

Contracting out: Dutch municipalities reject the solution for the VAT-distortion

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Abstract

In 2003, the Dutch government introduced a VAT-compensation fund in order to create a level-playing field for local governments with respect to Value Added Tax (VAT). This fund eliminates the effect of the tax difference between local governments that supply services themselves and local governments that contract out to the private sector. However, as this paper shows, according to most of the municipalities differences in VAT treatment did not hinder contracting out of public services. Therefore, the fund lacks legitimacy. In line with this, the fund is until now not effective, as the number of contracted public services has hardly increased since the introduction. In general, municipalities have a negative opinion about the fund. They state that non-budgetary effects and institutional reasons, such as the quality of services, the vulnerability of municipal activities and the care for the employment in the own municipality, are more relevant in the decision-making on outsourcing.

Keywords: VAT, Contracting out, Municipalities, Compensation fund

JEL codes: H25, H32, L33

Forthcoming in *Local Government Studies* (2010)

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1. Introduction

Over the last two decades contracting out of government services has increased. A broad range of studies show that this policy may generate benefits as competition for contracts can increase efficiency of public activities such as refuse collection, fire protection and cleaning services (Domberger and Jensen, 1997; Tang, 1997). Also other arguments as quality of private service provision may play a role. However, the VAT (Value Added Tax) system of the European Union favours public provision over contracting out. In many cases contracting out leads – despite the potential cost-efficiency - to higher gross costs for governments as the net costs of the service are raised by VAT for contracted out services. As VAT is not a net cost for society, it should not influence the decision making from a societal point of view. From the viewpoint of local decision makers, however, it potentially does influence the decision as they have to pay VAT, while the revenue is cashed by central government. Therefore, public authorities have fewer incentives to achieve maximal efficiency gains or to make an optimal decision for other non-budgetary reasons. As several other – especially North-European – member states of the European Union, the Dutch government introduced in 2003 a refund scheme to address this distortion (Wassenaar and Gradus, 2004). However, other arguments – such as the care for the local level of employment or the vulnerability of municipal activities – might be relevant for the decision making on the contracting out municipal activities as well.

This paper analyses the effectiveness of the Dutch refund scheme on contracting out by municipal activities in the Netherlands. The paper is structured as follows. Section 2 describes the arguments for public authorities to contract out their activities and provides theoretical explanations for the differences between municipalities in the degree of contracting out. In section 3, the VAT-compensation regime in the Netherlands is described and compared with other countries. Section 4 shortly presents the survey methodology we use in this paper to shed light on contracting out and the effectiveness of the Dutch approach. Section 5 discusses the results of an inquiry of the Dutch municipalities with respect to the extent of contracting out activities to the private sector. Section 6 describes the opinion of Dutch municipalities on the effectiveness of the fund. Section 7 offers the concluding remarks.

2. Contracting out of public activities

Municipalities can decide to contract out the production or supply of their services to the private sector for a number of reasons. Private contractors possess advantages over public organisations as they have a stronger focus on results due to competition among suppliers, the necessity to earn at least an average return on investment and more powerful structure of

incentives for managers (Hart et al, 1997; Shleifer, 1998). This means that they have more incentives for innovation, organisational improvement and lower cost production. In general, they can reach higher results as they have often a more flexible labour organisation and fewer procedural constraints than public organisations. A special advantage derives from economies of scale as private companies can distribute their fixed costs over more municipalities.

A number of these arguments for municipal contracting out to the private sector are valid for the contracting out to public organisations like inter-municipal corporations and public firms as well, as they achieve similar results by creating a market for service provision extending beyond a single jurisdiction and expanding economies of scale (Dijkgraaf and Gradus, 2003; Sorensen, 2007).

Due to these advantages, private and external public contractors may be able to offer these services at lower costs than the municipalities themselves could do. Many studies find support for the efficiency and cost-savings claims for public activities such as refuse collection, fire protection and cleaning services. Overview studies (e.g. Domberger and Jensen, 1997; Tang, 1997) based on experiences with contracting out a broad range of government services indicate cost savings of about twenty percent, without sacrificing the quality of services provided. However, other and more recent reviews of empirical literature suggest that the support for the efficiency claim is at best mixed (Boyne, 1998; Hodge, 2000). Bel and Warner (2008) conclude that no direct and systematic relationship can be established between savings or productivity and private production. As an example, Bel and Warner (2006) find in a meta-analysis based on an integral survey on published econometric studies of water and waste production little support for a link between privatisation and cost savings. They explain these findings by the existence of market failures (monopolistic production respectively weak competition or collusion) and conclude that scepticism of cost savings under privatisation is warranted. Therefore, they suggest that if privatisation is chosen as a tool for reform, governmental regulation and market structuring is necessary to ensure cost savings occur and sustain over time.

For none of the listed European studies it is clear whether in the reported cost savings the VAT-effect is excluded. This is remarkable as in the European Union contracting out leads to a VAT obligation increasing the gross costs, but not the net costs of service provision. If VAT is not excluded and studies conclude that that contracting out does not lead to lower gross costs, they in fact conclude that net costs are lower. In that case contracting out is preferred from a social cost perspective.

A second prominent benefit or motivation cited by public officials for outsourcing is the higher quality of private production (Brudney et al, 2004). However, only a few statistical studies have been conducted on this issue. As a result, the effect of contracting out on service quality remains largely unknown. In a meta-analysis (Hodge, 2000), the effect of contracting out on service quality was statistically indistinguishable from zero.

Differences in contracting out

Despite the potential benefits of contracting out, local governments differ to the extent they have chosen to outsource their activities. A number of economic theories have been used to understand the reasons for municipalities to contract out their activities to the private sector (see for example Bel and Fageda, 2007). As the theory of public choice focuses on the public organisation and the behaviour of managers, this theory is especially useful to investigate the reasons for municipalities to transfer a part of their production to the private sector. Another theory is the concept of transaction costs. This theory is especially useful for understanding the reasons why municipalities transfer certain activities to the private sector, while they provide other services themselves. However, as a lot of empirical studies have shown, the economic theories and arguments are in general not able to give a convincing explanation for the contracting out behaviour of municipalities. Recently, sociological-institutional literature has postulated theories that describe decision-making on a number of institutional choices. However, this range of literature has not yet been tested empirically on the aspect of contracting out of public activities. The rest of this paragraph describes the application of these theories on the issue of contracting out and their empirical evidence in more detail.

Public choice theory is used frequently to analyse contracting out behaviour of municipalities (Bel and Fageda, 2007). This theory focuses on the political motivations behind managerial decisions in the public sector and the source of managerial influence. Public managers are in the framework of public choice credited as self-interested agents who try to maximise their personal utility and interest through longer terms or larger budgets (Niskanen, 1971). As a consequence, they will monopolise public service delivery with a sub-optimal level of production and inefficiency as a result. Policy makers will also extract rents and political power from managing local public services. According to this theory, the remedy for this behaviour is competition in markets for public services. As a consequence, contracting out should lead to lower costs and higher technical efficiency. Public choice theory argues that competition brings market discipline to public service delivery, while preserving the benefits of public sector engagement. However, as Bel and Warner (2006,

2008) suggest, adequate government regulations and market structuring are necessary in order to achieve real cost savings.

Public choice theory leads in most empirical studies to four hypotheses to test the municipal decision making on the contracting out of public services (Lopez-de-Silanes, et al, 1997; Bel et al, 2007).

1. Efficiency. Cost reduction may be an important objective of contracting out, to be realised through competition and through the exploitation of scale economies. Hence, the potential for cost reduction may be higher in larger and urban areas where more private providers are available as this increases the potential for competition (Warner and Hefetz, 2002; Hebdon and Jalette, 2008). On the other hand, smaller municipalities may profit from contracting out as they can obtain scale advantages by the aggregation of the demands of more municipalities by a private company.
2. Political patronage. The decision to contract out may be dependent on the existence of pressure groups having a particular interest in the rents from a given form of service delivery. Hence, a high level of unionisation has been negatively linked to privatisation. On the other hand, strong industrial interests should be positively linked to privatisation.
3. Ideology. Although it may be hard to imagine that voters have preferences on something technical as the mode of delivery of government services, they surely have views about the role of government more generally. Therefore, ideology may influence privatisation discussions. Right-wing parties have been linked to more pro-private business values, whereas left-wing parties are conventionally associated with public values. Left wing governments will be more reluctant to privatise local services, while right wing governments will be more inclined to do so.
4. Fiscal constraints. Fiscal constraints (fiscal stress) should lead to more privatisation. In the last decades fiscal restrictions were introduced to reduce the ability to raise the local tax revenues in countries like the United States. Due to the fact that in the Netherlands these fiscal constraints are not applied, we will not test this fourth hypothesis in this study.

Empirical evidence

Lopez-de-Silanes et al. (1997), based on data for nearly all countries in the United States for 12 sectors, show evidence that political factors are important for the decision whether public services are contracted out. Politicians derive significant benefits from in-house provision of public services – such as political patronage, support from public employee unions, possibilities to influence unemployment through public payrolls – and may lose these benefits as a result of privatisation. Consistently, they find that factors that reduce the

political benefits from in-house provision, especially state clean-government and anti-union laws, make privatisation more likely. Otherwise, they find that factors that increase the cost of government spending, such as state laws restricting government financing and measures of the state's financial trouble, make privatisation more likely. Therefore, the privatisation decision is determined in part by the trade-off that politicians face between in-house provision of public services, which bring them political benefits, and higher government spending, which brings them political costs. This political trade-off, and not just the efficiency and ideological factors, was shown to determine the decision to privatise.

In a study on the contracting out of municipal refuse collection in the Netherlands using panel data for all Dutch municipalities, Dijkgraaf, et al. (2003) seek an explanation for reservations of local authorities towards contracting out. They find evidence that a high level of grants by the central government (the efficiency argument, as a higher transfer from the central government diminishes the emphasis on cost savings) or a high level of unemployment (the political patronage argument) raises the probability of contracting out to the private sector. Moreover, smaller municipalities are more likely to choose a private waste collector as they can profit more from scale economies. Remarkably, ideological factors seem to play only a minor role. Also Bel and Miralles (2003) conclude in a study – based on the privatisation of waste collection in Spanish municipalities – that local governments are led by pragmatic rather than ideological reasons. Warner and Hebdon (2001) show that local governments are more concerned with practical issues of service quality, and less with ideology, politics and unionisation. Pragmatism wins out over politics as local governments give a keen eye to market structure, service quality, and efficiency concerns.

In a meta-study, Bel and Fageda (2007) extensively analysed 28 multivariate studies from 6 countries on the factors explaining local privatisation. They find that fiscal stress and interest group pressures influence the privatisation of local services in early US-studies that consider a broader range of services. Interest groups also have their influence, particularly for governments in small towns. Cost considerations are especially relevant when the exploitation of scale economies is taken together with privatisation choices. However, the ideological attitudes of policy makers do not seem to influence the service delivery choice of local governments in a systematic way. Finally, the authors conclude that local government decisions appear to be more pragmatic than ideological.

However, Bel and Fageda (2007) conclude also that in general the explanatory power of these studies is low. According to them, one possible explanation is that in fact most studies do not analyse the privation decision in year $t-x$ (the move from public to private) but use the

production form (public or private service supply) in year t as a dependent variable. Therefore, these studies are based on a mis-specified model because the dependent variable does not measure a dynamic choice of service production technology but rather the current status of service production, which may relate to historical rather than contemporary characteristics of the city (Boyne, 1998c). In that case, factors testing for the theories might have changed completely, while the production mode is still in accordance with the factors that were applicable when the decision was made. Another explanation is the fact that local governments have limited capability to make discretionary decisions about the production form after the years privatisation has been implemented, due to for example the duration of contracts or difficulties of re-internalising production. Therefore, the decision to contract out is path-dependent.

Transaction costs

Despite the potential efficiency of the private sector, the process of contracting out comes with costs, the most important being transaction costs. These costs are defined as the ‘comparative costs of planning, adapting, and monitoring task completion under alternative governance structures’ (Williamson, 1989; Tavares and Camoes, 2007). The theory of transaction costs focuses on all costs, including the administrative costs and the costs of incomplete contracts. From this perspective, privatisation can deliver cost savings whenever the transaction costs involved are not too large. Hence, the conditions that influence the level of transaction costs should be central in determining when a local service can successfully be privatised (Bel and Fageda, 2007).

In his study on the contracting out by organizations, Williamson (1981) focuses on two broad types of service-specific characteristics— asset specificity and service measurability. Asset specificity refers to whether specialized investments are required to produce the service. Specialized investments are investments that apply to the production of one service but are very difficult to adapt for the production of other services. These specialized investments offer an advantage to the first contract winner, thus creating a barrier to entry. Contracting governments find themselves at a disadvantage in negotiating contract terms in subsequent rounds of bargaining. The result might be market monopolization. Service measurability refers to how difficult it is for the contracting organization to measure the outcomes of the service or to monitor the activities required to deliver the service. Domberger and Jensen (1997) explain that contracting out is likely to be more successful if the magnitude and the specificity of the physical assets required to provide the service are smaller, the quality characteristics that are non-contractible are less important and competitive supply in the market, both actual and potential, is large.

Empirical evidence

Easily measured services have more readily identifiable performance measures that accurately represent service quantity and quality. A service can be easy to measure if it is relatively straightforward to monitor the activities required to deliver the service. A service is difficult to measure when neither the outcomes to be achieved nor the activities to be performed are easily identifiable. Under these circumstances, the contracting government is exposed to the risk of unseen vendor non-performance or negligence (Praeger, 1994; Brown and Potoski, 2003).

In a study on 64 types of municipal activities based on a survey of 36 public managers in the United States no evidence is found for a clear relation between the contracting out decisions of municipalities and the potential transaction costs due to the asset specificity and the measurability of services (Brown and Potoski, 2005).

Levin and Tadelis (2007) show, based on data for American city managers, that services for which it is harder to write and administer performance contracts are less likely to be privatised. They also find that services that are less frequently provided, and which managers rank lower in terms of resident sensitivity to quality, are more likely to be privatised. They interpret this result that for these services city administrators focus more on the cost of privatisation rather than on the benefits.

Sociological institutional literature

The sociological-institutional literature shows that economically rational considerations do not fully explain the behaviour of government organizations. This literature focuses on the influence of institutional factors – such as rules, values, habits, power, and internal and external pressure – on change processes in organizations (Ter Bogt, 2008). For example, a decision to autonomize an organization, as well as the effects of the decision, may largely be due to certain social, institutional, legal and political settings (DiMaggio and Powell, 1983; Lapsey and Pallot, 2000; Ter Bogt, 2003).

Institutional theories assume that a primary determinant of organizational structure is the pressure exerted by external and internal constituencies on the organization to conform with a set of expectations to gain legitimacy and so secure access to vital resources and long-term survival (Brigall and Modell, 2000). Institutional reasoning can also be used to explain the motivations and processes that underlie an organization's response to institutional pressures

(van Helden and Tillema, 2005). Therefore, institutional reasoning can be used to investigate in which institutional setting public sector organizations are willing and able to engage. For example, fundamental changes in the organization require thorough preparation, sufficient means and close attention from the management and other personnel of the organization. Therefore, it could take a considerable amount of time to introduce and get acquainted with reforms (Ter Bogt, 2008).

Empirical evidence

In a study on contracting out using data for 500 cities in Southern California, Joassart-Marcelli and Musso (2005) show that service provision and production arrangements tend to be made at the time of city formation, and that political and institutional rigidity limit the extent to which arrangements subsequently are changed. This reflects the possibility of path-dependency – the fact that technologies are adopted randomly but that these choices have long-lasting impact. Despite the potential elucidation of this literature on the concept of contracting out, sociological-institutional literature has not been tested extensively on this subject yet.

Municipalities make different choices in the contracting out of their activities. As will be shown in the next paragraph, these choices may be influenced by levying of VAT. With the introduction of the VAT-compensation fund, this potential distortion is eliminated. By directly asking individual municipalities about the use and the effectiveness of this fund, we try to gain more insight in their arguments in the contracting out decisions. Primarily, we hypothesize whether the decisions are influenced by the costs of VAT. Secondary, we study the effects of the introduction of the fund. Therefore, this study differs from most other studies on contracting out behaviour by the fact that we focus on the potential effects of the levying of VAT.

3. VAT-compensation in the Netherlands

For municipalities in member states of the European Union, VAT rules may be an important explanation for the reluctant attitude of public authorities to contract out. In the case of contracting out to a private enterprise, VAT is charged on the full price. In the case of self-supply, the public authority has to pay VAT just on the costs for the purchase of goods and services. The value added by the public authority – consisting mainly of the employee costs which often is a large share of total costs – is not subject to VAT. As a result, VAT costs are significantly higher in the case of contracting out than in the case of self-supply. This effect occurs for most activities of public authorities and certain specified activities performed by both public as well as private suppliers. In addition to the arguments as mentioned in section

2, the decision making about contracting out may be influenced by the distortionary effect of the costs of VAT.

Several member states of the European Union – Denmark, Finland, the Netherlands, Sweden and the United Kingdom – and Norway have introduced refund schemes to address this distortion. In The United Kingdom, Sweden and Finland, the schemes are introduced simultaneously with the introduction of the present system of VAT. By giving compensation for the total VAT-costs, both in case of self-supply as well as in case of contracting out, a level-playing field for both options is created. Although several European countries introduced comparable refund schemes for abolishing the VAT-distortion, unfortunately no structured information is available about the effectiveness of any of these refund schemes. Only for Denmark, Sweden and Norway minor indications are available that after the introduction of the scheme, the contracting out by local governments has increased (Wassenaar and Gradus, 2004; Ministerie van Financiën (2006).

In the Netherlands, a VAT-compensation fund was introduced in 2003. The main reason for the introduction was the creation of a level playing field between self-supply and contracting out of public services as the VAT-distortion favours self-supply. In the preceding years, the fiscal effects of the VAT-distortion received more attention by the central government and as a consequence it decided to address these problems. Besides, in the public debate an increased interest for the potential cost advantages of private contractors was seen in the public debate. Also the increase of the general VAT-rate from 17,5% to 19% in 2001 had enlarged the fiscal distortion and thus the need for compensation.

The refund scheme applies to both municipalities and provinces. Compensation is given for VAT on non-taxable activities.¹ The fund is financed budgetary neutral in the year of introduction by a structural reduction of the general grant equal to the value of compensation in that year. After this year, the fund is increased by the addition of extra VAT receipts resulting from the growth in contracting out.

The administrative obligations of the VAT-compensation fund are in general comparable to the VAT rules for regular firms, although the exceptions for compensation – for example for education and health services - might complicate administrative procedures. Despite the generous budgetary compensation for the administrative costs, municipalities complain about the complexity of the legislation of the VAT-compensation.² This might be explained by the unfamiliarity of the municipalities and provinces with VAT-legislation.

The Dutch government expected an increase of the contracting out of local government activities after the introduction of the VAT-compensation fund, based on the assumption of the higher efficiency of the private sector and the desire of municipalities to take advantage of these potential efficiency gains. However, as Bel and Warner (2006, 2008) suggest, in order to achieve these cost savings, adequate government regulations and market structuring have to be in place. During the introduction, no attention was given to the creation of optimal market conditions for contracting out. Especially for waste collection, Dutch panel data about the outsourcing to private firms are available. The share of municipalities that contracted out the waste collection to private firms decreased from 38 per cent in 2002 to 34 per cent in 2005 (Dijkgraaf and Gradus, 2008). Therefore, this indicates that the introduction of the VAT compensation fund has had no effect on the contracting out of waste collection. The authors see as explanations for this effect the general erosion due to decreasing competition in the market for refuse collection as the cost advantages of the private sector have decreased over time, the possible price increase of private competitors due to the introduction of the VAT compensation fund and the merging of municipalities.

4. Data and methodology

In spring 2006, more than three years after the introduction of the refund scheme, we investigated the effectiveness of the VAT-compensation fund. We asked all Dutch municipalities by e-mail a number of questions about (1) the extent of contracting out, (2) the effect of the introduction of the fund on the outsourcing of activities and (3) the opinion of the municipalities on the fund. The survey was sent to the aldermen who were responsible for budgetary affairs. A representative group of 209 (46%) municipalities answered this survey.³ As data are not complete for 11 municipalities, our final database consists of 198 (43%) of all municipalities.

5. Contracting out by Dutch municipalities

In this section we analyse whether the extent of contracting is related to municipal characteristics or characteristics of the service, based on the theories described in section 3. In the survey, we asked the municipalities a number of questions about the extent of contracting out, providing them with a list of nine municipal activities that are eligible for VAT-compensation. The second column of Table 1 shows for these activities that are eligible for compensation the share of municipalities that had outsourced the activities before the introduction of the fund (before 1st January 2003). Relatively high shares are found for cleaning services, building of infrastructure and assessment of real estate.

In a multivariate analysis, we tested whether the extent of contracting out has a statistical significant relation with a range of variables (see appendix A for an overview of these variables). These variables are chosen to test the three most relevant hypotheses as based on public choice theory (efficiency, political patronage and ideology). For a limited number of municipal activities, we find a relation between the share of municipalities that outsource an activity and the municipal characteristics.⁴ However, both the number of significant coefficients as, the explaining power of the estimations is in general very low. These results are in general consistent with the conclusion of Bel and Fageda (2007) on this type of statistical analysis.

Table 1 Outsourcing of municipal activities, in % of all municipalities

	Outsourced the activity before 1/1/2003	VAT distorted outsourcing	Has outsourced since 1/1/2003, till spring 2006	Outsourcing expected in the next years
Cleaning services	86	2	0	3
Canteen services	31	1	0	2
Security	60	0	1	2
Salary administration	61	0	1	1
IT	16	0	0	3
Social policy	8	0	1	1
Waste collection	69	4	0	3
Building of structure	91	0	0	1
Assessment of real estate	87	0	0	0

The variables describing the size of the municipality (number of inhabitants and the square of the number of inhabitants) do in general not support the efficiency hypothesis. Only in three cases a positive relation is found between income of the municipality and the share of contracting out. The negative sign between the outsourcing of waste collection and both the density of the municipality as the level of the general is consistent with Dijkgraaf *et al.* (2003). For the political patronage hypothesis, we tested the relation between the level of unemployment and contracting out. We do not find support for this hypothesis. For the correlation between the political composition of the municipal council and outsourcing we find different results. As in other literature (e.g. Lopez-de-Silanes, 1997), we see for a number of cases a negative relation for the outsourcing of public tasks with most left-wing parties (Progressive Liberals, Greenleft and the Social Democrats). The percentage of votes for the right wing party ‘Conservative Liberals’ shows a positive relation. However, we found only for one activity (security) such a positive relation. On the contrary, the more right wing Christian Democrats show negative signs and the (very) left wing socialist party does

not give significant relations. In general we find only little support for the ideology hypothesis.⁵

According to the transaction costs theory, we expect that differences in the percentages of contracting out might be explained by the characteristics of the activities. Activities with a low asset specificity and a high degree of service measurability might have higher rates of contracting out compared with activities with relatively high asset specificity or relatively low service measurability. However, as the results of a simple multivariate analysis in appendix 2 show, both variables are not able to explain differences in contracting out for each of these nine activities.

Other arguments as mentioned in the sociological-institutional literature might play a role. However, due to the design of the enquiry, we are not able to test these open formulated hypotheses. On the other hand, we show using circumstantial evidence that sociological-institutional factors might play a role using the explanations of these answers in the survey (see section 6). For a further understanding of these choices, we should execute a more in-depth case study research at the municipal level to gain more insight in the arguments for contracting out, in addition to the hypotheses formulated by public choice and transaction costs theory.

6. The effectiveness of the VAT-compensation fund for Dutch municipalities

The VAT-compensation fund was introduced to create a level-playing field between self-supply and contracting out of public services. The Dutch government expected an increase of contracting out of local government activities, based on the assumption of the higher efficiency of the private sector and the desire of municipalities to take advantage of these potential efficiency gains. Although a range of arguments play a role in the decision making on contracting out, the decision may be influenced by the effect of the levying of VAT. The introduction of the fund is therefore based on the assumption that the decision-making by municipalities about the outsourcing of activities is negatively influenced by the effect of the levying of VAT. According to our enquiry results this assumption is not in accordance with reality. The third column of Table 1 shows that for six out the nine activities, most of the municipalities state that VAT did not hinder contracting out of activities. For the remaining three activities only a very small number of municipalities state that the tax hindered outsourcing. Only 4% of the municipalities state that - in the case of waste collection - without the fund the decision-making about contracting out was distorted. We tested the distortion assumption also by asking all municipalities whether the VAT previously had hindered the choice to outsource municipal activities. Of all municipalities, 92% answered

negatively to this question (Table 2). Therefore the cost effects of contracting out – being the balance between the potential efficiency of private parties and the costs of VAT – plays a minor role in the decision making on contracting out. As a consequence, the VAT-compensation fund lacks legitimacy as the assumptions behind it prove not to be accurate. In addition, we asked whether the introduction of the fund had caused a managerial discussion about the application of the fund. To this question, 95% of the municipalities answered negatively.

Table 2 Opinion on the introduction of the VAT-compensation fund

	VAT hindered the choice to outsource municipal activities	The introduction of the VAT-compensation-fund caused a managerial discussion	The introduction of the VAT-compensation fund caused the outsourcing of activities	For the next years, the outsourcing of municipal activities is expected, thanks to the introduction of the VAT-compensation fund
Yes	8%	5%	4%	12%
No	92%	95%	96%	88%

We asked the municipalities that did not start a discussion about outsourcing for an explanation (Table 3). About 26% of the municipalities states that most of the municipal activities that are eligible for compensation are already outsourced in the last years. About 18% of the municipalities state that contracting out of municipalities was not a political item. Besides, about 32% of the municipalities answers that other – non-budgetary – arguments are more relevant for the decision making on the outsourcing of activities. Municipalities mention the optimal size of the own organisation, the necessary knowledge for specific activities, the vulnerability of municipal activities and the lack of capacity in the own organisation, the legal status of the municipal employees and the care for the employment in the municipality. A number of these arguments are in line with the concept of public choice theory – as the optimal size of the own organisation and the care for the care for the employment in the own municipality – and transaction costs theory – as the lack of capacity or the necessary knowledge for activities. Other findings – as the argument of the vulnerability of municipal activities and the legal status of the municipal employees – are institutional factors that - related to the basics of sociological-institutional literature - are relevant for change processes in organizations. Some municipalities state that the discussion has taken place implicitly as the comparison between self-supply and contracting out is made without the effects of the levying of VAT.

Column 4 of Table 1 shows that the fund was not very effective to increase contracting out. A very small percentage of the municipalities (1%) has contracted out services since the introduction of the fund. Remarkably, for the activities the VAT hindered outsourcing (the third column), the introduction of the VAT compensation fund did not have any effect. Although outsourcing is expected in some municipalities for the coming years, most of the municipalities state that a relation with the introduction of the VAT compensation fund is absent. The fifth column of Table 1 shows the activities municipalities may decide to outsource.

Table 3 Why didn't cause the introduction of the VAT-compensation fund a discussion about outsourcing of municipal activities ?¹

Most of the municipal activities that are eligible for outsourcing have already been outsourced	26%
The outsourcing of municipal activities is not a political item	18%
Other – non-budgetary – arguments are more relevant for the decision making on the outsourcing of activities	32%
The VAT-compensation fund is too technical for politicians	4%
Other	31%

1. We categorized the municipal answers to this open question. As municipalities could give more than one answer, the percentages do not count up to 100%.

In accordance with these findings, almost all municipalities (96%) answered negatively on the question whether the introduction of the VAT-refund scheme had led to the contracting out of activities (Table 2). Therefore, not only is the assumption underlying the fund inaccurate, the opinion on the outsourcing of public activities has not changed since the introduction of the VAT-compensation fund. Also for the answers to this question, we tested whether the answers correlate with municipal characteristics (appendix A). As the negative answer dominates, none of the variables are significant. For the next years, 88% of the municipalities do not expect an increase in the outsourcing of their activities thanks to the introduction of the VAT-compensation fund. The answers are not correlated to any of the municipal characteristics.

Finally, we asked a general opinion on the introduction of the VAT-compensation fund. In accordance with the other findings, just 7% of the municipalities gave the judgment 'useful', 20% were indifferent and 72% assesses the fund as 'redundant'. These results do strongly doubt the legitimacy of the fund. We tested whether the judgments have a correlation with the variables of appendix A. We found that municipalities with a higher number of inhabitants judge the fund as useful. This result might be explained by the fact that they have knowledge about the VAT-rules and are better able to oversee the consequences of the

introduction of the fund as for example the administrative and the purchase aspects (Wojcik, 2008).

The municipalities with a negative judgment give different explanations to their opinion (Table 4). Of all municipalities 23% state that other – non-budgetary – arguments are more relevant for the decision making on the outsourcing of activities. They mention the optimal size of the own organisation, the necessary knowledge for specific activities or the lack of capacity in the own organisation. However, the small group of municipalities with a neutral or positive judgment notice comparable drawbacks.

Table 4 Why is the introduction of the VAT-compensation fund redundant ?

Relatively high administrative burden	79%
The VAT-compensation fund is just a shifting of funds	21%
Budgetary effect / budgetary risks	16%
Other – non-budgetary – arguments are more relevant for the decision making on the outsourcing of activities	23%
The VAT-law should be changed	4%
Other	6%

1. We categorized the municipal answers to this open question. As municipalities could give more than one answer, the percentages don't count up to 100%.

In addition to the answers of the first question, a remarkably high percentage of municipalities complain about the relatively high administrative burden. However, the administrative obligations of the VAT-compensation fund are comparable to the VAT rules for regular firms although the exceptions for compensation might complicate procedures. Therefore, administrative complexities, especially related to the introduction of the fund might have influenced the municipal opinion. The municipal complaints might be explained by the unfamiliarity of the municipalities and provinces with the VAT-legislation. Therefore, during the introduction of the fund, the attention of the municipalities might have been given more to administrative complexities than to the opportunities enabled by the fund.

In 2006, the tax regime for the main municipal tax - real estate tax - has changed radically. The real estate tax consisted of four separate taxes, based on residences (I) and other buildings (II) and levied on the owner (*) and the occupant (**). In 2006 the real estate for the occupants of residences (I**, about one third of the total receipts) was abolished and the budgetary possibilities of the other three taxes (I*, II* and II**) were diminished radically by the introduction of a maximum growth rate for the total tax receipts of all municipalities. This system change will cause a less prosperous budgetary position for a large share of all municipalities. Combined with the effects of the crisis on the financial markets on the

budgets for municipalities, this may lead to an increase of the outsourcing of municipal activities because of the efficiency argument and therefore a more positive opinion on the fund (compare Lopez-de-Silanes *et al.*, 1997; Bel and Fageda, 2007). Therefore, as a topic for future research, it is worthwhile to repeat the inquiry in later years to investigate whether such an effect exists.

7. Conclusion

In 2003, the VAT-compensation fund was introduced to create a level-playing field between public provision and contracting out of public services. However, as this paper shows, for most of the municipalities VAT did not hinder contracting out of public services. Therefore, the fund lacks legitimacy.

In general, municipalities have a negative opinion on this fund. Besides, as far as information is available, the introduction of the fund did not cause a significant increase in contracting out yet. Municipalities state that other arguments than the budgetary effects are leading the decision-making process on outsourcing as the optimal size of the own organisation, the necessary knowledge for specific activities, the vulnerability of municipal activities and the lack of capacity in the own organisation, the legal status of the municipal employees and the care for the employment in the municipality. For a further understanding of these arguments, we should execute a more in-depth case study research at the municipal level to gain more insight in the arguments for contracting out, in addition to the hypotheses formulated by public choice and transaction costs theory.

¹ European VAT legislation – the VAT-directives – for public authorities distinguishes three types of activities: taxable activities, non-taxable activities and tax-exempt activities. All activities of both private suppliers as well as public authorities in general are within the scope of VAT and are therefore taxable activities. With these activities, the VAT rate is charged and the input VAT can be recovered. There are two exceptions on this general rule. As described in Article 4(5) of the Sixth VAT directive, the first exception is made for activities of public sector bodies engaged in their role as public authority. The activities described in this article are called *non-taxable activities*. The second exception is made for specific activities listed in Article 13 of the Sixth VAT directive as for health, education and banking services. These activities are known as *tax-exempt activities*. Gendron (2005).

² As analyzed by EIM (2006) the structural administrative costs for the public authorities are about € 9.4 mln. The incidental costs related to the introduction of the fund were €55.6 mln. Compared with the annual payments of the fund, the incidental and structural costs amount just 3.0 per cent and 0.5 per cent. The public authorities receive every year a payment for administrative costs of €24.8 mln (1.3 per cent). In 2006 the payments of the fund amount €1,884 mln.

³ The group is representative in terms of the number of inhabitants. Although the average municipality size of our sample (nearly 40,000) is somewhat higher than that of all municipalities (nearly 36,000), we have a nearly equal distribution of municipalities across size classes. It should be noted, however, that municipalities which do not appreciate the fund might have more incentives to answer our enquiry. However, we do not have indications for such an effect.

⁴ Differences between these shares might also be explained by differences in market structure, for example the lack of competition (compare section 2). Further research is necessary to test this hypothesis.

⁵ The results are available on request.

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Appendix A Explanatory variables

Inhabitants	Number of inhabitants (* 10.000)
Inhabitants^2	Square of the number of inhabitants (*10.000)
Density	Average number of addresses, per 500 m ²
Disposable income	Disposable income, in euro per inhabitant
General grant	General grant, in euro per inhabitant
Municipal taxes and levies	Municipal taxes and levies, in euro per inhabitant
Real estate tax	Real estate taxes, in euro per inhabitant
Unemployment	Number of unemployed persons with an unemployment benefit per 1000 inhabitants
Orthodox Protestants (a)	Percentage of votes for the Orthodox Protestants (a) (SGP)*
Orthodox Protestants (b)	Percentage of votes for the Orthodox Protestants (b) (CU) *
Conservative Liberals	Percentage of votes for the Conservative Liberals (VVD) *
Christian Democrats	Percentage of votes for the Christian Democrats (CDA) *
Progressive Liberals	Percentage of votes for the Progressive Liberals (D66) *
Social Democrats	Percentage of votes for the Social Democrats (PvdA) *
Green left	Percentage of votes for the Green left (GL) *
Socialist Party	Percentage of votes for the Socialist Party (SP) *
Local	Percentage of votes for the Local parties*

* At the last election for the municipal council. In most municipalities, this was in 2002.

Appendix B

Table B.1 shows the nine activities of this study. For each of these activities, the table shows to what extent the activities are contracted out to the private sector and values for the asset specificity and the service measurability of the activities. The values of these characteristics are based on Brown and Potoski (2003). In this study, 75 municipal managers were asked about the level of asset specificity and the service measurability of 64 municipal activities. Due to the fact that the 64 activities do not correspond fully with the nine activities in our study, we have chosen the activities that correspond the most. The figures are on a 5-point scale, from 1 (low asset specificity, high service measurability) to 5 (high asset specificity, low service measurability). The right column shows which activity we have taken as a proxy.

Table B.1 Municipal activities, used in this study:

Activity	Percentage of contracting out	Asset specificity	Service measurability	Activity
Cleaning services	86%	2.26	2.00	Street / parking lot cleaning
Canteen services	31%	2.94	2.61	Recreation facility operation / maintenance
Security	60%	2.24	2.17	Building security
Salary administration	61%	2.36	1.53	Payroll
IT	16%	3.14	2.61	Data processing
Social policy	8%	3.46	3.74	Public health programs
Waste collection	69%	3.33	2.12	Solid waste disposal
Building of infrastructure	91%	3.11	2.50	Utility building
Assessment of real estate	87%	2.93	2.87	Tax assessing

Based on transaction costs theory (Brown and Potoski, 2004) we expect relatively high rates of contracting out for activities with low asset specificity and high service measurability. However, both indicators are not able to explain the differences in contracting out. As the results in Table B.2 shows, a simple multivariate regression of the level of contracting out, on the values of asset specificity and service measurability does not show significant results as well. Apparently, other arguments are relevant for the decision making on contracting out as well. We should, of course, be careful to draw robust conclusions from our analysis as it is based on nine observations.

Table B.2 Regression results with percentage of contracting out as endogenous variable

	Constant	Asset specificity	Service measurability
Coefficient	1.31	-0.07	-0.22
Standard error	0.68	0.33	0.24
Significant	Yes	No	No

Note: $R^2 = 0.27$