

# CEPOS

Henrik Christoffersen

## **The welfare coalition and compulsory municipal outsourcing**

Med dansk sammenfatning: Mønstre i kommunernes brug af udlicitering

CEPOS arbejdsrapport nr. 14



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# **The welfare coalition and compulsory municipal outsourcing**

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CEPOS arbejdspapir nr. 14

## **Forord**

Sideløbende med den kommunale strukturreform blev der indgået en aftale mellem regeringen og Kommunernes Landsforening om øgning af kommunernes anvendelse af udlicitering som organisatorisk løsningsmåde. Aftalen var fireårig, og det er derfor nu muligt at opgøre effekterne. Der er stor forskel på kommunernes anvendelse af udlicitering, og analyserne i dette arbejdspapir sætter fokus på, hvad der ligger bag de enkelte kommuners valg af udliciteringspraksis.

Selve arbejdspapiret er engelsksproget. Baggrunden er, at det indgår i den almindelige internationale forskningsudveksling. Det er således blevet antaget til præsentation på den årlige samling i det europæiske forskernet for forskere, som beskæftiger sig med økonomisk teori om politiske og bureaukratiske systemer, European Public Choice Society. Arbejdspapiret indledes imidlertid med en dansk sammenfatning.

Det statistiske analysearbejde i forbindelse med papiret er udført af stud.polit. Jeppe Madsen. I øvrigt har jeg modtaget gode kommentarer til papiret fra cand.polit. Karsten Bo Larsen.

Juni 2011

Henrik Christoffersen

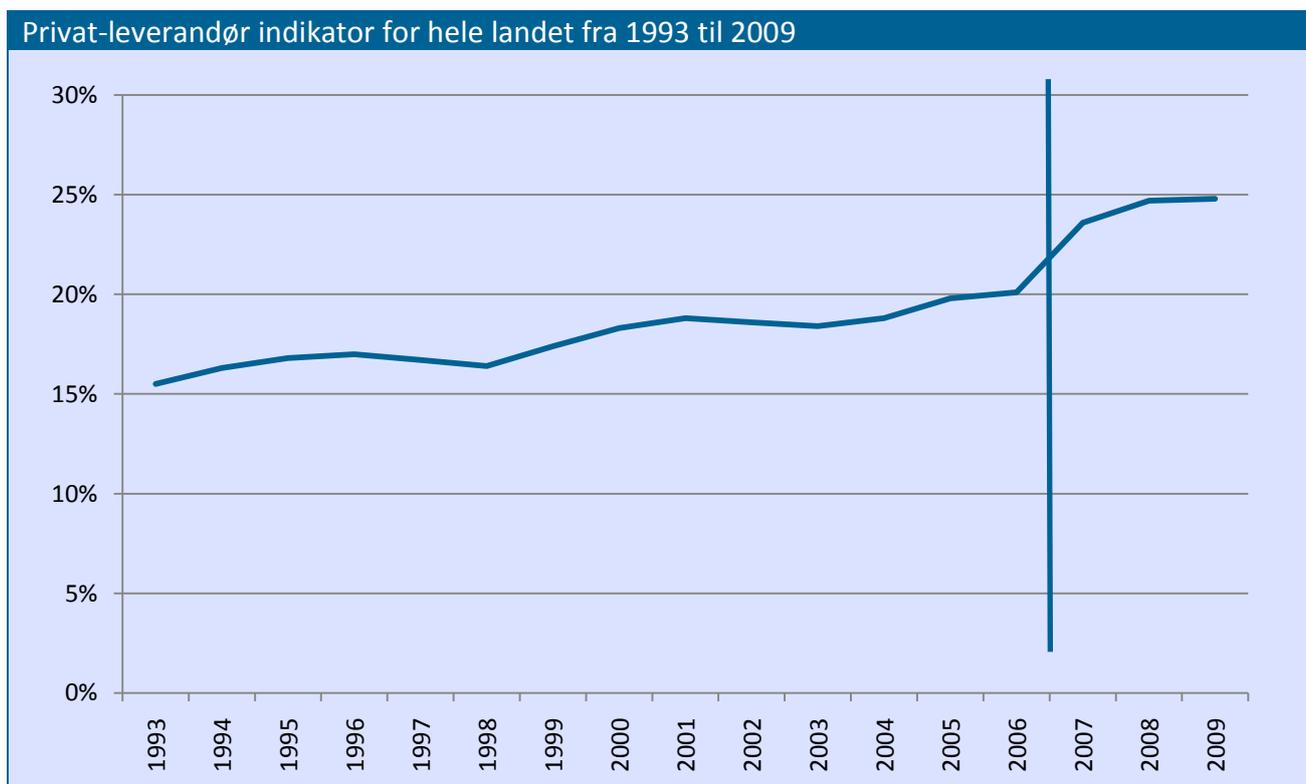
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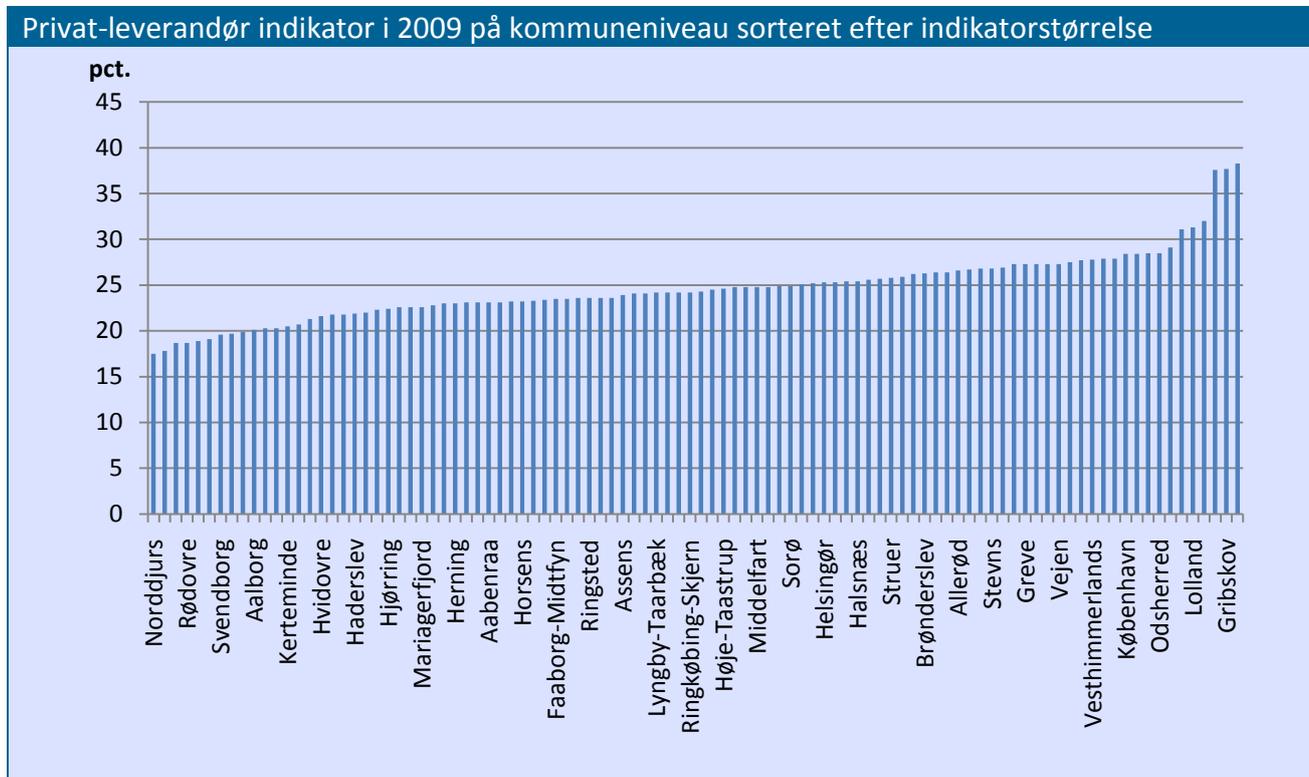
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## Sammenfatning

I sammenhæng med den kommunale strukturreform i 2007 blev der gjort foranstaltning til at øge omfanget af udlicitering i de danske kommuner. Der blev således i 2006 med virkning for de følgende fire år indgået en aftale mellem regeringen og Kommunernes Landsforening om øgning af udliciteringsomfanget i kommunesektoren som helhed. I lyset af denne aftale er anvendelsen af udlicitering faktisk øget. I figuren nedenfor er vist udviklingen i Indenrigsministeriets indikator for private leverandører, hvor løftet i anvendelse af udlicitering fremgår.



Aftalen om øget udlicitering kom til at gælde kommunesektoren under et. Der er dog stor forskel på, hvor meget de enkelte kommuner gør brug af udlicitering. Privat leverandør indikatoren er vist for hver enkelt af de 98 kommuner i den følgende figur.



I analysen i nærværende arbejdspapir undersøges, hvad der kan forklare de enkelte kommuners forskellige tendens til at anvende udlicitering. Der opstilles fem hypoteser om, hvad der forklarer anvendelsen af udlicitering:

1. Økonomiske presfaktorer. Dels indkomstgrundlag i kommunen, dels udgiftsbehov
2. Politik. Dels borgmesterens partitilhørsforhold, dels størrelsen af velfærdskoalitionen, hvilket vil sige andelen af vælgere i kommunen, der er offentligt ansat
3. Skala og grad af professionalisering. Kommunens indbyggertal
4. Soliditeten i kommunens økonomi. Dels serviceniveau, dels skatteniveau
5. Hittidig praksis. Graden af udlicitering året forud

I den regressionsanalyse, som gennemføres, viser det sig, at kun to hypoteser kan bekræftes. Det gælder hypotesen om, at kommuner med mange offentligt ansatte blandt vælgere har særlig stor aversion mod udlicitering. Ligeledes gælder det hypotesen om, at

kommuner med stor økonomisk soliditet i form af relativt højt serviceniveau og relativt lavt beskatningsniveau er særlig tilbøjelige til at anvende udlicitering.

I hovedsagen har kommuner selv mulighed for at indgive bud, når de iværksætter udlicitering. Indenrigsministeriet opgør både, hvor stor en del af kommuners budget, der konkurrenceudsættes, og hvor stor en del, der håndteres af private leverandører. Differencen mellem disse to størrelser udgør de udbud, som kommuner selv vinder.

I arbejdsrapiret gennemføres en undersøgelse af, hvad der særligt kendetegner de kommuner, som vinder egne udbud. Denne undersøgelse gennemføres også som en regressionsanalyse i en model med samme hypoteser, som anført ovenfor. Her viser det sig, at kun en enkelt af de fem hypoteser kan finde statistisk bekræftelse. Det viser sig, at de kommuner, som i særlig ringe grad har anvendt udlicitering, til gengæld i særlig stor grad vinder deres egne udbud.

Dette resultat kan have flere forklaringer. En forklaring kan være, at kommuner, der kun i ringe udstrækning anvender udlicitering, er særlig effektive, så der ikke er større gevinster ved at udlicitere. Det vil i givet fald forde, at disse kommuner er endda særdeles effektive sammenholdt med de øvrige kommuner, for i den – ganske vist begrænsede - danske forskningslitteratur om effekter af udlicitering findes ganske betydelige effekter på de opgaveområder, som er undersøgt. En anden forklaring kan være, at nogle kommuner med særligt store velfærdskoalitioner, som påvist ovenfor, også er kendetegnet ved en særlig stor aversion mod anvendelse af udlicitering. Når sådanne kommuner da i kraft af aftalen om øgning af den kommunale udlicitering udsættes for et pres for mere udlicitering, kan en reaktion være at udvise særlig iver efter at vinde udbud selv og derved undgå private leverandører.

Resultatet af analysen giver derved anledning til at rejse spørgsmålet, hvorvidt der er sikret en fair konkurrence, når kommuner foranstalter udbud og selv optræder som byder. Det kommunale regnskabssystem muliggør ikke direkte en aflæsning af kommunens omkostninger ved produktion af bestemte serviceydelser, og det er derfor vanskeligt at sikre, at krydssubsidiering ikke forekommer.

## **Abstract**

In this paper the outsourcing pattern in Danish municipalities is analyzed in the light of a structural reform in 2007, which drastically reduced the number of municipalities, and after the introduction of a government policy in 2006 enforcing the municipal sector as a whole to increase the degree of outsourcing. It is shown that municipalities inclined to use outsourcing as an organizational form are generally characterized by offering their citizens a relatively high service level compared to the tax price collected. And secondly: Municipalities with a relatively large proportion of the voters being occupied in the public welfare sector seem to have a particularly strong aversion against outsourcing. Danish municipalities are themselves allowed to respond on their own invitations to tenders. It is furthermore shown, that municipalities with limited use of outsourcing are strongly inclined to win their own invitations to tenders.

**JEL: H70, H77**

**Paper presented at the 2011 meeting in European Public Choice Society, April 28 to May 2 in Rennes.**

## **1. Municipal outsourcing as government policy**

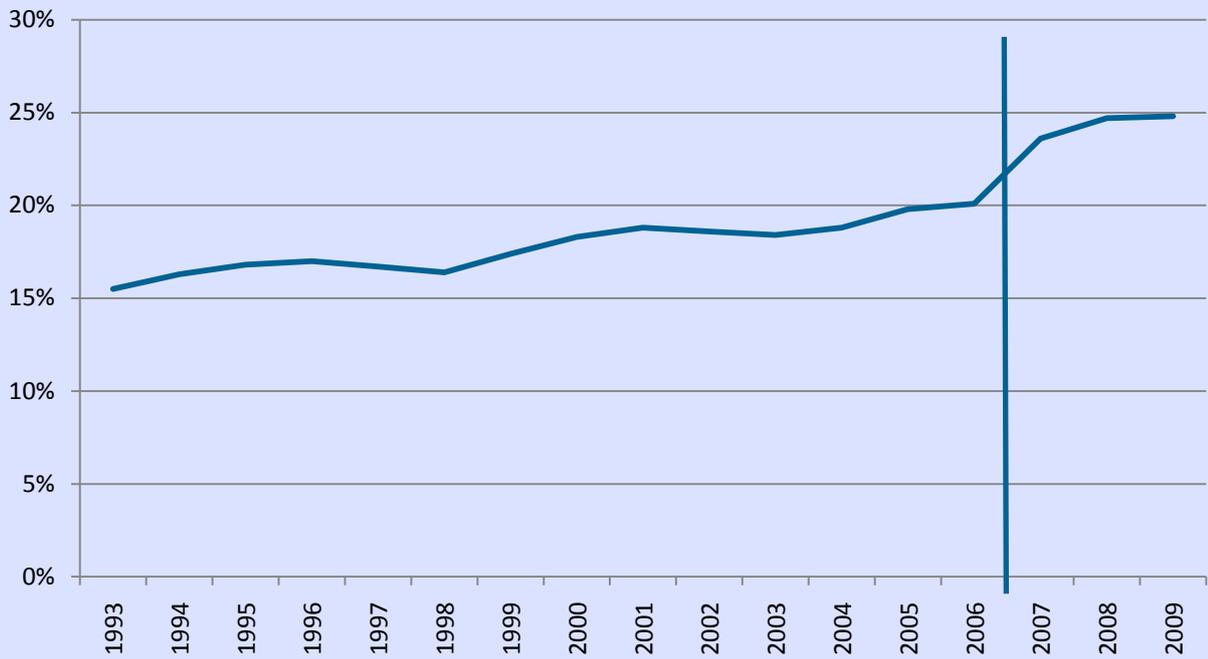
Christoffersen and Paldam (2003) showed that Danish municipalities generally hesitate outsourcing the production of welfare services to be allocated to the citizens in the municipality, and that important differences in the degree of outsourcing could be explained as a result of three factors: Municipalities with modern economic structures were especially in favor of outsourcing and the use of outsourcing was then spread to neighbor municipalities. On the other hand, municipalities with a large proportion of the local voters belonging to the “welfare coalition”, having their full income from tax financed sources as public servants or receivers of public transfer payments, had an aversion against outsourcing. In this paper the outsourcing pattern in Danish municipalities is analyzed in the light of changed basic conditions in two respects.

First, a structural reform in 2007 reduced the number of municipalities drastically from 271 to 98 and moved several tasks from the regional municipal level to the local level.

Second, the national government introduced in 2006 a policy for enforcing the municipal sector as a whole to increase the degree of outsourcing. This policy was drawn up as an agreement between the National Union of Local Authorities, KL, and the Minister of Finance saying, that the proportion of the municipal service production organized as outsourcing to private producers should be raised during a four year period from 2006 to 2010. This agreement has, as can be seen in figure 1, resulted in a slight raise in the proportion of the service production produced by private producers.

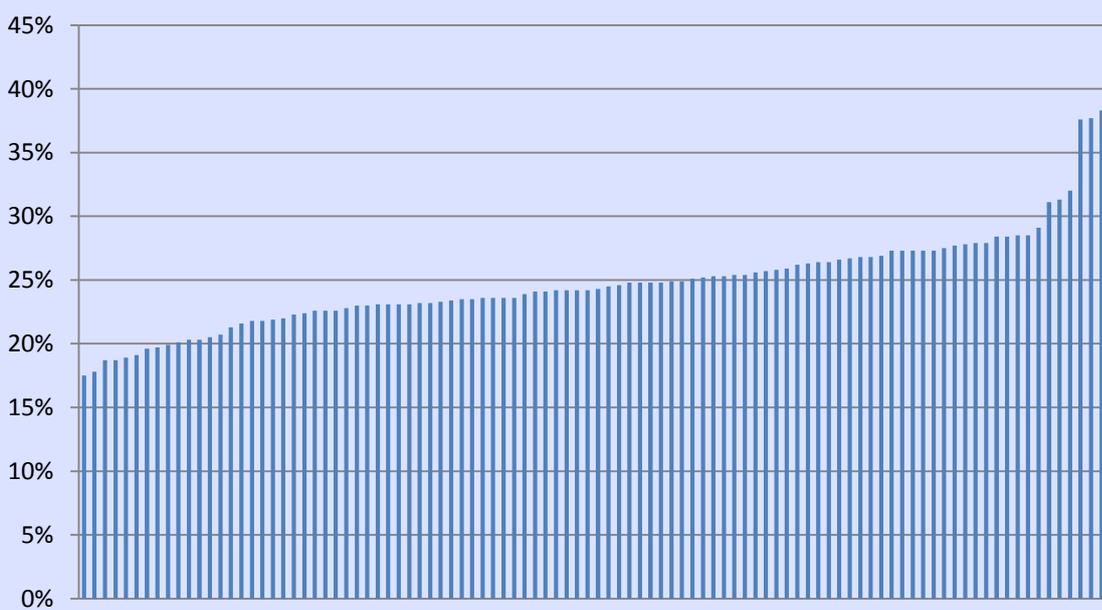
The important municipal differences in degrees of outsourcing have continued after the above mentioned changes in conditions. Figure 2 shows the proportion of service production organized as outsourcing in the 98 municipalities existing after 2007. A few municipalities are characterized by visible aversion against outsourcing and other few municipalities are especially for outsourcing as an organizational form.

Figure 1: Private supplier indicator in Danish municipalities, 1993 to 2009



Note: A municipal structural reform took place in 2007 reducing the number of municipalities from 271 to 98 and increasing the number of municipal tasks.

Figure 2: Private supplier indicator for 2009 in the 98 Danish municipalities ranked after indicator-size



## 2. A model explaining outsourcing

Several different explanations can eventually work at explaining the important differences in the use of outsourcing as an organizational form between the 98 municipalities. Four hypotheses concerning the size of the private supplier indicator in 2009, as described in figure 2, will be tested in section 3. These hypotheses are listed in figure 3 as model a.

Figure 3: The Hypotheses	
Hypotheses and variables	Definition of variables
<b>Explained variables</b>	
<b>a. Outsourcing tendency (model a)</b> <b>b. Priority to efficiency through outsourcing over high tax level (model b)</b> <b>c. Ability to win own tenders (model c)</b>	Private supplier indicator Private supplier indicator / Percentage municipal income taxation (Indicator for tasks under competition – Private supplier indicator) / Indicator for tasks under competition
<b>Explaining variables</b>	
<b>Hypothesis 1: Economic press factors</b>	
H:1.1: Income for taxation per inhabitant (model a, b og c)	Total tax base per inhabitant
H:1.2: Socio economy(model a, b og c)	Socio economic index
<b>Hypothesis 2: Political explanations</b>	
H:2.1: Mayors political party (model a, b og c)	Dummy for Liberal or Conservative mayor
H:2.2: Welfare coalition (model a, b og c)	Number of citizens employed as municipal, regional or state civil servant
<b>Hypothesis 3: Scale of production and professionalization</b>	
H:3.1: Number of inhabitants (model a, b og c)	Number of inhabitants (1.000)
<b>Hypothesis 4: The solidity of the municipal economy</b>	
H: 4.1: Service level (model a, b og c)	Municipal expenditures / Needs as measured in the block grant system
H:4.2: Level of municipal income tax (model a, b og c)	Municipal tax rate for income taxation in 2009
<b>Hypothesis 5: Past dependency</b>	
H: 5.1: Outsourcing in 2008 (model c)	Private supplier indicator in 2008

Hypothesis 1 states that economic pressure will establish an incentive to increase the use of outsourcing. There are only few Danish empirical studies of the effect of outsourcing in the municipal sector. Blom Hansen (20xx) finds that the production costs in road maintenance are about 20 percent lower when outsourcing is chosen as an organizational solution compared to production in traditional municipal form. Christoffersen, Paldam and Würtz (200X) find that school cleaning standardized for differences in quality and for economies of scale are produced at 30 percent lower costs when outsourced compared to traditional municipal organization. Christoffersen, Milhøj and Westergaard-Kabelmann (2009) construct a macro model estimating the potential if all Danish municipalities decided outsourcing to the same extent as the municipality with the highest value of the private supplier indicator in 2009. The potential such defined was estimated at between 6 and 7 percent of total municipal consumption expenditures. As the Danish empirical literature points out a significant economic potential in increased municipal outsourcing, it could be expected that municipalities not able to deliver average service level to average tax level would be especially inclined to savings through outsourcing. In H:1.1 a special need for money arises from a weak tax base, and in H:1.2 a special need of money is generated by factors indicating weak social structures among the citizens in the municipality.

Hypothesis 2 expresses a belief in politics. Two explaining variables are here introduced: understanding politics respectively as party politics and as stakeholder interests. In H:2.1 municipalities dominated by right wing political parties are expected to be more orientated towards outsourcing than other municipalities. In H:2.2 stakeholder interests are expected to work so that voters employed in the public welfare sector have special preferences for avoiding organizational forms establishing a pressure for efficiency.

Hypothesis 3 is an economies of scale hypothesis. This hypothesis is not trivial because economies of scale can exist as well in the production of municipal services as in administration of outsourcing itself. Economies of scale in production can make outsourcing especially relevant for small municipalities. Economies of scale in administration of outsourcing can make outsourcing especially relevant for large municipalities.

Hypothesis 4 is a hypothesis that municipalities which offer their citizens a worse service package than other municipalities will be pressed by the voters to increase efficiency. H:4.1 expresses a worse service package in the sense that the citizens must accept a poorer quality. H:4.2 expresses that the citizens have to pay a higher tax price.

The inclination towards use of outsourcing as an organizational form can also find expression in strategic decisions among relevant alternatives. Municipalities facing economic unbalance can decide to raise taxes or raise efficiency if not to reduce the service deliveries to the citizens. In model b defined in figure 3 the ratio “Private supplier indicator / Percentage municipal income taxation” is used to express this strategic choice in the municipalities. The four hypotheses introduced in model a are also included in model b.

### 3. The regressions

Model a explaining the private supplier indicator is tested in the regression in table 1.

Table 1: The full and reduced model explaining the private supplier indicator in Danish municipalities in 2009(model a)						
	Full model			Reduced model		
	Coefficient	t-value	P> t	Coefficient	t-value	P> t
<b>Hypothesis 1: Economic press factors</b>						
H: 1.1: : Income for taxation per inhabitant	0,01	0,39	0,70	-	-	-
H: 1.2: Socio economic index	1,63	0,98	0,33	-	-	-
<b>Hypothesis 2: Political explanations</b>						
H: 2.1: Liberal or Conservative mayor	1,33	1,76	0,08	-	-	-
H: 2.2: Welfare coalition	-16,19	-2,03	0,05	-14,42	-1,98	0,05
<b>Hypothesis 3: Scale of production and professionalization</b>						
H: 3.1: Number of inhabitants	0,01	0,94	0,35	-	-	-
<b>Hypothesis 4: The solidity of the municipal economy</b>						
H: 4.1: Service level	22,74	2,51	0,01	22,40	2,87	0,01
H: 4.2: Level of municipal income tax	-0,59	-1,06	0,29	-0,83	-1,93	0,057

Two of the four hypotheses seem to be confirmed by the regression. Municipalities inclined to use outsourcing as an organizational form are generally characterized by offering their citizens a relatively high service level compared to the tax price collected. And secondly: Municipalities with a relatively large proportion of the voters being occupied in the public welfare sector seem to have a particularly strong aversion against outsourcing.

If the level of municipal income tax H:4.2 is excluded, the welfare coalition H:2.2 will no longer be significant. It indicates, as can also be seen in the correlation matrix in table 3, a rather high correlation between welfare coalition and tax level. Also, the effect of the welfare coalition H:2.2 decreases, if the two municipalities with the highest welfare coalition (Two suburbs to Copenhagen) are excluded from the regression.

The test of model b in table 2 produces results very much similar to the results from model a. The municipalities giving priority to outsourcing compared to holding a high local tax level are generally characterized by a high service level compared to the local tax level, and

these municipalities furthermore are to a slight extent populated by voters being occupied in the public welfare sector and blocking for municipal outsourcing.

**Table 2: The full and reduced model explaining the priority to efficiency through outsourcing over high tax level (model b)**

	Full model			Reduced model		
	Coefficient	t-value	P> t	Coefficient	t-value	P> t
<b>Hypothesis 1: Economic press factors</b>						
H: 1.1: Income for taxation per inhabitant	0,00	0,50	0,62	-	-	-
H: 1.2: Socio economic index	0,07	1,04	0,30	-	-	-
<b>Hypothesis 2: Political explanations</b>						
H: 2.1: Liberal or Conservative mayor	0,05	1,78	0,08	-	-	-
H: 2.2: Welfare coalition	-0,65	-2,05	0,04	-0,57	-1,97	0,05
<b>Hypothesis 3: Scale of production and professionalization</b>						
H: 3.1: Number of inhabitants	0,00	0,99	0,33	-	-	-
<b>Hypothesis 4: The solidity of the municipal economy</b>						
H: 4.1: Service level	0,89	2,47	0,02	0,90	2,88	0,01
H: 4.2: Level of municipal income tax	-0,06	-2,79	0,01	-0,07	-4,24	0,00

Note: As table 1.

**Table 3: Korrelation matrix for explaining variables in model a, b and c.**

	Income level	Socio economy	Liberal or Conservative mayor	Welfare coalition	Number inhabitants	Service level	Local tax level	Outsourcing 2008
Income level	1,000							
Socio economy	-0,325	1,000						
Liberal or Conservative	0,149	-0,147	1,000					
Welfare coalition	0,142	0,303	-0,161	1,000				
Number inhabitants	-0,037	0,202	-0,134	0,273	1,000			
Service level	0,393	-0,078	-0,027	0,062	-0,143	1,000		
Local tax level	-0,548	0,074	-0,099	-0,273	-0,234	0,044	1,000	
Outsourcing 2008	0,293	-0,044	0,190	-0,115	-0,013	0,292	-0,182	1,000

#### **4. A model explaining municipalities winning own tenders**

When the Danish liberal-Conservative government in 2006 introduced a policy program enforcing the municipalities to increase the use of outsourcing as organizational form, it became a necessity for the municipal sector as a whole to come up with an increase in the indicator of tasks under competition measuring the proportion of the total service budget which relates to activities where invitations to tenders have been brought into use. On the other hand it was obvious that there still existed a certain resistance in the municipal sector against increased use of outsourcing. It was therefore to be expected, that not all municipalities had preferences for reacting in the same way. On the other hand the National Association of Local Authorities, KL, had to obtain from the member-municipalities, that the municipal sector as a whole was able to keep the agreement which the organization has entered into to hinder a loss of credibility. Furthermore it was necessary for KL to ensure, that all municipalities contributed to fulfilling the agreement. If not, KL was taking the risk that the outsourcing member municipalities would protest and demand solidarity. To some degree, a pressure was therefore established on the municipalities, which was strongest against increasing the use of outsourcing.

The Danish national regulation of the municipalities is open for municipalities responding themselves on their own invitations to tenders. The regulation contains rather detailed compulsory directions for calculating the production costs in municipal production in own municipal production units to avoid cross subsidizing the tasks under competition. Nevertheless this regulation has become very controversial, and the Danish lobby organizations representing industry and commerce have protested sharply against the possibility for municipalities to respond on their own invitations to tenders. The organizations argue that the regulation does not in practice prevent cross subsidizing and municipal offers to themselves to (?) dumping prices. It has, however, not been possible for the liberal conservative minority government to find support in the Danish Parliament for banning municipal offers to themselves.

The Danish Ministry of the Interior produces statistics offering data for tasks under competition, as well as private supplied goods for each municipality ([www.noegletal.dk](http://www.noegletal.dk)). The residual between these two indicators represents the extent to which municipalities are winning their own invitations to tenders. In figure 3 a model is formulated, which intends to explain the pattern of winning own invitations to tenders. The model, indicated in the figure as model c, adds an additional hypothesis to the four hypotheses in model a and b. The new hypothesis is a past dependency hypothesis, saying that municipalities being averse in relation to outsourcing are characterized by a low historical level of outsourcing, and that such municipalities will be especially inclined to win their own

invitations to tenders now that they are under pressure for setting production tasks under competition.

The results of the regression are shown in table 4. The first observation to do is that the explanations working in model a and b do not work in model c. Municipalities winning their own invitations to tenders are not especially under economic pressure. Neither are these municipalities characterized by having an especially strong welfare coalition among the local voters. Only one explanation can find confirmation, namely, the past dependency explanation. The variable used here, the private supplier indicator for 2008, is significant, and the sign is negative indicating, that municipalities with limited use of outsourcing are strongly inclined to win their own invitations to tenders.

When municipalities are winning their own invitations to tenders, it can indicate that these municipalities are working very efficiently, so that no private suppliers are able to come up with corresponding, equally efficient offers. On the other hand, the Danish literature finds as an average, as stated in section 2, that municipalities producing in own production units hold significantly higher costs than municipalities outsourcing their production. So the efficiency interpretation would presuppose a special behavior in some municipalities. Another interpretation of the results says that municipalities, as postulated by the lobby organizations for industry and commerce, are able to manipulate the calculated cost prices in own production and to cross subsidize production tasks threatened by private competitors. And that especially municipalities characterized by aversion against outsourcing, are in favor of engaging in such cross subsidizing.

Table 4: The full and reduced model explaining the own winning of tenders compared to total outsourcing in 2009

	Full model			Reduced model		
	Coefficient	t-value	P> t	Coefficient	t-value	P> t
<b>Hypothesis 1: Economic press factors</b>						
H: 1.1: Income for taxation per inhabitant	0,00	0,37	0,71	-	-	-
H: 1.2: Socio economic index	-0,01	-0,79	0,43	-	-	-
<b>Hypothesis 2: Political explanations</b>						
H: 2.1: Liberal or Conservative mayor	0,00	-0,07	0,95	-	-	-
H: 2.2: Welfare coalition	-0,05	-1,09	0,28	-	-	-
<b>Hypothesis 3: Scale of production and professionalization</b>						
H: 3.1: Number of inhabitants	0,00	0,11	0,91	-	-	-
<b>Hypothesis 4: The solidity of the municipal economy</b>						
H: 4.1: Service level	0,07	1,44	0,15	-	-	-
H: 4.2: Level of municipal income tax	0,00	-1,12	0,27	-	-	-
<b>Hypothesis 5: Past dependency</b>						
H: 5.1: Outsourcing 2008	-0,15	-2,88	0,01	-0,10	-2,09	0,04

## 5. Discussion

The Danish municipalities have increased their use of outsourcing as an organizational form after the municipal structural reform in 2007 and after the introduction of a government policy programme for increasing municipal outsourcing in 2006. Important differences in the use of this organizational form do, however, still exist despite the empirical literature pointing out important cost reduction potential in outsourcing.

Christoffersen and Paldam (2003) showed that the outsourcing pattern before the structural reform and before the introduction of the government outsourcing programme, was characterized by three significant working explanations, namely modern economic structures, diffusion from modern to traditional municipalities and the size of the welfare coalition. The model in Christoffersen and Paldam is not replicated in the present context. The reason is, that the structural reform amalgamated modern and traditional municipalities to a degree so that any comparison lacks grounds. Therefore the modern structure-hypothesis and the diffusion-hypothesis are excluded from the models in figure 3. The welfare coalition is on the other hand shown to still be working, indicating that the compulsory outsourcing programme has not succeeded in including the aversion-municipalities fully. Furthermore, the present analysis shows that municipalities characterized by aversion against outsourcing are willing to accept a higher local tax level as a strategy rather than to extent the use of outsourcing.

The compulsory outsourcing programme introduced by the government in 2006 is defined for the municipal sector as a whole, but it is likely that the programme has established a pressure on all municipalities and also on the municipalities characterized by aversion in relation to outsourcing. The result that municipalities with limited use of outsourcing are strongly inclined to win their own invitations to tenders can clearly be seen as a reaction pattern at the outsourcing-averse municipalities in relation to the government outsourcing programme.

Such a reaction pattern is possible because the municipalities are, to some degree, able to cross subsidize production activities organized in their own municipal organization. The municipal budget- and accounting system is a standardized system developed by the Ministry of the Interior in cooperation with the National Union of Local Authorities, KL. This system is, however, designed so that it is not possible directly to read the production costs of the municipal goods produced. Therefore the ministry has developed special calculation rules for municipalities giving in offers related to own invitations to tenders to avoid cross subsidies. This special regulation is not, however, necessarily so precise that cross

subsidies are ruled out. In the long run, it is a basic problem that the municipal budget- and accounting system is designed so that production costs are not visible. Re-designing the system therefore seems necessary. In the short run, it seems to be problematic that municipalities are allowed to respond themselves on their own invitations to tenders.

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