Outsourcing and Insourcing in Australian Local Government:

Productivity Commission's (2014) *Public Infrastructure* Report and Municipal Road Maintenance and Renewal

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EXECUTIVE SUMMARY

Over the past three decades, local authorities across the developed world have engaged in extensive privatisation and outsourcing in service delivery, largely in an attempt to reduce the costs of service provision. However, outsourcing has given rise to a host of unforseen problems. Not only have claims regarding costs savings often illusory, but service quality and reliability have frequently suffered.

In addition, outsourcing has had many deleterious social costs, especially in small regional, rural and remote communities, where local councils are often the major employers in small centres. The employment losses flowing from outsourcing have seen negative multiplier effects which have devastated the economies of these small communities and severely undermined local community sustainability.

As a consequence of these problems, the insourcing of previously outsourced local services has become common as local authorities strive to undo the damage inflicted by outsourcing. Empirical work on the performance of insourcing has demonstrated that it is not only often more cost effective than outsourcing, but that it also often generates higher quality and more consistent services, especially where the complexity of eservice delivery is difficult to manage and monitor efficaciously.

Efforts to impose widespread outsourcing on local government in Australia should thus be resisted, especially in non-metropolitan local government areas. Accordingly, current efforts to enforce the outsourcing of road maintenance and renewal across Australia, such as the Productivity Commission’s *Public Infrastructure* Final Report, released on 14 July 2014, which will adversely affect local authorities, should not proceed.

1. INTRODUCTION

Australian local government plays a pivotal role not only as a major element in the democratic structure of the country, but also as a significant economic entity in its own right. As the third tier of government in the Australian federation, local government accounts for more than AUD$10 billion in taxation, employs in excess of 192,000 people across seven different state and territory systems, and provides an essential range of local services vital to national well-being (Australian Government, 2010, p.3/4). However, despite its importance, it has always been the 'poor cousin' of its national and state counterparts, especially in terms of the attention which policy debates over its future have attracted.

A salient example of the dangers of the neglect of public policy formulation and its potential execution can be found in the report released by the Productivity Commission on 14 July 2014 entitled *Public Infrastructure*. *Public Infrastructure* flowed from a request by the Australian Government that the Productivity Commission undertake a wide–ranging inquiry into public infrastructure provision in Australia, including local public infrastructure provided by local government, to tackle various important questions concerning public infrastructure in contemporary Australia. The Productivity

Commission was requested to consider *inter alia* (a) public infrastructure funding by all levels of government as well as the private sector; (b) alternative funding and financing mechanisms; (c) cost structures in Australia compared with other countries; and (d) methods of facilitating a reduction in the costs of public infrastructure projects in Australia.

Public Infrastructure (2014, p.5) examined the full range of options for public and private involvement in public infrastructure provision, including the planning, construction and maintenance of roads, to 'achieve cost savings in the delivery of projects'. In essence, *Public Infrastructure* (2014, p.6) drew the following main conclusions from its analysis:

> 'A key message of this report is that there is a fundamental need for a comprehensive overhaul of the poor processes currently used in the development and assessment of infrastructure investments particularly, but not exclusively, by governments. The costs of poor project selection and delivery will be exacerbated if governments decide to increase their infrastructure investment programs without reforming their governance regimes. All other desirable or aspirational objectives — project pipelines, increased private financing, cost savings and even

> user charging and pricing reform — ultimately depend for their efficacy on having a much-strengthened and widely-applied set of credible and welfare-enhancing reforms'.

However, from a local government perspective, *Public Infrastructure* (2014, p.12) did at least acknowledge the complexities of radical reform of local government infrastructure provision given the special characteristics of Australian local government, notably its high degree of diversity:

> 'Sectoral and regional differences might mean that models of private sector involvement that best serve the community's interests in one sector or location may not be the most opportune in others. The choice of delivery model should be based on providing the best value for money to the community from delivering public infrastructure and services'.

Notwithstanding these caveats, the Productivity Commission (2014, p.21) nonetheless felt able to propose a number of radical changes to the current methods of providing public infrastructure, including local infrastructure, such as the 'establishment of road funds' by 'aggregations of local governments', which would 'integrate the tasks of road funding and provision into one entity, to enable road charging and provision to be more effectively considered on a regional portfolio basis'.

Against this background, the present Report seeks to place the Productivity Commission's recommendations in the broader context of the international debate over the contracting out, privatisation and outsourcing of activities previously produced within the public sector to private commercial entities which has characterised much public policymaking across the developed world for the past three decades. As the adverse consequences of privatisation and outsourcing have become more apparent, a vigorous debate has ensued over the most appropriate methods of ameliorating the unintended and often severely damaging effects of these policies. In the local government sphere, this has led in turn to the extensive 'insourcing' and 'remunicipalisation' of local government services previously privatised and outsourced as municipalities struggle to regain effective control over the cost and quality of service delivery.

The Report is divided into five main parts. Section 2 briefly clarifies the meaning of contracting out, privatisation, outsourcing and insourcing in local government. Section 3 provides a synoptic review of the international literature on the alternative methods of delivering local government services, as well as available empirical evidence on the effects of insourcing and remunicipalisation. Section 4 considers the social benefits and costs of outsourcing in the institutional context of Australian local government. Section 5 examines the recommendation of the Productivity Commission in its *Public Infrastructure* report as they pertain to local government in the realm of road maintenance and renewal. The Report ends with some brief concluding remarks in section 6 on the public policy implications of outsourcing and insourcing in local government.

2. METHODS OF ORGANISING PRODUCTION

Whereas in debates on contemporary local government, contracting out, privatisation and outsourcing are often used interchangeably, in fact they carry distinctive and different meanings (Wallis and Dollery, 1999). Privatisation refers to the transfer of ownership of assets from public ownership to private ownership. For example, the sale of Qantas by the Commonwealth Government represented a straightforward privatisation of a publically owned entity. Since newly privatised organisations may or may not operate in a competitive environment post-privatisation, privatisation is by no synonymous with competition, which depends on the nature of the industry in question. For instance, while

Sydney Airport has been wholly privatised, given its natural monopoly circumstances, it can hardly be described as operating in a competitive market.

By contrast, contracting out refers to deliberately invoking competition in the provision of a service previously provided without competition (Domberger and Jensen, 1997). In local government, municipalities typically invite bids from suppliers for contracts to provide particular services. The dominant characteristic of contracting out resides in competition for the market - as opposed to competition within the market - with the market defined by the contract specification and the associated bidding process embodying a form of auction. In general, tenderers offering the lowest price win the right to supply a service for the duration of the prescribed term of the contract. As a consequence, a local authority can secure service provision at least cost. Under contracting out, councils retain a degree of control over service provision by means of monitoring performance, imposing financial penalties, and dismissing the contractor in the event performance failure. This level of control is not afforded by privatisation.

A further distinction between contracting out or outsourcing and competitive tendering and contracting must be drawn (Horn, 1995). Contracting refers to instances in which a local authority seeks competitive tenders for the provision of a specified service from both external providers and in-house units presently delivering the service. By contrast, contracting out or outsourcing restricts competition to external providers only, thereby ruling out bids from in-house providers.

Disillusionment in local government with many of the consequences of contracting, privatisation and outsourcing has led many local authorities around world to take a much more pragmatic approach to the question of how best to provide local services. In many instances, this has led to 'reverse contracting' where earlier shifts from public delivery to market delivery have been replaced by 'contracting in' service provision back to in-house delivery. Hefetz and Warner (2004, p.173/4) argue that 'this ''reverse contracting'' reflects the complexity of public service provision in a world where market alternatives are used along with public delivery', demonstrating that whereas 'private firms that contract out balance concerns with efficiency, quality, timing, reliability, security, and internal capacity … local government managers who use market approaches to deliver services must balance an even wider set of concerns, including accountability and public preference'.

In local government, reverse contracting has seen the vigorous 'remunicipalisation' of services previously outsourced. In the literature, remunicipalisation is also often referred to as insourcing or sometimes 'new contracting back-in' (Hefetz and Warner, 2004, p.176). In essence, it involves the cessation by a local council of contracting out a service provision and performing it instead internally. Insourcing is thus the opposite of outsourcing.

3. INTERNATIONAL PERSPECTIVES ON OUTSOURCING AND INSOURCING

3.1 Conceptual Foundations

The economic analysis of alternative institutional methods of producing goods and services owes much to Ronald Coase (1937), Oliver Williamson (1985) and other seminal theorists in the New Institutional Economics (NIE) tradition. Economists in this tradition draw a basic distinction between markets and organisations as alternative modes of production, each associated with different characteristics. Thus, for example, Coase (1937) argued that a firm could employ a worker to perform a given task, such as providing secretarial services to its manager, or alternatively it could simply purchase these services in the market from individuals or entities selling these services. Put differently, in the language of economics markets and hierarchies (such as private firms, public agencies or non-profit organisations) represent alternative approaches to production.

Coase (1937) also argued that while market-based transactions and vertically integrated firms represent alternative modes of providing services, each has its relative strengths and weaknesses. For example, it was argued that organizational hierarchies owe their existence to the fact that many market-based exchanges are prone to high transaction costs related to search and information costs, the costs of negotiation and enforcing agreements, and the like. However, many transactions take place outside of firms because of the countervailing costs of vertical integration related to the overhead costs and the bureaucratic costs of managing complex organisations, as well as the cognitive limits of managers. These all represent specific types of transaction costs.

Williamson (1985) has argued that, in general, where the assets involved in a production activity are highly specialised and specific to that activity, and not readily tradable, then production activities involving these assets should be conducted in-house in organisational hierarchies coordinated though managerial hierarchies. By contrast, where assets can be used for a range of production purposes, and are tradable, then production activities involving assets with these attributes are best outsourced to the market.

While the market versus organisational hierarchy dichotomy has continued to dominate economic discourse on outsourcing, subsequent developments in this tradition have added a third category. This has seen the emergence of different triads of terms: markets, hierarchies and networks (Thompson et. al., 1991), community, market and state (Streek and Schmitter, 1985), markets, bureaucracies and clans (Ouchi, 1991), price, authority and trust (Bradrach and Eccles, 1991), and markets, politics and solidarity (Mayntz, 1993), many of which have their roots in Boulding's (1978) distinction between exchange, threat and integrative relationships.

In a specifically local government context, the analytical foundations for decisions on whether or not to produce local services in-house or outsource them derives from the pioneering work of Oakerson (1999) in his *Governing Local Public Economies.* Oakerson (1999, p.7) drew a fundamental distinction between local service ‘provision’ and local service ‘production’ and demonstrated that different criteria apply to these conceptually different functions.

The *provision* of local services involves determining whether to provide a particular service, the regulation of local activities, local revenue raising, the quantity and quality of local services provided, and how these services should be produced. By contrast, *production* involves the actual creation of a product or the rendering of a service rather than its financial provision. Compared with the services typically delivered by higher tiers of government, Oakerson (1999, p.15) argued that 'almost all' local public goods and services 'depend upon the availability of specific time-and-place information, such as neighbourhood conditions, to support effective production choices'. This implies that 'the scale and organization of the production process should allow producers to make locally informed judgments'. If provision is separated from production, it follows that council size and production scale are not necessarily related.

Oakerson (1999, p.15/16) argued that local public goods and services possessed three characteristics which differentiated them to varying degrees from other goods and services. In the first place, the phenomenon of 'co-production' is especially important in local government. Co-production refers to 'productive efforts of citizen-consumers as an integral part of the production process' and it must thus be distinguished from the 'citizen-voter' role of residents in service provision. In this role, citizens act as the ‘eyes-and-ears’ of local councils and their willing participation is thus essential to maintaining the quality of service delivery.

Secondly, Oakerson (1999) draws a distinction between ‘local public goods’ and ‘local public services’. Local public goods are usually capital-intensive and thus often exhibit economies of scale, as perhaps best exemplified by water and wastewater systems. By contrast, local public services, like development approvals, parks and gardens maintenance, ranger services, front-office services, and the like, are typically labour-intensive and scale economies are quickly exhausted.

In general, economies of scale thus differ widely between different municipal activities. In his *Merger Mania,* Andrew Sancton (2000, p.74) noted that ‘there is no functionally optimal size for municipal government because different municipal activities have different optimal areas’. At a more detailed level, Oakerson (1999, p.16) shows that due to large differences in scale economies between different goods and services, ‘much different economies may also be involved in increasing the level of production per capita as opposed to extending the same level of production per capita to a larger population’. These considerations have significant consequences for the organization of production, including decisions on outsourcing.

Thirdly, coordination or management costs also play a crucial role in the way in which production should be tackled. Oakerson (1999, p.16) summarised this characteristic of local goods and services as follows:

> The production and delivery of goods and services can be broken down into a large number of components, distinguishing direct service components delivered to citizens from various support-service components to direct service producers. Each component may be associated with a different economy of scale (although services typically exhibit constant returns over a broad range). Yet different components of service production require coordination to varying degrees. Coordination is costly, mainly in terms of time and effort devoted to transactions.

These transactions costs thus serve to limit the number of separate production entities within a local council as well as the number of separate services. Accordingly, the optimal number of production units depends on the trade-off between scale economies and coordination economies.

The conceptual separation of provision from production allows for choice between different vehicles for actually producing services. Oakerson (1999, p.17/18) has identified seven generic possibilities for linking provision with production in local government:

(a) 'In-house production' occurs where a local council arranges its own production. For example, a local authority could organise its own production units along traditional grounds by producing all local services itself;

(b) 'Coordinated production' takes place where councils coordinate production activities. For instance, the health inspection departments of two adjoining councils could cooperate on the regulation of activities affecting both jurisdictions;

(c) 'Joint production' occurs where two adjacent local councils organise a single production unit as in, say, joint rate notice processing and distribution;

(d) 'Intergovernmental contracting' takes the form of one local authority contracting services from another local council or state or federal government agency;

(e) 'Private contracting' where a private firm undertakes production for a council. In these cases, the local service is produced through outsourcing, which is paid for by the council in question;

(f) 'Franchising' where a local council gives a commercial producer the exclusive right to produce a given service and then sell it local residents who purchase the service if they desire; and

(g) 'Vouchering' where a given local council sets service standards and the level of service provision, but allows individual households to select their own producer using a voucher provided by the municipality.

A key question in the decision surrounding outsourcing hinges on the characteristics of local goods and services which lend themselves to outsourcing of various kinds. Writing in the context of Australian local government, Percy Allan (2001; 2003) identified the six characteristics of local services which may render them suitable for outsourcing: 'Low core capability' of councils; 'high supplier availability'; low task complexity'; substantial scale economies; 'specialized technology'; and 'low asset specificity'. We consider each of these elements in turn:

Low core capability: According to Allan (2001, p.39) core capability' refers to the 'steering' and not 'rowing' capabilities of local councils and includes 'community consultation, policy planning, general governance, service monitoring, regulating private activity and funding public purposes' and not the actual 'production and delivery of services' (Allan, 2001, p.39). It is commonly argued that without core capability local councils cannot adequately discharge their statutory responsibilities. Thus where a core capability is ceded through an outsourcing arrangement, this carries the danger that in the event of the unsatisfactory performance, or even collapse, of an outsourcing arrangement with private firms, a given council might not be able to adequately evaluate the problem, extricate itself and continue functioning. Accordingly, core capabilities should only be relinquished with extreme care. It follows that low core capabilities should be potential candidates for outsourcing.

High supplier availability: Allan (2001, p.40) considered 'supplier availability' as a criterion for deciding on whether or not to outsource a specific local council function. He concluded that the 'competitiveness of the tender' represented the crucial factor. Tender competitiveness in turn depends on whether 'there are a large number of potential contractors with the experience, skills and equipment to meet the specific needs of the council'. If these attributes are not present, as we may expect in the Australian local government milieu in many regional, rural and remote areas, then outsourcing carries the danger that it simply confers natural monopoly powers to private firms.

Low task complexity: The question of task complexity is also an important consideration for outsourcing decisions. Allan (2001, p.40) argued that 'complex tasks are difficult to monitor, hard to measure for inputs and require unique expertise to monitor' and are thus unsuited to outsourcing. 'Task complexity' thus renders outsourcing arrangements most unwise in local government.

Substantial scale economies: Allan (2001, p.40) contends that scale economies are typically associated with 'specialized products and services that are mass produced and highly standardized'. Byrnes and Dollery (2002) have demonstrated that the existence or otherwise of significant scale economies is difficult to establish and available empirical evidence is mixed for Australian local government. However, as we have seen, Allan (2006) has identified several 'back office' activities, especially in terms information processing systems, which promise substantial scale economies and thus may represent good candidates for outsourcing in small councils.

Specialized technology: Information technology represent a quintessential and ubiquitous type of specialized applied technology in local government. The costs involved in acquiring IT hardware and software and subsequently maintaining, upgrading and operating this equipment are substantial. Following Allan (2001), since capital costs are high, IT thus constitutes perhaps the best example of a service suited to outsourcing.

Low asset specificity: Allan (2001, p.40) has argued that ‘where a task requires an expensive and specific asset it may be more cost effective for the council to provide the asset than require a contractor to invest in something that may outlive its contractual life’. Similarly, where a private contractor owns an expensive asset specific to a specialised local government function, it is unlikely to operate in a contestable market and thus will enjoy a degree of monopoly power, making it an unsuitable outsourcing operator.

Both the NIE approach developed by Coase (1937), Williamson (1985) and others, as well as its local government application developed by Oakerson (1999) focus overwhelmingly on the achievement of least-cost service provision as measured in terms of the direct pecuniary costs involved. However, once broader social benefits and social costs are included in decision-making on whether or not to outsource local government functions to private providers, then the calculations involved change. Hefetz and Warner

(2004, p.174) have aptly noted that 'the social values inherent in public services may not be adequately addressed by the economic efficiency calculus of markets'.

3.2 Empirical Evidence

Disillusionment with the results of outsourcing in local government, together with a growing realisation that the negative social costs of outsourcing can be prohibitive has seen a trend towards the remunicipalisation of local services previously outsourced by means of insourcing. Against this background, it is instructive to examine the international empirical evidence on remunicipalisation in local government.

Initial empirical work was undertaken in the United States. Warner and Hebdon (2001, p.320) administered a comprehensive survey the 'chief elected official' in all 932 township and 57 upstate county governments in New York State soliciting information on five alternative modes of delivering local government services:

- 'Inter-municipal cooperation) including 'mutual aid, joint production, creation of a special district, or contracting with another governmental unit'.
- Privatization encompassing 'contracting out, transfer of assets or program to the private for-profit sectors or non-profit sectors or to a public benefit corporation'.

- ‘Reverse privatization’ consisting of ‘contracting back in from the for-profit or non-profit sectors or from another government’.
- ‘Governmental entrepreneurship’ such as ‘government contracting its services to private or non-profit sector clients’.
- ‘Cessation of services’.

Warner and Hebdon (2001, p.320) summarised their chief findings as follows:

> ‘Inter-municipal cooperation was the most common form of restructuring (55 percent of all reported restructuring cases since 1990) …. Privatization was next most common at 28 percent, followed by reverse privatization at 7 percent and governmental entrepreneurship at 6 percent. Cessation of service (4 percent) was the least common restructuring alternative. The incidence of these forms of restructuring supports our hypothesis that governments use a mix of restructuring forms, and that surveys focusing primarily on privatization fail to capture the importance of other restructuring alternatives’.

In a national study, Hefetz and Warner (2004, p.172) employed longitudinal survey data over the period 1992 to 1997 to examine ‘the dynamics of the contracting process’ in local government service provision. They found that ‘93 percent of the 628 governments that responded in both survey years newly contracted out at least one service, and 81 percent of these governments contracted back-in at least one service'. In addition, 'almost three-quarters of governments engaged in both new contracting out and contracting back-in'. Hefetz and Warner (2004, p.172) argued that their findings demonstrated a complex interplay between outsourcing and insourcing since 'on average, governments newly contract out six services and contract back-in four services'. The frequency with which outsourced services were contracting back-in illustrated the complicate dynamics involved in the local government service contracting process.

Hefetz and Warner (2004, p.184) found that local authorities consider a broad range of factors in the contracting decision, with monitoring and principal agent problems the most significant, but the degree of market competition also important. In particular, they found that 'higher levels of monitoring are associated with higher levels of new contracting out and lower levels of contracting back-in'. This demonstrated that 'government managers who are successful users of contracts for service delivery understand the importance of monitoring systems that assess cost, quality, and citizen satisfaction', with municipalities 'with lower levels of monitoring more likely to bring services back in-house'. For these local councils, 'contracting back-in appears to be a substitute for monitoring', which may reflect 'limited governmental capacity to monitor in general or selection of services for contracting that were inappropriate candidates for market delivery in that locale'.

In a second national study of American local government service provision, Hefetz and Warner (2012) used national survey data collected by the International City/County Management Association (ICMA) from local authorities across the United States over the period 2002 and 2007. This dataset possessed the distinct advantage that it covered all counties with more than 25,000 population (roughly 1,600 councils) and cities over 10,000 population (roughly 3,300 municipalities), a sample of cities with population levels between 2,500 and 10,000 people and counties under 25,000 population.

With respect to the mode of delivery by type of service, Hefetz and Warner (2012, p.316) found that the 'highest rates of continued contracting are found in physical infrastructure services like transit, waste management, and vehicle towing; and in social services like job training, elderly services, drug treatment, and homeless shelters'. By contrast, 'physical infrastructure services are more likely to be contracted to the for-profit sector, while social services are more likely to be contracted to the non-profit sector'. The most stable areas of continued public service delivery were in the following specific service types: Crime prevention, police and fire, water and sewer services, snowploughing, and back-office support services, such as personnel, billing, and data processing.

Hefetz and Warner (2012, p.323) concluded that in contemporary American local government 'levels of new outsourcing are matched by reversals (insourcing) among local governments', with 'considerable variation by service, and even within the same service'. Moreover, some local authorities 'will newly outsource while others insource previously privatized services', mainly because 'not all contracting is successful' since 'markets shift, citizen preferences change, and service requirements change'.

Hefetz and Warner (2012, p.323) draw some interesting implications from their analysis for public policymaking in local government. They contend that 'cities should retain some capacity to re-internalize previously contracted work so that they can ensure failsafe delivery and responsiveness to citizen interests'. In particular, a danger exists that if outsourcing exceeds a critical level, then vital capacity in terms of city managers, staff, and resources can be lost if local authorities excessively outsource assets and core functions.

Sager (2001) attributed these trends to a change in values on the part of many American local authorities. Sager (2001, p.645) has argued that local councils must ‘respond to the dilemmas (for example, of not being able simultaneously to fulfil goals of decision-making consistency and expert autonomy) by biasing the organisational structure to accentuate one value more than the other’. As a consequence, a municipality ‘develops a certain organisational profile with a built-in set of values matching that of a particular mode of planning’, such as outsourcing or insourcing as a dominant mode of production. This in turn leads managers to strive for concordance between the values embedded in structure and process, respectively, and thus regularity appears between agency structure and planning style’.

Empirical work in Britain has echoed these findings, partly as a consequence of the decision to remove compulsory competitive tendering in 1998 and allow local councils to municipalise previously outsourced services (Entwistle, 2005). For example, in a broad ranging empirical study of remunicipalisation in the United Kingdom the

Association for Public Service Excellence (APSE) (2009) (2011) surveyed 140 local authorities. APSE (2011) found that:

- Municipalities of ‘all sizes, locations and political control’ are engaging in insourcing services back in-house.
- ‘Intense budgetary pressures’ represent a ‘key driver in insourcing’.
- Insourcing is viewed as a flexible means of delivering services within the difficult and dynamic context in which local government is operating.
- Environmental services are the ‘most likely to be brought back in-house’.
- Local councils have found that that ‘insourcing contributes towards: accountability; flexibility; efficiency; cost effectiveness; service improvement; strategy and synergy; added value; risk minimisation; and workforce morale’.
- Human resource questions represent ‘a vital consideration when insourcing and lessons learned from case studies show that consultation and communication is a key factor when returning services back in-house’.

APSE (2011, p.40) drew the following conclusions from its analysis:

> ‘Reasons for insourcing identified in the previous research have become more pressing as a response to the current challenges faced by local authorities.

> Returning services back in-house is achieving significant outcomes including efficiency savings, performance improvements and increased customer satisfaction. Insourcing is also a means of responding flexibly to challenging financial circumstances, minimising risk and enhancing local accountability'.

Yurchenko and Lethbridge (2004) examined the performance of shared services in British government in a report entitled *Shared Services: Setting Unrealistic Expectations* produced under the auspices of the Public Services International Research Unit (PSIRU). Shared services in this institutional context refer to the outsourcing of mainly back-office services previously provided by the public service departments which used the services themselves. Wholesale outsourcing of this kind arose as a result of an Independent Review of Public Sector Efficiency (Gershon Review) which took place in 2004. The Gershon Review identified six areas of service provision which could yield significant cost savings: back office functions; procurement; transactional services; public sector policy funding and regulation; private sector policy funding and regulation; and freeing 'front-line public service professionals' from performing needless administration.

In March 2012, the British National Audit Office (NAO) examined the performance of five out of eight shared service units which has been established by 2011. The NAO investigation discovered that the cost of the centres as at the end of 2012 was £1.4 billion, far in excess of the previously anticipated cost of £0.9 billion. In addition, while cost savings of £159 million had been predicted by the end of the financial year 2010/11, the NAO uncovered losses, which differed across the shared service centres.

Numerous other problems arose from the operation of the shared service centres, not least unsatisfactory quality standards and a failure to deliver services as specified in contracts. Whereas the extent of these problems differed across different civil service departments, most departments had had to deal with substandard service delivery of one kind or another.

Yurchenko and Lethbridge (2004, p.10) drew several conclusions from their analysis. In the first place, they found that the NOA had established that ‘the most striking feature of many schemes is that there are no savings and quality of services falls’, with a clear-cut ‘failure to learn from the experiences of the last 10 years’. Yurchenko and Lethbridge (2004, p.10) concluded that the multinational firms involved were motivated overwhelmingly by a desire 'to maximise profits as well as secure future markets in the public sector'. Not only had this seen the dissipation of projected cost savings, as well as the delivery of unsatisfactory services, but civil service jobs were needlessly lost and 'the expertise and competence of government' undermined as a consequence. This had set the scene for widespread insourcing to correct these problems.

Much the same has occurred in many other national contexts. For instance, with respect to the employment impact of outsourcing in Germany, Gerstlberger (2014) observed that it had decreased public sector employment and eroded working conditions, with 'more than ½ million public jobs reduced in the German waste, (waste) water, electricity & health care sectors since 1990'. Warner (2008) has pointed similar trends in Australian and New Zealand local government.

4. EVALUATION OF OUTSOURCING AND INSOURCING IN AUSTRALIAN LOCAL GOVERNMENT

In common with several other federal countries, the structure, powers and responsibilities of the different Australian state and territory local government systems are determined at the state rather than the national level. From a policy analysis perspective, this substantially increases the complexity of Australian local government because, with state and territory governments establishing diverse legislative and regulatory frameworks for their respective municipal systems, significant differences have arisen between local government systems. However, while local government systems may diverge between jurisdictions, most of the major functions of local government are relatively similar across the different states (Dollery, Crase and Johnson 2006).

In contrast to many other advanced countries, such as Britain, Canada, Japan and the United States, but in common with New Zealand, Australian local government undertakes a relatively limited range of functions, concentrated mainly on 'services to property'. Unlike many other local government systems, it provides comparatively few 'services to people', such as education, fire protection and police, which in Australia are the primary responsibility of state governments rather than local councils. Councils typically fall under the control of (part-time) councillors and usually an indirectly elected mayor, both of whom face periodic elections and oversee the operations of professional staff led by a general manager.

The chief responsibilities of Australian councils centre on the provision of local infrastructure, like local roads, town planning, development approvals, and local services, such as management of sewage and stormwater, and solid waste disposal.

However, over the past few decades the range of services provided by Australian local government systems has increased (Dollery, Wallis and Allan 2006). Service provision now often embraces some community facilities, like libraries and recreational amenities, some community services, such as childcare centres, as well as some strategic roles, including local economic development, tourism and urban renewal. In addition, some services traditionally delivered by federal and state governments have been devolved to local authorities, such as some community health services, pollution regulation, and regional airports.

Australian local government is funded through a combination of property taxes (known as rates), fees and charges for services, intergovernmental grants, developer charges and various other minor sources (Dollery, Crase and Johnson 2006). On average, local authorities raise around 91 per cent of their own revenue, with rate income constituting 36 per cent of local revenue, and grants and subsidies comprising about 9 per cent (Australian Government 2010: 12 Table 1.5). In international terms, this represents a high degree of financial self-sufficiency. However, these averages mask a high degree of variation between councils, with marked differences between urban, rural and remote councils, as a result of substantial variations in population size, rating bases, and the capacity to levy user charges.

Australian local government is characterised by great diversity in many other respects. For example, population size varies from just 735 residents in Wiluna Shire Council in Western Australia to 1,006,936 people in Brisbane City Council in 2010. Similarly, population density differs greatly, as evidenced by Burnside in South Australia with 1,630 residents per square km and Flinders Council in Tasmania with 0.45 residents per square km. In recent years the larger cities have attempted to play a larger role in fostering economic development, and also in some niche areas such as sustainability policy and climate change adaptation.

In the Australian local government sphere, the economic efficiency of local service provision is only one of several dimensions of local service provision, which includes other considerations, such as local democracy. In all Westminster-style advanced democracies, local government plays a dual role. Aulich (2005, p.198) has described this twin function in Australian local government in detail. Local government 'provides a voice to local aspirations for decentralized governance'. What can be termed the 'local democracy approach' thus places fundamental value on 'local differences and system diversity' and encourages directed activities and policy reforms aimed at improving 'local choice and local voice'.

This is premised on the notion that a local council 'can and will make choices that will differ from those made by others'. According to this view, 'a premium is placed upon traditional democratic values' that fully embrace 'access', 'accountability', 'representativeness' and 'responsiveness' (Stewart 1997). The 'vibrancy' of local democracy thus becomes a desired outcome in its own right. Local service provision must thus embrace these factors in addition to simply the costs of service provision.

In addition to these attributes, it is possible to identify other dimensions that may be important. In this respect, the concept of 'social capital' is crucial. First conceived by Coleman (1988), social capital refers to those features of social life which enable participants to act together more effectively to pursue shared objectives. In the local government context, social capital engenders local civic awareness that manifests itself in a variety of community projects, ranging from the formation of local social associations and sports clubs to local business initiatives. The determinants of local social capital are complex and not well understood (Quibria 2003), but include a ‘sense of community’ and a ‘sense of place’ that derive from living in a small and distinctive community, such as a local government area. Council performance and community social capital are therefore intrinsically linked together.

Rather than being viewed as a burdensome financial impost on the local exchequer, representative local government is seen as a worthy policy goal on its own merit. The costs associated with local governance, including local elections, consultation processes, ‘democratic audits’, community participation, elected councillors, their supporting secretariat and the whole gamut of local democratic autonomy, can thus be justified in the same way as financial outlays on any other *bona fide* council service. Accordingly, local councils should not simply seek efficient local service provision, but also effective local democracy. Political process becomes as important as economic outcome. The result is an emphasis on ‘bottom-up’ local community consultation on local policy formulation.

A further factor complicating decisions on whether to outsource council functions resides in local economic development, especially in regional, rural and remote councils in the Australian context. Local councils are often a major employer of local people and thus council decisions on outsourcing, especially where these involve contracting with private firms located in other centres, can have decisive effects on the local economy. For example, if an important local council function employing a number of local people is outsourced, this can set in train powerful negative multiplier effects which induce displaced council workers to leave the area, thereby lowering population, reducing economic activity, and threatening the viability of other public and private services, like local public schools and banking facilities. In other words, the social costs attached to outsourcing can readily exceed any short-run cost savings to council service provision. In sum, local authorities are 'more than a business; they reflect collective identity, respond to diversity, and promote social equity' (Hefetz and Warner, 2004, p.174).

5. ROAD MAINTENANCE AND RENEWAL OUTSOURCING IN AUSTRALIAN LOCAL GOVERNMENT

It should be stressed that Australian local councils are no strangers to the process of outsourcing the services they provide. In 1996, the (then) Industry Commission estimated that the total value of local government services subject to competitive tendering or contracting out was $1.7 billion for the financial year 1993/94, or approximately 20 per cent of councils' total expenditure (Paddon and Thorowgood, 1996, p.2). Since that time the ratification of the National Competition Policy (1993) by the Council of Australian

Governments in April 1995, and its endorsement by state legislatures soon after, has given further impetus to entrenching these procedures as a part of the everyday business of municipal authorities.

Road maintenance and renewal is an especially important part of the overall role of state and local government in Australia. In local government it accounts for about 20 percent of annual outlays (Australian Government, 2010). Given the vast spatial scale of Australia, it is hardly surprising that road maintenance and renewal is a substantial task. For instance, the Australian national road network covers in excess of 800,000 kilometres, including 18,700 kilometres of officially designated national highway and some 260,000 kilometres of state roads.

Responsibility for the maintenance of this enormous network falls largely on state and local governments. The task is inordinately expensive: around half of the $15.8 billion aggregated public sector budget is spent on maintenance and renewal. Furthermore, state and territory governments invest more than $5.5 billion annually on road maintenance and repairs, while local authorities spend around $1.5 billion. In 2010/11, the NSW Roads and Traffic Authority (RTA) alone invested more than $1 billion on its core road maintenance program (Commonwealth Grants Commission 2011).

In common with many other Productivity Commission reports, *Public Infrastructure* is bound to become influential in public policy debates surrounding the provision of public infrastructure, including local government infrastructure provision. While the thrust of the deliberations in *Public Infrastructure* focus on substantial reform to existing arrangements, particularly the inclusion of the private sector, the Productivity Commission is hardly breaking new ground in this regard. For instance, Infrastructure Australia's (2011) *Road Maintenance: Options for Reform* represents a leading example of the kind of recommendations offered by *Public Infrastructure*, as applied to road maintenance and renewal.

Infrastructure Australia (2011, p.1) has argued that 'global and domestic experience of competitive models of road maintenance has been shown to deliver efficiencies ranging between 10 and 40 per cent', while 'a limited programme of road maintenance outsourcing in New South Wales delivered cost reductions of between 20 and 30 per cent'. On this basis Infrastructure Australia (2011, p.1) contends that 'the potential savings available to Australia's governments are in the order of at least $700 million, but could range as high as $2.8 billion per annum, if a uniform 40 per cent saving was achieved'. It further claims that 'using market incentives and benchmarking against world's best practice can drive investment, safety outcomes, whole-of-lifecycle management, innovation and availability in a way that traditional delivery methods have been unable to sustain'. Infrastructure Australia (2011, p.1) even goes so far as to make the extraordinary claim that 'competitive tendering for road maintenance services will also increase accountability in road network provision, with private sector providers held to account for poor performance'!

Infrastructure Australia (2011, p.6) advanced five recommendations for reforming road maintenance in Australia:

Recommendation 1: 'State governments should immediately investigate and pursue road maintenance outsourcing opportunities – delivering a process where all road maintenance is subject to competitive tendering'.

Recommendation 2: 'State governments should restructure their existing road maintenance functions to allow for a simpler transition to an outsourced model'.

Recommendation 3: 'State governments should establish collaborative road maintenance strategies with local councils to bundle road asset management to achieve efficiencies of scope and scale'. Thus, 'as the private sector becomes increasingly engaged in outsourcing, service providers should be participants in these strategic alliances'.

Recommendation 4: 'State governments should assist local governments to align their road maintenance functions with new, clearly defined, state regions'. This implies that 'local governments, assisted by state governments, should seek to collaborate with neighbouring councils to form road maintenance partnerships that align with these regions; this would unlock efficiencies of scale and act as a precursor to a competitive tendering that combines roads maintained by states and local councils into an integrated maintenance bundle'.

Recommendation 5: 'State governments should, where existing outsourcing contracts are in place, continually seek improvements to the model, adopting best practice deployed in other jurisdictions'.

While Infrastructure Australia (2011, p.4) does pay lip service to the consequences of these far-reaching recommendations for regional, rural and remote communities, it is dismissive of the damaging effects that wholesale outsourcing will have on these local communities:

> 'Opponents have argued against previous road maintenance reform efforts, arguing that a competitive outsourcing model poses a risk to employment, particularly in regional areas. This argument is not borne out by experience, given that private sector asset managers are as reliant on local labour as their public sector equivalents. Where road maintenance has been outsourced, employees have typically transferred to the private sector operator and benefitted from renewed investment, updated work practices and the latest technology'.

Indeed, no mention is made at all of the negative multiplier effects which an outsourced and highly mobile 'drive-in/drive out' workforce will have on small local communities in which local government is typically by far the largest employer. Nor does Infrastructure Australia (20111) even consider the broader ramifications of population loss contingent upon employment loss in terms of the closure of facilities, such as local schools, local banks and the like, as local economies suffer the consequences of a negative cycle of local economic downturns.

In *Public Infrastructure*, the Productivity Commission (2014) in effect generalises many of these conclusions to all kinds of public infrastructure provision in Australia at all levels of government. For example, Recommendation 7.1 *inter alia* calls for the 'use of transparent, innovative, and competitive processes for the selection of private sector partners for the design, financing, construction, maintenance and/or operation of public infrastructure', together with 'ensuring efficient allocation and subsequent monitoring of project risks between government and the private sector'. Furthermore, the Productivity Commission (2014) prescribes that receipt of funding from the Australian Government should be made contingent upon the full implementation of Recommendation 7.1. Thus Recommendation 7.3 prescribes that 'Australian Government funding or other forms of financial assistance (including incentive payments under Commonwealth–State agreements) for public infrastructure that is provided to State and Territory and Local Governments should be conditional on the adoption of the governance arrangements outlined in recommendation 7.1'.

This has potentially far-reaching effects on local government in light of the various Australian Government grants which are presently provided to local government by the Commonwealth, such Roads to Recovery funding, Financial Assistance Grants and the like. Given the importance of these grants to the ongoing financial sustainability of local authorities in all Australian state and territory local government systems, it is difficult to see how local government could resist the policy imperative to engage the private sector in road maintenance and renewal in areas presently undertaken within local councils themselves.

These generic recommendations for all public infrastructure provided at all levels of government are mirrored in the specific recommendations for roads advanced by the Productivity Commission (2014) in *Public Infrastructure*. For instance, in Recommendation 8.1, the Productivity Commission (2014, p.42) holds that 'the first step in a long-term transition to a more efficient and effective approach to the provision and funding of roads should be the establishment of Road Funds by State and Territory Governments'. Towards this end, 'State Governments and local government associations, should actively encourage and support local governments to form regional Road Funds for networks of local roads'. These Road Funds must - amongst other attributes - 'have the objective of clearly linking road-user preferences with investment and maintenance decisions', 'integrate the tasks of road funding and provision', and 'have a significant degree of autonomy'.

If we consider the probable impact of Recommendation 8.1 in the context of local government in regional areas of Australia, in effect it seeks to 'regionalise' the provision of road infrastructure away from individual local authorities towards regional bodies. From the perspective of individual councils, this will inevitably lead to job losses as councils outsource road maintenance and renewal presently undertaken in-house to the separate regional entities or private firms contracted to provide road maintenance and renewal on a region-wide basis. Regional entities will be funded from the regional Road Funds established by regional groupings of councils.

While Productivity Commission (2014) does not directly specify the nature of these regional entities in *Public Infrastructure,* in the context of its other recommendations, which all emphasise the need to secure private sector involvement, it is clear that Productivity Commission (2014) has in mind that road maintenance and renewal funded from the regional Road Funds will be conducted on the basis of competitive tendering processes. Thus, in *Public Infrastructure* (2014, p.281) Recommendation 7.1 holds *inter alia* that there must be 'monitoring of project performance and ex-post independent evaluation and publication of project outcomes'. It adds that responsible governments, including local government, must retain ‘sufficiently skilled public sector employees to be responsible and accountable for performing these functions’. In short, the Productivity Commission (2014) is effectively recommending the outsourcing of road maintenance and renewal away from local authorities to private companies to be undertaken regionally.

As we have argued in section 4 of this Report, the ‘regionalisation’ will set in train a vicious cycle of the loss of local council jobs as a consequence of local negative multiplier effects. Accordingly, fewer municipal jobs will induce a decrease in local economic activity which will see lower employment across affected local communities. The resultant fall in local expenditure will see the closure of local businesses, with workers moving away in search of employment and the subsequent loss in population leading to the closure of local public services, like schools and hospitals, as population falls below the threshold levels required to sustain these services. In sum, the outsourcing of road maintenance and renewal along the lines recommended by the Productivity Commission (2014) in *Public Infrastructure* will mean the end for many small regional, rural and remote communities.

6. POLICY IMPLICATIONS

What are the major public policy implications of outsourcing and insourcing as alternative methods of producing local government services? As we have seen in this Report, the great wave of privatisation and outsourcing which has occurred across the public sector in many industrialised countries over the past three decades has not only not met the extravagant claims made by its exponents, but instead has created a host of unforeseen and unintended problem, especially in the realm of the quality of service provision. Furthermore, as a general rule, prior expectations of cost savings have not materialised. Indeed, in many instances, the costs of service provision have exceeded that achieved by in-house. As a consequence, 'reverse privatisation' has been initiated by local authorities across the developed world, often in the form of insourcing services previously outsourced in the hope of ameliorating the problems that had arisen.

Hefetz and Warner (2004) and many other scholars have argued that the growing trend towards insourcing derives in large part from the complexity of public service provision compared with private sector production. Whilst private firms pursue profit maximization focusing overwhelming on minimizing production costs to the exclusion of factors such as service, by contrast local authorities must balance numerous factors, including service reliability and security, as well as procedural concerns, such as accountability and public inclusion. Put simply, most local public services are too multifaceted to make them amenable to private sector provision.

In addition, in the special circumstances of regional, rural and remote local authorities in Australian local government, characterised by the tyranny of distance, low population densities and an absence of competing suppliers of services, outsourcing is particularly unsuitable. Locals councils in these communities are often ‘government of last resort’, acting as the foundation for the very existence of local communities. If outsourcing is introduced, it typically sets in train a downward spiral of falling local employment, the closure of essential facilities and the emergence of ‘ghost towns’.

The major lesson which emerges from this Report is that whereas it outsourcing may at first blush look promising, especially in terms of its cost effectiveness as a means of delivering local services, this often later turns out to be illusory. Moreover, once a service has been outsourced, it can be difficult and expensive to acquire the lost capacity and skills necessary to bring it back in-house. It follows that public policymakers should act cautiously, and bear in mind the broader interests of local communities, rather than blindly pursuing the deceptive chimera of cost cutting and outsourcing. This is true of road maintenance and renewal presently undertaken by local authorities in Australia as well as many other local services.

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