

# Surviving and thriving in an irrational world

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Commentary based on a talk to the Alberta Urban Municipalities Association  
Red Deer, Alberta  
30 April 2009



My talk today was inspired by a comment I overheard while I was getting my breakfast. One of your number said to one of his colleagues as he was walking in the door, “I’m here to find out if we’re even going to be here in five years”.

That made me rush upstairs and give my talk the following title: *Surviving and Thriving in an Irrational World*.

Now the world is an irrational place in many ways. Who would have ever thought that there would be professional hockey in the hot dry desert of Arizona, that Oprah Winfrey would become one of the richest women in America, that Ontario would become a have-not province and get equalisation payments, or that we came within a hair’s breadth of getting a national government totally dependent on the votes of a party dedicated to breaking up the country?

But the irrational world I particularly want to talk about today is the different one of local government, and particularly its relationship with the provincial governments who establish much of the framework within which they operate. The questions of whether, in fact, some of you or your opposite numbers in

other provinces will be here in five years probably depends, more than any other single factor, on what provincial governments here and elsewhere do.

And that is a scary thought.

I probably don’t need to explain why it is a scary thought, but I do think it is important to discuss these matters by way of concrete examples. So let me tell you a story about the irrationality of senior governments, vis-a-vis municipalities, that comes from my home province of Nova Scotia.

This section of my talk is called “The Chief Cause of Problems is Solutions”!

In the 1990s the decision was made to force the amalgamation of the four municipalities that constituted the Greater Halifax metro area into the Halifax Regional Municipality (HRM). So if amalgamation was the “solution” what was it supposed to solve and what problems has it created instead?

In my view, to understand the HRM experience, you have to understand three particular circumstances.

For the first, one might easily make the case that the amalgamation of metropolitan Halifax was caused by the Price Club big box retailer now known as Costco. This is only a slight exaggeration. The old municipalities of Halifax and Dartmouth got in a destructive bidding war with each other to attract the Price Club store that had been announced for the metropolitan area. This was silly, since the benefits of the Price Club went well beyond the boundaries of each municipality. In the end, Halifax won the right to have the store built within its boundaries at a cost of about \$1-million. That amount was a direct gift from the taxpayers of Halifax to the shareholders of Price Club for zero public benefit, other than sticking it to the municipality of Dartmouth across the harbour. Ironically, of course, there will shortly be a Costco in the new Dartmouth Crossing shopping centre...! It opens on May 13<sup>th</sup>.

It was events like this that raised great suspicion of the rivalry between these municipalities and convinced many, including in the provincial government, that a single municipality would be cheaper and more efficient because it would abolish such wasteful behaviour.

Second, the discovery of natural gas off the shores of Nova Scotia triggered a huge flurry of public spending on the assumption that the revenue to pay for it was just around the corner. Except the corner turned out to be two decades away. By the early 90s, as the federal government cut back transfers in an effort to fix its own fiscal problems, and the province's debt had reached truly monstrous proportions, the province was in desperate fiscal shape – more so than virtually any other province – and they were desperate to cut costs. I am sure that this circumstance has absolutely nothing to do with the current state of Alberta's finances.

The third circumstance is that we have in Nova Scotia a culture of what I call executive personalism in government (that is the fancy social science-type term for it; you and I would call it pigheadedness, uninformed by any real information) – the policy formulation process is excessively weak, and fashionable ideas that get into the heads of premiers and powerful cabinet ministers are not subjected to searching analysis. If an idea sounds good to the right people, things happen – heavy water plants, steel

mills, long gun registries, Olympic stadiums, and municipal amalgamation being only a few examples. Again I am sure what I am describing here has absolutely no parallels with your experience of the Alberta government, but even if this is a totally foreign experience for you, humour me and hear out the rest of the story.

The Premier, John Savage, and his minister of finance, Bernie Boudreau, got it into their heads that there were major efficiencies to be had in amalgamating the municipalities. Now if they had actually wanted to test these ideas properly, if they had wanted to engage in that dangerously radical practice known as evidence-based policymaking, they could easily have consulted the literature on local government and amalgamation, a literature which is now quite vast. Had they done so, they would have discovered the following:

First, they would have discovered that local government is not merely a device for *supplying* municipal services, but also for finding out what services people *want* and how much they are prepared to pay for them. The smaller the government unit, the better they are at discovering this, because the evidence is very strong that local government is *closest* to the people, and the smaller it is, the closer it gets to the population. Amalgamation tends to undermine this relationship and therefore can only really be justified if there are pretty remarkable efficiencies to compensate for dilution of responsiveness and democratic accountability.

But, second, they would have discovered that the evidence is quite strong that creating **single-tier** local government monopolies doesn't reduce costs — it increases them. It levels costs *up* to the highest common denominator in the pre-existing units, and seems to result in higher *trends* of cost growth over time. This is especially true where amalgamation has **eliminated competition between pre-existing municipalities** both in terms of attracting residents and industry and in terms of tax and service levels.

It seems that the most dynamic force helping to keep costs down is not a highly centralised and bureaucratic monopoly provider of public services, but a decentralisation of authority and decision-making within several municipalities in an urban area

or even a mixed rural and urban region where residents cannot vote themselves benefits at the expense of other taxpayers in other parts of the region. This ensures that people only demand services that they're prepared to pay for, and municipalities have powerful incentives to keep costs low and satisfaction high, or risk the erosion of their tax base as people and businesses vote with their feet.

Where service provision has serious spillover effects (such as transit or water provision, for example) across municipal boundaries, it appears that the correct response is a co-ordinating body that takes over those specific functions. That's why Andrew Sancton has written that Greater Vancouver, with its many municipalities and the Greater Vancouver Regional District co-ordinating spillover activities, is the best form of municipal government in Canada. And this is an initiative you can take yourselves. Prove to senior governments that you can solve spillover problems and take away one of the main reasons they have to put a bull's eye on your back.

In most amalgamated municipalities, spendthrift city centres vote for big spending and pass the bill along to suburban and rural voters who don't want them. I am not aware of a single serious scholar studying municipal amalgamation on a broad scale in Canada or the United States who has concluded that they save money or improve efficiency. In fact, one of our leading thinkers on this issue, Howard Husock of the Kennedy School of Government at Harvard, is now arguing that de-amalgamation is the way to go....

Hey, Harvard has to be good for something, and if it is saving your municipality, I say "Go For It". Here is part of what Husock says:

[S]tudy after study has shown that the efficiency gains of bigger government do not materialize. [The evidence in one such study established] that such economies existed in only two areas: fire protection and library services. Localities...can provide other services-police, recreation, public works, waste management – at equal or less cost than an amalgamated, or, in the U.S. context, county jurisdiction. ...Somehow, however, the myth of efficiency through amalgamation lives on, so that it is worth explaining exactly

why bigger government won't save money. And it is worth considering the possibility that the greatest efficiency gains may actually be realized by moving in the opposite direction: breaking cities up into their component neighborhoods.

These findings are replicated in other work in Canada that I will come to.

Professor Husock introduces my third point, namely that it is a fairly small part of public services where there are significant "returns to scale" – in other words – where the bigger you are, the cheaper it is to produce a unit of a given service. Researchers seem broadly to agree that roughly 80% of municipal services enjoy no economies of scale. The evidence says pretty unambiguously that the lowest observable level of per unit costs for most services are compatible with *very* small municipal units (on the order of 5,000-10,000 residents). Moreover, there are significant *diseconomies* of scale beyond relatively small population numbers – on the order of 250,000 residents. And, finally, that the supposed savings from smaller councils and elimination of several city halls and other trappings of multiple local governments, is so paltry as to be not even worth mentioning.

But of course, given the culture of executive personalism (remember this means pigheadedness of the "don't confuse me with facts, my mind is made up" variety) that I mentioned, they didn't consult the literature or the research. Had they done so, they, like California under Ronald Reagan, would likely quickly have abandoned their amalgamation policy.

Instead they committed a nearly always fatal mistake – they hired a consultant. And instead of asking this consultant to review what was known about the dynamics of local government, they asked him to write an abstract report about all the ways one could, theoretically, save money if one were an omniscient manager and if there were economies of scale in the provision of most municipal services. The consultant duly told them that there were significant savings to be had at very low cost. This is not hard to do since any outsider can look at any organisation and identify ways that things could be done "better". In 1996 HRM was duly created.

Now what is interesting to note is that the HRM is an extremely valuable test case, because it is the only large scale amalgamation in North America to have been studied from the outset by a team of experts. A very great deal of what Bob Bish, one of Canada's leading authorities on local government, learned from his years of studying municipal government, and from the HRM study in particular, became the key material for his extremely illuminating paper for the CD Howe Institute a few years ago under the revealing title of "Local Government Amalgamations: Discredited Nineteenth-Century Ideals Alive in the Twenty-First."

Now before I report on their findings, let me emphasise that these results were preliminary, and the research team themselves recognised that the five years they gave themselves to study the new entity was not enough for it, and its procedures, to be fully formed.

Still, certain things are clear and I have not seen anything in the subsequent years of HRM's operation to persuade me that these early results were atypical or unrepresentative. In our work on our municipal performance report, I see no evidence that the trends I have identified have changed for the better.

So what can we see with hindsight? Well, for example, the consultant's implementation study underestimated the cost of amalgamation by a very significant margin. The final tally, including a new financial management system and labour agreements, reached something on the order of a minimum of \$40-million, whereas the estimate was under \$10-million.

No cost savings or economies of scale are observable yet, and it is not obvious that they ever will be, or where they might come from. Both taxes and other charges, as well as debt increased significantly. User charges rose and average residential property taxes went up about 10% in urban areas and by as much as 30% in suburban and rural areas in the early years, and it has got much worse since. Polling data show low levels of satisfaction with post-amalgamation services, although again it may be premature to make a strong judgment here.

Recalling the Price Club fiasco, it was clear that the business community thought that amalgamation would produce a more disciplined and efficient municipality and that this would improve the business climate. Other than the innovative public-private partnership that now looks after HRM's economic development, I haven't seen the evidence that this has occurred and it is worth noting, as an aside, that those US cities with the highest rates of economic growth count many with the most fragmented local government structure. ***There is no observable correlation between amalgamation and economic growth.*** The expectation that these two things would be correlated shows a misunderstanding of the relationship between local government and economic growth.

There is still a very high degree of monopolistic in-house provision of services, although there are exceptions, in areas like solid waste collection. An innovative public-private partnership process for the construction of a waste water treatment system collapsed, in large part, in my view, because the powers-that-be in HRM favoured in-house monopoly provision for political reasons, ignoring the efficiency losses and loss of innovation and accountability it almost always entails. Now that that system has been built, it is performing poorly and is going to have to be shut down for months this summer. Unlike with a private provider, who could have been made to pay penalties for this poor performance, the public sector monopoly sails on serene in its indifference.

## **Part II: Where should local government be headed?**

I've already remarked on some of the advantages of local government, and in particular the fact that it is the level of government most able to be relatively aware of the real concrete circumstances of their populations, and most able to see and correct the damaging and undesirable consequences of their policies. But the small scale of local governments, and having several of them, has other advantages.

For example, organised minorities and pressure groups benefit from centralised political power because that means that they can concentrate their lobbying power on a central point of authority. When power is widely dispersed to many small units of

government, it reduces their lobbying power because it is spread so thinly. Amalgamation in a large urban area, however, exaggerates the bargaining power of organised minorities in local government affairs. This is crucial to understanding why amalgamation drives up costs when previously different units, which specialised in different services to please their local population, are suddenly put together<sup>1</sup>:

“When amalgamation occurs, all the various services and amenities packages of the many individual jurisdictions get put together . . . As a matter of political reality, no municipality can long provide certain services only to one area. All the jogging enthusiasts who'd previously been outnumbered in Jurisdiction A, suddenly can turn to the new Mega-City and demand that, because there are great jogging trails in what used to be Jurisdiction B, they, too, deserve such amenities. In other words, rather than being reduced, service provision inevitably rises to meet the many tastes that had previously been separate. Cost increases, as facilities such as basketball courts are built in areas which previously had made them a lower priority. Public employment must necessarily increase, not decrease.”

In the same vein, decentralisation reduces significantly the ability of voters to pass the costs of local decisions along to larger communities, which forces voters to be more fiscally responsible. When governments cover relatively small geographical areas, it reduces significantly the cost of “voting with your feet”. It is much cheaper to move from one town or suburb to the one next door than it is to move to another province or country.

“Government, in amalgamated cities, inevitably becomes more distant from the individual voter. It is harder for any one voter, or group of voters, to influence policy. This situation works to the advantage of well-organized interest groups, with the resources to employ staff to influence policy on their behalf. Even the most zealous unpaid neighbourhood activist is little match for the full-time paid staffs of public sector labour unions, for instance, who know local officials, help elect them and understand how the system works. Inevitably, unions will, in representing the interests of their members, resist cutbacks in municipal employment. They will insist that the efficiency gains of smaller municipalities be

eliminated. Thus, for instance, if Jurisdiction A formerly paid its recreation workers less than those in Jurisdiction B, where recreation was not as important to voters, we can expect that the new amalgamated city will have just one pay scale – at the higher rate.”

The third consequence of the existence of a large number of local government units is that it allows the benefits of successful experiments to be copied by other local and even more senior governments. Decentralisation, when linked to a high degree of competition between localities, increases the likelihood of spreading local policies and practices when these are successful, and getting rid of them when they are not. Imitation is a powerful force. The London Borough of Wandsworth, to pick just one example, pioneered in the 1970s many of the innovations that later became the backbone of Thatcherism, including the hugely successful idea of selling council flats (publicly-owned housing) to the tenants for almost nothing, which overnight transformed for the better many public housing developments.

But none of these positive effects can or will be realised without a vital element of competition. Because municipal officials really don't know that much about what their local population wants, about the true costs of various services, and about the potential of new methods to deliver efficiencies and improved service levels, we need a **framework for local government** that spurs competition, and ends rigid monopolies in the supply of local government services.

Competition is how we find out what works. Only people who do not understand how to satisfy consumer tastes and preferences would look at the existence of Wal-Mart and Target and Costco and Canadian Tire and say, “Look at all the wasteful duplication of services, capital facilities, management, inventory, etc. Let's have a single giant store to service everyone.” This is the Soviet model of consumer choice. Inevitably such a system is run in the interests of management, not customers.

At the local level, competition takes place on two dimensions:

First, there is competition within municipalities. By this I mean that the most successful municipalities, places like Charlotte, North Carolina, Phoenix, Arizona, and Indianapolis, Indiana, are more and more getting out of the game of directly supplying traditional local government services where local government employees under a rigid contract supply individual services, such as garbage collection or sewer and water services, to the residents of an entire city as a typical public sector monopoly. There is now an association of so-called “contract cities” in the United States where municipalities provide almost no services in-house, and act instead as a purchaser of services from many competing suppliers on behalf of their population. A former Local Government minister in the UK once famously remarked that his ideal local council would only meet once a year to approve contracts with suppliers of services for the coming year.

So the model that is emerging is of a much smaller local government that acts as a kind of buyer’s co-op on behalf of the residents of the locality, an experience that dovetails nicely with the Prairie history of reliance on co-ops throughout rural areas. Service standards are set, and contracts are let on the basis of those standards, to competitive bidders. The winning bidder is then held accountable for his success or failure in reaching the agreed standards. The question of whether the service is provided by public sector or private sector workers and managers is actually becoming irrelevant.

Naturally the monopolists are the ones who resist the most, and especially large centralised service provision bureaucracies and their associated public sector unions, but the benefits are so great from contracting out and privatisation – as Jim McDavid at the University of Victoria, Local Government Institute has been instrumental in documenting with respect, for example, to garbage collection – that the momentum is clearly with the reformers.

The other kind of competition that it is vital to preserve is that *between* municipalities on the local level. One of the things that drives local government toward reform is the ease with which people vote with their feet. One strategy for frustrating this crucial means of disciplining and controlling the quality of local policy and holding local officials

accountable, is to expand the boundaries of local government to such an extent that the costs of getting away from bad government become prohibitive.

This movement toward what we call municipal amalgamation is driven, ironically, in many cases by the business community, who believe that we have “too many governments”, resulting in “overlap and duplication”. Surely, it stands to reason that having only one mayor, one council, one city hall, and one public works department would save money and promote efficiency.

But as the evidence I’ve outlined here clearly shows, being big in itself is no guarantee of anything and, as I have already remarked, research in local government leads us to think that at least 80% of municipal activities offer little prospect of economies of scale (i.e. saving money because you are bigger).

In fact, there are good reasons for thinking that bigger government will be less efficient and responsive, not more. Certainly in the private sector thinking is running the other way, as the break up of business giants releases hidden value in their assets. We have seen this, for example, in the decision of companies like Telus to sell many of its large office buildings, because they argue that they are in the telecommunications business, not the property management business. Almost all conglomerates trade at a discount to the value of their component parts, which has driven many of them to break themselves up in one way or another. And of course in the municipal world we know now that the experience of amalgamation has been to drive costs up to the highest level, rather than down to the lowest.

So if single-tier amalgamation isn’t the answer (although remember what I said about the GVRD), what is?

The province can usefully play the role of stimulator of competition between local governments, as we see in the UK, New Zealand and Australia. Local governments undergo regular audits, where service levels and taxation levels are compared, permitting the publication of league tables and other instruments of accountability that grant to local voters much greater insight into the performance of their local

government and hence more means to hold them accountable. Research indicates that people and businesses that move from one municipality to another are actually quite knowledgeable about the conditions in both their old and new municipalities. Our Institute has just released its own performance report for municipalities in Nova Scotia and New Brunswick, and has prepared one for Maclean's magazine on the 30 largest municipalities in Canada. Our hope is to introduce and stimulate exactly this kind of competition between municipalities by increasing the knowledge of voters and taxpayers about what they are getting for their money.

It is important here to signal that it is not only senior government officials who act irrationally. I know because I could show you the knife scars on my back from the many angry municipal officials who are outraged and resentful that anyone would dare to gather information and report on their performance. My advice to them (and you can take this advice if you think it applies to you) is to 'Get Over It'. In fact, if your future is threatened by politicians at the senior level who hold the power of life or death over you, you shouldn't wait to fight a rearguard action against policies they've already decided. Take the initiative. Tell them and your own citizens and voters that you take performance seriously and that you intend to be measured against the highest, most stringent levels of public performance. Don't resist the drive to open up local government, or to collect important and useful performance data, and to use that data to make meaningful comparisons between municipalities based on those comparisons. My view is that your lives depend on it.

We must create a customer-service oriented culture in our municipal governments, something I have not seen much of anywhere in Nova Scotia. We must align the incentives of our elected officials so that they get rewarded for providing efficient, high quality services. This means we need them to focus on defining service levels, measuring them and rewarding superior performance by service providers.

Consider, again, New Zealand's cities, which Larry Mitchell has spoken of so eloquently. There performance pay is a significant portion of the management's compensation. Cities set goals or outcome measures that are important; they might say

that they will turn a building permit around in a week or fix a pothole in 24 hours. With sophisticated measurement systems, the services actually provided are benchmarked against such standards. Achieving performance goals, or continuous improvement against ever rising benchmarks, results in pay bonuses for management and employees. It is no longer about spending budgets or losing them, or prolonging and complicating service to minimize effort or maximize overtime.

In Indianapolis, unionized in-house providers actually proposed and benefited from an internal system called gain sharing where 25% of all savings beyond the bid price went to employees. With their eye on the ball of efficiency and good service, they out-competed the private sector several years ago and became the most successful municipal employee union in the U.S., winning the highest pay increases in that country.

High performing entrepreneurial communities measure their services in terms of what they get for their money, not on what they spend or how many employees they have. That way we can measure and reward performance. The employees, management, present and future citizens and taxpayers all find their interests looked to and positive behaviour rewarded. The behaviour that would be rewarded, by the way, would include creation of a co-ordinating tier of government for spillover services that allows economies of scale to be captured in those limited areas where they do exist.

One final observation about irrationality: the financing of much of our local government infrastructure (parks, roads, water, sewers and the like) is economically irrational and it poisons relations between the municipalities and both provincial and federal governments. I can't speak to the experience in Alberta, but I can tell you that I spend a lot of time in Nova Scotia giving municipal leaders this message: for God's sake, stop whining about downloading and underfunding. In many cases you have the power to fix these problems yourself but shrink before the political fallout. Then don't come crying to me when senior governments decide you can't get the job done.

Many municipal services are provided to consumers at considerably less than the real long-term cost, on the assumption that politicians at senior levels will pick up a significant part of the tab after the infrastructure's useful life is over. The totally predictable result is both that infrastructure is poorly maintained and that use of the infrastructure is much greater than if consumers had to pay the real cost of that use. Hence the fact that, for example, a great deal of municipal water in Canada is still unmetered and people pay a flat fee regardless of consumption. A formula guaranteed to encourage heedless consumption of water as well as egregious waste.

It is thus absolutely essential that we do something that Larry Mitchell constantly reminds us of: "separate capital and operating budgets for efficient, transparent and accountable capital investment" as well as "carefully constructed cost-benefit analyses" so that costs and benefits are correctly and completely documented and "co-ordinate capital projects between local departments and special purpose bodies such as utility commissions" so that, for example, road and water main maintenance and repair are jointly planned. Stop doing all that stopgap maintenance. It is costly and inefficient in many cases compared to doing the proper long term maintenance and repair. We all know that politicians prefer projects that will happen before the next election, but proper accounting, public reporting and other accountability measures would reduce this temptation.

But the difficulty in achieving these common sense recommendations is nothing compared to the key piece: "municipal infrastructure should be financed, as far as possible, by the residents who benefit from it, because this provides the surest guide to how much should be invested in what."

This recommendation, which comes from one of Canada's leading local government experts, Harry Kitchen, however sensible and essential it is, butts up against the reality that local politicians regard it as a matter of commendable machismo that they can arm twist politicians at senior levels of government to pony up for their pet projects, with the result that the projects are often delayed by political wrangling and the final outcome is serious overbuilding relative to what is really needed. Ottawa thus contributes to the economic irrationality of municipal infrastructure by

essentially bailing out local governments who have failed to account properly for their infrastructure and failed to make people pay the real costs of their use of that infrastructure and now find themselves with their pockets empty when the infrastructure reaches the end of its useful life. As Harry Kitchen so delicately observes "Economic arguments in support of capital grants are not strong. Their use should be conditional on recipient governments setting efficient user fees, prices and local taxes for services provided. As well, recipients should have proper asset-management programs, along with requirements that asset replacement costs be included in the charge for services."

Now I know that many of you will object that municipalities have to share the property tax base with e.g. education taxes, and I agree that this is a problem. However, the point I have been making is that, where the law allows, there are lots of mechanisms that allow the financing of infrastructure beyond the property tax base. Ditto for borrowing, again where the law allows. Where a piece of infrastructure has been subjected to a rigorous cost-benefit analysis and you are satisfied that it will provide a stream of genuine benefits that exceeds the capital cost over the life of the project, you *should* borrow to finance it, since it makes no sense to make today's taxpayers foot the bill for benefits to be enjoyed by future citizens. Borrowing is a way to distribute equitably the cost of the benefits enjoyed across the entire life of the infrastructure. Borrowing also allows you to cross the divide between today's system, where we have allowed the capital stock to deteriorate and not set aside any reserves to replace them, and tomorrow's where we will charge people the full cost of the infrastructure (and many other) services they consume.

There is lots that could be said about the right way for municipalities to finance long term investments, including multi-year capital budgets and dedicated fund accounts, revenue bonds, their own gasoline tax (not a transfer from Ottawa's tax), parking lot taxes, congestion and toll charges and much more use of P3s. This, however, is not the place to do so. What I can say, however, is that if you want senior governments to allow you to survive, wrong-foot them by demanding that legislation not only allow but require such measures in order to ensure that municipalities can do their jobs and not constantly be crying poor.



Public sector competition, like private sector competition, is not “wasteful”, but is a healthy discipline that promotes efficiency, accountability and good service. Such competition, where it has been introduced into local government, has transformed it for the better. That’s a lot more than the evidence suggests we can say about most of what passes for local government reform in Canada.

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<sup>i</sup> I am indebted for some of the following paragraphs to “Why Bigger Local Government Isn't More Efficient: The Case for Breaking up Cities” A talk given by Howard Husock, Director of Case Studies at John F. Kennedy School of Government, Harvard University, on Friday, May 18, 2001 at Montreal's Omni Hotel.



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