

REVISITED SERIES In the Revisited Series, *Local Government Studies* offers short updates of some of the journal's most cited articles of recent years. In these updates, the authors reflect on changes since their original contribution, while underlining the continuing relevance of the thinking behind the latter and indicating the direction in which this could be extended in the future.

Here, Germà Bel and Xavier Fageda revisit an article they wrote for LGS Vol 33 No 4: 'Why do local governments privatize local services? A survey of empirical studies', in which they reviewed the then existing empirical literature on factors explaining privatization of local public services, focusing on four different types of factors: Fiscal constraints, cost efficiency, political partisan interests, and ideological attitudes. Here, they return to the issues raised in that paper, and review what we can learn from the empirical studies published after their article appeared in *Local Government Studies*.

What have we learnt after three decades of empirical studies on factors driving local privatization?

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**ABSTRACT:**

Scholarly empirical studies on factors that motivate local privatization have greatly grown in the last decade. As well, having available better and more comprehensive databases, and using more refined empirical techniques have made possible to enhance our understanding of the dynamics of local privatization, particularly in many European countries. The influence of fiscal stress, cost considerations - scale economies as well as transaction costs - , and political partisan interests is usually confirmed. Furthermore, ideological attitudes appear to be more influential than they seemed to be, particularly when considering social services, rather than the technical ones.

**KEYWORDS:** Privatization; contracting-out; local public services; empirical analysis

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## **Introduction**

The privatization of local public services was a policy that gained increasing attention and acceptance in the final quarter of the last century. After a decade of contracting out, multivariate empirical studies analysing the drivers of privatization began to appear in the literature, the first being those published by Ferris (1986) and Feldman (1986). Twenty years after these earliest articles appeared, the authors sought to understand the main drivers of local outsourcing in these years (Bel and Fageda, 2007). To do so, we reviewed all the empirical studies we could track down – published articles and those available only online. In total, we reviewed 28 studies, 22 conducted in the US, and six in various European countries.

Our review identified first two families of variables, both closely related to economic factors and frequently employed in the literature. One of these, fiscal conditions, above all the fiscal stress to which the municipality was exposed, were identified as an important driver of privatization, particularly in the US. The second family involved costs. Thus, improving cost conditions by exploiting scale economies was another relevant driver of privatization, although the transaction costs associated with the service were an important moderator of the privatization decision.

Besides these financial and cost-related factors, we introduced the distinction between partisan political interests and ideological attitudes. We found that political processes – particularly the pressure brought to bear by interest groups – had been influential, again especially in the US. However, ideological attitudes were absent from the privatization decision, which appeared to be primarily a choice based on pragmatism.

In terms of the methodologies employed, we observed a potential problem of reverse causality affecting most existing studies, since they typically employed a yearly cross-section of data that was subsequent to the time when the privatization decision was taken. Only three

studies [Chandler and Feuille, 1994; Bel and Miralles, 2003; and Miralles, 2009<sup>1</sup>] used data corresponding to the year in which the last contract was awarded in each municipality. We concluded that dealing with this potential problem of endogeneity should be the objective for subsequent research.

In the decade that has elapsed since we published our review (Bel and Fageda, 2007), many more studies have examined the factors driving local privatization. We have identified thirty-two articles,<sup>2</sup> indicating that the annual rate of publication has doubled. Below, we analyse what this growing body of literature has contributed to our understanding of the motivations of local privatization. As is customary in the literature, we organize our analysis around the following four families of factors: fiscal restrictions, economic efficiency, political interests, and ideological attitudes.

### **Fiscal restrictions**

In Bel and Fageda (2007),<sup>3</sup> the positive influence of fiscal stress on privatization was generally confirmed in those studies considering several services. These were, in the main, studies drawing on 1980's data for the US municipalities. In more recent studies, the variables used to examine the influence of fiscal stress on privatization have been expanded to include tax

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<sup>1</sup> Note that the reference here is to the final published version of the study. In Bel and Fageda (2007) we reviewed a preliminary version dated 2006. The same is true of Levin and Tadelis (2010) and Zullo (2009); in both cases, we reviewed working papers dated 2005.

<sup>2</sup> Although we conducted a careful search for newly published articles, it is highly likely that the actual number published in the last decade exceeds thirty-two. However, as our aim here is not to conduct a meta-regression analysis, it was not necessary to ensure that we identified every single new paper – published or otherwise.

<sup>3</sup> Bel and Fageda (2009) perform a meta-regression analysis with the same sample of studies as that used in Bel and Fageda (2007), and reach similar conclusions.

burden, debt, budget deficit, and the financial dependency of the municipality. Unlike previous findings, the positive influence of fiscal constraints on privatization has become a frequent result in most studies conducted in European countries. This is the case regardless of whether they consider one service (Bel and Fageda, 2010; Bel et al., 2010; González-Gómez and Guardiola, 2009; González-Gómez et al., 2011; Picazo et al., 2012; Plata-Diaz et al., 2014; Zafra et al., 2016) or several (Boggio, 2010; Geys and Sorensen, 2016; Shoute et al., forthcoming; Zafra et al., 2014).

It is worth noting that the most recent studies have introduced several improvements in terms of both the techniques and the data they employ. In the case of methodology, Geys and Sorensen (2016) exploit exogenous variation in municipality revenues, and Zafra et al. (2014, 2016) use several variables simultaneously to provide measures of different dimensions of fiscal stress. As for the data used, an increasing number of studies use information over a period of several years, which permits econometric analyses of panel data (Boggio, 2010; González-Gómez and Guardiola, 2009; Plata-Diaz et al., 2014). Other refinements worth mentioning are the focus on small municipalities (Bel et al., 2010), and the consideration of different privatization options (Bel and Fageda, 2010; Shoute et al., forthcoming).

In contrast with our earlier review, the number of new studies for the US is much smaller. Moreover, recent US studies present mixed results with respect to the influence of fiscal stress, reported as being relevant in Carr et al. (2009), but found not to be significant in Fernandez et al. (2008) and Mohr et al. (2010).

Interestingly, a few studies conducted in European countries [Bhatti et al., 2009; Foged and Aaskoven, 2017; Rodrigues et al., 2012] find evidence of a negative relationship between fiscal stress and contracting out, which could lead to privatization being seen as the ‘politics of good times’. Note that the first two studies do not apply a discrete choice analysis, and

both consider the share of services privatized in the municipality as the dependent variable. Rodrigues et al. (2012) draw on data that refer to a single year.

### **Economic efficiency**

Bel and Fageda (2007) showed that several studies dealing with just one service obtained evidence to show that privatization was used to exploit scale economies. In these studies, the results pointed to a negative relationship between the size of the population of the municipality and the decision to contract the service out. In contrast, the most common finding in recent studies is that privatization is more likely in larger municipalities. This positive relationship between privatization and population is found in Bel and Fageda (2010), Boggio (2016), González-Gómez and Guardiola (2009), Fernandez et al. (2008), Hefetz, Warner and Vigoda-Gadot (2012), Helby Petersen et al. (2015), Picazo et al. (2012), Shoute et al. (forthcoming), Sundell and Lapuente (2012) and Zafra et al. (2014, 2016). A likely explanation for this result is that larger municipalities have higher contracting capabilities, so that they are better able to handle the transaction costs associated with external production.

It should also be borne in mind that small municipalities are increasingly turning to cooperation, which provides a viable alternative to privatization, to exploit scale economies. This might explain why population size does not appear to be significant in two studies dealing with solid waste in Spain (Bel and Fageda, 2008; Plata Diaz et al., 2010). The absence of scale economies in the service may likewise explain the non-significant result for population obtained for employment reintegration services in Netherlands by Platinga et al. (2011). Finally, studies that consider a broad array of services (such as Bhatti et al., 2009; Carr et al., 2009) do not find any influence of population.

Several studies dealing with different services also analyse the influence of transaction costs on the privatization decision. These studies typically employ such indicators as asset

specificity and the difficulty of output measurement, related to each service. A common finding here is that privatization is more likely for services with lower transaction costs, a result reported in Bel and Fageda (2008), Carr et al. (2009), Rodrigues et al. (2012) and Shoute et al. (forthcoming). Wassenaar et al. (2013) obtain mixed results, and the only real exception to this general trend is Hefetz and Warner (2012), who find no significant relationship between privatization and transaction costs. Overall, recent studies generally confirm the negative relationship between transaction costs and privatization, in line with the conclusion drawn in Bel and Fageda (2007).

Other hypotheses related to economic efficiency have been tested in recent studies. Some place the emphasis on competition, adhering to the rationale that privatization is more likely when the availability of external providers is greater. Indeed, studies for the US tend to find evidence of more frequent privatizations in the suburbs, where external provider availability is greater (Fernandez et al., 2008; Mohr et al., 2010; Hefetz, Warner and Vigoda-Gadot, 2012; Hefetz and Warner, 2012). Additionally, some studies report evidence of some kind of spatial dependence, as the probability of a municipality privatizing a service is higher when there have been more previous experiences of privatization in that neighbourhood (Alonso et al., 2016; Bel, Fageda and Mur, 2010; Gómez, Picazo-Tadeo and Guardiola, 2011). A possible explanation for this finding is again the potentially greater availability of external providers in the area. However, other factors related to political strategies and network diffusion are likely to play a role.

### **Political interests**

Bel and Fageda (2007) found that studies that analysed a broad range of services, or whose focus was on small municipalities, tended to validate the hypothesis of interest group influence. In recent studies, the most common variables used to test the influence of interest

groups are indicators of the wealth of the municipality, including such variables as the mean income level, the rate of poverty and the percentage of the population receiving welfare benefits. The hypothesis that high-income households have a greater preference for privatization is validated in most of the studies that consider an income variable of some kind (Fernandez et al., 2008; González-Gómez, Picazo-Tadeo and Guardiola, 2011; Hefetz, Warner and Vigoda-Gadot, 2012; Mohr et al., 2010; Rodrigues et al., 2012; Sundell and Lapuente, 2012). Here, it is worth mentioning Bhatti et al. (2009), who find evidence in favour of a negative relationship between privatization and public employees in an analysis that addresses the potential endogeneity of this last variable. Finally, Bel and Fageda (2008) report that governments with conservative mayors privatize more frequently, regardless of the ideological orientation of the constituency.

### **Ideological attitudes**

One of the most generalized results observed in Bel and Fageda (2007) was that the ideological orientation of the municipality had no apparent influence on the privatization decision. In testing this hypothesis, recently published studies have, on the whole, continued to use the traditional variable based on the percentage of votes cast for left-wing (right-wing) parties. Most of studies report findings consistent with those in the previous literature to the effect that ideological attitudes have no influence on the contracting out of services. This is the case in Bel, Fageda and Mur (2010), Boggio (2016), Fernandez et al. (2008), González-Gómez and Guardiola (2009), González-Gómez, Picazo-Tadeo and Guardiola (2011), Hefetz, Warner and Vigoda-Gadot (2012), Petersen et al. (2015), and Wassenaar et al. (2013).

However, this view has been challenged in several recent studies conducted for European countries, including Bhatti et al. (2009), Platinga et al. (2011), Plata Diaz et al. (2014), Shoute et al. (forthcoming), and Zafra et al. (2014, 2016.), where an ideological bias is found in the

privatization decision. Of particular interest is the study by Sundell and Lapuente (2012), who find that the role of ideology is stronger when electoral competition is more intense.

On a related subject, studies conducted in Scandinavian countries have placed special emphasis on social-welfare related services, distinguishing between what are primarily ‘technical services’ (such as waste management and roads) and ‘social services’ (such as care of the elderly, primary schools and other public-welfare related services). Elinder and Jordahl (2013), for example, apply a difference-in-differences analysis to exploit similarities and differences between the provision of preschools and primary schools in Sweden and find a positive association between privatization and the strength of right-wing parties. Similarly, Guo and Willner (2017) conduct an analysis of care centres for the elderly in Sweden, and find a positive association between right-wing strength and the preference for privatization. By differentiating between technical and social services, these studies introduce a distinction that may prove useful in future research.

## **Conclusion**

Overall, recent studies (particularly those conducted in European countries) seem to find stronger evidence in favour of the influence of fiscal stress, economic efficiency and the strength of interest groups opposed to public production on the privatization decisions taken by municipalities. Moreover, several recent studies call into question the earlier consensus that privatization was the pragmatic choice, reporting that ideology also has an influence on production choices, particularly on what might be labelled ‘social services’ (that is, public-welfare related services) as opposed to ‘technical services’ (such as solid waste collection).

In terms of the techniques adopted, many recent studies use data for several years and/or employ more robust identification strategies to analyse the link between local privatization and each of its potential explanatory factors. This has provided us with more robust results. However, it should be borne in mind that recent studies might be more heavily

affected by publication bias; that is, studies that find significant relationships tend to be published more frequently in scientific journals.

Finally, it is interesting to note that parallel to studies of factors explaining privatization, scholars are paying increasing attention to the empirical analysis of factors that explain inter-municipal cooperation, often seen as an alternative to contracting out in certain circumstances. The recent meta-regression on the drivers of inter-municipal cooperation conducted by Bel and Warner (2016) includes more than 40 empirical studies. Because the privatization of local services shares a large part of its theoretical framework with inter-municipal cooperation, we believe that scholars interested in analysing privatization further should be aware of, and become more familiar with, this literature on cooperation.

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