

ABSTRACT

Contracting out is a policy that yields unambiguous fiscal gains to the governments that practise it . However, the majority these gains represent transfers from employees through reduced wages or increased work intensity. Some of these transfer losses are passed on to central governments through increased tax evasion. In this paper, the social costs and benefits of reductions in public sector wages are examined. It is argued that exploitation of labour market monopsony power by governments may create social losses even when the aggregate real wage is above the equilibrium level.

THE FISCAL GAINS FROM CONTRACTING OUT: TRANSFERS OR EFFICIENCY IMPROVEMENTS

For the last fifteen years or so, governments have been urged to adopt measures such as privatisation and contracting out in order to improve their fiscal position, and to increase overall economic efficiency. Interestingly enough, although privatisation has an obvious impact on measured budget balances, there is no evidence that it actually increases the net worth of the public sector, and advocates of privatisation have not thought it necessary to look for such evidence. The limited evidence available suggests a strong case that privatisation actually reduces the net worth of the public sector. For example, the privatisation of British Telecom (arguably the pivotal event in the recent history of privatisation) involved the issue of 50 per cent of the shares in a secure and highly profitable enterprise for an amount approximately equal to one year's gross earnings (or about three years' net profits). Partly paid shares sold at 50p were immediately traded for 93p. Mayer and Meadowcroft (1986) suggest that this privatisation represented a transfer of about 20 per cent of BT from the UK government to the share purchasers (a significant proportion of whom were not UK citizens). Further evidence suggesting a systematic loss of public sector net worth from privatisation is presented in Quiggin (1994).

No such doubts arise in the case of contracting out. A large number of studies have found that the budgetary cost of providing services is reduced by contracting out. Domberger, Meadowcroft and Thompson (1986) and Cubbin, Domberger and Meadowcroft (1987, 1988) (hereafter Domberger et al) examine two such cases of contracting out and estimate average budgetary gains of 20 per cent. This figure has been very widely quoted, and appears to have some support from other studies. Although, there are may be some grounds for questioning the magnitude of the estimates, there appear to be no grounds for doubting that contracting out reduces budgetary costs.

Given the existence of these gains, it is important to determine their source. If

the gains arise from increases in the efficiency with which tasks are performed, there is presumably a net social benefit from contracting out. On the other hand if the gains arise from reductions in wages or from other transfers, the issues are much more complex. Domberger et al attempt to partition budgetary savings into efficiency gains and transfers, but their techniques are open to a number of objections.

The object of this paper is to argue that the majority of the budgetary gains from contracting out represent transfers either from employees, or, through tax evasion, from the Federal government. Given this result (and assuming that tax evasion is unambiguously undesirable), the question arises of whether there is a net social benefit arising from the use of contracting out to reduce wages and, if so, how this benefit should be assessed.

Because of its influential role in the literature and because of the generally high quality of the data and of the analysis, attention will be confined to the work of Domberger et al¹. Domberger et al examine the contracting out of garbage collection and hospital cleaning services in Britain. In-house teams as well as outside firms were permitted to compete for contracts. Both when in-house teams were successful and when the contract went to outside firms total cost reductions are estimated to be of the order of 20 per cent.

This was lower than initially estimated gains. In the first round of contracting out of hospital cleaning services, average savings of 40 to 50 per cent were achieved, but many contractors either failed to provide adequate service or lost money doing so. To counter the potential for failure, contractors were in some cases required to post performance bonds. Because of this and the losses on early contracts, savings on later contracts were smaller. If this adjustment process was not completed at the time the Domberger et al studies were undertaken, the total gain may have been overestimated. However, this issue will not be pursued here.

¹ The review presented in this section is based, in part, on work previously presented in Quiggin (1992).

Milne and McGee (1992) re-examine the question of contracting out of hospital cleaning and catering services, using data for 1985-86. They obtain higher estimates of cost savings, primarily because they treat changes in the prevailing level of wages as a source of benefits. Milne and McGee emphasise the role of wage reductions (and also losses incurred by over-optimistic contractors) as a source of cost savings for local authorities. They observe that in-house NHS staff partially or wholly forfeited bonuses (which could amount to one-third of total pay) and that similar reductions relative to pre-existing wage levels were imposed on contract staff.

Domberger et al attempted to address the question of whether cost savings represented transfers using Farrell's (1957) notion of technical efficiency. Using linear programming to estimate a frontier cost function, the gains were partitioned between those attributable to differences in technical efficiency and those attributable to other sources including reductions in wages and fringe benefits.

Domberger et al observe that the gains not accounted for by differences in technical efficiency may arise from a number of sources other than wage reductions - most notably increases in the efficiency of the input mix. This issue deserves a little further attention. Measures of technical efficiency involving the fitting of a frontier typically have the property that extreme observations will lie on the frontier unless they are strictly dominated. As an example, suppose that there are two inputs, labor and capital, a given firm is the most capital-intensive in the entire sample. As long as there is no other firm which achieves higher labor productivity with lower capital input (implying a negative marginal product of capital) this firm will lie on the frontier, even if the implied marginal product of capital is very low. By contrast, if there are a large number of firms with fairly similar capital-labor ratios, the great majority must lie inside the frontier. It follows that frontier techniques will tend to identify efficiency gains whenever firms adopt input mixes that differ from those of most existing firms.

A more critical problem is that the measured technical efficiency gains could include a substantial transfer component. The first possible source of transfer is increased intensity of effort. Indeed, the main source of efficiency gains explicitly noted by Domberger et al is the replacement of fixed 'task and finish' payments (sometimes for tasks which have become less onerous since the time rates were set) with piecework rates. Productivity gains from such changes in payment schedules will arise primarily from increased effort. Furthermore, the observation that tasks have become less onerous since rates were initially set implies that the new piecework rates will embody an effective reduction in wages in the absence of increased effort. Ganley and Grahl (1988) cite a number of cases of increases in working hours or reductions in working conditions associated with contracting out of garbage collection.

There is a tendency, criticised in Quiggin (1992), to regard output gains arising from increased effort as a free good. Such a view has no basis in neoclassical economic theory, although it may be supported by X-efficiency arguments (Liebenstein 1966). Such arguments require the existence of unexploited gains from trade, arising from distortions in the bargaining process (in addition to any element of union monopoly power). The implied claim is that the wage bargain embodies excess on-the-job leisure, in the sense that both workers and employers would prefer a bargain with higher wages and higher work intensity. There is no clear reason why bargains should be systematically biased in this way.

The argument that apparent increases in technical efficiency are more likely to reflect increases in work intensity gains strength from consideration of the tasks contracted out. Cleaning is a job with very limited capacity for either technical or organisational innovation. Cleaners typically work alone or in pairs, using equipment which has not changed substantially for decades. Furthermore, cleaners are normally paid for completion of a specified task, with no direct monitoring of time spent on the task, so that there is

little scope for unions to impose restrictive work practices. The claim that there exist unexploited changes in cleaning methods permitting a twenty per cent increase in output with no increase in effort or reduction in service quality seems inherently implausible.

In the case of garbage collection, there is more scope for technical innovation (for example through the use of large ‘wheelie’ bins). However, such changes would probably have been captured explicitly in the detailed data available to Domberger et al. The simplest source of increased labor productivity in tasks of this kind is speed-up — in this case, requiring collectors to run faster. Up to a certain point, speed-up yields efficiency gains as well as transfers, since the truck and driver are used more efficiently. However, speed-up can easily be pushed to the point where the risk of acute injury or repetitive strain injury increases at a rate that outweighs any benefits of more effective capital utilisation. Contracting out may well create incentives for employers to disregard these costs, either because of moral hazard associated with workers compensation insurance or because of the availability of workers who are unaware of the risks of injury.

A second source of gains which is likely to appear in the measured improvement in technical efficiency is that arising from tax evasion. The opportunities for evasion and avoidance are increased by contracting out. Public sector wage employees have less opportunities for evasion than any other group of income-earners. By contrast, contractors and their employees are in a very good position to evade taxes, especially if, like cleaners and garbage collectors, they work non-standard hours. The evidence reported in Tanzi (1982) indicates that evasion is insignificant among government employees and highest in the small business sector. This is, of course, what would be expected given the incentives and opportunities faced by different groups.

The existence of employees who are concealed from the income tax system is unlikely to be reported to local authorities, especially if workers compensation insurance as well as income tax is being evaded. The output of these employees will be measured as

a productivity gain. In this context, it is noteworthy that the in-house teams studied by Domberger et al showed much lower gains in technical efficiency and much larger gains arising from wage reductions. In-house teams would, at least initially, consist of workers already known to the authorities. Hence, it is likely that they would find it difficult to achieve cost reductions through tax evasion and would, instead, find it necessary to accept explicit cuts in wages and conditions.

In the Australian context, the relatively stringent controls on tax evasion introduced since the mid-eighties suggest that the gains from tax evasion are likely to be smaller than in countries where the informal sector is less tightly controlled. This suggests that gains from contracting out will be smaller than would be estimated on the basis of UK evidence or of Australian evidence from the period prior to the introduction of the Tax File Number and Prescribed Payment Systems.

In summary, it seems likely that at least part of the budgetary gains associated with contracting out services such as cleaning and garbage collection are derived, in the first instance, from reductions in wages or, equivalently, from increased intensity in the work required to earn a given wage. (Some of these losses may be passed on to central governments through tax evasion). It is then, of interest to consider, whether such transfers are socially desirable. In some cases, such as cleaning services, where the scope for increased efficiency is limited, the majority of the budgetary gains may be derived from transfers.

Tax evasion is often regarded as a transfer. However, there are deadweight losses associated with tax evasion, including the resources dissipated in public efforts at tax enforcement and private efforts at concealment of untaxed income. Thus, to the extent that the measured benefits from privatisation are due to tax evasion, it is likely that the true social benefits are negative. Hence it is reasonable to confine attention to the question of whether the wage reductions associated with contracting out are socially desirable.

Public Sector Wage Policy

A number of advocates of contracting out have argued that if contracting out generates wage reductions, such reductions must be socially desirable. Domberger, Meadowcroft and Thompson (1988, p 89) state

If it turns out that the best case that can be made for the retention of a public sector monopoly in refuse collection is that it provides a basis for the expropriation of monopoly rents, then this seems to us to be a compelling argument *in favour* of the introduction of competition rather than the reverse.

From an ethical viewpoint, this statement relies implicitly on a form of marginal productivity ethics. The 'expropriators' in this context are garbage collectors and cleaners. Unless one is committed to marginal productivity ethics, it seems difficult to develop much moral outrage over the possibility that such workers are earning 25 per cent² in excess of the market wage for their labor³.

From an efficiency viewpoint, it would normally be assumed that the setting of wages in excess of the market rate would produce distortions and welfare losses, although these would be second-order in magnitude. A standard welfare triangle analysis, assuming a unit elasticity of demand for labor would suggest that the removal of a 25 per cent distortion in wages would yield a welfare increase of around 3 per cent. However, the validity of this analysis is far from clear in the context of public sector wage and employment policy.

The public sector is a very large employer, accounting, directly and indirectly, for as much as a third of the workforce in many developed countries. For many categories of workers, such as teachers and health workers, the public sector is the principal employer. As a result, the public sector enjoys considerable monopsony power. Obviously

² I assume, as seems plausible for tasks of this kind, that 80 per cent of costs are labour costs. Thus, a 25 per cent reduction in effective wages yields a 20 per cent reduction in total costs.

³ The situation may be different in less developed countries where even unskilled urban workers are often above-average income earners.

a policy of exploiting that monopsony power to maximise the consumer/taxpayer surplus associated with the provision of public services would be unlikely to promote social welfare. Such a policy would imply the adoption of excessively capital-intensive techniques and the provision of suboptimal service levels, with a resulting suboptimal level of employment.

Since contracting out has been shown to reduce wages and conditions below those that typically result from bargaining between unions and public employers, the possibility of monopsony power is relevant to any assessment of the desirability of contracting out. In itself, a commitment to contracting out need not imply any exploitation of monopsony power. Provided the units of work that are contracted out are small in relation to the relevant labor market, and that each contracting decision is undertaken without consideration of the effect on other contracts, the public sector will behave in a competitive fashion. However, there is no guarantee that these conditions, and in particular the second of them, will be fulfilled. Governments have very frequently used their own wage bargains as an instrument of policy, and public sector employers making 'excessive' wage settlements have been subject to considerable pressure. In the British case considered here, the imposition of contracting out coincided with a series of measures including rate-capping, abolition of local authorities and direct intervention in local government decisions by a central government overtly hostile to public sector employees. These actions were defended as an attack on the monopoly power of public sector unions. However, in a bilateral monopoly situation it is difficult to tell where monopoly ends and monopsony begins. There is, therefore, every possibility that the effect of contracting out is to exploit monopsony power and to drive wages below the socially optimal level.

The existence of high rates of unemployment complicates the issue here. Suppose for simplicity that high unemployment results from wages in the private sector being fixed above the market-clearing level and that this is taken as unchangeable, so that

public sector wage policy must be developed in a second-best context. Then the second-best optimum will involve a lower public sector wage, and a higher public sector employment level, than the first-best optimum in which the private sector wage is flexible.

A policy of contracting out aimed at minimising the cost of provision of a predetermined level of public services, or at maximising the consumer/taxpayer surplus associated with the provision of services will imply that both wages and employment are below the first-best optimal levels. In both cases, the existence of monopsony power gives government an incentive to set employment levels below the optimum.

A public sector policy of this kind will tend to move the wage share of GDP and the average real wage closer to the equilibrium level, but will nevertheless result in higher levels of unemployment, and greater welfare losses, than a policy that fixes wages and employment levels at the first-best optimum. This is a situation in which the aggregate-level reasoning characteristic of much discussion of unemployment may be seriously misleading.

The situation is even worse if unemployment is generated by restrictive macroeconomic policies. In this case, the successful exploitation of monopsony power depends on the maintenance of high levels of unemployment. A relaxation of macroeconomic policy will generate a public sector wage breakout which is likely in turn to provoke a new tightening of fiscal policy. The government's role as an employer creates a bias in favor of excessively high rates of unemployment.

Concluding comments

Contracting out is a policy that yields unambiguous gains to the governments that practise it (provided that they are not also collectors of income tax). However, the majority these gains represent transfers from employees through reduced wages or increased work

intensity. Some of these transfer losses are passed on to central governments through increased tax evasion.

Provided the public sector acts in a quasi-competitive fashion, there will still remain a net allocative efficiency gain from the elimination of wage premiums, although this will be much smaller than the 20 per cent figure usually cited as the direct fiscal benefit from contracting out. However, if the public sector exploits its monopsony power in the labor market the process of contracting out may be associated with a net reduction in social welfare.

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