

## What you need to know about Privatization

by Mark Friedman

### Introduction:

When government-delivered services are contracted out to for-profit and/or nonprofit providers, it is called “privatization.” While this method has been part of the government landscape for many years, elected officials and government managers often don’t know the basics of when privatization is appropriate and how to make it work.

Privatization appears to offer many benefits, including the possibility of reduced costs, better service and less bureaucracy. But these benefits can only be achieved under certain conditions. Here is what you need to know about privatization, the pros and cons and how it is sometimes possible to make it work.

### Pros:

1. We can take government money, give it to contractors and not worry about it. If anything goes wrong it will be the contractor’s fault and not ours.
2. We can cut a lot of government positions and make it look like we’re reducing the size of government.
3. We will save money on contract employees because they are not entitled to the same level of benefits as government employees.
4. By using competitive contracting methods we can look very business like.
5. When we beat up on contractors for not meeting targets we will look tough.
6. When people look only at the contract cost, it will look like we’re getting the same service for less money.

## Cons:

1. Unless you spend money for oversight staff, you won't be able to monitor contractors' performance. This means you can't cut all the government staff (and dollars) you think you can. You need to keep a well staffed oversight operation.
2. No matter what oversight staff you have, you will have less control over the quality of service at the point of contact with the public. This uneven service almost always leads to customer complaints to elected officials and sometimes newspaper articles.
3. Between paying for oversight staff and paying for companies to make a profit, you will often end up paying more for the same service and not less.
4. You have to worry about what amount of profit is fair. The contractor has an incentive to spend the least amount for service quality to maximize profits. This is a fundamental conflict of interest that is impossible to fully remedy with oversight staff (unless it's an existing market – see below). This will sometimes lead to big time scandals with serious political fallout.

## What you need to know if you're going to do this:

1. Privatization should only be considered in cases where there is an existing market for the services you wish to purchase. Many years ago, Indianapolis called this the "Yellow Pages Test." If you can open the Yellow Pages and find business listings for a particular kind of service then it's a candidate for privatization (e.g. trash collection). Otherwise, it's not. Privatization often creates the illusion that government can create markets and then reap the benefits of competition. Governments are very bad at creating markets and this almost never works. Governments often lose market benefits even when there is an existing market. Government entry into the market on a large scale completely distorts market functioning, so that demand greatly exceeds supply. It becomes a sellers market, and the government immediately loses any advantage it might have had in price negotiations.
2. You must invest in a well staffed oversight operation. Without this you will end up giving taxpayers money away to unsupervised companies and will almost certainly pay a political price for this down the road. It is very rare that you will ever recover misspent contract money and recovery will always involve expensive litigation and public embarrassment.

3. Oversight functions must involve quality control at point of front line service delivery and not just summary review of performance measures. There are several forms this can take, including surprise inspections and “secret shopper” audits of service quality.

4. You must have a safeguard against unreasonable profits. This is hard to do, because you appear to be tampering with the free enterprise system. There are several approaches possible here. One is to have an annual audit of the contractor that makes the amount of profit clear by government, and not contractor, definitions. This could be linked to an annual renegotiation process or a rebate arrangement for profits over a certain margin. Another approach could be a fixed or graduated profit cap. A fixed cap is sometimes also called a “cost plus” contract. Its principle disadvantage is that the contractor gets the same profit no matter how much they spend. This creates a perverse incentive that makes the contract much harder to manage. A graduated cap is one where the company keeps 100% of the first 1% profit margin, 50% of the second 1% of profit margin and so forth. These arrangements keep the profit motive active but prevent the company from diverting too much money to profit and away from service.

5. You must make sure that contractors provide fair compensation and fair fringe benefits to their employees as well as a fair grievance process. Health benefits are particularly important because failure to provide adequate health insurance simply shifts those costs back to government. This cost shifting shows up in a different part of the budget and therefore doesn't get counted as a cost of privatization, making the contract look less expensive than it really is. An analysis of the true costs of privatization must include not only direct costs, but cost effects on other parts of the budget.

### Conclusion:

Buyer beware.