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ABSTRACT

This paper provides a detailed examination of "contracting," a type of privatization, and is intended to clarify the issues surrounding decisions to privatize public services. Privatization introduces competition among market participants as a means of generating revenue, spurring development of an industry, and/or improving the quality of services at a lower cost to taxpayers. Contracting is where the government purchases services from the private sector through a competitive bidding system designed to force down costs. Contracting is also intended to increase accountability based on performance. Opponents claim that only the government will truly protect the public interest, but there have been an increased number and focus on contracting initiatives at the state and local level over the past 30 years. Even so, a government's decision to contract a service is difficult. It requires significant evaluation and complex planning and includes such basic questions as what effect the contract will have on the community and local businesses. Several obstacles have regularly impeded the progress in contracting initiatives, but the main obstacle is resistance from public employees who would most likely be replaced by the contracted vendor. The decision to contract thus tends to be affected by political, economic, and social pressures, all of which weigh on the initiative differently. (Contains 16 references.) (RJM)

A Primer on Privatization

Seth J. Menell and Richard P. Phelps

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Privatization

Privatization is the process of shifting a function, either in whole or in part, from the public sector to the private sector. The most common forms are *asset sales, deregulation, contracting* and *managed competition.*[i] *Asset sales* are divestitures, in which government sells assets to the private sector in order to generate revenue or spur private sector development. Similarly, *deregulation* opens 'public services' to competitive private delivery (common in utility industries for example). *Contracting* entails competition among private companies in a bidding system to perform traditional government activities, such as sanitation or highway maintenance. *Managed competition* extends contracting to include competitive bids from government agencies.

The decision to privatize public services involves both macro and microeconomic factors. According to S.H. Hanke, the most frequent macroeconomic objectives of privatization include:

> (1) the improvement of the economic performance of assets or service functions concerned; (2) the depoliticization of economic decisions; (3) the generation of public budget revenues through sale receipts and taxes; (4) the reduction in public outlays and borrowing requirements; (5) the reduction in the power of public-sector unions; and (6) the promotion of popular capitalism through the wide ownership of assets.[1]

On a microeconomic level, the decision is based on improving the quality of service, reducing costs to taxpayers and increasing accountability. In either situation, the decision to privatize is rooted in the intent to protect the public interest, and competition is the facilitating process.

Privatization introduces competition among market participants as a means of generating revenue, spurring development of an industry and/or improving the quality of services at a lower cost to taxpayers. The government can thus concentrate on other areas in which it is most effective and essential, while ensuring the delivery of other traditionally public services.

The private sector (according to theory) enjoys several advantages over the public sector, which facilitate the achievement of these goals in the competitive marketplace. First, because the private sector operates predominantly on a profit incentive structure, companies focus on minimizing costs and maximizing productivity and efficiency. Improving services and lowering price attract consumers and customers; failure to do so will lead to a company's replacement or removal from delivering the service. Second, the private sector has more flexibility to respond to change (in consumer behavior, demand, cost, etc.) than does the public sector, which allows companies to be more attentive, respond faster and be more accountable for their performance. Third, the private sector encourages innovative strategies and new ways of performing tasks; competition provides the motivation and arena for such strategy. Moreover, public management is constrained by layered authority, mandatory reviews, civil service rules, formal bid procedures, and so on; private management is not.[2] Last, a heightened

[i] Other types include load shedding, volunteerism, self-help, user fees, franchises, vouchers and grants/subsidies.

demand for accountability for performance is also increasingly likely with competition. In a competitive marketplace, customers can always look elsewhere for goods and services if unsatisfied with their current provider. Competition forces participants to improve quality, cut costs and assume accountability for performance, and thus creates a more productive and efficient marketplace. Privatized services are believed to create a more efficient delivery of services than those commonly provided through the government's monopolistic delivery because the inefficient are weeded out through competition.

Proponents of privatization point to several aspects of the modern American situation as reasons for transferring service to the private sector: (1) an intrusive government brought about by large-scale growth and expansion of government functions over the last century; (2) poor performance by the public sector in providing services; (3) dissatisfaction with bureaucracies and lagging performance; and (4) the inability of the public sector to fix itself without reform.[3] To remedy these ills, advocates of reform support privatization of public services and the introduction of competition into the poorly performing public monopolies when "practical concerns, such as the level of public interest, the degree of public need, the availability of private services and the likelihood of popular and legislative support" demand it.[4]

The debate surrounding privatization is more than "public versus private. It is competition versus monopoly."[5] In a government monopoly, the motivation to cut costs or improve quality of products is removed; there are no incentives to perform better because there are no substitute providers—the government is the only provider. Bureaucrats, union workers and tenured employees are unfortunately afforded a certain level of job security in this system that isn't contingent on performance. The nature of accountability is also weakened in such a system; it is difficult to determine who is actually accountable within multi-layered bureaucracies. For example, who is accountable in delivering city sanitation services—city officials, management, union workers, etc.? If the services are not up to par, where does one turn to for improvements? By introducing competition, it is assumed that parties involved (top to bottom) will quickly become more accountable for their performance, improve the operation or be subsequently replaced by others who will.

Characterized by ineffectiveness and inefficiency, government monopolies "result in the provision of goods and services substantially lower in quality and higher in cost than those provided in the presence of competition."[6] According to E.S. Savas, a leading expert on competition in public service:

> The real issue is not so much public versus private; it is monopoly versus competition. Far too many government services—federal, state and local—are provided as monopolies when they need not be, and it is very difficult to tame monopolies and make them work in the public interest. So the introduction of competition is appropriate whether the competition comes about from the use of vouchers, competitive bidding for service contracts, franchising, or voluntary efforts. It is the introduction of competition that makes the difference.[7]

Savas has participated in numerous comparisons of public and private services, in which "private firms under contract were equally effective, equally responsive, but vastly more efficient than government agencies."[8] Public policy analyst John D. Donahue similarly suggests that "efficiency springs primarily from competition, not from privateness *per se*."[9] The distinction between privatization and competition is important to recognize; though the two concepts dovetail in certain respects, they are different.

In fact, evidence from studies indicates that private service providers not engaged in competition for business are often times just as inefficient as public monopolies.[10] Not surprising, improvements in efficiency levels often come from the specification of tasks and measurable performance indicators before the service begins, a staple of competitive firms. After all, the more precisely a task can be specified in advance and its performance evaluated after the fact, the easier it is to assess the delivery of service during and afterward and thus make changes accordingly. But most monopolistic delivery is not subject to strict delivery criteria. The service must simply be provided, but there are limited performance measurements and enforcement methods, and no impetuses to spur improvements (setting aside public outcry and political pressure). Introducing competition into public service delivery creates a strong incentive to improve performance and efficiency; failure to do so is met with replacement. Competition thus provides the arena for the benefits of privatization to be realized.

Critics of privatization, however, demand a closer look at the potential benefits of privatization and competitive delivery, suggesting that private delivery can have lower up-front costs than public sector delivery, but may also have several hidden and associated costs. "While competition *can* lead to very large gains in efficiency, it is an empirical question, case by case, as to whether the savings exceed the increased costs" associated with paperwork, time, specifications, oversight, etc. notes one critic.[11] Moreover, "the more completely rules, obligations and procedures are defined in order to enforce accountability, the higher the price in time, money and flexibility."[12]

The nature of the savings and efficiency enjoyed through competitive delivery is also a concern for critics. Costs may be lowered through competition and privatized services, but at what expense? Donahue frames this notion best:

> "Public sector organizations are more unionized, have older workers with longer average tenure, offer more vacation time, spare workers from the chore of maintaining their own equipment and require more due process before a worker can be disciplined...a good deal of what taxpayers stand to gain from privatization comes at the expense of municipal employees.[13]

Private companies may be able to lower costs easier than the public sector, but these savings may be reflected in lower wages, leaner benefits and less satisfactory working conditions--hardly the goal of taxpayers or politicians.[14] The decision to seek privatized services is complicated further when one considers that there has been limited conclusive research and information gathered regarding whether, when and how value is actually secured for taxpayers. Also of importance is that the potential benefits can vary from service to service and within different levels of government, as can costs. There is no rulebook for privatization or the decision-making process; success and failure are essentially measured through trial and error. Likewise, there are no guarantees that government officials will select the 'right' services in the 'right' order or that the services will produce the intended results.

It is important to recognize, despite these minor concerns, that the true value of privatization is derived from its availability as a possible and tangible means of improving efficiency and lowering costs of public services. The issues surrounding the decision to privatize are complex, just as collective spending decisions are themselves complex. But by embracing this option and exploring its potential as a means of delivering public service, politicians and city officials can demonstrate to their constituents and fellow citizens that they are dedicated to improving services and revitalizing public institutions. Privatization is not the solution, it is one solution.

Contracting out

The ensuing pages provide a more detailed examination of contracting- the most common form of privatization- and seek to clarify many of the important and sensitive issues surrounding decisions to privatize public services.

Contracting is the process in which government (city, state, federal, agencies, etc.) purchases services from the private sector—either from for-profit or not-for-profit organizations—through a competitive bidding system designed to force down costs. To avoid losing the service, vendors constantly seek to improve their performance and quality of service. Competition motivates all participants to attempt achievement of minimized costs and maximum efficiency and productivity.

Contracting is also intended to increase accountability based on performance. The process seeks to dissolve bureaucratic layers, confusion and lethargy by concentrating responsibilities of service on the visible, answerable vendor management and staff. Moreover, contracting is designed to reduce the expensiveness and inefficiency of existing public vendors, such as unions, by slashing and balancing budgets, lowering costs, cutting back on unnecessary personnel, hiring cheaper labor, and eliminating government benefits packages.[15] The private sector in theory provides more resistance to union demands and more flexibility in cutting costs or shifting resources.

As an alternative to contracting to only external organizations, managed competition can be used to allow the public sector to compete in the bidding process. This strategy has proved to be successful in many cases, as the unions and public agencies are forced to lower costs and maximize efficiency and productivity in order to compete with the private sector. (see Phoenix and garbage collection, circa 1978-80s)

Opponents of contracting as a means of improving service and quality suggest that only the government will truly protect the interests of the public. The private sector will instead seek bottom-line results and profits at the expense of the very public it is providing services for; private vendors will lower costs by cutting programs, finding loopholes and shortcuts, and especially by dissolving unions, social fixtures whose members are believed to be valuable resource based on long-term experience and specific, on-site knowledge of activities. Opponents also contend that government must be careful in turning over public revenues/taxes and control of public services to outside vendors. Taxation is a sensitive issue and important tool to support social services; tax dollars are not supposed to be used to pay a company's shareholders or go toward its profits. Finally, critics of contracting argue that managed competition doesn't provide enough of a chance for the unions and similar organizations. Contracting companies are no longer just local or regional companies; many now include large, multi-national corporations that have vast resources to outbid local vendors and dominate the marketplace. Consider as evidence the large companies ServiceMaster, Inc., Laidlaw Transit, Inc. and Sodexho Marriott serving public schools in the food, student transportation and custodial industries.[16]

There has been an increased number and focus on contracting initiatives at the state and local level over last 3 decades, mainly for support services. Cities and states rely on contracting in areas such as social services, transportation, mental health care, corrections and prisons, health services, sanitation, street and highway maintenance, and airport management. Federal initiatives, though dominated by defense and computer technology procurement and prison contracting, have proceeded at slower rate because of rigid rules, as well as strict agency requirements regarding bid/evaluation criteria and the discretion of contract officials that have only recently been relaxed.[17] The following table, using public education as an example, effectively demonstrates how contracting has become a widespread institution in public services.

Table 1: Non-Instructional Services That Are Contracted Out by Public School Districts[18]

Accounting / auditing services	Evaluation services	Parking lots or garages
Advertising / public notices	Executive searches	Procurement of goods
Architectural services	Fleet or vehicle maintenance	Public relations services
Building cleaning	Food service	Pupil transportation
Building maintenance	Insurance services	School security
Building security	Legal services	Solid waste collection or disposal
Construction	Medical / nursing services	Utilities
Data processing	Moving services	Vehicle towing or storage
Energy management	Paving services	

Interestingly, a trend in public education services has emerged in the last decade in which contracting out has taken on a new meaning. In some school districts and cities, such as Baltimore, Maryland and Hartford, Connecticut, public officials have contracted out the management of schools in an attempt to reform and rejuvenate the public education system. Though a very popular topic of discussion among privatization experts, there is actually very little conclusive data on the results of these experiments. It is clear that neither the Baltimore nor Hartford contractors could lower the costs of public education as promised in their contracts. Moreover, because there is no standardized system for measuring results (beyond a few standardized tests, of which the results are still very inconclusive), it is difficult to assess the performance of the contracted management. The experiments do deserve positive attention for significant expenditures toward improvements and upgrades in existing facilities and for installing computer technology in the experimental schools, efforts that have been considered beneficial despite discontinued private management.

The decision to (not to) contract out hinges on the fact that the private sector provides certain services better (worse) than the public sector. That the government understands this notion and is willing to implement contracting initiatives in order to improve and maximize city, state and federal situations—through activity effectiveness, efficiency, equity and accountability—demonstrates just how serious of a commitment contracting out can be. Table 2 juxtaposes several areas where government and private sector participants tend to perform better than their counterpart, useful criteria for a contracting strategy.

Table 2: Government and Private Sector Performance Advantages[19]

Government	Private Sector
Policy management	Performing economic tasks
Regulation	Innovating
Ensuring equity	Replicating successful experiments
Preventing discrimination and exploitation	Adapting to rapid change
Ensuring continuity and stability of service	Abandoning unsuccessful activities
Ensuring social cohesion	Performing complex and technical tasks

Proper consideration of these comparative advantages is necessary for the public sector in deciding whether or not to contract out activities.

The public sector must also examine the factors that drive the existing service status when considering contracting. For example, is there an incentive for current employees to excel in service or perform well? Is there an accountability structure in place for performance? A reward structure? Do restrictive rules and regulations detract from delivery of the service? Do authorities have adequate flexibility in controlling operations?[20] In addition, considerations should be given to the level of public interest, degree of public need, availability of private/competitive service vendors and the likelihood of public and legislative support for contracting initiatives.[21]

A government's decision to contract a service is difficult. The decision requires significant evaluation and complex planning by government officials (and private vendors). Though there is no definitive method for ensuring success in contracting initiatives, a 1997 study by the General Accounting Office sheds some constructive light on the process. Based on extensive research, information collection, and interviews with policymakers, agency managers, labor representatives, audit and legislative oversight officials involved in numerous state and city privatization efforts, the GAO report identifies six lessons learned through experiments, and offers strategies to maximize the success of contracting initiatives.[22]

1. Privatization is best introduced / sustained when a committed political leader champions the initiative, a figure obviously sensitive to and concerned with city and state financial health, interests of public and social structure (unions, etc.)
2. Governments need to establish an organizational and analytical structure (commissions, offices, support staffs, etc.) to evaluate cost, performance, consider which activities to privatize and drive the implementation effort.
3. Governments may need to enact legislature or reduce resources available to its agencies in order to encourage greater use of privatization. By reducing the size of state workforce, cutting budgets or promoting privatization plans in legislature, a commitment to privatizing can be signaled.
4. Essential to considering, preparing for and implementing privatization efforts are research and reliable cost data. Governments should work with other governments or companies with experience in similar initiatives to get better understanding of costs, performance issues to be adequately prepared for the transition.

5. Governments may need to assist the public workforce in transitioning to privatization in order reduce obstruction, and possibly bolster support for the initiative.
6. Governments need better monitoring, oversight policies and systems to protect public interests. The government's role in delivering a service may be reduced in privatization, but the commitment to protecting the interests of the people is not.

These lessons are intended to provide a basis of support for a government intent on privatizing a public activity. The reality of the situation is that each effort and decision to privatize or contract a service will be different. The goal of contracting, however, will always be the same: to better serve the public through improved quality, efficiency, and lower cost. The decision therefore is not whether or not to contract; it is which services to contract and when to do it.

Listed below are several important questions for public officials to consider when exploring contracting as a delivery strategy.[23]

- Why do you want to contract this work out?
- What effect will the contract have on the community and local businesses?
- What is the proposed length of the contract?
- How can you guarantee competition?
- Can the contractor or jurisdiction renegotiate price and terms of the contract before it expires?
- Are there financial penalties against the company for unsatisfactory performance?
- Is there a list of current and past contracts to perform similar contracts with other jurisdictions? What is the vendor's experience in the particular service?
- Does the plan comply with all federal, state and local laws governing bidding procedures and employment policies?
- What is the means of administering the contract and monitoring performance and cost?
- What is the fallback plan if this arrangement fails?
- Is there an alternative means of achieving budgetary and service delivery goals than contracting?

These questions are not the only considerations, of course, but do provide a good starting point for public officials.

Several obstacles have regularly impeded the progress in contracting initiatives. The main obstacle to contracting out public services is resistance from public employees (unions, tenured workers, etc.) who would most likely be replaced by the contracted vendor. There are essentially two courses of action the contracting government agency can choose in such a situation. The first course is to continue contracting and do nothing to involve these workers. The alternative is to somehow involve the incumbent employees. Regardless, the contracting agency or government would be best served by developing strategies to assist the workforce in transitioning and by preventing large-scale layoffs that could potentially damage the surrounding social structure and contract.

If the contracting agency or government chooses to involve the incumbent employees, it can proceed in several different ways. Governments can avoid massive layoffs by requiring or encouraging the vendor to hire the incumbents at comparable or lower wages or give them first crack at job openings.[24] This would require a level of cooperation by both sides, but more so by the unions as a lower-paying job is better than no job at all. Managed competition, in which the workers would compete for the service, could also be introduced. Or the government could place the workers elsewhere (other employment areas). Yet another possibility would be to offer additional training and safety net services for displaced workers so that they may either re-enter the workforce qualified for other areas or choose an alternative path to their liking. It is unclear if any single alternative would guarantee the most success in implementing contracting initiatives though a combination of the strategies would likely prove to be most effective.

A few problems with the contracting process have been identified over the years. As discussed, the removal of unions and tenured employees tends to be an unpopular policy with the local public. The decision to contract thus tends to be affected by political, economic and social pressures, all of which weigh on the initiative differently. The most common contracting problem is that the contracts themselves are not specific enough regarding performance evaluation and goals to be achieved. Moreover, there are usually limited indicators in place to measure results from the contracted experience. Attention has also been focused on the blurred relationships between the contracting organization and vendor, in which issues of accountability, responsibility and funding often interfere with the contracting effort. Similarly, the proper balance of involvement, management and control between the agency and vendor is rarely reached, which has a negative effect on the contract.

Concerns for corruption during the bidding and bid evaluation processes have also been voiced. The federal government's procurement and bid system, using rigid rules and criteria, was until recently designed to limit the discretion of contracting officials to avoid corruption and favoritism in awarding contracts, though it has been argued that this lack of discretion actually undermined the efforts to get the best value in procuring services.[25] Corruption is difficult, however, when "the bidding process is truly competitive...based on hard information about cost and quality of performance, the contractors are monitored carefully and a relatively non-political body is set up to perform these tasks."[26] These safeguards cannot eliminate corruption, but they will certainly help prevent it. Another strategy to limit corrupt contract awarding is to limit the lobbying efforts and campaign contributions by all vendors; removing the political pressure will focus the decision more on the economic and social factors involved.

Like most collective spending decision, the decision to contract a public service is complex and sensitive. Contracting is the most visible and frequent form of privatization, as well as perhaps the most controversial. The strategy should be recognized, however, as an innovative way to lower costs and increase efficiency. It is important to remember that the goal is not to undermine the existing social structure. Rather, the goal is to refocus efforts to maximize public undertakings and tax dollars. As many proponents of privatized services have noted, "it is not government's obligation to provide services, but to see that they're provided." Contracting represents one potentially successful manner in which government can still ensure the delivery of public services without assuming direct control.

Appendix I

A Typology of Privatization Initiatives—by Extent and Domain[27]

		Finance / Allocation		
		Government	Private	
Provision / Distribution	Government	*(1) Government Service*	*(2) Government Vending*	Government
	Private	*(3) Mixed Service*	*(4) Market & Volunteer*	Private
		Contracting	Volunteerism	
		Grant / Subsidy		
		Voucher	Self-Help	
		Franchise	Load Shedding	
		Deregulation	Asset Sales	
		Government	Private	

Appendix II

Useful definitions[28]

Competition	Occurs when two or more parties independently attempt to secure the business of a customer by offering the most favorable terms. In relation to government activities, consider (1) public versus private, in which public-sector organizations compete with the private sector to conduct public-sector business; (2) public versus public, in which public-sector organizations compete among themselves to conduct public-sector business; and (3) private versus private, in which private-sector organizations compete among themselves to conduct public-sector business.
Contracting Out	Hiring of private-sector firms or nonprofit organizations to provide a good or service for the government. The government remains the financier and has management and policy control over the type and quality of services to be provided. Thus, the government can replace contractors that do not perform well.
Managed Competition	A public-sector competes with private-sector firms to provide public-sector functions or services under a controlled or managed process. This process clearly defines the steps to be taken by government employees in preparing their own approach to performing an activity. The agency's proposal, which includes a bid proposal for cost-estimate, is useful to compete directly with private-sector bids.
Outsourcing	A government agency remains fully responsible for the provision of affected services and maintains control over management decisions while another entity operates the function or performs the service. This approach includes contracting out, the granting of franchises to private firms, and the use of volunteers to deliver public services.
Privatization	Generally defined as any process aimed at shifting functions and responsibilities, in whole or part from the government to the private sector.

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