Insourcing versus outsourcing in the United States
or
Reverse Privatization in the Heartland of Capitalism

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ABSTRACT
Privatization proponents presented privatization as superior to public provision theorizing contracting would be a one way street towards market delivery. However practical experience suggests otherwise. Just as in the private sector where insourcing is now on the rise again, the same is true in the public sector. There has been a host of privatization reversals around the world. In the US, longitudinal surveys permit analysis of the actual levels of new outsourcing and new insourcing over time. We find that new outsourcing and new insourcing are equal as percentages of service delivery, suggesting contracting is a form of experimentation at the margin. Problems with service quality and lack of cost savings are the primary reasons city managers report for reversing their contracts. Improvements in public sector efficiency is the third most important reason cited. When we look inside the contracting process we see that contracts to for profit partners are unstable, more likely to be reversed. Private contracts to for profit firms are also more likely to be mixed – where public delivery remains a part of service delivery. This mixed public/private delivery maintains a level of public control, accountability and oversight in the process. Contracts to other governments now account for the majority of all contracts. This inter-municipal cooperation seeks to achieve economies of scale and coordination of services across a region while maintaining public control over service delivery. Contracting, as inter-municipal cooperation, is the new reform.

INTRODUCTION

Privatization has been a longstanding policy proscription by the European Union and the Washington Consensus, but application in the US and Europe has generally not been as aggressive as in many countries of the Global South. In the United States, we find when local governments are given a choice, they choose to stay public, which accounts for almost half of all local government service delivery on average (Homsy and Warner 2014). When cities do contract out, they typically mix public and private delivery dynamically over time through insourcing and outsourcing (Warner and Hefetz 2012), or over space through mixed public/private hybrid systems of service delivery (Gradus et al 2014, Hefetz et al 2014). These dynamic forms of market management reinsert some level of public management control into the privatization process – by attempting to manage the market.

While insourcing has been measured in the US since 1992 (Hefetz and Warner 2004, 2007), it has only recently been studied by European scholars who term this process re-municipalization (Chong et al 2013; Hall et al 2013). Re-municipalization is also found in cities in the Global South including some high profile cases of privatization reversals (Pigeon and McDonald 2012). Case study research points to concerns with service quality, price and citizen access as key reasons driving the decision to re-municipalize. But our ability to say anything more general is limited by the lack of large-scale trends research. This paper helps to fill that gap.

In this paper I present national survey data on US local government service delivery to show how these dynamics of mixed public/private delivery over space and over time (insourcing and outsourcing) create avenues for a reinsertion of public control. Results suggest an important role for city managers and for public workers in assessing private delivery and improving public service delivery. Insourcing requires cities maintain their production capacities, so in case the market fails to perform as expected, the city can step back in, without too disruptive an effect on the service itself. Insourcing can be understood as a critical market management tool in the risky contracting business.

In addition, I explore the nature of contracting partner and point to the importance of public partners, neighboring municipalities, as compared to private partners (for profit firms). What we see is that contracting is more likely with public partners – where public ethos, accountability and openness are present. Such contracts are more stable than contracts with private partners. These inter-municipal contracts are a local form of the public-public partnerships now being explored between North and South municipalities. Inter-municipal contracting is now larger than for profit contracting among US local governments (Homsy and Warner 2014).

When contracting with private partners, contracts are more likely to be mixed over space to ensure continued public involvement alongside private contracts. The private partners gets a portion of the service or a sector of the city, while the city remains active in service delivery elsewhere. This ensures the city maintains capacity to reverse the contract if necessary, and it provides ongoing information for benchmarking costs and quality and ensures continued avenues for direct citizen involvement through the governance process (Hefetz et al 2014; Hefetz and Warner 2008).

Because the debate on privatization is slightly less politicized in the US, and because nationwide longitudinal surveys enable more robust empirical analysis, we can derive some understanding of the possibilities and challenges these dynamics present for a way forward. This is of relevance to countries in the Global South as well who are looking for new alternative forms of public service delivery, which challenge the neoliberal Washington Consensus.

I begin with the theoretical challenges that the empirical research calls forth. Next I present the most recent data on US local government practice. I conclude with recommendations for policy.

Challenging market superiority

Privatization was supposed to yield greater efficiency due to competitive pressures on private providers to produce quality service at a lower cost (Savas 2000). However, after 40 years of experience, this result has not been born out. Bel et al (2010) conducted a statistical meta regression on *all* empirical economic studies on privatization in water and solid waste services (the two services with the greatest experience in privatization worldwide) and found no statistical support for cost savings under privatization. Indeed they found cost savings were more likely in the earlier studies (1960s and 1970s) and in waste collection where some technological innovations have occurred. This suggests cost savings from privatization may have been short-lived – in part because private pressure caused public delivery to improve.

There is also the challenge of market management. One of the keys to cost savings from privatization is competition. But competitive markets in most public services do not exist. This is especially true for natural monopolies like water. Public choice theory argues that competition is the key to public market efficiency (Tiebout 1956). But nationwide surveys of local government find that even in the US, where competitive markets are more likely to be found, competition is lacking. On average there is only one alternative provider for most services in most local government markets (Hefetz and Warner 2012; Warner and Hefetz 2010). For water it is less than one. So privatization merely substitutes a private monopoly for a public one.

Lack of competition brings several problems. Absent the discipline of a competitive market, more responsibility rests on public regulation to ensure service quality. In economics, property rights theory argues that private providers will reduce service quality to enhance profits - especially if competition is not present (Hart, Shleifer, and Vishny 1997). Contracting out to low competitive markets requires local governments spend so much time managing the market that it cuts into their ability to monitor (Girth et al 2012). So when the competitive requirements for market delivery are not met, it creates more problems than just lack of cost savings. It creates service quality problems and regulatory problems. This has led local governments to explore ways to reinsert public control.

Exploring market complementarities

Local governments have a broader set of concerns than just cost savings. Public services must be failsafe – delivered no matter what. Thus some level of redundancy is needed in the system to ensure failsafe provision. Public systems, when embedded in a multipurpose local government, can have cross-departmental back up. But corporatization and privatization make cross-departmental collaboration more difficult, if not impossible. This undermines system resilience. What we see in both the private and public sectors is increased attention to mixed delivery systems that incorporate both internal and external production to ensure internal control but take advantage of potential market complementarities (Hefetz et al 2014; Parmigiani 2007).

In the public sector this mixed delivery can take the form of mixed market delivery (public and private delivery of the same service over space) (Warner and Hefetz 2008; Albalate et al 2012), or of mixed public/private firms (Cruz et al 2014). Mixed firms are more common in Europe than the US (Warner and Bel 2008). Such mixed firms operate under commercial law and have greater flexibility regarding labor deployment. This can be used to facilitate labor shedding as was the case of Berlin public transit (Swarts and Warner 2014). While mixed firms increase public sector control, they still raise important questions regarding accountability (Peters et al 2014).

Mixed market delivery is more common in the US and it involves contracting and direct public provision in the same service area. This mixed delivery is more than competitive bidding as it enables an ongoing public presence in the service delivery process. For example a city may be divided into districts with some served by contract providers and others served by public crews. This enables benchmarking of processes and costs across the public and private partners in a process that stimulates innovation and retains avenues for citizen engagement (Warner and Hefetz 2008). It also ensures that the city retains capacity for reinternalizing service delivery should the contract fail. In the US such mixed delivery is more common when contracting with private partners and accounts for almost a fifth of all service delivery (Hefetz et al 2014).

Ensuring public value

One of the concerns with the market turn is the loss of public value logics as primary in service delivery. We see this in the financialization of public infrastructure through PPPs – turning public infrastructure into a new investment class (O'Neill 2013) and shifting risk to the public sector in exchange for private capital investment (Hodge 2004). Do these hybrid market management forms of service delivery ensure public values? Does the continuation of public sector involvement through mixed delivery across space or over time protect public interests? These are critical questions.

Bozeman (2007) argues that the insertion of public funding into private organizations increases their publicness. However, increasingly we have seen that insertion of private finance in public services actually pulls the public sector more toward private objectives (Dahl and Soss 2012). Sclar (2009) has laid out all the public planning elements that are lost when primary consideration is given to the needs of private finance. Geddes and Wagner (2013) have outlined what elements are commonly found in private finance enabling legislation across the US states – and all privilege private objectives. Clifton (2014) has outlined all the ways in which the European Union has tried to insert competition criteria into public service delivery so that subsidies and state control are eroded.

Such regulatory rules create structural constraints to local government reversals. And the subtle shifts in values – toward private financial interests, make reinserting public values and public control more difficult. Despite this, we find evidence of US local governments attempting to ride this privatization wave by managing the market and trying to insert more public values and public control in a kind of Polanyian counter movement (Warner and Clifton 2014). McDonald (2014) and McDonald and Ruiters (2011) provide some guidance by laying out criteria for evaluating public alternatives to privatization. These include equity, participation in decision making, efficiency, quality of service, accountability, transparency, quality of the workplace, sustainability, solidarity, public ethos, and transferability. We are now dealing with a market mix in many public services. What is the nature of that mix and how do we ensure that public goals remain at the forefront when private financial interests are inserted? These are primary questions for future public sector reform.

DATA AND ANALYSIS

This paper draws on a national survey of US local governments conducted by the International City County Management Association in 2007 and 2012. The ICMA surveys cover 67 public services and ask how the service is delivered: by government directly, or through contracts to for-profits, other governments or non-profits. The surveys also ask managers specifically why they brought previously contracted work back in house. The 2007 ICMA sample includes all counties with more than 25,000 population (roughly 1,600) and cities over 10,000 population (roughly 3,300) and a one in four random sample of cities with population between 2,500 and 10,000 and counties under 25,000 population for a total sample of 6095. To better capture experiences of rural municipalities, the 2012 ICMA sample was expanded to include all counties and all cities with population over 2500 for a total sample frame of 10,552. While the response rate dropped from 26% in 2007 to 21% in 2012, the actual number of respondents increased by 649 municipalities. The survey is representative of the full variety and range of local governments in the United States. This is what makes it such an important resource for understanding trends.

Why contract back in?

One question asked on the survey is if the local government brought back in house services that were contracted out in the previous five years. About 20% of responding municipalities said they did. The slight drop in response in 2012 is due to the expansion of rural governments in the sample, as small rural governments often lack the capacity to re-municipalize services once they have been contracted out. See Table 1.

Table 1: Reasons for Contracting Back In

	2007	2012
Local government brought back in house services that were previously contracted out	21.5% n= 330 of 1,535	18.2% n=386 of 2124
Reasons for Contracting Back In:		
Service quality was not satisfactory	61.2%	51.4%
The cost savings were insufficient	52.4%	52.5%
Local government efficiency improved	33.9%	30.4%
Successful proposal by in-house staff	--	23.4%
There was strong political support to bring back the service delivery	17.0%	15.0%
There were problems monitoring the contract	17.0%	12.9%
There were problems with the contract specifications	10.0%	10.0%
Lack of competitive private bidders	--	7.1%
Other	13.3%	12.1%

Source ICMA Alternative Service Delivery Surveys, 2007 2012, Washington, DC

The table above also provides measures of the reasons city managers give for insourcing previously outsourced services. Building from a series of case studies conducted by Ballard and Warner in 2000 the following reasons for contracting back in were added to the survey questionnaire. City managers' responses show that the top two reasons for reversing contracts were problems with service quality and lack of cost savings. These are the key theoretically expected elements of contract failure. The third most common reason for reversals was improvement in local government efficiency. This shows the innovation impact of contracting – producing competition and market complementarities that promote public sector innovation. Problems with contract management and monitoring and political support to bring services back in house were listed less often by managers. Privatization is relatively uncontroversial in the US and so decisions about outsourcing and insourcing are generally managerial and technical in nature.

In the 2012 survey we added two additional factors, successful proposal by in-house staff, and lack of competitive private bidders. This demonstrates continued public sector capacity to reengage in service delivery either through a direct competitive proposal from in house crews or indirectly by improving internal process efficiency without being required to competitively bid to bring the service back in house. What table 1 clearly shows is that the theoretical predictions regarding contract failure (lack of cost savings, problems with service quality, competition, contract specification and monitoring problems) are borne out by local government experience. Note that politics are not the primary driver of reversals – cost, service quality and internal efficiency are the main drivers.

How do insourcing and outsourcing compare?

To move our analysis to a deeper level we merge responses from the 2007 and 2012 surveys. We do this because no national survey directly measures reversals in privatization. However the consistency of the ICMA survey design allows pairing surveys over time to see if the form of service delivery has changed. About a quarter to a third of respondents are the same in any two, paired surveys. To track changes over time, we paired the 2007 and 2012 surveys and found 523 governments that responded to both. We used the matrix method first employed by Hefetz and Warner in 2004. The light shaded areas capture new outsourcing and new insourcing. These provide very conservative measures of reversals as they only count services that come all the way back to pure public delivery. New outsourcing includes anything that is not completely public. Stable contracting is very broadly defined to include both mixed and complete contracts.

For the period 2007 to 2012, new outsourcing accounted for 11.1% of all services and new insourcing accounted for 10.4% of all services in the paired sample. This is almost even between new contracting and reversals. Stable contracting was 29.7% and stable public delivery was 48.9%. These figures show that contracting involves experimentation at the margin. Public delivery remains the most common form of service delivery across local governments in the US.

Figure 1 Matrix of Service Delivery Dynamics

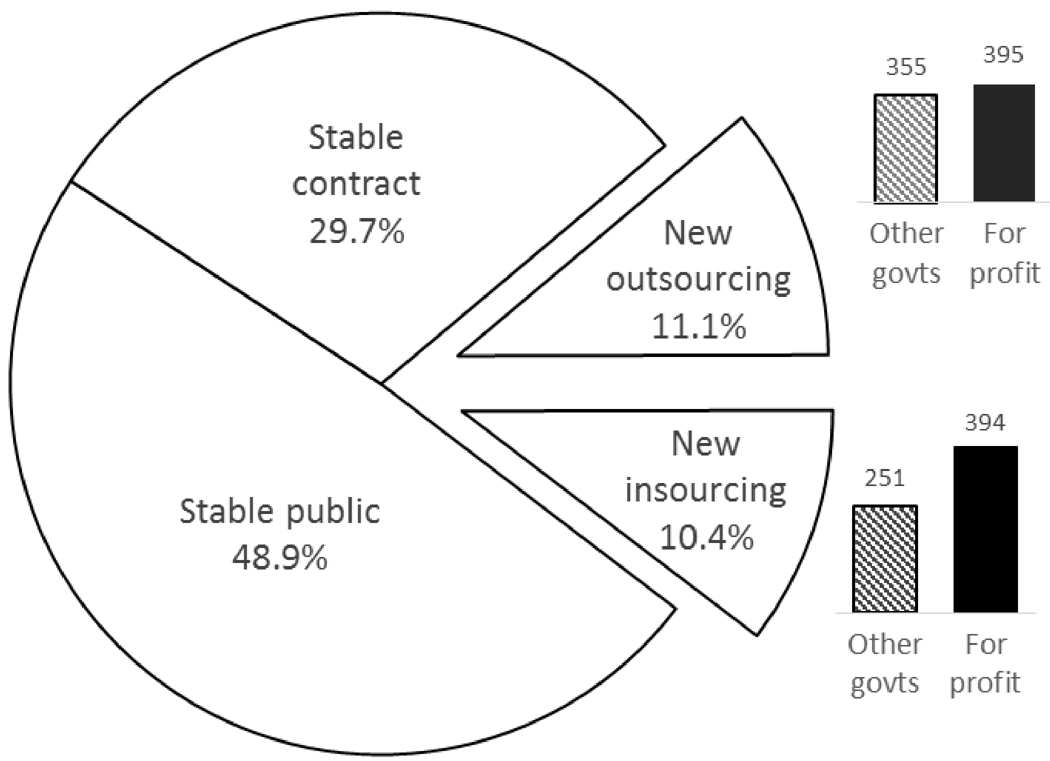
		2012 Survey **Direct Public Delivery**	**Mixed Public/ Private Delivery**	**Total Contracting Out**
		Towards Contracting Out →		
2007 Survey	**Direct Public Delivery**	**Stable Public** Public → Public	**New Outsourcing** Public → Mix	**New Outsourcing** Public → Contract
	Mixed Public/ Private Delivery	**New Insourcing** Mix → Public	**Stable Contracting** Mix → Mix	**Stable Contracting** Mix →Contract
	Total Contracting Out	**New Insourcing** Contract → Public	**Stable Contracting** Contract → Mix	**Stable Contracting** Contract → Contract
		← Towards Public Delivery		

Does contracting partner matter?

Contracting in the US involves both public and private partners. Contracting to for profit providers has dropped in the US. In the 2007 national survey public to public inter-municipal contracting equaled for profit contracting (Hefetz et al 2012) and in 2012 inter-municipal contracting surpassed for profit contracting in popularity (Homsy and Warner 2014). This inter-municipal cooperation is a localized form of the public-public partnerships (PUPs) being pushed globally (Lobina et al 2013). But in contrast to the north-south PUPs, inter-municipal cooperation is most common among adjacent municipalities. Such cooperation is growing in popularity in the US. Local governments view cooperation as a means to gain economies of scale, better coordinate services in a region and still keep public control. Rather than being focused on competition as the basis for efficiency, inter-municipal contracting is built on the positive benefits of cooperation (Warner 2011). European studies of inter-municipal cooperation find strong evidence of cost savings (Bel and Warner 2014), but US studies find inter-municipal contracting is focused less on cost and more on other objectives such as service quality, coordination and equity in service levels across the urban region and ensuring continued avenues for citizen voice (Warner and Hefetz 2002).

We can disaggregate new outsourcing and new insourcing to see what portion is to for profit parties and what proportion is to other governments. We find new outsourcing is almost evenly divided between other governments (355 cases) and for profit partners (395 cases). Thus as municipalities explore contracting they are equally likely to explore it with public or private partners. The difference shows up in the reversals. Insourcing is much more common among for profit contracts (394) than among inter-municipal contracts (251). This is a ratio of 1.6 to 1. Thus contracts to for profit partners are 60% more likely to be reversed than contracts to other governments. The instability of private contracts relates to the problems listed above – contract management, lack of competition, lack of cost savings. Cooperative agreements may also fail, but failure rates are much lower and this helps explain the growth in inter-municipal cooperative agreements in the US.

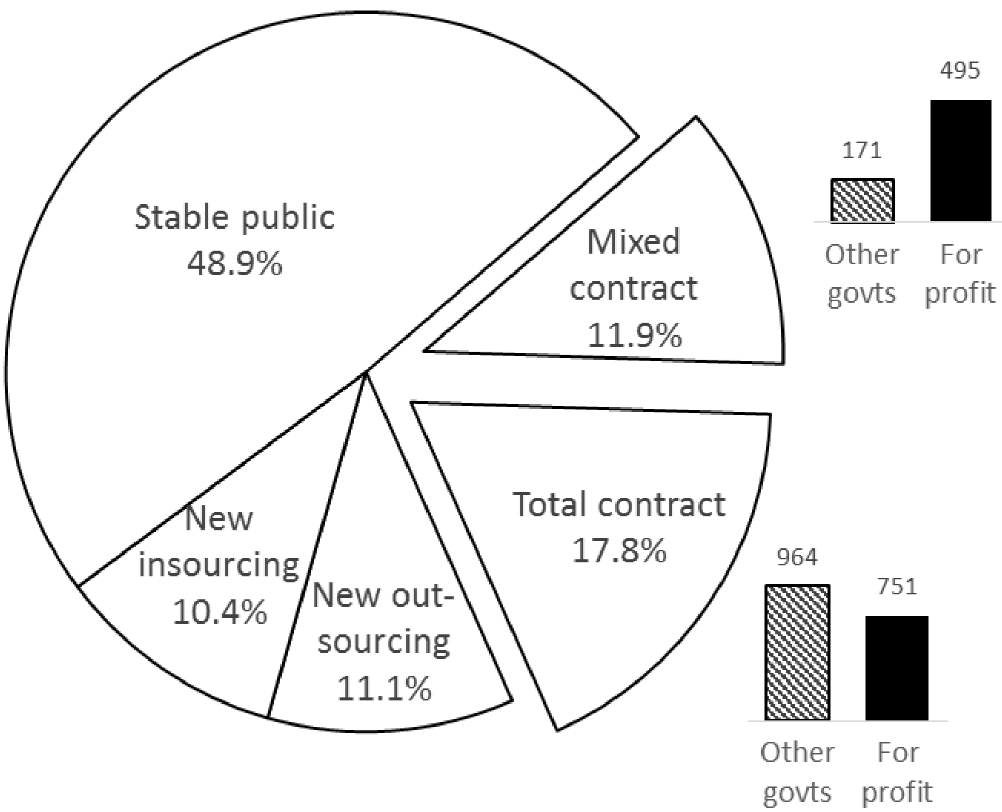
Figure 2 Contracting Dynamics 2007-2012: Insourcing, Outsourcing and Partners



Author Analysis based on 2007 and 2012 ICMA Alternative Service Delivery surveys of US Municipalities, paired sample of common municipal respondents over two time periods, N= 523 municipalities, 11,425 cases.

If we look inside the stable contracts – we find similar results. Mixed contracts are much more likely to be found with for profit partners (495 cases) than with other municipalities (171 cases) – a ratio of 2.9 to 1. City managers recognize that if they want to contract with private providers they can enhance their ability to manage the service by retaining a mixed market position. By contrast total contracts are only 78% as likely to be found among for profit partners (751) as among other municipalities (964). When you totally contract out, you are less likely to be able to reverse, so contracting with other municipalities is preferred to contracting with private partners.

Figure 3 Contracting Dynamics 2007-2012: Components of Stable Contracting



Author Analysis based on 2007 and 2012 ICMA Alternative Service Delivery surveys of US Municipalities, paired sample of common municipal respondents over two time periods, N= 523 municipalities, 11,425 cases.

DISCUSSION AND POLICY RECOMMENDATIONS

This analysis has taken a look inside the dynamics of local government service delivery and shown that insourcing and outsourcing are now equally common among US local governments. These are tools used at the margin to experiment with new forms of service delivery. Together new insourcing and new outsourcing only account for 21.5% of all service delivery, while stable contracting accounts for 29.7% of service delivery. But even in this stable contracting we find important differences by contract partner. More than half of these stable contracts are with public partners – other governments – not for profit providers.

What implications do these trends suggest for policy?

First they make clear that privatization should never be a one way street. Local governments have the obligation to provide failsafe services in an efficient manner to their citizens. While outsourcing may perturb the system and promote efficiencies in the short term, research shows cost savings are ephemeral and competition is limited.

Second these trends show that to ensure continued cost savings and maintain service quality, local governments must retain some level of public control. In the US this is typically done through market management – using mixed public and private delivery in the same service at the same time, or through outsourcing and then insourcing again over time.

Third this market management approach is costly, risky and unstable. Competitive markets are hard to maintain. Research shows efforts to maintain such competition distract public managers from other important tasks such as monitoring to ensure service quality (Girth et al 2012).

Fourth it is important to maintain internal capacity. Insourcing can be made more difficult if a local government loses capacity – such as equipment or technical know how when the service is first contracted out. This is why mixed delivery is often preferred as a means to maintain government control and presence in the market.

One of the challenges to insourcing is higher level government directives to contract out or subject services to competition. This competition is false, ephemeral and just serves to gut government capacity in the future. Some have argued this is a form of state self-cannibalization as states acquiesce to market interests (Clifton 2014). This is most often visited on cities by nation states or international organizations (the EU, WTO, GATS), which attempt to subject public services to competition (Gerbasi and Warner 2007). While local governments can do little to alter the structural rules under which they operate, we are finding evidence of “riding the wave” where local governments attempt to manage market forms of service delivery to ensure public values are met (Warner and Clifton 2014). Insourcing and mixed market delivery are part of the local government market management strategy.

CONCLUSION

Local governments are pragmatic actors. They are in a position to see how service reforms play out on the ground, and thus should be given more space to experiment and to control their own choices regarding service delivery. Policy proscriptions from above requiring privatization, deny these local realities. In the US local governments are more free to experiment, without state directives to privatize as occurred in the UK, Australia, New Zealand and now across the EU (Warner 2008, Clifton 2014). This freedom has caused US local governments to carefully assess when privatization works and when it does not. We find both lower rates of privatization and higher rates of reversals among local governments in the US as compared to Europe.

The US is the heartland of capitalism. Local government managers believe in markets and understand how they work and how to use them. Opposition to privatization is not political in the US. It is practical and springs from experience and a pragmatic desire to employ reforms that work. If reverse privatization is so common in the heartland of capitalism, then maybe local governments in contexts that have even less robust markets should proceed with caution. Local governments' job is to ensure failsafe service delivery to residents. Having the ability to test market delivery and reverse those choices is critical.

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