

CONTRACTING OUT BY THE PUBLIC SECTOR: THEORY, EVIDENCE, PROSPECTS

SIMON DOMBERGER
PAUL JENSEN

*Graduate School of Business, University of Sydney*¹

Unlike privatization, contracting out (or simply ‘contracting’) does not generally involve the sale of publicly owned assets. Yet it has been widely used as a mechanism for reform of public-sector service provision. Contracting introduces ex-ante competition—competition for the market through competitive tendering. This article examines both the theory and evidence of contracting by the public sector. It considers the theoretical conditions, such as contractual incompleteness and the ownership of physical assets, which may impede efficient contracting. It also reviews the international evidence which suggests that savings in the order of 20 per cent are achievable, without sacrificing the quality of service provided. In the UK, savings of between £240m and £280m have been estimated for contracts let at the central government level. Substantial savings have also been generated by contracting at the local government level.

I. INTRODUCTION

In November 1986, the *Financial Times* published a leader article under the curious headline, ‘Good and bad privatisation’. The transfer of ownership of UK public corporations to the private sector had already gathered pace by this date. Yet doubts continued to be expressed about the economic benefits of mere changes in ownership, without the promotion of competition. Such changes were labelled ‘bad’ privatization by the *Financial Times*, whereas the introduction of competitive tendering and contracting out for the provision of local author-

ity services was designated ‘good’ privatization. Compared to the sale of public assets, this activity attracted hardly any public attention, as it did not involve expensively promoted share offers. Instead, requests for competitive tenders were being unglamorously advertised by County Halls up and down the country, inviting service providers to submit bids for contracts for services such as street cleaning, refuse collection, school meals, and other amenities provided to local residents. One wonders if privatization is the right word to describe this process, since few physical assets actually changed hands after contracts were let. Indeed, more often

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than not the council's own employees won the tender, so that employment relationships remained unaffected.

Although privatization and contracting out are often used synonymously, particularly in the USA, they are quite distinct. Privatization refers to the transfer of ownership of physical assets from public to private ownership. The sale of BT or BAA via a share float constitutes straightforward privatization. The privatized organizations may or may not operate in a competitive environment. Thus privatization is essentially independent from the promotion of competition. How much competition there is post-privatization will depend largely on the structure of the industry and on government policy (see Vickers and Yarrow, 1988, for a detailed discussion).

Contracting out, on the other hand, means opening up to competition a set of economic activities which were previously immune from it. Organizations are invited to submit bids for contracts to provide particular services to the client. The distinctive feature of contracting out is the element of *ex-ante* competition—competition *for* the market as opposed to competition *in* it. The market in this case is defined by the contract specification, and the bidding process resembles an auction. Other things being equal, the lowest-price tenderer would win the right to supply for the duration of the contract term. In this way the government is able to secure the provision of services at the lowest possible cost. With contracting out, the client retains a fair measure of control over the activities concerned, monitoring performance, imposing financial penalties, and replacing the contractor in cases of outright performance failure. This level of control is not afforded by privatization.

Privatization shows no signs of losing its appeal, and is being vigorously pursued worldwide. But contracting out of government-funded services has also been on the increase, both in the UK and in other countries. Substantial evidence that has emerged since the mid-1980s suggests that governments can save in the order of 20 per cent of expenditures on services by putting them through a competitive tendering process. The benefits are therefore substantial, and have been sustained by the growth of specialist private-sector firms providing a wide range

of blue- and white-collar services. Not surprisingly, the policy has gained currency as an instrument of public-sector reform—achieving better value for taxpayers' money.

This article examines both the theory and evidence of contracting out. Section II considers the theoretical factors behind the benefits of contracting out, as well as the circumstances in which its application is likely to be problematic. Section III provides a detailed overview of the international evidence, including impact on cost and quality. In section IV, we cast our net more widely to the broader issues including public-sector accountability and employment effects. Lastly, section V discusses the potential effects of further extensions of contracting out on public expenditure outlays in the UK.

Before we proceed, a brief note on terminology. Competitive tendering and contracting refers to situations in which the in-house public-sector service provider competes with outside contractors by submitting a tender. For example, the introduction of compulsory competitive tendering under the 1988 Local Government Act obliged local authorities in England and Wales to put a group of services out to tender and to include in-house providers in the competitive process. By contrast, contracting out restricts competition to outside providers. In this article we shall use the shorthand term of 'contracting' to refer to the process at its most general—the appointment of an organization to provide services under contract following a competitive tender.

II. THEORETICAL CONSIDERATIONS

Arguments about contracting can be divided into two principal types: those that take a public policy perspective and those that focus on the underlying economics. The public policy questions include the proper role of the state, the problems of accountability when private firms supply public services, and issues concerning citizens' rights in a contracting framework (see, for example, Kerr and Radford, 1995; Corry, 1997; Jackson, 1997). Turning to the economics of contracting, we consider, first, how *ex-ante* competition for contracts yields efficient outcomes, second, how the costs of contracting can limit its practical application, and third, what infer-

ences may be drawn from contract failure regarding potential market failure.

(i) Natural Monopoly

There are two principal methods through which services can be delivered by the state to its citizens: through public production or by calling for competitive tenders. The growing use of competitive tendering to determine the most efficient method of service provision has come about primarily as the result of increased fiscal pressure on governments—the need to save money. As a consequence, approximately £2 billion of expenditure on white-collar services and £2.4 billion of expenditure on local authority services had been subjected to competitive tendering by 1995.

Many publicly provided services have natural monopoly characteristics—least-cost production requires that there be only a single service provider at any one time. It is surprising how commonplace such natural monopoly characteristics are. For example, in individual schools it would be highly inefficient if several caterers competed simultaneously within the school kitchen to provide students with their meals. At any given time, the production of such services is most efficiently handled by a single producer. Does that mean that production will suffer from the usual inefficiencies associated with monopoly—allocative as well as productive inefficiencies resulting in higher prices? Not necessarily. To see how natural monopoly can be combined with *ex-ante* competition for contracts, consider the illustration suggested by Szymanski (1994) for the case of refuse collection.

For reasons of general health and sanitation, it is mandatory that all households be provided with a service to remove waste on a regular basis (usually weekly or twice weekly), and that this be paid for through council taxes. The local authority then has to decide how to perform this activity in the most cost-effective manner. One option is to allow several competitors to bid for the work at individual households, letting them decide which of the contractors offers the best value for money. However, this is clearly inefficient because it could result in several contractors removing refuse from different households in the same street. The most efficient solution is to bundle up a number of households (or

streets) to form a discrete unit, and to invite tenders to service it for a specified period. Bid prices will vary according to the operators' estimated costs of delivering the service, and expectations about the intensity of competition. The authority will select a single operator from among those bidding for the contract. By choosing from among the lowest prices submitted, it can reduce the costs of service provision compared to the *status quo*. This will be true irrespective of whether the winning tenderer is a publicly owned, in-house team or a private contractor.

But how can the authority be confident that *ex-ante* competition for the contract will tame the power of the natural monopoly service provider to charge monopoly prices? Recent work in auction theory suggests that competitive tendering generally leads to efficient (competitive) prices, and that introducing additional bidders always puts further pressure on prices (see, for example, Bulow and Klemperer, 1996). The capacity of *ex-ante* competition to yield efficient outcomes despite structural conditions of natural monopoly was persuasively argued by Demsetz (1968). Ironically, he envisaged *ex-ante* competition for contracts to run public utilities—the very same that are being hastily privatized around the world. But the principle applies with equal force to the provision of publicly funded services.

In a similar vein, Baumol *et al.* (1982) introduced the concept of a 'contestable' market which, while not competitive in the sense of having several suppliers, can nevertheless generate competitive outcomes in terms of price and output. Contestability occurs when the sole supplier does not have a permanent hold on the market and could be displaced by a more efficient producer, charging lower prices. It should be evident that competitive tendering is a mechanism for introducing such 'contestability' into publicly funded services. Provided the selection process of the contractor and choice of the contract type are appropriate, natural monopoly characteristics in service provision need not result in losses of economic efficiency.

(ii) The Costs of Contracting

In some circumstances, the costs of transacting in the market-place can be large enough to offset the benefits. When this occurs, in-house or integrated

production is optimal. This line of reasoning is generally attributed to Oliver Williamson (see Williamson, 1979, 1985), who developed the framework known as transactions cost economics. Whether it be buying fruit in a local market or purchasing complex information technology (IT) services, every transaction involves a cost in addition to the price: finding the right supplier or negotiating the final purchase price. With regard to contracting, transaction costs include the writing of specifications and contracts, evaluating tenders, and negotiating the final contract with the winning tenderer—the administrative elements of the transaction.

But there are other factors which need to be considered, namely the degree of contractual incompleteness and the ownership of physical assets required for service delivery. Contractual incompleteness refers to the fact that it is impossible to write a contract which incorporates every contingency likely to arise during the life of the contract, or every dimension of the service. If unforeseen events occur, control over the physical assets is conferred by ownership of the assets. Therefore, whether ownership of assets remains in the public sector or is transferred to the service provider can be important. As Hart (1995) has shown, ownership of assets matters because it confers power to control *ex-post* contractual outcomes when contracts cannot completely specify the rights and obligations of the parties.

To examine these issues more closely, consider three different services that have frequently been contracted out by governments and that are associated with low, moderate, and high levels of physical assets. They are cleaning, refuse collection, and prison management, respectively. In the first case, the level of physical capital required is negligible—the service is labour-intensive. The question of who should own the physical assets—the vacuum cleaners, brooms, and brushes—is therefore trivial, and asset ownership is almost universally left in the hands of the service provider. Note that these assets are not specific to the contract, and can be easily replaced or transferred to other like activities by the contractor.

In the case of refuse collection, the level of capital investment is moderate, but significantly higher than with cleaning: specialized vehicles are required to

provide the service and vehicles require regular maintenance. There are two possibilities: public-sector or contractor ownership. In the former case, the vehicles would be owned by the client and leased to the contractor for the duration of the contract. While this may seem like an efficient contractual solution in that the client retains full control over the assets, it may create problems with respect to maintenance and renewal. The contractor has little incentive to maintain the vehicles to a level that extends their economic life beyond the contract term. The same will be true of ‘relationship-specific investments’—sunk expenditures by the contractor that enhance the operational characteristics of the vehicles. In other words, under-investment may be a significant problem if the assets are owned by the state. In order to overcome these problems, the majority of refuse collection contracts stipulate that the contractor should own the vehicles. Importantly, because the assets are not specific to the particular contract, the contract duration does not need to allow for a period of capital amortization.

Now consider the case of prison management. The ratio of physical to human capital is extremely high because the construction of a prison represents an enormous capital investment. If the facility remains in public ownership and is leased or loaned to the prison manager, then incentives problems occur once again: the contractor may skimp on maintenance and avoid relationship-specific investments. The contractor will also be aware of the potential ‘hold-up’ problem when it makes relationship-specific investments: the client may try to appropriate additional rents at the re-bid stage. The alternative is to let the manager own the facility. But because of the sheer size of the investment involved, the contract will have to be very long to make the activity profitable. This creates two significant problems. First, enforcing contractual performance becomes difficult because contract termination requires a buy-back of the facility. Second, long-term contracts attenuate the force of *ex-ante* competition thereby reducing the potential benefits to the purchaser. Hence, both ownership options present significant costs (see Brealey *et al.* in this issue on the problems of expropriation of assets by the government).

The second factor to be considered arises from the *ex-ante* non-contractability of quality. This refers to

the situation where quality characteristics of a service are both difficult to identify and to specify prior to service delivery. Assuming that reductions in cost do have an adverse affect on quality, and that some quality is non-contractable, Hart *et al.* (1997) show that private contractors have a stronger incentive to reduce costs (and thereby quality) than a public service provider. Because certain aspects of quality are non-contractable, it is difficult to establish that the private contractor is *not* providing the level of service stipulated in the contract specifications. As a consequence, the contractor's incentive to reduce costs tends to override the incentive to maintain or improve service quality. This is referred to as the 'quality-shading hypothesis'. As the impact of cost reductions on quality increases, the case against contracting out of services grows stronger.

In conclusion, the theoretical conditions under which contracting is likely to be successful may be summarized as follows.

- Contracting is likely to be more (less) successful wherever the magnitude *and* specificity of the physical assets required to provide the service are smaller (greater). Note that asset size and specificity have independent effects on contracting, but their interaction can be particularly powerful.
- Contracting out is likely to be more (less) successful whenever the quality characteristics that are non-contractable are less (more) significant.
- Contracting out is likely to be more (less) successful whenever the availability of competitive supply in the market, both actual or potential, is large (small).

(iii) Does Contract Failure Imply Market Failure?

If contractual incompleteness has a systematically adverse effect on quality for a particular service, we would expect this problem to result in widespread contract terminations in that market. It is therefore important, when observing individual instances of contract termination, to try and make a clear distinction between contract failure and market failure. They are clearly not the same: contract failure

refers to the singular—a specific case of a contract which fails to produce the desired outcome, possibly because of poor contract design or problems with performance monitoring. Market failure, on the other hand, refers to the plural—systemic failure of contractual transactions.

Despite the difficulties of contracting prison management services (see Donahue, 1989; Logan, 1990; Shichor, 1995), Britain, America, and Australia have continued their experiments with private prisons. Through the Private Finance Initiative (PFI), Britain has recently extended the coverage of private prison services with the decision to award a contract to a Group-4 joint venture with Tarmac to design, construct, manage, and finance a new 600-bed prison in Liverpool. (For a detailed discussion of the PFI see Grout in this issue.) One well-publicized prison contract, with Esmor Correctional Services Corporation at the Elizabeth Detention Centre in New Jersey in the United States, ended after a prison riot in 1995. A subsequent investigation revealed that Esmor had broken the terms of the contract by employing prison guards without the necessary qualifications and training (see Sullivan and Purdy, 1995).

Hart *et al.* (1997) cite the Esmor contract in support of the conclusion that private management of prison services is prone to failure owing to the significant non-contractable elements of quality which result in incomplete contracts. They infer that this activity may be more appropriately kept within the scope of government. While not denying the importance of quality shading problems in such contracts, the Esmor failure appears to have been attributable to the inability or unwillingness of the client to enforce contract terms. This is echoed in a recent US General Accounting Office (1997, p. 17) report which stated that: 'Officials . . . said that performance monitoring was their weakest link in their privatization process.'

The difficulties of contract monitoring have often been highlighted in the context of public service contracts. Indeed, some critics see this as the principal reason why such contracts must necessarily fail (see, for example, Foster, 1996). Contract monitoring inevitably incurs a cost which will be exacerbated by the presence of contractual incom-

pleteness. But recent studies (Audit Commission, 1995) suggest that the costs of monitoring are no more than a few percentage points of the contract price. Perhaps the evidence is revealing a lack of experience in public-sector contract management. A proper assessment of this issue must await further empirical studies.

III. EMPIRICAL EVIDENCE

Not surprisingly for a topic that is politically charged, the evolution of the empirical evidence is closely intertwined with policy developments. In the 1960s and 1970s, when the public production model was still dominant, investigations of the efficiency of contracted-out services were few and far between. Academic studies such as those by Hirsch (1965) and Collins and Downes (1977) concentrated on the mathematical properties of cost functions associated with the provision of refuse-collection services—whether or not they were subject to economies of scale. But two studies, one by Savas (1977) and another by Edwards and Stevens (1978), examined the effect of competition on the costs of providing a range of municipal services in US cities. Savas, an early advocate of ‘privatization’, discovered that competition tended to reduce costs by between 15 and 29 per cent, while Edwards and Stevens found cost reductions to be as high as 41 per cent, in some cases.

The flow of empirical studies grew in the 1980s, fuelling the controversy and strengthening the resolve of policy-makers intent on bringing market forces to bear upon the supply of public services. There are, however, some problems in interpreting the evidence which are a frequent source of confusion. These problems fall under three headings: estimating changes in costs, measuring changes in quality, and distinguishing the effect of competition from that of ownership. We examine each of them in turn.

(i) Cost Changes

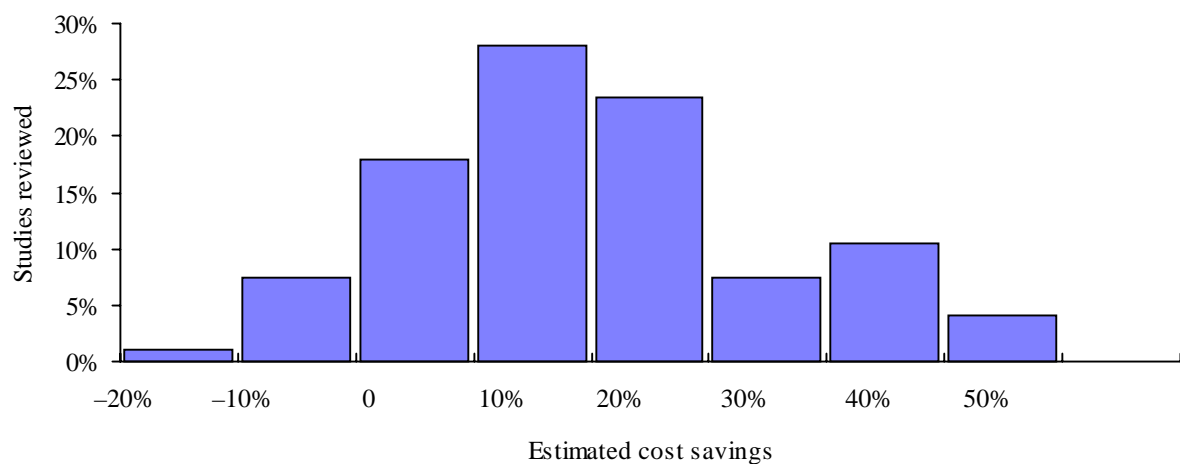
Estimating changes in costs as a result of contracting is complicated by the fact that one may not be comparing like with like. Contracting brings with it changes in specification of service requirements—

indeed, experience showed that many government agencies and local authorities did not have formal specifications of service requirements prior to their first contracting initiative. As a consequence, it is quite likely that some changes will be introduced into service levels at the time tenders are called, changes which might affect costs even if the service had *not* been put out to competitive tender. For meaningful cost comparisons, other factors have to be *held constant*, which they seldom are. This problem is compounded by the fact that public-sector accounting methods rarely captured the full *economic* costs of service provision. So comparing the price of a new private-sector services contract with the historic costs of public provision may be misleading.

To ensure that cost comparisons are not distorted by changes in service specifications before and after contracting, it is necessary to have a method of *controlling* for the effect of individual service characteristics on costs. For example, if it can be established that increasing the frequency of refuse collection from once weekly to twice weekly increases costs by 50 per cent, then an allowance can be made in any cost comparisons which involves a contemporaneous change in frequency of collection. The most effective way of controlling for such factors is by means of econometric modelling—using regression analysis. McDavid (1985) used such analysis to control for scale of output, collection method, environmental conditions, and service levels in a study of refuse collection costs in 126 Canadian municipalities in 1981. He found that public collection was 41 per cent dearer than private collection. Without controlling for service characteristics the difference was 50 per cent.

In the UK, the first study to analyse the impact of competitive tendering on refuse collection costs was made possible by comparative data from the Chartered Institute of Public Finance and Accountancy. The study, by Domberger *et al.* (1986), was based on an econometric model of the costs of refuse collection in England and Wales, and used data on 305 local authorities for two consecutive financial years—610 useable observations in total. The model controlled for a dozen different service-related factors, such as collection method or frequency, which could affect costs, and included variables capturing volume of refuse collected and

Figure 1
Distribution of Savings from 203 Studies of Contracting Out



Source: Industry Commission (1996).

the wage levels applicable to different regions in the country. The results showed that those local authorities that had put the service out to tender and awarded the contract to a private operator had achieved savings of 22 per cent on average, allowing for all other factors influencing costs.

This cost difference was both large and significant. In their article, Domberger *et al.* suggested that if all local authorities, instead of just 38 out of a total of 403, had put refuse collection services out to contract, an estimated £80m (in 1985/86 prices) could have been saved. These findings have been corroborated by subsequent research by Szymanski and Wilkins (1993), who found that savings were maintained at around the 20 per cent mark even after the introduction of *compulsory* competitive tendering in local government. However, the results of a questionnaire survey of 40 English local authorities conducted by Walsh (1991) found that respondents estimated the savings to be much lower—around 6 per cent. In interpreting this result it must be borne in mind that the estimated savings were provided by the respondents themselves, with no allowances made for differences in service characteristics across authorities.

Similar or even higher levels of efficiency gains have been reported in non-local-government services. For example, in hospital domestic services, using a sample of nearly 3,000 hospitals in the UK,

Domberger *et al.* (1987) found savings to be as high as 34 per cent. These results were later confirmed, using more recent data, by Milne and McGee (1992). Most recently, the Efficiency Unit of the UK Cabinet Office (1996) undertook a review of the *Competing for Quality* programme which market tested (competitively tendered) services worth nearly £2 billion, ranging from activities such as estate and facilities management to scientific and technical research and development. Savings achieved by the programme were estimated to be, on average, 18 per cent of service expenditures.

The international evidence is broadly in agreement with the British findings. In 1996, the Australian Industry Commission, an economic advisory body, conducted a major study on the effects of competitive tendering and contracting by public-sector agencies. As part of that investigation no fewer than 203 separate international studies on the effects of contracting on costs were reviewed. They included surveys, quantitative analyses, and more qualitative case studies. The results of this meta-analysis are shown in Figure 1.

It can be seen that the distribution of reported savings across the studies is rather wide. It should also be noted that the analysis did not take into account the role of asset ownership or non-contractability of quality. However, what is striking about these results is that the most frequently

reported magnitudes of cost savings lie in the ranges of 10–20, and 20–30 per cent. This is entirely consistent with the conclusions based on UK data.

There has been some debate regarding the sources of these efficiency gains. The critical issue is whether they represent wealth transfers—reductions in wages and salaries of staff—or genuine productivity gains.² Untangling the individual effects is no easy task, but the available evidence suggests that the bulk of the savings are accounted for by better management, more flexible working practices, more efficient use of capital and greater innovation spurred by competition (see Cubbin *et al.*, 1987; Industry Commission, 1996).

(ii) Service Quality

While the concept of quality is universally, if not uniformly, understood—most people *believe* they know what quality means—applying it more rigorously turns out to be devilishly difficult. First, there are problems of measurement: quality may be identified in terms of certain performance characteristics, but their assessment may require subjective judgement rather than mere accumulation of facts. Cleaning is perhaps a good example: what constitutes a high standard of cleanliness may vary from one observer to another. However, the consequences of non-contractability of quality are generally not critical in this activity.

In the context of contracting there is another problem. ‘Before and after’ comparisons of quality can rarely be made because of the lack of data on service quality prior to contracts being let. There is a significant asymmetry in the availability of performance information. This stems from the fact that after the policy shift, critics of contracting raised concerns that cost savings would only be achievable at the expense of quality of service (Evatt Research Centre, 1990)—the familiar ‘quality-shading hypothesis’—lower contractor prices require a sacrifice in terms of performance. For that reason, and because of the politically and administratively sensitive nature of contracting, improved performance monitoring followed the implementation of contracts almost everywhere.

Despite these difficulties, studies that have examined the quality issue have been published in recent years, although in far fewer numbers than those on costs. The study by Walsh (1991, p. 5) based on a survey of 40 English local authorities, concluded that ‘Competition has led to major changes in the monitoring of service, with explicit inspection processes being introduced, and a clear emphasis on standards.’

Another recent study by Domberger *et al.* (1995) focused on the quality-shading hypothesis: do contractors systematically shade quality after contracts are let in order to maintain profitability in the face of reduced prices? The study was based on a sample of 61 cleaning contracts, monitored by specially trained inspectors over a 9-month period. Since performance data prior to contracting were not available, the study took a different tack: it analysed a sample of contemporaneous contracts that had been tendered with another that had not subjected to any form of market testing. This would enable the researchers to isolate the effect of competition on price and quality. Controls were introduced into the model for different cleaning environments, different ownership patterns (whether publicly or privately owned contracts), and inspector effects. The last was added to ensure that the results would not be biased by the propensities of different inspectors to judge contract performance either harshly or leniently.

The results showed that while competition lowered contract prices by between 35 and 50 per cent, cleaning performance was maintained or even enhanced in some cases. These findings do not support the quality-shading hypothesis, although they are limited in their scope and should not be treated as definitive. For a more comprehensive view of the evidence on quality of service it is instructive to turn to the Australian Industry Commission’s study once again. It reviewed over a dozen international studies and also took evidence from contractors, unions, and other interested parties. On the basis of this information it concluded: ‘The improvements in quality reported after [competitive tendering and contracting] appear to arise because of a much clearer focus on what is required in the service, improved performance

² In the UK, the TYPE legislation safeguards continuity of terms and conditions of staff transferred to contractors. However, TYPE does not universally apply to public-sector contracts.

monitoring and the ability to choose among alternative providers' (Industry Commission, 1996, p. 124).

This conclusion echoes the assessment of Walsh (1991) discussed earlier. It also makes clear that, if quality deteriorates following contracting, it could be a problem of contract design or implementation, and therefore preventable (see Domberger and Rimmer, 1994, for further discussion).

(iii) Competition or Ownership?

Perhaps the most vexed issue in the contracting debate is whether its impact on costs and quality stems principally from the pressure of competition or the discipline of private ownership. Some commentators, notably Savas (1987), have suggested that the public sector cannot be expected to deliver services as efficiently as the market, assuming one exists. The principal reasons are that public-sector organizations are not client-oriented and have broader and often ill-defined public-service objectives; they lack incentives to perform. Also, because they are free from the 'bankruptcy constraint', they can go on performing poorly without fear of the ultimate sanction of going out of business. Other commentators (Kay and Thompson, 1986), however, have suggested that these are the ills borne by market structure: the public-sector service-provider has a monopoly. Private-sector monopolies would perform no better: the spur of competition is what enhances performance.

The evidence provides qualified support for the view that competition is the key. Domberger *et al.* (1986, 1987) found that in cases where in-house teams bid against private contractors and won, the level of savings achieved was substantial and often not significantly different from that realized by private contractors. In their study of price and quality, Domberger *et al.* (1995, p. 1469) concluded that 'the effect of ownership (private versus public) on both price and quality was negligible relative to that of competition'.

However, in a recent study Szymanski (1996, p. 11) found that after the introduction of competitive tendering, local authorities that had awarded service contracts to their in-house teams were achieving significantly lower savings compared to those that had engaged private contractors: 'Following the

introduction of CCT [compulsory competitive tendering], the estimates indicate that DSOs [in-house teams] reduced costs by around 10 per cent while private contractors tended to reduce costs by around 20 per cent.' These findings suggest that ownership does matter. They also raise another fundamental question: are the benefits of contracting transitory? This is a complex issue which is beyond the scope of the present paper. However, there should be no doubt that as long as *ex-ante* competition (or the threat of *ex-ante* competition) is maintained, efficient outcomes should be attainable. If the incumbent in-house teams persistently under-perform compared to private contractors, yet continue to win tenders, then competition is not effective. The problem may get worse, as private contractors stop bidding for contracts they believe are destined to remain in the public sector. The challenge for policy-makers lies in achieving competitive neutrality between private- and public-sector tenderers, so that competition is both effective and real.

IV. BROADER CONSIDERATIONS

(i) Employment Effects

A significant area of concern with the increasing use of contracting has been its impact on jobs. This can be separated into short-term effects, such as the impact on wages and the terms and conditions of employment, and the long-run impact, particularly its effect on long-term unemployment.

In the short term, as the competitive process compels organizations to use labour more productively, one of the first observable effects of contracting is staff reductions. There is, as noted earlier, disagreement about the effect of contracting on wages and conditions of employment. Some have argued that contracting has resulted in reduced pay rates and worsened employment conditions (see Ascher 1987), while others contend that there has been little impact on terms and conditions of employment (see Cubbin *et al.*, 1987; Walsh, 1991). The introduction of contracting is also likely to increase flexibility in work practices, such as the greater use of casual and part-time labour. However, this is mirrored in the general labour market trend towards greater labour flexibility, and is not unique to contracting.

In the long term, the organizational restructuring which typically leads to reductions in the number of staff may have an effect on unemployment. When a contract is awarded, there are three possible employment outcomes for staff: redeployment within the government organization, transfer to the contractor, or redundancy. The observable trend with regard to employment opportunities is that those employees with higher skills are more likely to be re-employed by the incoming contractor. However, there is no systematic evidence to suggest that contracting does lead to increases in long-term unemployment. In fact, it is conceivable that it may actually improve employment opportunities by stimulating the growth of the private sector.

The unemployment debate has gradually led to a growing awareness among private-sector operators of their social responsibility towards staff that are made redundant through contracting. Some large UK firms specializing in government contracts are now providing assistance with career transition management for those staff that are not offered positions. In effect, contractors are starting to take some responsibility for redeployment, retraining, and relocation of staff that would otherwise have relied on redundancy pay-outs or the state's unemployment benefit system.

(ii) Public-sector Accountability

On the public policy side of the contracting debate, some concerns have been raised about the loss of public-sector accountability. Briefly, the argument is that once contractors take control of service provision there is a loss of accountability since the contractor, and not the authority or department, is now responsible for the activity (see, for example, Boston, 1995). Accountability is understood to mean a capacity to call an authority or department into account by having its senior officials answer and explain their conduct. Clearly, contractual relationships do not operate in the same way as administrative channels, but that does not mean that contracting does or should reduce departmental accountability. The controversy stems in large part from a confusion over the difference between responsibility and accountability. Where a public-sector organization transfers responsibility for certain functions to the private sector, it does not relinquish accountability for them. In the words of the Austral-

ian Industry Commission (1996, p. 102): 'Whatever the method of service delivery, the government agency must remain accountable for the efficient performance of the functions delegated to it by the government.'

Contracting can actually enhance accountability in three different ways: by prompting reviews of standards and service specifications; by introducing rigorous performance monitoring along the lines discussed earlier; and by setting up mechanisms for redress in cases where individuals or organizations have suffered loss or damage. While some clearly prefer the traditional administrative channels of accountability, however opaque they may be, experience has shown that contracting need not reduce public-sector accountability, only the way in which it manifests itself.

V. FUTURE DEVELOPMENTS

It is evident from the empirical findings that the savings generated by contracting are substantial. And there is no reason to suppose that they are not sustainable over time, provided the discipline of competition is maintained. This raises an important question: what has been the overall impact of contracting for services on public expenditure in the UK? A detailed estimate would be difficult to calculate without considerable research which is beyond the scope of this paper. However, some figures are available which allow us to derive indicative estimates of what has been achieved at the local and central government levels.

At the local government level, using figures from the Department of the Environment, the Audit Commission, and the Institute of Public Finance, the value of contracts let under the Compulsory Competitive Tendering (CCT) programme in 1994 was estimated to be £2.4 billion. Assuming that the average net percentage cost reduction generated by CCT ranges from 10 to 18 per cent, this implies that the financial savings from contracting lie between £266m and £526m.

At the central government level, the Efficiency Unit of the UK Cabinet Office (1996) recently produced a report entitled *Competing for Quality*, which contained estimates of the savings generated by the

programme of the same name. The programme put out to competition a range of white-collar services previously undertaken in-house. The report estimated that net savings of between £240m and £280m were generated on total contract expenditures of £1.85 billion.

Taking these figures at face value would suggest that contracting can have a significant effect on public expenditure by reducing the costs of providing a whole range of publicly funded services. It is surprising, therefore, to find influential commentators who take precisely the opposite view. In a recent article on the evolution of public expenditure in the UK, Flemming and Oppenheimer (1996, p. 62), claim:

So far, any cost reductions achieved by contracting out have been insignificant. Claims have been made from time to time that contracting out has achieved substantial reductions in the cost e.g. of hospital cleaning; but it has not been shown that such economies are big enough to have perceptible effects on aggregate expenditure.

One way of explaining this apparent contradiction is by noting, as Flemming and Oppenheimer (1996, pp. 66–7) do, that the bulk of public expenditure in the UK represents transfer payments, including social security, unemployment benefits, and pensions: ‘By far the largest single category of government spending is the social security budget. In the years 1992–

95, it amounted to roughly one-third of the total or 13.5 per cent of GDP. This category consists of transfer payment, as opposed to purchases of goods or services’. It is clear that expenditure on transfer payments cannot be reduced by means of competitive tendering and contracting, since it does not involve the production of services where efficiency gains might be obtained.

Although this constrains the ability of contracting to have a more significant impact on public expenditure, it does not exclude it altogether. The administration and management of social security benefits consume considerable resources. These activities, which do involve the provision of services, could be subjected to competition under closely regulated conditions. A good example of such an initiative comes from Australia, where the federal government has decided to restructure the Commonwealth Employment Service in favour of a scheme where private- and public-sector providers compete for the provision of employment-placement services to the unemployed. This experiment, which is still in its infancy, suggests that the scope of contracting in the provision of publicly funded services may be broader than appears at first sight. Whether it is to reduce public outlays, or improve the quality of services delivered, the potentially beneficial impact of competition should not be lightly dismissed.

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