Local Government Reform: Privatization and Its Alternatives

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Abstract
Privatization is only one of several alternatives for local government reform. Problems with lack of cost savings and the challenges of contract management have led local government reformers to explore other alternatives including municipal corporations, relational contracting and dynamic market management. Empirical analysis shows concerns with fiscal stress, efficiency, and managing political and citizen interests drive the reform process more than ideology. We argue a more comprehensive framework is needed that gives attention to a wider array of alternatives for institutional reform.

1. Introduction

Privatization has been an important aspect of local government reform for several decades. The papers in this special issue explore what factors cause local governments in North America and Europe to privatize or not, and what other institutional reforms they explore as alternatives. The challenge facing local governments is one of institutional reform; but privatization is by no means a panacea. The papers in this special issue[1] challenge traditional understandings about the factors leading to privatization, the role of ideology and interest groups, and present alternative approaches to institutional reform. We emphasize the role of local government as an actor in both the political and economic marketplace. Privatization does not allow local governments to contract out and walk away. Rather, it requires governments assume a critical market management role. We argue local government reform is more than a simple market management process; it requires the capacity to manage political interests and citizen concerns as well. Alternatives to privatization are becoming more common because they better enable local governments to manage both political and market concerns. We argue a more comprehensive theoretical framework that incorporates both political and economic management is needed. Such a pragmatic framework offers a means to get beyond the dichotomy of government or market and address the benefits of a combined approach.

2. Why Privatize: Ideology or Political Interests?

[1] These papers were presented in the Barcelona International Workshop on *Local government reform: Privatization and public-private collaboration*, held on 12/13 June 2006 at the University of Barcelona, Spain. The workshop gathered scholars from the fields of economics, public policy and public administration, political science, and business and management. Overall, 23 papers from 11 different countries were presented. The six full articles included in this special issue were selected because of their quality and the relevance of the contributions they make.

Wide consensus on the efficacy of public intervention in the economy began to break down in the 1960s and an increasing number of scholars in Economics, Public Policy and Public Administration endorsed market based service delivery, particularly privatization (contracting out), as a means to reduce costs, increase efficiency, and enhance citizen voice (Tiebout, 1956; Niskanen, 1971; Hood, 1991). Early empirical studies suggested the potential for cost savings under privatization (Domberger & Rimmer, 1994; Domberger & Jensen, 1997) and led to the expectation that privatization would rapidly extend to an increasing number of local governments. Margaret Thatcher's government promoted competitive tendering throughout the 1980s and compulsory competitive tendering was required of local governments in the UK after 1988 (Stoker, 1997). However, in both Canada and the U.S., despite strong support of market ideology, direct public provision has remained the primary form of local government service delivery (Hebdon & Jalette, 2007; Warner & Hefetz, 2007). This raises an apparent paradox: Why were so many governments reluctant to reap the benefits of cost reductions through privatization when the earliest evidence indicated that privatization saved money? Early analyses on the factors leading to local privatization focused on this paradox and presented ideology as the major constraint to increased privatization (McGuire, Ohsfeldt & Van Cott, 1987; Savas, 1987).

The meta analysis by Bel & Fageda in this issue extensively reviews the multivariate empirical literature (28 studies from 6 countries) on the factors explaining local privatization. They analyze the four most common hypotheses tested in the literature to explain local privatization. These are: 1) Fiscal constraints should lead to more privatization; 2) Cost reduction may be an important objective when choosing private production, either through competition or by the exploitation of scale economies. 3) The relative strength of different interest groups, such as unions or industrial business, should influence local government privatization decisions. 4) Left-wing governments will be more reluctant to privatize local services, while right-wing governments will be more inclined to do so.

Bel & Fageda group study variables into four categories to test these relationships: (1) fiscal restrictions, (2) economic efficiency, (3) political process and (4) ideology. They find fiscal stress and interest group pressures are especially influential on local services privatization in early studies devoted to the U.S. that consider a broad range of services. Fiscal stress refers primarily to legal limitations on local tax levels, and this is uncommon outside the U.S. Political factors related to interest groups are also influential, particularly for governments in small towns. The impact of cost considerations is particularly relevant when the exploitation of scale economies is taken together with the transaction costs associated with privatization choices. However, the ideological attitudes of policy-makers do not seem to influence the service delivery choices of local governments in a systematic way. Thus, they conclude, local government decisions appear to be more pragmatic than ideological.

Fitch's work (2007), explores the influence of local interest groups relative to national political ideology using a comparative study of water privatization in France and Germany. Her work explains an important paradox, why local water delivery is 75 percent private in France where political ideology is pro-state, whereas in corporatist Germany, privatization is only 18 percent. She argues the strong central state encourages privatization in France because it implies weak municipalities and weak civil society. By contrast, in Germany, the central state is relatively weaker and municipalities are politically and financially more autonomous. Here local leaders are less likely to promote water privatization, and if specific financial or political reasons incline them to do so, the strength of civil society and opposition groups is likely to prevent or modify the privatization reform. Fitch (2007) recognizes financial motivations as one of the strongest grounds for water privatization. But financial pressures are complemented with the political interests of parties involved in privatizing. The "economic and political strength of local municipalities brings on the start of a privatization process, but the voice of opposition groups, unions and NGOs determines its outcome." She concludes privatization is most likely in financially weak municipalities with weak opposition groups.

Attention to political interests, both citizen and business groups, is a critical component of government managerial reform. These interests determine how government policies and privatization schemes work out in practice (Miralles, 2007; Hirsch & Osborne, 2000). While empirical research shows ideology per se, is not a significant factor in the privatization decision (Bel & Fageda, 2007), attention to citizen voice and participation is (Warner & Hebdon, 2001; Warner & Hefetz, 2002, 2007). Recent innovations in local government reform point to the importance of giving attention to political engagement (Nalbandian, 1999), and serving the citizen rather than simply steering a market process (Denhardt & Denhardt, 2000). In this issue, we argue local governments are pragmatic and give attention to both market management and political processes.

3. Managing Markets

Early surveys of the literature concluded that privatization of city services was linked to cost savings (Savas 1987, Domberger & Rimmer, 1994; Domberger & Jensen, 1997). However, meta-analyses such as Hirsch (1995), Boyne (1998a, 1998b) and Hodge (2000) find mixed evidence on cost savings and raise both methodological and theoretical concerns about such expectations. In a broader review of studies, including works from Europe and other regions of the world, Bel & Warner (2006) conclude that no direct and systematic relationship can be established between savings or productivity and private production.

What explains the lack of significant differences in cost between public and private production? Understanding market structure is the key. A high degree of market concentration is common in many local services, especially water and waste. Without market management by government, we can expect dynamic degradation of competition. Local governments can use inter-municipal cooperation as an alternative to privatization to exploit scale economies (Warner and Hebdon 2001, Warner and Hefetz 2003, Warner 2006), or they can promote the establishment of public firms to instill competition in the market (Bel & Costas, 2006).

Dijkgraaf & Gradus in this issue (2007) explore the degree of concentration in the market for solid waste collection in the Netherlands, and estimate the effect of concentration on costs. Using a wide sample of Dutch towns and cities, they elaborate indicators of concentration and competition at the regional level. They find solid waste collection by private firms or publicly owned firms does not significantly differ on costs, although both organizational forms are less costly than direct production (bureaucracy) by the municipalities. However, the solid waste sector exhibits significant market concentration that is associated with higher total costs and may reflect collusion. Their models show savings with private production are significantly higher when the regional market is competitive. Private firms are more cost-effective when publicly owned firms operate in the same territorial area. The existence of public firms increases competitive pressure and reflects a market structuring role played by the public sector.

Thus, market management by local governments is a critical element to ensure privatization success. Whether government engages directly in the market to enhance competition or achieve economies of scale, or uses its regulatory and oversight authority to track and control costs, the clear message from empirical research is that government must stay in the game as a market manager (Hefetz & Warner, 2007; Warner & Hefetz, 2007; Warner & Bel, 2007; Bel & Costas, 2006; Dijgraaf & Gradus, 2007).

4. Alternative Approaches to Institutional Reform

The above discussion has shown that political interest group management is more important than ideology in explaining local government privatization decisions. The remaining papers in this volume explore other alternatives for public sector reform. Public service delivery involves a complex combination of public and private delivery alternatives (Warner & Hebdon, 2001). Governments can create municipal corporations as a more flexible form of market engagement as described in the Portuguese paper by Tavares & Camões (2007). They can use the market in a dynamic framework (as called for by Bel & Fageda 2007) and contract out and back in as shown by Hefetz & Warner (2007) in the U.S. case. Or they can move beyond the competitive market dynamic and focus on relationship building in a public private network as Brown, Potoski & Van Slyke (2007) show in two U.S. case studies. We look at each of these alternatives in turn.

Tavares & Camões point out that very little privatization has actually occurred at the local government level in Portugal. What they see instead is significant growth in municipal corporations which are single function entities whose revenues derive from user fees (not taxes), and which have independent corporate status (discretion in employment and financial operations, right to own property and be sued). Of 308 local governments in Portugal, 269 have transferred services to municipal corporations since the reform allowing municipal corporations was adopted in 1998.

Tavares & Camões use a transactions costs theoretical framework to understand this transition. While traditional transactions costs models look at the costs of contract specification and monitoring (Williamson, 1999), Tavares & Camões expand this concept to address the challenges of *political transactions costs* as well. In addition to the typical measures of asset specificity and measurability of the service, their probit model of 278 municipalities includes variables on labor force, size of government, fragmentation and ideology. While the literature normally considers asset specificity in its physical dimension, they describe it in terms of human assets (skilled labor pool) and find that services that require an asset specific labor pool are less likely to be transferred. Municipal corporatization is more common in services with user fees, and in fragmented districts with greater service needs. Corporations are most common in recreation, economic development, culture and science, and parks and landscaping services. Political transactions costs are important, but not always as we would expect. They find governments are more likely to transfer services with heterogeneous preferences – thus avoiding the political costs of decision making within government itself.

Hefetz & Warner (2007) look at the dynamics of the privatization decision process in the U.S. Like Tavares & Camões, they argue that transactions costs present only a partial explanation. They present a new theoretical framework - social choice - that combines new public management (Hood, 1991), transactions costs economics (Williamson, 1999), and communicative planning/deliberative democracy concerns (Sager, 2001; Denhardt & Denhardt, 2000; Frug, 1999). They model privatization as a dynamic process and look at both new contracting out and reverse contracting over two time periods 1992-1997 and 1997-2002 using a national sample of U.S. municipalities. New contracting out has fallen over the decade, while reverse contracting has increased substantially and is now 50 percent larger than new contracting out.

What explains this shift away from privatization? Hefetz & Warner's probit models use a social choice theoretical framework that measures market characteristics (transaction costs, fiscal stress and efficiency), management, and political process variables (place characteristics, citizen voice). They find a managerial learning process over the decade where managers reduce new contracting out of asset specific services and bring these services back in house. Rural areas and core metro governments are more likely to experience market failure than suburbs (Warner and Hefetz 2003, Warner 2006), and they show lower rates of new contracting out and higher rates of reverse contracting over the decade. Attention to citizen voice, which was insignificant at the beginning of the decade, is associated with less new contracting and more reverse contracting at the end of the decade. Their models show a dynamic process in which managers pay attention not only to transactions costs, but also to place characteristics, citizen voice and market management. Government managers use a sophisticated market management process that includes new contracting, reverse contracting and mixed public/private delivery. Hefetz & Warner argue it is time to move beyond the either/or dichotomy of public vs private production and look instead at local government contracting as a complex management process which combines managerial, transactions costs and democratic management concerns in a social choice theoretical framework. This complexity is illustrated in the practitioner papers by Termes & Alerm (2007) on waste collection in Barcelona, Spain, and by Rayón Martín (2007) on water privatization and regulation in Latin America.

Another way to address transactions costs is discussed by Brown, Potoski & Van Slyke (2007). They present theoretical arguments and case evidence for relational contracting as a response to the high transactions costs of contracting. Evidence comes from two cases – refuse collection in Ohio and social service provision in New York. The local level for-profit refuse collection case and the state level non-profit social service case make a nice comparative contrast. The cases explore how trust levels vary over time and affect the level of contract completeness. They argue the challenges of performance management lead to a relational contracting position that is more likely to reduce contract risk and create a win-win situation for both government and contractor. They discuss how trust develops over time through repeated contracting experience, reputation, mission alignment, and performance management. But they also show how trust can erode leading to more contract specificity and completeness. Although more specificity may increase control, the loss of flexibility means risk may not be reduced. They argue relational contracting offers the promise of more flexibility and innovation and potentially lower costs and thus is worthy of more study.

5. Conclusion

The papers in this special issue have shown that the debate on local government reform must move from a simple discussion of privatization to a broader discussion of the nature of institutional reform. We have seen that internal reform may offer more promise – whether it is municipal corporations in Portugal, dynamic market management in the U.S., or relational contracting. Each of these approaches requires a critical look at the importance of market structure and the power to control and manage a market network. Mixed public-market approaches maintain more public sector control and structure markets to reduce risks and maximize public gains (Warner & Hefetz, 2007; Warner & Bel, 2007).

The papers in this issue recognize the importance of political factors and political processes in the privatization decision, but they distinguish these from ideology that has less importance (Bel & Fageda, 2007; Fitch, 2007). Local government managers must pay attention to political interests at both the local and national levels (Fitch, 2007), between public and private producers (Dijkgraaf & Gradus, 2007; Brown, Potoski & Van Slyke, 2007), and among citizens (Tavares & Camoes, 2007; Hefetz & Warner, 2007). Political interest groups are a legitimate and expected part of local government. Managing these political interests, in addition to market dynamics and contracting costs requires a more comprehensive theory than the narrow view offered by traditional public administration and economics theories alone. Social choice theory recognizes that local government managers must manage *both* a market and a political process (Hefetz & Warner, 2007). Understanding how local governments pragmatically manage these combined processes is one of the primary contributions of this special issue.

Past literature on privatization has argued for the importance of ideology in explaining privatization levels, but, Bel and Fageda's meta analysis finds limited empirical support for an effect. Political interest group management, by contrast, is quite important. The work by Fitch makes especially clear the importance of a local focus as local interests in both the German and French case studies trump national political ideology.

Tavares & Camões point to the importance of local option in prompting Portuguese municipalities to explore municipal corporations over privatization as an alternative to direct public delivery. Dijkgraaf & Gradus demonstrate the importance of market management to ensure competitiveness and efficiency of refuse collection in Holland. Hefetz & Warner show the increasing importance local managers give to citizen voice and public satisfaction in service delivery, leading to a process of reverse contracting in the U.S.

We need to unpack the dynamics of political interests in public service delivery and look at the relative power and influence of private firms, public citizens, and local government managers in the service delivery choice process. Who controls the market? Who controls the contracting process? Shall we move to a relational contracting process bounded by trust as argued by Brown, Potoski & van Slyke? Or should we worry about collusion and lack of transparency under such close contracting situations as Dijkgraaf & Gradus caution? Whether government engages directly in the market to enhance competition or achieve economies of scale, or uses its regulatory and oversight authority to track and control costs, the clear message from empirical research is that government must stay in the game as a market manager.

Local government is about both service delivery and voice. While cost savings is one goal, transparency and public engagement are equally valued. Our research shows local governments are pragmatic actors who recognize the importance of managing markets, political interests and public participation in the service delivery process.

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