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PERSPECTIVES ON PRIVATIZATION: CONTRACTING OUT

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Since 1979, the National Association of Schools of Public Affairs and Administration has had a cooperative agreement funded by US AID missions and the Bureau of Science and Technology's Office of Rural and Institutional Development. As part of the Performance Management Project which funds a portion of that agreement, NASPAA has recently begun to build expertise in the area of policy reform. To that end, NASPAA in 1986 hired two Research Associates, Steve Morrison, of the University of Illinois, and Richard Moore, of Princeton's Woodrow Wilson School. Moore, a Latin American specialist with extensive experience in urban finance and housing, will be working with NASPAA on a two year contract.

NASPAA foresees an increasing role for itself in assisting US AID missions and host countries in their efforts to reduce the cost burden of the public sector while strengthening the private sector's contribution to development. NASPAA anticipates that as missions become increasingly active in the area of privatization, in response to the 'Guidance Cable on Privatization' issued by AID/Washington in June, 1986, they will require assistance in the development of concept papers, in the design and evaluation of projects, and in the provision of applied research to meet mission needs.

Of special concern to NASPAA are programs which encourage the private delivery of public services (contracting out). Such efforts, NASPAA feels, are highly promising. Their potential, however, is likely to be realized only after significant challenges have been met. Systematic field work aimed at generating comparative data on performance, relative efficiencies and operating procedures will be essential in the formulation of guidelines for mission activity. Equally pressing will be the need for focused analysis of the changes in development administration which privatization measures demand. The turn to private forms of delivery will substantially alter several dimensions of government practice: attitudes of staff, strategic goals, appropriate administrative and regulatory practices, requisite capacities, specific data needs. Lastly, privatization implies significant changes in the relationships which missions have to host country actors, both public and private. These too will require careful attention.

The statement below defines the perspective which NASPAA has adopted in understanding the private delivery of public services. It presents the framework and methodology which NASPAA intends to employ while working with missions to advance this particular reform strategy.

The Private Delivery of Public Services

Introduction

1. The ongoing search for viable strategies to reduce the burden of the public sector and shift responsibilities to the private sector increasingly directs the attention of development professionals to the private delivery of public services--especially contracting out. Recent experience had demonstrated that the outright divestiture of state entities remains an exceptional policy outcome in all but a few developing countries. In general, it has been highly difficult to achieve, owing to formidable economic and political obstacles. Far more realistic and hopeful are those reform strategies which strive to revise the institutional arrangements under which the public sector provides services.

2. Public choice theorists, among others, have argued that it is not necessary for developing countries to abandon commitments to established public services in order to contain runaway public costs. Rather, governments can withdraw from the actual production of public services and permit private interests to fill that role (Bish and Warren).

3. Two of government's essential functions, it is argued, should be understood as (i) the creation of conditions which foster a competitive private market, and (ii) the creation and management of public markets, whereby the government's energies are concentrated upon arranging the delivery of public services in an efficient and quality-conscious manner. Vital public functions can be retained, even in the midst of severe financial crisis. The state sheds its formal productive responsibilities and redefines its role to that of managing the delivery of services by the private sector in ways that promote efficiency, equity and entrepreneurship.

4. By this logic, it becomes theoretically possible for bureaucratic monopolies to be broken, for the public sector to manage competitive forms of private delivery involving multiple sources, and for new levels of efficiency and savings to be realized. Advocates place overriding importance upon ensuring competition. "While comparisons of alternative service delivery focus on public versus private, the issue which is central to efficient production of local government services is competition" (McDavid). If successfully implemented, this strategy will avoid gross dislocations in established public activities and gradually reduce public sector employment. Of the several forms which this strategy of privatization can assume, contracting out receives special emphasis. Other means include franchizing, management contracting, leasing, and the use of vouchers.

5. As part of NASPAA's efforts to organize a program of applied research and mission support, centered upon the private delivery of public services, four interrelated sets of issues must be considered:

(i) Is this strategy truly viable in developing country contexts? What are the perspectives taken towards understanding it, what empirical data are available, what uncertainties remain?

With these in mind, what field research designs appear most appropriate?

(ii) How is an evaluative framework to be structured? That is, what are the factors which bear most strategically upon experiments in the private delivery of public services?

(iii) Which economic sectors should be selected as areas of concentration, bearing in mind both the economic realities of LDCs and the specific areas in which US AID missions have had (and continue to have) significant involvement?

(iv) What effects will a programmatic emphasis upon private forms of delivery have upon missions' relations with host countries? (In regard to loan accountability, the selection of private sector recipients of assistance, established mission relations with key ministries, 'dialogue' begun with public officials on macroeconomic management.)

Perspectives on Contracting Out

6. In the United States, the integration of the private sector into government operations has long been a familiar practice, far more extensive, in fact, than in other advanced Western countries. In the post-war period, as the American 'contract state' rapidly took shape and contributed to a series of technological breakthroughs, mostly concentrated in the defense industry, enthusiasm for this approach grew. Arguments in favor of contracting out were initially not rooted in any formal critique of government per se. Rather, they rested upon pragmatic considerations at play in America (how to expand government functions without creating a large permanent bureaucracy), a political culture which favored business, the extensive expertise which resided in the private sector, and a technocratic faith in the benefits to be derived when multiple channels contributed to the challenges of major scientific projects (Danhof, Scharkansky 1979,1980).

7. Beginning in the late 1960s, the 'public choice' perspective added an important new voice to this field (see Tullock, the

Ostroms). Driven by neo-classical assumptions regarding the self-interested behavior of bureaucrats, as well as by the desire to systematically understand the nature of publicly-provided goods, these theorists heartily endorsed contracting out: their basic rationale has been outlined in the introductory section above. Early work in this field focused upon alternatives for the delivery of municipal services in America (Ostrom, Savas, Poole). Upon President Reagan's entry into office, the strategies developed in local urban settings were consciously transported to the federal government (e.g. the Grace Commission, the HUD studies: see Goodsell, Florestano) and to international development programs (US AID's Private Enterprise Bureau).

B. At its purest, public choice analysis operates from the following assumptions:

(i) For those public goods that can be privately exchanged and consumed, the marketplace is virtually always superior in performance to that of government. Such faith is grounded in neo-classical theory, as well as empirical outcomes. Indeed, recent technological changes now make feasible private delivery in sectors (electricity, telecommunications) heretofore regarded as natural public monopolies (Roth 1985). In sum, a vibrant and competitive private sector can be (and is) assumed (Hanke).

(ii) Institutional arrangements are decisive in determining whether competitive, market-like conditions (and efficiency) are attainable in the delivery of government goods and services. Great savings can be realized in converting from government "force account" delivery of goods and services to contracted arrangements. Often cited as proof are the data collected on US cities' experience in waste disposal (Savas).

(iii) Problems of equity, corruption, contract administration, regulation, and public employment are manageable. Whereas public choice theorists regard the behavior of monopolistic bureaucrats as costly and self-serving --deeply resistant to proper functioning -- these same analysts make quite optimistic predictions about the public sector behavior which will result under institutional arrangements encouraging competitive forms of delivery. Technocratic solutions exist for routine policy problems. Vouchers can be employed to offset inequities; procedures can be devised to control for corruption; techniques can be refined to deal with reductions in public sector employment. At base, bureaucracies are seen as distinctly separate from the political realm: the task is to create institutional arrangements which subordinate bureaucrats to the interests of political clients. Once such accountability is in place, sound administration becomes possible.

(iv) Experience gained in the US and other advanced industrial countries is transferable to developing countries.

Special precautions may often be necessary, data from developing countries are admittedly scant, yet overall the universal superiority of markets vs. states can be demonstrated, provided markets are given sufficient opportunity to function (Hanke, US AID Privatization Conference, February, 1986).

9. The public choice perspective is itself seriously divided on certain points. Stuart Butler of the Heritage Foundation, a major voice on the conservative wing of public choice, rejects contracting out as a viable option, reasoning that the entry of private sector entrepreneurs will only expand the coalition favoring the expansion of public sector spending: costs, rather than declining, will inflate (Butler, Kolderie). Ironically, his argument resonates strongly with the familiar critiques -- from the left -- of the defense contracting establishment (see Kuttner.)

10. Some public choice analysts, while openly advocating this approach, nonetheless worry that predictions of improved efficiency are not sufficiently supported by empirical data. In lieu of substantial proof, theoretical assertions remain speculative and ideological (Mueller, Savas 1978).

11. In recent years, testing has truly increased. Quite forcefully, it has revealed the extent to which US municipalities turned as of the early 1980s to private delivery as a means of coping with dire financial difficulties (Savas 1985.) Sectorally, this policy shift has remained concentrated in solid waste disposal, street construction, and skilled professional services (Florestanc and Gordon). While confirming some predictions, empirical studies have also generated ambiguous findings, results which have in certain significant respects contradicted theoretical expectations: the field of public choice "has rapidly grown from its formal, deductive stage into its messy, experimental stage" (Weschler).

12. The police study directed by Elinor Ostrom highlighted the importance of <u>contextual</u> considerations. Diverse institutional arrangements -- not one single model -- could be successful: "organizational structure does make a difference; variety and diversity are good, but structural form is so idiosyncratic and specific as to fail to predict efficiency, effectiveness, equity, and responsiveness in police services." A survey of different institutional arrangements employed in 84 California municipalities (Sonnenblum) demonstrated that contracting out, rather than enhancing local control, often actually undermined it: "Seeking the most administratively and economically efficient solution may produce unacceptable political costs." Miller's 1981 study revealed that political struggles along social class and racial lines -- not the quest for greater efficiency-- motivated cities in the LA metropolitan area to incorporate and

turn to LA County for the contractual delivery of services. He found "that the political market has a systematic bias and the poor are disadvantaged by widespread contracting for services. ..the fragmented system defended in public choice theory does not permit equality in voting with one's feet. Housing costs alone would prevent relocation of populations in Los Angeles County to areas with most desirable amenities. Contracting out does provide subsidies to the contracting cities... Thus, the issue of social equity and welfare is not as clean as pure public choice theory has it" (Weschler).

13. Outside the public choice camp, many other analysts have written on the subject of contracting out. Apart from the academics and watchdog journalists who specialize in exploring the foibles of the defense industry and the 'contract state' in general (Hanrahan, Adams, Guttman and Willner), there are various analysts who share a pragmatic, middle-of-the-road stance: these include a large number of liberal public administration specialists who are sensitive to the malfunctionings of large scale bureaucracies, while also often actively engaged in the practical reform of various levels of government (See Urban Resources, Scharkansky, Kettl).

14. Other contributors include political scientists of the 'neo-pluralist' perspective, prone to emphasize the consequences of the 'cooption' of bureaucrats by private special interests (de Hoog); organizational theorists who perceive government behavior --regardless of institutional arrangements -- as a persistently slow and incremental form of decision-making ('satisficing'); theorists of a statist bent, who argue that in many advanced Western states there are well-organized collectivities of public officials able to exert the state's power over other political interests (Krasner); analysts specialized in understanding the patrimonial form of governance prevalent in many developing countries, where the public sector serves elaborate patronage functions, effectively obliterating any analytical distinction between public and private spheres (Bates, Leonard).

15. In contrast to the strong enthusiasm which public choice theorists generally show for contracting out, the pragmatists qualify their endorsements in important respects. (To be fair, many less doctrinaire public choice theorists share these same sensitivities.) Contracting out is regarded as one of several reform mechanisms -- potentially quite useful, but not a panacea. In assessing contracting out's ability to bring the gains which public choice theorists posit, in designing and evaluating programs of this sort, development professionals need to be highly sensitive to the following considerations:

(i) It is important to examine the neo-classical assumption that markets are vibrant and competitive, (especially as regards developing countries.) Markets can be weak and imperfect,

dominated by powerful interests often of a problematic racial or ethnic character. High entry costs may impede genuine competition. Even in sectors where multiple private interests have replaced a single state agency (e.g. road construction in the UK) costs can rise as a function of redundancy (Brittan). Contractors, once in place, may inflate costs over time. One must inquire whether sufficient managerial skills and stability (re. strikes, bankruptcy) exist in the private sector.

(ii) One should avoid assuming that effective administration of contracts will occur automatically. Ensuring competitive bidding, guarding against manipulation over time by powerful private interests, designing and enforcing quality contracts: these are all highly complex dimensions of contracting out which require careful and active attention. Clearly, the shift to new institutional arrangements implies a significant change in the nature of development administration: it requires that public officials systematically manage private sector performance, vested with the responsibility of assuring public accountability and cost control. Increased effectiveness in these areas, as recent experience in the Ivory Coast has shown, can reap substantial benefits (Dei).

In the American experience, the administrative function has proved critical in determining the success or failure of contracting out efforts (Cooper, Hunt). Quite often, it has not been easily accomplished (Kettl). In practice, politics and bureaucratic behavior do not remain distinctly separate spheres; public and private interests become intertwined in ways which blur boundaries and create serious difficulties of control and rationality. The integrity of the state relative to pressures for the distribution of favors persists as a vitally important issue. In LDCs, where in many instances the decomposition of government is pronounced and patronage politics is extensive, one must examine closely whether effective contract administration is possible and whether public and private domains are separable.

(iii) Macro-economic policies which exert a critical influence upon private sector incentives must not be overlooked. The turn towards the private provision of particular public services is likely to go nowhere if there are severe deficiencies in rate structures and other regulatory measures, in the functioning of the legal system, in existing tax provisions, and in the availability of finance.

(iv) Understanding the long term, "process" side of privatization is essential. Underpinning most successes is a sustained political will, whereas the more familiar experience with contracting out is one in which multiple motives enter the picture and in which commitment and interest vary enormously over time. In this same vein, efficiency goals cannot be divorced from equity considerations. Changes in the form of service delivery frequently imply winners and losers. In the latter

category are usually public sector employees: "managing the employee impact is the most crucial item" (Bayer). So too, certain categories of consumers (the poorest) and well organized urban interests (senior ministry officials, the military, intellectuals) may oppose reductions in the scope of the public sector. Hence contracting out can stir important struggles which greatly affect final policy outcomes. For that reason, these considerations demand priority in any systematic analysis.

(v) Data remain "disparate," uneven and scant. Even in the United States, where the "Reagan administration triggered an avalanche of privatization activities, studies, ordinances etc..," empirical evidence demonstrating the unequivocal superiority of contracting out does not yet exist: "it may be that the euphoria which has surrounded the notion for the last four years is premature" (Florestano).

Studies of the private delivery of public services in LDCs are few, and concentrate upon transportation, construction and urban services (Harral, World Bank, Roth, Dei, Nolan, Marceau). In computing costs, it is essential to overcome the difficulties of devising genuinely useful measurement instruments. Official records of LDCs are often quite poor, while the calculation of comparative costs involves incorporating a multitude of public sector outlays (e.g. fringe benefits, hidden subsidies, etc...) Further, it is important to assess service quality accurately (versus focusing simply upon costs,) to scrutinize levels of actual public sector employment over time (to determine if privatization has truly reduced the number of public sector jobs,) and to employ a mix of methodologies (interviews, analysis of public documents, surveys.)

16. Finally, there must be careful consideration of how the promotion of private forms of delivery alters missions' relations with host countries. As missions begin providing assistance, financial and otherwise, to the private sector, they will encounter several pressing issues. Which private interests are to be favored (voluntary organizations, traders, urban commercial interests, industrial producers); by what means is loan accountability and effective contract administration to be assured; how to mediate this new relationship with missions' established ties with government ministries; how to link the promotion of contracting out with the 'dialogue' begun with public officials on key macroeconomic issues (fiscal, regulatory, legal, legislative.)

A Framework for Evaluation

17. Advocates of contracting out argue that the private delivery of public services can reduce costs and improve quality: institutional arrangements are regarded as the key variable in determining the effectiveness, or ineffectiveness, of the public sector. However, the preceding discussion has also shown that several other factors have a strategic influence upon outcomes: (a) whether there is effective contract administration, (b) whether adequate market conditions exist, (c) whether macro-economic policies encourage greater private sector involvement, (d) whether the political will of ruling elites is favorable.

18. These factors are the core of the framework to be employed in the design and evaluation of experiments in the private delivery of public services. Also, whenever possible NASPAA is to adhere to a methodology of formally comparing the delivery of specific public goods and services under different institutional arrangements. That is, in building comparative knowledge of the benefits which contracting out offers LDCs, it is essential that NASPAA analyze systematically the costs and quality of private, competitive forms of delivery -- versus private, non-competitive forms -- versus delivery by monopolistic public bureaucracies. Admittedly, in some instances local conditions will preclude such comparisons. On the other hand, certain sectors (e.g. construction, housing) do show a complex mix of public and private involvement, and hence suggest there is opportunity for rigorous comparison.

19. Essential also is the formulation of genuinely appropriate indicators of costs and quality. For certain sectors (road maintenance, waste disposal) measurement should be fairly straightforward: ready professional standards are available. In other areas, particularly human services, evaluation will require much more careful consideration.

20. To summarize: NASPAA proposes to organize the evaluation and design of experiments in the private delivery of public services around objective measures of costs and quality, in integration with systematic study of the following factors:

(i) <u>the political context</u>:

-- elite commitment
-- the role of public sector employees and other organized urban interests (degree of entrenchment of coalitions in specific sectors)
-- impact of changes upon equity and consumer access to services
-- international pressures
-- racial/ethnic composition of society

(ii) <u>the macroeconomic context</u>:

-- the regulatory environment
-- taxation
-- finance markets
-- courts and other aspects of the legal system
-- tensions associated with national external debt

(iii) <u>features of specific sectoral markets</u>:
(e.g.,construction,transport)

-- degree of concentration/competition
-- size of consumer market
-- entry costs
-- stability (e.g. strikes, bankruptcy)
-- management skill levels
-- degree to which contractors are able to inflate costs over time

(iv) <u>public sector administration of privatization</u>:
(integrity of the state relative to the private sector)

-- contract administration performance: maintenance of competitive bidding; quality and fairness in contract design; surveillance and enforcement of contract terms

-- existence of external oversight bodies (e.g.,auditors)

(v) Mission relations with host countries:

-- private interests to be favored
-- loan accountability/ effective contract administration
-- shifts in established relations with governmental ministries
-- links to policy dialogue

Likely Areas of Concentration

21. Most contracting out experiments undertaken in LDCs and investigated empirically are in the area of transportation and construction. Though transportation receives great attention in World Bank's programs, it generally falls outside of US AID's activities. Gabriel Roth, in his recent writings, has argued that great potential exists for private sector involvement in telecommunications and the provision of electricity; for the present, however, his views remain largely speculative.

22. Given US AID's areas of greatest programmatic emphasis, both past and present, it appears that the following areas offer the greatest latitude for experimentation and analysis of contracting out.

(i) construction: of health facilities, housing, school buildings, roads (including road maintenance.)

(ii) provision of services: distribution of agricultural inputs, health supplies, education, water supply, waste water treatment.

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