CHALLENGING ISSUES IN LOCAL PRIVATIZATION

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ABSTRACT

Local government privatization has not delivered as expected on cost savings. Using empirical studies from North America and Europe, we show that local governments are pragmatic managers who must manage costs, markets and political interests simultaneously. Using a theoretical framework of actors, interests and incentives, we explain the lack of cost savings and demonstrate the importance of alternative management approaches. We argue analyses of local government contracting must address the dynamics of market management and do so in a comprehensive framework that includes both public and private actors and interests.

1. Introduction

Analysis of local privatization is giving increasing relevance to the insights provided by transaction costs and industrial organization theories. These theories point to the importance of a sector's market structure and incentives as the key factors explaining differences between sectors and dynamics within sectors. By focusing on incentives we see how contracting creates pressure on managers to benchmark costs and production practices with private actors. It also encourages managers to consider other innovations that could increase efficiency. These include mixed public and private production which is growing in the US (Warner and Hefetz 2007), and inter-municipal cooperation to gain economies of scale (Bel and Costas 2006, Warner and Hefetz 2003). Local privatization is not ideological; it has been shown to be primarily pragmatic, as local governments must manage political interests in both the market and policy arenas (Hefetz and Warner 2004, 2007, Bel and Miralles 2003, Bel and Fageda 2007, Warner and Hebdon 2001).

In this article we present evidence on lack of cost savings with privatization and show the importance of managing markets, policy and political interests to ensure benefits from privatization. We draw on our own work and that of papers presented by members of the Scientific Committee at the Barcelona International Workshop on *Local government reform: Privatization and public-private collaboration*, which we organized in June 2006 at the University of Barcelona, Spain. We give critical attention to the challenges of managing costs, structuring the market and managing political interests. We argue the debate on local government reform is moving beyond the "either/or" dichotomy of public or private and now must focus on synergy between the public and private sectors. The challenges of a dynamic market management approach are the focus on this special issue.

2. Local Privatization and Costs

A primary goal of local government privatization is cost reduction. Early surveys of the literature (Domberger and Rimmer 1994, and Domberger and Jensen 1997) concluded that privatization was linked to cost savings. However, meta-analyses including more recent studies, such as Boyne (1998) and Hodge (2000) emphasized the evidence is mixed and no systematic relation between private production of public services and costs savings can be proven. More recent studies are less likely to find cost savings with privatization. In Bel and Warner (2006) we review all econometric studies of costs for waste collection and efficiency/productivity for water distribution from 1965 to the present and find the majority of studies find no difference in costs and efficiency/productivity between public and private production. See Table 1. These two services are the most commonly privatized local government services and the subject of the majority of econometric studies of costs.

Table 1 Privatization and Cost Savings: Meta Analysis of Empirical Studies 1965-2006

	Private Production Cheaper / More efficient	Public Production Cheaper / More efficient	No Cost / Efficiency Difference Between Public or Private Production
Water Distribution	3 studies	4 studies	10 studies
Waste Collection	6 studies	1 studies	11 studies

N = 35 econometric studies of costs in water and waste delivery 1965 – 2006. Full detail on studies reviewed found in Bel and Warner (2006).

Cost savings are more likely to be found in the earlier studies from the 1970s and 1980s. Only two studies find cost savings with privatization in the 1990s (Szymanski 1996 for the UK, and Reeves & Barrow 2000 for Ireland). What accounts for this erosion in cost savings? The answer is simple. Competitive markets for water and waste are uncommon and prone to erosion. Most economic theories arguing for lower costs under privatization base that savings on competition. Public choice theory argues competition would restrict excessive public supply of public services, thus decreasing the cost of delivery (Niskanen, 1971); property rights theory points to stronger incentives for cost reduction under private property (Shleifer, 1998); and industrial organization theory suggests contracting out could take advantage of economies of scale (Donahue, 1989).

The reality is that markets for both water and waste are rarely competitive. In waste collection the only potential competition is *for* the market – for the initial contract. Economies of scale require monopoly production, at least at the neighborhood or municipal scale. In the case of water, due to the nature of a fixed infrastructure of sunk costs (pipe systems), long term concessions are the norm. This creates incomplete contracts. Even when a concession is reopened for bidding, the position of the incumbent is extremely strong given the asset specificity of water service. In extreme cases, such as England and Wales where regional private firms own the infrastructure itself, there are strong barriers to entry, typical of non-contestable markets. Cost savings should not be expected from privatization without competition.

However, even competition *for* the market is facing increasing difficulties. Recent evidence on the changing structure of the solid waste management sector shows significant consolidation during the 1990s (i.e. Bel and Costas 2006, Dijkgraaf and Gradus 2007). Most municipalities do not face a competitive market of alternative suppliers. Competition *for* the market also erodes due to incumbency – contracts are typically renewed as other providers exit the market. In the US, Hefetz and Warner (2004, 2007) have shown the importance of reverse contracting and the need for local governments to structure the market through direct intervention in order to maintain competition over time. Reductions in service quality and lack of cost savings were the primary reasons for this reverse privatization.

Dijkgraaf and Gradus (2007), in this issue, show the importance of erosion of competition and the challenges of market management as the Dutch government tried to ensure competition and cost savings through new pricing policies. In a dynamic analysis using a standard function of total costs for solid waste collection, they assess the impact of a VAT compensation fund and unit-based-pricing on relative costs of public and private firms. They test their model for 1998-2005 with a sample of 380-450 Dutch municipalities and find private production is on average 10% cheaper than public production but that cost savings erode over time. By 2004 and 2005 no significant differences in costs between private and public production are found and they attribute this to eroding competition. By contrast, unit-based-pricing (UBP) is strongly linked to lower costs whether the system is public or private. UBP is more frequent in municipalities using private production, so not considering UBP in the analysis would bias upwards the cost savings from private production. Dijkgraaf and Gradus' analysis shows that managing the market through efficient pricing (such as UBP) can be more powerful in reducing costs than contracting.

3. The dynamics of service delivery choices

Markets are dynamic and so are local government service delivery decisions. Local government contracting is not a simple decision. It involves a broad array of choices (Warner and Hebdon 2001) and requires a dynamic view of contracting behavior over time. Hefetz and Warner have pioneered work on the dynamics of contracting in the U.S. and found local governments both contract out and reverse contracts in response to market and political considerations (Hefetz and Warner 2004, 2007). This reverse contracting is growing in the US and reflects a pragmatic 'social choice' market management approach (Hefetz and Warner 2007).

We have analyzed differences in reverse privatization between the U.S. and Spain, where reverse privatization is less common (Warner and Bel 2007). Rather than managing competition at the level of the market as in the U.S., Spanish local governments focus at the firm level through publicly owned firms or mixed public-private firms to manage costs. We believe wider flexibility in the use of hybrid organizational forms in Europe may have induced more stability in markets for services where private delivery has an important role (Warner and Bel 2007). For rural and small towns, inter-municipal cooperation has been used as an alternative to privatization to exploit economies of scale (Bel and Costas 2006, Warner and Hefetz 2002, 2003, Warner 2006).

By looking inside the contracting decision at the costs of contract specification, monitoring and the nature of market competition, we can learn how governments choose between public and private delivery alternatives. Brown, Potoski and Van Slyke (2007) build off earlier work on the dynamics of service delivery choices (Hefetz and Warner 2004) and reverse privatization (Warner and Hebdon 2001) to explore why governments shift between alternatives over time. Using measures of the costs of switching (asset specificity and measurability) and the power of inertia (how the service was originally provided) they explore the likelihood of shifting between public delivery, cooperation, for profit or non-profit privatization in the 1992-1997 time period. Although asset specificity was not significant in most of the models, measurability was for joint contracting. The models of joint contracting show a slightly higher likelihood of switching to and from other forms which suggests the costs of switching in and out of joint production are lower. This is confirmed by other work that shows significant growth in mixed delivery modes since 1997 and the importance of managerial learning over the 1992-2002 decade (Warner and Hefetz 2007).

4. Prices and Political Interests

Privatization has long been linked to political and financial interests (Bel 2006a, 2006b). At the local government level we see a pragmatic politics where ideology is of limited importance and management of interest groups is more critical. However, political interests may work in opposite ways than expected. Hebdon and Jallette (2007), present the first ever survey on Canadian municipalities' use of privatization and find it is higher than in the US despite Canada's more communitarian ideology. Miralles (2007) shows how industrial water users in Spain influence cross subsidy policy in their favor under privatization.

Hebdon and Jallette compare 2002-2003 survey data from U.S. and Canadian municipalities to explore differences in local government privatization by region. They expected lower levels of privatization in Canada due to its more coordinated market economy, compared to the liberal market orientation of the United States. While this was true in culture and arts services, it was not true over all. Even at the regional level, they found higher levels of privatization in regions considered to be more opposed to privatization (due to more labor union activity and stronger support for direct government), such as the U.S. Northeast and Ontario in Canada, than among more politically favorable regions in the US south and west and Canadian west. What explains these ironic results? Hebdon and Jallete test four theoretical perspectives: public choice (Tiebout 1956), transactions costs (Williamson 1999), pragmatism (Warner and Hebdon 2001), and social choice[1] (Hefetz and Warner 2007). They determine that pragmatism and social choice provide better explanations because local privatization choices are driven as much by contract costs as by political interest management. They conclude managers are pragmatists who balance citizen voice, political interests, market competition and contract management in a comprehensive social choice framework.

Miralles (2007) analyzes the effect of recent privatization of water services on the difference between the marginal price paid by the average residential and industrial consumer. He builds a simple theoretical model with two types of consumers, industrial and residential, where the local

[1] Hefetz and Warner articulate a 'social choice' theoretical framework which combines markets, governments and deliberation in a comprehensive approach.

regulator solves a maximization problem of a weighted sum of surpluses and profits. Using a sample of 133 Spanish municipalities in Catalonia, he finds a link between recent privatization and a reduction of the regulator's preference for residential consumers. Hence, privatization of water may reduce the cross-subsidization from industrial to residential consumers. These results are consistent with industrial sector lobbying for privatization in recent years. Until now the empirical literature has tested the hypotheses of trade unions and rent-seeking groups of residential consumers negatively influencing privatization,[2] but few have analyzed the influence of industrial sectors on privatization, found to be positive in Miralles' analysis. The challenge of price and interest group management is also shown in the Dijkgraaf and Gradus (2007) paper where government introduced the VAT compensation scheme to make private producers more cost competitive, but instead private firms increased their prices.

5. **Conclusion: Managing Costs, Markets and Interest Groups**

One of the challenges of local privatization has been its failure to deliver lower cost service delivery. Inadequate understanding and management of local government service delivery markets is partly to blame. Lack of competition is common and other forms of market management - mixed public private delivery, mixed public private firms, inter-municipal cooperation, and dynamic contracting (in and out) may achieve better results.

But local government reform is more than a market management process. Competition and price policies must be considered in a framework of political interest groups as well. The debate needs to move beyond ideology and recognize that contracting decisions, at least at the local government level, are primarily pragmatic. Political interests are an expected and legitimate aspect of local government. Understanding how these interests affect the privatization process is an important contribution of this special issue.

The debate on local government reform is shifting toward a network management approach which looks at the potential of service delivery in a mixed market/public delivery framework. But in these networked systems, we must carefully assess manageability, transparency and accountability (Salamon 2002). Concerns over cost savings, must be balanced with concerns about managing interest groups and citizen voice. Local governments' mission is not merely cost reduction; but to achieve cost savings it must manage markets, contracts and political interests. Indeed, the challenge of privatization is it does not deliver adequately on all three dimensions and for this reason we are seeing a 'reform of the reform' toward a more comprehensive, balanced approach.

[2] Bel and Fageda (2007) provide an extensive review of these works.

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