New Rules for Key German Non-Profits: The Services of General Economic Interest

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Introduction: Quantum Leaps

So-called "services of general economic interest" in Germany are analogous to the non-profit organizations in North America that operate services mandated by governments. In Germany, these organizations are primarily sponsored by municipal enterprises. The owners of these enterprises are cities and rural districts. They represent an innovation that could well promote more efficient and effective service delivery in the public sector. However, these entities are currently challenged by new thinking about governance that may be counterproductive.

The first quantum leap in the local economy took place in Germany in the 1920s and 1930s. It culminated in the Municipal Undertakings Order of 1938. Through it, ancillary municipal enterprises for "the economic activity of the local communities" were hived off from official administration, the budget plan, and governmental accounting, and were made independent. Although the municipal enterprises that arose at first did not have a distinct legal identity, they did have their own management bodies -- namely works management and works committees, as well as their own financial plans and commercial accounting. In many places after World War II, a process of gaining legal independence for these enterprises began with forms of private law initiatives. The municipal enterprises became *Eigengesell-schaften*, limited liability companies owned by local authorities. These changes also made it possible for private investors to be able to hold shares of these companies. At the same time, similar mixed-economy activities, such as these municipal enterprises, developed in all of the old EU Member States. Currently, the new EU Member States are catching up with this process of "breaking up," or diversifying their service delivery mechanisms, and in part this includes providing new opportunities for private investors.

Both the old and the new Member States currently see themselves confronted with a further quantum leap. It is called "market opening," or what is referred to as privatization in North America, and it is replacing the state-run logic of local governments which, until recently, provided their own means of completing tasks assigned to them. In its place will be the liberalistic logic that relies on the market forces and competition. Government at the local level is experiencing a metamorphosis: it is being transformed; its design and monitoring functions remain, while the actual "services of general economic interest" (Art. 16 and 86 of the Amsterdam EC Treaty of 2 October 1997), or non-profit organization, are subject to the "principle of an open market economy with free competition" (Art. 4 para.1 EC Treaty). In addition to the rendering of services determined by local policy in the main areas of electricity, gas and water supply, as well as public transportation, there are also a number of other local public service sectors that private competitors are currently entering which are now being guided from the demand side of the economy. Examples include: sewage removal, waste disposal, housing, trade fairs, tourism, technology and economic promotion, health care, social services, cultural institutions and credit management.

This development of *de-nationalization and de-politicization* in favour of competition and commercialization may be welcomed or rejected, but one thing has to be taken into account in the meantime: that is the fact that "services of general economic interest" (that is, non-profit organizations) are also an option in the future for those areas of service where individual and, at the same time, collective needs must be covered.

New Governance

This change has serious consequences for the local governments whose political-administrative involvement in the municipal enterprises is weakened. These enterprises are now more strictly subject to market mechanisms, as well as cost and performance pressures. This results in the local authorities asserting themselves as the supporting agencies of enterprises and the municipal councillors, and they must work out *strategies* with the managers of the enterprises and set them out in *agreements on objectives*. The primary issue is the fact that the approaching predominance of market requirements, in combination with the prohibition of competition-distorting state aid, leads to a situation where even more senior governments are having to purchase politically desirable services in relation to type, extent, quality and price, and in some cases, even from the local authority's own enterprises. The previous ruling and monitoring, in the sense of governance, is making way for a new governance which now strives only for strategic goals and measures the achievement of those goals. It could also be said that the directing is less detailed and people-related, and is now based on abstract principle and paper relevance.

Admittedly, the basic identity of municipal enterprises may not necessarily be sacrificed with these changes. The municipality is a partner ("shareholder") with ownership rights that can be exercised and the municipal enterprise trades in the services required by the community, which is the general public, while servicing that community ("stakeholder"). Substantial maintenance of local government's power in the area of "services of general economic interest", or non-profit organizations, therefore requires *new reflection* on the way municipal tasks are fulfilled. This challenge is not so much a matter of the nature of the public tasks themselves, for they prove for the most part to be undisputed and justified by the public interest.

In the following sections, the ways in which the delivery of services may change will be outlined using five criteria: the subsidiarity principle, competitive tendering, the locality principle, mandatory market investigation, and accountability.

The Subsidiarity Principle

The subsidiarity principle refers to those local authority economic activities that are under the purview of the private sector. According to the subsidiarity principle, public tasks can only be exercised under local government if private offers do not suffice. Behind this the *view of the theory of regulation* is concealed, according to which private businesses in the market and a competitive economy work "more efficiently" than politically-administratively guided local authority undertakings. "Efficient" here means successful dealings of a kind, such that the competition leads to products of high quality and low prices, and the enterprises obtain profits as a result.

This efficiency concept, for the fulfilment of public tasks, proves to be too one-sidedly related to private goods. For the fulfilment of public tasks it is not only a matter of success in the market that matters, rather *viewpoints external to the market* also play an essential role, such as "services of general economic interest" (non-profit organizations) or the municipality's task of guaranteeing them in the public interest. With "services in the general economic interest" (services provided by non-profit organizations) it must be noted that they

are offered generally and are accessible to all by social contract, continuously, lastingly, safely, with quality, transparently and with environmental compatibility.

The subsidiarity principle may not lead to a situation such that the *product characteristics* entrusted to local governments are sacrificed for market requirements. If market opening (privatization) is also understood in the sense of a transformation of these product characteristics, which until now were politically determined and were far from market influences, into service offers that are determined by the market, then it follows from this.

In the investigation as to whether and to what extent private businesses are capable of fulfilling local authority tasks better or as well, special attention must be directed to these product characteristics. On the part of the local governments "marketing" will be used – that is: equivalency of service and service in return. It must be asked how expensive the product characteristics ordered will be for the citizens and the local authority budgets? Payments and settlements will thus acquire increasing significance. For private undertakings, which can be led by formal objectives and which strive for substantive objectives such as customer orientation, performance and competitiveness for the sake of the formal objectives, now societal and ecological, generally *meta-economic objectives*, become relevant. In accordance with the objectives decided by local authority's policy, the entrepreneurial performances must be calculated and offered.

Since as a rule, municipal enterprises derive their legitimacy from their public purpose, the various substantive objectives have always possessed a high, usually even the highest, value (and the striving for profit and profitability only forms a subsidiary but indispensable condition). The opportunity for municipal enterprises lies in the *quality management of the substantive objectives*. Here they can bring in their many years of experience, and do not need to fear any competition, if they combine their "commercial exploitation" with improved marketing. Viewed in this way, the subsidiarity principle first takes hold where the orientation toward formal objectives dominates. In this case private undertakings may usually do better than municipal undertakings.

Besides this, people are also happy to bring in the subsidiarity principle because they hope to foster medium-sized private undertakings. Doubts arise regarding this, because a smaller or medium-sized private firm will hardly be in a position to comply fully with the required product characteristics. Larger private firms, with successes in other cities, are more likely to profit from these situations. To this extent the subsidiarity principle *promotes concentration*. Another question must also be asked, when a private firm is present. Does a mixed-economy enterprise count as one and how should a foreign state undertaking be categorized with regards to its subsidiary companies?

Competitive Tendering

European contract law requires that public clients, independent of their legal form, call for a tender for services and work performance that exceeds a certain threshold. The *public client* scenario is assumed when it is a question, for example, of a municipal stock corporation. There is also mandatory tendering either for legal entities whose management is supervised, or for which half the managers are determined, by a local government. Through this regulation, even a local authority cannot escape tendering by using a municipal enterprise, because if necessary it too will be subject to mandatory tendering.

People hope to obtain from tendering, and tendering competition, increased competitive pressure between the suppliers, low procurement costs and an assessment of performance

which is suitable to the market. In the model of the perfect market, people can count on these positive effects. What happens, though, with *an imperfect market*? With longer-term incomplete contracts, which are characteristic for infrastructure services, the transaction costs increase sharply, as a result the lower procurement costs achieved through tendering are in some cases overcompensated in the long term. It must also be assumed that among the competition only a small number of potential suppliers are suitable for the fulfilment of public tasks. It will not be easy for private suppliers to suppress their strive for profit in favour of quality and other substantive objectives. A continuous and lasting provision of service, which guarantees access with equal rights to the users, has priority. Having very few suppliers leads to oligopolistic ways of behaving and, under some circumstances, to agreements on conditions and prices. The following scenario is conceivable: the municipal service corporation and a big private electricity corporation apply for the contract to complete the public task. If the latter loses in this and in other supplier competitions as well, it can cope with it. In contrast, a single, or especially a repeated non-granting to the municipal enterprise will affect its very existence. At the least, smaller and single-sector undertakings of the local government will then become marginal operations and will then be eliminated from the market.

The fulfilment of a public task is also affected in another way by the tendering competition. With "services of general economic interest" (non-profit organizations) there is a danger that the *minimum standards in the substantive objectives* will be set as low as possible in the tenders, so that there is a better possibility of profit resulting in incentive for applicants to take part in the supplier competition. If people are not satisfied with this, they either have to demand higher standards in the substantive objectives and pay for them, or they have to give them up, renouncing the essential content of the public task.

The *conclusions* from these objections are obvious: with the tendering competition local governments and municipal enterprises must pay special regard *first* to the substantive and formal objectives and their interdependencies, and readily express this in the call for tenders. *Second* it is important to set the opportunities and the risks of contracts, namely the rights and obligations of the partners (rights concerning notification, liability regulations, guarantee clauses as well as market and operating risks, subsequent negotiation etc.) – knowing full well that such requirements, with respect to product characteristics, are difficult to put into operation. This is why mediation and arbitration procedures should be a component of the contract straightaway. *Third* the subjective capability of the competitors must be compared to the objective requirements. For the fulfilment of public tasks, value must be given to the upholding of contracts and the law by institutions and people, and reliability of the supply of the service and the release of the product; this means punctuality, constancy, endurance, through to flawlessness and honesty. These criteria should play a major role in awarding contracts, to which it is also evidently entitled, as is well known, with confidential goods.

Locality Principle

The activity of municipal enterprises used to be restricted in principle to the area of the local authority; but in part they also took care of municipalities in the surrounding area, so that instead of the locality principle it would be better to speak of the regional principle. The limitation was justified with the congruency of local authority supervision, local self-government and regional sovereignty, as well as with public budgets and liability risks. The new competition rules for local authority's economic activity – key word: market opening – has made this restriction obsolete. The economisation leads as well to *spatial opening*. The growing together of cities, the streams of people settling down and moving out, the exercise

of central local functions, regional planning, care and disposal concepts, transport associations, economic promotion, etc., have all shifted the mass of arrangements and expanded the local sphere of activity to a regional action radius. The municipal enterprises have acted and reacted in relation to this expansion of the business region with the use in synergy of company sizes and the advantages of associations. Two lines of development are noteworthy: on the one hand municipal enterprises have strengthened their independence through inter-communal cooperation and through mergers, often also by taking on private partners; on the other hand, they have joined large joint businesses and received company shares for this.

From all these cases one consequence has resulted: the so-called *in-house transactions* – that is, agreements between local governments and municipal enterprises without tendering – are hardly possible any more. They occur when the city or rural district is the sole owner of the undertaking and is thus able to control it like one of its own departments, and the municipal undertaking essentially works only for the local government and not for third parties. Since these prerequisites can be met less and less often, spatially opening up beyond the borders of the municipality is resulting in the release of mandatory tendering with the effects described.

Mandatory Market Investigation

The opening up of markets in favour of private enterprises, combined with supplier competition and the spatial opening that is starting to also work for municipal enterprises – to a limited extent – outside the region of the local authority, require the local governments to conduct market analyses. Before taking up a local economic activity, the market environment must be investigated with respect to opportunities and risks with regards to their activity; in addition their effects on private suppliers must be estimated. Moreover, it may also be required that the existing municipal enterprises be investigated from time to time, in terms of the justification for their existence and material privatization. The results of such a market analysis will reveal the strategies of municipal enterprises. Besides the expense for analysis, municipal enterprises experience *competitive disadvantages* when their medium- and long-term objectives as well as planning become clear.

Accountability

In the next few years the economic plans, the accounting, reporting and auditing for municipal enterprises will change. The *requirement for change* has two bases: *First*, international development is leading to a harmonization of public accounting methods for local governments, which are emulating the commercial accounting methods in structure and assessment while aspiring to a consolidation of the local government units with the municipal enterprises. The International Financial Reporting Standards (IFRS – abbreviated formerly to IAS) are gaining in their significance for accounting and indirectly also for budgeting; the presentation and auditing of the capital, financial and returns position are being oriented toward the International Public Sector Accounting Standards (IPSAS); the accounting objective of "decision usefulness" and the "accrual basis" have the consequence that a "true and fair view" or "fair presentation" results. This means that the trade law balance sheet and choice of valuation law which was guided by the protection of creditors is being replaced by new accounting principles, which impart a picture corresponding to the actual relationships in the interest of shareholder protection.

Due to the nature of the public tasks of municipal enterprises – more precisely: the *guarantee of the public purpose through business management* – in addition to the investigation which will be conducted to determine whether the management is taking place in compliance with the general regulations in the local economy. Among the duties and responsibilities of the management of municipal enterprises are the establishment of an early warning system for risks and internal monitoring which will allow for appropriate risk management. The auditor of the annual accounts must also report on this in the audit report.

Second, the growing need for information by different interested parties is leading to a situation where the municipal enterprises will increasingly establish controlling and reporting systems. Sound indexes, comparative values, quality and effect indicators, which are understandable and meaningful to the decision makers and stakeholders in the municipality, must be made available. However, a business report that explains and complements the number values of the balance sheet as well as profit and loss accounts while reporting on the situation of the undertaking is not sufficient. In addition, data on the cash flow, in the form of capital flow accounts, and the turning over of accounting to work areas, in the form of sectors report, are not enough, because they also relate to formal objectives and actual sizes.

In addition, municipal enterprises require accounts and reports that give information about substantive objectives and their achievements. With social and ecological reports as well as social and ecological balance sheets, attempts are being made in theory and practice, including in the private economy, to supply corresponding proofs. What is at stake and what should be on the agenda, in particular for the municipal enterprises, can be expressed simply in this way: their successful work will be measured according to the extent to which they have fulfilled *the public task with provable effectiveness and efficiency*. But the new regulations do not give these aspects any priority; market success is seen as the yardstick for the local government's economic activity.

It is up to the municipal enterprises to think over the nature of their task, to work in the service of local government, and to survive in competition with private competitors, while commercial success is made more difficult under these conditions. The restrictions of European law, national local authority, and budget law certainly narrow down the behaviour options for municipal enterprises; however, they should *offensively assert their strengths* – that is, act in the general interest of the local economy and not manage themselves like private enterprises, which pursue their own (legitimate) interests.

About the Author

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