

**COMPETITION
IN
GOVERNMENT-FINANCED
SERVICES**

JOHN C. HILKE

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Preface

This study first reviews the rationale for government financing and provision of services and presents arguments for the position that competitive provision of some of these services is likely to be more efficient. The study then examines the principal methods of increasing competition in government-financed services and presents a summary of U.S. and other industrialized countries' experiences to date in the "experiment" of increasing competition in these services. The purpose is to alert the public to the potential magnitude of cost savings from additional increases in competition in government-financed services in the United States and to describe the types of services for which increased competition is likely to be most effective in reducing costs. The insights from this review should have application to considerations of privatization in Eastern Europe and developing countries, as well as to further competitivization of government-financed services in the United States.

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Although the author holds the position of staff economist in the Bureau of Economics at the FTC, this study has not been reviewed by, nor does it necessarily reflect the views of, the Federal Trade Commission or of any individual commissioner.

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1

Introduction

CONTEXT AND PURPOSE OF THE STUDY

This study primarily concerns the extent to which real resources can be saved by increasing competition in the supply of commercial services currently produced on a sole-source basis by government. The focus is on services that will continue to be financed by government even if government no longer directly produces the service.

When economists are asked about the institutional setting for voluntary exchange that typically advances the interests of consumers, the response is almost invariably a competitive setting, in which informed buyers have a choice from among several sellers. The rationale for this response is that, in the absence of market failures, a competitive setting offers the best chance of avoiding artificially high prices and shoddy services or products. Competing sellers have strong profit incentives to minimize costs for any given quality and to offer consumers the highest quality for any given price in order to gain and retain customers. Without the spur of competition, monopoly suppliers, whether public or private, may be tempted to charge excessive prices, allow quality to deteriorate, fail to minimize costs, and tolerate stagnant productivity.

Despite near unanimity about the benefits of competition to buyers, most governments, by reason of habit or law, have produced most services provided to their citizens using a sole-source supplier: the in-house agency or bureau assigned to that

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particular service. Until recently, economists have not contributed much to assessing the costs of sole-source internal (i.e., in-house) supply of government services, principally because economists often have associated government responsibility for *financing* (or arranging) a service, with actual government *production* of that service.¹ In fact, there is no necessary conceptual connection between the two.²

The traditional rationale for government involvement in financing services concerns the concept of public services. However, governments often internally produce both public and private services.³

Public services have distinctive characteristics that make it unlikely that private sellers will provide them in sufficient quantities to efficiently satisfy total demand.⁴ In particular, public services are characterized by "nonrival consumption." The consumption of the same service by one individual does not necessarily prevent or diminish consumption by others. Public services may also be characterized by high costs of excluding would-be consumers. That is, it is costly to prevent those who have not paid for the service from consuming it, once the service has been provided to some consumers. Because of these two characteristics, it is difficult to obtain a price from consumers that is sufficient to recoup the costs of providing the public service. Each consumer will bear only a small fraction of the cost of providing the service. Thus, each consumer has an incentive to understate how much the service is worth to him or her because the amount each person consumes is largely independent of the amount he or she contributes.⁵

Government may be able to overcome this market failure by forcing consumers to reveal their valuations of different levels of public goods through the combination of voting and involuntary payments (taxes).⁶ In voting, consumers are faced with choices among budget proposals that specify prices in terms of the consumers' required tax payments. By overcoming the ability of other consumers to free ride, the voting and tax combination available to governments encourages consumers to express their real valuations and may help to create a market reflecting them. In this way, the government, at least in theory, can set the level of production at the economically efficient level and obtain (purchase) that quantity of output from private producers.⁷

An example of a public service might be the broadcast of regional weather information for the Chesapeake Bay. This service involves nonrival consumption because providing the information to one person does not appreciably diminish the value of the information to others. It also presents an excludability problem because it would be difficult to broadcast to those who pay for such a service while excluding others, without resorting to expensive specialized broadcast and receiving equipment.

Private services include all services that are not public services, although they may be used as inputs in the production of public services. Private services are characterized by exclusive consumption and the ready ability of sellers to distinguish between (and exclude) those who do and do not pay.

In-house government *production*, as distinguished from *public services*, simply means that the government that finances provision of the service actually produces the service. In-house production means that this government unit hires workers, owns machinery, buys raw materials and semifinished goods, and transforms them into services. Outside *production*, as opposed to *private services*, means only that an organization other than the government that financed it produced the service. Any organization, even a different government, could, in effect, be a outside producer in this context.

Although outside production can be widely applied to many government financed products and services, there are some services for which outside production is generally held to be inappropriate. These *inherently governmental services* involve wide government discretion and extensive value judgments. Use of police powers, judicial decisions, regulation, and policy setting are among the arenas where outside production is likely to have limited applicability. Extension of market competition to inherently governmental services may encounter transactions costs and other problems such as delegation of powers and conflicts of interest. For example, delegation of the government's authority to determine guilt or innocence could be subject to abuses that would erode fundamental constitutional rights. In addition, such abuses could be very costly for the government to detect and document.⁸

Other forms of competition may be viable routes for reducing costs where outside production by private firms or other private groups is inappropriate. Both competition between agencies within

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a jurisdiction and competition from other governments are possible alternatives.⁹

In contrast to inherently governmental services, *commercial services* currently produced by the government are often supplied by private firms in other contexts and characterized by readily definable outputs and well-understood technologies. These services are generally good candidates for outside production aimed at reducing costs. The distinctions between commercial and inherently governmental services are not absolute; commercial services are services that are provided by the private sector for the private sector and that can also be provided by the private sector for government.

Figure 1.1 shows the distinctive combinations of production of government financed services in the format of a two-by-two table.¹⁰ The vertical axis distinguishes between in-house and outside production. The horizontal axis distinguished between public and private services. Commercial services include all private services and those public services that are not inherently governmental services.

"Commercial public service" is not a contradiction in terms because there are some public services that are frequently provided in the private sector, but for only a segment of the citizens. For example, library services are often considered to involve nonrival consumption and positive externalities and therefore may qualify as a public service. Library services are not, however, confined to the public sector. Most major firms, for example, have libraries and so library services are a commercial service, although arguably a public service. Thus it may be possible for localities to finance more efficient outside production of library services, that is to shift production of library services from cell I to cell III. This flexibility is possible because (1) library services generally do not involve wide discretion and value judgments that make them an inherently governmental service and (2) private suppliers may be available to provide library services to the government because library services are extensively produced in the private sector.

As another example of how Figure 1.1 represents type of service and production differences, consider the Chesapeake Bay weather forecasting service example mentioned earlier. Assume initially that the service was financed by the federal government,

produced in-house by the National Weather Service, and broadcast by the Coast Guard. This would make it a cell I service, although it still might be a commercial service since private firms also routinely provide both weather forecasting and broadcasting services. If instead, the government competitively contracted a private firm to both forecast and broadcast the information, the service would move from cell I to cell III because it would shift from in-house to outside production.¹¹

Finally, consider a decision to put the broadcast portion of the original weather service up for bid. If the Coast Guard won the bidding, but at a lower cost than it previously experienced, the broadcast service would remain in cell I, but subject to the competitive effects of the possibility of moving to cell III.

Any type of service can be produced by the government. At the extreme, government can control virtually all means of production, as in a totalitarian communist society.¹²

Figure 1.1
Production Options for Public and Private Services
Financed by Government

	Public Services	Private Services
In-House Production	Cell I	Cell II
Outside Production	Cell III	Cell IV

At the other extreme, government can contract with private firms for production of most services, as some local governments do.¹³ Finally, some public (private) services financed by a government may be supplied by a mix of in-house and outside production. This case would lie in between cells I and III (cells II and IV).

Although empirical estimates of cost savings generally include all types of cost savings,¹⁴ this study primarily concerns ways of conserving real resources by increasing competition in the production of services in cells I and II in Figure 1.1.¹⁵

Despite the absence of any compelling efficiency justification for government financing or production in cell II, some governments may reject shedding these services for noneconomic reasons, and yet they may wish to supply these (cell II) services more efficiently.¹⁶ Consequently, this study asks whether governments can increase efficiency by increasing competition in the services, particularly commercial services, that governments currently produce.¹⁷

In addition to real resource savings, increased competition may also reduce economic rents (i.e., wage premiums) obtained by some factors of production. Economic rents may be largely a matter of income distribution and therefore may not directly present an issue of economic efficiency (real resource savings). Appendix A provides a discussion of this distinction and chapter 4 presents empirical evidence separating direct efficiency (real resource) effects from wage premium effects. An indirect economic efficiency rationale for concern about wage premiums is that they may induce waste of real resources.¹⁸ Wage premiums become a matter of economic efficiency concern if (1) real resources are lost in the process of raising tax revenue to finance the service, (2) real resources are consumed in preserving or enhancing the wage premiums, and (3) allocative efficiency is reduced by the distortions (in government choices about the quantity, quality, and mix of services that are supplied through government) caused by the wage premiums. Because of the possible indirect efficiency costs of wage premiums, the final empirical cost savings estimates in chapter 5 will be present estimates of both total cost savings and cost savings from direct efficiency improvements.

To anticipate the study's conclusions, sole-source in-house production of government financed services does not appear to be

inevitable. Competition from various alternative sources can be introduced. Increasing competition in producing government services can both directly improve efficiency and reduce the total costs of government services at the federal, state, and local levels. This study gathers the available data to reach an overall assessment of the potential direct efficiency and total cost savings from increasing competition ("competitization") in government-financed services that are currently produced in-house.

DETERMINING THE KINDS OF SERVICES SUITABLE FOR COMPETITION FROM OUTSIDE PRODUCERS

Whether a service is produced most efficiently by the government that finances it or by external parties can be analyzed using the same models that explain private firms' choices on the extent of various forms of vertical integration.¹⁹ Private decisions about vertical integration are typically driven by the goal of minimizing costs. The economic literature that focuses on the comparative costs of transactions between and within organizations is termed "micro-microeconomics" or the "new institutional economics."²⁰ The theme of this literature is that arms-length market transactions, while ideally more efficient, are sometimes subject to various types of market failures that may make vertical integration preferable. Essentially it sometimes is too costly to obtain enough accurate information to make independent market transactions (including long-term and short-term contracts) work properly.²¹

For example, the electronics industry has found that the probability of success with consumers is greatly enhanced if marketing personnel are closely involved in developing new product designs and components. Arranging for such close contact between marketers and product developers through a contract has proven costly and difficult. Security and prospective patent rights, in particular, are difficult to specify and enforce through a prenegotiated contract. As a result, many electronics firms produce both marketing services and product development services in-house.²²

The U.S. automobile industry in the first three quarters of the century illustrates another set of explanations for vertical integration. Although U.S. automobile manufacturing firms could have limited their efforts to assembling parts produced by independent suppliers,²³ uncertainty about supplies and uncertainty about the competitiveness of prices charged by suppliers apparently led U.S. automobile manufacturers to vertically integrate in many areas.²⁴ In some cases, the integration extended to the raw materials stage, as in Ford Motor Company's steel operations.²⁵ Integration of car body and other assembly operations also reportedly occurred for the same reasons.²⁶

The problems noted above can occur within any organization, public or private. Controls within an organization may or not be able to overcome these problems better than market transactions and may add significant costs in the process.²⁷ The trick for both the private and public decision makers interested in minimizing costs is to determine when market failures make in-house production more efficient than buying from outside firms in a competitive market.²⁸

The vertical integration literature indicates that outside production (purchasing on the open market) is routinely used by private firms to obtain many, if not most, inputs into final production of goods and services. Firms generally revert to in-house production only when there are important market failures. The market is likely to be a more efficient form of procuring inputs unless (1) there are very few potential suppliers, (2) costs of switching from one producer to another are high, (3) information about the production process and supplier performance is expensive to obtain, and (4) the good or service being provided cannot be clearly defined. Inability to institute incentives and controls in in-house government production also increases the probability that relying on the open market is the most efficient means of procuring production inputs.²⁹

Many of the distinctions in product and production characteristics that are critical to decisions about vertical integration parallel the discussion of product characteristics in the product quality literature.³⁰ For example, "inspection" services in that literature are defined as services whose quality is obvious on inspection. Inspection services often approximate the