

Example 21.1

Private Contracting for City Services

The average city in the United States provides about forty public services, covering a broad range of functions such as public safety, education, healthcare, sanitation, recreation, transportation, public assistance, and housing and community development. Approximately 60% of the services are provided in-house by city government agencies and 20% are contracted out to the private sector. The remaining 20% are either contracted out to other public agencies (12%) or provided in some other manner, such as through franchises, vouchers, and volunteers (8%). Cities often make different choices about how to provide the same public services, which adds fuel to the ongoing debate in the U.S. about whether city services should be provided by city agencies or private firms. Indeed, some people question whether these services should be in the public sector in the first place.

Chapter 21 discusses the normative question of why cities provide the services that they do. This example considers the positive question of how cities decide whether to provide the services themselves or contract them out to private firms. The cities oversee the provision of these services no matter how they choose to provide them.

PROVISION IN-HOUSE OR THROUGH PRIVATE CONTRACTING?

Economists have identified three sets of factors that determine how a particular city will answer the question of public or private provision for each of its services: economic factors, political factors, and the characteristics of the city itself.

Economic Factors

The economics of a city government's decision whether to provide a service in-house or through private contracting is essentially identical to the make-or-buy decision of a private firm for any material input that it uses to produce its output. The typical model of this decision envisions a trade-off of the following kind.

On the one hand, contracting for the service is assumed to be cheaper than in-house provision, either because private firms can hire labor more cheaply or are simply more efficient. Unions are much more important in the public sector than in the private sector, and have often been successful in bargaining for higher wages and more fringe benefits than received by comparable workers in the private sector. Public sector workers also tend to be more secure in their employment, which can generate incentives for shirking (not working very hard).

On the other hand, private contracting raises a number of potential difficulties. If the city government contracts out a service, it has to be able to ensure that the contractor will deliver the services promised, in a timely manner. There is always the possibility that the contractor will provide a lower quality service than contracted for, or be late in delivering the service, or renege on the contract altogether. Performance criteria can sometimes be difficult to specify in a contract and to enforce if they are not being met. At the very least, the government has to bear some costs to monitor the performance of the contractor, even if the contract goes well. If performance is easy to specify and monitor (for example, the service may be routine, such as towing illegally parked cars) then the cost advantages of the private sector may lead the city to contract out the service. If performance is difficult to specify and enforce (for example, the service may have many complex dimensions, such as police protection for public safety) and the government cares about the quality of the service, then the government is likely to provide the service in-house despite the cost advantage of the private sector.

Political Factors

Some economists argue that political factors are more important than economic factors in the in-house vs. private contracting decision. They believe that local politicians have a strong bias for in-house provision because it better promotes their political agendas and careers. They will consider private contracting of particular services only if the voters are upset with the government's performance or budgets are tightly constrained. In the latter case, the cost savings of private contracting reduce expenditures, which can be especially appealing if the budget is in deficit. Unlike the federal government, city governments cannot routinely issue debt to cover operating expenses. Budget deficits have to be quickly closed.

The political argument may be a bit strong as stated, but it suggests that voters' sensitivity to particular services and financial considerations such as the height of city tax rates and budget deficits should be important determinants of the in-house vs. private contracting decision. Another political factor is the conservative/liberal bias of the city residents. Presumably the more conservative the city's residents and the politicians they elect, the more likely services are to be contracted out since conservatives tend to believe that private provision is generally more effective than government provision.

City Characteristics

In addition to a city's political leanings, additional factors such as its size, structure of governance, and age may well influence how its services are provided. Small cities may not enjoy sufficient economies of scale to offer some services efficiently and therefore be forced to contract services out, either to public agencies in larger cities or to private contractors. (Or, they may not offer some services that are commonly provided by large cities).

The two main governance structures in U.S. cities are mayor/council and city manager-public administrator/council. Presumably, mayors are more likely to be swayed by political factors than city managers and therefore more likely to want services to remain in-house.

Finally, newer cities may have fewer unionized workers and also less experience with private contracting. Both factors would tend to push them towards in-house provision.

EMPIRICAL ANALYSIS

Jonathan Levin and Steven Tadelis (LS) recently undertook a study of the factors that determine the in-house vs. private contracting decision for U.S. cities.¹ The International City/County Management Association (ICMA) conducts a Service Delivery Survey of city managers every five years. LS used data from the 1997 and 2002 surveys to construct a data set on the provision of services for 1043 cities, giving them a total of 41,227 city-service observations. They also conducted their own survey of twenty-three city managers to determine how easy it would be to specify performance criteria in a contract for thirty services that most cities offer, assuming that these services were to be contracted out to the private sector. They asked about three dimensions of private contracting:

1. The ease of measuring and monitoring performance
2. Whether the service requirements are routine and predictable
3. Whether private contracts would be liable to hold-up by the contractors (meaning that, if problems developed, the city would be unable to turn easily to another contractor to provide the service – *i.e.*, the contractor could hold the city hostage to its contract).

¹ J. Levin and S. Tadelis, 'Contracting for Government Services: Theory and Evidence from U.S. Cities,' *Working Paper No. 13350*, National Bureau of Economic Research, 1050 Massachusetts Avenue, Cambridge, MA, August 2007. This example draws heavily from their paper. The earlier data on the number of services provided by the average city is on p. 5 and on the percentages of city services provided in the various ways is presented in Table 1.

LS then constructed an index of the responses to these three dimensions as a measure of the difficulty of contracting for the service. In addition, LS asked the city managers to rank the services in terms of the public's sensitivity to how well the service is performed. Finally, they collected variables from a variety of data sources on the political factors and city characteristics mentioned above. A set of summary statistics showed the following in-house/private contract breakdown in their sample of thirty services for the 1043 cities:²

- *Five services provided **most often in-house** (percentages of the total number of cities in parentheses):*
 1. crime prevention/patrol (86%)
 2. inspection/code enforcement (84%)
 3. fire prevention and suppression (82%)
 4. snow plowing/sanding (80%)
 5. utility meter reading *and* water treatment (tied at 78%).

- *Five services provided **least often in-house**:*
 1. drug and alcohol treatment programs (5%)
 2. vehicle towing and storage (9%)
 3. operation of daycare facilities (24%)
 4. operation of museums (25%)
 5. programs for the elderly (28%).

- *Five services **most often contracted out** to private firms:*
 1. vehicle towing and storage (81%)
 2. legal services (58%)
 3. operation of daycare facilities (55%)
 4. commercial solid waste collection (43%)
 5. drug and alcohol treatment programs (39%).³

The summary data are suggestive of some of the factors mentioned above. Of the services most often provided in-house, police, fire protection and code inspection would be difficult to monitor under private contracts, and citizens are likely to be sensitive to the performance of all five services. They want the roads to be snowplowed effectively and they are unlikely to trust private firms to do honest inspections, ensure the safety of the water supply, and perhaps even to read utility meters. They want independent

² *Ibid.*, Table 2.

³ The lists of least in-house provision and most private contracting do not overlap perfectly because some of the least in-house services are contracted out to both public agencies and private firms.

government verification of these functions. At the other end of the spectrum, towing and waste removal are routine services and easily monitored.

Beyond this, however, LS performed a logit regression analysis of the probability of in-house or private contracting using as regressors a set of variables representing the economic and political factors and city characteristics mentioned above. The city-service observations were the thirty services that they asked the city managers to rank in terms of the difficulty of performance contracting and public sensitivity over the 1043 cities from the ICMA Service Delivery Surveys. The main results of the regression analysis were almost entirely as expected:

1. *Difficulty of contracting index*: This has a powerful effect on private contracting. A one standard deviation increase in the difficulty of contracting index leads to a 40% reduction in the probability of private contracting.
2. *Voter sensitivity*: This is another important factor. A one standard deviation increase in the city managers' sensitivity ranking leads to a 20% reduction in the probability of private contracting.
3. *Geographic preferences*: Western cities are the most likely to privatize. LS speculate this is because people in the West are the least likely to support government intervention to solve social problems.
4. *Economies of scale*: As expected, small cities are more likely to engage in public contracting than large cities. Public contracting is apparently viewed as a closer substitute to in-house provision than is private contracting.
5. *City managers-public administrators vs. mayors*: Cities run by appointed city managers-public administrators are 12.5% more likely to turn to public contracts and 10% more likely to turn to private contracts to provide services relative to cities run by mayors.
6. *Economies of scope*: Having already contracted privately for at least one service increases the probability of contracting privately for one more service by 3% to 5%. Familiarity with private contracting apparently makes it easier or less costly to contract privately for additional services. Economists refer to this as economies of scope because the advantages to contracting derive from having a number of private contracts simultaneously, that is, from the scope of the private contracting across the services.
7. *Tight budget constraints*: Cities subject to tight budget constraints, such as those running current operating deficits, are more likely to contract out services to the private sector, presumably to reduce costs.
8. *Conservative bias?*: LS used a city's votes in the 2000 presidential election between Republican George W. Bush and Democrat Al Gore to measure the conservative/liberal leaning of the city. This led to the one surprising result: cities that voted for Mr. Bush were less likely to engage in private contracting of their services.

9. *Cost savings*: Finally, the more cities privatize their services, the lower their expenditures per capita. This cost-saving effect is quite strong. Changing just one service from in-house provision to a private contract reduces expenditures per capita by 0.6% in their sample of cities.

In summary, the analysis by Levin and Tadelis provides strong support for the standard views among economists of the factors that drive the in-house vs. private contracting decision.⁴

⁴ The results are discussed in *Ibid.*, pp. 16–24, and the coefficient estimates are presented in Tables 3–9.