Privatization in Theory and Practice: The Issues to be Considered

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Abstract

The concept of privatization is fairly recent. This paper examines the different perspectives of the privatization literature, analyzes and assesses the proposed advantages and disadvantages of privatization as a strategy for providing public goods. The paper concludes by instilling a conceptual framework that should be considered before undertaking a privatization policy.

Introduction

In his campaign for the presidency of the United States, the then presidential candidate Ronald Reagan promised the American people to get government off their back and balance the federal budget. One of the primary means of implementing these objectives was the federal policy of privatization. This paper will examine the historical evolution of privatization, analyze and assess the proposed benefits and advantages as well as the alleged problems and disadvantages of the privatization strategies, and attempt to develop a framework for analyzing the conceptual issues which should in principle be considered before undertaking a privatization program, if at all. As such, the paper does not seek to convince anyone or change anyone's opinion but inform and stimulate debate about privatization policy.

Privatization, however, is not an easily defined concept. The literature on privatization, albeit extensive and fairly recent, is not in absolute agreement on the definition and context in which privatization is discussed and evaluated. The literature, in fact, is only clear on one point: that it means different things to different people. Some examples may illustrate the variation in conceptualization and definition.

According to Thompson (1982) and Kolderie (1986) privatization means no more than contracting out functions which were performed by the public sector to the private sector. Perry and

Babitsky (1986) on the other hand maintain that contracting out is just one of the levels in the road towards privatization which range from load shedding to franchising and contracting. Carrol (1987), in contrast to many writers, views privatization as a political economy component of an administration's approach to the conduct of public business. Pirie (1985:4), one of the strongest advocates of privatization, defines privatization as a "process by which the public sector is reduced by transferring its functions to the private sector" without apparently affecting ownership.

A more specific and comprehensive definition of privatization is offered by Miller (1987:48) when he stated that privatization is actually "private development, ownership, management, and operation of facilities for public use that traditionally are owned and operated by local government." British literature (Kaldor, 1980; Steel and Heald, 1984; Kay, 1986; Dunleavy 1986) which has a much more extensive coverage of privatization than its American counterpart concurs with Miller's definition.

Privatization itself is a fairly recent term. It is lacking in most lexicons and is missing in all but the most recent textbooks. Only few books have given it a full treatment, notably Emanuel Savas' work, *Privatizing the Public Sector: How to Shrink Government* and Madsen Pirie's *Dismantling the State: The Theory and Practice of*

Privatization. The standard public administration and public finance books give privatization little more than a casual mention, and the mention only occurs in the most recent of them. The newness and contemporary advent of privatization is strongly indicated in the choice of verbiage highlighted in the related literature. Privatization is called a "boom" (Dunleavy, 1986), "phenomena" (Wollan, 1986), "emerging industry" (Miller, 1987), "current hot topic" (Kolderie, 1986), "latest strategy" (Morris and Stone, 1986), and is referred to as a "contemporary issue" in numerous other articles.

How New Is The Notion of Privatization?

Although the term privatization is undeniably recent in nature, whether or not the actual concept of privatization is new depends on how privatization is defined. If privatization is simply another name for contracting, for example, then the idea of privatization is not really new. Contracting, in the United States, has been one of the major means of financing government projects since the early 1900's. Many of the services which are now public sector functions can be readily traced as far back as colonial days--when private production was an important and necessary part of colonist's subsistence existence. As time evolved and society became more complex and specialized, some services gradually took the form that they have now and government began to assume many of today's roles, e.g. provider, educator, protector, regulator, etc. Several authors have noted that the concept of privatization, as discussed in much of the literature, is actually a case of "history repeating itself", rather than a new development. Heins (1986), for example, notes that the United States' first planned and engineered roadway, built in 1794, was a product of private provision and production. The roadway, about 62 miles long between Philadelphia and Lancaster, Pennsylvania, was built at a cost of \$465,000 by private businessmen who recouped their investment from road tolls. Heins (1986) also points out that private organizations were responsible for building much of the New York City subway system, as well as most of the country's railroads. Heins further indicates that it was the abuses of private ownership of essential public services that eventually led the way toward nationalization and municipalization. Regulation and taxing of private corporations to build public

assets followed. Indeed, it soon became the natural thinking of the time that government could provide services and programs more cheaply than the private sector because government could operate without making profits. Cases in point are the role and functions of the federal government during the Great Depression of the 1930's and the New Deal period that followed it.

The pendulum, however, is now swinging back to private provision and production of services. This is due, in part, to the belief that the public provision of goods and services over the past decades has generally been disappointing. As Samuel Paul of the World Bank observed at the international level, that "In country after country, unbridled state expansion has led to: economic inefficiency..., ineffectiveness in the provision of goods and services..., and rapid expansion of the bureaucracy..." (Paul, 1985:42). Others, however, argue that the rapid development of a privatization boom in Britain and the attention it is receiving in America is indicative of the New Right's Political intention to limit the role of government in the production and delivery of social goods which in the final analysis may reduce the overall social welfare. Hence, the debate for and against privatization has ensued.

The Argument for Privatization

Proponents of privatization advance a number of advantages including reducing government costs, lowering public taxes, improving levels of service, and controlling government growth (Pirie, 1985). Although many of these benefits are not universally proven, numerous cases are cited in the literature where a changeover from public to private delivery of services has directly resulted in distinct and tangible advantages (Hanke, 1986).

The most readily visible and most often cited benefit of privatization is that it can provide immediate financial relief for decreasing traditional sources of capital supply of government. For example, Miller (1987) points out that three primary capital sources historically have been available to local governments for financing needed public facilities: property taxes, federal grants, and tax-exempt bond proceeds. The availability of capital from each of these three sources, however, has been sharply reduced in

recent years by a combination of legal, economic, and political forces. To maintain or expand current levels of services most local governments have been forced to search for alternative sources of funding and privatization of public assets is advanced as one major funding alternative.

Heins (1986) points out that the Federal government is looking at increased privatization of its holdings as an alternative source of funding. The office of Personnel Management has recently proposed privatizing 600,000 federal jobs, such as laundry, data processing and vehicle repair that the office contends are strictly commercial in nature. It is claimed that the new savings from this policy action will be over \$4 billion per year. The general belief, both at the local and federal level, is that by removing funding responsibility from public to private, the ability of government to cope with decreased budgets would be substantially strengthened.

The financial relief from privatization applies to several aspects of government funding. First, since many governments operate by utilizing the legal debt capacity, which itself is limited by law, private sector funding would assist to "stretch" the debt capacity and allow it to be saved or used for other programs or projects. Miller (1987) points out that the Joint Economic Committee of Congress has projected that just the repair and maintenance of facilities such as sewers, roadways, and bridges through the year 2000 will potentially cost over \$450 billion than can be raised by conventional means, including legal debt capacity. Alternative sources of funding, such as private financing, proponents argue, will be required for maintenance of existing facilities.

There are numerous specific examples cited in the literature reviewed as advantages of privatization. For instance, Heins (1986) cites a savings of over \$500,000 a year to the Kansas City Airport after privatizing its fire services. Wollan (1986) cites similar advantages concerning privatization of prisons, while Quinn (1986, 1987) and Morris and Stone (1987) cite similar advantages in the park and recreation field. In addition to these areas, savings are noted in social services (Barber, Slavin, and Barnett, 1983; Gilbelman and Demone, 1983), police services (Stewart, 1985), public transit (Perry and Babitsky, 1986), waste disposal (Atkinson, 1984), waste

water treatment (Davidson, 1984; and Lombardo, 1987), education (Hatry, 1983) and fire services (Hatry, 1983). Cost savings, in these examples, range from a few dollars per ton of garbage collected, to millions of dollars annually. Miller (1987) for example, points out that the cost saving for the private financing, construction, and operation of the private wastewater treatment plant in Chandler, Arizona, netted an initial savings of \$6 million in construction costs (the difference in what it would have cost the city to fund construction) and is estimated to result in an annual savings of over \$1 million in operating costs.

In addition to saving governments money, privatization can also supply services to governments without the financial ability to supply services. This financial advantage has been noted in cities like Auburn, Alabama, and Scottsdale, Arizona where these cities found it nearly impossible to provide wastewater treatment without private funding. In the Auburn, Alabama case, for example, it was noted that public funding of the wastewater treatment plant would have caused sewer rates to triple, rather than simply double, as they did under private supply of these services (Watson, 1987). Other actual and potential advantages to privatization are reported to include:

- * improvement in the level of services, resulting from better equipment, training, and specialization in the private sector;
- * speed in the construction and delivery of projects which in turn cuts down cost;
- * the ease in which government programs or services can be adjusted without the constraints of the long and drawn-out process of the public budget making cycles;
- * the ease and freedom to establish and implement performance evaluation standards in the private sector; and
- * the private firm absorbs much of the public relation problems which at times are expensive and time consuming to the public administrator.

Proponents of privatization further argue that privatization can also benefit service delivery and programs by providing specialized skills and equipment as needed. The public sector does not have the financial capability to directly purchase all of the specialized equipment or to hire

all of the experts that it may need to call upon for various projects, programs, and services. Contracting out for these specialized skills and services, as needed, is the most logical answer to this dilemma. Fisk, Kiesling, and Muller (1978), Hatry (1983) and Ferris and Graddy (1986) all cite examples supporting the benefit of privatization in adjusting program size and in providing specialized skills and equipment as needed. Quinn (1986, 1987) and Morris and Stone (1986) indicate that this benefit of privatization is especially valuable with the recreation field, where specialized program instructors may be hired to deliver a specific program(s) when the necessary skills or knowledge is not available through the public recreation staff.

Two additional benefits that can directly result from privatization are also cited from the park and recreation field. For example, Morris and Stone (1986) and Quinn (1986, 1987) note that privatization can result in additional choices for the consumer when recreation programs are privately offered. This is due, in part, to two major factors in public offered recreation: the rising cost of insurance, and the need to justify park and recreation expenditures. Insurance for most publicly administered programs, especially for local parks and recreation department, has recently become very difficult to obtain, and when it can be obtained, it is offered at exorbitant costs. Accordingly, many park and recreation departments have either ceased offering many physically active programs or have stopped programming altogether. The private sector, on the other hand, because of the necessary profit margin and normally higher fees, is seemingly able to more readily obtain insurance, even for high risk activities such as hang-gliding, parachuting, and scuba diving. Hence, privatization is offered as one way to increase the choices available to the consumers. Although it is difficult to clearly establish the reasons for privatizing government programs and services in order of importance, some writers have indicated that the most important benefit of privatization is its potential for cost savings (Ferris and Graddy, 1986). Other writers, such as Savas (1982) and Pirie (1985) have stressed that the major advantage of privatization is shrinking and controlling the enormous growth of government bureaucracy. Privatization, they insist, acts as a kind of divestiture of the government monopoly of programs and services. Furthermore, privatization

acts as a form of sunset legislation because inefficient or nonproductive programs (i.e. those without a profit) will quickly be eliminated. Privatization, in short, acts to directly reduce the scope and complexity of government bureaucracy by directly relieving government from much of its bureaucratic and non-administrative workload. "In effect", says Madsen Pirie, (1985:2), "privatization controls the public sector by dismantling it". Unfortunately, however, nothing in the privatization debate is as clear cut, for counter possibilities can be cited in each of these cases.

The Argument Against Privatization

Many opponents of the privatization thesis challenge the purported advantages of privatization and raise additional issues which seem to be outside of the purview of the pro-privatizations' discussion. For example, McEntee (1987), the president of AFSCME, argues that the production and provision of services at a lower cost by the private sector is a misconception. As he sees it, once all the different costs of "going private" are considered, the bottom line cost may actually be higher with the private sector. This is so, McEntee (1987:48) insists, because "...private companies exist to make a profit and the necessity of a profit drives up costs, if not immediately, then eventually". The hidden costs of going private that McEntee points out include costs such as contract preparation, administration and monitoring of the contractor's performance, the appropriate use of public facilities, the expense of renegotiating the contract, public employees training of contractor work crews and the contracting out effect on the morale of the remaining public workers. Furthermore, McEntee contends that once dependency on private sector delivery of services is established, the eventuality of rising cost, much higher than would have still been the case under the public sector delivery, is certain. Empirical examples abound which support many of these claims in the AFSCME publication, *Passing the Bucks*, (1983), that crisscross the whole intergovernmental system.

Another criticism leveled against privatization is the lack of flexibility and perhaps even inability to respond to unplanned or unexpected problems that may require immediate attention (Downs and Larkey, 1986). Although greater ease in adjusting program size is claimed as one

of the benefits of privatization, opponents insist that a private firm is only obligated to supply services as per specification in the firm's contract or agreement, a contract which governments may not adequately draft to cover all aspects of a potential problem. On the other hand, much of the work in providing services, opponents claim, is done as a matter of course by public employees who are responsible for handling all aspects and problems of a service delivery.

Privatization, opponents claim, may also increase corruption, through bribery, kickbacks, collusive bidding, and political patronage. Although these problems may not be unique to the private sector, opponents of privatization claim that the private sector is generally less exposed to media scrutiny than the public sector; hence, corruption may continue undetected over a wider area, or for a longer period of time than it would in the public sector. Collusive bidding or the awarding of contracts through political patronage may also obscure true competition for service delivery contracts and may dictate that the final cost to the public taxpayer is not the lowest cost possible (Hanrahan, 1977).

Another potential problem with privatization, opponents argue, is that it can result in less accountability or responsiveness by the service delivery organization. Since public administrators are also perceived as "public servants" there tends to be at least in theory, a direct relationship between the administrators' job and the citizens' needs and demands. A citizen disgruntled with the lack of a given service for example, may, through a phone call to his/her representative impact upon policy actions, while the same may not be said about the private sector.

Kolderie (1986) raises six major issues with privatization, all of which have the potential to create problems: creaming, control, community, competition, corruption, and cost. The first three concepts are worth expanding on here (the other concepts generally parallel concerns voiced by others above).

According to Kolderie, creaming is when the service provider provides services to only the easiest or most profitable customers, often neglecting the difficult or unprofitable customers. This, opponents of privatization argue, is a dis-

tinct possibility because of the private provider's attempt to cut corners in order to maximize profits (Abramovitz and Epstein, 1983; Strassman and Farie, 1981; Kettner and Marting, 1985; Weddell, 1986). Empirical examples of creaming abound in the AFSCME publication, *Passing the Bucks* (1983: 19-50), which covers trash collecting in Rochester, New York, inadequate nutrition in school lunches in Chicago, and the higher cost and reduced services that Milwaukee County experienced in 1981. Even the frequently cited study by Bennett and Johnson (1979), to support the provision of public services by the private sector, has documented the practice of creaming. If the primary goal of public organizations were managerial efficiency, opponents argue, then, efficiency could probably be increased if the Postal Service merely assigned every citizen within a hundred mile radius a post office box in a single building and made the citizen pick up his own mail (Meier, 1979:7). It is doubtful, however, that the public would passively accept such proposals. The issue of control, according to Kolderie, refers to the general lack or decrease in overall control that a government may have when it privatizes public services. The lack of control by government may directly result in either lack of accountability or responsiveness by the private agency providing the service. As Levenson observed,

Private contractual services cannot be viewed as merely a vehicle for efficiency and economy. The private contractor and consultant affect policies and decisions of the agency with which they have contract, yet the lines of control and accountability over the contractor are not clear (Levenson, 1977:36).

Kolderie's presentation of the issue of community is a theoretical and ideological construct rather than a practical or tangible disadvantage of privatization. The issue of community with privatization, Kolderie (1986:288) asserts, is the feeling, by some, that "going private" loses the public purpose of the privatized program and may actually contribute toward a further erosion of the "sense of community in contemporary society and may intensify the individualistic ethic of our time."

Others such as Kozlowski (1982) have raised the legal problem to privatization. For example, Kozlowski points out that attempts to privatize

the operation and maintenance of a public parks which had previously been deeded to the public and were to "forever remain as a public trust" may not be feasible. In many instances, according to him, privatization may directly conflict with ordinances contained in city charters, laws on state books, and even with federal grant guidelines.

Finally, opponents to privatization argue that the current push, (Alleys and Barnes, 1986; Pirie, 1985), for privatizing government programs, services, and enterprises, (for example transportation, housing, social security, education...etc.) is an ideological attempt to reverse the traditional roles and functions of government. And they insist that some types of goods and services cannot be efficiently provided by an unrestricted free market. As the former George Washington University Vice President for Medical Affairs recently put it "social goods, I've come to the conclusion, don't lend themselves to the free market" (Kaufman, 1987:3).

Appraising the Debate

To say that privatization is a contentious issue is to put it mildly. The conflicting claims of advantages and disadvantages of privatization are not easily resolvable. How, for example, is one to make sure that a private firm that is responsible for delivering a public good does not default, (prior to delivery on shorter term contracts), or interrupt vital services? The empirical evidence, cited above, supports this claim. Even proponents of privatization admit that this is a definite possibility. They quickly point out, however, that the possibility of going bankrupt or defaulting can be minimized, if not eliminated, by insuring that the company to which the service is released has adequate financing and insurance prior to privatization. Furthermore, proponents suggest that private firms with proven track records should be chosen over unproven firms. This argument, in our view simply begs the question. Could not, for instance, the selection criterion of "unproven track record" lead to an undesirable monopolistic situation, where cost efficiency might be lost and the quality of service declined? By the same token, are all public goals and services best produced and delivered by the public sector exclusively, as opponents of privatization would have us believe?

Admittedly the answer to this and other similar questions are not objectively clearcut. What we can hope to do, in the remaining pages is to attempt to disentangle the issues in privatization and instill some kind of framework into the conceptual issues which should in principle be considered before undertaking, if at all, a privatization program.

A closer examination of the growing body of literature on privatization, here and abroad, suggest that the issues that underscore the debate on privatization include:

- * ideological differences on the role of government in the modern capitalist state;
- * the connection between ownership system and managerial efficiency, hence profitability;
- * issues concerning the relationship of public programs to the government budget; and
- * the implication and consequences of privatization policy.

Beginning with the first, it is apparent in Pirie (1985), Savas, (1982), and Alleys and Barnes (1986), that their notion of privatization is to reverse what they consider is the intervention of government in the free flow of the market forces. As Alleys and Barnes (1986:38) put it,

Privatization is the opposite of nationalization; it seeks to return to the private sector operations previously performed by the state. In moving toward it, the Reagan Administration is riding the crest of a Worldwide intellectual wave.

Despite such ideological motives for advancing privatization, a good section of the literature we reviewed in this group is couched in managerial superiority, and all that implies, of the private sector. We believe that mixing ideological preferences with unsubstantiated claims that anything the government produces and delivers is low in quality and high in cost simply complicates the issue. However unsuccessful the effort might be, a straight-forward argument for privatization that is unencumbered by a host of economic nomenclature might better focus on the appropriate role of government in a capitalist state (for example to limit its role to what it was before the Great Depression).

The second notion that managerial efficiency is directly related to the ownership system is a

valid inquiry. A significant part of the literature reviewed indicates that public operations tend to use higher manpower levels for identical operations, and make much less efficient use of other resources. Such case studies are available at the local, state, national, and even international level. However, the comparative case studies by proponents of privatization reject the assumption that public sector is different in objective and that it is entitled to a different standard of evaluation. Ignoring the assumption that the two sectors are different, makes it possible to subject both sectors to a standard evaluation. The theoretical and methodological accuracy of such a study, however, is questionable. Furthermore, Millward (1982) has reviewed the empirical evidence for the contrasted views and concluded that there is not clear evidence to suggest that ownership systems have any bearing on profitability of firms.

Once the case for privatization is acknowledged, at least in some circles, it seems to be considered relevant across the entire government programs. One such example is the connection often made between privatization and the Federal budget deficit. The reasoning goes as follows: first, if privatization leads to greater efficiency and/or lower financial losses, there might be a reduced call on the budget for subsidy. Second, privatization of government enterprises such as urban transportation and utility companies might lead to elimination of uneconomic activity, opening up the field for the private sector, and thereby creating additional revenue sources. Third, by privatizing, it is often suggested, business would no longer look to government for its financing needs and thus eliminating its felt legitimate claim upon the budget.

However, the issue is not as clear-cut, for counter arguments can be advanced in each of these cases. First, the claims upon the budget might remain the same or become even larger. As David Heald (1986:9) observed, once a privatization policy is adopted, the government would be "...financing an activity over which it has relinquished operational control." Second, the privatized enterprise may successfully lobby for government subsidy or because of its possible monopolistic position may increase prices for the service that it delivers. These and other questions that one may raise are open to different answers, and therefore increase the need for

detailed empirical work on the individual issues that the privatization thesis involves.

The last issue we want to briefly focus on is the implication and ensuing consequences of privatization. As discussed earlier opponents of privatization point out that attempts to reverse the role and function of government that have become the norm beginning the 1930s is anti-social progress. Such actions, the argument goes, have a negative impact on the poor in the first place and on the nation as well. A full appraisal of the negative consequences of privatization is impossible, opponents insist, because the idea is very recent but they are sure that the problems will eventually appear. But, is privatization actually new? Here again, what is needed is specificity of the issues. Because as discussed earlier, some aspects of privatization, such as contracting out, are not so new. And in terms of managerial efficiency, when the results are compared on a case by case basis, the advantages of privatization outweigh the disadvantages (for example Atkinson (1984) on waste disposal, Beaver (1985), Morris and Stone (1986) on recreation, Perry and Babitsky (1986) and Hanke (1986) on public transit, Heins (1986), Hatry (1983) on fire services...etc.). However, these and several other studies we reviewed fail to include measures of service quality, not to mention the impact of privatization on public sector workers. As noted earlier wages in the private service agencies are typically lower than those paid to public sector workers in the same service area. That has significant implications for service quality. Because since private providers often pay low wages and offer few benefits, they suffer from inexperienced staff and high turnover rates. Low wages and inferior retirement benefits at the present means increasing demands by senior citizens for public services in the future. In other words, we might not care about workers welfare in the short term, but lost savings under such circumstances are likely to have negative consequences for the public sector in the years to come.

The issue is not then whether or not there ought to be any privatization, rather given the differing conclusions of the contending point of views, how does one go about to determine the viability and appropriateness of the privatization strategy? The evidence reviewed here suggests that what is essential and useful in the privatiza-

tion debate is specifying and isolating the issues including ideological preferences from managerial superiority myths (Henry 1986) of the private sector, production from delivery, and policy from implementation strategy. As discussed earlier, the very fact that some aspect of privatization has emerged and re-emerged as a major concern indicates that the issue is not a managerial issue but a political one. It is conceivable to argue that all common and collective goods, perhaps even including national defense, might be provided by a private sector. Furthermore, the empirical studies examined in this

study suggest that in order to avoid confusion when evaluating the performance of public and private enterprises for comparative purposes, the evaluation methodology must take into account inter-intra organizational environments that set apart private and public sector management. After all, to paraphrase Graham and Hays (1986), government organizations are porous and the public's business is conducted in an environment within which managers, politicians, employees, interest groups, and numerous other actors and institutions participate in give-and-take relationships.

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