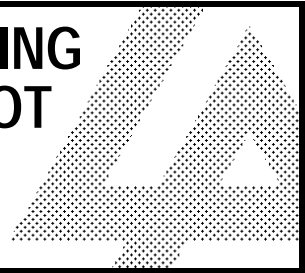


WHY COMPULSORY COMPETITIVE TENDERING FOR LOCAL GOVERNMENT SERVICES IS NOT AS GOOD AS PRIVATISATION

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INTRODUCTION

Through the Local Government Planning and Land Act (1980) and the Local Government Act (1988), local authorities have been required to subject more and more of their services to competitive tendering. Services identified for this compulsory competitive tendering (CCT) may be carried out by a local authority's own employees only if the in-house organisation wins the tender (bid) for the contract to provide those services against private sector competition. Local authority in-house organisations are known as direct service, or direct labour, organisations (DSO/DLOs).

Services subject to CCT through the 1980 Act were: new construction; building maintenance; and some highways work. Activities defined for CCT through the 1988 Act were: refuse collection; building cleaning; street cleaning; schools and welfare catering; other catering; grounds maintenance; repair and maintenance of vehicles; and management of sports and leisure facilities. Through powers granted to the Secretary of State by these Acts (and also by the Local Government Act 1992), CCT is also to be extended to part or all of each of the following services: fleet management; security; architectural; engineering; property management; finance; personnel; legal; computing; corporate and administrative; housing management; home-to-school transport; libraries and theatres.

In putting work out to CCT, local authorities have to abide by a set of regulations, designed principally to avoid anti-competitive behaviour.

THE RATIONALE FOR CCT

Every business divides its tasks into two categories:

- (i) those which it carries out itself, by means of its own employees;
- (ii) those which it gets others to carry out for it under contract.

For example, some manufacturers contract with a delivery company to deliver their wares, rather than deliver them themselves; some companies hire cleaning contractors to clean their offices rather than employ cleaners themselves; companies generally purchase furniture rather than produce it in-house; and so on.

Whether a business should carry out a specific task itself or contract it out depends upon which option is the most cost-effective. Assuming, for simplicity, that the *result* is the same in the two

cases, it depends on whether it is cheaper to achieve the result by hiring, organising, directing and managing employees, or alternatively by seeking out suitable suppliers, comparing terms, and negotiating and managing a contract. To introduce some jargon, it depends on whether *organisation costs* are lower or higher than *transaction costs*. It is this balance between organisation costs and transaction costs which determines the boundary of the firm (or, looked at from the other side, the limit of the market). Firms exist because organisation costs are sometimes lower than transaction costs.¹

For any given task, the balance between organisation costs and transaction costs is liable to change over time, in response to any of the factors which determine relative costs, including market conditions (especially volatility), available technology, and the pattern of people's preferences as consumers and as producers (including attitudes towards risk). In consequence, the question of whether to undertake an activity in-house or to contract it out must be kept under review if cost-effectiveness (ie. value for money) is to be secured.

Accordingly, one would expect, and one in fact sees, that the private sector is awash with vertical integrations (both forward and backward), as well as unbundlings and moves to contracting out.

In an open market, the drive to cost-effectiveness is imperative. The consumers don't have to buy from you; so if you don't provide value for money, they may buy instead from your competitors, or they may decide not to buy that type of product at all. In an open market, a company which consistently fails to provide value for money (as judged by the consumers) will not survive.

In the public sector, things are different. Public sector services are usually financed, at least partly if not wholly, from taxation, which means that people do not have a choice about whether or not to pay. If they think the services provided are not value for money, they can't take their money elsewhere. Consequently, if value for money is to be ensured, then some additional mechanism is required to see that public sector organisations have incentives to cost-effectiveness.

CCT can be seen in this light. For certain defined activities, it imposes the requirement to test in-house organisations (or parts of them) against the private sector market. The activities can only be carried out in-house if the in-house organisation (DSO/DLO) wins the contract for the work against private sector competition (by offering better value for money).

THE BENEFITS OF CCT

CCT has undoubtedly brought benefits both in significant cost savings and in improvements in service quality. In some cases, in-house organisations have been supplanted by more efficient private sector suppliers. In most cases contracts have been won by DSO/DLOs which have slimmed down, become more cost conscious and responsive, and improved productivity and quality of service. Of course, there have also been contract failures, the cost of which has to be offset against the benefits; but a good part of this is just the short-term cost of learning to adapt to the new environment.

A MINOR PROBLEM WITH CCT

One problem with CCT is the following. Whether a contract put out to CCT is won by the private sector or by the in-house team, the result is a contractual relationship between the local authority

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and its supplier. Of course, if this supplier is a DSO/DLO, then the contractual relationship is not a legal contract, because the DSO/DLO is still legally part of the local authority, which cannot have a contract with itself. But that is neither here nor there. The important point is that *all the transaction costs* of striking a deal with an external supplier have been incurred. This means that, for defined activities, local authorities are barred from taking the option of organising the activity in-house and thereby avoiding transaction costs, *even if this is the most cost-effective option*.

So private sector companies can and do review the balance between organisation costs and transaction costs and then decide, on the basis of cost-effectiveness, whether to contract out or to undertake in-house. Local authorities, on the other hand, are *compelled* to go to contract (although the result may be a “contract” with a DSO/DLO which is formally in-house), *even though managing an organisation (rather than managing a contract) might be the most cost-effective option*.

I have already said that, in the absence of market forces, there must be some external incentive to cost-effectiveness. In the light of this discussion, however, it would appear that *compulsory market comparison* would be better than CCT. A market comparison would be a comparison between:

- (i) the costs of organising and directing employees (without recourse to contracts, apart from contracts of employment);
- (ii) the costs of obtaining the service through the market.

In other words, it would ascertain whether, for the particular service concerned, it is more cost-effective to give people orders or to strike deals with them. One would then only go out to tender in the latter case.

The benefits of CCT therefore fall into two categories:

- (i) improved organisational management (through clearer objectives, articulation of standards and setting of targets, better monitoring, reorganisation of work to improve productivity, reduction of waste, etc.) achieved in response to the stimulus of competitive comparison (and thus the *prospect* of contracting out);
- (ii) substitution of (lower) transaction costs for (higher) organisation costs.

However, the second category of benefit is not necessarily obtained in all cases. For in some cases, organisation costs may be *lower* than transaction costs; in which case enforced substitution of the latter for the former will be a *cost* of CCT. Market comparison would be superior to CCT in prescribing the substitution only where it is a benefit, not where it is a cost.

Whether the benefits of compulsory market comparison over CCT could be realised in practice is a question which needs to be investigated. In particular, there would have to be some independent auditing of local authority practice in carrying out the comparisons, and the cost of this would have to be weighed against the cost of monitoring CCT and the cost of CCT over compulsory market comparison (referred to in the previous paragraph).

A COMPARISON WITH INTERNAL MARKETS

These considerations about CCT can also illuminate the issue of internal markets, which a number of local authorities are developing. An internal market is not a real market: it involves a mixture of, on the one hand, management (or corporate) direction and, on the other, freedom for individual managers to strike deals with each other over what goods and services are exchanged and for what prices and under what conditions. The aim is to improve efficiency and effectiveness by moving toward the effective utilisation of dispersed knowledge, and the motivation, cost-control, self-monitoring and customer orientation, that are characteristic of markets. However, the cost of these benefits is an increase in transaction costs, viz., the costs of costing activities and charging for them, negotiating quasi-contracts (service level agreements), recording costs, billing, accounting, and so on and so forth. The development of the internal market will, therefore, be justified only to the extent that the additional benefits of introducing market-type

arrangements are worth the additional transaction costs. There is consequently a danger of pursuing the development of internal markets beyond the point at which transaction costs start to outweigh efficiency and effectiveness benefits.

To revert to the terminology used above: internal markets involve a *mixture* of organisation costs and transaction costs; and how far they should be developed depends upon the balance between these two types of cost (a balance which will change over time).

THE MAIN PROBLEM WITH CCT: CONTRACTING OUT IS NOT PRIVATISATION

The aim of CCT is to try to ensure that local authority services are provided efficiently by encouraging competition between alternative service providers. In so far as it is successful, the result is better value for taxpayers' money. The problem is that the values to be produced are defined by the local authority and not by the consumers or taxpayers. The best that CCT can achieve is to secure the most efficient provision of the services that the local authority (its councillors and officers) thinks the local community should have. This is quite different to the efficient provision of the services that the members of the local community would choose for themselves.

One benefit of CCT has been to make councils more aware of the consumers of local authority services. Many councils now carry out surveys to find out what the public think of the services provided and how they would like the services improved. None of this changes the facts that taxpayers are still *compelled* to pay for the services; that committees of councillors and bureaucrats can never have the knowledge of individual preferences that those individuals have themselves (and which they could put to use if they were allowed to make choices for themselves); that in many instances councils may not even be interested in providing people with what they really want themselves, but are instead concerned to get people to take the services that the council thinks they *should* want; that individual preferences differ widely and are therefore best served by allowing different people to go their different ways, rather than having everyone receive the same (or broadly similar) services; that innovation in meeting the desires of consumers is stifled when decisions are made on behalf of those consumers by a single purchaser (the council) which makes its decisions under bureaucratic constraints (which encourage conservatism).

The remedy for these ills is to go beyond CCT to *privatise* local authority services, giving tax monies back to the citizen so that he/she can exercise his/her own choice in purchasing the type and quality of services that he/she wants. The types of services currently supplied by the local authority would then be supplied by a variety of private sector and voluntary organisations in response to the variegated demands of different consumers; and innovation would be encouraged as enterprising individuals or groups explored new ways of satisfying consumer need to attract the newly liberated consumer purchasing power.

It is no use objecting to this on the ground that tax-funded services involve a redistribution of wealth from the better-off to the less-well-off. First, because it wouldn't be true: tax-funded services tend to redistribute wealth to the middle classes who understand best how to milk the system. Second, because even if redistribution were desirable, it would be more efficient and effective to redistribute *money* so that the less-well-off receive enhanced purchasing power to choose for themselves.

Finally, although I have been speaking specifically about local government, the same applies to the public sector in general. Thus, within the last decade, competitive tendering has been imposed on parts of the civil service (central government) and areas of the National Health Service. The benefits are real, in terms of both financial savings and/or improvements in service quality; but compared to the benefits for the consumer to be obtained through *privatisation*, compulsory competitive tendering is really just tinkering.

NOTE

1. See R. H. Coase, “The Nature of the Firm”, in *The Firm, The Market and The Law*, University of Chicago Press, 1988.