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Local Public Enterprises: A Taxonomy

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LOCAL PUBLIC ENTERPRISES: A TAXONOMY

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Executive Summary

Local public enterprises have an important role in public service provision.

Local public enterprises (LPE) represent a popular mode of public service delivery in OECD countries. In Europe, where the use of LPEs is particularly pronounced, local governments use not only public enterprises integrated into the administration but also 16,000 legally independent organizations, which they own at least partially. The use of LPEs varies, however, greatly between countries and is largely determined by the allocation of public service delivery between public and private sector as well as the functional decentralization in federal systems. In Japan, for example, 9,000 LPEs are active in public service delivery whereas only 300 LPEs exist in South Korea.

LPEs are active in a wide range of services, very often in basic infrastructure services where market failures or high transaction costs are present.

Typical areas of operation for LPEs are classic public services like water and sewage, waste collection, electricity distribution but also urban planning and development. The former, especially, are signified by high transaction costs, natural monopolies, and general market failures. Despite this general tendency, there are large differences between countries. For example, while water provision is largely public in many countries, private companies can be used to replace LPEs. In France municipalities often contract the service out while in the UK a central authority regulates private regional providers.

From an organizational governance perspective we can distinguish 1) directly managed LPEs, 2) corporatized LPEs, 3) intermunicipal cooperation, and 4) mixed public private LPEs.

Although country-specific differences in the actual design of LPEs exist and make comparisons difficult, a comprehensive taxonomy of LPEs can be developed along three criteria. First, directly managed LPEs are characterized by the fact that the government retains decision rights. Alternative governance types require the creation of a legally separate organization, where the government has to surrender decision rights at least partially. Consequently, corporatized LPEs represent the second

type of LPE, which is owned exclusively by the local government but decision rights lie with the firm's management. If the government further gives up exclusive control and ownership, partnerships with public or private partners become possible. The third and fourth types of LPEs are therefore intermunicipal cooperations and mixed public private partnerships, where the latter involves a private share in ownership.

The main trends among LPEs relate to efforts of public sector reform and the adoption of alternatives to direct provision—corporatization, private sector involvement, and cooperation among local government.

In the search for efficiency, a number of governance alternatives to directly managed LPEs have become popular with local governments. Instead of real privatization, most municipalities have separated enterprise operations from the administrative body, either remaining sole owner of the enterprise or bringing in a partner. In the former case, i.e. corporatization, governments simply spin off tasks or whole departments into a publicly owned company. This trend of agentification is possibly the single most important trend for LPEs and has affected virtually all OECD countries. For this purpose a number of countries, for example Italy, France, and Japan adapted their legal framework to allow for corporatized firms. Associated with this, given the increased interest in private sector participation in LPEs, is the fact that the regulations regarding mixed ownership have been subject to change. Not surprisingly, public private partnerships in their institutionalized form have consequently been another popular alternative provision mode. While some countries already have long experience of such arrangements, recent trends have also led to the adoption of mixed public private LPEs in countries where in the past public provision was the norm. Finally, instead of simply private partnerships, partnerships between local governments have also gained in importance in recent years.

Local governments choose different types of LPEs for pragmatic reasons. Political and institutional factors, however, also play a role.

Reviewing the empirical studies comparing the efficiency of different types of LPEs, no clear picture arises and the evidence points toward no clear efficiency advantage of one over the other. This is consistent with the idea of transaction cost economics suggesting that governance types are chosen deliberately in order to reduce transaction costs. Organizational decisions by local governments are largely based on transaction costs related to task-specific contracting difficulties. More complicated

tasks are typically not contracted out but, rather, provided through a LPE. The more discretion and control the government deems necessary, the more likely it is that more integrated LPEs are chosen. Partnerships with public or private partners are envisaged if limitations of purely local provision exist or in the search for external capacities, for example for finance and skills. On the other hand, political factors also play a role and may potentially prevent the adoption of cost economizing governance types.

Although alternatives to directly managed LPEs solve some institutional challenges for local governments, new challenges are created by their adoption.

Directly managed LPEs are faced with a number of challenges, such as territorial restrictions or resource restrictions in terms of finance and skill. The trends of corporatization, private sector involvement, and intermunicipal cooperation, are specific responses to these challenges. These types of public sector reform lead, however, to new institutional challenges for the local government. In partnerships, especially with private partners, different objectives may hamper operations. Removing an LPE from the direct political discretion of the local government also raises questions of accountability. Finally, steering these types of LPEs also requires the municipality to acquire contracting abilities to manage the relations with the legally independent LPE, giving rise to potential accountability problems.

Despite the fact that different types of LPEs represent a trade-off between different institutional risks, the prevalence of these risks is strongly related to the capacities of the local government.

As a result of the different possible allocation of decision rights, property rights, and fragmentation of control, LPE types vary in how prone they are to various different types of risks and institutional challenges. When decision rights are with the government, the risks of political capture and risks of a soft budget constraint are elevated. Conversely, when decision rights are transferred from the government to an independent LPE management (for example under corporatized firms or mixed public private arrangements), risks to financial integrity increase along with potential risks for accountability. Similar trade-offs arise when control over an LPE is fragmented because risks for coordination increase with multiple principals who have potentially heterogeneous objectives, while political capture is less of a problem in this case. Involving private partners (mixed public private property rights) acts as an amplifier to the existing trade-off because it further increases risks to

financial integrity and accountability, while at the same time representing a more credible gatekeeper against the risk of soft budget constraints.

Despite this characterization of LPEs as a collection of pros and cons, it does not automatically follow that the choice of LPE alone determines the eventual risk for public service provision. How strongly the various risks actually affect public service provision also depends crucially on the institutional capacities of the local government. The risk potential is not exogenously given but varies according to the risk management capacities of the respective municipality. Various types of capacities as checks and balances but also more governance capacities can help to reduce and even neutralize the harmful effects of such risks. Capacity building in terms of LPE governance should, consequently, be emphasized both by local governments themselves but also with support from the regional and national level.

Local Public Enterprises

Introduction

The way local public services are managed at the European level, and more broadly all over the world, is a crucial issue. The activities of local public authorities concern the whole population and generate a large part of GDP, investments, and employment. For instance, local governments account for roughly two thirds of total public investment among OECD countries (see e.g. OECD (2011)).

These figures also reflect to a large degree the crucial role of local governments in public service delivery. To provide public services like water, waste, or local public transport, local governments have a wide range of different institutional arrangements at their disposal. A common way, for instance, is directly through a department or a government agency. Although decreasing in relevance, this is considered the traditional way of providing public services, especially in Europe.

Over the last 20 years more innovative ways have been developed and applied throughout OECD countries, but to varying degrees. Virtually all of these alternative arrangements are characterized by decreased possibilities of control by the local government as compared with direct provision. Most notably, these alternatives comprise public procurement as well as various different types of Public Private Partnerships—PPPs (see Box 1 for more information). Under such contracts, private contractors are paid directly by the local government or the consumers but the payment is spread throughout the (long) duration of the contract.

Although these new governance arrangements were thought by many to replace traditional types of public service provision, LPEs still play an important, if not dominant, role in many OECD countries. In addition, new hybrid types of LPEs have emerged over the last decades in order to combine the pros and cons of public and private sector. In this respect, halfway between public management and delegated management, public service provision through “*mixed companies*” (sociétés d’économie mixte) has become a possible alternative. The law of the European Community refers to them as “*institutional public-private partnership*.” These are limited liability companies governed by commercial law, used for a given project with public and private capital. They have the advantage of the flexibility of management, while ensuring effective control of the activity by the presence of representatives of public authorities within the company.

Mixed companies allow a **continuum** between public and private management of local public services. This continuum features various different institutional arrangements since there are *local public companies*, for which the capital is 100% public—so-called corporatized public enterprises. These local public companies differ from direct public management through *régies* because they are public limited-liability companies with private accounting rules.

Box 1: Public Private Partnerships

Two families of PPPs can be usefully distinguished with regard to private operators' remuneration schemes. On the one hand, concession contracts are characterized by the fact that payments are usually made by users or substantially connected to the number of users (e.g. shadow tolls). One consequence is that the private operator bears the demand risks because revenues are directly and substantially connected to the consumption level. On the other hand, Private Finance Initiative (PFI) contracts are characterized by a payment that is based on availability schemes, with a payment that is usually impacted by the capabilities of the operator to meet performance targets. One consequence is that the demand risk is more extensively transferred in concessions than in PFIs.

Having started in the UK, at the beginning of the 90s, PFIs are now common in many European countries, even if the amount of deals is still quite low. France is at the first European rank with only six billion euros of PPP deals in 2011.

Concession contracts exist for several centuries in some European countries (e.g. France and the UK). Often presented as a French creation (born under the monarchy) concession contracts have rapidly developed over the past half-century to cover the management of a large number of local public services (water, waste water, urban transport, and many other services) and has spread over many countries during the last 20 years. This trend reflects the willingness of local public authorities to subcontract to a private entity.

This report is interested in all those modes of local public service provision where public enterprises are used. The critical condition is therefore the existence of a special purpose organization, regardless of its legal status and potential private participation that is controlled by the government with the goal of providing public services. Those kinds of arrangement are identified below by the term local public enterprises (LPEs). While a more precise definition of LPEs is given in the ensuing section, it should be understood that this rules out all those governance types where a service is directly delegated or contracted-out to a private partner. As a result, classic PPPs, such as concessions and public procurement, are not considered to be LPEs and not covered in this report because there is no public enterprise involved.

A central task of this report will be to define and distinguish the different arrangements of LPEs from an economic point of view in order to grasp their characteristics, trends, advantages, and challenges. As we will see, a taxonomy of LPEs is possible by looking at how property rights and decision rights are shared between economic actors involved in the provision of public services, giving rise to a continuum of possible arrangements. Such a characterization of LPEs helps to understand how well they are adapted to external pressures. We argue in this report that observed trends are the result of external pressures favoring or disfavoring different types of LPEs, or other alternative arrangement, to organize local public services. Apart from fiscal stress and tightening government budgets, the increased focus on performance as well as the marketization of public services is also identified as main drivers of such institutional trends. Such an analysis also helps to delineate future challenges associated with LPEs.

The chosen classification characteristics for distinguishing types of LPEs—the allocation of decision rights, fragmentation of control as well as private sector participation—will also be used to identify the main types of risk and institutional challenges. Different types of risks vary between different types of LPEs. Although LPEs therefore present themselves as a trade-off between different types of pros and cons, the governance capacity of municipalities serves as an important moderator of such risks. To this end, the evaluation of local government capacity to manage LPEs will also be dealt with in this report.

The report is organized as follows. We discuss what could be an economic definition of LPEs (Part 1) before presenting the general trends concerning LPEs (Part 2). We then explore the empirical literature concerning LPEs in order to assess their efficiency relative to other ways of organizing local public services (Part 3) before assessing the institutional challenges associated with LPEs (Part 4). Conclusions follow.

1 Local Public Enterprises (LPEs)—Definition and Taxonomy

1.1 Definition and Overview

A central task of this report relates to classifying the various different types of LPEs. Given the diverse country-specific characteristics along with the development of new and hybrid types of organization, multiple potential criteria have been proposed to structure the plethora of LPEs. Unfortunately, several different definitions of what LPEs exist, which complicates the definition of the object of interest.¹ More specifically, some countries or national LPE associations have put forward more or

¹ It should be mentioned that the problem of identifying and distinguishing public organizations that are active in potentially private markets is not specific to the local level but also true for state and federal governments.

less precise definitions, like the French *Fédération des entreprises publiques locales*, but there appears to be no consensus among countries. Comparing the different existing definitions reveals that basically a broad and a narrow definition of LPEs can be distinguished. A broader definition used by the United Nations interprets public undertakings, irrespective of its legal basis, as a public enterprise:

“Public Enterprise can be considered as an organization established by the government under public or private law, as a legal personality which is autonomous or semi-autonomous, produces/provides goods and services on a full or partial self-financing basis, and in which the government or a public body/agency participates by way of having shares or representation in its decision-making structure.”²

Similar definitions can be found in a wide range of reports and articles, especially if governance of State-Owned-Enterprises (SOE) and public sector reform are of importance (see e.g. OECD (2005a)). However, a more narrow definition, which puts more emphasis on the legal basis and corporate entity, has for instance been proposed by an influential review of European practices by Dexia (2004). The main points of the definition, which is very similar to the definition by the French *Fédération des entreprises publiques locales*, are the existence of a 1/ corporate entity with 2/ general interest vocation and 3/ public control. That is to say, a percentage of capital held by one or several local governments of no less than 50% (Dexia 2004). Sometimes it is also found that public capital can be less than the 50% threshold, but then local governments must have real control over the company's activities (Colorito 2011). Thus, the second (more narrow) definition considers only as a public enterprise those public entities that are corporatized and therefore organizations under private law.

At least partially as a result of the varying definitions of LPEs, there are very few sources offering internationally comparable data on the existence and the importance of LPEs in a country. Moreover, because national associations of corporatized LPEs, like Confservizi in Italy, are typically the only source of publicly available data, the picture conveyed has to be considered as an incomplete account of the actual number and variety of LPEs. For this reason, the underlying report will follow a pragmatic approach concerning the definition of LPEs. Conceptually, and in order to understand the recent trends in the provision of local public services, the broader definition of LPEs will be applied. As a consequence, in-house provision by government entities like Régies in France or Eigenbetriebe in Germany will be considered. This is necessary because as the traditional type of providing local public services they are indispensable to explain the increased presence of private participation or the emergence of corporatized forms of LPEs. These more current types of institutional

² See United Nations Department of Economic and Social Affairs (2008).

arrangements for the provision of local public services are very often chosen specifically to substitute direct public management. Moreover, some OECD countries like Japan or Luxemburg use, almost exclusively, direct public management for LPEs, which are embedded in the local government. It would thus not suit the empirical reality to consider only incorporated LPEs.

With respect to the data constraints previously discussed, the report will present all available data, although it should be noted that this often covers only corporatized LPEs. Thus it should always be borne in mind that the empirical picture conveyed gives only an incomplete account of the actual situation of LPEs, as defined more broadly.

Table 1 provides a first overview of the number of (corporatized) LPEs along with turnover and personnel figures for a large sample of countries. As the table makes clear, LPEs play an important role in most developed countries but to a varying degree. Where available, the economic weight in terms of turnover and employment are also presented in Table 1 in order to control to some extent for the large differences in municipalities, i.e. the federal structure. The differences between countries remain large, however, and it makes clear that there is substantial variation in terms of the use of LPEs between countries.

Table 1: LPEs in some selected countries
(Sources: *Dexia (2004)*; *Japanese Local Public Finance Bureau (2007)*; *New Zealand Department of Internal Affairs (2009)*; *UNESCAP (2002)*)

Country	Municipalities	Number of LPEs	Turnover	Employees
Austria	2,359	149		44,000
Belgium	589	243		27,250
Czech Republic	6,258	339		
Germany	13,854	3,500	82,000	530,000
Denmark	275	224		
Estonia	247	224	150	10,900
Spain	8,106	770		
Finland	448	944	2,100	
France	36,565	1,198	13,300	66,426
Greece	900	1,116	448	27,500
Italy	8,101	963	16,700	152,662
Latvia	547	669	718	53,142
Poland	2,489	2,415	5,200	160,402
Portugal	4,037	76		
Sweden	290	1,750	16,000	55,000
Slovenia	193	60		
Slovakia	2,920	239		
United Kingdom	326	185		
Japan	1,727	9,379		
New Zealand	85	257		
South Korea	232	306		

Sector specific activity of LPEs

Besides their large number, LPEs are also present in a variety of different sectors and provide a wide range of services. On the one hand, there are classic infrastructure and utility services like water, sewage, waste, local public transport (LPT), and electricity distribution. On the other hand local governments also use various types of LPEs for economic, regional, and business development and planning as well as housing or even health and care services.

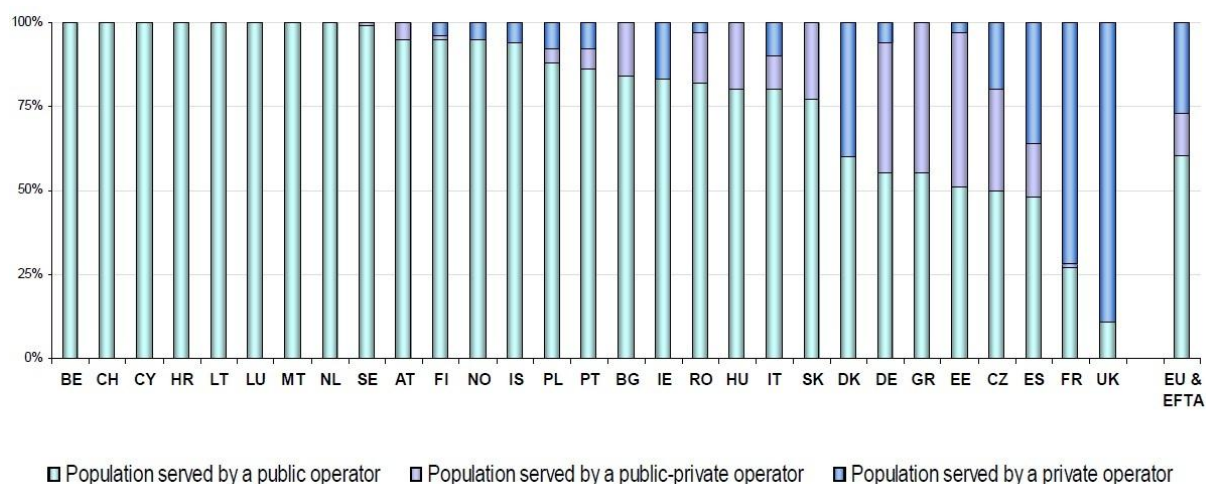
The country differences are, however, quite substantial. In general the existence of LPEs in a sector depends on two main factors. First, the degree of functional decentralization as indicated by the extent and variety of public services delegated to the local government level. For example, in the case of health care, some countries choose responsibility for hospitals to be at least partly on the local government level (Norway, Hungary, and Germany) while others allocate hospitals to higher government levels or external bodies (UK, Sweden, and the Netherlands). The existence of LPEs in a

certain sector in some countries but not in others is therefore already dependent on the federal structure of a country.

Second, even if a service is in the field of municipal responsibility, local governments may still choose to have a private company producing and/or delivering the service. In this case private sector provision represents a substitute to LPEs and effectively replaces public provision. As indicated by a number of empirical studies, this choice is, however, all but random and itself depends heavily on service and sector characteristics. Thus, in line with the ideas of Transaction Cost Economics, the make-or-buy decision of municipalities is also affected by factors increasing transaction cost, such as service complexity or contracting difficulties (see e.g. Levin and Tadelis (2010)).

Despite this general conclusion that LPEs are predominant in infrastructure sectors with potentially high transaction costs, high degrees of contractual incompleteness and monopolistic structures, considerable differences between countries still remain. For instance, as shown in Graph 1, although the water sector in Europe is dominated by publicly owned firms, in most cases LPEs, countries like the UK or France have mainly private providers and therefore exhibit a different provisional pattern.

Graph 1: Water provision by ownership type
(EUREAU 2009)



As a consequence of these underlying differences between countries in their use of private or public provision, cross country comparisons of LPE activity need to take both the federal structure and the institutional background into consideration. Countries with pronounced private sector participation or a rather centralized federal structure will almost naturally exhibit less LPE activity as a share of the economy. Moreover, as shown in Box 2, the differential reliance on LPEs will also strongly affect the distribution among sectors of activity.

Box 2: LPEs in France and Japan

Case 1: France

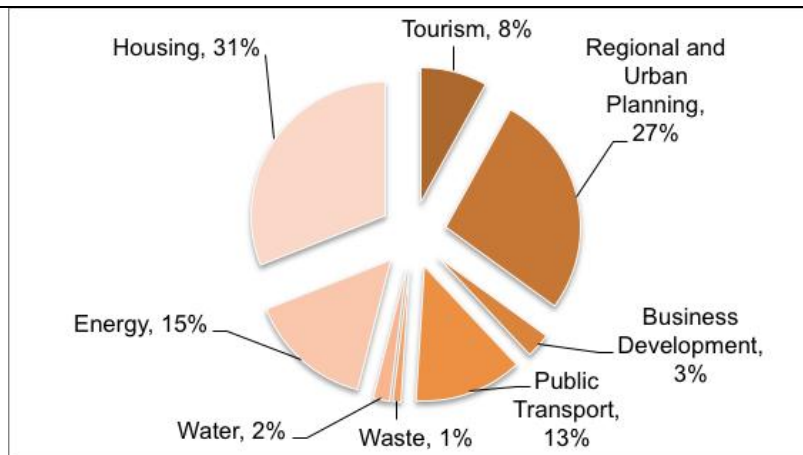
The French federation of local public enterprises defines a local public enterprise as an entity that is organized under private law and that delivers services of general interest. Public authorities hold at least the majority of the capital of those companies.

Three different types of local public enterprises can be distinguished in France: SEM, SPL, and SPLA. The financing of *Société d'économie mixte* (SEM) is both public and private while *Sociétés publiques locales* (SPL) and *Sociétés publiques locales d'aménagements* (SPLA) are exclusively financed by public capital.

- S
EM—Société d'économie mixte—Semi-public company—is traditionally the most significant type of local public enterprise in France. It requires at least seven shareholders, some of them being private organizations, such as banks, companies, or the chamber of commerce or industry. Between 50 to 85 percent of the capital share has to be held by public authorities, i.e. the state or local authorities. Such local public enterprises are not limited to the territory of the local authorities that are financing it. They can compete with private enterprises in other geographical areas. To do so, they have to go through the usual call for tender procedures.
- S
PLA—Société publique locale d'aménagement—Local public enterprises for local development—was created in 2006 and requires a minimum of two local authorities for setting up a public enterprise, which is exclusively financed by public authorities. Such LPE is limited to regional and urban planning and cannot operate outside of the local authorities' territory.
- S
PL—Société publique locale—Local public enterprise—has been in existence since 2010. Its activities go beyond regional and urban planning. It might be dedicated to construction or all kind of services of general interest. Its activities can, however, only be exercised for its public shareholders within its territory and it does not have to go through usual call for tender procedures.

In 2012, in France, there are 1,111 local public enterprises: 38 SPLA, 47 SPL and 1,026 SEM. They have 70,000 employees and an annual turnover of 11.6 billion euros (see Graph 2).

Graph 2. Annual turnover of French local public enterprises (Source: French federation of local public enterprises – 2012)

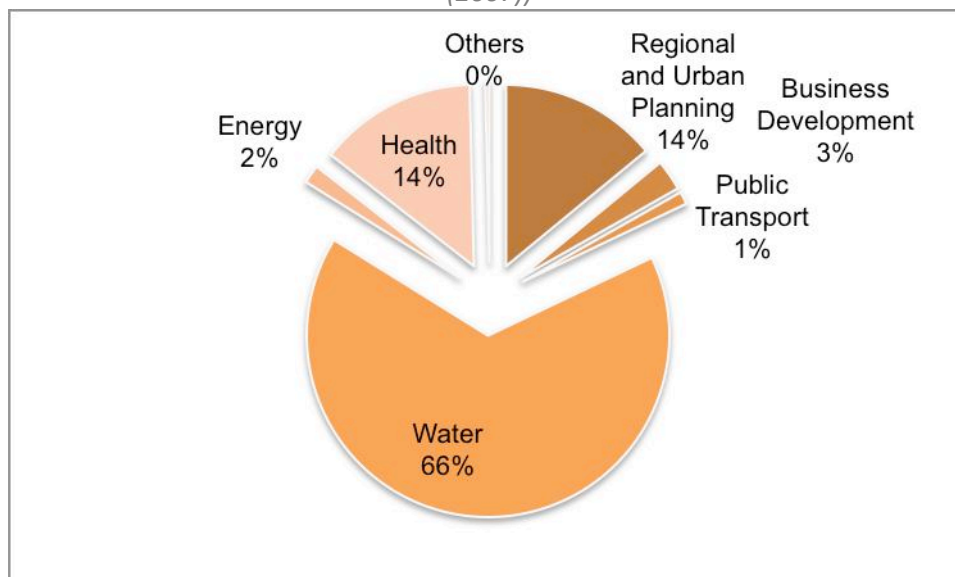


Case 2: Japan

In contrast to the rather narrow definition of LPEs in France, Japanese public law explicitly considers LPEs as closely related to the local government body. Therefore, a similar set of laws, in addition to provisions specific to LPEs, applies to them. For instance, Japanese law does not consider LPEs to be independent organizations, but to be controlled and managed by the local government body. Only since 2004, with the enactment of the Local Incorporated Administrative Agency Law, has it been possible to run LPEs in the form of incorporated enterprises.

On top of the tendency to have specific laws and regulations for each sector, public enterprise laws define a) Basic management principles, b) Organization, c) Finance, d) Employment Administration, and e) Associations between LPEs. In 2007, the 1,727 Japanese municipalities managed 9,379 LPEs. LPE expenditure amounted to 203,182 billion Yen³.

Graph 3. Number of Japanese LPEs (Source: Japanese Local Public Finance Bureau (2007))



³ This corresponds to roughly 1,640 billion € — exchange rate 107.2 as of 09 Feb.2013.

After this rather general discussion of LPEs, potential definitions, and its alternatives, the next section will try to develop a comprehensive taxonomy of LPEs, covering the relevant types of LPEs in OECD countries.

1.2 Taxonomy and Classification

The remainder of this section will try to take account of the various types of LPEs. The resulting taxonomy should not only help to classify LPEs but also differentiate them in a meaningful way with regard to a small number of critical governance dimensions. Among the existing criteria used by the relevant literature, the following have been identified as being applicable in the present context. While the list is not exhaustive in terms of potential criteria to structure LPEs, the dimensions were chosen in order to minimize the necessary criteria while at the same time being able to describe virtually all relevant types of LPEs from an economic perspective. Although other classification criteria would have been possible, for example see Box 3 for a digression on the type of financing, the focus here clearly lies on a governance perspective. The final definition of different types of LPEs in terms of governance structures is related to the approach by Baker et al. (2008), who use different allocations of assets and decision rights to describe a number of different organizational types:

Box 3: LPEs and Their Source of Finance

A distinction frequently used in Public Finance tries to classify LPEs according to the source of revenue. Basically two types of revenues are relevant: Market revenues in the form of prices/user-charges for public goods or, in the absence or a shortfall of these, government finance in the form of subsidies. Especially in the case of most network industries on the municipal level, user-charges for water, sewage, or waste typically account for a part of the cost of the service. At the same time, the extent of cost recovery through user charges for public services is a sensitive question and full cost recovery is neither always politically desired nor feasible. For example, although the European Water Framework Directive (2000) generally supports full cost-recovery as a main principle of tariff setting, it acknowledges that countries have to take social, environmental as well as general economic conditions into account. Despite the fact that there is considerable variation between and within countries and different sectors, e.g. more intensively in local public transport, government subsidies of LPEs to finance residual revenue shortfalls are rather the rule than the exception. In addition, investment and environmental subsidies from higher tier government levels, potentially from central as well as state governments at the same time, can be observed in a number of countries (e.g. Austria, Germany).

Distinguishing LPEs according to the reliance on taxes and subsidies in contrast to user-finance is potentially highly relevant for explaining differences in incentives across public firms. As suggested by the literature on soft-budget constraints, public firms behave quite

differently in terms of debt and excess expenditure in the presence or absence of fiscal constraints (see e.g. Bertero and Rondi (2000)). Therefore, to understand differences in the behavior of LPEs, the financing structure and source of revenues should be taken into account. Although there are few studies and little data available when trying to relate the source of revenue with different types of LPEs, corporatized firms are believed to be more cost recovering and to use their own sales as their primary source of revenue (see e.g. Stiglitz (1998) or Grossi and Reichard (2008)). This is not unlikely given the fact that corporations typically provide individual services that are at least partially user-financed, like water or waste. Moreover, government representatives frequently give increasing performance and cost-recovery as a motive for corporatization (see Edeling et al. (2004)).

1.2.1 Classification by Ownership/Property Rights

Ownership and the distribution of ownership rights are probably the most widely used criteria to classify public enterprises in general, and LPEs in particular. The reason for choosing ownership as the defining criteria can be explained in terms of the Theory of Property Rights (see Alchian and Demsetz (1972)) for the landmark paper on the subject or Hart, Shleifer, and Vishny (1997) for an application to the public versus private discussion), which emphasizes that control over assets and residual rights of control, for example what happens in uncontracted for situations, is intimately related to ownership. A large literature therefore distinguishes enterprises along public, private, or mixed ownership. Since private participation in traditional LPE served sectors has gained in importance over the last decades, the question of ownership still receives considerable attention.

The French definition of LPEs is based on the ownership criteria: LPEs are entities for which public authorities hold at least the majority of the capital (see Box 2). In this definition there is the implicit assumption that without ownership there is no control. And with public ownership, there is a full control held by public authorities.

Problems with this definition arise, however, in those cases where ownership and control are separable or where different types of public ownership exist. For instance, municipal cooperation in an LPE should certainly be considered to be different from an LPE directly managed by a single municipality. Similarly, corporatized public companies are potentially very different from directly managed LPEs.⁴ In the ownership perspective, however, a large number of different types of LPEs would analytically appear to be the same. Thus, while the degree of private involvement is an important dimension to consider, a large number of LPEs cannot adequately be described by simply referring to public or private ownership.

⁴ This vision can be challenged for delegated management contracts in France, where the administrative law governing those contracts enables the public authorities, at least theoretically, to exert a large degree of control over the private firm that is investing and operating the public service.

To summarize, one of the criteria used in this report to distinguish LPEs is the distribution of property rights. It is particularly helpful to characterize institutionalized PPPs, where private firms become (minority) partners in public enterprises. Examples in this respect are the French SEM or typical joint-stock enterprises with a private shareholder. While the distribution of property rights is an important and insightful criterion to classify LPEs, it is insufficient. At local government level especially, various different types of 100% publicly owned enterprises exist. Hence, in addition to ownership, other dimensions need to be considered in order to allow for a more nuanced classification of LPEs.

1.2.2 Classification by Allocation of Decision Rights

In contrast to what a distinction by ownership might suggest, the existence of property rights of a public entity in an LPE does not imply a mechanical way of control and decision-making. The allocation of decision rights is crucial because it determines how closely the government can influence and control the management of an LPE. Hence, depending on whether the local government retains decision rights and how closely an LPE is integrated into the public administration, different types of LPEs can be represented.

A few decades ago, the traditional and prevailing form of controlling LPEs was usually via direct management or even as part of the government administration. Different degrees of managerial and financial independence always existed to a certain point, but generally LPEs were closely connected to the government and political bodies. Decision rights clearly remain with the government. Examples in this respect are “Régies” for France or “Stadtwerke” for German and Austrian municipalities. While potentially these firms have separate budgets from the municipality or are even considered distinct public law entities, they are generally a part of the municipal structure. As the responsible executives in this highly integrated type of governance are very often employees or public servants of the local government, control is very often exercised by hierarchical power, direct orders, and fiat. For example, in directly managed firms dispute settlement between the public entity and the LPE is typically solved by direct orders through the hierarchical structure. Apart from occasional labor regulations the public servants are therefore rather dependent on the local government and the political representatives, thus ensuring tight public control over the LPE. Thus, one way, and the traditional way of ensuring control over LPEs is through allocation of decision rights to the local government, effectively reducing the decision space for the management of the LPE, the public servants.

With the advent of public management ideas and the diffusion of business practices from private organizations to the public sector, the traditional control model over LPEs has lost in importance over the last decades. In quite a few OECD countries, and especially for larger municipalities, there is an increasing trend to corporatize LPEs and treat them like separate business units. Under such governance structures the LPE is spun off from the municipality in the form of joint stock or limited liability enterprises (for example for many German Transport Associations) that is controlled more loosely through contractual relationships and shareholder rights. Importantly, decision rights are transferred to the management of the LPE, which is therefore independent with regards to business decisions. While this paradigm shift from direct control to shareholder-like control over LPEs is generally driven by the intention to make LPEs more efficient, increase managerial independence, and reduce political influence, it is obvious that the source and quality of control is markedly different under this kind of governance structure. Unlike the case of direct management, exerting control through property rights in terms of shares is certainly more restricted in the sense that the government cannot as easily influence managerial decision making. The executives in corporatized LPEs are employed by the LPE itself and legally no longer subject to direct instructions from the local government, which can exercise its control rights only in its function as a shareholder. This style of control can be described as ex-post control, which is often limited to auditing as well as the exercise of voting and shareholder rights.

Thus adopting the view chosen by Baker et al. (2008), we can structure LPEs according to the allocation of decision rights. Increased agentification through organizational autonomy would then imply a shift of decision rights from the local government to the management of LPEs. Thus similar types of LPEs, for example directly managed versus corporatized LPEs, would be distinguished according to this view. Using decision rights as a classification criterion for the taxonomy of LPEs also allows us to consider the role of control intensity. Shifting decision rights from the local government to the LPE inevitably leads to a decrease in control intensity, simply because the government has less means to affect business decisions in LPEs. Although this does not mean that governments have no way of controlling and changing the behavior of legally independent LPEs, it is certainly more difficult without decision rights. As a result, and to conceptualize this idea in the following classification, the

allocation of decision rights, effectively determining the extent of government control, will be used as a classification criterion.⁵

To summarize, when distinguishing LPEs according to the allocation of decision rights, two broad approaches can be identified. First, and at one end of the spectrum, decision rights remain with the local government and the LPE is connected very intimately to the public administration, exhibiting a rather low degree of independence and directly controlled as a department-like organization. Second, although potentially still fully owned by the municipality, the government transfers decision rights to the LPE management, which steers an independent enterprise. Such LPEs are typically more independent from the municipal government because control is less intense and decision rights lie with the LPE, for example as incorporated firms.⁶

1.2.3 Classification by Fragmentation of Control

The third and final criterion to distinguish LPEs is the fragmentation of control in terms of the number of parties or agents that effectively share ownership. The two major cases to distinguish are unique and joint control. While the unique control case, as for example, in direct management but also corporatized firms, is straightforward, joint control gives rise to various governance issues. For instance as outlined in Baker et al. (2008), joint control requires procedures to combine the varied preferences of different owners. In the case of LPEs, this question has been intensively discussed for mixed public private enterprises where, for example, the profit goals of the private partner have to be taken into consideration. Although in many countries the existing legal framework for mixed public enterprises very often limits private ownership in order to ensure dominant public control, the issue of fragmentation undoubtedly becomes relevant even before any numerical limit is reached. In some cases the legal framework specifically emphasizes a fragmentation of control in terms of a minimum number of shareholders. For example, the most popular type of incorporated LPE in France, the SEM, requires at least seven shareholders, which are often banks or political institutions like the chamber of commerce (see Box 2).

The issue of unique and joint control is also relevant in the case of intermunicipal cooperation like intercommunalities. While various different types of municipal cooperation

⁵ While decision and control rights are often used synonymously, we prefer the use of decision rights to more clearly distinguish our classification criteria. In contrast, control rights therefore refer more closely to the monitoring and control possibilities for the government and other owners of LPEs.

⁶ A more nuanced discussion of different types of LPE autonomy and government control over LPEs can be found in the next subsection on corporatization.

can be found in OECD countries, a unifying characteristic is the shared municipal control and typically also ownership over the organization. As such, municipal cooperation is distinguishable from corporatized LPEs along the lines of joint and unique control respectively. Given the sometimes large number of members in associations, the issue of fragmentation may also be regarded as a continuum that increases with the number of agents whose preferences have to be considered.

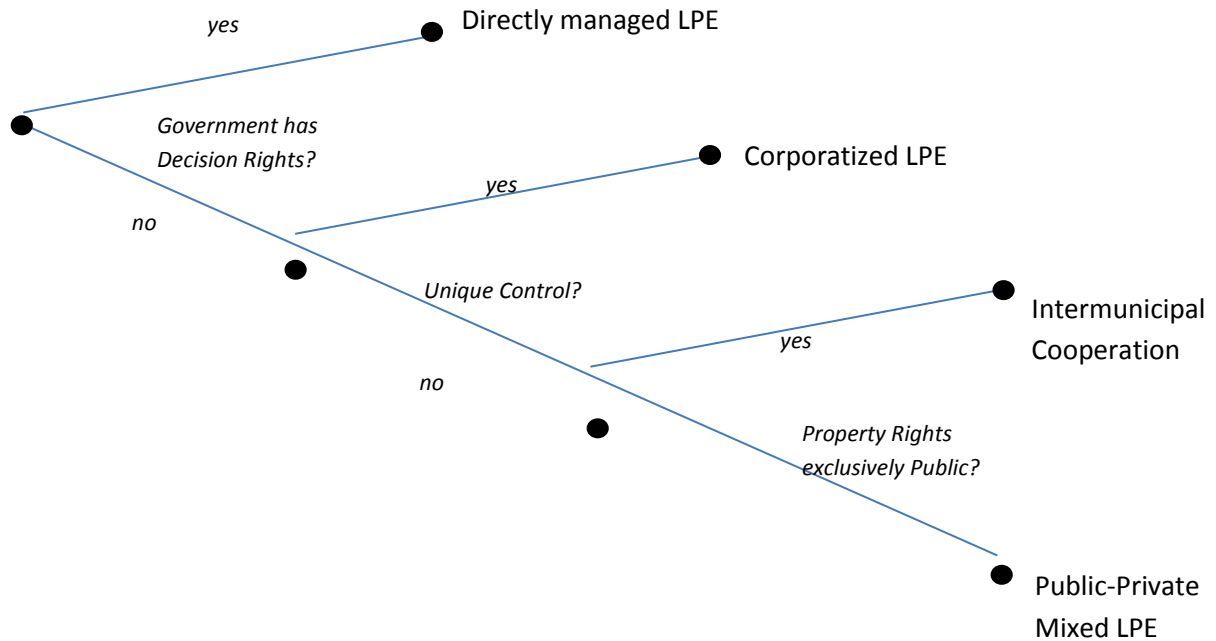
Combining the dimensions proposed above would theoretically lead to $2^3=8$ different organizational types. However, not all of the potential combinations exist in reality and as argued by Williamson (1999) this is a natural result of the fact that not all of them represent viable organizational types. Thus, in analogy to the typology of Williamson (1999) regarding governance types, the following criteria are used to distinguish viable and non-viable organizational forms:

- Strong government control in terms of exclusive decision rights with the local government rule out private participation as well as shared ownership in general. As soon as such government arrangements are envisaged, a separate legal entity is set up and the local government has to give up decision rights and therefore control to some extent. Also for corporatized firms, the creation of a public company inevitably leads to a transfer of decision rights to the firm's management because the government withdraws to a shareholder owner position.
- Mixed Public-Private arrangements with unique control are not considered relevant because this would mean one partner giving up control despite bearing risk.⁷ Thus, despite a wide range of different risk sharing schemes, shared ownership in an LPE without a fragmentation of control is not considered to be a viable organizational type.

Using the dimensions proposed above and at the same time bearing in mind the criteria that not all combinations of these represent viable organizational forms, the following classification scheme for LPEs arises:

⁷ Such risks need not only be financial risks but also comprise political risks or a public service obligation. For instance, even if a service is contracted out to a private partner bearing all economic risk, concerns of probity and public guarantor responsibilities ensuring the provision of a service remain with the government.

Graph 4: Taxonomy of LPEs



As can be seen in Graph 4, the question of decision rights is key to distinguishing directly managed LPEs from other types of LPEs. Unless the government is ready to give up some decision rights, which requires the creation of a separate organizational entity, alternative types of LPEs are ruled out. Second, apart from the decision rights of an LPE, the issue of joint vs unique control is helpful to distinguish corporatized LPEs, which constitute a separate legal entity but are owned by a single municipality, from the remaining types of LPEs. Third, if a local government shares control over an LPE, the question of whether this involves public or private partners is the final step to distinguishing public-public partnerships, i.e. intermunicipal cooperation, from public private partnerships in the form of public-private mixed firms. All in all, the chosen taxonomy boils down to four general types of LPEs, as presented in Table 2.

Table 2: Taxonomy of LPEs

	Decision rights	Fragmentation of control	Property rights
Directly managed LPE	Local government	Unique control	Public
Corporatized LPE	LPE management	Unique control	Public
Inter-municipal cooperation	LPE management	Joint control	Public
Mixed LPE	LPE management	Joint control	Public-Private

Straight away, the proposed taxonomy is deemed helpful because it covers a large range of different types and certainly the large majority of existing LPEs in OECD countries. At the same time, the classification remains at a general enough level to allow a meaningful conceptual approach to the plethora of existing LPEs, whose final shaping is of course dependent on the national legal and institutional characteristics.

To give a more specific insight into the actual arrangements of the proposed types of LPEs, some country-specific examples and a case study are given in Box 4. Two main points have been developed in this section. First, the report has tried to give a workable definition of LPEs, which, given the goal of this paper, is a rather broad one. Although data restrictions are severe and hamper systematic comparisons among OECD countries, the report presents some evidence on the importance of LPEs in a sample of countries. Second, using a number of dimensions proposed by research on institutions and governance, a taxonomy and classification of LPEs has been synthesized. The succeeding sections will try to deepen the understanding of LPEs in terms of general trends and an assessment of performance differences, but also with respect to main institutional challenges.

Box 4: Examples of LPEs From Some Countries and Swedish Case Study⁸

Directly managed LPEs:

- Austria: Stadtwerke, Eigenbetriebe
- France: Régies
- Germany: Stadtwerke, Eigenbetriebe
- Italy: Aziende municipalizzate, azienda speciale

Intermunicipal cooperation:

- Austria: Zweckverbände
- Belgium: Intercommunales, sociétés coopératives à responsabilité limitée
- Denmark: Andelsselskaber med begrænset ansvar
- France: Intercommunalités
- Germany: Zweckverbände
- Italy: Intercommunalità, consorzi

Mixed and corporatized LPEs:

- Austria: Aktiengesellschaft, Gesellschaft mit beschränkter Haftung
- Belgium: Sociétés anonymes
- Denmark: Aktieselskaber, anpartsselskaber
- Finland: Julkinen osakeyhtiö, yksityinen osakeyhtiö
- France : Sociétés anonymes, sociétés économique mixtes
- Germany: Aktiengesellschaft, Gesellschaft mit beschränkter Haftung

⁸ Based on Dexia (2004).

- Italy: Società per azioni, società a responsabilità limitata
- Poland: Spółka akcyjna, spółka z ograniczoną odpowiedzialnością

Case Study: Roslagsvatten AB in Sweden—A case of inter-municipal cooperation in a jointly owned municipal corporation:⁹

As an increasing trend in Sweden, municipalities have started to organize and provide services in the form of cooperation. This is usually done either in the form of a jointly owned company, or through a local government federation. The former case applies to the water and sewage provision by Roslagsvatten AB, which is a limited company serving six small to medium-sized municipalities in the Stockholm region. The majority owner is the municipality of Österåker with 61.8% of the shares, whereas the rest of the shares are distributed among the other five local governments. Four of the six participating municipalities have handed over the municipal responsibility for providing water services to local subscribers to the cooperation. The two remaining municipalities are only partially provided by Roslagsvatten AB, hence also have a smaller stake in the shares and the company.

The organizational structure of the cooperation comprises a mother company and one subsidiary for each of the four fully participating owners. Ownership and administration of the infrastructure is allocated to the respective subsidiary. In contrast, daily operations and administrative business such as employment are the responsibility of the mother company. A sophisticated cost and revenue/fee sharing agreement is in place to ensure incentive compatibility.

Governance of the mother company is achieved through the board of directors, consisting of politicians from the four largest owners. In contrast, the board of the subsidiary companies comprises only politicians of the respective local government. Since infrastructure investment is therefore decided largely independently for each municipality, the level of fees can differ from one municipality to another.

The reasons for the chosen organizational type are numerous. First, as in many other countries, municipalities are typically not allowed to provide services outside their territorial area. In addition, the individual municipal experiences have convinced them to join in a company to overcome limitations due to their reduced size. The corporatization of the cooperation was chosen in order to separate water and sewage services from other services, where it is not possible to recover costs to a similar degree, and which are therefore largely tax finances. As such, the municipalities try to live up to the legal requirement of cost recovery.

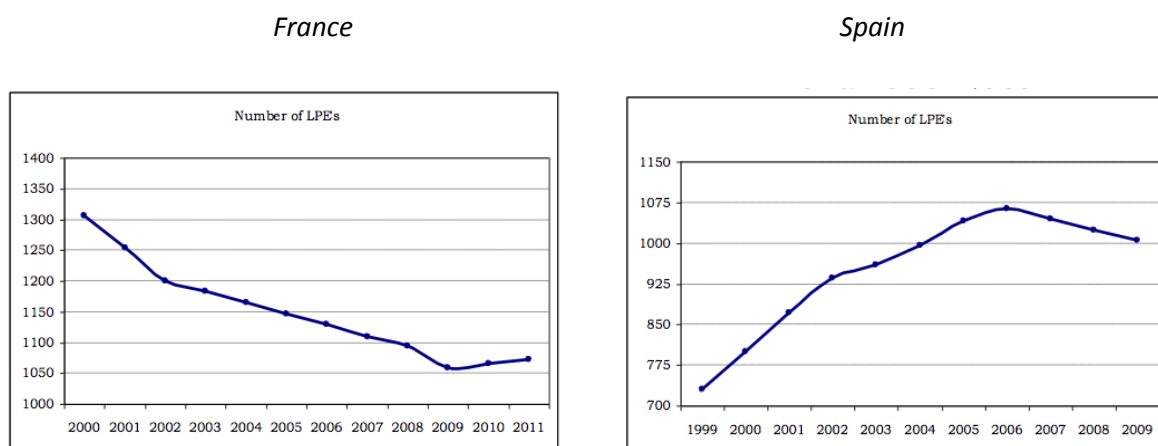
2 General Trends Among LPE Approaches

As was the case at national level, the major trends among LPEs typically occurred as a reaction to various challenges faced by governments. However, slightly in contrast to the national level, wholesale divestiture and privatizations in the sense of a sale of assets in LPEs was and is rather uncommon (see Clifton et al. (2006) for a review of privatization trends on the national level). See,

⁹ This section draws heavily on Mattisson and Thomasson (2010); see the article for the more detailed case study and a review of the Swedish water sector.

for example, Graph 5 below showing that such movement toward privatization might be true in France but not in Spain, suggesting that there is no European trend.¹⁰ In addition, the often mentioned move from a producing state to a guarantor and ensuring state that is not actively involved in the production of public services cannot be generally confirmed for local government level. Instead, the main approaches at local level were rather to reform the public sector and LPEs from the inside and therefore keep critical decision and control rights over enterprises providing public services within the public sphere. To this end, particular emphasis was put on the implementation of New Public Management practices and governance changes in order to improve the steering of LPEs. Nevertheless, apart from changes in the structure of LPEs private-sector involvement has also increased over the last decades, with public public private partnerships (PPPs) and contracting out now representing standard modes of providing public services for many local governments.

Graph 5: Evolution of the number of LPEs in France and Spain (Source: Colorito 2011)



Before discussing the general trends for LPEs, this section tries to identify some common factors that are shared by local governments in many countries and that increased the pressure for changes and triggered the associated trends. In the following section a number of drivers and underlying reasons are discussed in order to facilitate the understanding of current trends among LPEs:

2.1 Underlying Factors

2.1.1 Fiscal Constraints

The budgetary pressure, which over the last two decades triggered a number of changes in the public administration, was not only a phenomenon of central governments but was

¹⁰ As far as we know there is no European data set tracking the evolution of the number of LPEs in European countries.

usually matched on the local level. Although the exact source of pressure in terms of the precise budgetary item is somewhat country specific, also depending on the vertical allocation of functions across the government levels, very often a mix of factors on both the revenue and expenditure side can be identified. For instance, as argued by Reichard (2006) in the case of Germany, continuously growing expenditures together with restrictions on own tax revenues and increased dependency on government subsidies were among the main drivers of LPE reforms. A similar situation of continued fiscal stress as a result of increasingly limited revenue raising capacities seems to have influenced local privatization in the US during the 1970s. Furthermore, reviewing the empirical literature on the determinants of local privatization, Bel and Fageda (2007a) confirm in a meta-study for a wide range of countries that fiscal stress is a primary explanatory factor of privatization. Importantly, however, the reactions to fiscal stress do not always seem to lead to privatization but often also involve “softer” types of public sector reform.

As the goods and services provided by LPEs are very often capital intensive, as is the case of water and sewage and also local public transport, investment and maintenance expenditures represent a major burden for municipal budgets. Moreover, the current implementation of more stringent environmental regulation requires increasingly large investments from the side of local governments. Examples in this respect would be the European Union directives on landfill or water, which introduce best available technology standards and ban certain, usually cheaper production or treatment practices. As a result, external sources of finance from private investors became more attractive to financially constrained local governments.

2.1.2 Performance Focus

Partially related to the lack of financial resources but also in response to the dissatisfaction with the performance of local public enterprises and the ideological debate about the right size and scope of the public sector, the performance of LPEs started to be tracked with rising attention. As indicated by Baumert and Bloodgood (2004), performance goals such as increasing efficiency are among the main motives for local privatization. Similar results regarding the motivation of local governments for reform efforts are found by Edeling et al. (2004) for corporatized German LPEs. Thus, apparently changing the governance structure of LPEs is considered a potential means to increase efficiency and improve performance.¹¹

¹¹ The following subsection on corporatization also briefly discusses the idea that corporatized firms are chosen as a means to circumvent public sector employment regulations.

The growing focus on performance also implies that the traditional way of controlling public enterprises through *ex ante* devices such as signing requirements and budget controls loses importance. Conversely, *ex post* control mechanisms like spending reports and financial audits, which are typical for the private sector, gain in importance and are progressively used for performance evaluation. In general, there is an intimate relationship between the focus on performance and public management tools, which have been increasingly applied in the public sector over the last decades. As indicated by OECD (2005b) the interest in performance evaluation has already progressed substantially in the public sector, stating that up to 50% of the work of external auditors now involves performance audits.

2.1.3 Marketization of Public Services

Additional pressure and incentive to reform public sector activities can also be attributed to national and international programs to open the public service markets. For instance, the activities of the European Commission to liberalize public services and reduce entry barriers for private firms, especially also across borders, has certainly added increased competitive pressures for LPEs. Despite the fact that these marketization activities seldom automatically prescribe privatization or organizational solutions involving the private sector, for example the European Commission that repeatedly expressed its neutrality regarding questions of ownership, it causes local governments to consider the potential of market competition (see Reichard (2002)). As a result and in combination with regulations on anti-subsidy laws, LPEs are increasingly regarded as independent organizational structures instead of part of the government.

At the same time, procurement and state aid regulations have the potential directly to affect the choice of the institutional arrangement for LPEs, for example as procurement rules do not apply to LPEs, which are part of the government administration or are sufficiently controlled by the contracting authority,¹² European common market competition laws may induce some bias towards institutions that fall under the so-called “in-house” awarding rules. In contrast, in the case of a private shareholder in the LPE, the government authority fails the control criteria and standard procurement procedures are necessary before awarding the contract (see Box 5). Similarly, the more clearly the budget of the LPE is separated from the local government, the greater the potential for state-aid concerns. Thus, while the

¹² See the rulings of the European Court of Justice in the Teckal case for clarification of the control criteria. A second criterion applied by the court is the “function” criterion, which specifies that essential parts of the LPEs’ business are with the contracting authority.

regulations and directives discussed are originally targeted towards increasing competition, especially in areas where public monopolies are dominant, the overall effect is unclear. If some institutional solutions allow circumventing more strict regulation, the desired competition effects may not materialize after all.¹³

Box 5: Competition and Local Public Enterprises: The “In-house” Exception

The French SPL—Local public enterprise is often seen as a way for local authorities to benefit from the “in-house” exception, defined by European jurisprudence. Indeed, when a contracting public authority enters into a contract with a separate legal entity, the Court of Justice of the EU has interpreted the European Directives on Procurement and the provisions of the European Union Treaty, as implying a general principle of transparency and competition among candidates, including when her partner is a public enterprise or another public authority.

However, this general principle is subject to exceptions and exemptions, among which is the case of a separate legal public entity, distinct from the contracting public authority, but entirely under her control. In this case, the Court of Justice in several judgments, generated an exception to the general principle of competition, so-called “in-house” exception (“in the house”) because even if the legal public entity is a separate entity from the local authority, it remains “in the fold” of the local contracting authority.

However, this exception comes with its own rules, issuing from a jurisprudence of the Court of Justice, which defines an “in-house” entity as an entity that:

- is entirely controlled by the government, which grants it a “public contract” (as defined in European law), to an extent similar to the control exercised by the public authorities on their own services;
- does most of its business with its its shareholders, to prove that it has no vocation to compete with the markets’ private actors.

To meet these two conditions, the SPL can only be held 100% by local authorities, and operate on behalf of their shareholders, and their territory exclusively.

Until 2005, the French authorities, supported by the French Government, argued that SEM should benefit from the jurisprudence of the “in-house,” and signed their contracts with SEM without transparency or competition. The 2005 judgment Stadt Halle ended this vision by establishing the principle that any private participation in a public entity was not compatible with the requirements of transparency, competition and non-discrimination of an “in-house” entity, and therefore encouraged the creation of the SPL. Today, some SEM have become SPL after local authorities have redeemed their shares to private shareholders.

If the creation of SPL in France in 2010 was a response to the requirements of the European Union on the need for SEM to respect the call for tender procedures, this is not the only organizational innovation that might occur to reduce competition. Indeed, The French Federation of local public enterprises (FNEPL) is pushing for a new kind of local public

¹³ An example in this respect are cases of re-municipalization (i.e. reintegration of a formerly corporatized public enterprise into the local government) in Germany in order to avoid price controls by the antitrust authority, which has no legal oversight over water providers under public law.

enterprise: SEM contract (or “SEM project”). Presented as an alternative to public-private partnership contract it would allow a local authority to launch a bid for a stake in the SEM it wants to start to fulfill a mission. After this initial competition phase, it would be unnecessary to launch a second tender in order for the SEM to assign the task for which it was created. Another advantage is that “SEM project” allows the private partner to be in a majority position concerning capital shares. It can theoretically hold the majority of economic risk, while local governments can, through a blocking minority, for example, retain the control of the structure.

As a result of and in order to cope with the aforementioned points, two major and a number of smaller trends have emerged among LPE approaches. The two general paradigms influencing LPEs over the last decades are corporatization and organizational independence on the one hand and various forms of private sector involvement on the other. What the two trends have in common is that they have typically led to a move away from the traditional model of providing local public services, where the LPE was operating from within the public authority. These two general trends along with other important developments are explained in the following:

2.2 Main Trend 1—Corporatization and Organizational Autonomy

Corporatization is certainly one of the major trends among public and local public enterprises and a large number of countries have experienced significant corporatization movements on various levels of government over the last decades (see e.g. Lane (1997) or OECD (2002); see Box 6 for a case study on Italy and Germany). Although corporatization has been applied in developed countries for some decades, a recent report by CEEP (European Centre of Employers and Enterprises providing Public services) confirms that the development of autonomous agencies is still one of the single most important trends in public sector reform (see CEEP (2010)). From a conceptual point of view and as outlined in the previously derived taxonomy of LPEs, corporatization is usually understood as a transfer of decision rights regarding managerial decisions from politicians to managers (see Shleifer and Vishny (1994)). Therefore corporatized firms are often considered as hybrid forms of public enterprises between purely public and private firms. Corporatization was, however, not only restricted to public enterprises but may also be seen as a part of a general trend towards organizational autonomy in public organizations. Following the approach of Verhoest et al. (2004) the general trend towards agentification and organizational independence can be broken down into various different dimensions of agency autonomy (see Table 3):

Table 3: Organizational Autonomy according to Verhoest et al. (2004)

Dimension of autonomy	Description and control by the government agency
Managerial autonomy:	Degree of <i>ex ante</i> control on inputs, approval of decisions and involvement in decisions concerning management of

	financial, human, and organizational resources.
Policy autonomy:	Degree of <i>ex ante</i> specified rules, standards and norms concerning processes, policy instruments and outputs, objectives, and effects.
Structural autonomy:	Potential to influence organizational decisions through hierarchical and accountability lines toward the agency head or through the supervisory board.
Financial autonomy:	Potential to influence organizational decisions through increasing/decreasing the level of budget.
Legal autonomy:	Degree of organizational separation from the government body.
Interventional autonomy:	Degree of reporting requirements, evaluation and auditing with regards to goals and potential sanctions and direct interventions.

Analyzing the case of corporatization in light of these criteria, a number of points can be noted. First, while the general definition of corporatization itself is rather loose in that it only specifies the resulting shift in decision rights, obviously a number of instruments can be used to achieve that goal. One of the most frequent ways to corporatize firms, as observed by researchers for multiple countries and multiple sectors (see e.g. Hall (1998b), Reichard (2002) or Zatti (2011)), is to convert LPEs from public law to private law status. In addition to the obvious change in legal autonomy, such a conversion typically also affects other dimensions of autonomy. For example, very often managerial decision-making competences (i.e. managerial and policy autonomy) increase automatically with a change in legal status, simply because the agent gains in decision-making autonomy. *Ex ante* rules and norms may be specified contractually but the government is much less flexible in its influence. Similarly, a number of governmental constraints can be lifted through corporatization, for example in joint-stock companies structural autonomy can be strengthened by restricting government influence to the supervisory board. Although financial autonomy can also increase as a byproduct of a change in legal status, an independent budget does not necessarily imply more financial autonomy if the LPE remains financed by government subsidies. Comparing different sectors of LPE activity, financial autonomy is potentially possible in utilities like water, energy but also waste, while it is rather unlikely for local public transport. Finally, an important secondary effect of legal autonomy through corporatization is that as a firm under private law, corporatized LPEs can circumvent public sector employment regulations and restrictions because workers are employed under private sector law. It is unclear how strongly this factor has contributed to the apparent attractiveness of corporatized LPEs but it has to be considered a major determinant, for example, in the case of Italy, Grossi and Reichard (2008) report that local politicians themselves wanted to “escape” into the relative “freedom” of the business sector.

Box 6: Corporatization: The Cases of Italy and Germany

Italy¹⁴: According to Confservici, the Italian association of corporatized LPEs, a total number of approximately 2,000 corporations are owned by Italian municipalities. On average this translates into 10 units per municipality. The average for large municipalities is, however, significantly higher. For example, municipalities with a population above 50,000 have 25 corporations on average. Corporatized firms are also important regarding municipal employment, representing around 30% of the total municipal workforce. The typical form of corporatization is first through Joint Stock companies then by limited companies. With regard to private sector involvement, 27.3% of Joint Stock companies, where private participation is possible, are co-owned by public and private shareholders. As in most countries, municipalities retain a majority of ownership, which was on average 64.6% of the shares. Looking at the distribution of corporatized LPEs relative to other types of service provision, the following picture arises:

Type	No.	%
Stock Company (SpA): Totally or partially owned by local governments, designed for medium and large-scale activities (min equity: 120,000 €)	731	57.74
Limited Company (SRL): Totally or in majority owned by municipality, designed for small-scale activities (min. equity: 10,000 €)	293	23.14
Consortium (consorzio): Owned by several municipalities, public law based, with own legal status; usually for different services such as public transport, water supply, refuse collection	82	6.48
Special Undertaking (azienda speciale): Public law based, with own legal status but dependent on municipal grants; same service profile as above	74	5.85

Germany¹⁵: German cities above 50,000 inhabitants own about 2,500 corporations. It is estimated that the total number of corporations is as large as 4,000 when including smaller municipalities. While this leads to 20 corporations on average for a German municipality, the number is significantly higher (90 on average) for larger cities. With regard to municipal employment, almost 50% are already employed by incorporated LPEs. The most popular legal forms are again limited companies and Joint Stock companies. Even more important than in Italy, around 40% of these firms have some kind of private partner. Again, however, the typical case is a minority share of the private counterpart. The organizational landscape according to a survey among large municipalities yields the following distribution of provisional types:

Type	No.	%
Limited Company (GmbH): Totally or partly owned by local government, for very different service fields	1,671	73.4
Semi-autonomous Utility (Eigenbetrieb): Public law based, without own legal status, active in all service areas	210	9.2
Stock Company (Aktiengesellschaft): Totally or partly owned by local governments, mainly owned by large cities	111	4.9

¹⁴ See Confservici (2006) and Grossi and Reichard (2008).

¹⁵ See Grossi and Reichard (2008); it should be noted that some of the data have been collected through a survey and are thus potentially not representative and do not correspond to the numbers presented in the introductory section.

and used for typical infrastructure services such as public transport		
Consortium (Zweckverband): Owned by several local governments, public law based with own legal status, for different services where a single municipality is too small	107	4.7

To sum up, while there are many different possible implementations of corporatization, a key outcome is increased LPE autonomy. Apart from the initially described forces that may have pressured governments to reform, local politicians can themselves be an important driver behind corporatization, especially when public sector regulations are perceived as too excessive and inflexible. It appears, therefore, that not only external but also internal reasons have contributed to the corporatization trend.

2.3 Main Trend 2 – Private Sector Participation

Related to the move to reform LPEs and increase organizational independence, private sector involvement, in various distinct forms, represents a second major trend among LPEs. In contrast to corporatization, however, it involves one or several private partners. The potential arrangements are numerous and range from contracting-out to various forms of PPPs and mixed public enterprises (see European Commission (2003) for an overview of types and structures). As already described above, material privatizations in terms of selling the majority of assets of an LPE to private owners are rather the exception on the local government level.¹⁶ Notable exceptions are for instance electricity, gas, and water provision in the United Kingdom.¹⁷ More commonly, however, a number of less intrusive institutional solutions with private sector involvement but without giving up predominant government control over the service provision were frequently adopted. The reasons for private involvement on the local government level have been extensively studied in recent years (see e.g. Bel and Fageda (2008), Levin and Tadelis (2010), Rodriguez et al. (2012) or Picazo-Tadeo et al. (2012)). A broad assessment of this evidence points toward pragmatic and economic, but also political and ideological reasons for and against outsourcing (see also section 4). Thus, while organizational theories like Transaction Cost Economics can explain organizational choice to some extent, public sector specific factors need to be taken into consideration to get a more comprehensive view of the underlying processes. In the following, rather than discussing the various types of private sector involvement, the complementary or substitutive character of different arrangements with regards to LPEs are discussed.

¹⁶ Some confusion has been created by labels like “formal privatization” or “legal privatization,” which is typically nothing else than corporatization, i.e. when a LPE changes from a public law to a private law based firm.

¹⁷ See Hall (1998a) for a skeptic view of these privatization experiences.

2.3.1 Contracting-out and PPPs

The mere existence of contracting relationships with the private sector typically says very little about the extent of private sector participation in the actual task of delivering public services. Some kind of sourcing from the private sector is almost always necessary for a public entity producing public goods and services. Therefore, the decisive feature that differentiates these arrangements is related to how strongly the private sector is involved in the core function of providing the service. At one end of the continuum there are standard traditional procurement contracts and the outsourcing of internal tasks like IT services. These types of arrangements are usually not regarded as substitutes to provision by the LPE but rather are a convenient way for the public service provider to ensure the production and distribution process. However, it is a gradual shift from such non-essential procurement arrangements to using contracting-out and deepened relations with third parties. Moreover, frequently LPEs are used alongside with supplementary contracting practices, for example in the case of waste disposal it is quite common for municipalities to have the core activities being taken care of by the LPE whereas some specialized services like the collection of recyclables is contracted-out to a private firm. Similarly, local governments sometimes choose to contract-out a regionally limited part of a municipality to be serviced by a private provider (see Warner and Bel (2008)).

The more recent trends, however, which have affected virtually all developed countries, increasingly treat contracting-out as a substitute for public production of the public good or service itself. In this logic, LPEs are but one of several institutional arrangements to ensure the provision of a public service. Depending on the chosen type, the degree of private sector participation has, therefore, evolved along the transfer of additional tasks, risks, and overall responsibilities regarding the provision process. This development is highlighted in the surge of PPPs over recent decades and the increased production of public services by private partners. Although ownership of the assets may remain with the public authority, PPPs in the form of concession and lease contracts typically replace LPEs, underlining its character as a substitute, for example in the case of lease contracts in water provision, the private partner operates and maintains the utility, whereas under a concession contract he also invests in the infrastructure.

To conclude, the significant contracting-out tendencies of the last decades have had a strong effect on LPEs in at least two ways. On the one hand, the use of external sourcing in combination and as a supplement to “purely” public provision has gained in importance, also for LPEs, who increasingly make use of such contracting practices. On the other hand, the production of public services is no longer the sole domain of LPEs. As noted by a number of researchers (see e.g. Reichard (2006)), the concept of the government as necessarily producing public goods and services itself is progressively replaced by the so-called “ensuring” state view. In this view, safeguarding the provision of public goods through contracts, regulation and oversight is sufficient and often preferable. Today, contracting-out and PPP arrangements are widely regarded as an alternative to provision of public services by LPEs.

2.3.2 Mixed Public Enterprise

An increasingly popular group of hybrid public-private arrangements are LPEs, where property is distributed among public and private owners. This type of LPE is sometimes also called “institutionalized” PPP to signify the functional resemblance but also organizational difference to PPP. While mixed public-private market delivery in the US means competition for a regionally limited market, actual mixed public enterprises are predominantly present in Europe (see Warner and Bel (2008)). The reasons for using them are somewhat similar to those of corporatization but the decisive difference is expected from involving a private, profit-oriented partner.

In contrast, corporatization is supposed to induce a change in performance by increasing managerial autonomy and reducing government constraints. Moreover, involving private partners through contracting or institutionalized PPPs is often discussed against the background of allowing the public sector access to resources and capabilities offered by the private partners. This potential value added comes in various forms like professional technical and engineering know-how, the reaping of economies of scale and scope as well as simply access to financial resources. In light of the already sketched shortage of resources in the public sector, particularly with respect to the funding of large investment projects, the possibility of outside finance has certainly contributed to the rise in public involvement in LPEs.

What both corporatized and mixed public enterprises have in common is the need to establish a private law based organization, where it is possible to transfer property rights. Private ownership implies, of course, that in addition to the already existing public goals of the government owning the LPE, the profit orientation of the private partner has to be taken into consideration. To ensure sufficient weight of public interest in LPE decision making, the vast majority of cases features a (large) majority ownership by the public side. As explained by Bel and Fageda (2010) it is quite common that the private partner assumes responsibility for day-to-day operations whereas the local government limits its activities to monitoring and exercising control rights.

The trend toward partial private ownership in LPEs is strongly conditional on a specific country's corporate legal basis. Until rather recently, limitations on private ownership in public companies still existed in several OECD countries. The necessary evolution of the legal framework to allow for such governance arrangements is illustrated for the Italian case in Bognetti and Robotti (2007) or Japan in Japanese Local Public Finance Bureau (2007). Over two decades, a number of regulatory changes in the legal basis had to be effected in order to allow the creation of mixed private public enterprises.

2.4 Additional Developments

Apart from the two major trends outlined above, important secondary developments in LPE approaches can be observed.

2.4.1 Intermunicipal Cooperation

As an alternative to privatization, intermunicipal associations have gained in importance over the last few years. The main idea behind this type of municipal cooperation is to reap efficiency gains from achieving economies of scale. It is argued that if exploiting economies of scale generates the main benefit of privatization, cooperation between municipalities may be able to deliver similarly efficient results without the need for private sector involvement (see Bel and Fageda (2007b)). The incentive for municipalities to organize in such a way is, therefore, largest in those cases where individual municipalities do not operate at optimal scale and where the aggregation of production of several territorial jurisdictions yields significant returns to scale. Therefore, and not surprisingly, intermunicipal cooperation has been

especially relevant in countries and sectors with a decentralized federal system featuring a high fragmentation in the size of service providers. Examples of a relatively strong presence of cooperations are the water and/or waste sectors in Belgium, Spain, Italy, Germany, and Austria (see Collignon and Gathon (2009), Bel and Fageda (2007b), Grossi and Reichard (2008), Bauby (2011)). Some quantification of the trend can be found in Table 4.

Table 4: Intermunicipal Cooperation. (Source: Hulst et al. (2009), Soguel (2006), Bolgerini (2011))

France	Between 1995 and 2006 more than 1,500 new multi purpose organizations—Communautés de communes, Communautés urbaines and Communautés d’agglomération—were set up. At the same time, this integration process led to a decrease in single purpose organizations from 14,490 to 11,739.
Finland	From 1997 and 2004 62 multipurpose intermunicipal arrangements for sub-regional development emerged. In 2006, there were 228 joint authorities.
Spain	From 882 mancomunidades (most of them multi-purpose) and 428 consorcios (mostly single-purpose) in 1998 to 1005 and 1014 organizations respectively in 2007.
Switzerland	The percentage of municipalities using intermunicipal arrangements increased between 1998 and 2005 from 63% to 72%.
Italy	Between 1999 and 2010 the number of cooperations (Unioni di Comuni) increased from 16 to 322.

At the same time, it should be noted that even in countries where intermunicipal cooperation is more prevalent, their share in population served is typically rather small because urban and metropolitan areas, which represent large populations, seldom engage in intermunicipal cooperation. In some cases, however, most notably local public transport, intermunicipal cooperation is also quite frequent in larger metropolitan areas. Apart from considerations that relate to economies of scale, such cooperation is frequently chosen to solve coordination problems that arise in designing public transport systems.

2.4.2 Benchmarking and Non-market Competition

As a result of the focus on performance and driven by the New Public Management movement, government authorities increasingly use benchmarking and performance comparisons as a potential way of introducing “soft” competition. Importantly, this type of public sector reform aims toward improving the performance of government services, and therefore also LPEs, without necessarily changing the overall institutional structure in terms of organizational form and ownership. The practice of

collecting performance data is fairly well established in many developed countries, with the UK and the US at the forefront of this development (see Cowper and Samuels (1997) and Ammons and Rivenbark (2008)). Despite the proliferation of such benchmarking exercises in OECD countries, the approach is usually unsystematic, incomprehensive, and typically also without any consequences, positive or negative, for the compared government organizations. In many, if not most cases, participation is voluntary, the results anonymous, and implementation of reforms is assigned to the participating municipality itself. Contrary to benchmarking as a regulatory tool for private operators, for example as used extensively in the Australian water sector, this kind of non-market competition has no direct consequences for LPEs. As argued by Ammons and Rivenbark (2008) it is therefore unclear to what extent the sole collection of performance measures actually leads to improvements in public services.

While the two major trends—corporatization and private sector involvement—along with potential motives, have already been addressed, it remains to be discussed how the two types of public sector reform relate to each other. Indeed, although presented as distinct and independent trends, corporatization is very often regarded as the first step toward privatization or some kind of private sector participation. The reason for this potential chain of events is that as a precondition for private involvement, public enterprises typically need to be corporatized and given independent legal status to enable the private sector to participate, for instance to issue shares. Under this assumption, the current trends and with it the different types of LPEs are complements rather than substitutes and corporatization represents just an intermediate step toward more far-reaching private sector involvement.

On the level of LPEs, similar multistep developments have been expected and partially also intended by the national authorities. In the case of Italy, for instance, multiple amendments have been introduced since the 1990s to simplify the transformation of municipal companies into joint-stock companies. At the same time, restrictions regarding the degree of private involvement and mandatory public majority ownership were lifted (see Bognetti and Robotti (2007)). Looking at the actual data, however, the authors conclude that the “widespread tendency to formal privatization has not however been accompanied by a sizeable substantive privatization.” Similar developments from other OECD countries seem to support the

notion that corporatization is not just a precursor of privatization but often, to be more precise, an explicit institutional choice for LPEs.

To conclude, the main trends in approaches to LPEs are corporatization and organizational autonomy on the one hand, as well as the involvement of the private sector on the other. In contrast to some expectations, corporatization did not turn out to be a simple stepping stone toward privatization but seems to have been deliberately chosen by local governments. The question of corporatization is an attractive alternative to privatization, also in terms of performance and efficiency, is more thoroughly discussed in the next section.

3. Comparative Performance Assessments of LPEs

The comparative research on the performance of LPEs is deeply embedded in the more general discussions about public versus private arrangements. The key determinant in this huge literature is typically public and private ownership, which are compared with respect to various outcome measures of performance and efficiency. Given this strong focus on the distribution of property rights, there is a lack of studies comparing different types of LPEs, which cannot be appropriately described by the simple public versus private dichotomy. For example, a large part of the literature would make no difference between directly managed and corporatized LPEs, as public ownership is typically 100% for both of these institutional structures. As a side effect of this undifferentiated treatment of various types of LPEs in performance comparisons, the empirical results are often uninformative regarding the drivers between performance differences. When, for instance, comparing the performance of privatized water utilities, it is unclear whether efficiency differences, if any, arise from the process of corporatization or the actual change in ownership. It appears unclear which of the two organizational changes is more crucially affecting firm behavior and performance. Some observers, for example Stiglitz (2000), attribute a large part of the restructuring process to corporatization itself and question the need for privatization after corporatizing public firms in terms of efficiency gains. Consequently, and as argued by Villalonga (2000), a meaningful performance comparison among governance structures requires differentiating various types of effects, for example ownership, organizational, and political or dynamic effects.

Apart from these methodological remarks regarding the limitations of existing studies, it is necessary to emphasize a few crucial points, which distinguish the case of LPEs from the more general public-private performance comparisons. First, the main task of the LPEs considered here is to provide public goods and services, that is to say a commitment to public purpose and interest. In terms of transaction cost economics, such services are characterized by a high degree of probity, which implies that the potential failure to provide the services entails high political and social cost (see

Williamson (1999)). Clearly, such tasks are different from the provision of private goods, the case analyzed by the vast majority of the empirical literature. As a matter of fact, the results on the performance of public versus private enterprises are most favorable for private firms in the latter case, while they are most ambiguous or even reversed when it comes to the provision of public goods and services (see e.g. Willner (2001)). Second and related, LPEs very often operate in imperfectly competitive markets such as network industries or even natural monopolies. As a result of these market imperfections, traditional competition in the market is infeasible and alternative regulatory regimes have to be envisaged. Although franchise bidding, concession contracts, and approaches in the same vein try to overcome this problem and introduce some kind of competition, the emerging empirical picture is highly inconclusive about the associated performance consequences.

Taken together, these points should illustrate why it may be problematic to translate the insights from the traditional public-private comparisons in the present context to LPEs. Recent research has convincingly shown that organizational performance is multidimensional and therefore highly dependent on transaction characteristics and the market environment. Given that the transactions of LPEs are usually highly complex and the operating environment very often imperfect in terms of competition, there is but a very limited number of applicable comparative studies. This should further emphasize the apparent research gap for systematic assessment of the performance of alternative governance institutions beyond the typical public-private dichotomy.

Looking at the preliminary evidence from existing research on the comparative performance of LPEs that has been accumulated so far, the following picture arises:

Table 5: Performance comparisons involving LPEs

Author	Year	Sector	Countries	Comparison	Result
Bel et al.	2010	Water, Waste	Multiple (UK, US; Ireland, Spain, Holland, Sweden, Canada...)	Meta analysis with various studies analyzing cost savings from private production (contracting-out) compared with public production	Newer studies don't find significant difference in costs
Bel, Warner	2008	Water, Waste	Multiple (UK, US; Ireland, Spain, Holland, Sweden, Canada...)	Qualitative review of the existing empirical literature on cost differences between public provision and contracting-out to the private sector	Inconclusive result
Bae	2010	Waste	US (North Carolina)	Cost differences between public delivery (incorporated firms) or private contractors	No significant difference
Bognetti and Robotti	2007	Multiple sectors	Italy	Profitability differences between full and partial public ownership	Increased profitability for partial ownership
Chong et al.	2006	Water	France	Price differences between directly managed firms (<i>régie</i>) and contracting-out (concessions, lease)	Significantly higher prices for contracting-out
Chong et al.	2012	Water	France	Price differences between directly managed firms (<i>régie</i>) and contracting-out (concessions, lease) and switches from public to private	Significantly higher prices for contracting-out only for small municipalities; no difference for large ones
Kwoka	2005	Electricity	US	Cost and quality differences between municipal utilities and Investor Owned Utilities	
Beuve et al.	2012	Waste collection	France	Cost and quality differences between directly managed firms (<i>régie</i>) and contracting-out	Significantly higher costs for <i>régie</i> when municipalities are small.
Martinez-Espineira et al.	2009	Water	Spain	Public (usually LPEs) vs mixed and private enterprise	Higher prices under private/mixed provision
Monteduro	2012	Multiple sectors	Italy	Comparison of corporatized public enterprises under public and mixed public-private ownership	Higher profitability of mixed public-private enterprises
Roy and Yvrande-Billon	2007	Transport	France	Comparison of direct public with mixed and private	Mixed < Public < Private with regard to production efficiency
Saal and Parker	2001	Water	UK	Over time comparison of water providers that were privatized	Improved efficiency through regulation rather than privatization per se
Saal et al.	2007	Water	UK	Over time comparison of water providers that were privatized – Update of Saal and Parker (2001)	Productivity growth after privatization not significantly different after privatization
Cambini et al.	2010	Transport	Italy	Corporatization of local bus companies	Significant efficiency gains through corporatization

In line with classic research on the effect of public vs private production, Bel and Warner (2008) and Bel et al. (2010) summarize the results of a large number of studies since the 1970s, analyzing cost differences between public provision and contracting-out in the water and waste sector. The main message from these studies is that there appears to be no systematic cost difference between LPEs and private firms providing the services. An interesting result is that especially newer studies are unable to find statistically significant differences. This finding is supported by Bae (2010) focusing specifically on the cost difference for waste collection between corporatized LPEs and contracting-out to private firms. Again, no difference in costs could be identified. This may be interpreted as indirect evidence that the various reforms of LPEs like corporatization or New Public Management practices have closed the initial efficiency gap between public and private providers. Another study focusing on the water sector that indicates that the potential for efficiency gains through private sector participation may be limited is Saal and Parker (2001) and the follow-up study by Saal et al. (2007). The over-time analysis of the performance of privatized LPEs suggests that the majority of effects are attributable to changes in the regulatory environment rather than private ownership, which did not produce gains in efficiency.

Systematic results on LPE performance from sectors other than waste or water are quite rare, with Kwoka (2005) and Roy and Yvrande-Billon (2007) representing two notable exceptions. The former finds privately owned electricity utilities to be advantageous from a cost perspective. Conversely, publicly owned utilities, that is to say incorporated LPEs, deliver higher quality in terms of service reliability. Finally, the study by Roy and Yvrande-Billon (2007) for the French local public bus sector indicates that the relationship between efficiency and private ownership may in fact be non-linear. More precisely, the authors find that while fully contracting-out the service to a private operator is more efficient, mixed-public-private enterprises perform even worse than direct administration by the local government.

Despite this somewhat skeptical view on the expected efficiency gains through involvement of the private sector, it should be noted that there are very few empirical studies that present evidence that contracting-out leads to increased costs or decreased efficiency. Thus, while the empirical studies reviewed cast some doubt on potentially exaggerated expectations, at the same time they do not imply that provision through LPEs is more efficient. In contrast, an observation that appears to represent an empirical regularity that is less favorable for private involvement, at least for the water sector, is that contracting-out in the form of PPPs leads to higher prices than provision through LPEs. Interestingly, this result has been confirmed for France (see Chong et al. (2006)) and Spain (see Martinez-Espineira et al. (2009)), two of those countries with the largest private sector participation in water services.

Beyond the typical public-private comparisons, there are only a few empirical studies trying to assess the performance implications of different types of LPEs. With respect to the performance of mixed public-private LPEs, the previously mentioned results of Roy and Yvrande-Billon (2007) are somewhat challenged by positive experiences with mixed public enterprises in Italy, leading to increased profitability as compared with traditional LPEs (see e.g. Boggetti and Robotti (2007)). A similarly inconclusive picture arises for corporatized LPEs. While earlier evidence from developing countries like Shirley (1999) has cast doubt about the potential of corporatization as an effective means of public sector reform, more current studies are more supportive (for instance Bilodeau (2006)). The only piece of evidence, which specifically studies the performance consequences of corporatization for LPEs, is Cambini et al. (2011). Their findings for local bus service providers in Italy suggest that the transformation of formerly municipal enterprises into autonomous companies has a positive and significant impact on a firm's efficiency.

The bottom line of the discussion regarding the relative performance of different types of LPEs and potential alternatives to LPEs is strikingly similar to the findings of the more general public-private debate. Namely, there is no unequivocal effect of corporatization or private sector involvement on firm performance. The sector specific environment and country specific institutional differences seem able to introduce substantial heterogeneity, not only in the existing governance types, but also regarding the potential performance effect of adopting new institutional arrangements.

The finding of no or only marginal differences in types of LPEs can also be explained by the fact that organizational choices are anything but random. As predicted by transaction cost economics, institutions are chosen to achieve transaction costs minimizing outcomes. If this is the case, it is not surprising that no substantial differences are found between LPEs because they are adopted for the very reason of dealing with transaction specific characteristics.¹⁸ We would therefore expect the optimal governance choice to depend on the sector and task in question but also the municipal environment and potential external restrictions. As a consequence, the next section will analyze the different types of LPEs in light of this idea that organizational choices represent different configurations to deal with transaction costs and institutional challenges in general.

4 The Strategic Choice of LPEs

The result of the previous section, that there are no clear-cut advantages of some types of LPEs over others is not surprising when acknowledging that organizational choices are non-random but strategic as to achieve optimizing outcomes. The "right" type of LPE may very depending on the

¹⁸ Empirical studies in table 5 rarely consider organizational choices as endogenous (i.e. not random). Notable exceptions are Chong et al. (2006, 2012).

transaction characteristics and the municipality specific situation as well as depending on institutional factors.

4.1 Characteristics of the Transaction and the Municipality Specific Situation

The “right” type of LPE may vary depending on the transaction characteristics and the municipality specific situation. For instance, the optimizing type of LPE is expected to differ between services, for example water vs local public transport, but also for small vs large municipalities (Chong et al. 2012). A number of empirical studies have analyzed these hypotheses and find some general patterns in the choice of LPEs:

- **More complex services increase the probability of a directly public provision**—One of the major insights is that more complicated contracting situations increase the probability of in-house provision through a directly managed LPE. For example, Levin and Tadelis (2010) find that the need for flexibility and potential hold-up problems associated with a service decrease the probability of contracting out. Simple services like solid waste collection are, therefore, more often contracted out than water distribution or health and security services. In view of the previous classification, this implies that for complex services we would expect to see directly managed LPEs or corporatized LPEs.
- **Joint Service Delivery, that is partnerships with public or private partners, are more likely in the presence of investment needs and when services are difficult to specify**—As suggested by Brown et al. (2012) the use of intermediate or hybrid types of delivery between direct public or contracting-out seems most suited for situations where the local government may benefit from external resources, for example finance or know-how, but does not want to give up control over delivery because the service is too complex to consider all contingencies (incomplete contracts). Thus despite the fact that partnerships lead to a fragmentation of control, municipalities appear to choose intermunicipal cooperation or mixed public private LPEs even if the service is complex. The advantages of such cooperation seem to outweigh the potential costs of additional monitoring and control. Conversely, control over delivery is still higher in such partnerships than when contracted-out.
- **Intermunicipal cooperation is an attractive alternative to contracting-out if competition is low**—If external partners are considered, the choice strongly depends on how competitive supply markets are. Hefetz and Warner (2012) conclude for US municipalities that cooperation is an interesting alternative to competition, particularly if the latter is infeasible. Consequently, we will often observe intermunicipal cooperation when direct

public management is unattractive, for example because of restrictions on economies of scale, but at the same time contracting-out represents no interesting alternative because markets are thin.

Considered as a whole, the above empirical studies seem to confirm the so-called discriminating alignment hypothesis that governance types are chosen in order to achieve transaction cost economizing results (see e.g. Williamson (1999)). The institutional arrangements are typically chosen systematically by local governments in order to deal with transaction costs and challenges related to market and public service characteristics.

4.2 The Role of the Institutional Environment: Probity, Opportunistic Behavior and Corruption

Despite the finding that pragmatic and economic considerations apparently drive organizational choices on the local government level, most of the previous studies also show that political considerations affect governance choices. For example, Levin and Tadelis (2010) find that political sensitivity decreases the probability of outsourcing. In addition, the governance choices from elected mayors seem to differ significantly from appointed city managers, who are less susceptible to political interests (see Hefetz and Warner (2011)). In most cases, the political determinants would increase the probability of direct government provision, for example directly managed LPEs, or at least decreasing the probability of contracting-out because the government wants to retain control over a service. This is also clearly linked to the citizen interest for public services (Hefetz and Warner 2012).

In addition, the existence of various policy constraints like unions or restrictive labor contracts seems to affect the choice of specific governance structure. This can lead to a decreased use of directly managed LPEs in order to bypass these constraints.

Hence in contrast to the private sector, where arguably cost economizing results are the primal driver, public sector decision-making also involves political cost and benefits. Interest groups themselves, but also the efforts of the government to escape such influences, evidently affect LPE choice. Moreover, the pressure to restructure loss-making firms is less strong in the public sector and therefore misaligned organizations may prevail for longer periods of time. Thus even if predictions from transaction cost economics are quite clear, we may observe various different governance types even for comparable situations and transactions.

Whether such political influences on governance choices are desirable is not clear. Basically two interpretations arise. First, if objectives beyond cost-efficiency are deemed important, organizational

choice in the public sector will and should be markedly differently from the private sector. Considerations like redistributive policies but also economic stabilization may warrant a closer integration of local public enterprises in order to ensure the transmission process of such policies. Conversely, the second and alternative interpretation to political influences on LPE governance choices is more skeptical. For example, instead of considering political influences as policy oriented in order to solve market failures, this view challenges the notion that LPE choices are taken by benevolent actors. Politicians and bureaucrats may be following personal goals and use LPEs for these purposes. If different types of LPEs vary regarding their potential use for personal gains, it may be welfare increasing to decrease policy discretion by local actors in the choice of LPEs.

It is clear that concerns regarding potential rent-seeking or corruptive behaviors associated with the use of LPEs depend strongly on the institutional setting. As shown by Charron et al. (2012) the quality of government varies significantly, even within developed countries like the EU. Moreover, there is significant variation not only between countries, but also between regions within a country. As a consequence, it has to be acknowledged that a singular recommendation for one type of LPE or another is not advisable. How advantageous a specific type of LPE is in a given situation is, therefore, likely to be conditional on the quality of local government and governance, that is to say depend crucially on the local setting. The specific institutional conditions shape not only the incentives of local politicians or bureaucrats but also the potential for corruption in terms of institutional checks and balances. Monitoring and auditing of LPEs should be a prime concern in this respect in order to reduce the potential for malpractice.

Given that political and institutional aspects are not only important drivers of governance choice decisions but may also have a great impact on the actual outcomes, the remainder of this section tries to highlight some key considerations that should be taken into account:

- **Increased privatization and contracting-out is more prone to corruption and favoritism**

As put forward by Hart et al. (1997), different types of LPEs are prone to different types of misconduct. In the case of corruption and bribes, it is typically assumed that higher payoff and personal benefit is possible if a service is contracted-out or involves at least a private partner as in a mixed LPE. Some evidence for such practices can be found in Martimort and Straub (2009) for Latin American countries.

As a result of the possible private gains from involving a private partner, we would expect that corruption would lead to more contracting-out and mixed public private arrangements than what would be optimal. Hence, if corruption is a key concern, the involvement of private partners certainly increases the risk of bribes because there is the

incentive to redirect LPE cash flows to the benefit of the profit-maximizing partner and the politician or bureaucrat involved. Again, the institutional setting will have a large impact on how great the risk for such problems is.

- **Political goals can prevent the adoption of efficient LPE types**

Political considerations regarding control and the use of LPEs can prevent the adoption of economically superior governance types. Lopez-de-Silanes et al. (1997), for example, find that US counties contract-out more often if spending and debt limits are present and political interest groups like unions are weaker. Another potential effect is that specific types of LPEs are chosen in order to avoid debt or fiscal limits (see section 5.2). Institutional arrangements are therefore only chosen so as to maximize the benefit of the political or bureaucratic agent. Different types of LPEs are then chosen depending on the possibility of rewarding political supporters and interest groups or conversely of binding successive governments to certain policies through choosing governance arrangements that are hard to reverse (see Horn (1995)).

If control over LPEs can be used to pursue political goals, we would expect a bias against contracting-out of public services and more directly managed LPEs than is reasonable from an economic point of view. To this end, and to curb political interference in LPEs, it may be necessary to depoliticize a task. A functional separation from the general budget or corporatization and therefore shifting control rights over the LPE from politicians to firm managers may be envisaged.

- **High political sensitivity regarding a particular public service increases transaction costs**

One reason advanced by Williamson (1999) why governments might and should choose more integrated types of organizations in some situations is that potential failures or inflexibilities may prove disastrous. Loosely speaking this may be interpreted as a kind of risk aversion related to public service obligations. In these cases directly managed LPEs allow for the possibility of discretionary intervention and therefore higher flexibility. Political sensitivity is therefore just another transaction characteristic that alters the optimal governance choice.

In a similar vein, it has been argued that stakeholder concerns in terms of public service value should be taken into account when considering the various possibilities for public service provision. As a result, the optimal type of LPE is defined not only by considering

transaction and market characteristics as in the private sector but also political sensitivity. Thus when applying the ideas of transaction cost economics on the choice of LPEs, it has to be modified for the specific circumstances in which potentially critical public services are delivered.

- **Public opinion and discontent with policy choices has to be taken seriously**

In light of the experiences in Latin America, where public discontent in the wake of privatizing former state owned enterprises has increased considerably (see Martimort and Straub (2009)), the role of public opinion appears important in ensuring public support for the chosen type of service delivery. Despite likely increases in efficiency, the perceived and sometimes real increase in corruption can undermine public support for governance types involving private partners. To this end a transparent process along with clearly stated expectation of public sector reform are indispensable to avoid discontent from unclear and inflated expectations.

These political economy arguments principally highlight the fact that the choice of LPEs depends on the wider institutional setting, signified by the rule of law or institutional quality that affect the presence of corruption or rent-seeking activities in the public sector. Depending on the type of political risk, different types of LPEs exhibit different exposures to such problems. While stronger integration, for example directly managed firms, reduces the risk of corruption, the opposite is true for problems regarding the opportunistic political use of LPEs. In the latter case involving outside partners may ensure an alignment of LPE behavior with its primary goal of providing public services.

To summarize, the choice of LPEs by local governments seems to be largely based on efficiency considerations. This implies that, depending on the characteristics of the service, different types of LPEs are optimal in decreasing transaction cost. In addition to service characteristics, the situation of the respective municipality in terms of size, financial, and contracting capacity may change the relative attractiveness of LPEs. If the discriminating alignment hypothesis also holds for local governments, that is to say municipalities will choose the economically most favorable type of LPE given a situation, capacity building should be a key concern when trying to improve the efficiency of local governments (see also section 5.5). Finally, apart from economic incentives, political determinants also are poised to affect governance choices in the public sector. Strengthening accountability and transparency may be necessary in order to ensure both an economizing choice of LPEs and the consideration of potentially important and justified non-economic goals.

The main conclusions from this section are summarized in Box 7, which lists some of the most critical factors that should be taken into account when choosing an LPE to provide public services. This checklist may serve as a rough guiding principle to structure the decision on how to organize local public service delivery. Importantly, to choose a suitable type of LPE according to the specific situation, local governments are required to have substantial knowledge about the regulatory framework, market characteristics, service characteristics, and institutional environment.

Box 7: Checklist for LPE Choice

	Description	Relevant questions for assessment
Regulatory Framework		
Intensity of regulation	Depending on the sector in general and public service in particular, different types and intensities of regulation can be observed. The intensity of oversight and regulation by higher tier national authorities may facilitate service provision in that it decreases procedural uncertainty.	Is there a national or regional regulatory body? Are there any national or regional guidelines of directives regarding price and quality of public services? Are public and private firms subject to the same regulatory framework?
Regulatory incentives	Central governments sometimes incentivize the use of special types of LPEs through fiscal incentives.	Are there incentives to adopt a specific type of LPE? Are there financial subsidies that are available only to specified organizational structures?
Market Characteristics		
Thin markets and intensity of competition	Thin markets with a lack of competition typically strengthen the case for LPEs in general as efficiency gains from competition are unlikely. Thin markets also increase the potential for collusion among private partners, e.g. through regional segmentation of markets.	What is the size of the potential market? What is the competitive structure? Are private firms competing in the same market?
Metropolitan areas vs rural regions	Large cities and metropolitan areas typically enjoy considerable economies of scale and may exhibit larger internal capacities than small cities. As such, the case for cooperation with public or private partners is somewhat weakened as additional advantages from combined production are unlikely.	Is there a trained staff to manage contractual relationships and outsourced services? Are local government capacities available to manage services internally?
Public Service Characteristics		
Service complexity	Higher complexity is usually associated with a greater need for flexibility and ex-post adaptations. More integrated types of LPEs are preferable in these cases.	If the service is contracted out, are renegotiations frequent? Are dimensions of quality easily specifiable?
Spillover effects and coordination needs	If the functional territory and the jurisdiction do not overlap, as for not just local public transport but also waste treatment, types of LPEs should be envisaged that allow for an intensified coordination among municipalities. In particular, public public partnerships in	Is intermunicipal cooperation frequent in this type of service? Are the higher tier institutions coordinating local governments? Are there interactions and dependencies in a service with neighboring municipalities?

	the form of intermunicipal cooperation are advantageous under such circumstances.	Is service provision characterized by complementarities or substitutability?
Economies of scale	If a service exhibits significant economies of scale, cooperations with public or private partners are to be envisaged. As indicated by the previous point on Metropolitan areas, this is strongly dependent on the ability to exploit economies of scale locally.	Is the service under consideration characterized by significant economies of scale? Is the current level of production characterized by increasing, constant or decreasing returns to scale? Are potential partners, public or private, available?
Institutional Environment		
Corruption and favoritism	Involving outside firms and partners, especially privately owned, increases the risk of corruption because it facilitates shifting profits and cash flow through contractual arrangements between the local government and the private partner. While this risk is generally somewhat reduced for LPEs in contrast to pure contracting-out, a higher degree of integration diminishes the problem further. More generally, however, monitoring and independent audits are indispensable also for directly managed LPEs to increase the probability of uncovering misconduct.	How prone are public officials and politicians to corruption? Are there national guidelines that govern the choice of contracting partners? Are there regulations regarding the transparency and openness of concessions and procurement procedures? Are there external bodies auditing LPEs as part of local governments?
Political capture of LPEs	Public service provision may be subject to political opportunism using the firm for political objectives, e.g. through excess employment. Conversely to the problem of corruption, reducing political influence by shifting decision rights from politicians to the firm's management would suggest less strongly integrated types of LPEs.	Is there a separation between LPE budgets and the general local government budget? Are external experts without political affiliation present on the board of directors of an LPE? Who has control rights over main business decisions and investment?

5 Institutional Challenges

In accordance with the multi-level governance approach developed by the OECD (see e.g. Charbit (2011)), a number of potentially critical challenges for local governments in the effective provision of public services have been identified throughout the paper. Unattended, these challenges may not only have an adverse effect on public service provision but also give rise to coordination requirements. Moreover, some of the governance types already discussed are the endogenous response to overcoming existing challenges and can therefore help to explain why some forms of LPEs are more common in some situation than in another.

5.1 Administrative Challenge

The underlying source of administrative challenges is largely related to the potential mismatch between jurisdictions and the allocation of functions across jurisdictions in a decentralized federal system. Unless the functional territory and the jurisdiction overlap, some form of voluntary or regulated coordination is indispensable to ensure an efficient and effective provision. The considerable administrative challenges that result from such a functional misalignment can be roughly distinguished by whether coordination (or the lack of coordination) among jurisdictions affects the service from a citizen perspective. This is, for example, the case in local public transportation (LPT), where coordination between local and regional partners is crucial in order to ensure a smooth functioning of the service across jurisdictions. It is no coincidence that for LPT a wide range of rather formal and institutionalized coordination mechanisms already exists in many countries. In Germany and Austria, for instance, the providing LPEs are members of so-called transport associations (Verkehrsverbünde), which coordinate public transport on a larger scale. The system of such higher-tier governance institutions integrates the services of different operators and covers virtually the whole territorial area (see Zatti (2011) for an overview of LPT in 10 European countries).

In other cases, where the demand side incentives for coordination are weaker, alternative, potentially more regulative interventions from the higher-level authorities may be necessary to stimulate cooperation among local governments and therefore LPEs. An instructive example is the waste sector, especially as far as the supply of treatment capacity is concerned. Triggered by an increasing environmental awareness, several international agreements, for example the EU landfill directive, affecting waste disposal and treatment, have been reached in recent years. Although the associated need for additional thermal and mechanical treatment capacity (as compared with traditional landfill) was straightforward on the national level, the actual implementation, however, typically required substantial coordination on the sub-national level. For instance, although waste

treatment often requires a scale beyond a single municipality, making the need for joint facilities obvious, the voluntary coordination can be significantly hampered by free-riding behavior of individual governments. In particular the location of waste disposal facilities is often met by local resistance and proves to be a politically sensitive issue. Voluntary agreements between municipalities may not always be achievable without support or intervention from a higher level government.

LPEs are an important factor to consider in this case where voluntary cooperation is less likely, because designing an incentive compatible regulatory framework it may be necessary to consider the interest of the various different stakeholders involved. Apart from heterogeneous interest between political actors, firm managers, and profit oriented contracting partners, the increased tendency to contracting-out may complicate the cooperation process even further. This concern is raised in Antonioli and Massarutto (2011) concluding that the increased disintegration of waste services, for example collection and treatment, may make coordination more difficult.

Consequently, the main administrative challenge in this respect is to implement mechanisms, if possible incentive compatible, which strengthen the propensity to cooperate in cases where cooperation is not voluntary. One instrument in this respect would be a modification of investment subsidy schemes, which are particularly frequent in decentralized federal countries, so as to ensure sufficiently high scale efficiency. Regarding fiscal incentives in general, as the varied institutional landscape suggests, a sectorial approach would be preferable in order to avoid deadweight spending in sectors where (voluntary) coordination already exists.

5.2 Fiscal Challenges and Going LPE for Bad Reasons

A major concern related to the use of LPEs, which also has some empirical foundation, is the potential lack of fiscal transparency and their potential misuse as an off-budget financing option. As already mentioned, fiscal constraints for local governments have typically tightened over recent decades. Very often increasing concerns about public debt have led to (numerical) fiscal rules on the budget or indicators of financial stability like debt or deficit. Such rules, however, have partially incentivized governments to seek alternative sources of credit and finance. Given the somewhat ambiguous status of public enterprises in the national accounts and public accounting rules, LPEs have repeatedly been used to shift financial liabilities from the budget.

In recent years a number of potential practices for escaping fiscal discipline have been reported. For instance, as Maastricht debt and deficit criteria do not include public enterprises if these enterprises are sufficiently independent and cost recovering (using the definition of the ESA95), there has been a notable tendency to shift debt and/or deficit heavy public companies out of the public sector. This

way of creating so-called shadow budgets is usually achieved by corporatizing a company and is also not uncommon for LPEs (see Llera and Valinas (2010) for evidence of such practices in Spain). Instead of shifting existing debt, LPEs can also be used as a source of credit by issuing contingent liabilities for loans taken out by the public enterprise. As explained by Brixi (2004) in this way the local government can effectively replace direct government borrowing by issuing contingent liabilities, which are usually neither captured by debt and deficit rules nor by public accounting standards. A similar development has been attributed to the increased use of Private Finance Projects (PFP) in the UK. Indeed, the inquiry by the Economic Affairs Committee of the House of Lords (2010), which followed a public debate about the potential hidden government debt in PFPs, concluded that there was a systematic “institutional bias” in favor of financing local infrastructure projects through PFPs. The resulting policy recommendation by the inquiry of the House of Lords was to increase transparency in the area of off-budget items and to have local governments disclose such indirect types of debt and risk along with standard government finance statistics. The latter was deemed especially important in order to assess the actual size of the off-budget items, which was in fact largely unknown at the time the report was written.

In the same vein, the latest revision of the European System of National Accounts, the ESA 2010, will effect several changes in the reporting requirements for national but also local governments with respect to public enterprises. The intention is not only to get a measure of the size of off-budget debt but also to get a clearer picture on the diffusion of entrepreneurial activity of local governments outside the public sphere. As such, a number of interesting insights regarding the use of corporatization or public-private arrangements instead of traditional LPEs could be gained. Eventually, the increased transparency regarding the use of alternative types of LPEs may help to raise public support and acceptance of public sector reform.

5.3 Accountability Challenge

One of the most contentious issues surrounding the recent developments of LPEs and public sector reform is accountability. The two major organizational trends for LPEs, corporatization and private sector participation, have very early on been met by concerns that political accountability and therefore responsiveness to public interest would be critically diminished. Notions of the “hollowing out of the state” were present not only in the public debate but also academia, not strongly from political science (see e.g. Rhodes (1994)). Also from a public management perspective the question of how to control and monitor more autonomous public or mixed public-private enterprises has received a lot of attention. Reviewing municipal corporatization in Germany and Italy, Grossi and Reichard (2008) conclude that the steering of more independent LPEs is probably the single most important challenge. Apart from managerial issues, concerns are raised that in the absence of serious

problems there is an effective lack of political control of municipal corporations because local politicians have withdrawn themselves from their corporations. The result is that the diverging interests of the various corporations are not embedded in a general municipal strategy. Particularly large cities, which should effectively manage and coordinate dozens of corporations and contractual relationships with private partners, may be unable to integrate all their external business operations into a coherent strategy. Moreover, a side effect of the decentralization of responsibilities may be an aggravated risk of managerial misconduct and corruption, as indicated by Maravic (2006).

A more positive summary of the recent changes in governmental governance is given by OECD (2005b), which considers the decrease in internal control mechanisms as a shift in favor of ex post and external controls, for example in the form of audits. An interesting point put forward by the report is that despite some common trends in public sector reform among developed countries, there appears to be no visible convergence in accountability procedures. This idea is supported by Zatti (2011) who provides an analysis of the trade-off between autonomy and accountability in the local public transport sector. Two polar institutional arrangements seem to arise with regard to the transport authority that coordinates the individual operators. For example, in France, the UK, Spain, and also Poland, a highly integrated approach with little practical autonomy is chosen, whereas comparatively independent corporatized company structures are used in Germany, Sweden, and Austria. Thus, although accountability has been identified as a key issue in the provision of public services through LPEs, there seems to be no consensus among countries, neither regarding its optimal extent nor the appropriate monitoring mechanisms.

5.4 Objective Challenge and the Role of Risk Sharing

As soon as control over an LPE is shared between local governments (intermunicipal cooperation) or between the local government and a private partner (mixed public private LPEs) potential issues of heterogeneous interest arise. While in the former case it may be argued that the objective challenge is limited because exclusively public interests and objectives still dominate the LPEs' strategic decisions, the situation is much more complicated in the latter type of LPE. Indeed, a typical reason for cooperating with partners from the private sector is the increased cost saving incentive of private partners, which in turn should lead to increased efficiency. Thus by definition objective challenges in mixed LPEs are not a coincidence but the very motivation for engaging in a business operation with a private partner. Public entities usually do not have financial objectives such as profit maximization or cost minimization and if at all, such factors are deemed rather to be constraints limiting the leeway of public organizations. Transferring control over LPEs to private partners will therefore inevitably lead to objective challenges.

Shifting control over an LPE is, however, not enough to trigger high-powered incentives in the behavior of private partners. For example, if the potential revenue from an LPE activity is fixed, there is no reason to expect a private partner to behave differently from a public agent because there are no incentives to manage the firm more efficiently or to decrease cost. Only if the private partner has the possibility of increasing profit by adapting the management of the LPE, can a different result to pure public provision be expected. Depending upon the specific arrangement, two distinct strategies are to be expected by profit oriented private partners. First, if the revenue is contractually fixed, for example the price and the quantity of the public service cannot be altered, the main focus is on reducing cost. While this is one of the main drivers of efficiency improvements, this incentive may also lead to quality shading behavior by the private partner, resulting in lower quality and too little investment (see Hart, Shleifer, and Vishny (1997)). Second, if price and quantity are capable of being altered, private partners will have an incentive to engage in monopoly pricing to increase profit, leading to higher prices and, therefore, potentially excluding certain groups of consumers. Moreover, as shown by Bognetti and Robotti (2007) there is a tendency in mixed public private LPEs to increase the range of activities as well as the territory served. To summarize, while the potential increases in efficiency are interesting for the public sector, especially in times of tight budgets, it is vital to take the different objectives of private partners in mixed LPEs into account.

As a consequence, a prime role in order to steer incentives in mixed public private LPEs, but also in public private arrangements more generally, is the allocation of risk. As highlighted in a number of OECD publications, different types of public private partnerships usually lead to different risk allocation schemes (see e.g. OECD (2008)). When considering potential PPP arrangements ranging from management contracts to Build-Own-Operate to concession contracts, it is clear that increasing the scope of activities and responsibility for the private partner is essentially related to an increasing transfer in risk. Conversely, however, the allocation of risk also affects the intensity of potential objective divergence between the public and the private partner.

Similar considerations are relevant in the specific case of mixed public-private LPEs, an institutionalized type of PPP, where the private partner may not only represent a shareholder in the LPE but also assume management tasks. Hence, typically, not only are both parties represented on the board of directors but also various risk-sharing schemes are possible. This may be particularly relevant in those cases where full cost recovery is not achievable or politically desirable in order to align the incentives of public and private partners.

To conclude, potential objective challenges are inherent to mixed public private LPEs. There is an intimate relationship between the extent of risk transferred to the private partner and the expected level of objective heterogeneity. Choosing a suitable risk-sharing scheme therefore represents a key instrument in aligning the incentives of parties in mixed public private LPEs.

5.5 Capacity Challenge

Corporatization of an LPE is often considered as a mean to professionalize, sometimes also to depoliticize, public service provision. Using the legal structure of firms in the private sector with a board of directors to manage the firm, it is usually assumed that a more effective and efficient provision may be achieved. However, the local government itself needs to build capacity to be able to manage and monitor corporatized firms. As argued by Grossi and Reichard (2008), the capacity of local government to control external business units clearly lags behind the general corporatization trend.

A similar situation applies to intermunicipal cooperation. Representing another alternative to directly managed LPEs, they are often thought of as a way of overcoming the restrictions for participating municipalities. Apart from the typical scale effect argument, intermunicipal cooperation very often exists between rather small municipalities, and can therefore also lead to an increase in managing capacity because the combined resources are typically managed by a professional management, which is hired exclusively for this task. However, even if the direct business operation is no longer the task of the local government, skills in terms of managing the contractual relationship and coordinating with the association and its members are now required.

Also with regard to mixed public private LPEs, the capacity of the local government to manage the relationship with the private partner plays a central role. Given the previously mentioned objective heterogeneity between public and private partners, capabilities to design, manage, and renegotiate contracts are of high importance.

It therefore appears that adopting alternative types of LPEs requires the local government to have the capacity to effectively manage the resulting contractual relationships. This is also confirmed by a number of studies analyzing the institutional choice of local governments for public service provision. For instance, there is evidence that the decision to switch from a directly managed LPE to an alternative form (for example intermunicipal cooperation) strongly depends on the sophistication of the local government and the experience of the mayor (see Warner and Hebdon (2001)). In a similar vein, Warner and Hefetz (2008) show that although general learning effects exist when new institutional arrangements become possible, those US municipalities with more professional

managers (that is to say council managers instead of elected mayors) adopt new governance types earlier.

Apart from affecting the choice of different types of LPEs, the contracting capacity of local governments also appears to have a significant impact on the actual performance of a contractual choice. For US cities it appears that governments strategically invest into contract management capacities when faced with internal and external threats to the efficiency of service delivery. For example, if services are characterized by high transaction costs, municipalities respond by an increased use of feasibility studies and evaluation practices (see Brown and Potoski (2003)). However, as investment in contracting capacity is not the same across governments, this may explain why some types of contractual arrangements and therefore LPEs are successful in some cases but not in others.

As identified by Brown and Potoski (2003), municipalities may build three different types of contracting capacity effectively to manage different types of LPEs or even complete contracting out:

- Feasibility assessment capacity: To evaluate whether a type of service is compatible with the envisaged governance type.
- Implementation capacity: Contract negotiation and legal capacity to identify and choose external partners as well as build systems to manage contracts.
- Evaluation capacity: Data collection and analysis procedures to conduct audits.

This leads to the conclusion that capacity has a twofold role with respect to the choice of LPEs for public service provision. On the one hand, different types of LPEs are chosen to overcome existing capacity limitations such as:

- territorial boundaries, scale economies, and the sharing of budgets to reach a critical investment mass (intermunicipal cooperation);
- depoliticize and professionalize services and to overcome skill constraints (corporatized LPE);
- a large range of potential financial resources and management capacity (mixed public private LPEs).

On the other hand, engaging in these alternative types of LPEs and entering the realm of contractual relationships with external partners also sets capacity requirements of its own. Among others this means that local governments need to build capacity and acquire the ability to manage, monitor and renegotiate such arrangements.

6 LPE Specific Risks and the Role of Governance Capacity

The previous sections have given a rather general account of the institutional challenges and factors influencing LPE choice and behavior. This section will try to identify more specifically for each type of LPE the main types of risks. While most of the risks and challenges affect all types of LPEs to a certain degree, there are some general tendencies that appear to make different types of LPEs more or less susceptible to the same risk. For instance, although issues of soft-budget constraints affect all types of LPEs because of the final responsibility of the local government to provide critical public services, there are still institutional differences that make directly managed LPEs more problem-prone in this respect. The main risks and institutional challenges identified in this report are:

- **Political capture and special interest:** Higher degrees of integration increase the risks that politicians will use their influence to affect LPE behavior. This can affect various different areas ranging from prices for public services, quality to excess employment (see Shleifer and Vishny 1994). Related to this, the potential for pork barrel politics is more aggravated if LPEs are under direct political control and the financing of LPEs is not clearly separated from the general budget. As predicted by Horn (1995) politicians may simply use public firms to reward their supporters.
- **Soft budget constraint:** Efficiency and cost-recovery concerns are typically less pronounced in more directly managed LPEs because there are few incentives to reduce cost. If budget regimes allow it, publicly owned firms in general will not adhere to budget restrictions (see Bertero and Rondi (2000)). Is it likely that the partners in public private mixed or potentially also in public public partnerships will try to enforce fiscal discipline in LPEs.
- **Accountability:** The government as the elected representative of citizens' interests has more or less influence and control on LPE decision making depending on the chosen governance type. Somewhat inversely to the political capture and special interest problems that affect directly managed LPEs, various and different accountability problems arise for less integrated types of LPEs.
 - **Intermunicipal cooperation:** The single municipality can no longer decide independently about various features of public service provision. Different preferences between municipalities cannot easily be considered because the chosen policy will reflect the average preference of the participating municipalities. Thus depending on the voting power, the municipality specific preferences may be poorly reflected.
 - **Corporatized LPEs:** It is unclear how the objectives of a professionalized management are aligned with public interest. Given the indications of Grossi and

Reichard (2008) the additional managerial independence in corporatized firms may create problems in that citizen interests are less important for more decentralized governance structures. Eventually there is the risk of a hollowing-out of political responsibility because firm management is not directly accountable to the citizens, for example through elections.

- **Mixed public private LPEs:** The accountability risks for this type of LPE are similar to those of corporatized firms to the extent that citizen interest may be less important. In addition, however, the risks are even more pronounced because both the incentives of the firm's management and the objectives of the private partner, as a holder of property rights, may diverge from public interest. A stronger focus on profits and similar financial objectives can create conflicts with equity, environmental and other "soft" public service goals.
- **Fiscal integrity:** As discussed in section 5.2, spun-off types of LPEs, typically with a separate legally entity and under private law can be used to shift debt and as a source of off-budget finance, for example by using contingent liabilities instead of actual debt. The risks for fiscal integrity therefore increase when government control and transparency of municipal relations with LPEs are diminished.
- **Risk of coordination costs and objective heterogeneity:** If ownership in an LPE is shared, as part of an intermunicipal cooperation or with private partners, the need for coordination increases. In such multi-agent environments where collective decision making becomes relevant, strategic behavior like shirking, free-riding or common pool problems may arise.

Table 6 (below) summarizes the different types of LPEs regarding the risks and challenges to give a combined account of the most prevalent risks.

Table 6: LPE types and their risks

	Main risks	
Directly managed LPE	Political capture and special interest	++
	Soft budget constraint	++
Corporatized LPE	Accountability problems	+
	Soft budget constraint	+
	Political capture and special interest	+
	Risk for fiscal integrity	+
Inter-municipal cooperation	Risk of coordination costs and objective heterogeneity	+
	Soft budget constraint	+
	Accountability problems	+
	Risk for fiscal integrity	+
Mixed LPE	Accountability problems	++
	Risk of coordination costs and objective heterogeneity	++
	Risk for fiscal integrity	++

When looking at the types of risks associated with the different types of LPEs it is possible to relate these risks directly to the taxonomy of LPEs from section 1.2. The classification characteristics chosen to distinguish types of LPEs—the allocation of decision rights, fragmentation of control as well as private sector participation—are extremely important in explaining why certain risks are more prevalent in some governance structures than in others:

- **Allocation of decision rights**

If the government has decision rights over the LPE, such as in directly managed LPEs, the **risk of political capture and special interest politics** is aggravated because political actors have direct policy discretion over important dimensions of public service provision. Similarly, the **risk of a soft budget constraint** is prevalent if the LPE is part of the local administration because there are hardly any incentives for public managers to make cost savings. Conversely, public bureaucrats who try to achieve a larger budget will have an overly high spending propensity. Even if the municipality remains owner but transfers decision rights to the management of a corporatized firm, the efficiency may increase (see Cambini et al. (2011)).

Other types of risk, however, are diminished if the government has decision rights. For instance, **risks for accountability** are lower compared with other types of LPEs because the local government has to be elected by its citizens, which should align public service provision with the preferences of its constituency. Finally, since decision rights with the local government also require the LPE to be highly integrated, the **risks for financial integrity** are reduced. The expenditures, deficits, and debt of LPEs are more clearly attributable to the municipality, which is ultimately responsible for LPE liabilities.

- **Fragmentation of control**

Similar to the question of decision rights outlined above, the issue of fragmenting control over an LPE also represents a trade-off with respect to different risks. Having multiple principals can reduce the **risks of political capture and special interest** because the principals need to formulate a common policy position and heterogeneous preferences may therefore curtail political capture.¹⁹ Moreover, since a **soft budget constraint** would affect all principals in increasing costs, institutional mechanisms can be put in place to reduce such risks. The relevance of a soft budget constraint under fragmented ownership and control will

¹⁹ See Sorensen (2007) for a discussion of the argument.

certainly depend strongly on how independent LPE management is and whether or not principal interests are aligned in their view of the necessary degree of cost recovery.

Conversely, fragmented control bears the potential for increased **risk of coordination costs and objective heterogeneity**. Apart from decreased **accountability** if principal objectives are very heterogeneous, this can lead to higher transaction and decision-making costs. Evidence that these costs may eventually outweigh the benefits from joint production and economies of scale are presented by Sorensen (2007) for the Norwegian refuse collection. One size fits all solutions may respond badly to the individual local challenges of public service provision. Complementarities and spillover effects may be tackled through shared ownership but do not guarantee advantageous outcomes for the main stakeholders. Moreover, in multi-agent environments where collective decision making becomes relevant, strategic behavior like shirking, free-riding or common pool problems may arise – increasing coordination costs additionally.

- **Ownership and property rights**

The question of private sector participation can actually be considered as further deepening the existing risk trade-off between integrated types of LPEs vs less integrated types. Central to this effect is the profit orientation of a private partner who is poised to further aggravate **risks for accountability** as well as the **risk of coordination costs and objective heterogeneity**. Given the involvement of an external partner from the private sector, the risks to **financial integrity** are elevated because debt shifting can easily be affected through such off-budget structures (see the case of UK PFIs in section 5.2).

In contrast, the profit orientation decreases the **risk of a soft budget constraint** because incentives for private principals increase the focus on performance and cost efficiency. Similarly **political capture**, unless bought through corrupt practices which may affect other types of LPEs, is less likely because using LPEs for political goals is usually costly in terms of performance and therefore not in the interest a private partner.

Although the different LPEs have been presented as a trade-off between different types of risks, this is not to say that the risk depends only on the choice of LPE. How prevalent the risks in Table 6 potentially affect public service provision through LPEs also depends crucially on the institutional capacities of the local government. Thus the risk potential is not exogenously given but varies according to the risk management capacities of the respective municipality. Various types of capacities such as checks and balances but also more general management capacities can help to

reduce and even neutralize the harmful effects of such risks. Evidence that the local governance capacities affect the decision for an LPE has been put forward in section 4. Higher contracting skills and experience can significantly affect these choices, not least because this has an influence on the risks associated with different types of LPEs.

The review of Brown and Potoski (2003) further shows that increases in governance, contracting, and management capacity of local governments presents a critical determinant of failing or successful arrangements. US municipalities appear to invest strategically into governance capacities in the face of threats to contract performance.

As a consequence, the remainder of this section focuses on the various layers of sub-national capacities and suggests a potential framework for the evaluation of municipal governance capacity. Similar to findings for other areas such as investment, a practical assessment of the capacity of local governments to manage public services through different types of LPEs requires comprehensive information. Thus instead of trying to identify a number of key indicators of capacity, Table 7 (below), which builds heavily on the assessment scheme proposed in OECD 2012, tries to give a rather broad account of governance capacity as present in local governments.

*Table 7: Capacity in the governance of LPEs
(based on OECD (2012))*

Capacity	Question for self-evaluation
To engage in strategic planning for regional development	<ul style="list-style-type: none"> • Do mechanisms exist to ensure that sub-national LPE strategy corresponds to regional or national goals? • Is there a clear strategy regarding public service provision through LPEs at the national level?
To coordinate across sectors	<ul style="list-style-type: none"> • Is attention being given to potential complementarities and conflicts among LPE choices in different sub-sectors? • Do formal or informal mechanisms exist to coordinate LPEs horizontally across sectors at the municipal level?
To coordinate with other jurisdictions to secure economies of scale and promote complementarities	<ul style="list-style-type: none"> • Have cross-jurisdictional partnerships involving LPE coordination previously been implemented? • Does a higher level of government require, support, or provide incentives for cross-jurisdictional coordination?
To involve stakeholders in planning to enhance the quality and support for LPE choices – while preventing risks of capture by specific interests	<ul style="list-style-type: none"> • Do mechanisms exist to identify and involve stakeholders in the process of LPE choice and operation? Which categories of stakeholders are most/least engaged? • Are stakeholders regularly consulted to see if they are satisfied with the public services provided by LPEs? • Do citizens have access to information regarding LPE operations? • Is stakeholder feedback incorporated into decision making? How?

To conduct rigorous ex-ante appraisal before adopting or changing LPE types	<ul style="list-style-type: none"> • Are LPE choices subject to ex-ante assessment? What kind of criteria? • Is the local government able to tap appropriate expertise, either in-house or elsewhere, to ensure proper appraisal of the different potential types of LPEs?
To link strategic plans to multi-annual budgets	<ul style="list-style-type: none"> • Are LPE budgets, even if externalized, enveloped in municipal budget planning? • Are the costs of operation and management of contractual relationships assessed on a long-term basis? • Is there a medium-term planning and budgeting framework?
To tap traditional financing but also innovative financing mechanisms	<ul style="list-style-type: none"> • What is the fiscal situation of local governments? What are the main fiscal challenges? • How is LPE operation financed? • Do local governments have access to information concerning (supra) national funds for LPE investment?
To mobilize private sector financing	<ul style="list-style-type: none"> • Is private sector participation considered for public service delivery as a means of acquiring access to external financing? • Has the local government already used private partners as an external source of finance, both through a mixed public private LPE or more direct contracting-out? • Does a dedicated PPP unit exist that can assist sub-national governments?
To possess a well-designed indicator system with realistic, performance promoting targets for LPEs	<ul style="list-style-type: none"> • Is there a pre-defined system of performance indicators for LPEs? Is this set sector-specific? • Does the monitoring system facilitate credible and timely reports of LPE fiscal balances and performance? • Does the indicator system incorporate output and outcome (results) indicators? • What percentage of indicators are associated with pre-defined targets?
To conduct and use regular ex-post evaluation	<ul style="list-style-type: none"> • Is ex-post evaluation of LPE operations and performance required? • What share of LPEs and in what sectors are subject to ex-post evaluation? • Do clear guidance documents exist that detail ex-post evaluation standards?
To use monitoring and evaluation information to enhance decision making	<ul style="list-style-type: none"> • Is there alignment of timing of budget preparation and the availability of monitoring and evaluation data? • Do policymakers incorporate performance information from previous periods into current decisions, e.g. regarding LPE budgets and investment? • Are actors sanctioned or rewarded based on the achievement of targets?
To engage in “better regulation” at sub-national levels, with coherence across levels of government	<ul style="list-style-type: none"> • Does the sub-national government have access to and participate in mechanisms for coordinating regional or national strategies in public service provision? • Is regulatory impact analysis used? • Are public consultations in connection with the preparation of new regulations of sufficient duration,

	<p>accessible, and appropriately targeted?</p> <ul style="list-style-type: none"> • Is there consistent consideration of alternatives to regulation? • Have there been efforts to reduce the stock of regulation or simplify administrative procedures in the past few years?
To ensure the quality and availability of technical and managerial expertise necessary for planning and executing public service provision through LPEs	<ul style="list-style-type: none"> • What percentage of employees works on management of public services and LPEs? • Is there specialized staff with a formal education or training in public management? • Is external technical assistance (e.g. for adopting new governance types and legal procedures) readily available? • Has external assistance been used in the past?

7 Conclusion

Local public enterprises (LPE) represent a popular mode of public service delivery in OECD countries. In Europe, where the use of LPEs is particularly pronounced, local governments use not only public enterprises integrated into the administration but also 16,000 legally independent organizations, which they own at least partially. **This gives rise to definition problems.** In addition, we show in this report that the use of LPEs varies greatly between countries and is largely determined by the allocation of public service delivery between the public and private sector as well as the functional decentralization in federal systems. In Japan, for example, 9,000 LPEs are active in public service delivery whereas only 300 LPEs exist in South Korea.

Typical areas of operation for LPEs are classic public services like water and sewage, waste collection, electricity distribution, but also urban planning and development. The former are signified especially by high transaction costs, natural monopolies, and general market failures. **However, despite this general tendency, there are large differences between countries.** For example, while water provision is largely public in many countries, private companies can be used to replace LPEs. In France municipalities often contract the service out while in the UK private regional providers are regulated by a central authority.

Although country-specific differences in the actual design of LPEs exist and make comparisons difficult, **a comprehensive taxonomy of LPEs can be developed.** We proposed in this report a taxonomy following three criteria. First, directly managed LPEs are characterized by the fact that the government retains decision rights. Alternative governance types require the creation of a legally separate organization, where the government has to surrender decision rights at least partially.

Consequently, corporatized LPEs represent the second type of LPE, which is owned exclusively by the local government but decision rights lie with the firm's management. If the government further gives up exclusive control and ownership, partnerships with public or private partners become possible. The third and fourth types of LPEs are therefore intermunicipal cooperations and mixed public private partnerships, where the latter involves a private share in ownership.

In addition to being complex to define, **several trends characterize the use of different kinds of LPEs**. Indeed, in the search for efficiency a number of governance alternatives to directly managed LPEs have become popular with local governments. Instead of real privatization, most municipalities have separated enterprise operations from the administrative body, either remaining sole owner of the enterprise or bringing in a partner. In the former case, that is to say corporatization, governments simply spin off tasks or whole departments into a publicly owned company. This trend of agentification is possibly the single most important trend for LPEs and has affected virtually all OECD countries. For this purpose a number of countries, for example Italy, France, and Japan, have adapted their legal framework to allow for corporatized firms. Linked to this, given the increased interest in private sector participation in LPEs, is the fact that the regulations regarding mixed ownership have been subject to change. Not surprisingly, public private partnerships in their institutionalized form have consequently been another popular alternative mode of provision. While some countries already have long experience with such arrangements, recent trends have also led to the adoption of mixed public private LPEs in countries where public provision was the norm in the past. Finally, instead of private partnerships, partnerships among local governments have also gained in importance in recent years.

Reviewing the empirical studies comparing the efficiency of different types of LPEs, no clear picture arises and the evidence points toward **no clear efficiency advantage** of one over the other. This is consistent with the idea of transaction cost economics suggesting that **governance types are chosen deliberately (and not randomly) in order to reduce transaction costs**. Organizational decisions by local governments are (or should be) largely based on transaction costs related to task-specific contracting difficulties. More complicated tasks are typically not contracted out but instead provided through an LPE. The more discretion and control the government deems necessary, the more likely it is that more integrated LPEs will be chosen. Partnerships with public or private partners are envisaged if limitations of purely local provision exist or in the search for external capacities, for example for finance and skills. **On the other hand, political factors also play a role and may potentially prevent the adoption of cost economizing governance types**.

We conclude this report by pointing out that directly managed LPEs are faced with a number of challenges, such as territorial restrictions or resource restrictions in terms of finance and skill. The trends of corporatization, private sector involvement, and intermunicipal cooperation are specific responses to these challenges. **These types of public sector reform lead, however, to new institutional challenges for the local government.** In partnerships, especially with private partners, different objectives may hamper operations. Removing an LPE from the direct political discretion of the local government also raises questions of accountability. Finally, steering these types of LPEs also requires the municipality to acquire contracting abilities to manage the relations with the legally independent LPE, giving rise to potential capacity challenges.

In order to go a step further in the analysis of LPEs and their efficiency, case studies would be of great interest. Such studies would permit to reveal how public authorities decide on their organizational choices in order to provide public services (economic factors as well as political ones) as well as the main differences between LPEs types and efficiency. The selection of case studies should also take into consideration, as pointed out before, the market's characteristics (that is to say. competition level) as well as the institutional environment's characteristics (such as fiscal constraints, corruption levels, etc...).

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