

Delivering Local/Municipal Services

Prepared by:

Harry Kitchen
Department of Economics
Trent University,
Peterborough, Ontario, Canada, K9J 7B8
Email: hkitchen@trentu.ca

Prepared for:

A workshop on:
Strengthening Responsive and Accountable Local Governance in China
Organized by the Ministry of Finance, China, the Canadian Agency for International
Development and the World Bank
Dali, Yunnan Province, China

August 9-12, 2004

Table of Contents

A. Public Sector Alternatives	3
A.1 Local/Municipal Responsibility	3
A.2 Local Government Enterprise	4
A.3 Why Are Local Government Enterprises Used?	5
A.4 Criteria for Evaluating Local Enterprises	6
A.5 Do Local Government Enterprises Play A Unique Role?	8
A.6 Governance of Local Government Enterprises	13
B. Private Sector Provision	14
B.1 Contracting Out	14
B.2 Franchise	19
B.3 Grants for Specific Services	20
B.4 Vouchers	21
B.5 Volunteers	22
B.6 Self-Help	23
B.7 Private Non-Profit Agencies	24
B.8 Mix of Delivery Systems	24
C. Public-Private Partnerships	24
C.1 What Is The Role For Government?	27
i. Price Regulation	27
ii. Monitoring	29
D. Summary	30

Delivering Local/Municipal Services

Municipal and local services may be delivered in a variety of ways. Alternatives range from complete public provision to complete private provision or a mix of these including public-private partnerships.

Public sector provision ranges from responsibility resting with the local council or city hall to responsibility assigned to some kind of independent or quasi-independent special purpose body or local government enterprise.¹ Private sector alternatives include contracting out, franchises, grants, vouchers, volunteers, self-help organizations, and non-profit agencies.

This paper will examine and evaluate these options by concentrating on the incentives and efficiency implications inherent in each structure² rather than on cataloguing their frequency of use.³ Where possible, it will also provide a brief summary of the empirical evidence on cost differences under these alternative structures.

A. Public Sector Alternatives

This section compares service delivery through a separate local government body or enterprise versus delivery by the local government itself.⁴

A.1 Local/Municipal Responsibility

Local or municipal governments are directly responsible for a range of public services for which fees or prices tend not to be used - local streets and roads, street lighting, fire and police protection, neighbourhood parks are almost always funded from local taxes, grants from senior governments, and other locally generated revenues. In many countries, they are also responsible for services for which they charge user fees or prices – water, sewers, recreation, public transit and so on. For all municipal services, local government staff and personnel generally share accounting, auditing and legal services, municipal employees and capital equipment. As for governance, local councils are responsible for making policy decisions for all services including the trade-off between spending on one rather than another.

¹ Special purpose bodies and local government enterprises have similar structures and objectives and may be referred to as business enterprises or enterprises in Part A of this paper.

² Harry Kitchen, *Efficiency Delivery of Local Government Services*, Discussion Paper No. 93-15 (Kingston: School of Policy Studies, Queens University, 1993).

³ It should be noted that there is no practical and useful way of cataloguing the frequency of each option.

⁴ An earlier version of the material in Part A appears in Harry Kitchen (2001), “Local Government Enterprise”, (Washington: World Bank.), 58 pages at 1-11 – available from www.worldbank.org/wbi/publicfinance/decentralization/fiscalfederalism_Russia.htm.

A.2 *Local Government Enterprise*

The universe of what constitutes a local business enterprise is wide ranging. There is no single and uniform definition but it is generally the case that each body or enterprise is responsible for the provision of a marketable good(s) or service(s) – one that has ‘private’ good characteristics and for which a fee or price per unit can be charged. This explains, partially at least, why electricity, water, sewers and public transit are often (but not always) the responsibility of local government enterprises or special purpose bodies; and why local streets and roads, street lighting, sidewalks, fire protection, and neighbourhood parks – services that have ‘public’ goods characteristics and for which specific fees or charges per unit cannot be imposed - are the responsibility of local government itself.

Each enterprise generally operates as a separate functioning business entity – sometimes independent of the locally elected council and sometimes under some kind of governing control or affiliation with the locally elected council. Each tends to be responsible for only one service (water or electricity or sewer and so on). Usually, each body has its own independent or quasi-independent (from local council) governing body that is responsible for all policies affecting the enterprise. Each has its own accounting and financial system, frequently its own work force and capital equipment, and is responsible for monitoring and reporting on its own activities.

In New Zealand, North America and Europe, local government enterprises are responsible for relatively few local services. Furthermore, almost all of them are provided in an environment where there are generally no alternatives or no competitors. These often include one or more of the following: electricity; telephone; water and sewers; municipal airports; and social housing. In other countries, by contrast, local government enterprises are responsible for many more services – a number of them may compete with the private sector. For example, subnational governments in Russia have long looked to state enterprises to finance many essential services. In 1992, it was estimated that 40 percent of subnational budgetary outlays came from enterprise contributions.⁵ In most one-company towns, the percentage was much higher, sometimes reaching almost one hundred percent. At the subnational level in Russia, for example, revenues from local enterprises are important because they help to finance basic services that might not be funded if left to the local tax base.⁶ A similarly important revenue-generating role for local government enterprises has been reported for Colombia.⁷

Local government enterprises may be separated into those that operate in an environment where there are no competitors and those that openly compete with the private sector. For the former, there is only one supplier – a public sector monopolist. Water and sewers in a municipality, for example, are the responsibility of one agency – a separate utility or business enterprise, sometimes under the direct governance of the municipality and

⁵ Jorge Matinez-Vazquez (1994), “Budgeting in the Russian Federation”, draft report, (Washington: World Bank, Europe and Central Asia Department).

⁶ Roy Bahl and Christine I. Wallich (1995), “Intergovernmental Fiscal Relations in the Russian Federation” in *Decentralization of the Socialist State*, edited by Richard M. Bird, Robert D. Ebel, Christine I. Wallich (Washington: World Bank), 321-378, at 352.

⁷ Richard M. Bird (1984), *Intergovernmental Finance in Columbia*, (Cambridge: Harvard Law School, International Tax Program).

sometimes under the governance structure of a special purpose board/commission that tends to have features and characteristics similar to that of a separate business entity. Similarly, electricity is the responsibility of one agency as is public transit and so on. Furthermore, services with high infrastructure costs such as water, sewers, and electricity have characteristics of a natural monopolist.⁸ Others such as public transit may not benefit from economies of scale over their entire output (not a natural monopolist) but they are, nevertheless, provided in a protected setting. In short, there is no competition for many of these services (electricity, water and sewers) and limited and indirect competition for others (cars competing with public transit).

For publicly provided goods or services that compete with the private sector, there is the question of whether or not the public sector should be involved at all. In response, there is no solid economic rationale for public sector provision, although their provision has been defended on the basis of generating revenue for the local government. Examples include public sector involvement in bakeries, paint shops, flower shops, sports clubs, mushroom growing and handicraft businesses in Russia.⁹

A.3 Why Are Local Government Enterprises Used?

A variety of arguments have been advanced in defense of using special purpose bodies or local government enterprises for specific services.

First, in some countries or provinces/states/regions within countries, legislated requirements stipulate that specific services must be the responsibility of a separate body or enterprise, generally under a governing structure called a commission, board or utility. This is the case for municipal electricity distribution in the province of Ontario in Canada where all policy decisions are made by either a private corporation or municipally appointed Board of Directors operating at arms length and independent of local council.

Second, where local governments are free to choose their governing structures for the provision of local goods and services, tradition often plays a role in relying on separate enterprises – it has always been done this way and there is no reason to change.

Third, these bodies have been defended on the grounds that appointed or elected officials governing single purpose enterprises will make better decisions than directly elected municipal politicians who must make decisions, choices and trade-offs over a vast range of local government functions. A single purpose governing council, the argument goes, is more likely to consist of experts and therefore, able to make better decisions when compared with locally elected politicians and government officials who have heavy workloads and insufficient time to plan, administer, and oversee all governing functions. This is supported by those who assert that financially independent public utilities are generally well-run, honest

⁸ A natural monopolist is often depicted by local utility type services (water, sewers, natural gas where it is a municipal responsibility). Their predominant characteristic for analytical purposes here is that they exhibit decreasing per unit costs over the entire range of output (economies of scale).

⁹ Galina Kurlyandskaya, Yelena Nikolayenko, Natalia Golovanova, (2001), “Local Governments in the Russian Federation”, a paper prepared for Local Government and Public Service Reform Initiative, (Budapest: Open Society Institute), at 29.

and efficient, while utilities governed by local councils are alleged to be markedly worse in each of these respects and likely to be run at a financial loss.

Fourth, enterprises are used in some countries as a way of escaping rigid controls (by a senior level of government) that apply to what and how local governments spend, who it employs for what, how much it pays them, which revenues it can access, on what terms it may borrow and so on?

Fifth, local government enterprises may be preferred in those countries where senior levels of government share in local tax revenues but do not share in revenues generated by local enterprises.¹⁰

Sixth, these bodies are used in some countries to provide employment.

Seventh, there is a perception in the minds of many politicians and a large proportion of the population that local business enterprises are more efficient and accountable in their operation because they are run more like a business – they deliver a product, sell it, retain the revenue and cover all costs - when compared with other municipally provided services that are not sold for specific fees, charges or prices.

Finally, local politicians and administrators sometimes prefer business enterprises because there tend to be fewer citizen complaints about revenues generated from the sale of goods and services by what is deemed to be a business enterprise than from increasing local taxes to raise the same amount of money. More bluntly, it seems to be more acceptable politically to set up a local business enterprise and sell a good or service to raise revenues than to raise local taxes. Generating revenues from the sale of goods and services by local government enterprises may also be preferred if municipal governments face legislated requirements against their ability to raise taxes.

A.4 Criteria for Evaluating Local Enterprises

To evaluate the role for these bodies and how they should be structured, one needs a set of criteria. For this purpose, the following are appropriate: allocative or economic efficiency, transparency, accountability, and ease of administration.¹¹ Issues of fairness are important but of little relevance in this discussion. Fairness is associated with the way in which specific services are funded (benefits received arguments¹²) or with income distribution issues (ability to pay arguments¹³) and not with the agency (enterprise or local government) responsible for the service.

¹⁰ Jorge Matinez-Vazquez and Jameson Boex (2001), *Russia's Transition to a New Federalism* (Washington, D.C., World Bank), at 38.

¹¹ These are the same criteria that are used in evaluating municipal finance issues. Their application in local service delivery, however, differs somewhat from their application in local financing issues.

¹² For a discussion of the benefit model of local finance, see Richard M. Bird (1993), "Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralization", vol. XLVI, no. 2, *National Tax Journal*, 207-227; and Harry Kitchen (2004), "Financing Local Government Capital Investment", a paper prepared for this workshop.

¹³ For a discussion of income redistribution and how it should be handled, see Robin Boadway and Harry Kitchen (1999), *Canadian Tax Policy*, third edition (Toronto: Canadian Tax Foundation), ch. 8.

Economic (Allocative) Efficiency: This is achieved within the local public sector when all service responsibilities are organized and allocated so that society gets the greatest possible gain from the use of all resources (inputs) at its disposal. In other words, if reliance on local government enterprises leads to the use of fewer resources than would be required if the same service were provided directly by local government, then it would be more allocatively efficient¹⁴ to provide the service by a local enterprise because society would be better off collectively. If, on the other hand, the existence of one or more enterprises provides barriers or impediments to efficient local public sector decision-making and leads to a greater use of (waste) resources, local enterprises could be deemed to misallocate resources and be more costly to society collectively.

Accountability: In the provision of local public sector services, accountability is achieved when the customer/taxpayer is able to identify who is responsible for what and is able to link the governing unit responsible for the service directly to its funding. Where there is only one governing unit, taxpayers know who is responsible for what and who to contact if they wish to have an impact on decision-making. Where there are a number of local governing units responsible for a diverse range of services, customers/taxpayers may become confused and not know who is responsible for what and how to have an impact on decision-makers.

Transparency: This is achieved when citizens/taxpayers have access to information and decision-making forums so that the general public knows what is happening and able to judge whether it is appropriate. Vehicles or instruments for enhancing transparency should include legislation that requires public sector decision makers to consult with and report to the public annually on planned activities; enforcement of regulations by officers, and purchasing of inputs through contractual arrangements with internal staff or the private sector. This could include the annual publication of local public sector performance measures, thus providing local citizens with information for making intermunicipal efficiency and effectiveness comparisons. All of this is intended to mitigate the risk of corruption by making information statutorily available and by ensuring that all public policy decisions are made in an open and transparent manner.¹⁵

Ease of Administration: This is an extension of the criteria of efficiency and accountability. The easiest system to administer is one that is not confusing and does not require an unnecessary amount of time and effort in consultations, correspondence, and meetings in reaching decisions.

¹⁴ Economic efficiency is more than technical efficiency- the latter is a necessary but not sufficient condition for economic efficiency. Technical efficiency exists when a producing unit (firm, government, commission) operates in a way such that it is not possible to secure any additional output given the available inputs (labour, material and capital) and level of technology. In other words, technical efficiency is achieved when the output per unit of input is maximized or the cost per unit of output is minimized. This, it should be noted, is not concerned with whether one good or service generates more or fewer net benefits than another good or service. It simply concentrates on the efficient employment of inputs in the production of a specific good or service. Finally, as the level of technology advances, a technically efficient production process leads to increased output with the same inputs.

¹⁵ This corresponds to the “Code of Good Practices on Fiscal Transparency” (Washington, D.C.: International Monetary Fund), March 23, 2001.

A.5 Do Local Government Enterprises Play A Unique Role?

Does a local government enterprise perform a service delivery role or function that cannot be performed or not performed as efficiently by the local government (local or municipal council) directly? Based on the above criteria, some light may be shed on this question. At the outset, it is asserted that the best and most socially desirable governing structure is achieved when locally elected councilors have decision-making responsibility for all local goods and services regardless of how they are delivered.¹⁶ Perhaps this is illustrated best by pointing out a variety of problems – real and potential - that frequently emerge when some local public sector decision-making powers are the responsibility of local government enterprises. For example, if a local government enterprise can make policy-decisions and has funding control over specific goods and services and if it operates independently or semi-independently of the locally elected council that is responsible for a range of other goods and services, there is less incentive or possibility that local public sector efficiency, transparency and accountability will be achieved. As well, if additional resources and time are wasted on reaching agreements and coordinating policies between these competing governing units, the system will be more expensive to administer than it should be.

As noted earlier, support for local government enterprises rests, partially at least, on the assertion that individuals appointed or elected to an enterprise's governing board can govern more efficiently and effectively than locally elected politicians who are responsible for a range of local public sector goods and services. These services, it is argued, must be kept free from political interference. This approach to municipal government as basically corrupt and unrepresentative of consumer demands, however, is a poor principle upon which to organize municipal service responsibility.

Furthermore, arguments supporting 'removal from politics' seem to be an attempt to substitute special politics for general politics or a withdrawal from the struggle to change the political decisions of the community. And if politics is understood in the pejorative sense of partisan or personal patronage and influence, the independence of local government enterprises does not guarantee freedom from spoils but rather opens possibilities for methods of self-enrichment of their own. Technical specialists in many functions and their respective supporting groups of citizens may believe that their function is so important to the general welfare and the methods involved so technical that their objectives can be accomplished only if they are protected against interference by non-professionals.¹⁷ Practical politics, however, involves a compromise in the decision-making process. Experts and special interest groups should be available for advice

¹⁶ For a discussion of the importance of distinguishing between decision-making or governance and service delivery, see E.S. Savas, (1987) *Privatization: The Key to Better Government* (Chatham: NJ: Chatham House), at 6; David Osborne and Ted Gaebler (1992), *Reinventing Government - How the Entrepreneurial Spirit is Transferring the Public Sector* (Reading, Mass.: Addison Wesley Publishing Co. Inc.); T. Kolderie (1986) "Two Different Concepts of Privatisation", *Public Administration Review* 46: 285-91; J.S. Wunsch (1991) "Institutional Analysis and Decentralization: Developing an Analytical Framework for Effective Third World Administration Reform", *Public Administration and Development* 11(5): 431-52; and E. Ostrom, L. Schroeder, and S. Wynne (1993) *Institutional Incentives and Sustainable Development: Infrastructure Policies in Perspective* (Bolder, CO.: Westview); Richard Batley (2001), "Public-Private Partnerships for Urban Services" in *The Challenge of Urban Government: Policies and Practices*, edited by Mila Freire and Richard Stren (Washington, D.C.: The World Bank), 199-214, at 202; World Bank (1994) *World Development Report 1994: Infrastructure for Development*, (New York: Oxford University Press for the World Bank).

on such decision-making, but they need not be responsible for policy. In cases in which the proponents of an activity find the existing political situation distasteful the tempting alternative of avoiding involvement must be resisted in favour of seeking basic political improvements.

Another dubious contention by advocates of local government enterprises is their assertion that funding specific goods and services from user fees/charges or prices is more business-like, and therefore preferred, if conducted by an independent or semi-independent business enterprise rather than if funded in the same manner but under the governance of a locally elected council. Such an argument overlooks the essentially political nature of decision-making with regard to many services supported in whole or in part by user charges or public sector prices. There is no reason why a user-supported service cannot be operated on a business-like and self-sustained basis under a department at city hall.

The existence of a number of independent and semi-independent enterprises complicates local government to the point where citizens cannot understand its structure or determine who is responsible for what. The weakening of municipal council through removing some responsibilities, combined with the inability of citizens to understand government (who is responsible for what), results in a loss of accountability, a lack of transparency and reduced public interest in local government. As the municipal organization becomes more diffuse it becomes less accessible to political control. Also, the agencies into which local government is fragmented are often only indirectly responsible to the public, particularly if its members are appointed. Fragmentation of government into separate enterprises further complicates the problems of administrative integration and co-ordination.

Bringing all governance and policy-making decisions for local enterprises under local council governing responsibility (day to day management should be left to the managers regardless of the governing structure) has been criticized, however, because local politicians in some countries apparently use these enterprises as places of employment for relatives, friends, and cronies. If governing responsibilities for enterprise operations were left with local enterprises, it has been suggested that these potentially inefficient and unfair employment practices could be minimized. There are at least two reasons why this might not be true. First, there is nothing inherent in the governing structure of either a local government enterprise or local council operation to suggest that either agency is more or less susceptible to this type of employment abuse. Second, where this is a problem, its resolution should involve the implementation of fair, effective and transparent employment policies that prevent this kind of nepotistic behaviour.

Of the enterprises that exist, many enjoy considerable autonomy and financial independence. In fact, there is a tendency for them to become little governments in themselves with the inherent characteristic that they are independent and in no way subordinate to the elected municipal politicians. This can lead to an environment over which residents/taxpayers have little control and hence, is politically inefficient. For those that are funded partially by grants or local taxes, there is often no direct link between the policy-making body (that is, the body making the expenditure decisions) and revenues (local taxes) that are collected by municipal

¹⁷ Richard M. Bird (1980), *Central-local fiscal relations and the provision of urban public services*, (Canberra: The Australian National University, Centre for Research on Federal Financial Relations), at 30.

councils and must be used to fund these agencies. Whenever expenditure and revenue decisions such as these are made independently, the system is likely to be less accountable or transparent¹⁸ and unable to allocate its resources efficiently across all competing municipal services. For those that are fully funded from sales of their output, there is greater likelihood that they will become independent and more removed from the governing decisions of local council.

When a large number of independent single purpose enterprises exist, co-ordination of inter-related activities is difficult and, in some instances, impossible to achieve.¹⁹ Attempts by locally elected politicians to provide services are frequently thwarted or made more difficult because of decisions made by these independent enterprises over which the politicians have little, if any, control. For example, actions taken by electrical utilities, water and sewer utilities, public transit authorities may conflict with council's overall planning effort.

This institutional structure, which may be referred to as a 'localized monopoly', creates a potential impediment for pursuing competitive forces if municipal councils are prevented from making all decisions affecting the local municipality in the most accountable, transparent and efficient manner. This may happen, for example, where a municipality defers all decisions over spending and funding until a local government enterprise has determined its level of spending and funding. For example, a decision by a separate water utility (enterprise) to replace or rehabilitate a water line or sewer main (underground services) may affect a municipality's timing for resurfacing or improving a local road or street (above ground services). This, in turn, may affect the way (both in terms of timing and its choice of competing alternatives) in which the municipality allocates its resources to other municipal services.²⁰ Similarly, if a decision by a local enterprise to borrow in order to finance the rehabilitation or provision of new capital infrastructure crowds out or inhibits the local council's ability (perhaps because of debt limits) to borrow for other capital projects, then resources are not allocated efficiently.

In general, where municipal councils are directly responsible for a service, there tends to be greater pressures towards public accountability²¹ and political responsibility. Greater public

¹⁸ For a discussion of the importance of this linkage between revenues and expenditures, see John Bossons, Harry Kitchen and Enid Slack (1993), "Local Government Finance: Principles and Issues", (Toronto: Ontario Fair Tax Commission).

¹⁹ Harry Kitchen, (1989) *Report and Recommendations: A Review Of Regional Government in Niagara*, (Toronto: Queen's Printer for Ontario) chapters 8 & 9.

²⁰ Information gathered from interviews with municipal officials in Ontario. Similar results have been observed for school board and police spending (both are under governing structures that are independent of municipal council) in Ontario where expenditure decisions and ensuing property tax requirements of these two independent local bodies frequently crowd out municipal expenditures over which the municipal council has control. Crowding out, it is argued, occurs because municipal councils are reluctant to raise property taxes (for municipal expenditures) and incur the wrath of local citizens if expenditure decisions of school boards and police boards have resulted in higher property taxes for their specific services. See Almos Tassonyi and Wade Locke, (1994) "Shared Tax Bases and Local Public Expenditure Decisions", *Canadian Tax Journal*, Vol. 41, 941-957; and David Knapton (1993), "Police Commissions: Do They Crowd out Other Municipal Expenditures?" (honours economics essay, Trent University, Economics Department, Peterborough, Ontario).

²¹ Harry Kitchen, (1975) "Some Organizational Implications of Providing An Urban Service: The Case of Water", *Canadian Public Administration*, Summer, pp. 297-308.

accountability leads in turn to greater pressure to reduce costs,²² improve efficiency, and justify expenditure increases. When compared with governance under a municipal council, most enterprises are free from the limelight of major municipal elections and consequently further removed from these important political pressures. The elections of commissioners, where elections rather than appointments occur, are generally dull affairs that go virtually unnoticed by the public and often result in acclamations. Voter apathy develops in municipal elections but the general desire to control costs at city hall extends to all departments, whereas such pressure is less frequently exerted on a separate enterprise. Partly for this reason, many governing boards for local enterprises slip into the 'rubber stamp syndrome' and allow policy decisions to stem from dominant, technically competent managers.

Connected with the idea of political accountability is the financial flexibility available to each type of organization. A sufficient degree of political leverage and direct accountability to the public must be maintained over the governance of local public services; otherwise, strong temptation exists for these organizations to engage in unwarranted expansion or to invest in new assets that is far out of line with investment in other municipal functions. Municipal council operations appear to satisfy such a condition much more than separate local enterprise operations, and the latter's financial freedom may permit greater indulgence in empire-building²³ and wasted expenditures.

An important source of economies available to municipal council run operations and often not available to single purpose enterprises comes from the opportunity for certain personnel, facilities and capital equipment to be engaged in multiple functions. Some of these economies are identified as follows. First, municipally provided services may share office space at city hall, whereas separate enterprises are generally established in separate buildings. Second, a municipally governed service easily shares administrative and operational tasks with other departments at city hall (for example, accounting and legal services), whereas separate enterprise operations tend to set up their own administrative and operational facilities. In the latter structure, economies of scale and cost savings are less likely to be achieved than in the former structure. Third, opportunities exist for pooling capital equipment and labor in city-governed operations. This permits a reduction in idle hours for capital and labor through the opportunity to transfer personnel and equipment to different functions as need arises. As with many of its departments, city hall can achieve economies of scale in the use of unspecialized personnel and equipment. This source of savings is more important for smaller than for larger municipalities, since the smaller-scale operations are much more likely to encounter indivisibilities in capital and labor inputs. Local government enterprises, on the other hand, have a tendency to acquire a separate complement of labor and equipment and these inputs are not used, as a rule, for other municipal government functions. In many instances, especially for capital equipment, there is considerable down time and lack of use of some of the capital equipment.²⁴

²² Harry Kitchen, (1976) "A Statistical Estimation of an Operating Cost Function for Municipal Water Provision", *Journal of Urban Analysis*, January, pp. 56-76. The results of this study indicated that the cost of supplying water through a separate water utility or enterprise was significantly higher than the costs of supplying it by a department directly responsible to the municipal council.

²³ Kitchen (1975), *supra* footnote 21.

²⁴ Kitchen (1975), *supra* footnote 21; and for a more recent illustration and discussion, see W. Douglas Armstrong and Harry Kitchen (1997), *Peterborough County/City Municipal Review*, a report

In summary, the economic and political arguments in support of independent and autonomous or semi-independent and semi-autonomous local government enterprises are generally weak. They do not appear to contribute anything that is unique. Their existence creates or has the potential for creating decision-making problems and unnecessary costs both for local governments and local residents. Elimination of local government enterprises should improve the extent to which local public sector efficiency, accountability, and transparency could be improved. Certainly, it would remove the confusion over who is responsible for what and allow local councils to set priorities and weigh and consider the trade-offs necessary in making decisions on the relative merits of spending on water and sewer systems versus roads versus public transit versus police versus fire versus local parks and so on.

All of this assumes, of course, that we are operating in a first best world and that the current decision-making structures could be changed. Unfortunately, this may not be possible for many enterprises and in many countries. Local government enterprises are solidly entrenched in local public sector services. And they will continue to be used even though they have declined in importance in some countries over the past decade²⁵ largely because of the types of decision-making problems described above.

A.6 Governance of Local Government Enterprises

Even though arguments in support of local government enterprises are not strong, these enterprises will continue to be responsible for a range of local goods and services in many countries. The discussion here, then, will concentrate on policies designed to improve the efficiency, accountability and transparency of the governance structure of these agencies.

Governance refers to the political body responsible for making all policy decisions. It does not refer to the day-to-day management of local government or its enterprises²⁶ and it does not refer to service delivery because this may be handled in a variety of ways. Since a major objective of the local government sector should be to design an overall governance structure that, in principle and as closely as possible in practice, meets the criteria described earlier, it is best achieved if all local public sector decision-making powers are left with a democratically elected local council. In effect, then, a case exists for governing all special purpose bodies by the same body that governs city hall. This creates an environment where it would be easier to coordinate all municipal services and functions and it would minimize instances where the policies of local enterprises conflict with policies of local councils. In principle, a system where local councils have responsibility

prepared for the Joint Restructuring Committee of the City and County of Peterborough, Ontario, Canada, at 134-139.

²⁵ In the province of Ontario, reliance on utility commissions (local enterprises) for water provision declined from 112 separate utilities in 1990, to 41 in 2000, and 15 in 2001. Andrew Sancton and Teresa Janik (2001), "Provincial-Local Relations and Drinking Water in Ontario" An Issue Paper commissioned by the Walkerton Inquiry, Table 3.

²⁶ In New Zealand, it is legislated that policy-making responsibilities of elected municipal councils must be 'decoupled' from day-to-day management of the authority. June Pallot (2001), "Local Government Reform in New Zealand: Options for Public Management as Governance", available at www.willamette.org/ipmn/test/papers/pallot.htm.

for making decisions on the appropriate trade-offs to be made over all local expenditures reduces the possibilities of conflict between certain local agencies seeking to promote their own special interests and the municipality attempting to hold the line on taxes, restricting expenditures, or altering expenditure choices among those services over which it does have substantial control.

Putting all municipal public policy decision-making powers – including those that are politically sensitive and those that are not so politically sensitive – under council control should improve local accountability and responsiveness to the tax-paying public.²⁷ When one stops to think about it, an independent body in charge of a basic service such as water, sewers, electricity, police, and so on, that can set its own rates or determine its own property tax requirements, determine its own policies, and formulate and approve its long range plans, has considerable control over the range of other municipal services and how a community is governed, and how and where it develops residentially, commercially, and industrially.

B. Private Sector Provision

The most obvious private sector delivery option is contracting out but it is not the only option. Private sector involvement may also include the use of franchises, grants, vouchers, volunteers and self-help.²⁸ Public-Private partnerships have recently grown in interest as an acceptable option for funding services, especially where there may be substantial capital or infrastructure costs. Since each of these creates a unique service delivery option, their potential efficiency strengths and weaknesses are discussed.

B.1 Contracting Out

In the Great Britain, local authorities are now required to enter into competitive tendering for the provision of municipal services. In New Zealand, legislation introduced in the early 1990s had a significant impact on the way services are provided but it does not go as far as Britain in requiring mandatory competitive tendering. In New Zealand, delivery exclusively by local council departments declined from 70 percent in 1989 to 26 percent in 1994 while delivery by business units rose from 2 percent to 18 percent.²⁹ The core services of water supply, sewage systems, stormwater and drainage are delivered by business units in over 50 percent of the councils while the majority of councils that provided legal services, refuse collection, commercial forestry and refuse disposal use external providers.³⁰

²⁷ Municipality of Metropolitan Toronto, (1988) "First Report of the Sub-Committee on Special Purpose Bodies", mimeograph, Metropolitan Toronto, Ontario; and Philip Stenning and Landau, Tammy, (1988) *The Niagara Regional Board of Commissioners of Police: Its Role and Accountability*, a background study for the Niagara Region Review Commission, Niagara Falls, Ontario.

²⁸ E.S. Savas, *Privatizing the Public Sector*, (Chatham, New Jersey: Chatham House, 1982); and Harry Hatry, *A Review of Private Approaches for Delivery of Public Services*, (Washington, D.C.: The Urban Institute, 1983).

²⁹ Department of Internal Affairs (1994), "Territorial Authority Service Delivery 1993-1994" (Wellington, N.Z.; Department of Internal Affairs).

³⁰ Pallot (2001), supra footnote 26.

Since the current fashion is to advocate privatisation of local public services, primarily through contracting out, the efficiency advantages of this action should be noted. In essence, it is alleged that contracting out through competitive tendering improves the competitive environment and leads to lower per unit operating costs for the delivery agent. Contractors face positive incentives to be efficient and negative sanctions if they are not. Contracting need not apply only to contracting out to the private sector; indeed, it could equally apply to enterprises and governments that contract from each other and for non-profit and voluntary organisations as well.³¹

Contracts are typically awarded on a competitive tendering system where the lowest bidder is normally chosen. In addition, some jurisdictions have adopted a policy whereby regions, counties, or cities are subdivided and contracts tendered for a series of sub-regions or areas for those services where economies of scale do not exist. The purpose of this is to encourage smaller firms to bid on contracts - a situation that would not arise if all contracts were large - and to permit, in some cases, municipal crews to compete with the private sector in securing a contract. This provides a stimulus for increased competition and ultimately, cost savings and greater efficiency. In fact, in some cities in the United States, it is not uncommon to see municipal government employees competing with the private sector for service delivery responsibility. Where this has happened, considerable cost savings and efficiency gains along with enhanced service levels have followed.³²

The most successful contracts tend to be those that are based on outputs that can be measured (solid waste, recycling, and so on) primarily because it is easier to monitor the quality of the output. As well, writing contracts in terms of outputs rather than inputs leaves the contractor free to organize the operation to attain output goals or targets in the most efficient way possible.³³

Many local government politicians and administrators who are not strong advocates of contracting out have argued that service quality is inevitably lower in the private sector. This concern over quality deficiency has led to suggestions that a monitoring system be established to ensure that quality is maintained at an acceptable level. There is no *a priori* reason to believe, however, that public sector monitoring will be any more effective or efficient than a policy of competitive tendering for service delivery on a relatively frequent basis (annually, bi-annually or every three years, for instance). Tendering, by itself, can create an incentive for a firm to maintain quality if it wishes to be a candidate for continuation of its contract at the time of rebidding.

Most of the empirical work on contracting out suggests that per unit operating costs are lower in privately run operations. While the bulk of these studies have been completed in the United

³¹ Robert L. Bish, (1986) "Improving Productivity in the Government Sector: The Role of Contracting Out", in *Responses to Economic Change*, edited by David Laidler, Vol. 27 of the Royal Commission on the Economic Union and Development Prospects for Canada, (Toronto: University of Toronto Press) at 217.

³² Stephen Goldsmith (1997), "Can Business Really Do Business with Government? The Answer is Yes, Just Ask the Mayor of Indianapolis", *Harvard Business Review*, May-June, 110-121; and (1998) "Smaller Government Prescriptions for Big City Problems" *Fraser Forum*, September, 6-15.

³³ Bish (1986), supra footnote 31.

States and Europe,³⁴ similar studies have been conducted in other countries. In New Zealand, for example, cost savings from contracting out are reported to range from 45 percent to 60 percent in the case of refuse collection in the city of Dunedin to 15 percent to 30 percent for other services in Dunedin and the city of Christchurch.³⁵ In Canada, there are also a number of studies on a variety of services (solid waste collection, recycling and disposal, public transit operations, and electrical utility maintenance) that provide similar results – these are reported in Table 1. Similar results have been noted in an examination of private sector involvement in three urban services (waste collection, water, and electricity supply) in developing countries.³⁶ A further study that compiled the results of 203 separate studies on contracting out (without regard to whether public sector units were invited to bid) concluded that savings in the order of 20 percent were most frequently reported without any sacrifice in the quality of service.³⁷ Finally, a critical assessment of several studies concluded that the private sector is more efficient in refuse collection, fire protection, cleaning services, and capital intensive wastewater treatment, while results are less conclusive for water supply and railways.³⁸

Table 1: Private versus Public Sector Delivery in Canada		
Services Studied: author/year	Delivery Alternatives	Results

³⁴ T. E. Borchering, Pommerehne, W., and Schneider, F., (1982) "Comparing the Efficiency of Private and Public provision: The Evidence from Five Countries" in *Nationalokonomie, Journal of Economics*, Supplement 2, Springer-Verlag, pp. 127-156; and John Hike (1992), *Competition in Government Financed Services*, (Quorum Books).

³⁵ Michael Douglas (1994), "New Zealand Paths to Competitive Tendering"; and J. Williamson (1994), "The Christchurch Case Study on Competitive Tendering". Both studies in *Introducing Competitive Tendering in Local Government in Australia*, (Melbourne: Foundation for Local government Education and Development Fund, Department of Management, RMIT).

³⁶ Batley, (2001) supra footnote 16, at 219-221.

³⁷ S. Domberger and P. Jensen (1997), "Contracting out by the public sector: Theory, evidence, prospects", *Oxford Review of Economic Policy*, vol. 4, pp. 67-78.

³⁸ K.L. Tang (1997), "Efficiency of the private sector: A critical review of empirical evidence from public services", *International Review of Administrative Sciences*, vol. 63, pp. 459-474.

Bus Service: Kitchen (1992) ¹	Municipal dept. versus privately contracted service in Ontario municipalities.	Significantly lower costs per km. under privately contracted operation
Electric Utility Maintenance: Kitchen (1986) ²	Utilities contracting out utility maintenance vs. in-house maintenance in Ontario municipalities.	Contracted out service significantly less expensive.
Refuse Collection: Kitchen (1976) ³	48 Canadian cities - municipal versus privately contracted firms.	Municipal suppliers more expensive than private firms.
McDavid, Richards & Doughton (1984) ⁴	Comparison of costs before and after Richmond, B.C. switched from private to public collection.	Residential solid waste collection fell from \$46.24 per household in 1982 to \$30.63 in 1983.
McDavid (1985) ⁵	Survey of private collection versus municipal collection of residential solid waste in 107 Canadian municipalities.	In municipalities with sole delivery agents (public versus private), collection was 51% more expensive in municipal operations. In municipalities with a mix of public and private, the public sector was 12% more expensive. Differences attributed to much higher productivity in private operations.
Tickner & McDavid (1986) ⁶	Detailed survey information on output, inputs and costs for private vs. public collection of residential waste obtained from 100 municipalities.	On average, private collectors were 28% less expensive.
McRae (1994) ⁷	Comparison of charges for collection of commercial/ industrial solid waste in 3 communities on Central Vancouver Island.	Depending on the size of container and frequency of pickup, municipal services were between 16% and 67% higher than private sector prices.
McDavid and Eder (1997) ⁸	327 questionnaire responses to survey on solid waste collection services in Canadian municipalities.	For all of Canada, government collection was 22.3% more costly per household than private contractors.
McDavid (2001) ⁹	327 questionnaire responses to survey on solid waste collection services in Canadian municipalities	<ul style="list-style-type: none"> - On average, public producers have higher costs than contracted private producers; - In municipalities where collection is split between private and public, both have lower costs than the national average and private producers are lower than public producers; - Municipalities that competitively bid their solid waste collection contract enjoy significantly lower costs per household.
Landfill Sites: McDavid and Laliberte (1998) ¹¹	Comparison of operational cost of 72 public and private landfill sites across Canada.	Operational costs of privately run operations was lower - \$15.75 per tonne compared to \$23.48 per tonne.
Residential Recycling: McDavid and	Private versus public sector comparison of 132 recycling	Net cost per tonne is virtually identical for

Laliberte (1999) ¹⁰	agents	public and private producers except in 7 communities where public and private producers compete directly. Here, 16 substantial cost savings were reported for private producers when compared with public producers.
--------------------------------	--------	--

Sources:

- ¹ Kitchen, Harry, "Urban Transit Provision in Ontario: A Public/Private Sector Cost Comparison", in *Public Finance Quarterly*, volume 20, Number 1, January 1992, pp. 114-128.
- ² Kitchen, Harry, (1986) *Local Government Enterprise In Canada*, Discussion Paper No. 300, Economic Council of Canada, at 66-85.
- ³ Kitchen, Harry, (1976) "A Statistical Estimation of an Operating Cost Function for Municipal Refuse Collection", *Public Finance Quarterly*, January, pp. 56-76.
- ⁴ McDavid, James, P.L. Richards, and B.E. Doughton, (1984) "Privatization of Residential Solid Waste Collection in Richmond, British Columbia", University of Victoria School of Public Administration, mimeograph.
- ⁵ McDavid, James, (1985) "The Canadian Experience With Privatizing Residential Solid Waste Collection Services", *Public Administration Review*", pp. 602-608.
- ⁶ Tickner, Glen and James McDavid (1986), "Effects of Scale and Market Structure on the Costs of Residential Solid Waste collection in Canadian Cities, *Public Finance Quarterly*, 14, 371-393.
- ⁷ McRae, James J., *Efficient Production of Solid Waste Services by Municipal Governments*, Discussion Paper No. 94-11, (Kingston: School of Policy Studies, Queen's University, 1994).
- ⁸ McDavid, James and K. Anthony Eder, *The Efficiency of Residential Solid Waste Collection Services in Canada: The National Survey Report*, (Victoria: Local Government Institute, School of Public Administration, University of Victoria, 1997), 35 pages.
- ⁹ McDavid, James (2001), "Solid-waste contracting-out, competition, and bidding practices among Canadian local governments", *Canadian Public Policy*, volume 44, No. 1, 1-25.
- ¹⁰ McDavid, James and Verna Laliberte, *The Efficiency of Canadian Solid Waste Landfills: National Survey Report*, (Victoria: Local Government Institute, School of Public Administration, University of Victoria, 1998), 40 pages.
- ¹¹ McDavid, James, and Verna Laliberte, *The Efficiency of Residential Recycling Services in Canadian Local Governments: National Survey Report*, (Victoria: Local Government Institute, School of Public Administration, University of Victoria, 1999), 47 pages.

Briefly, the conclusion of these studies is that most of the efficiency gains from contracting out have resulted from an increased scope for competition rather than from the fact that the service was provided by a private contractor.³⁹ In addition, the results suggest that where economies of scale are not prevalent, the creation of delivery zones creates a more competitive environment than exists when there is only delivery agent for entire municipality.⁴⁰ Introducing or increasing rivalry, however, may not be possible without the existence of some private ownership. In other words, some degree of privatization through contracting out may be a necessary but not sufficient condition for substantial performance improvements.⁴¹

Although most of the studies have concentrated on contracting out individual services, there is some experience in the United States with cities that contract out most service responsibilities. These cities have formed an Association of Contract Cities and are mainly concentrated in California. This group has generated a highly competitive local service environment with a vast network of producers and contract arrangements. Cities buy and sell to one another and private firms compete actively among themselves and with government producers for

³⁹ Robert L. Bish (2001), "Local Government Amalgamations: Discredited Nineteenth-Century Ideals Alive in the Twenty-First", *Commentary*, (Toronto: C.D. Howe Institute) at 15; and John Donahue, (1989) *The Privatization Decision: Public Ends, Private Means*, (New York: Basic Books); and Christopher Johnson, editor, (1988) *Privatization and Ownership*, (London: Lloyds Bank Review).

⁴⁰ Carl R. Bartone (2001), "The Role of the Private Sector in Municipal Solid Waste Service Delivery in Developing Countries: Keys to Success", in *The Challenge of Urban Government: Policies and Practices*, edited by Mila Freire and Richard Stren (Washington, D.C.: The World Bank) pp. 215-223, at 219.

⁴¹ John Vickers, and George Yarrow, (1991) "Economic Perspectives on Privatization", *The Journal of Economic Perspectives*, Volume 5, Number 2, pp. 111-132, at 117.

contracts.⁴² One empirical analysis of these contract cities indicated that they received services at lower cost than the non-contract cities in Los Angeles County.⁴³

While potential cost reductions seem to be prevalent from increased competition, it is well understood that unions are generally opposed to contracting out.⁴⁴ In particular, they are concerned about their members losing jobs and the extent to which contracting out would undermine the union, fragment the workforce, side-step provisions of collective agreements, and reduce labour costs with resultant profit taking opportunities for businesses.⁴⁵ In addition, the cost savings and increased efficiencies as noted in the empirical studies are not universally accepted because, it has been alleged, they fail to consider some important cost items. In particular, the critics have argued that contracting out results in additional costs due to time and money spent on drafting, negotiating, and monitoring a contract;⁴⁶ the contractee must train and oversee the contractor's employees to ensure productivity; and additional costs are incurred in laying off employees after their services have been contracted out.⁴⁷ Further concerns with contracting out have arisen because employees do not identify with the company and they have multiple clients and are not able to give priority to the current client.⁴⁸

Offsetting these concerns and criticisms, however, are a number of advantages of contracting out: greater flexibility for management in allocating human resources; greater productivity and efficiency, particularly if workers are paid on an incentive basis; increased ability to hire specialized expertise when needed; reduced turnover; and greater variety for the employee.⁴⁹

B.2 Franchise

A franchise exists when a private firm provides a service to residents within a specific geographic area and when the supplier is paid (price or user fee) directly by the users (customers/clients). Franchises may be exclusive (one producer) or non-exclusive (many producers).

⁴² Bish (1986), supra footnote 31, at 213; and "California Contract Cities" (1997), a policy brief, (Winnipeg, The Frontier Centre for Public Policy, September 22).

⁴³ R.T. Deacon, "The Expenditure Effects of Alternative Public Supply Institutions" *Public Choice*, vol. 34, pp. 381-397.

⁴⁴ E. Dijkgraaf, R.H.J.M. Gradus, and B. Melenberg (2003), "Contracting out refuse collection", *Empirical Economics*, vol. 28, pp. 553-570, at 554; and Canadian Union of Public Employees (1985) "Contracting Out: It's a Trend CUPE Must Continue to Oppose", *Facts*, 7, pp. 14-15.

⁴⁵ Gordon Cassidy (1994), "Contracting Out" Discussion Paper No. 94-06, (Kingston: School of Policy Studies, Queen's University).

⁴⁶ For a discussion on the proper design of contracts along with efficient monitoring systems, see T. David (1988), *Privatization in America*, municipal yearbook (Washington, D.C.: International City Management Association).

⁴⁷ R.W. Sauter, R.D. Weisman and R.W. Percy (1988) "Union View: Subcontracting the Work of Union Members in the Public Sector", *Labour Law Journal*, vol. 39, no. 8, pp. 487-496.

⁴⁸ Cassidy (1994), supra footnote 45.

⁴⁹ Ibid; and Dijkgraaf et. al. (2003), supra footnote 44.

If services are provided by exclusive franchises, prices may have to be regulated.⁵⁰ Further regulations may be imposed to guarantee that quality standards or performance measures are met and that all consumers within a specific area (served by the franchise) have access to the service if they pay for it. For exclusive franchises that are largely capital intensive, not tendered on a frequent basis, and not subject to competitive forces (such water and wastewater), adherence to performance standards⁵¹ along with carefully drawn up contracts spelling out the terms and conditions of the agreement is essential. For services that are not capital intensive (refuse collection, for example), frequent tendering for the right to provide the service (similar to contracting out) should assist in maintaining the necessary competitive forces to ensure high quality and low cost services.

For services provided by non-exclusive franchises, price regulation and monitoring activities would likely be less. The attractiveness of this organizational structure is mainly a function of the number of firms involved and hence, the degree of competition created. The larger the number of firms, the greater the competitive environment and hence, the greater the incentive for improved efficiency, lower costs and quality services.

A possible problem with franchise operations is that some users (perhaps low income families) may discontinue consumption of certain services. If users view the price of the service as being too high, they may decide to do without it or find a substitute. This has occurred, primarily in smaller communities, where solid waste collection has been privatised and franchised. Not only could this be unsanitary and impose externalities on those who pay, it could lead to lower quality service and/or greater costs for existing users if economies of scale disappear. Use of a franchise operation in lieu of contracting out, therefore, may not be desirable on efficiency grounds, especially for services where negative externalities might be created because individuals choose not to use the service.

Where franchises are considered, a franchise agreement between the local council and the supplier is critical because it is the core legal document by which both parties are bound and which can be enforced. This agreement should include, among others:

- terms of payment for a franchise fee;
- principles and practice to follow in setting prices;
- all standards and performance measures that are to be met;
- a list and description of all financial and performance reports that are to be provided on a regular basis to local council and the public;
- procedures to follow in renegotiating standards and conditions in the agreement;
- for services where ownership of capital assets are retained by local council, the conditions for their return at the end of the agreement period.

B.3 Grants for Specific Services

Grants are often provided by local governments for various community groups or activities including volunteer groups, charitable organizations, recreational and cultural activities, and

⁵⁰ For a discussion of price regulation, see the discussion in the public-private partnership section later in this paper.

⁵¹ Discussed under monitoring sub-section in public-private partnership section later in this paper.

special boards such as arena boards and library boards. Some of these grants are ad hoc while others are provided annually although applicants for the latter are often required to apply annually. On efficiency grounds, grants are justified if the service delivered through the grant receiving agency is provided less expensively or more efficiently vis-a-vis provision by the municipal government itself. For example, if the grant is to a volunteer organization, it may be less expensive to deliver the service through this type of organization rather than through some body or organization at city hall.

Grants to boards involved in the production of a service are typically made to cover all or a portion of operating costs (library boards, for instance). Once again, on efficiency grounds, this policy may be appropriate if the service can be provided less expensively vis-a-vis provision under the responsibility of local government directly. Implicit in this statement, of course, is the condition that the budgets for these boards be determined by local council in competition with the range of other services provided by local government.

In reality, local government grants are almost never given to improve productive efficiency. They are generally given for one of two reasons; first, to appease specific groups who are persuasive in appealing to the social conscience of local councils to support their respective cause; or second, to provide a particular service through a special board (library board, for example) that is at least one-step removed from direct council responsibility.

B.4 Vouchers

Vouchers are yet another way of privatizing the provision of public services with their distribution coming directly from municipal governments to citizens deemed to be eligible for a particular service. The user would then submit the voucher to the private provider of his/her choice. The provider, in turn, would forward the voucher to the government for payment (which, in all likelihood would be a constant dollar amount per voucher of the same type).

Determining the cash value of the voucher (that is, the value that the government pays to each firm) is particularly important for it could impact on the production and delivery efficiency of the provider. In providing the service for which the voucher is used, the quantity and quality of the service supplied would have to be stipulated. For example, if the cash value of the voucher were set equal to the average cost of each unit delivered by the firm or if it equalled a weighted average of costs incurred by all firms, the scheme would penalize more efficient producers. To overcome this problem, the per unit cash value should equal the average cost of the most efficient supplier. The advantage of this payment schedule is that a highly efficient firm can lower the costs to governments and in turn, taxpayers.

A system of vouchers can provide incentives for diversity and hence, a large number of producers. This would increase the choice available to local residents. For this reason, the delivery of services such as day-care, homemaker services, foster homes, and group homes could be well suited to a voucher system. They are frequently used for public transportation for welfare recipients and the disabled and sometimes for medical expenses.

A potential off-shoot of increasing the choice for voucher-holders is the increase in service quality and efficiency that should follow. This outcome, however, would depend on the effectiveness of the information network established among voucher-holders. If the network is

effective, the existence of competitive forces should lead to improvements in service quality and lower delivery costs. Reduced delivery costs, however, may be partially offset by increased monitoring and administration costs to prevent voucher forgery, for example.

Although this approach may encounter some administrative and monitoring problems, experimentation with a voucher system for certain services ought to be encouraged. Initially, vouchers might be tried in those areas where the government is providing assistance to non-governmental agencies, such as social services for low-income families.

B.5 Volunteers

Volunteers are used by governments in many countries to deliver specific services. One typically notes non-paid help in places such as libraries, hospitals and teachers' aids programs where volunteers are normally assigned to tasks that might not otherwise be undertaken.

Smaller municipalities in Canada frequently have volunteer fire departments or a mix of volunteer and professional fire fighters. In fact, one study on 104 municipal fire departments in Canadian municipalities in 1981 and 1982 concluded that fire departments employing a mix of full-time and part-time (volunteers) fire fighters in communities up to 50,000 people enjoyed the benefits of lower fire service costs without sacrificing effectiveness. Beyond 50,000 people, effectiveness tended to diminish with a mixed force. As well, the effectiveness of an entirely part-time fire department was reduced because the firemen took longer, on average, getting to fires.⁵²

Since existing labour is usually not replaced (at least in the first instance), one cannot presume that the use of volunteers will lower delivery costs immediately. Indeed, there may be some administrative costs in maintaining a volunteer staff; for example, training programs, guidance and general co-ordination requirements consume regular staff members' time.

While costs may be lower in the short run, the dependence on volunteers may also lower costs in the long run, especially if volunteers serve as substitutes for paid employees. Further cost savings arise, in both the short and long run, if the use of volunteers permits extra service or longer hours of service – volunteer library assistance, for example. . Whether or not this use improves the quality of existing services greatly depends on the quality of the volunteers and the perception of recipients (the use of volunteers in hospitals, for example, may be perceived to improve the quality of hospital care).

A potential problem in using volunteers arises if they are available only at selected times (weekends and/or evenings, for instance) or if they are not dependable which they may not be since they are not paid to perform various functions. Further problems and costs might be incurred if a system of continuous recruitment is necessary in order to staff the volunteer program.

B.6 Self-Help

⁵² James McDavid, (1986) "Part-Time Fire Fighters in Canadian Municipalities: Cost and Effectiveness Comparisons", *Canadian Public Administration*, vol. 29, no. 3, pp.377-387.

The self-help concept is closely related to the concept of using volunteers. Self-help programs are designed so that individuals or neighbourhoods provide services for themselves. Typical examples in North America include 'Neighbourhood Watch' and 'Block Parent' programs, or flooding and maintaining outdoor ice-skating surfaces in neighbourhood parks. These have grown in popularity over the past few years. In some of the larger municipalities, residents on certain streets or in certain neighbourhoods have collectively organized (and funded) for the purpose of hiring security firms whose purpose is to reduce the incidence of crime and generally improve safety for local residents. Here, the service is provided and paid for directly by the users.

Whether or not self-help groups (for many services) are willing to organize on their own is a debatable issue and, of course, is likely to depend on the severity of the reason for organizing in the first instance. For example, citizens are more likely to organize for protection purposes than for maintaining a neighbourhood park. Unless it can be proven that delivery costs will fall and/or service quantity and quality rise for the beneficiaries (for example, improved security), individuals are unlikely to agree to undertake the activity. In addition, there is the obvious problem of operating a delivery system if 'free-riders' emerge. This problem is likely to be more apparent if large set-up costs are involved in establishing certain services. Given these potential problems, efficiency gains will be maximized only if the majority of residents within a given jurisdiction agree to co-operate.

Conversely, if governments are able to convince established groups or neighbourhoods to convert to self-provision as a substitute for, rather than an addition to, existing public services, then significant savings in the delivery of specific services might be realized. These savings, however, may be offset or partially offset by increased personal costs associated with their delivery.

Further problems and increased costs may arise if self-help groups decide, after a short period of time, to terminate their activity and revert to public provision, possibly through increasing pressure on local politicians to supply the service via the local public sector. Clearly, such indecision could create inefficiencies and higher costs. To avoid this, partial government assistance may be required, not only during the initial establishment stages, but also on an ongoing basis. In fact, this is frequently the practice with maintaining outdoor neighbourhood skating surfaces in municipalities in Canada where the local government often pays a small per diem honorarium to a resident of the neighbourhood to ensure that the ice is maintained for local residents.

B.7 Private Non-Profit Agencies

A number of services have traditionally been provided by private non-profit agencies in many countries. Common examples in North America include organizations such as Alcoholics Anonymous, Salvation Army, and the United Way. If these organizations provide services that would be provided, otherwise, by local governments, cost savings may be observed. Three potential concerns arise, however, from dependence on the non-profit sector. First, it may be difficult to ensure a high quality service since this may depend on the quality of the people working for the agency. Second, without a reliable and on-going source of funding, these organizations may not be a stable supplier of services. Third and perhaps more philosophically, there is the important issue of whether or not the public sector is

relinquishing some of its public responsibility by relying on non-profit agencies (with no or very little financial assistance from municipal governments) to provide services such as food banks and shelters.

B.8 Mix of Delivery Systems

In addition to the large number of purely public and purely private delivery systems, more and more services are being provided by a mix of these organizations. This mix may consist of provision by one government (level of government or department or local business enterprise) for another government or governmental agency or it may consist of the private sector providing part of a service (generally via contracting out) for a government department or agency. This use of mixed delivery systems has increased substantially over the past decade. In some instances, this mix of delivery systems is to take advantage of savings that arise from economies of scale or scope in the provision of a number of services. These economies are attributed to efficiencies that may be gained from servicing a larger population or geographical area. In other instances, however, this mix is used to overcome problems of diseconomies of scale because no municipal government is the most efficient size for providing all public services. As well, this mix may resolve concerns over efficiency problems created by monopolistic service providers through the introduction of more competition into delivery systems.

Examples where one government contracts from an adjacent and generally larger governmental unit occurs in areas such as road maintenance and repairs; operation and maintenance of municipal electric utilities; repair and servicing of public works vehicles; delivery of transit services; accounting and legal administrative services; solid waste management; and so on. Most governmental construction projects including buildings, roads, water and sewage lines and certain professional services such as engineering design, consultants' studies and legal advice are contracted from the private sector.

C. Public-Private Partnerships

Although policy-making and funding decisions around public sector infrastructure must ultimately be the responsibility of the governing council this does not mean that the governing body must own the assets and deliver the services.⁵³ Asset ownership and service delivery may be handled in a variety of ways including some type of public-private partnership.⁵⁴ The major implications of this are discussed in this section.

Over the past decade or more, there has been a growing interest in delivering public sector infrastructure through public-private partnerships,⁵⁵ particularly for services with

⁵³ See references in footnote 16.

⁵⁴ The use of public private partnerships to finance capital infrastructure was discussed in another paper for this workshop; hence, the reader will note some overlapping coverage. See Harry Kitchen (2004), "Financing Local Government Capital Investment".

⁵⁵ Roy Hrab (2003), "Private Delivery of Public Services: Public Private Partnerships and Contracting-Out", research paper 21 prepared for the Panel on the role of government in Ontario, available at <http://www.law-lib.utoronto.ca/investing/index.htm>; and Roy Hrab, (2003), "Privatization:

substantial capital costs. To illustrate, eighty-five percent of government respondents to a survey by the Canadian Council for Public-Private Partnerships noted that their government was increasing its reliance on public private partnerships.⁵⁶ Similar trends have been noted in other countries.⁵⁷ This involvement can take different forms including project initiation or planning, construction, operation, ownership and financing. These public-private partnerships are a form of contracting out and involve the direct participation of one sector in a venture controlled by the other sector. Both partners contribute funds or services in exchange for certain rights or future income.

Public-private partnerships can take many forms such as the following:

- The private sector operates the facility for a fee. The public sector retains responsibility for capital costs.
- The private sector leases or purchases the facility from the public sector, operates the facility, and charges user fees.
- The private sector builds or develops a new facility, or enlarges or renovates an existing facility, and then operates it for a number of years.
- The private sector builds the required infrastructure, operates the facility for some specified period of time, and then transfers it to the government.
- The private sector builds and operates the facility and is responsible for capital financing. The public sector regulates and controls the operation.
- The private sector builds the infrastructure and then transfers ownership to the public sector.

Public-private partnerships provide some advantages. In addition to a source of capital funds, public-private partnerships enable the public sector to draw on private sector expertise⁵⁸ and skill in order to minimize costs. This advantage may be especially important to small municipalities, which may have greater difficulty than large ones in attracting expertise. Third, private sector involvement tends to lead to more innovative and efficient operations than if the public sector provides the service on its own.⁵⁹

Like most options, public-private partnerships also have disadvantages. First, there may be some uncertainty whether the private sector will be able to carry through its role, especially if there is a risk of private sector bankruptcy in the provision of essential local services. Second, there is a potential loss of control to the private sector. Third, there may be a trade-off of upfront capital costs for future operating costs; for example, the annual cost of private sector financing of a project may turn out to be greater than the cost of public sector

Experiences and Prospects”, research paper 22 prepared for the Panel on the role of government in Ontario, available at <http://www.law-lib.utoronto.ca/investing/index.htm>.

⁵⁶ Stephen Martin (2001), “Public-Private Partnerships: An Effective Tool for Providing Best Value” a paper presented at a conference on Managing the New Realities of Municipal Amalgamation, sponsored by Insight Information, Toronto, February 13-14.

⁵⁷ Akos Szalai (2001), “New Models of Privatizing Public Utilities: Highlights of Reform in Post-Soviet Countries”, in *Local Government Brief: The Quarterly Journal of Local Government and Public Service Reform Initiative* (Budapest, Hungary), 18-24, at 19.

⁵⁸ The Conference Board of Canada (2003), *Defining the Canadian Advantage*, (Ottawa: The Board).

⁵⁹ S. Probyn (1997), “Public-private partnerships on the way to nowhere”, *Financial Post*, April.

financing would have been.⁶⁰ Finally, private sector financing may include government financial or credit backing, hence continuing to impose a potential burden on the public sector.

Experience with public-private partnerships suggests that, in general, most have produced cost savings⁶¹, efficiency improvements and expanded services with the most notable improvements occurring in the presence of meaningful competition.⁶² Even where competition has not been prevalent and service provision has remained largely monopolistic, the evidence suggests that where the private sector bears the risk, private participation delivers better results than any credible public sector alternative.⁶³ It is also apparent that public-private partnerships are more appropriate for infrastructure that provides services with ‘private goods’ characteristics.

For a governing jurisdiction that may be considering a public-private partnership, the following questions should be asked and answered.

- To what extent is it possible to describe objective standards and performance measures for the service?
- Is competition present – that is, are there two or more contractors able and willing to provide the service?
- Would it be possible to replace the private provider if the firm goes out of business or its performance is below standard?
- Has the asset in question been outsourced elsewhere?
- To what extent will the government be able to monitor the contractors’ performance?
- What impact would outsourcing have on current employees?
- How much opposition might there be to privatisation?
- Is private sector involvement in the asset in question legal?
- How much time will it take to structure and implement privatisation?⁶⁴

⁶⁰ L. De Luca (1997), *Labour and Social Dimensions of Privatization and Restructuring – Public Utilities, Water, Gas, Electricity: Part II Europe*, (Geneva: International Labour Organization, Interdepartmental Action Program on Privatization, Restructuring- and Economic Democracy); and Probyn, *supra* footnote 139.

⁶¹ Enid Slack, “Financing Infrastructure: Evaluation of Existing Research and Information Gaps”, CMHC: Ottawa, 1996; Patrick C. Mann (1999), “Financing Mechanisms for Capital Improvements for Regulated Water Utilities”, a report prepared for The National Regulatory Research Institute, Ohio State University, Columbus, Ohio, at 25; and correspondence with municipal officials in Canada.

⁶² Clive Harris (2003), “Private Participation in Infrastructure in Developing Countries: Trends, Impacts and Policy Decisions” (Washington: World Bank), mimeograph, p. 27-28; and Hrab, (2003), *supra* footnote 55.

⁶³ Harris (2003), *supra* footnote 62, at 28.

⁶⁴ Carl R. Bartone (2001), “The Role of the Private Sector in Municipal Solid Waste Service Delivery in Developing Countries: Keys to Success”, in *The Challenge of Urban Government: Policies and Practices*, edited by Mila Freire and Richard Stren (Washington, D.C.: The World Bank) 215-223, at 219-221; and Glenna Carr (1996), “Promoting Entrepreneurial Municipalities”, a background paper for the Greater Toronto Area Task Force (Toronto).

If the answers to these questions suggest that a public-private partnership is appropriate, one further question remains and that is ‘what role should the government play’?

C.1 What Is The Role For Local Government?

Because public-private partnerships for most physical infrastructure projects are monopolistic in nature and because they provide services that were, in the past, or could be provided by the public sector, there is likely to be a role for local government. Local governments need not be involved in the construction of the asset nor should they be involved in the day-to-day management and delivery of services provided by this asset. Instead, the government should, through a carefully drawn up contractual agreement, set the terms and conditions for service delivery, funding, quality of service, and establish performance standards or measures to be met. It could even set out the pricing structure to be used (volumetric pricing for water and sewers; tolls for roads; user fees for solid waste disposal; and so on). In addition, government involvement might consist of setting up a price regulatory system and/or introducing monitoring practices that could include the establishment of performance measures.

i. Price Regulation

Although private sector providers are likely to oppose price regulatory schemes,⁶⁵ support for price regulation is founded on the premise that it is necessary to protect consumers/taxpayers from inefficient and unfair price increases when decisions over service responsibility and funding are made in an environment in which there is no competition.⁶⁶ Setting up a regulatory system is a complex task, however. When should prices be regulated? Who should regulate them? How should they be regulated?

When? Current practice in many countries is inconsistent when it comes to local price regulation. For example, prices are regulated for specific local government services (electricity, for instance) but not for other services in the same countries (water and sewer, public transit). The rationale behind this differential treatment is far from clear. The practice appears to be based on tradition and what is done elsewhere as opposed to any solid economic rationale. Presumably, however, the case for price regulation is strongest in instances where competitive pressures both in terms of decision-making (lack of opportunity for local council to make decisions on the trade-offs for all local goods and services) and production/delivery are weakest such as in non-contestable markets.

Who? Should regulation be the responsibility of the governing council or an independent body set up by the governing council? Of these options, the use of an independent regulatory body operating at arms length from all levels of government with experts appointed jointly by local and senior levels of government and fully versed in financial, budgetary and operational details may best serve local citizens. Certainly, it may minimize the opportunity for public sector interference in the day-to-day activities of the private sector provider.

⁶⁵ Mann (1999), *supra* footnote 61, at 26.

⁶⁶ KPMG and CMS Cameron McKenna (2002), “Analysis of Business Models and Their Applicability to Ontario”, Study 7 prepared for the Ontario SuperBuild Corporation, Toronto, Part IV.

How? What is the benchmark or criteria that should be used in determining the appropriate price? Should it be based on financial costs or economic costs? Should it be based on a defined standard of service and if so, what is that standard? These are not easy questions to answer.

In general, price regulatory schemes have two common prototypes: rate of return and price cap regulation.⁶⁷ Where rate of return is used, the regulator defines a fair and reasonable profit level and the company has the opportunity to increase price to the point where its maximum profit level is reached. Because reasonable profit is counted as a percent of the asset base, the company has an incentive to over-invest to increase its asset base and hence, its profit. Further concerns with this regulatory pricing scheme exist because there is little incentive for the provider to be efficient and vigilant in controlling costs since providers are generally permitted to recover all costs. Monitoring this price is time consuming and expensive because it would require regulators to check the usefulness of all investments so that unnecessary ones could be dropped from the asset base – a formidable task, to say the least.

Price cap regulatory schemes concentrate on creating incentives for the enterprise to increase efficiency.⁶⁸ This scheme adjusts the regulated price each year by the rate of inflation minus the rate of the expected efficiency gain. If the company reduces its costs through technological innovation or production efficiencies, it earns extra profit. If it does not, it incurs a deficit. A major difficulty with this scheme is establishing a measure of efficiency. The practice has been to compare relevant performance indicators for a company or utility with similar indicators from companies or utilities in other municipalities or to take the average for all similar enterprises within a country adjusted for geography and other factors that affect cost. The difference between a specific provider and the comparator group may be called the “efficiency deficit” (gap). Where a deficit arises, it is not always expected that it will be corrected immediately. It may take a few years with a condition that a specific percentage of the deficit be removed each year. For example, the water regulator in the United Kingdom requires that less efficient companies close 50 percent of the gap yearly. Again, such regulation, to be effective and efficient, requires a high degree of knowledge and competence on the part of the regulator.

Where the costs are less than expected under price cap regulation, owners of the physical infrastructure will earn unexpectedly high profits. One solution here is to give each customer a refund (at the end of the fiscal year) equal to that customer’s share of the profit (could be referred to as a patronage dividend). Another possibility, although less preferable economically because it would reward those customers who did not consume the service in the year when the profit was earned, would be to use the profits to reduce prices in the following year.

ii. Monitoring

Where public-private partnerships are used, governments may also wish to monitor the activity and performance of private sector providers through the use of performance measures. While relatively new for the public sector or for private providers of services for

⁶⁷ Szalai (2001), supra footnote 57, at 23.

⁶⁸ For a more detailed discussion, see KPMG et al. (2002), supra footnote 66, Part V.

the public sector, the importance of performance measures is widely recognized and has been for some time.⁶⁹ A performance measure, if correctly set, records the output, rather than the input, of spending on specific programs or services.

Implementation of a performance measurement system has a number of advantages. It allows providers and consumers to compare performance over time and across similar agencies and municipalities - referred to as benchmarking. It strengthens accountability because consumers/taxpayers are in a better position to evaluate services provided given the cost of producing these services and therefore, in a better position to judge whether service provision is effective and efficient. It enhances transparency because citizens will be able to observe and monitor activities more closely. Performance measures reinforce managerial accountability⁷⁰ and often provide an incentive to stimulate staff creativity and productivity. Finally, performance measures help providers develop budgets based on realistic economic costs and benefits rather than on historical patterns (incrementalism).

Performance measures are also used for determining the effectiveness of service delivery. Effectiveness measures the extent to which an activity contributes to the achievement of the stated goals, objectives, or targets. For example, an activity such as building a road may be very efficient in terms of cost per kilometer, but its effectiveness will depend on the usefulness of the road in providing convenience, safety, and economy for vehicular transportation. When a direct evaluation of the benefits arising from local services is not possible, the demand for services subject to quality standards could be measured through citizen surveys, studies of local economic conditions, reports on the number of applications, requests or complaints received, expert evaluations, and so on, of specific needs. In this way, a measure of the value of the service provided can be estimated. Thus, effectiveness will measure the success of not only doing things, but of doing them to citizens' satisfaction.

Performance measures are now required for a wide range of services in all municipalities and their agencies in the province of Ontario, Canada. More than 100 municipalities across North America now participate in a municipal performance measurement program developed by the International City/County Management Association (ICMA).⁷¹ These municipalities share their performance measurement results with each other annually. Sharing information on performance measures should help to improve the efficiency, accountability, and transparency of the private sector partner as long as the results are reported to users on an annual basis. This reporting could take a variety of forms including mail outs to all users and residents through property tax and/or utility bills; notices in local newspapers; and postings on the municipality's website.

D. Summary

⁶⁹ Harry Hatry (1999), *Performance Measurement*, (Washington: D.C., The Urban Institute Press).

⁷⁰ Paul L. Solano and Marvin A. Brams (1996), "Budgeting", in J. Richard Aronson and Eli Schwartz, eds., *Management Policies in Local Government Finance*, Fourth Edition (Washington, D.C.: International City Management Association), p. 164.

⁷¹ Ontario Ministry of Municipal Affairs and Housing (2003), *Municipal Performance Measurement Program*, (Toronto: Queen's Printer for Ontario), at 6-7.

Municipal services may be delivered in a variety of ways. Alternatives range from complete public provision to complete private provision or a mix of these including public-private partnerships. For public sector provision, the economic and political arguments in support of independent and autonomous or semi-independent and semi-autonomous special purpose bodies instead of city hall are generally weak. The former do not contribute anything that is unique. Their existence creates or has the potential for creating decision-making problems and unnecessary costs both for local governments and local residents. Eliminating special purpose bodies and transferring their responsibilities to municipal council should improve the extent to which local public sector efficiency, accountability and transparency could be improved. Certainly, it would remove the confusion over who is responsible for what and allow local councils to set priorities and weigh and consider the trade-offs necessary in making decisions on the relative merits of spending on water and sewer systems versus roads versus public transit versus police versus fire versus local parks and so on.

Although private sector provision of municipal services is generally interpreted as 'contracting out' or entering into public-private partnerships, it also includes the use of franchises, grants for specific services or functions, vouchers, volunteers, self-help and private non-profit agencies. Privatization does not mean that governments should forego ownership of municipal services. Indeed, they should retain the right to set standards, specify conditions and generally retain overall responsibility through the use of contractual arrangements. The private sector's role is to deliver services according to the specifications and conditions laid out by government.

There are a number of studies at the municipal level that compare the cost of delivering services in the public sector versus the private sector. In each study, the cost comparison is between local government provision and provision under 'contracting out' to the private sector. In virtually all cases, significant per unit cost savings have been observed for private sector provision. This saving, it is argued, is due to competitive forces present in private sector delivery but generally absent in public sector delivery.

Overwhelming as the empirical evidence may be, it has not silenced some critics. Perhaps the strongest criticism has come from public sector unions who feel particularly vulnerable because of possible job losses and reduced bargaining power. On the other hand, contracting out has the potential for increasing management's flexibility in managing manpower, for increasing productivity especially if incentives are built into payment schemes, for increasing a manager's ability to hire specialized expertise when needed and for lowering the public sector's payroll costs.

Although there has been relatively limited discussion and application of the role of franchises, grants, vouchers, volunteers, self-help programs and private non-profit agencies in delivering public services, these instruments or organizations may become important in the future especially if governments reduce or discontinue some services. Similarly, there is increasing evidence that public private partnerships will grow in importance.

As for the future of private sector delivery of public services, the debate will continue. There will be advocates for greater privatization as there will be critics. In

reality, however, political pressure to reduce government expenditures and reduce or restrict tax and user fee increases will force governments to resort to private sector delivery, in one form or another, for a variety of what are currently referred to as municipal services. In fact, this is even legislated or mandated in some countries.