

Debate on cost allocation in the municipality of Statendam¹

It started with a letter

Statendam, November 5, 2001

To: Henk Jacobs, director finance department

From: Bob Jansen, manager refuse collection department

Dear Henk,

Someone told me that you had to see the teachers of one or your children last night, so you could not be present at the council meeting. Well, you have really missed something! The Conservative-Liberal Party seized the opportunity to use the 2002 budget for an attack on the municipal privatization policy. My department was seen as a possible spearhead of a new policy. The Conservative-Liberal Party thinks that only financial considerations should determine whether a municipality performs its duties itself or leaves them to the market. The Conservative-Liberal Party has conducted a small survey to compare the refuse collection rate for private persons in Statendam with the rates of four municipalities of similar sizes. Two of these four municipalities have contracted refuse collection out to a private enterprise and the two remaining municipalities work together with other municipalities in a joint refuse collection scheme². Table 1 shows the figures presented by the Conservative-Liberal Party.

Table 1. Refuse collection rates for private persons in different municipalities (2001)

| Approach to refuse collection, a municipal duty* | Refuse collection rate (waste collection levy) per household |
|---|--|
| Refuse collection, a municipal duty, contracted out to a private enterprise | €190 to €197.50 |
| Refuse collection through a joint scheme of a number of municipalities | €202.50 to €17.50 |
| Refuse collection by the municipality itself, i.e. Statendam | €209 |

* The services offered by the municipalities mentioned above hardly differ, as far as I can tell. All the municipalities collect different kinds of waste separately, i.e. vegetables, fruit and garden waste are composted and other waste goes to the regional dump. Waste is collected once a week and people can dispose of special kinds of waste such as glass, cartons of juice or milk, etc., and household chemical waste at the usual places. All the municipalities in Table 1 use rates that cover the costs involved. In addition, Statendam and the other municipalities use separate rates for the collection and processing of industrial waste.

The group leader of the Conservative-Liberal Party thinks that his survey demonstrates that Statendam should contract out refuse collection. If the VAT-exempt status of public services disappears in the future, contracting out will become even more advantageous, according to the Conservative-Liberal Party³.

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² A joint scheme is a collaborative arrangement made by a number of municipalities to perform a particular municipal duty together; a joint scheme is a public body.

³ At this moment, government organizations do not have to pay any VAT on services provided internally. If such

You know that I have no fundamental objections to contracting out government tasks. However, I do think that discussions about this subject should be based on solid facts and figures, and our council's discussion is not. What the Conservative-Liberal Party is doing in its little table, is comparing apples and oranges. It is reasonable to compare the rate of our municipality with that of a municipality in a joint scheme, but it is unfair to compare it with the rates of private enterprises. And why is that? Well, the overhead costs of private enterprises are almost negligible; only the cost of employing a director and keeping accounts, that's it. Quite a contrast with the overheads of a municipality. Our accounting system has to meet all kinds of government regulations, which makes it expensive. And we have a costly administrative system, i.e. municipal council, municipal executive, and support staff. What's more, my department is really at a disadvantage because of the way our organization's overheads are allocated. All the overhead costs are added up and then each department is allocated overhead costs that are proportionate to the number of employees in the department in question. This calculation method puts my department at a disadvantage. A relatively large number of people are employed in my department, while we hardly use support services in such areas as housing, automation, financial policy, personnel policy, financial accounting, and human resources. And my department is hardly a burden on the administrative system. I submit my budget and report twice a year. And that's it. My department is very seldom involved in complex projects, which tax the administrative system.

When the Conservative-Liberal Party was carrying on yesterday, I was quite disheartened for a moment. I am running an efficient department which can hold its own with its competitors, including private enterprises. I can prove that our labour productivity and the utilization ratio of our fleet are excellent. But I may come off badly because I am saddled with far too large overheads. This is not fair, admit it. That's why I want to ask you to do me a favour. Next week the alderman has to be well prepared for the council's discussion about privatization proposals. I could write a policy document for the alderman, but it would not impress many people. They would probably think I was a bit biased. For that reason, I would like you to provide the alderman with information that shows that we are not more expensive than private enterprises at all, as far as refuse collection is concerned.

Please let me know what you are going to do.

Best regards,

Bob

Suggested assignment 1

You are the director of the finance department. You know that in a few days' time the alderman will have to be provided with information which she can use during the municipal council's discussion about privatization. You also realize that the tricky overheads problem will play an important part in the discussion. There is not enough time left to look into the municipality's overhead costs and you are too busy to write a detailed report on this subject, although you could come up with a few essential considerations. Your assignment is to write them on one sheet of paper.

Analysis

services as cleaning, catering, and refuse collection are bought from external suppliers, VAT will have to be paid.

A month has passed since the council debated the overhead costs of refuse collection. Bob Jansen has had enough time to do some calculations for himself. As far as the ‘products’ collected are concerned, he distinguishes two cost centres (which are products), namely:

- tonnes of refuse collected and processed for private persons;
- tonnes of refuse collected and processed for businesses.

In addition, he distinguishes three so-called cost pools. The first two relate to the overheads of the municipal organization as a whole, to which he referred in his letter of November 5, 2001, and the third cost pool relates to the overheads of his own department:

- central administrative department (personnel, finance and information); annual budget of €1.6 million;
- central coordination (political management and central management of the municipality); annual budget of €1.1 million;
- management of the refuse collection department and planning its activities; annual budget of €0.3 million.

At present each department is allocated costs from the first two cost pools that are proportionate to the number of employees in the department in question (expressed as a full-time equivalent (fte)). The total number of employees of the municipality to which the costs from the first two cost pools are allocated amounts to 550 ftes; the number of employees in the refuse collection department is 99 ftes. Each of the two cost units is allocated costs from the third cost pool that are proportionate to the work done for the cost unit in question, i.e. about 70% of the work is done for private persons and about 30% for businesses. Table 2 contains the number of tonnes and the direct costs for each type of waste for the year 2001.

Bob Jansen starts his calculations by determining full unit costs per tonne of waste, for private persons and for businesses. To that end, as is customary in his municipality, he decides to allocate the central overheads (i.e. overheads from the first two cost pools) to the two cost centres proportionate to the tonnes of waste collected for private persons and the tonnes of waste collected for businesses respectively.

Table 2. Number of tonnes and direct costs per type of waste (2001)

| Type of waste | Number of tonnes | Direct costs |
|-----------------|------------------|--------------|
| Private persons | 21,000 | €2.6 million |
| Businesses | 14,000 | €0.9 million |

Assignment 2

Please calculate the full unit cost per tonne of waste from private persons and that per tonne of waste from businesses, using the data mentioned above.

In 2001 the average amount of waste per private person (i.e. per house) amounted to 1,415 kilos (= 1.415 tonnes). Bob Jansen now wants to know how much the central overheads allocated to his department have to be decreased in order to arrive at a full rate per household which might meet the Conservative-Liberal Party’s market-based requirements (see Table 1).

Assignment 3

Please show how much the central overheads allocated to the refuse collection department have to be decreased in order to meet the market-based requirements mentioned above.

Please suggest how this could be achieved by changing the apportionment keys for the first two cost pools. A few tips:

- *use Bob Jansen's letter for your suggestions;*
- *discuss to what extent the cost allocation principles for support department costs and joint costs apply to the first two cost pools.*

Implementation

The municipal council's discussion about the privatization of refuse collection, a municipal duty, has not resulted in clear conclusions. A majority of the municipal council has passed a motion in which the municipal executive is instructed to look closely into the overheads problem. The director of the finance department, Henk Jacobs, is in charge of this inquiry. He is due to report back within four months.

Assignment 4

Please outline a possible decision-making process concerning the allocation of overheads. You might choose different cost allocation principles for the various cost pools. Indicate too how, after one or more cost allocation methods have been selected, cost allocation should be implemented.

Why 'integral management'?⁴

After Henk Jacobs has completed his inquiry, the municipal executive and senior officials have heated discussions about the municipality's cost allocation policy. The key question is: should municipal departments be able to influence the size of the overheads allocated to them. Henk Jacobs suggests in his report that a considerable part of the overheads allocated to each of the departments should be proportionate to the number of employees working in the department in question. Several of the municipality's managers are in favour of this. For this reason, they do not like the response of the alderman for staff matters, Linda Tolsma. She says:

'At the beginning of every council term, I come to an agreement with the public sector personnel unions on the number of people employed by our municipality. Last time I agreed to decrease the number of employees by 5% (from 620 to 590 ftes). After such an agreement has been made, it is translated into so-called target numbers of employees per organization unit (i.e. per department) on the basis of policy-based proposals for new policies and savings. I cannot face the unions if the agreement has not been honoured. If you, as managers, were free to deviate from fixed target numbers of employees, for example to decrease the size of the overheads allocated to you, then I would run the risk of ending up with a total number of employees equalling 570 ftes instead of 590 ftes. Well, that would be a disaster. So I think you should stick to the agreements on employment that are reached at the beginning of each council term. The matter can be reconsidered before a new council term. And another thing, it is vitally important to prevent any unrest in our organization, so we must see to it that we do not have to negotiate every single adjustment to the number of employees with the unions. The kind of complete agreement I make gives a sense of security and clarity, not only to the employees, but also to us.'

⁴ Integral management can be defined as assigning full control on policy making, policy execution and available means to managers, within boundaries set by the municipal council and executive.

The head of the welfare department, Richard van Delden, is speaking for many of his colleagues when he says:

'How can you be held accountable for providing services and products and for managing the money involved if you are not given a free rein to decide for yourself how you are going to use your resources? The costs involved include not only your own costs, such as the direct staff costs of your department, but also the support department costs that are allocated to you. In this municipality all of us have decided to use integral management. So we are supposed to be fully accountable for both the policy-based and the financial aspects of the work done by our departments. If I interpret the alderman's response correctly, we are going to be judged on the products agreed on, although our hands are tied by the agreed way of using resources. I am not allowed to use freelancers for certain projects, for example, although it would be a good idea - even if their hourly wages are a bit higher than the permanent staff's. If my department was allowed to use freelancers, it would not run the risk of understaffing and it would be not be allocated so many overhead costs.'

Assignment 5

Please analyse the above discussion. You should use responsibility accounting principles and should also try to find a solution to the differences of opinion described above.