Privatization of Public-Sector Services in Theory and Practice

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Abstract

The last ten years have seen a marked increase in the analysis and implementation of private-sector alternatives to the production of public-sector services. The impetus for privatization has two sources: (1) opposition to further growth of the public sector, and (2) the belief that the private sector would be a more efficient producer. Yet as privatization moves beyond the acquisition of intermediate goods and services (payroll processing and housekeeping services, for example) to more complex public outputs (such as education, social security, public safety, the postal system, for example), it is subject to increasing challenge on both efficiency and equity grounds. Nonetheless, private alternatives to public production are finding increased acceptance.

INTRODUCTION

For the past decade or so the public sector of the economy has been subject to increasing scrutiny and challenge. The challenges are of several types: (1) it is argued that the government has taken on the production of goods and services readily available from private sources; (2) as regulatory activities and public production activities have expanded, the costs of regulation and the inadequacies of public production have become more obvious; and (3) questions are being raised, in the spirit of the first two challenges, about whether public financing might be combined with private production to provide merit goods more efficiently.

The view that market failures of all sorts justify public intervention is no longer so widely accepted. The extensive deregulation activity of the last decade—a response to the perception of increasing costs of regulation, in contrast to the former exclusive focus on its potential benefits—provides the clearest evidence. The growing interest in and attention to various forms of privatizing public-sector responsibilities offers further evidence. Even equity arguments for specific types of public intervention are being reexamined.

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In the following sections I review the major issues underlying privatization. Many of these issues were debated at a conference on The Privatization of Public Sector Services held at the University of Pennsylvania in September of 1986.[1] Three papers covered the most general underlying themes: (1) the role of government in a mixed economy—what should government do; (2) the role of institutions in public-service provision—having decided what the public sector should do, how should it be done; and (3) privatization, information, and incentives—what roles do incentives and imperfect information play in the privatization decision? There were also several applied papers. One provided an overview of U.S. experience with privatization to date, in particular at the state and local level. Three other papers dealt with specific areas of public intervention: in education, in health, and in social security. Throughout the applied papers and the conference discussion, the same general questions recurred. Why is an activity a public one? If it is to be a public activity, how should its production be organized? What problems arise in shifting increased parts of the production process from the public to the private sector? Although this introduction does not attempt to summarize each of the papers, it does incorporate the important ideas represented in them and in the general discussion at the conference.

WHAT IS MEANT BY PRIVATIZATION?

Discussions of privatization involve two important questions. What is the public intervention to be privatized? How is privatization to be achieved? Public intervention has three elements, each of which may be a candidate for privatization: finance, production, and regulation. The principal forms of privatization are divestiture or devolution of the public function, maintaining public finance but shifting the locus of production from the public to the private sector, and deregulation.

Public financing concerns which and how much of particular goods and services the government will underwrite. For example, the government may provide all children with access to twelve years of free education, or all households with trash collection once a week. If the financing of trash collection were shifted to households, the city's sanitation department would be closed, compensatory tax reductions could be made, and individuals would be left to choose the quantity and quality of trash collection through their selection of private trash collectors. The range of choice left to private decisions might be narrower. The city could require contracting with a specific set of trash collectors for a fixed number of trash-collection options. Thus, privatizing public finance takes the function out of the city budget, except perhaps for regulatory expenses.

Public production and delivery of goods and services covers the direct production by the government of both final goods and services—education, transit, defense, trash collection, libraries—and the intermediate inputs used by the public sector—schoolbooks, park benches, stationery, tanks, missiles. If the *production* of trash collection were privatized, the municipality, having decided to *finance* once-a-week curbside collection to all residences, might contract with private companies to do the trash collection. Or it might give vouchers to residents to enable them to purchase trash collection services from private companies. In either case, the city retains trash collection as a line in the budget, but its own sanitation department disappears.

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In the case of education, privatization of production might be achieved by providing an educational voucher for each eligible child to be used at the school of choice (including private schools) or by contracting with private schools to provide all or part of the designated educational package. In these cases, some or all of the public school system's facilities and personnel will no longer be required, but the item will remain in the budget.

The production of intermediate inputs is to a great extent already privatized. Government agencies do not, for the most part, manufacture their own furniture, office supplies, buses, tanks. Nevertheless, governments vary substantially in the extent of private acquisition of intermediates and in the potential for further privatization. Many of the items produced in house could be purchased on the private market, and in some places they are—park benches, landscaping and highway maintenance, laundry services, public relations, and fleet maintenance are just a few.

Finally, the privatization of public regulation is deregulation. It is in this activity that privatization has been most marked during the last decade—in the airlines, banking, and trucking.

PRIVATIZATION IS INCREASING

Recently, but certainly predating the Reagan administration, interest in private-sector or quasimarket approaches to public-service provision has grown. Numerous articles and books on user charges (rather than free provision), use of outside contractors (rather than in-house production), and regulation by incentives (rather than by command) reflect the surge in scholarly interest. The adoption of each of these measures is growing at all levels of government.

Increasingly, public agencies are shifting (or trying to shift) the production of goods and services to the private sector, by contracting out with private companies, by giving households greater choice in selecting a supplier (by providing vouchers, for example, for housing, food, or education), or by withdrawing the public role and allowing citizens to substitute private provision (permitting retailers to hire private security guards diminishes the public responsibility for police protection).

Both the President's Private Sector Survey on Cost Control (the Grace Commission) and the Office of Management and Budget have proposed major new initiatives for giving many of the service operations currently carried out within government agencies to private contractors (e.g., "movie making, health services, fire protection, medical laboratories, geological surveys, industrial shops, maintenance, landscaping, protective services, laundry and food services, data processing, and transportation"[2]). Though the list includes some final goods, its emphasis is on intermediate inputs produced by the government.

Despite the numerous, more radical proposals by the Reagan administration for government to withdraw from provision, these generally have not been adopted. Among the federal activities proposed for divestiture have been the electric power administrations, National and Dulles Airports, public housing projects, Amtrak, and Conrail.

Thus, the major proposals for privatization focus primarily—although not exclusively—on privatizing the production of intermediate inputs to government output. As the papers in this volume make clear, most of the privatiza-

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tion activity is to be expected and has occurred here. Nevertheless, there is great interest in and experimentation with private production of final services that have traditionally been produced by government agencies (for example, health care, infrastructure, public safety, education, transit, and prisons). It is in this category that the major problems and disagreements arise.

WHY PRIVATIZATION AND WHY NOW?

The Public Sector Has Grown Too Large

To some extent the source of the interest in privatization lies in a public sector grown too large. By any measure—current dollars, percentage of GNP, per-capita constant dollars—government expenditures, inclusive of transfers, have grown enormously in the last 50 years. The very substantial growth between 1929 and 1949 can be explained by the depression of the 1930s and the Second World War during the first half of the 1940s. Total public expenditure during these two decades increased from 9.9% to 23% of GNP (from $258 to $757 per capita, in 1972 dollars). Although this rapid growth was not subsequently sustained, a booming economy and the end of the war did not mean the end of the public sector's expansion. Between 1949 and 1974 the cold war, two hot wars, and a commitment to expanded social programs resulted in further public-expenditure increases: from 23% to 32% of GNP (from $757 to $1,872, per capita in 1972 dollars). In the next decade—spanning a rapid inflation, the tax-limitation movements, and the first term of the Reagan administration—growth continued, albeit more slowly: Public expenditures increased from 32.1% to 34.3% of GNP (from $1,872 to $2,379 in per capita *real* expenditures.)[3]

For some, big government (and not so big government) is a problem because it threatens personal autonomy and freedom. For others, big government became a problem—and a target—in the 1970s because real per-capita incomes grew very slowly (about 22% compared with 35% in the previous decade). Tax reduction (public-expenditure reduction) was an obvious way to protect private consumption. The most direct attempts to control public budgets have come from state tax-limitation initiatives—California's Proposition 13 and Massachusetts's Proposition 2½, for example—and from similar, so far unsuccessful, attempts to set constitutional limits on federal spending.

Thus the push for privatization of public-sector services is often motivated by the desire to reduce the size of the public sector. Divestiture of a particular service—getting out of the business of financing and provision—is the extreme form of privatization. Although many calls for divestiture occur, there are not many examples. In general, public financing has been a less significant target of privatization efforts than has been public production. Reducing public financing may be the ultimate aim of many advocates of privatization, but it does not appear to have played a major role in actual privatization decisions. These have been more closely tied to efforts to improve the efficiency with which public goods and services are produced.

The Public Sector Is Inefficient

A less radical form of privatization than divestiture involves contracting out the management or production of publicly financed goods and services. This

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approach permits the public sector to take advantage of the assumed greater efficiency of private-sector production. More efficient production of public-sector services could, of course, also control aggregate public expenditures. Why should private production of publicly financed goods and services be less costly than public production? The model behind the conclusion is straightforward: *competitive* bidding by profit-maximizing firms for a well-specified output guarantees that the product will be produced at the lowest cost. The absence of competition and profit incentives in the public sector is not likely to result in cost minimization.[4] The simple model and the important qualifications to its realization are discussed below and in the paper by David Sappington and Joseph Stiglitz.

Part of the answer to the question "Why are we concerned now with privatization?" lies in the nature of public expenditures, and particularly in the introduction and expansion of programs aimed at solving exceedingly complex social and technical problems that began in the latter half of the 1960s. In 1950, and in 1960 as well, federal expenditures on energy, natural resources and environment, housing, transportation, and community development, and on education, training, social, and health programs came to about 10% of the federal budget. By 1980, the proportion in these categories had reached 25% of the federal budget. Underneath these aggregates lie numerous, diverse, and complex goals as well as literally *hundreds* of programs.

The growth in domestic public expenditure reflects an ambitious social and technical agenda—so ambitious that failure to achieve everything promised and hoped for should occasion no surprise. Despite the fact that public budgets increase, public services are alleged to be increasingly inadequate. Increasing high-school dropout rates, deteriorating public transit, and dilapidated public housing are just a few examples. The persistence of social problems and of technical dilemmas (environmental pollution and hazardous-waste disposal, for example), in the face of a multiplication of public programs, undermines faith in the ability of the public sector to deal with the outstanding problems; it induces a search for alternative means. One result of this process is a reconsideration of how the capabilities of the private sector might be effectively employed in these areas. Despite automobile recalls, cost overruns by defense contractors, and low private-sector productivity growth during the last decade, the belief persists—even among public officials—that the private sector could more efficiently carry out many of the productive activities of the public sector. The paper by Robert Poole and Philip Fixler provides an overview of the extent to which public-service provision has already been privatized, particularly by state and local governments.

WHY DO WE DO THINGS IN THE PUBLIC SECTOR?

In order to think about whether privatization is a good idea, it is important to keep in mind why particular goods and services are publicly financed and produced.

Efficiency. There are many reasons why markets left to themselves will fail—that is, they will not produce goods desired by the public or they will not produce them in the appropriate amounts. Market failures arise because of the existence of public goods, externalities, and natural monopoly. There are few examples of pure public goods (national defense and environmental

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quality are the two most frequent illustrations). However, there are many goods that exhibit important elements of publicness (knowledge, roads, parks, dams). Many persons can benefit from them simultaneously, before congestion becomes a problem, and exclusion, if not impossible, is very costly.

Externalities provide perhaps the most pervasive justification for public intervention—for regulation, for financing, and for production of goods and services. Production externalities, particularly negative ones like environmental pollution, have called forth a host of government regulations designed to make either the producer of the product or its consumer absorb the cost of the negative externality. Federal regulation of automobile emissions, local limitations on the types of containers which may be used in packaging, or bottle-deposit laws are examples. Or consider the positive externality created when a retailer plants trees in front of his store. The beneficiaries of this beautification are not simply the retailer and his customers but all who are nearby. Thus, the retailer is unlikely to make an expenditure on public beautification equal to the benefits to all recipients. Recognizing the value of such beautification, public agencies regularly undertake to provide goods such as tree planting and public benches.

Most local public services have positive production or consumption externalities as a major justification, for example, education, fire and police protection, and trash collection. To internalize the externalities, to realize the social benefits which cannot be realized solely through private market transactions, government is generally required, except where only a few parties are involved.[5]

Many methods of intervention are being used simultaneously by all levels of government to deal with market failure—governments provide goods and services directly; they contract with private firms for such provision; they require individuals, households, and businesses to provide some goods and services in particular ways. Both regulation and direct provision have been under attack in recent years. The simplest argument says that the private sector (read: a competitive, profit-maximizing private sector) is always more efficient; the more subtle argument says that while market failures do occur, it is not obvious that public intervention improves overall efficiency.

Although market failure provides the principal argument for a large number of public interventions, the more recent literature discusses the subject of government failure on which the argument for privatization often stands.[6] In neither case does it inevitably follow that the proposed remedy improves the situation. In the event of market failure, the issue is whether the government can perform more effectively. With government failure, the question is reversed: Can the private sector do it better? Failure of one provides no information about the other. In general the comparison is between imperfect alternatives, not between an idealized private sector and failing public sector or vice versa.

Richard Nelson argues that research and development activity in the United States, which is characterized by much public financing but mostly private production, illustrates many dimensions of market failure—only some of which have called forth a government response. The less appropriable the R & D output—basic research, training scientists, or biochemical research in agriculture—the larger and longer standing the public role. The more appropriable or proprietary the output, the less government involvement (except for the basic legal intervention, patent law). The weakness of

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market failure as a major argument for intervention is well illustrated here. Although in many cases "strong latent public good properties" exist and "the system leads to restricted use of a new innovation, at least in its early stages," R & D in the United States remains mainly a private activity carried out by a large number of participants, a structure encouraging substantial duplication of effort. Furthermore, firms may be deterred from investing in areas not well protected by the patent system. But the great strength of this decentralized R & D system is its pluralism, its multiple approaches to technical improvement. "Committees of experts [as in a centrally planned system] are unreliable judges of where the bets should be laid. . . ." Thus, "the system surely isn't optimal but it has proved wonderfully powerful." ". . . the market system appears to be a far stronger engine of technical advance than the planned socialist system."

Equity. Equity is at least as important an impetus for public intervention as efficiency. The public sector alters the market-determined income distribution by providing transfers and merit goods. Many public undertakings combine both equity and efficiency concerns. Job-training programs have both private and social benefits; therefore, their provision is efficiency enhancing. Their redistributive effect occurs when they are targeted to the poor.

Why should redistributive objectives involve the public sector in so much more than income transfers? Why in housing, day care, job training, health care, food stamps, fuel subsidies? This is not the place to reexamine the paternalistic underpinnings of the multidimensional transfer system that has been stitched together, much of it built around the concept of merit goods. The issue cannot be avoided entirely, however. The advocates of increased privatization propose several alternatives to public provision of merit goods. The first is simply an extension of the general argument, namely, that contracting for the production or management of the various public goods and services that have a redistributive component is no different from contracting for other aspects of public goods production. The second means of privatizating redistributive activities would provide vouchers for the purchase of goods and services of different value for different classes of the population. For example, a comprehensive education voucher program might provide vouchers of higher value to families of students needing remedial programs or English as a second language.

Yet equity concerns must be more broadly interpreted than simply as income (or good and service) redistribution. Fairness and equal opportunity are part of the issue, but not the same thing. Incentives exist for exclusion on a wide variety of dimensions, which contradict a preference for fairness and equal opportunity. Society may be more willing to have the private market deal with equal access to hotel rooms—an item with almost exclusively private benefits—than to trust the provision of a good like education, with its presumptive social benefits, to private provision. These issues are given specificity in Nelson's discussion of public policy toward children, which includes welfare programs, compensatory education, and day care; in Laurence Kotliloff's paper on social security; in Henry Levin's on education; in the paper on health care by Randall Bovbjerg, Philip Held, and Mark Pauly; and in John Chamberlin and John Jackson's discussion of credit markets. In each of these policy areas, a variety of equity motives underlie numerous public interventions.

The scrapping of the social security system, perhaps in favor of a broader

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system of Individualized Retirement Accounts is suggested from time to time, although it has not attracted many adherents. Kotlikoff argues for both public financing and public provision of a social security system—OASDI in particular—on the basis of both equity and efficiency concerns.

His case has three elements: (1) *Paternalism*—the need to act for all the "myopic, misinformed, miscalculating, and lazy households," who would otherwise inadequately save and insure for their old age. (2) *Market failures*—the absence of a complete private annuity market due to problems of adverse selection and moral hazard that the government can overcome by requiring universal coverage, or from the private market's inability to incorporate intergenerational risk sharing, whereas the government can "pool good and bad times across generations." (3) *Self-serving altruism*—we care about the welfare of our neighbors. And, perhaps because they know we care, they save too little for their future and thus ride free on our caring. For such a system to work, the government must provide incentives for or require more saving than would be made voluntarily. Compulsory saving may be more efficient than subsidies.

Does any evidence indicate that in the absence of the social security system too little saving and insuring would be carried out? The paper shows dramatic calculations indicating that, absenting the social security system and assuming all social security tax contributions would have been consumed rather than having been put into private saving, "for the population that is retired and has no pension benefits. . . . 65 percent . . . would face a 50 percent or greater reduction in their standard of living." The critical element in the evaluation depends upon the saving response, however. The author cites other research that does "suggest a potential problem of inadequate savings in the absence of government intervention." As for the adequacy of insurance, the evidence indicates that "a significant minority of elderly couples appear to have inadequate amounts of life insurance," where inadequate is defined as providing insufficient income to maintain standards of living. Thus, Kotlikoff concludes that the arguments for a public social security system are persuasive.

The arguments for public education are also founded on an exceedingly complex underpinning of efficiency and equity goals. Nonetheless, there are many proposals for privatization. As Henry Levin argues, the climate favoring the introduction of greater private alternatives in elementary and secondary education arises from a general belief, reinforced by numerous studies, that the public schools are not doing a very good job and that private schools provide better education at lower cost. In addition, over the last thirty years the public-school system has become more uniform and more egalitarian as inequalities of financing among districts and racial segregation have been challenged in the courts. This has resulted in a loss of influence and perceived benefits for those who had benefited most from the less uniform, less egalitarian system, leading to increasing insistence on greater choice by them—in particular for public support of private options.

Levin rejects the notion that private schools—sectarian, "segregated," schools—can do an adequate job of transmitting the important social values, even if publicly regulated. The costs of regulation, such as the measurement of output and monitoring of compliance, are enormous. Moreover, the transmission of social values requires a diverse student body in which exposure to a wide range of views takes place. Increased reliance on private schools,

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through the use of vouchers that may be spent anywhere, will increase the segregation of pupils into schools with values close to those of their parents along religious, ethnic, ideological lines. Therefore, Levin defines the important challenge as improving the public-school system to increase the level of private outputs and to retain a diverse student body in the face of centripetal forces.

Levin also argues for increased choice within the public-school context as a means of preserving the output of social goods and increasing the output of private goods. He makes several specific proposals, including *school-site governance* to increase the responsiveness of the schools to parental preferences; *open enrollment among school districts; specialized schools of choice* (e.g., in the arts, music, science); using *post-seconday options* (i.e., making it possible for secondary school students to take advantage of local two and four-year colleges for part of their education); *mini-vouchers* that could be used for specialized "enrichment" educational services both in and outside the public schools (e.g., creative writing, computer programming); and using *private contractors* for specific limited purposes.

In his comments, Albert Shanker argues that the emphasis in the paper on the production of social goods is both a major strength and weakness of the paper. It constitutes a strength because so much of the traditional argument for public schools turns on their role in the production of social goods, a weakness because, in fact, no evidence confirms that they produce much in the way of social goods. Indeed, evidence to the contrary is cited. Anita Summers also argues, however, that evidence to the contrary notwithstanding, the belief in public schools as producers of social goods is well entrenched and will remain a central element in educational reform.

Although Levin, Shanker, and Summers emphasize the dissatisfaction of parents and the general public with the level and quality of private goods production in the public schools, it may be that real disagreement concerning the nature of the social values that are being transmitted is the cause of much of the dissatisfaction. Furthermore, some would argue that the paper also describes the public schools unrealistically by implicitly assuming that the population of the public schools is highly diverse. Given the substantial amount of housing segregation in metropolitan areas and the existence of numerous independent school districts, many parents have succeeded to a great extent in segregating their children within the public-school system, thus making the output of social goods, by Levin's definition, very difficult within the existing public-school system. Vouchers and a broadening of boundaries might in fact increase access for students unable to live in the areas where they would choose to attend school.

Clearly the arguments for public intervention are both more complex and more subtle than can be encompassed in the summary categories of efficiency—market failure—and equity—income distribution. Market failure offers only an imperfect guide to whether or not government should intervene by producing, financing, or regulating the production of goods and services. Whether one takes Nelson's view that market failure is so pervasive that it provides little guidance at all, or whether one agrees with the perspective in Gerald Faulhaber's comments that market failure is an important screen—necessary but not sufficient—for public intervention, there is widespread agreement that explicit consideration should be given to whether the public intervention is an improvement over the nonoptimal private state of

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affairs. Because such evaluations have not been very common, and market failure—albeit not all market failures—has provided a casual rationale for many public interventions, there may indeed be considerable scope for privatization. As analyzed by Sappington and Stiglitz (and discussed below), the complexities of public-private sector interactions may reduce the potential gains from privatization. Further reduction of the scope for privatization arises from the other motivations for public intervention—equity, fairness, equal opportunity—which may be exceedingly difficult to bring about without substantial public intervention.

WHAT IS KNOWN ABOUT PRIVATIZATION?

Privatization is the term of the day, but it is important to recognize that privatization is not a new phenomenon. The public sector has always contracted for goods and services from the private sector. Defense spending, aside from military personnel, is largely for the procurement of military hardware and research from the private sector; highways are paid for by public revenues but built by private contractors; Medicare payments cover the services of private doctors and private hospitals; public housing is financed with federal aid or municipal bonds and built by private contractors. Stationery, desks and chairs, lamps, pens and pencils, fire engines, and police cars are all bought from private firms.

The current discussion of privatization urges even more purchasing of goods and services on the private market. Many of the production activities of public agencies are (or could be) available from private firms—school lunches, school bus transportation, vehicle fleet maintenance, building security, building maintenance, and many others. It is possible that substantial savings could be obtained from further expansion in the size and scope of purchases from the private sector. Such expansion may encounter resistance from public employee unions or from public managers interested in maximizing their budgets and staffs. Nonetheless, the narrow privatization question—whether the public hospitals should do their own laundry or contract with private linen suppliers—is not very interesting. If privatization is an interesting and difficult issue, it is so because of the fundamental, general questions that it raises about the proper role and the nature of the role of public-sector activities that involve externalities or merit goods.

For the most part, privatization arguments look like pure efficiency arguments: Public production can be replaced, at lower cost, by private production. However, as many of the conference papers (Levin on education and Bovbjerg, Held, and Pauly on health) and the discussions make clear, any reorganization of service delivery (vouchers, contracting out) has distributional consequences—even where the only intention is to achieve an efficiency improvement. The incentives of the producer, in particular the profit-maximizing imperatives of the private sector, make it more likely that there will be attempts to exclude higher cost activities, such as health care for the sickest patients or education for handicapped children. These difficulties can not be overcome simply by appropriate contract provisions or different-valued vouchers. As Sappington and Stiglitz emphasize, precision in contract specifications is often elusive, and monitoring is difficult and expensive. As John Chamberlin and John Jackson argue, differential vouchers in a cost-

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containment environment may not be adequate to cover differential costs. It should also be kept in mind, however, that in a more cost-conscious environment, similar incentives to avoid dealing with high-cost cases may also operate in the public sector.

Aside from several studies of the economics of public and private trash collection and recent work on transit, very little is known about the real potential of privatization for cost reduction or for improved service quality. Similarly, we understand little about how to avoid the possible diminution of quantity or quality that allegedly occurs in the push for private profits in sectors where consumers have little information or choice. Nevertheless, the competitive-bidding cost-minimization model is exceedingly attractive and has a substantial following.

In their analysis of institutional alternatives for public-service provision, Chamberlin and Jackson emphasize the important role of rents and rent-seeking behavior in influencing the interests of the parties in preserving the present system and in its reform, as well as the efficiency and equity properties of the alternative organizational forms. The benefits of privatization will be realized to the extent that competition is increased. Without an increase in competition, the reorganization may simply transfer rents—payments to a factor of production (labor, for example) in excess of what is required to obtain the use of that factor—from public employees to private firms.[7]

What critical assumptions are required for the efficient outcome to result? Are they likely to hold? If not, how do they affect the result and the choice between public and private producer? Sappington and Stiglitz conclude that the principal difference between public and private production arises when intervention is necessary. They judge such intervention to be more difficult when the activity has been contracted out to the private sector. Thus, in choosing between producing the good or service internally or contracting it out, an important consideration for the public agency must be the likelihood that it will need to intervene, and the expected benefits and costs of intervention.

When will intervention be necessary? (1) When the goods or services demanded are difficult to define and there is no agreement on how to weigh the elements of complex products like education, health care, or safety. This makes it very difficult to write contracts and to measure and monitor producer performance, which raises serious control problems. Consider education. Is the desired output numbers of graduates, levels of achievement, job placement, citizenship, integration, richness of course offerings? All of these? In what combination? (2) When the production process not well understood by either the public agency or the potential private suppliers. The simple model assumes that all requirements can be spelled out in the contract. If, however, a contract must be written with many contingencies to protect both the government and the private supplier, then continued communication and renegotiation is inevitable.[8] Department of Defense contracting offers a case in point.

The problems and costs faced within the public sector when the desired output is difficult to define and measure may also be considerable. In the last 15 years, public policy analysts have concentrated a great deal of attention on the problems of evaluating public programs. Investigators have found that output is often difficult to define and measure, confounding the efforts of the analyst and of the public sector itself to design programs, and to deter-

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mine whether they are working efficiently, or even working at all. Any attempt to answer such questions is itself expensive—whether it costs more to contract out production to the private sector is not immediately obvious and needs further consideration. The major problems may be inherent in the nature of the activity, not in the locus of production. The implementation literature provides many examples. Empirical studies emphasize the enormous transaction costs within the U.S. federal system, when programs to be implemented by local governments are financed (and designed) by the federal government. The results are widespread program failure and inefficiency.[9]

Regulation, combined with private production, may help to overcome some of these problems. Particularly in the absence of competition, regulation may make better monitoring of performance and limiting of rents possible. In the presence of uncertainty about either the output desired or the production process, the contract is, in effect, renegotiated as appropriate.

Given these factors, we would expect contracting out to be less difficult for many of the intermediate inputs used in the public sector and most problematic for production of final goods and services, e.g., education or defense. The intermediate inputs are generally well defined (simple goods or services for which there is an existing active private market), there are many suppliers, and the competitive, minimum-cost outcome is likely to result from the bidding process with no further intervention required.

Incompletely specified contracts and the need for frequent renegotiation, contingency clauses, and short-term contracts make the bidding process less dispositive. If both sides understand that the bid is not necessarily the final outcome, it is not clear what choosing the lowest bid means; and choosing the lowest initial bid may not result in the lowest ultimate cost. The important question is not whether the least cost outcome is achieved, however, but whether privatization results in lower (than public) cost outcomes.

In his comments, Dennis Yao correctly emphasizes the need for a much better understanding of public decision making and production processes. It may be that current dissatisfaction with the public sector and interest in privatization stems from just those factors that also are alleged to complicate private production: complex, difficult to agree upon, difficult to measure outputs; complex or not-yet developed production processes; lack of competition; and the existence of substantial rents in the production system. Where desired outputs are difficult to specify or agree upon (in the Congress, among bureaucrats), conflicts over specification continue into the implementation or production process, enormously complicating and increasing the costs of production. As Yao suggests, contracting out would increase the need to reach agreement and specificity and perhaps bring the political struggles to a close sooner. Although, as Sappington and Stiglitz argue, the generally monopolistic conditions of public production may reduce the transactions costs, in some cases they may seriously impede technical progress (see Nelson's discussion of R&D). Despite the fact that it is not clear *a priori* how intragovernmental transactions costs compare with the costs of public-private sector interactions, Sappington and Stiglitz provide an important set of cautionary considerations for the privatization option—indeed, for the more general question of the appropriate location for production of publicly financed goods and services.

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The overview of privatization in practice by Poole and Fixler and the discussion of that paper suggest that a great deal of privatization has already occurred, resulting in substantial cost saving. They provide a sharp contrast with the earlier papers, many of which elaborate the obstacles to efficient privatization. Or perhaps, in spite of the apparent cost reductions cited by Poole and Fixler, a closer look would indicate hidden costs not considered, substantial equity shifts, and differences between what appears to be the outcome in the short term and the long term.

For example, Levin carefully examines the studies that find private schools do a better job at lower cost than public schools. He concludes that the cost differences are more apparent than real, the result of faulty accounting systems that assume private school costs to be equal to tuition charged and that do not take into account other sources of funds and the large amounts of volunteer labor (or not fully priced labor). The outputs are not comparable given the service mix differences in the public and private schools; e.g., the latter do not have programs for the handicapped and do not admit the most difficult to educate pupils. Moreover, a reexamination of the achievement differences also shows these to be very small.

Poole and Fixler's survey of experience with various forms of privatization focuses on state and local governments. The authors make four major points: (1) an impressive amount of privatization has already occurred; (2) although most of the privatization to date may be classified as intermediate inputs—various maintenance functions—contracting out of public production and delivery of relatively simple final services is rising; (3) research into relative costs shows that contracting out of both intermediate housekeeping functions and the production and delivery of final public services result in substantial savings; (4) there is a growing interest in, and some examples of, privatizating of public services of much more complex types (such as transit, highways, water and sewer facilities, prisons, and police functions).

They discuss four objections to privatization: (1) corruption, (2) low initial bids to get a foot in the door, (3) poor quality, (4) reduced service to the poor. With respect to the first, the authors stress that little evidence has surfaced of corruption relative to the large number of examples of privatization activities. Low initial bids, they argue, may be dealt with by requiring multiyear contracts. Quality control requires the writing of better contract specifications and the maintenance of proper contract monitoring once the contract is underway. In addition, performance bonds may be called in where contractors do not meet performance specifications. Such prescriptions are likely to be adequate for only a very limited range of goods and services. As Stiglitz and Sappington argue, this may be precisely where the problems of private contracting lie. The more complex the product, the more complex and uncertain the technology, the harder it is to specify, measure, and monitor output, then the higher the transactions costs of the contract. Moreover, it may not be possible to require adequate performance bonds. The amount necessary to compensate for inadequate performance may discourage bidding. Protecting service delivery to the poor could be accomplished in numerous ways, according to Poole and Fixler. For example, service delivery to specific groups may be spelled out in the contract. If, however, the incentive remains for the provider to avoid service to higher-cost clients, it places an enormous burden on contract monitoring. Another alternative would be to provide vouchers to the poor so that they can pay for the service. If the vouchers are adequate to

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cover the costs of serving them, then the provider no longer has an incentive to exclude.

Most of the comments on the Poole and Fixler paper centered on the possible sources of cost savings. The authors emphasize the benefits resulting from the discipline of competition, citing evidence not only of cost savings when public services are contracted out to private firms but of cost savings achieved by public agencies operating in an environment in which they are forced to compete with private bidders. Commentators emphasized that private management was able to achieve considerable labor input saving, indeed that most of the cost saving could be attributed to this factor. Why should this be so? The profit incentive for cost reduction in the private sector has no counterpart in the public sector. Moreover, accumulating evidence from positive models of government shows that the incentive system is antithetical to smaller government. Because measures of success are difficult to come by, bureaucrats seek larger budgets, more programs, and additional personnel to indicate their worth. Edwin Mills emphasizes in his comments that many production activities have been undertaken by the public sector based upon general market failure arguments, without any evidence for a comparative advantage in public production. By implication, the public sector must have undertaken some production activities in which it had no comparative advantage. Privatization, particularly contracting out, may, therefore, simply be turning the production activity over to the producer with the comparative advantage.[10]

Privatization of health care does not mean quite the same thing as in education or other public activities. Although the *financing* of health care has a large public element—40% coming from public funds (primarily Medicare and Medicaid), the *production* of health care is largely a private activity. The major issue on the public agenda involves cost containment. Thus, the administration and management of health-insurance programs have become increasingly important. Competitive bidding in the administration and management functions is the focus of the paper by Bovbjerg, Held, and Pauly.

Various bidding schemes have been introduced as cost-control methods. The public agency requests that hospitals or HMOs, for example, make proposals to cover some part of the publicly insured population for some or all covered services. If there are rents in the existing system or differential efficiency among providers, then the bids should differ, with the low bid producers offering the best value (low or no rents and higher efficiency). Note that the only change in the locus of production of health care comes about from shifts within the private sector. Once the contracts are let, the public sector is no longer in the business of determining appropriate payments and administering the insurance system, except for a monitoring function.

The success of the bidding system will depend upon the possibilities for defining the health services required of the supplier. Most difficult of all is the specification of quality. If the desired output is not well specified and the lowest bidders are accepted, profit-maximizing suppliers will set quality levels as low as the monitoring mechanism allows. Choosing several winning bidders—as contrasted with winner take all—will place some limits on the decrease in quality as users (if they can evaluate quality differences) will shift among providers.

In the various Medicaid programs, two types of bidding schemes appear to be taking hold since the early 1980s. The first involves bidding for the supply

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of standard items ordered by physicians for patients—prescription drugs, eyeglasses, laboratory tests, x-ray services, and hearing aids. Bids are requested for volume supply of such goods and services; insured persons are then limited to using only approved suppliers. In 1982, 9 states had implemented 14 separate programs, with 17 more states proposing 40 additional programs. The initial evidence appears to indicate substantial cost reductions are possible, and, in at least one case, there seems to have been both quality improvements and cost savings in the provision of eyeglasses.

Bidding schemes are also being developed for comprehensive medical care under Medicaid. In 1982, California, under the budgetary pressures deriving from Proposition 13, redefined the payment unit for inpatient care for Medicaid patients to be an all-inclusive per diem, irrespective of diagnosis or intensity of care. Hospitals were asked to submit per diem bids, and only accepted bidders could receive payment for treating Medicaid patients. In the event, these bids were not accepted as final but became the basis for discussions with a "Czar" negotiator who had good knowledge, experience, and bargaining skills. It had been anticipated that savings would be realized through (1) a shift from high- to low-cost providers and (2) reductions in payments to hospitals below what they would otherwise have been. Because there was relatively little exclusion of hospitals, the second factor must have accounted for the observed decrease in per diem payments compared with previously observed steady annual increases. Were these reductions in costs achieved without quality sacrifice? As no systematic complaints about the new system have surfaced, the authors conclude there do not seem to be grounds for concern in this regard. If this conclusion is sustained over time, then we can conclude that there were, before bidding, substantial rents accruing to private providers which have now been reduced.

Arizona was a state without a Medicaid program. Under a waiver allowed by the federal government, it designed a system in which bids were sought from service providers in each county for comprehensive or partial health-care services. Sealed bids were requested, winners were to be chosen after a single round of bidding (that is, no negotiation), and multiple winners were desired for each county. It turned out that the bids exceeded the funds allocated to the program, so a round of negotiation of "voluntary" bid cutting followed. As a result, bids were received and contracts awarded in each county. The cost and quality impacts are not yet clear.

From these examples the authors conclude that bidding in these areas is feasible; meaningful contract specifications can be written; bids will be submitted at less than prevailing prices; and services will be delivered. Some negotiation, however, is necessary. Uwe Reinhardt takes a very skeptical view of the cost-savings conclusions in his comments. He cites the more rapid increases in aggregate health costs from 1980 to 1985, when competitive strategies were being adopted, than in the previous five years.

Despite the fact that the cost-savings picture is not yet clear, the examples cited by Bovbjerg, Held, and Pauly are important in light of the emphasis in so many of the papers and in the discussion on the difficulty of writing and negotiating contracts for outputs that are difficult to comprehensively describe and measure. Indeed, these examples from the health-care sector may have important empirical lessons for privatization more generally. Because production is largely a private activity with about 75% of payments from third parties—private and public insurers—health care has a long history of

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specifying the output for contract purposes. Covered and uncovered items are always specified by the insurance policy. Problems arise when there is little agreement on the quantity or quality of care desired, but this is a financing issue more than a production issue.

Still another arena is open for the privatization of health care: public hospitals. Despite evidence of an increasing interest in giving public hospitals over to private management, selling them to private firms, or closing them entirely, the authors argue that a continuing need exists for the public hospital to provide care for the growing number of persons not covered by existing public or private insurance (including Medicaid). The argument for public hospitals rather than subsidy of private production of charity care is that the public is not willing to cover the private costs (for high-quality care), but the public hospital is especially suited for rationing public care, particularly if it faces a fixed budget rather than the usual net deficit financing system of funding. This is an interesting inversion of the argument of the benefits of private versus public production. In his comments, Reinhardt questions the greater efficiency of the public hospital in providing indigent care. His view is that public hospitals make it possible "to operate a two-tier health system without ever explicitly having to admit it." Nonetheless, there appears to be a growing interest on the part of public authorities in increasing the role of private firms. Poole and Fixler cite the contracting out of a mental retardation facility in Kentucky and a state mental hospital in Florida, the conversion of ten major public hospitals to private nonprofit status, and numerous contracts with private for-profit firms for management and operation of public hospitals. These represent an increased role for the private sector. Given the central concern for distributional issues in the public provision of health care, these developments warrant close monitoring for changes in access and additional evaluation of how cost savings have been achieved.

CONCLUSIONS

Despite the theoretical cautions about the appropriateness and difficulties of privatizing, particularly of contracting out public-sector production activities, a substantial amount of contracting out and privatization appears to have taken place and still more is planned. Consistent with the cautionary discussion, however, government is not—or not often—stepping back from previous commitments for the financing of traditional public-sector goods and services. Yet more production activities are being shifted to the private sector for intermediate public-consumption items and for the final goods and services delivered to consumers.

Nonetheless, privatization is still very limited in terms of the types of activities covered, the numbers of places involved, and its claim on the public budget. At the local level one can point to Scottsdale, Arizona's privatization of fire-fighting services, but that is the exception, not the rule. In education one can point to Minnesota's school district contracts with private-practice teachers, but this is exceptional. Such examples, however, and there are many of them, point to an underlying dissatisfaction with the existing public-production regime. Whether or not the next decade will be

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one in which such activities multiply or should be encouraged to multiply will depend upon answers to many of the questions raised at the conference.

How inefficient is public production? This depends upon how well an alternative regime can perform, not on an absolute efficiency standard. Some problems may defy solution irrespective of production regime. They may depend upon social or scientific knowledge not yet developed.

How efficiently can the private sector produce traditional public services? In areas in which private activity already exists, careful evaluations are still required, over a longer term than current experience provides in most cases, of the quality and distributional implications arising from relocating production in a profit-seeking firm.

How much needs to be spent on regulation and monitoring by the public sector in order to insure conformity with contract specifications?

These constitute an important but narrow subset of questions. They are important in dealing with the kinds of goods and services for which we are indifferent as to the producer, except for efficiency considerations. They may productively be raised for the many goods and services produced by the public sector in which the elements of publicness are very limited.

Other difficult questions arise for those activities in which the primary outputs are equity-enhancing rather than efficiency-enhancing activities. In these cases the most fundamental question of why this is a public activity can not be answered simply, and therefore neither can the question of the appropriateness of privatization. The more complex the underlying motives for public financing and production—that is, the more they combine both efficiency and a diversity of equity goals—and the more the output is seen as conferring both private and social benefits, the less likely it is that a transfer from public to private production will proceed very far.

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NOTES

1. The conference, held on September 18 and 19, 1986, was organized by Janet Rothenberg Pack, under the auspices of the Department of Public Policy and Management of the Wharton School. The financial support of the Sloan Foundation, the Samuel S. Fels Fund, and the Fishman-Davison Center for the Study of the Service Sector is gratefully acknowledged.
2. This summary list is taken from an article by Martin Tolchin, "U.S. Pressing Plan to Contract Work," *The New York Times*, March 11, 1985.
3. All figures taken from Table 1, Government Expenditure, *From Own Source*, Selected Years, 1929–1985, Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1985–86 Edition*.
4. As Nelson points out, however, many of the apparent "inefficiencies" in public production result from the checks and balances built into the system to preserve freedom and equal opportunity, to protect minority interests, to maintain balance among the branches of government. Consider the following example: "the New York Court of Appeals held that private security guards . . . were not re-

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quired to tell a man accused of shoplifting that he had the right to remain silent. They asked him to sign a statement acknowledging that he had stolen seven shirts and he did, acting on their assurance that he would be released. But the store decided to prosecute and the statement was admitted in evidence at his trial, where he was convicted. The court ruled that constitutional protections against self-incrimination did not apply to a private questioning unless it was "pervaded by government involvement.'" (Martin Tolchin, "Private Guards Get New Role in Public Law Enforcement," *The New York Times*, November 29 1985.) Public activity is held to a standard which involves expenditures not necessary in the private sector. Moreover, it is precisely this difference that many opponents of increased privatization fear.

5. It is not impossible for interested parties to form voluntary associations to internalize various externalities—block associations, for example, perform such functions. However, the exclusion of free riders may be impossible and the costs of organization very high. See, for example, James M. Buchanan, "An Economic Theory of Clubs," *Economica*, 32 (Feb. 1965): 1–14.
6. Charles Wolf, Jr., "A Theory of Non-Market Failures," *The Public Interest*, No. 55 (Spring 1979): 114–133.
7. If the journalistic literature and anecdotal evidence are any guide, it is low-skilled public employees who receive rents in the current system. Public officials who have turned to private contractors cite lower wages and employee benefits as the principal source of cost saving. However, critics of privatization, union leaders and public employees among them, respond that the quality of the labor force declines substantially. (See Martin Tolchin, "Private Guards Get New Role in Public Law Enforcement, *The New York Times*, November 29, 1985; and Jeremy Main, "When Public Services Go Private," *Fortune*, May 27, 1985.) These allegations and counterallegations are impossible to evaluate, although lower wages with no decline in productivity in private firms has been documented in studies of trash collection and transit. [E.S. Savas, *The Organization and Efficiency of Solid Waste Collection* (Lexington Books, 1977); and Edward Morlok and Philip Viton, "The Comparative Costs of Public and Private Providers of Mass Transit," in Charles Lave, Ed., *Urban Transit: The Private Challenge to Public Transportation* (Pacific Institute, 1985): pp. 233–254.]
8. Kimberly argues, in his comments, that public contracting with private firms cannot be viewed statically. His studies of contracting for management of public hospitals shows that public officials have, over a relatively short time, become much more sophisticated consumers of contract management services, redefining both their own needs and their expectations about contractor performance.
9. Robert A. Levine, *Public Planning: Failure and Redirection* (Basic Books, 1972); Jeffrey L. Pressman and Aaron Wildavsky, *Implementation* . . . , 3d ed. (University of California Press, 1984); Walter Williams and Richard Elmore, Eds., *Social Program Implementation* (New York: Academic 1976).
10. As indicated above, despite the theoretical arguments for cost-reducing private production, the evidence is very limited. Wage reductions are widely claimed and just as widely disputed. For example, comparisons of police salaries and private security guards are alleged to be misleading given the great differences in qualifications and in responsibilities between the two groups. More systematic analysis and data gathering are clearly required.

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