



## Political preferences and public sector outsourcing

Mikael Elinder<sup>a,b</sup>, Henrik Jordahl<sup>b,\*</sup>



<sup>a</sup> Department of Economics, Uppsala University, P.O. Box 513, SE-751 20 Uppsala, Sweden

<sup>b</sup> Research Institute of Industrial Economics (IFN), P.O. Box 55665, SE-102 15 Stockholm, Sweden

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### ABSTRACT

Given the intensive and ideologically charged debate over the use of private contractors for publicly funded services, it is somewhat surprising that many social scientists have preferred to explain government outsourcing by the pursuit of economic efficiency. Starting out from different theories, we investigate political explanations of government outsourcing using a Swedish data set in which outsourcing varies between municipalities and over time, as well as between services. Our identification strategy focuses on two services with similar contracting problems and local market conditions: preschools and primary schools. We study a period in which Swedish municipalities had full discretion in the provision of preschools, while their influence on the private provision of primary education was limited by a national voucher system. The comparison of preschools with primary schools in a difference-in-differences model suggests that the political color of the ruling majority influences outsourcing, which is consistent with the Citizen Candidate model of representative democracy.

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### 1. Introduction

The last 30 years have witnessed an intensive, ideologically charged debate over the use of private contractors for publicly funded services such as education and health care. With this in mind, it is somewhat surprising that many social scientists have preferred to explain government outsourcing by the pursuit of economic efficiency. Building on Coase (1937), Williamson (1981, 1985) and Grossman and Hart (1986), the Transaction Cost model of Hart et al. (1997) explains outsourcing by the contracting difficulties of different services. The difficulty of contracting, in turn, depends on the difficulty of measuring and monitoring quality, the need for flexibility, and the risk that “specific assets” give rise to hold-up problems.<sup>1</sup> An implicit assumption is that policy makers maximize social welfare; political parties, ideology, and the self-interest of voters and politicians do not matter.

Other models of government outsourcing or of policymaking in general have more of a political flavor. The political models assume that politicians are motivated either by the desire to implement their preferred policy or by the rents that come with holding office. The Citizen Candidate model of Besley and Coate (1997) and Osborne and Slivinski (1996) has policy motivated politicians. Office motivated politicians are found in the Patronage model of government outsourcing (Lopez-de-Silanes et al., 1997) and in the Downsian model of electoral competition (Downs, 1957).

In the Citizen Candidate model, politicians are motivated to run for office by the prospect of implementing their own preferred policy. Policies are expected to diverge such that outsourcing – like other political choices – depends on the identity of the winning side in elections. The prediction is that right majorities will use outsourcing to a larger extent than left majorities.

\* Corresponding author. Tel.: +46 8 665 45 33; fax: +46 8 665 45 99.

E-mail address: [henrik.jordahl@ifn.se](mailto:henrik.jordahl@ifn.se) (H. Jordahl).

<sup>1</sup> See Levin and Tadelis (2010) for a comprehensive theoretical account of the Transaction Cost model.

According to the Patronage model, politicians derive significant rents from in-house production by public employees, including support from public employee unions, and the ability to use local government employees on political projects, as well as the ability to control unemployment and to hire relatives (Lopez-de-Silanes et al., 1997). The cost of patronage is that it has to be paid for by higher taxes, which is something voters generally dislike. The Patronage model predicts that politicians will choose lower levels of outsourcing than voters prefer, but that this difference will be smaller in competitive elections as politicians then need to accommodate voter preferences in order to be reelected.<sup>2</sup> The model does not, however, predict any difference between political parties to the left and to the right.

As is well known, the Downsian model predicts policy convergence even if the competing politicians prefer different policies. The policy outcome is determined by the preferences of the median voter. The use of outsourcing is thus predicted to depend on the preferences of the voters and not on the political color of the ruling majority.

The Citizen Candidate model is thus the only one of the four described models in which the political color of the ruling majority influences outsourcing; right majorities are predicted to opt for higher levels of outsourcing than left majorities. The four models also differ with respect to the influence of voter preferences on outsourcing. Preferences for the right give rise to more outsourcing in the Citizen Candidate model and in the Downsian model, but not in the Transaction Cost model. In the Patronage model, voter preferences matter only when elections are competitive. In view of this, we focus our empirical investigation on the political color of the ruling majority and on the preferences of the voters, as captured by the vote share of parties to the right. In contrast to the traditional approach which uses a large battery of explanatory variables to compare different theories, we are able to assess the four leading theories in a simple empirical framework based on their ability to capture the increase and variation in outsourcing in Swedish municipalities.

For several reasons, Swedish municipalities provide a suitable testing ground for the models that we have described. Firstly, we have data in which government outsourcing varies between publicly financed services and between municipalities, as well as over time. The data contain information on the outsourcing shares of several services in 290 municipalities from 1998 to 2006. This is a considerable improvement compared with previous studies, which have either lacked the time dimension or have been limited to a single service (e.g., garbage collection).<sup>3</sup>

Secondly, Sweden has witnessed an ideological realignment in which the number of municipalities governed by right parties has increased considerably since around 1990. It is quite suggestive that this trend coincides with a steady increase in local government outsourcing. The Transaction Cost model predicts that outsourcing will differ between services rather than between municipalities or over time. Thus, the Transaction Cost model can neither account for the observed general increase in outsourcing nor for the fact that outsourcing varies widely between municipalities.<sup>4</sup>

Thirdly, we are able to compare the models by using a difference-in-differences strategy, making use of both similarities and differences between preschools and primary schools. This approach allows us to address selection problems that arise when political preferences are correlated with unobserved determinants of outsourcing. Preschools and primary schools are similar services when it comes to contracting difficulties and local market conditions, making it reasonable that unobserved determinants influence outsourcing of both services similarly. Moreover, the legislative treatment of these two services has differed in one important respect. The provision of preschools was fully determined by municipal discretion between 1992 and 2006. During the same period, a voucher system effectively limited the influence of local politicians on the choice between public and private primary schools. Since 1992, a municipality has to finance private schools that meet national requirements and attract pupils. This gives the ruling majority better possibilities to influence the outsourcing of preschools, whereas the preferences of the electorate have a direct and relatively larger influence on the private provision of primary schools. We test how the political color of the local majority and the outsourcing preferences of the electorate influence differences in outsourcing between preschools and primary schools.

Previous empirical studies have arrived at varying conclusions. Based on a literature review and meta-regressions, Bel and Fageda (2007, 2009) conclude that a general explanation of local government outsourcing has been hard to find. Still, pragmatic cost considerations seem to be more important than ideological motivations. If anywhere, ideology seems to matter in Europe and in large cities. Studies that report that political preferences are unrelated to outsourcing include Christoffersen and Paldam (2003), Dijkgraaf et al. (2003), McGuire et al. (1987), and Zullo (2009); they incorporate various services in Denmark, the Netherlands, and the United States. On the other hand, Bhatti et al. (2009) report that Danish municipalities with a conservative or liberal majority rely more on outsourcing than municipalities with a left majority. Merzyn and Ursprung (2005) study voting behavior and find that both income and ideology determine the support for education vouchers and subsidies to private schools in Switzerland. Lopez-de-Silanes et al. (1997) find that the Patronage model explains outsourcing in U.S. counties. Brown and Potoski (2003) and Levin and Tadelis (2010), instead, present evidence from local governments in the United States that supports the Transaction Cost model of public sector outsourcing. Ohlsson (2003) finds that cost differences did not affect outsourcing decisions of refuse collection in Swedish municipalities, suggesting that policy makers did not minimize costs.

We find that the political color of the ruling majority influences the choice between outsourcing and in-house production in Swedish municipalities. This finding appears both as a general visual pattern in our data and in econometric tests where we

<sup>2</sup> The Patronage model of government outsourcing is similar to the theory developed by Boycko et al. (1996) on the privatization of state-owned enterprises, c.f. Bjørnskov and Potrafke (2011) for an empirical account of this kind of privatization with the focus on government ideology.

<sup>3</sup> Using cost shares of outsourcing is also an improvement compared with the discrete choice framework in most of the studies in the literature. For example Brown and Potoski (2003) and Levin and Tadelis (2010) both use dummy dependent variables for mode of production (partly or fully contracted out).

<sup>4</sup> Because the savings from outsourcing seem to be quite large when the public sector is first opened up for competition (Andersson and Jordahl, 2011), the fact that many municipalities produce several services fully in-house is another shortcoming of the Transaction Cost model.

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