

**LOCAL GOVERNMENTS PUTTING A CONTRACT OUT ON COSTS**

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### 1. Introduction

Contracting out, a special type of privatization, is vociferously praised by some as offering a solution to many of local government's financial ills, whereas others speak about it in most disdainful and depreciating terms. The first group consists mainly of political conservatives, preoccupied with curing an anemic and inefficient economy. The second group is dominated by liberals, particularly labor leaders and minorities, who see employment in the public sector as a work opportunity from which to climb up the social ladder.

This paper is offered in the hope of providing a framework for evaluating the policy positions of the two opposing groups. It is written from the point of view that intellectual inquiry should be an assault on ignorance; its creed is that knowledge is a good thing; and its boast is that progress depends on knowledge.

### 2. Economics of Contracting Out

It is useful to look at permanent and temporary forms of privatization separately. The former entails transfer of rights and obligations in

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perpetuity from government to private firms, i.e., sale of government assets. Temporary privatization transfers rights and obligations for a limited time and mainly takes the form of contracting out or franchising. This paper focuses on contracting out.

In order to provide economic insight into contracting out, we will provide an analytical framework within which a socially efficient decision to privatize can be made. Within this framework, a decision to contract out should depend on expectations regarding such a step's effects on efficiency, quality of output and accountability for it, and distributional consequences. Some of these factors, particularly efficiency and distribution, are affected by the fact that government in-house production does not generate taxes, while private firms do. The basic argument within this framework is that contracting out, as opposed to government in-house production, will have either positive or negative effects on each of the above factors. Summing over these factors will yield an estimate of the net benefit (or cost) of contracting out. In the abstract, as long as the net benefit is expected to be positive, the government should contract out. Conversely, if contracting out is expected to yield a negative net benefit, the service should be produced in the public sector.

However, a socially efficient privatization decision will often not be adopted, because of different, usually inconsistent, objectives and decision rules by the government facing the privatization decision. Local jurisdictions, for example, are likely to be significantly influenced by considerations on whether contracting out is likely to offer them significant tax gains; how special interest groups, especially unionized labor, will be affected; and how externalities will be dealt with.

Within our analytical framework, we can readily explain the reasons why some groups in society strongly advocate contracting out while others are just as strongly opposed to it. Proponents, within our framework, are all too preoccupied with potential cost reductions stemming from contracting out. They appear to equate cost reductions with efficiency increases. The two are not necessarily the same, however, since cost reductions can be the result, for example, of exploitation of labor or reduced union monopoly power. The first source could be looked upon as socially undesirable, whereas the second can be socially desirable.

When comparing costs of public and private firms, a complicating factor needs to be considered. It relates to the issue of competition, which can be more important than privatization. As Borchering, et al., have observed, "...it is not so much the difference in the transferability of ownership but the lack of competition which leads to the often observed less efficient production in public firms".<sup>1</sup> John Kay and Mathew Bishop go even further. They urge that, "...in any future privatization..., the government will see the symbol of privatization as just that, and reassert promotion of competition over the transference of ownership."<sup>2</sup>

Moreover, proponents often make the additional mistake of citing savings due to contracting out which cover only those instances in which it has in fact been carried out. Clearly we would expect contracts that are entered into to provide the privatizing government with lower costs than

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<sup>1</sup>Thomas E. Borchering, "Comparing the Efficiency of Private and Public Production: The Evidence from Five Countries," Zeitschrift für National Ökonomie, (Supplement 1982), p. 10.

<sup>2</sup>John Kay and Mathew Bishop, Privatization: The UK Experience, Colloquium: Privatization in the European Community, Maastricht, Holland, 10-11 December 1987, p. 42.

they would incur under in-house production. Otherwise, contracting out would not occur. In short, common sense would lead us to expect lower costs for services that were in fact privatized. Crucial questions remain: what percent of services were contracted out at these savings, were quality standards maintained, and did an undesirable redistribution occur?

The opponents of contracting out are especially deeply concerned about its accountability, as well as distributive effects. Accountability means that those who are entrusted to provide highly valued goods and services effectively and dependably, at agreed upon quality standards, are held responsible for the satisfactory discharge of their duty. There are two aspects of accountability. The first is whether the output of the good is acceptable. For example, is the garbage collection quality adequate, are the trees trimmed correctly, etc. The more easily quantifiable is the output, the easier it is to determine whether the provision is acceptable. While this holds true for both public and private producers, it is especially important for private production since it greatly simplifies the contracting process between government and private firms.

Related to the acceptability of product or service quality is the desirability of timely, uninterrupted supply. For certain goods, most notably police and fire protection, uninterrupted supply is extremely important, if not crucial. For example, the supply of labor is a case in point. Labor laws protect the worker through the right to strike. Legally, it may be easier for public sector workers and management to arrive at contractual arrangements that give up the right to strike in exchange for a different means of settling disputes, e.g., binding arbitration. Therefore, those goods and services for which an uninterrupted supply is most important should be publicly provided, ceteris paribus, based on this aspect of

accountability.

The second issue of accountability concerns the actual production processes of specific goods and services. Though it is often difficult to distinguish between inputs and outputs in the production of certain goods and services, in some cases the nature of the production itself is exceedingly important. Police protection constitutes a prime example. It is imperative that individuals hired to uphold the law operate within the boundaries of the constitution. The police must be immediately accountable to the citizenry at all times. There have been instances of police brutality and prejudicial behavior on the part of the police. In these cases, the government is placed on the firing line directly and expeditious and credible action often follows. In addition, citizens might find it extremely undesirable if a privately held corporation were to make decisions about people's personal protection, e.g., incarceration. Real and perceived conflicts of interest are often unavoidable.

Accountability in the past has played, and indeed should play a leading role in identifying public services to be considered for contracting out. Services for which accountability is very important and yet very costly to implement, are poor candidates for contracts. Activities of legislatures, judges, and planners are examples of services which, if contracted out, would be unlikely to assure society the expected accountability.

The distributive effects of contracting out are of two types, i.e., of services and of factor payments. If government specifies output precisely so that output distribution is similar in public and private production, the focus can be on how contracting out affects employment and tax burden distribution.

Rules and regulations governing employment in the public sector tend to be more prevalent and rigid than those in the private sector, and are more likely to be enforced. For example, residency requirements and racial, ethnic or gender quotas are more common in the public sector, where they are easier to monitor, and where enforcement tends to be more rigorous. Consequently, if an important objective of government is to further the economic wellbeing of specific groups of people (or in the same vein to reward loyal voters), public production is a more direct and easily monitored and enforced arrangement.

Clearly, also, tax receipts are affected by the decision to contract out. In a simple closed economy, government could redistribute resources through income or other taxes. However, under our very complex system of federalism, three distributive aspects of privatization play an important role. First is how much of the taxes paid by the private firm are passed on to the constituents based upon an increase in taxes and fees. The incidence of taxation has important ramifications on the distribution of revenues. If demand is very inelastic relative to supply (as is very likely for police and fire protection), then most taxes paid by private firms will actually be borne by constituents. This also holds true if a profit level is specified to firms, which appears to be the case in many contracting out situations. Conversely, if demand is elastic relative to supply, then the firms will bear most of the burden of the taxes.

The second aspect relates to the distribution of the taxes paid among various levels of government, and how that money is subsequently spent. This pattern depends upon the respective tax rates and expenditure policies of the different branches of government. There is evidence that federal taxes paid by specific firms as part of their costs of doing business for

local governments are a substantial percentage of operating costs. For profitable firms the percentage of taxes normally ranges from the lower to the upper teens. Federal taxes, however, are only a portion, though often a major portion, of the tax liabilities these companies incur as a result of carrying out business for local governments; both state and local taxes are also owed. Consequently, these figures constitute a lower bound which undoubtedly understates the tax burden as a proportion of operating costs.

The fact that the federal government and state governments, to a lesser extent, receive a substantial amount of money when government production is privatized has major implications on income distribution. Contracting out clearly enhances federal government tax revenues. Parts of any operating cost savings resulting from contracting out do not benefit the citizens in the locality, since private firms must pay state and federal taxes. The federal tax structure and, to a lesser extent, that of most states is progressive, and therefore results in significant income redistribution.

A third aspect is the share of ownership in the private firm held by residents of the community. Individuals with ownership interest profit by carrying out the business, thereby increasing the wellbeing of specific citizens. Concurrently, some portion of any taxes they bear will be returned to the locality. As the proportion of local ownership in the private firm grows, persons in the community benefit more from their firms receiving the work; but the tax payments increasingly become a transfer from some persons in the community to the community as a whole.

With the aid of our analytical framework, it is also possible to provide an explanation why contracting out, in spite of so many speeches in



its favor, has not significantly taken hold in the 1980s.<sup>3</sup> Reasons for the limited extent of contracting out can again be deduced from our economic framework. In addition to strong opposition coming from organized labor, accountability problems greatly limit the number of services that are candidates for privatization. Moreover, defining and measuring service outputs, when not impossible, is often so difficult that true estimates of performance and efficiency are unobtainable. Finally, concern with distributional implications of denying disadvantaged groups opportunities for public employment is not readily dismissed.

### 3. Status of Contracting Out in the Northwest

We next turn to ask what services have been contracted out by municipal and county governments of the Northwest, i.e., Washington, Oregon and Idaho. In an attempt to obtain information about this issue, we mailed questionnaires in late 1990 to all municipalities with populations in excess of 25,000 in Washington and Oregon and all counties with populations in excess of 50,000 in all 3 states as well as two special districts in Oregon. Specifically, questionnaires were mailed to a total of 52 local governments in the states of Washington, Oregon and Idaho of which 30 or 58% sent in completed replies (see Table 1).<sup>4</sup>

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<sup>3</sup>The fact that contracting has not been an important factor in the life of local governments during the 1980s is well illustrated by this example -- the largest United States county with a board of supervisors totally committed to privatization for more than nine years, i.e., Los Angeles county, in 1987-88 contracted out a mere 1.5% of its budget and gained savings of merely 0.5% therefrom. (Communication from C. Goodman of the Chief Administrative Office of Los Angeles County to the author, April 4, 1989.)

<sup>4</sup>5 Washington cities (45%) and 7 Oregon cities (78%) replied while 3 Washington counties (43%), 7 Oregon counties (and 2 metropolitan districts) (53%) and 4 Idaho counties (50%) replied.

The service most frequently contracted out in the decade of the 1980s was solid waste collection, with 57% of the responding governments contracting out for this service.<sup>5</sup> The percentage for road services was 52 and that for vehicle maintenance and repair was 33, respectively. Only 17% of the governments contracted out park services and only 4% day care services. The frequencies of services contracted out are summarized in Table 2 and absolute numbers in Table 3.

In addition to the eight services (enumerated in Table 2), the questionnaire asked what other services respondents during 1980-90 had contracted out. They were in order of frequency -- janitorial services -- mentioned by 4 governments -- legal services -- mentioned by 4 governments -- and water/waste water -- mentioned by 2 governments. The following were mentioned by only a single government -- sidewalk cleaning, sewer construction, dial-a-ride, dog pound, printing, facility repair, alcohol detoxification, grounds maintenance, office machine maintenance, and asbestos abatement.

During this period, Oregon's cities had a significantly higher propensity to contract out than Washington's cities. The propensity of counties to contract out, however, was quite similar among the 3 states -- between 21% and 33%. Cities contracted out more frequently than did counties, a fact that may be mainly related to the type of services cities and counties render.

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<sup>5</sup>All of Washington's and Oregon's counties with populations in excess of 50,000 who replied contracted out solid waste collection.

#### 4. Conclusions

I would like to express the hope that the economic framework advanced in this paper will provide for more objective discussion by local governments as to whether they should or should not engage in contracting out. Moreover, it is interesting to apply the framework to a review of the local government services that in the 1980s were contracted out in the Northwest. We found these services in terms of their frequency of contracts to be -- solid waste collection, road services, vehicle maintenance and repair, management and operations services, parks, recreation services, and security services.

The results are quite consistent with our economic framework. On the top of the list are local services whose output lends itself quite readily to quantification, thereby facilitating accountability. Moreover, efficiency gains of these services are likely to occur when they are offered under competitive conditions. Admittedly, the distributional consequences are rather unclear. The framework could help higher level governments and their constituents consider steps to bring lower level privatization decisions into harmony with societal interests. In short, it would lead to an examination of the desirability of higher levels providing sticks or carrots which could move local jurisdictions to make socially efficient privatization decisions. Most importantly, our framework should prove helpful to an examination of the validity of the often extravagant claims of both proponents and opponents of contracting out.

TABLE 1

RESPONSE RATE

	SENT	RECEIVED	
CITIES:			
Washington	11	5	45%
Oregon	9	8	89%
COUNTIES:			
Washington	7	3	43%
Oregon	17	9	53%
Idaho	8	4	50%
OVERALL:	52	30	58%

**TABLE 2**  
**Frequencies of Services Contracted Out by Cities**  
**In Washington and Oregon and by Counties**  
**in Washington, Oregon and Idaho**  
**1980-1990**

	A	B	C	D	E	F	G	H	ALL SERVICES REQUESTED
<b>Cities:</b>									
Washington	0.40	0.00	0.20	0.00	0.00	0.40	0.20	0.20	0.18
Oregon	0.38	0.63	0.50	0.38	0.50	0.50	0.50	0.00	0.43
All Cities	0.38	0.38	0.38	0.23	0.31	0.46	0.38	0.08	0.33
<b>Counties:</b>									
Washington	1.00	0.33	0.00	0.00	0.00	1.00	0.33	0.00	0.33
Oregon	0.50	0.00	0.30	0.00	0.00	0.60	0.20	0.00	0.21
Idaho	1.00	0.00	0.00	0.50	0.50	0.00	0.50	0.00	0.33
All Counties	0.73	0.06	0.18	0.13	0.13	0.53	0.29	0.00	0.26
All observ.:	0.57	0.21	0.27	0.17	0.21	0.52	0.33	0.04	0.29

**EACH CELL IS:**

The number which contract out in part or in total divided by number of responses in which it was not explicitly stated that the service was not provided by that government entity where,

**Services:**

- A - Solid Waste Collection
- B - Security Services
- C - Management and Operations of Facilities
- D - Parks
- E - Recreation Services
- F - Road Services
- G - Vehicle Maintenance and Repair
- H - Day Care Services

**TABLE 3**

**Absolute Numbers of Services Contracted Out by  
Cities In Washington and Oregon and by Counties  
in Washington, Oregon and Idaho**

**1980-1990**

<b>Cities:</b>	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>	<b>E</b>	<b>F</b>	<b>G</b>	<b>H</b>	<b>TOT</b>	<b>OTH</b>	<b>Number Of Cases</b>
Washington	2	0	1	0	0	2	1	1	7	3	5
Oregon	3	5	4	3	4	4	4	0	27	12	8
All Cities	5	5	5	3	4	6	5	1	34	15	13
<b>Counties:</b>											
Washington	3	1	0	0	0	3	1	0	8	0	3
Oregon	4	0	3	0	0	6	2	0	15	10	10
Idaho	4	0	0	2	2	0	2	0	10	1	4
All Counti	11	1	3	2	2	9	5	0	33	11	17
All Cities and Counties	16	6	8	5	6	15	10	1	67	26	30

OTH - the number of additional services  
written in - several localities listed more  
than one.