The central design challenges that both models of education must take seriously are paternalism, co-ordination problems and externalities. That is, we must take seriously (1) the inability of individuals to understand their own best interests (paternalism); (2) decisions which, when taken individually, are benign, but which, when aggregated, lead to detrimental social results (co-ordination problems); and (3) choices made by individuals which are antithetical to the values of the community as a whole (negative externalities).

Paternalism is a particularly acute problem in the case of education. The consumers of the educational product, students, are unable to make informed and rational decisions regarding their education since the ability to make such choices is itself one of the principal desired outcomes of education. Further, since a major rationale for public education is the integration of individuals on the margins, whether because they are new immigrants, very poor, or for other reasons, we cannot always assume that parents are in a position to make informed decisions on their children's behalf. Indeed, several studies have demonstrated a link between the education of parents and the quality of education provided to their children.<sup>15</sup> Primary and secondary education is a particularly difficult area in which to establish the appropriate scope of government paternalism. On the one hand, a high degree of expertise is required to make judicious decisions on matters of education; on the other hand, the education of one's children is one of the most important decisions a parent can make and is likely to be taken very seriously by most, but not all, parents.

Next, individual choices that may be individually rational might lead to results that are collectively sub-optimal. Accordingly, collective action is required to avoid prisoners'-dilemma-type problems. For example, if white parents consistently choose to send their children to schools separate from those attended by black children, because, say, their children prefer the company of friends from their immediate neighborhood, the result may be one

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<sup>15</sup> See CANADA COMMUNICATION GROUP, *EDUCATION AND TRAINING IN CANADA* 27 (1992) ("[A]wareness at home of the importance of education is the crucial factor.").

of *de facto* segregation, which most people may not prefer. In this case, there is a strong case for government intervention.

Relatedly, the significant negative externalities of individual choices sometimes mandate government action. In liberal democratic societies such as those in present-day North America, it is unacceptable for the government to interfere so much in the private lives of individuals as to determine how parents should raise their children. Nevertheless, another core value of our societies is that the basic values of respect for individuals, tolerance and the rule of law must be maintained as necessary conditions to preserve our society. The case of parents who choose to educate their children in intolerance and violence presents a particularly pointed problem.

Against this backdrop, we address four key design issues that must be resolved in designing a school voucher system.

#### A. *Qualified Consumers*

The social value of primary and secondary education gives society good reason to provide it to all children, regardless of means. However, if our primary motivation for public education is the promotion of equality, we may have good reason not to provide funding for education to the wealthy. The “skills” model suggests that there are sufficient economic incentives for rational agents to spend money on education, even though individuals without personal resources may face difficulties in borrowing against the collateral of prospective human capital and may justify means-tested assistance. The strongest argument in favor of universality is that it creates a collective interest in maintaining the quality of voucher-assisted education by ensuring that the value of the voucher is not degraded over time. If some families are in the voucher system and others not, effective political voice may be attenuated and the values of equality of opportunity and equal citizenship may be compromised through a two-tier or multi-tier educational system.<sup>16</sup>

#### B. *Qualified Suppliers*

The failure of an educational institution may result in serious problems including loss of years to pupils and personal disruption. As a result, regulations may be necessary to limit entry to the market to only those institutions which are likely to remain in operation over the long-term akin to the so-called “prudential controls” common in the financial services sector.<sup>17</sup> In addition, quality control of existing institutions may be necessary. Although regulation, in particular entry controls, should in principle be kept to a

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<sup>16</sup> See HIRSHMAN, *supra* note 3, at 15-16 (examining the relationship between markets and politics).

<sup>17</sup> In one of the few experiments with school choice—the Juanita Virgil Academy in Milwaukee—this sort of school failure actually took place, causing the students to lose a year’s education. See CARNEGIE FOUNDATION FOR THE ADVANCEMENT OF TEACHING, SCHOOL CHOICE 67 (1992).



minimum in order to avoid the problems of the existing single-provider model, such as inefficiencies and lack of innovation, there may be legitimate concerns with a free-for-all of educational suppliers some of whom may be grossly incompetent, socially insidious, or politically subversive. Making actual decisions as to what to tolerate and what to over-ride, however, raises many of the difficult problems of externalities and paternalism inherent in the liberal position. It is far from clear how this regulation can be carried out. Public funding through vouchers of ethnically or religiously separate schools is likely to raise acute concerns in this regard, particularly within the "citizenship" model of education. A universal voucher may mitigate problems of sorting by class, but it may substitute sorting by religion and ethnicity. These concerns are only likely to be mitigated by detailed regulation of school curricula and admissions policies. This is antithetical in important respects to assigning a central role to individual choice which voucher proponents view as the principal virtue of vouchers.

Government accreditation, standardized tests, and mandatory disclosure of data about school administration and performance provide some means of disciplining inefficient suppliers. The particular means chosen, however, will be of central importance. For example, reliance only on *ex ante* government accreditation fails to discipline institutions that decline over time. Rather than encouraging educational suppliers to maintain a high quality of service to consumers, *ex ante* accreditation encourages institutions to first to meet the minimum standards for accreditation, and subsequently to disregard quality for the sake of profit. While non-profit suppliers may be less prone to such incentives, modelling the incentive structure of non-profits is not a straightforward exercise.<sup>18</sup> A more rational incentive system might entail a continuous process of standardized pupil testing after a school is in operation. However, there are several problems with this *ex post* method of evaluation: (1) it entails high administrative costs, and (2) it encourages schools to "teach to the test" rather than to innovate or to take risks to provide better education to students.

Requiring the disclosure of key administration and performance data of the school takes advantage of market pressures on poor providers. For the market to work effectively, however, we must depend on the sophistication of consumers to discriminate good from bad suppliers. This, of course, is far from assured.<sup>19</sup> The market for primary and secondary education involves everyone. Accordingly, the consumers of this good will be as varied in terms of their capacity to evaluate complex comparative performance data as is the

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<sup>18</sup> See BRADFORD & SHAVIRO, *supra* note 5, at 48-50 (articulating the incentive structure of a non profit agency).

<sup>19</sup> See J. Douglas Williams & Frank H. Echols, *The Scottish Experience of Parental School Choice*, in SCHOOL CHOICE: EXAMINING THE EVIDENCE 49 (Edith Rasell & Richard Rothstein, eds. 1993) (finding that parents who exercised choice were "more highly educated and had more prestigious occupations than those who sent their children to the designated school.").

population as a whole.

Finally, making certain results the basis upon which suppliers' performance is measured and compared may create serious perverse incentives or moral hazard problems. For example, if the measure of school success is the pass rate, then schools will have incentives simply to pass all of their students, regardless of their actual academic achievement. Given that education is a "credence" or "experience" good rather than a "search" good, this kind of strategy, and its effects, may be difficult for parents to monitor effectively in the short run. While more sophisticated mandatory comparative disclosure requirements can obviously be devised, their complexity is likely to intensify the information-processing challenges faced by many parents.

### C. *Value of Proposed Vouchers*

Although the special needs of some children may entail higher costs, there are also serious moral hazard problems in providing unlimited funding to individuals. On the one hand, we must recognize that it is more expensive to provide the same level of education to disabled or economically disadvantaged children. Also, providing funding support for transportation to and from the best schools is essential in order to prevent the best schools from being dominated by those who live nearby, who are usually the wealthiest.<sup>20</sup> On the other hand, we must control the perverse incentive effects of allowing individuals to spend an unlimited amount of someone else's money. Striking this balance may require a complex scheme of calibrated vouchers that are risk-adjusted by class of student and carry different but limited values. At present, these differential costs are buried in public education budgets. Rending them explicit has the advantage of transparency, but risks invidious political debates about "pricing (commodifying) the priceless".<sup>21</sup> Even determining the value of the basic voucher is likely to raise complexities. Should the value of vouchers be the same in all regions of a jurisdiction despite differences in underlying costs and elasticities of supply? Within a region, should the value be set at the per capita costs of the most "efficient" school, the current per pupil public expenditures on education, or some other figure?

### D. *Extra Billing and Cream-skimming*

Extra billing and cream-skimming are intimately related. Extra billing is the practice by which educational providers charge consumers a premium for their services above the government-provided voucher.<sup>22</sup> Cream skimming is a

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<sup>20</sup> See JEROME J. HANUS & PETER W. COOKSON, CHOOSING SCHOOLS—VOUCHERS AND AMERICAN EDUCATION 160 (1996).

<sup>21</sup> See Guido Calabresi & Philip Bobbitt, *Tragic Choices*, in LIBERTY AND JUSTICE: ESSAYS IN POLITICAL THEORY 2 (Brian Barry ed., 1991) (recognizing the argument that human life is priceless and should always be protected).

<sup>22</sup> See MYRON LIEBERMAN, PRIVATIZATION AND SCHOOL CHOICE 244 (1989) (noting that extra billing is allowed in Vermont for secondary level education, but only for the wealthy).

process of selection of students by educational providers. Its purpose is to keep costs down by screening out those who will require costly additional services to achieve a given level of performance.<sup>23</sup> Assuming education providers are rational self-interested actors,<sup>24</sup> they will try to provide their service for the highest price at the lowest cost to themselves. If we do not allow institutions to vary prices by banning extra billing and if the government does not provide calibrated vouchers, then their only option to maximize profitability is to provide their service at a lower cost.

If our goal is to provide an excellent education to only our top students, we might consider allowing "cream skimming." This would allow for specialized learning adapted to the needs of different sorts of students. On the other hand, it may obviously undermine the values embodied in the "citizenship" model of education.

Extra billing seems to guarantee a high quality education to those who can pay for it, rather than to those who can most benefit from it, which may not maximize social welfare. Further, allowing those with greater resources to purchase the best educational opportunities undermines our equity concerns. It does, however, preserve the autonomy of those who have the resources and are willing to pay for a better education. Moreover, prohibiting extra billing suppresses the price system as both a signal and a reward for differential quality.

This issue is likely to prove most problematic with respect to the question of whether to permit vouchers to be used as a credit towards tuition fees charged by purely private schools. One problem with this situation is that it might dilute the quality of publicly financed education by spreading the present public education budget more thinly across a larger cohort of students. In addition, allowing vouchers to count as a credit towards private school tuition fees is regressive and may exacerbate inequalities in access to educational opportunities. While less wealthy families may now be able to afford educational opportunities formerly beyond their means, perhaps public resources should be devoted to equalizing educational opportunities for all families. It may be possible to design educational vouchers in the form of a refundable tax credit that phases out above a particular income level, but this would mean that wealthier families who are content to send their children to schools that do not extra-bill would also be denied any benefit from the voucher. This would amount to means testing all voucher recipients, potentially creating additional incentives for wealthier families to opt out of the publicly financed school system altogether. As a result, some of the values

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<sup>23</sup> See Taryn Rounds Parry, *Will Pursuit of Higher Quality Sacrifice Equal Opportunity in Education? An Analysis of the Voucher System in Santiago*, 77 Soc. Sci. Q. 821, 828 (1996) (noting that in an educational choice experiment administrators tried to "deter the wrong type of students from attending their schools").

<sup>24</sup> Since most educational institutions are, in fact, likely to be non-profit institutions, their incentive structure will be more difficult to predict than this model would suggest.

embodied in the citizenship model of education will be undermined. Also the effectiveness of political voice in maintaining the value of voucher entitlements will be attenuated. One solution to these problems is to require all schools to make a discontinuous election into or out of the voucher system. All schools that opt in would accept a no extra-billing constraint, in effect a one hundred percent tax on the voucher for parents electing this option.

Even if we do not allow extra billing, one might still allow individuals to pay for an education more to their liking entirely at their own cost (as we do at present with purely private schools). If we do this, the citizenship model of education will be compromised to some extent. However, if we ensure that these individuals continue to pay their fair share of the cost of the publicly-financed system, it does not undermine our ability to provide quality education to the rest of society. Perhaps most importantly, we should keep in mind that this is always, *de facto*, an option for those with sufficient means - one can always go to a jurisdiction where private education is available.

The extra billing and opt-out issues cast into sharp relief the tension between efficiency and equity. Obviously, both provide greater diversity of supply and hence expanded consumer choices. It is also possible that the superior quality of education that they may facilitate will have demonstration effects that translate into political voice by those in the basic voucher system to enhance the value of the voucher. Alternatively, allowing partial or complete opt-out from the basic voucher system may promote efficiency, but may also attenuate political voice in maintaining the value of voucher entitlements and, hence, compromise equity considerations. Wealthier families may prefer lower taxes, lower value basic vouchers and greater ability to pay "top-up" payments for superior educational services. The determinants of these "tipping points" are far from clear.

In summary, the introduction of school vouchers does not create a perfect congruence of equity and efficiency and a simple and limited role for the state. Perhaps better trade-offs can be achieved than the current public education system provides, but these trade-offs will be a function of how the critical design issues identified above are resolved. Thus, school vouchers *may be* a good idea, but they are not unambiguously so.

## II. OTHER APPLICATIONS OF THE VOUCHER CONCEPT

We briefly identify here other actual or potential applications of the voucher concept in the social services field. We elaborate on these applications in a longer study in which we are currently engaged.<sup>25</sup>

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<sup>25</sup> See Michael Trebilcock, et. al., *Government By Voucher* (1999) (unpublished manuscript, on file with the University of Toronto Law School) (applying the voucher concept to education, labor market training, day care, health care, legal aid, long-term care, pensions, food stamps and low income housing).

### A. *Post-Secondary Education*

There are two broad types of ways in which governments now provide vouchers to students at post-secondary institutions. The first way of providing *de facto* vouchers to students is by providing direct funding to public post-secondary institutions based on enrollment. Since education providers know that all students come with a certain per capita government subsidy, they will charge students less in tuition fees as their cost curves, and the industry supply curve, shift down. The second way of providing vouchers is to provide subsidized loans or grants, often means-tested, directly to students to be used toward the payment of their education-related expenses. Debates in this context relate less to the possibility of instituting a voucher system and more to refining the existing voucher scheme.

In any analysis of the role of a voucher system in post-secondary education, it is important to recognize the considerable diversity among post-secondary education programs. At most universities, there are graduate and professional programs in addition to undergraduate arts and science programs. In addition, there is also an extensive network of community and vocational colleges, both public and private, providing different forms of education. Each sort of post-secondary program has its own particular set of goals. Nevertheless, the conceptual distinction between “citizenship” and “skills” drawn in our earlier discussion also seems relevant to the post-secondary sector. While we would exclude skills-related programs from a universal voucher system, there may be good reason to subsidize generally those programs that could be characterized as promoting citizenship values. Generally, these are undergraduate, non-professional and non-vocational degree programs. With respect to skills-oriented or professional programs, given the difficulties that individuals without private means often have in borrowing against the collateral of prospective human capital, distributive justice concerns can be largely addressed through generous, government-sponsored, income contingent loan programs, in effect, equity investments in students, that calibrate repayment obligations to *ex post* realized income.<sup>26</sup> One design issue that such schemes must address is potential moral hazard problems due to reduced incentives to maximize post-graduation incomes.

In many jurisdictions that are dominated by public post-secondary institutions, new entry into post-secondary education is currently more difficult than new entry into the primary/secondary system. This seems difficult to justify. The same dynamic efficiency considerations militate in both cases in favor of greater ease of entry and the standard reasons against allowing new suppliers (paternalistic concerns for ill-informed consumers, collective action problems surrounding public goods, and communitarian considerations in favor of a common curriculum) all have much less force in the post-secondary context than in the primary/secondary context. However, ease of entry raises

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<sup>26</sup> See FRIEDMAN, *supra* note 13, at 87 (advancing the proposition that educational loan programs should be based on realized income).

quality assurance issues.

Generally, there are three methods of quality assurance available: (1) *Ex ante* government accreditation; (2) mandatory standardized testing of students; and (3) voluntary or mandatory disclosure of basic facts about the institutions such as attrition rates and employment placement rates. In the post-secondary context, the first two options are much less attractive than the third. This is because consumers at the post-secondary level are, for the most part, well-informed in making their choice of academic institution. Therefore, paternalistic measures such as accreditation are much less important. Furthermore, since a standard curriculum is impossible at the post-secondary level, standardized testing is impracticable. The third option of broad dissemination of information about programs, however, is already partly in place and arguably could be standardized and made mandatory.

Although cream-skimming is often condemned in the delivery of many types of public service, it is fundamental to post-secondary education. That is, even in countries where post-secondary education is fully publicly funded, admission to the best schools or programs is by high academic achievement only. Although there may be communitarian and distributive justice considerations that favor equal access to all universities, these are greatly outweighed by the efficiency and social benefits of maintaining institutions with high academic standards. Compared to primary and secondary education, the importance of academic achievement is much greater at the post-secondary level. Moreover, at the post-secondary level, students have typically revealed differential capacities which the system should respond to and reward.

Extra billing, although it compromises the distributive justice and communitarian considerations that gave rise to public subsidies in the first place, plays an important part in maintaining efficiency in the post-secondary education market. That is, allowing the quality-signalling and incentive properties of differential pricing promotes greater allocative and dynamic efficiency, the separation of strong from weak suppliers, and the allocation of resources to areas that are in greatest demand. In the primary/secondary education context, where income-contingent loans are not a feasible option and where equality of initial educational opportunities looms large as a policy of objective, as noted above we would be less receptive to extra-billing, although recognizing the trade-offs involved.

#### B. *Job Training Programs*

Job training programs are often advocated as a response for those suffering the consequences of unemployment. Citizenship values have a more limited role in job training programs than in primary/secondary education, and in some forms of post-secondary education, given the overwhelming vocational objective of such programs and the high fraction of internal benefits captured by participants. However, unemployment entails various negative social externalities and thus creates a significant public stake in ameliorative measures. Distributive justice considerations are also likely to justify some

form of public intervention. This is especially true for the long-term structurally unemployed, who almost by definition are likely to lack the private means to finance their own job training programs, and who are likely to face difficulties borrowing against the collateral of prospective human capital.

Job training programs in most Organisation for Economic Co-operation and Development ("OECD") countries have produced mixed results.<sup>27</sup> While government funded job search assistance is often cost-effective, more expensive forms of classroom and on-the-job training often yield very poor cost-benefit ratios. Classroom training programs often entail government agencies assigning displaced workers to designated classroom programs, while on-the-job training typically entails wage subsidies to employers in designated industries who hire unemployed or displaced workers. Often classroom training programs are poorly targeted to labor force needs, and are too short-term to provide workers with a significantly enhanced set of job skills. Alternatively, on-the-job training programs are poorly targeted to long-term labor market needs. They also entail a significant moral hazard problem because employers may simply hire workers at subsidized wages whom they would have hired anyway at market wages and ignore training commitments.

It is possible to imagine a role for a voucher system where all unemployed or displaced workers receive a voucher enabling them to purchase job search or placement assistance. For the short-term unemployed, the value of the voucher would equivalent to the government's avoidable cost of providing the service itself. For the long-term unemployed, a fixed value voucher that workers can allocate to either classroom or on-the-job training, or some combination of the two, may be appropriate. In order to create incentives for prudent allocation of the vouchers to job training options, recipients should not be entitled to unemployment benefits after completion of a program without a substantial period of re-qualifying employment. Long-term remedial education has generally not been assigned a high priority in many OECD countries' job training programs, despite evidence of high levels of illiteracy and low levels of basic education amongst the long-term structurally unemployed. In this context, some form of income-contingent loan program may be responsive both to distributive justice concerns and the inability of individuals without private means to borrow against the collateral of prospective human capital.

### C. *Child Care*

Much child care literature tends to focus on two major benefits from government funding of child care: increased participation and productivity of parents (usually mothers) in the paid labor force, and increased productivity and well-being of children raised in effective child care environments. Both of

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<sup>27</sup> See e.g., ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, THE OECD JOBS STRATEGY, ENHANCING THE EFFECTIVENESS OF ACTIVE LABOUR MARKET POLICIES 9 (1996) (reporting statistical data of the success of job training programs in OCED countries).

these considerations suggest that there is a significant public good aspect to child care.<sup>28</sup> There is, of course, a significant private good aspect of child care as well: parents with children in child care can increase their private earning capacity as a result of their reduced child care responsibilities.

Child care in Canada and the U.S. is a largely unregulated, highly diverse market. Child care funding is the result of a patchwork of government programs and a large amount of private spending by individuals. The types of child care programs are widely divergent, ranging from highly informal arrangements with family members, neighbors and nannies to formal child care facilities. One conception of child care is that it is a form of "protective custody" for pre-school children with working parents. An alternative conception of child care is that it is a form of early childhood education and development. Proponents of the latter view make a strong case for targeting government financial assistance at formal, regulated child care centers committed to the goal of early childhood education. Currently, many poor families simply cannot afford this form of child care and are remitted to less formal arrangements that provide minimal commitment to early childhood development. It is possible to imagine a voucher system that is targeted to accredited child care programs committed to an early childhood development objective that is similar to a voucher system targeted to primary/secondary schools.

#### D. *Health Care*<sup>29</sup>

The voucher concept has large potential for application to the health care field. Universal fee-for-service, single payer health care systems such as in place in Canada, entail an unlimited voucher for individual citizens requiring necessary primary or secondary medical services. While such systems tend to meet distributive justice goals reasonably well, they create perverse moral hazard incentives on both the supply-side and the demand-side of the market. On the demand-side, consumers of medical services have no incentive to weigh the marginal benefits of a particular medical service against its costs. On the supply-side, physicians compensated by the state on a fee-for-service basis are similarly insensitive to the relative costs and benefits of prescribed or recommended services, and have a positive incentive to maximize the volume and frequency of services provided.

An alternative conception of health care provision entails a form of managed

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<sup>28</sup> See Martha Friendly, *What is the Public Interest in Child Care?*, 18 POL'Y OPTIONS 3, 6 (1997) (arguing that there is a strong public policy inherent in public-funding child care); Michael Krachinsky & Gordon Cleveland, *Rethinking the Rationales for Public Funding of Child Care*, 8 POL'Y OPTIONS 16, 16-18 (1997) (identifying reasons for the public funding of child care).

<sup>29</sup> For a recent review of various health care models, see CAROLYN HUGHES TUOHY, *ACCIDENTAL LOGICS: THE DYNAMICS OF CHANGE IN THE HEALTH CARE ARENA IN THE UNITED STATES, BRITAIN AND CANADA* 127-203 (1999).



competition amongst competing health care plans or insurers. Under this conception, employers are mandated to underwrite all or most of the costs of employees and their dependents joining a plan of their choosing that covers a prescribed set of basic health care services. Alternatively, the state could directly provide citizens with a voucher designed to cover the costs of joining a basic health plan. One significant complication that would need to be addressed is whether vouchers need to be risk-adjusted to reflect the differential health status of individual members of the community. Otherwise considerable problems of cream-skimming by health plan providers are likely. Another significant design issue is whether citizens should be entitled to use the voucher as a down payment on higher quality, more expensive basic health services, and pay the difference out of their own pockets (a form of extra-billing). We are skeptical of the wisdom of permitting this in terms of distributive justice values. There is a persuasive case for allowing private markets for non-essential medical services and allowing individuals to opt-out of the voucher system altogether for essential medical services, entailing in effect a one hundred percent tax-back rate on the value of the voucher. The limited ability of wealthy members of the population to purchase superior basic health care services is likely to enhance the effectiveness of political voice in maintaining the value and efficacy of the basic voucher system.

#### E. *Legal Aid*

One approach to the normative case for government provision or financing of legal aid is grounded in the rule of law itself. The rule of law for the provision of legal aid is based on a minimal set of normative assumptions and appeals to the Hobbesian notion of the publicity of laws required for the rule of law itself. This view begins from the premise that the rule of law requires that all those subject to the law be able to learn its content. This does not require that the state must ensure that everyone *in fact* is made aware of all laws to which they are subject. Rather, it simply requires that those who are actively engaged in a proceeding or transaction that implicates a particular body of law, whether criminal, family or otherwise, should be entitled to understand the full import of that law as it relates to them. If they are unable to do so themselves, because of their own intellectual limitations or because of the inherent complexity of the law itself, then the state should ensure that they are represented by someone with requisite expertise when they lack the resources to acquire it themselves.<sup>30</sup>

Currently legal aid delivery and financing systems vary widely from one jurisdiction to another. For example, in Ontario, private lawyers provide the majority of legal aid services. Qualifying individuals requiring legal services seek out representation in roughly the same way a paying client would find

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<sup>30</sup> See *Report of the Ontario Legal Aid Review: A Blueprint for Publicly Funded Legal Services*, ONT. LEGAL AID REV. 137-44 (1997) (setting out "a revised and reinvigorated approach to the delivery of legal aid services" in Ontario).

representation; the client engages the services of a practicing lawyer. However, the client qualifying for legal aid pays for the lawyer's services with a certificate or voucher. The certificate or voucher is issued by the legal aid plan administrator and is financed from tax revenues. This is known as the *judicare* model. The advantages of this model are not inconsiderable. First, because clients choose their lawyers in much the same way that paying clients do, it provides them both with a degree of choice and a degree of dignity. Second, its incentive structure is correct in principle because the same individuals who receive the service choose their provider.

The main alternative to the *judicare* model is the staff office or community legal clinic model. Under this approach, the legal aid plan hires salaried lawyers directly or indirectly through grants to community legal clinics and allocates their services to those in need. The advantages of this model are also significant. First, the model may benefit from economies of scale and specialization because a large number of legal aid cases are very similar to one another. Therefore, it is most efficient to ensure that particular lawyers specialize in particular areas of the law. Economies of scale and specialization may also permit more efficient utilization of para-legal personnel. Second, under the community clinic model, lawyers employed in clinics may be more sensitive to the particular needs of a certain class of client. Clinics oriented toward the African-American or Native populations, for example, arose in reaction to a legal profession that is largely ignorant of the special needs of such clients. Third, this model might have better information properties than the *judicare* model because individuals may find it easier to choose between clinics or staff offices rather than between the vast array of individual legal aid lawyers. Finally, clinics may be able to plan their caseloads better to take on test cases with systemic implications even if the stakes for a particular client are small.

While both systems present advantages, each has its own problems. Under a *judicare* system, without significant constraints on the value of a voucher, lawyers and clients have congruent incentives to run up bills at taxpayers' expense. On the other hand, lump sum vouchers or capped vouchers create incentives for lawyers to plead clients guilty or settle cases early, even when the merits of the case require otherwise. Under the clinic or staff office model, lawyers are remunerated primarily on the basis of salary, so financial incentives are not tied closely to quantity or quality of output and truncated career ladders often make it difficult to attract and retain senior and more experienced lawyers.

#### F. *Low-Income Housing*

Many developed countries in the post-war era committed themselves to large-scale public housing projects for low income citizens. More recently there has been a trend toward supply-side subsidies to for-profit, non-profit, or co-operative providers of low-cost accommodation. Under a voucher concept, the state would abandon any role on the supply-side of the housing market and

simply provide rent vouchers to qualifying citizens for private market rental accommodation. One concern with this approach is that given likely supply-side lags in increasing the availability of low-income housing, suppliers may well appropriate most of the value of the vouchers through rent increases. Thus, low-income tenants will be deprived of most of the value of the voucher.

#### G. *Privatizing Public Pensions*

Recently, in the U.S. and many other countries, there have been extensive debates over moving from a defined benefit, publicly-provided pension scheme to mandatory defined contribution private pension schemes. Under these pension schemes, employers, employees and self-employed workers are required to contribute to accredited or approved competing private pension funds (in effect, largely self-funded vouchers). Proponents of moving to a private pension scheme argue that these schemes substantially out-perform public pension schemes in terms of returns on investment. In addition, proponents argue that private pension schemes avoid serious problems of inter-generational equity entailed in Pay-As-You-Go public pension systems. In a Pay-As-You-Go scheme, a declining proportion of younger workers are required not only to fund their own pension entitlements but those of an increasing percentage of retired workers.

There are a number of problems that these kinds of reforms must address. One problem is the transition burden faced by current workers in funding both their own private pension contributions as well as the public pension entitlements of currently retired workers. Another is the problem of providing some form of pension entitlement to individuals who have not substantially participated in the external workforce.

#### H. *Long-Term Care for the Elderly and Disabled*

With a growing aging population, many countries are beginning to address the long-term care needs of the elderly, as well as the needs of the mentally and physically disabled, recognizing that providing high cost intensive care in hospitals is often inefficient, and that providing in-home care to the elderly is more respectful of their individual autonomy. However, many elderly lack the resources to purchase the broad spectrum of in-home services that may be required in order to sustain themselves. Thus, distributive justice considerations may argue for some form of state assistance, perhaps means-tested, although means-testing will create perverse incentives to over-utilize universally accessible health care substitutes. The voucher concept would permit the elderly, or in some cases family or other members acting on their behalf, to purchase required services from private suppliers. Amongst a number of difficult design issues raised by the voucher concept in this context are: first, how to determine the value of the voucher, given the widely varying needs of the elderly; and second, how to determine who qualifies as a supplier, given that many of these in-home services are presently provided free or at nominal cost by relatives, friends and neighbors and substantial program costs

are likely to be entailed in compensating these informal care givers (although it will be argued that it is unfair to expect such care givers—often women—to continue to provide these services without compensation).

#### CONCLUSION

A purely theoretical understanding of the role of vouchers might suggest that it is a panacea for policy makers. The voucher concept appears to resolve the apparently intractable efficiency-equity trade-off because it can combine the demands of distributive justice and efficiency well.<sup>31</sup> The purpose of this essay has been to determine whether such an optimistic claim is warranted. We conclude that voucher systems do not eliminate this trade-off, but generate different trade-offs from other forms of social services provisions.

Once we move beyond mere aphorisms or sloganeering, the detailed design of voucher systems raises technically complex and normatively contentious issues. These design issues are likely to elicit substantially different responses and different efficiency-equity trade-offs from one program to another. Moreover, the claim that invoking the discipline of market-driven exit vouchers offers an escape from the messy and unprincipled compromises of politics and the frailties of voice as a disciplining mechanism is largely an illusion. Under voucher schemes, supply-side interests have strong incentives to lobby for restrictions on entry in order to avoid competitive pressures on job security, wages and benefits, and to argue for unlimited or expansive vouchers. Similarly, demand-side interests will also be conflicted over qualifying suppliers, qualifying consumers, the value of the voucher, extra-billing (add-ons), opt-out, and cream-skimming. All of these issues will require political resolution. Markets never exist in a state of nature but in an endless and uneasy embrace with politics. Under a voucher system it is not clear that “steering” is politically less problematic than “rowing.” While the state would have withdrawn from its role as direct provider, its roles as financier and regulator may attract no less political intensity. The American writer H.L. Mencken once remarked, “For every complex problem, there is a solution which is simple, elegant, . . . and wrong.”<sup>32</sup> Our conclusions as to the prospects for voucher systems attempt to take seriously this cautionary wisdom.

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<sup>31</sup> See OKUN, *supra* note 4, at 48 (identifying the efficiency-equity trade-off and the resulting problems).

<sup>32</sup> Mark A. Hall & John D. Colombo, *The Charitable Status of Non-Profit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 330 n.76 (1991) (quoting H.L. Mencken).