

## Chapter 3

### Privatization

#### 3.1 Privatization : Concept & Forms

Adopting market principles in government activities is an important feature of the new public management, and privatization is one of its principal elements. Privatization involves the transfer of activities and functions that traditionally rested with the Government to private sector. The definition of privatization is rather muddled, however, as there are numerous definitions, each one focusing on only one narrow aspect or managerial technique. We can define privatization in general as under:<sup>23</sup>

*“Privatization is the act of reducing the role of government or increasing the role of the private institutions of society in satisfying people’s needs; it means relying more on the private sector and less on government.”*

The basic goal of privatization is the introduction and use of market-based competition by government for the delivery of public services or goods by the private sector. The term “privatization” is most commonly used to refer to any shift of government activities or functions from a public agency to the private sector. It is an umbrella term used to account for greater private sector participation in the delivery of public services. Privatization has also been characterized as “sometimes leaving very little government involvement, and other times creating partnerships between government and private service providers where government is still the dominant player.”<sup>24</sup>

Specifically, privatization is defined as the economic process of transferring property, such as a building, road, or enterprise system that

<sup>23</sup> Savas E.S. (2001), *Privatization and Public Private Partnerships*, New Delhi: Affiliated East – West Press.

<sup>24</sup> Privatization.org (June 6, 2007), “What is Privatization,” [www.privatization.org/database/whatisprivatization.html](http://www.privatization.org/database/whatisprivatization.html).

delivers services from public ownership to private ownership.<sup>25</sup> Privatization as the involvement of the private sector in providing goods and services that otherwise might directly be provided by governments.<sup>26</sup>

Government intervention in society and the economy in various forms and to varying degrees is necessary. The classical reasons are to supply risk capital when massive investments are needed in uncharted areas; to establish rules for an increasingly interactive, urbanized nation where people get in each other's way; to plan for and provide, directly or indirectly, services deemed necessary and to subsidize them if unaided market forces cannot satisfy society's need; to handle external costs that otherwise desirable activities impose on others; and to regulate natural monopolies.<sup>27</sup>

Three broad methods that result in privatizing government-run services and functions and government-owned enterprises and assets are<sup>28</sup>

- (1) Delegation, where government retains responsibility and oversight but uses the private sector for service delivery, for example, by contracting for services, or outsourcing;
- (2) Divestment, where government relinquishes responsibility; and
- (3) Displacement, where the private sector grows and displaces a government activity.

Each of these incorporates several specific approaches that are identified in Table 3.1.

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<sup>25</sup> Encyclopedia Britannica (June 6, 2007), "Privatization", *Encyclopedia Britannica Online*.

<sup>26</sup> California Legislative Analyst Office (1996), "LAO Analysis of the 1996-97 Budget bill, P&I Part V-6 Privatization in California State Government," *1996-97 Budget Perspectives and Issues: Major Issues Facing the Legislature (Sacramento, 1996) Introduction*, [www.lao.ca.gov/analysis\\_1996/p965-6.html](http://www.lao.ca.gov/analysis_1996/p965-6.html).

<sup>27</sup> Savas E.S. (2001), *Privatization and Public Private Partnerships*, New Delhi: Affiliated East – West Press.

<sup>28</sup> Savas E.S. (1990), "A Taxonomy of Privatization Strategies," *Policy Studies Journal* 18 (2): 343-55.

1	Delegation	Contract Public Private Competition Franchise Public Private Partnership Grant, Loan, Favoured Tax Status, etc. Voucher Mandate
2	Divestment	Sale Free Transfer Liquidation
3	Displacement	Default Withdrawal (load shedding) Voluntary Action (voluntarism) Deregulation

Source: Savas E.S. (2000), *Privatization and Public-Private Partnerships*, New York: CQ Press

### **3.1.1 Delegation**

Delegation or partial privatization, requires a continuing, active role for government, which retains responsibility for the function while delegating the actual production activity to the private sector. The "tools of governance"<sup>29</sup> most suitable for delegation are contracts, public-private competition, franchises, public-private partnerships, subsidies by grants etc, vouchers and mandates.

#### **i. By Contract**

Government can privatize an activity by contracting with a private organization, for-profit or non-profit, to perform the work. This is also referred to as competitive sourcing. This is the most common form of privatization in the United States, used by federal, state, and local governments, and the most direct form of delegation. (The most common form of privatization elsewhere is divestment, because of more statist economies and the correspondingly larger number of state-owned enterprises.)

<sup>29</sup> Lester M. Salamon, ed. (2002), *The Tools of Government: A Guide to the New Governance*, New York: Oxford University Press.

The contracting with private firms in a deliberate effort to introduce competition and thereby reduce the cost of on-going government activities that public employees currently provide directly, is a new phenomenon since 1970. Accordingly, competitive contracting ("tendering") is compulsory for selected local government services in Britain.

To simplify Williamson's crucial analysis,<sup>30</sup> functions can be carried out externally through markets or internally through vertically integrated hierarchical organizations (firms or governments). Both incur costs. Markets incur transaction costs; hierarchies incur costs due to the chain of goal-displacing principal-agent links between the top and bottom of the hierarchy and to limitations of human understanding and competence; together these lead to nonmarket failure.<sup>31</sup> Leaders have to gauge the costs of each approach to decide whether to use markets and explicit external contracts or their own hierarchy and implicit internal contracts.

Procurement is fairly straightforward for goods such as chairs, buses etc. but much more complex for other goods such as computers and computer networks.<sup>32</sup> Purchase of services is more complicated. It is used for direct services, support services, and for services delivered to third-party clients. Local governments purchase (outsource) direct services such as solid-waste collection, street repair, street cleaning, snow removal, and tree maintenance. The average American city contracts out almost a quarter of its common municipal services to the private sector.<sup>33</sup> The average American

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<sup>30</sup> Oliver E. Williamson (1975), *Markets and Hierarchies*, New York: Free Press, p. 8-9.

<sup>31</sup> Charles Wolf, Jr. (1993), *Markets or Governments: Choosing between Imperfect Alternatives*, 2<sup>nd</sup> ed., Cambridge, MA: MIT Press.

<sup>32</sup> Steven Kelman (1990), *Procurement and Public Management: The Fear of Discretion and the Quality of Government Performance*, Washington, DC: AEI Press.

<sup>33</sup> Miranda R. and Andersen K. (1994), "Alternative Service Delivery in Local Government, 1982-1992," in *Municipal Year Book 1994*, Washington, DC: International City-County Management Association, Table 3/5.

state contracts out 14 percent of its activities, including the operation of some prisons.<sup>34</sup>

Services purchased from organizations (often non-profit) for delivery to third-party clients commonly include programs such as family counselling, employment training, senior citizen day-care, "meals on wheels," foster care, adoption programs, drug counselling, and shelters for the homeless and for victims of spousal abuse. Purchase of such services poses different problems than other forms of contracting.<sup>35</sup>

Contracting presents the ever-present, principal-agent problem: Is the agent, the contractor, pursuing the principal's (government's) goals or his own? Moreover, market imperfections may override government imperfections or vice versa. Transaction costs can be high enough to forestall contracting attempts – establishing the requirements, designing the proposal or bidding process and the contract instrument itself, assuring that there is a truly competitive market, defining and choosing the best bid, overcoming political and public opposition, dealing effectively with affected employees, working with the contractor both cooperatively and at arms length simultaneously, monitoring the work, evaluating the results, and determining whether to renew or terminate upon contract completion.

Government has to be a smart buyer, meaning knowing what to buy, deciding from whom to buy it, and then determining what it has bought; that is, preparing careful specifications as what is to be purchased, conducting a competitive procurement in a competitive market, and monitoring the

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<sup>34</sup> The Council of State Governments (November, 1993), *State Trends & Forecasts*, vol. 2, no. 2.

<sup>35</sup> Ruth Hoogland DeHoog and Lester M. Salamon (2002), "Purchase-of-Service Contracting," in Lester M. Salamon, ed., *The Tools of Government: A Guide to the New Governance*, New York: Oxford University Press, 319–339.

contractor's performance.<sup>36</sup>

The following few points outlined by Kelman are worth mentioning:<sup>37</sup>

- Candidate selection: services suitable for outsourcing;
- Source selection: sole source, limited competition, or open competition;
- Type of contract: fixed price or cost reimbursement; completion contract (performance contract) or best-effort contract;
- Contract for multiple provision: delivery order, task order, or indefinite-quantity procurement;
- Contract incentives and modifications, and resolution of claims and disputes;
- Criteria for evaluating bids;
- Degree of allowable official discretion;
- Nature and degree of oversight.

The contracting is likely to be better than direct, in-house provision under the following circumstances:<sup>38</sup>

1. The more precisely a task or result can be specified in advance;
2. The more easily performance can be measured and evaluated;
3. The more competition there is among potential providers;
4. The less the activity is core to the agency's mission;
5. The more the demand for service varies over time;
6. The private providers can hire people with the needed skills more

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<sup>36</sup> Donald F. Kettl (1993), *Sharing Power: Public Governance and Private Markets*, Washington, DC: Brookings Institution, chapter 8.

<sup>37</sup> Steven J. Kelman (2002), "Contracting," in Lester M. Salamon, ed., *The Tools of Government: A Guide to the New Governance*, New York: Oxford University Press, 282–318.

<sup>38</sup> *Ibid.* See also, John D. Donahue (1989), *The Privatization Decision: Public Ends, Private Means*, New York: Basic Books, p. 81–100.

easily than government can;

7. The private providers have greater economies of scale in producing the service.

The strong commitment from the top is needed to build the capacity for effective contracting because of the complexity and challenges of public contract management.

ii. **By Public-Private Competition**

The goal of contracting is competition, not necessarily contracting with a private firm. Therefore, governments are encouraging their own workers to compete for contracts with private contractors increasingly. This is called “managed competition” or “competitive sourcing,” and it has proven to be a powerful incentive for public agencies—under the threat of privatization—to improve their performance. “Competitive sourcing” gained prominence in President George W. Bush’s *President’s Management Agenda* and was an important thrust of his government reform effort. Both terms are somewhat confusing in that they seem to be contrasted with sole-source contracting rather than with giving public employees a chance to compete to retain their jobs. The term “managed competition” is used primarily in local government; this process became the standard approach in Indianapolis and in San Diego County, for example, for many municipal services. This term is unsatisfactory, however, because all competitions have to be managed; therefore the term “public-private competition” is preferred. Public-private competition requires the creation of a level playing field so the in-house group can compete fairly with outside private contractors, and vice versa. Martin identifies many of the

principal design features of a fair system; they are shown in Table 3.2.

<b>Table 3.2. Designing a Level Playing Field for Public-Private Competition</b>	
I.	<p>Process design issues</p> <ul style="list-style-type: none"> <li>A. Public and private sectors should submit their bids in parallel, not in sequence.</li> <li>B. The public agency should have access to consultant help.</li> <li>C. An independent body should evaluate public-sector proposals and bids.</li> <li>D. The government purchaser and the government provider should be separate entities.</li> </ul>
II.	<p>Cost Issues</p> <ul style="list-style-type: none"> <li>A. Government should not mandate private-sector wages or benefits.</li> <li>B. Government should not establish a minimum savings threshold.</li> <li>C. Using "avoidable cost" in the cost calculation favors the public sector; using "fully allocated cost" favors the private sector.</li> <li>D. Transaction costs should be either excluded or included symmetrically, viz., included for the public sector when current delivery is private and for the private sector when current delivery is public.</li> <li>E. Contract administration and monitoring costs should be either excluded or included symmetrically, like transaction costs.</li> </ul>
III.	<p>Contract Administration</p> <ul style="list-style-type: none"> <li>A. If a contract is awarded to the public agency, the terms should be documented in a memorandum of understanding.</li> <li>B. The performance of the public or private contractor should be monitored.</li> <li>C. The contract terms for the public or private contractor should include a penalty for failure to perform, and the penalty should be imposed whenever justified.</li> </ul>

(Source: Adapted from Lawrence Martin (October 29, 1999), "Determining a Level Playing Field for Public-Private Competition," presented at the Northeast Regional Conference of the American Society for Public Administration, New York, NY.)

iii. **By Franchise.**

Under a franchise, government awards a private organization the right (often the exclusive right) to sell a service or a product to the public. The private firm usually pays the government a fee. Two forms of franchising exist. One involves the use of the public domain - airwaves, air space, streets, underground space, etc. For example, broadcasters, airlines, bus and taxi companies, and utilities (electricity, gas, water, telephone) use the public domain in carrying out their commercial activities. This arrangement is usually called a concession. Infrastructure projects - water supply, wastewater

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treatment, highways, airports, and bridges - that are built, expanded, or upgraded through public-private partnerships are franchises, usually in the form of concessions. The second form is a lease, where a private lessee uses tangible, government-owned property such as land or a building to engage in a commercial enterprise.

There is no sharp distinction between a lease and a concession. Some differentiate the two in that capital investments under a lease are made by the owner, the government, while under a concession they are made by the concession holder, the franchisee. This is important in some privatizations, but the distinction has little significance with respect to infrastructure privatization. This method was used, for example, to build public schools on public property where there is also enough adjacent space for a private commercial development. The latter generates the income to allow the developer to pay for the former.

iv. **By Public-Private Partnership.**

Infrastructure projects are increasingly being built through public-private partnerships (PPPs). PPP in this sense refers to an arrangement where government states its need for capital-intensive, long-lived infrastructure and the desired facility is built using a complex combination of government and (mostly) private financing and then operated by a private entity under a long-term franchise, contract, or lease. The payments are usually spread over twenty to 99 years and cover construction, operation, maintenance, and capital costs. Typical PPP projects are roads, bridges, airports, water systems, pipelines, and power plants, but prisons, stadiums, schools, and municipal buildings have also been developed through this method, as have

urban economic development projects.<sup>39</sup>

v. **By Grants and Other Subsidies.**

Delegation is also carried out by awarding grants, below-interest loans, favored tax treatment, and other kinds of subsidies. Instead of government itself carrying out an activity, it arranges for a private entity to do the work, and it provides financial support. In the United States, grants are used for mass transit, low-income housing, maritime shipping, and innumerable other activities. Grants are distinguished from contracts in that grants usually involve only the most general requirements (run a bus service, build houses that rent at below-market prices, conduct research, promote the arts), whereas contracts are usually specified in great detail for a particular service. Grants and loans can generally be thought of as one-time payments, often to initiate a new activity, while favorable tax treatment and other subsidies tend to be continuing and to cover pre-existing as well as new services.

vi. **By Voucher.**

Governments can also delegate by issuing vouchers to eligible recipients of formerly state-run services. Instead of subsidizing producers, as grants do, vouchers subsidize consumers. Vouchers are used in the United States for food, housing, education, job training, health care, drug treatment, treatment of developmental disabilities, child day care, cultural activities, and transportation. For some services, for example, food and housing, eligible recipients can supplement food stamps or housing vouchers with their own funds when purchasing these goods and services in the market place. Vouchers offer great promise but possibly great complexity, depending on the

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<sup>39</sup>Savas E.S. (2000), *Privatization and Public-Private Partnerships*, New York: Chatham House Publishers, 237-258.

service being "voucherized."

vii. **By Mandate.**

The fifth and final form of privatization by delegation is a government mandate requiring private agencies to provide a service at their expense. Unemployment insurance is a long-standing example of such a mandate in the United States; private employers provide it for their employees. Privatization connotes a direction of change and therefore mandates, like grants, vouchers, franchises, and contracts, can be considered forms of privatization only when they lead to a lesser, not a greater, role for government. Thus if the government-run social security (retirement) system in the United States were replaced by mandatory, individual retirement accounts as in Chile, this would be privatization by mandate, a form of delegation – in this case, to private individuals. On the other hand, if market-based health care were replaced by mandatory, employer-provided health care, this would be the opposite of privatization, as it would involve a greater rather than a lesser role for government. A trend in the United States that many consider ominous is to create new social programs (for example, family leave, aid to the handicapped, job training) by imposing government mandates on private employers instead of doing it directly. The net economic effect, of course, is the same, but the public is forced to pay covertly, through higher prices, rather than openly, through taxes.

**3.1.2 Divestment**

Divestment means shedding an enterprise, function, or asset. Like delegation, this requires a direct, positive act by government but unlike delegation it is a one-time event. The enterprise or asset is either sold or

by securitizing and selling tax liens, an idea replicated in New York City by Mayor Giuliani.<sup>42</sup> At the federal level the largest privatization in the United States since the Homestead Act took place when the Clinton Administration began to sell government-owned uranium enrichment plants, helium plants, power-marketing agencies, and oil fields.

**(b) By Free Transfer.**

Divestment does not require sale of an enterprise; the latter could be given away, for example, to employees, to users or customers, to the public at large, or to a qualified class of people. New York City proposed to privatize its municipal hospitals by giving them away to newly created, local, non-profit, community-based boards representing the residents (i.e., users) who rely heavily on that hospital. Proposals to privatize America's air-traffic-control system call for giving or selling the assets and responsibilities to a consortium of airport users.<sup>43</sup>

**(c) By Liquidation.**

Finally, divestment can be carried out by shutting down and liquidating a poorly performing government enterprise, that is, selling its assets if no buyer can be found for it as a going enterprise and if the prospects are bleak for ever making it profitable. This can be considered privatization because the assets are recycled into the marketplace and become available for better uses.

**3.1.3 Displacement**

In contrast to the first two methods, which require positive acts by government, displacement is a more passive or indirect process that leads to

<sup>42</sup> Andrisani, Hakim, and Savas, *New Public Management*.

<sup>43</sup> Savas E.S. (June 9, 1995), "Is Air Traffic Out of Control?" *New York Newsday*; Robert W. Poole, Jr. (February, 1995), "Privatizing Air Traffic Control," *Reason Foundation*, Los Angeles, CA.

government being displaced more or less gradually by the private sector a withering away of the state, so to speak, as markets develop to satisfy unmet public demands. It has also been called privatization by attrition, or by stealth. Often unrecognized as a form of privatization, displacement is both commonplace and an extremely important process by which effective privatization often occurs with relatively little political battling.

Displacement occurs by default, by withdrawal, by voluntary action, and by deregulation, and it depends ultimately on local initiatives and entrepreneurship. It can be accelerated by imposing market-based user charges on hitherto "free" government goods and services – which makes the cost of government provision clear and invites private competitors - and by encouraging voluntary action. Generally speaking, it does not involve competition per se, but it does involve choice: on the part of the entrepreneur or volunteer who initiates the alternative and on the part of the customer who patronizes the nongovernmental option.

(a) **By Default.**

When the public considers government production of goods or services to be inadequate, and the private sector recognizes and satisfies this unmet demand, this is displacement by default. This, too, satisfies the definition of privatization, namely, relying more on the private sector and less on the state to satisfy people's needs. Gradually, the public begins to look to the private sector for this activity, and, if the service grows over time and the government-supplied goods or services continue to be neglected or the government role shrinks in relative terms, the private sector will play a larger and larger role. Simply put, customers desert or avoid the public service. A common example

is the growth of private transportation where the public deems government - provided bus service unsatisfactory or inadequate. Gypsy cabs, commuter vans, minibus systems and other informal, quasilegal, or technically illegal transport services have emerged in numerous cities throughout the world. We are also seeing displacement by default in public education in large American cities: Even parents of limited means have been withdrawing their children from the public schools in droves, enrolling them in proliferating private schools and schooling them at home. Private police offer another example. The public's unsatisfied demand for conventional police protection and dissatisfaction with the level of public safety in the United States led to the growth of private guard and patrol services. Although the latter have not displaced the former, in the United States the growth has been primarily in the private sector: by 1990, private police comprised three-fourths of all police.<sup>44</sup>

Throughout the United States and elsewhere, private firms are satisfying infrastructure needs that government agencies alone cannot. Thus, the private sector is financing, building, owning, and operating roads, bridges, water systems, and wastewater-treatment plants. The pressing need for such facilities can be considered examples of "default," but these are, in effect, franchises, and often involve some public support through complex public-private partnerships.

**(b) By Withdrawal.**

Whereas default is unintended or inadvertent, government can engage in deliberate withdrawal, or "load shedding,"<sup>45</sup> by constricting the growth of a government agency or shrinking its size while the private sector expands into

<sup>44</sup> National Institute of Justice (1991), "Private Security and Police in America", *Hallcrest Report II*, Washington, DC.

<sup>45</sup> Savas E.S. (1982), *Privatizing the Public Sector: How to Shrink Government*, Chatham, NJ: Chatham House, 118.

that field. This has also been termed "privatization by extinction."<sup>46</sup> In the United States, local governments often give funds to nonprofit organizations such as museums, zoos, opera houses, theaters libraries, and social service agencies. Such institutions are in the anomalous position of paying no taxes but receiving city services, while businesses pay taxes but do not receive certain city services (for example, refuse collection). City governments could withdraw some or all of their support, reduce their subsidies, or otherwise encourage – for example, with matching grant programs – the cultural institutions to raise more funds from patrons and philanthropists.

Withdrawal often goes hand-in-hand with default. In Britain, private health care is re-emerging as the system of socialized health care deteriorates in quality and availability and funds are cut; people are slowly migrating toward a private alternative.<sup>47</sup>

Load shedding, or withdrawal, can occur by accommodation, that is, informal cooperation between government and private-sector providers. This happens when the latter relieve the former of a function the public agency would rather not perform. For example, private companies provide security inside shelters for the homeless, an unpleasant task, but it is agreed that regular police officers will respond expeditiously to calls for help from such private guards.<sup>48</sup> Some states grant campus police and other private security personnel the power of arrest and give them jurisdiction on public streets in the vicinity of their employer's property.

A study of employees in a large American insurance company showed

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<sup>46</sup>Roberto Salinas-Leon (1996), "Between Mercantilism and Markets," in *The Privatization Process*, Terry L. Anderson and Peter J. Hill, eds., Lanham, MD: Rowman & Littlefield, 192

<sup>47</sup>Sarah Lyall (January 30, 1997), "For Britain's Socialized Health Care, a Grim Prognosis," *New York Times*, p. A1.

<sup>48</sup> Marcia Chaiken and Jan Chaiken (1986), *Private Provision of Municipal and County Police Functions*, Cambridge, Mass: Abt Associates, 5-7. A report prepared for the National Institute of Justice.

that 28 percent of the full-time employees over the age of thirty provided regular care for elderly relatives and friends; they devoted an average of 10.2 hours per week to such care, and 42 percent of the caregivers had daily contact with the elder.<sup>49</sup> The remarkable aspect of this finding is that this traditional pattern of family care persists and is adhered to even by people holding full-time jobs outside the home. To the extent that this practice can be rewarded, made easier, and encouraged by government through changes in tax and zoning policies and in building codes (for example, allowing extensions to single-family houses to accommodate aging parents—"grandma flats"), the demand for more government provision of such care will be reduced.

**(c) By Voluntary Action.**

Besides private action instigated by government default or withdrawal, government - encouraged voluntary action may also lead to cost displacement in particular cases. Examples are programs to adopt highway segments and parks for cleaning and to adopt libraries, zoos, and schools. Such "adoption" generally means making voluntary contributions to subsidize those activities and institutions. These go beyond ordinary and conventional contributions to charitable and other nonprofit organizations.

Another form of voluntary action is the creation of geographic collective units. A new, very local level of government has emerged in the United States. Ranging in size from a single building to a condominium, a neighborhood organization, a civic association, or a large community, it can be called a voluntary microcollective, a micropolis, or a common-interest

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<sup>49</sup> Glenn Collins (January 6, 1986), "Many in Work Force Care for Elderly Kin," *New York Times*, B5.

community. These provide an array of collective goods, including cleaning and maintaining local streets and parks, removing snow, collecting refuse, operating volunteer ambulance and fire services and block patrols, and providing plantings and attractive urban "street furniture" (signs, litter baskets, benches, bus shelters, street lights, and consolidated newspaper vending machines).<sup>50</sup> City services are often reduced in these areas, as unneeded local governments step aside. Almost one-fifth of the U.S. population lives in communities governed by such associations.<sup>51</sup>

Besides improving the local quality of life, such organizations can forge a desperately needed sense of community and can restore and hone citizenship skills atrophied from disuse, skills without which a democracy cannot long survive. Voluntary associations obtain the services they want, custom tailored to their specific local needs and preferences, thereby exercising direct influence over the quality of their surroundings, although complaints are growing about the intrusiveness and dictatorial behavior of such bodies.

These kinds of units can best be formed in established communities that have well-defined geographic boundaries, are relatively homogeneous in terms of income or ethnicity, and have shared values with respect to the services to be provided through this mechanism. Local leadership is necessary, as is an encouraging posture by the local government. The latter can mean giving tax rebates to residents in areas that forego city services. This poses a minor administrative problem for the local government, but many communities do it, including Houston, Texas and Kansas City, Missouri. In the latter, local Homeowner Associations can choose to opt out of municipal

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<sup>50</sup> Heather Mac Donald (1996), "BIDs Really Work", *City Journal* 6(2): 29-42.

<sup>51</sup> Motoko Rich (July 27, 2003), "Homeowner Boards Blur Line Of Just Who Rules the Roost," *New York Times*, 1.

refuse-collection service and receive a proportional rebate on their property taxes, but they contract with private firms for a higher level of service than the city provides. Moreover, government can encourage the creation and assure the viability of such self-governing associations by granting them taxing authority as special assessment districts. New York State has such legislation.<sup>52</sup> Dozens of business improvement districts, "BIDs," in New York City and elsewhere utilize this approach. An important attribute of such microcollectives is that members may have an opportunity to contribute their labor instead of their money. In the days of a barter economy, people could pay their taxes in specie such as grain and livestock. In a market economy they must pay cash. Voluntary associations can restore to the taxpayer the choice of paying in kind—with labor. One might then think of "off the books" earnings in the underground economy as having their counterpart in "off the books" tax payments, that is, payments in kind for collective goods.

As the demand for certain collective goods exceeds the ability of government to supply them at a suitable price and quality, dissatisfied citizens subsidize, supplement, or supplant the municipal service. Displacement occurs through government default and withdrawal and as citizens desert municipal services and band together in voluntary action.

**(d) By Deregulation.**

Government-owned enterprises and government activities often exist because they have monopoly status and the private sector is prohibited from competing. Deregulation facilitates privatization if it enables the private sector to challenge a government monopoly and even displace it altogether. In the

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<sup>52</sup> BIDs Association (1995), *The BID Manual: Establishing and Operating a BID*, New York: NYC BIDs Association.

United States, message delivery by facsimile and express mail services and parcel delivery by competing companies have grown rapidly by *de facto* deregulation, at the expense of the U.S. Postal Service. The latter claims and vigorously defends its exclusive right to handle first-class mail and prohibits its competitors from depositing mail in recipients' mail boxes, but the regulations are under attack and their repeal was advocated by the President's Commission on Privatization.<sup>53</sup> In any event, e-mail is displacing conventional mail.

Day care is a good candidate for deregulation. Since time immemorial, parents have arranged for relatives, friends, and neighbors to care for their children, and parents have taken into consideration the character and qualities of individuals to whom they entrust their children and the surroundings in which their children are placed. In recent years, however, day care became the object of increasing government involvement and financing. The result has been an increasingly complex web of legal restrictions as to who can provide the service, the number and kind of personnel who must be in attendance, the nature and design of the facilities, and so forth. The bizarre result of all the restrictions, however well intended, was that most families and homes would not be certified by government as suitable for childcare. In fact, the situation has been changing: vouchers for childcare have been introduced, and they can be given to any provider of care chosen by the parent.

### **3.2 Privatization : International Perspective**

In many countries, years of state regulatory intervention have produced

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<sup>53</sup> President's Commission on Privatization (1988), *Privatization: Toward More Effective Government*, Champaign, IL: U. of Illinois Press.

bureaucratic obstacles and economic stagnation. Hernando de Soto illustrates how much time is wasted in Peru following the labyrinthine official procedures to start a business or build a house: It takes 289 days to register an industrial enterprise and 26 months to license informal taxi operators, for example. The informal economy (i.e., "black market") encourages far greater productivity than the official sector.<sup>54</sup> (It is dismaying to realize that getting a license for an informal taxi is even more difficult in New York City.<sup>55</sup>) He advocates deregulation, debureaucratization and decentralization.

One prominent journal "Economist" succinctly summarizes the situation in developing countries: "[B]ad government is the biggest single reason for poverty in the third world, and less government is the most effective single remedy."<sup>56</sup>

Overall, the People's Republic of China offers the best example of privatization by displacement. The first step was the deregulation of agriculture in 1978. In effect farmers were able to exercise virtually all property rights customarily associated with ownership of specific parcels of land, provided they paid rent to the state in the form of contracted deliveries of grain. Agricultural production mushroomed, in sharp contrast to the famines that occurred under collective farming, when millions died. The resulting rural wealth, coupled with further *de facto* deregulation, led in turn to the creation of (politically correct) village and township enterprises which engaged in manufacturing that contributed immensely to China's economic boom. Although some may question whether this can be called privatization, such enterprises are analogous to employee stock-ownership plans. In the 1990s

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<sup>54</sup> Hernando de Soto (1989), *The Other Path*, New York: Harper & Row.

<sup>55</sup> Wall Street Journal (July 14, 1997) "Let the Vans Roll," *Wall Street Journal*, A14.

<sup>56</sup> Economist (May 26, 1990) "Growth Beats Poverty," *Economist*, 15.

this nominally communist country withheld support for SOEs, often by failing to pay the workers, thereby hastening their departure from the inactive, moribund enterprises. This is withdrawal of sorts, but it aroused social unrest. At the same time the rulers are encouraging the formation and growth of private enterprises instead of forbidding them as in the past. Many displaced workers are getting jobs and starting businesses in the new, booming private sector. Finally, in 2004, private property rights were legalized, essentially ending the 55-year Communist nightmare and driving the final nail in the socialist coffin. The end point of such deregulation in this former socialist state is capitalism.<sup>57</sup>

### 3.3 Caveats about Privatization

Critical concerns about privatization are both pragmatic and theoretical (or ideological, or philosophical). The pragmatic concerns cluster about the kinds of failures that sometimes occur under privatization:<sup>57</sup>

1. Public officials fail to specify properly the full dimensions of a service to be purchased from contractors; this inevitably leads to misunderstandings and disputes.
2. They undervalue an asset to be divested, thereby short-changing their citizens.
3. They fail to conduct a proper competitive procurement or sale. The conflicts of interest in procurement are a constant danger in the purchasing process of both public agencies and private companies; vigilance and oversight are necessary. Sole-source procurement is not necessarily bad, but one resorts to it with caution and only after

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<sup>57</sup> Savas E.S. (2000), *Privatization and Public Private Partnerships*, New York: Chatham House Publishers

full justification.

4. They fail to monitor the performance of a private provider, thereby abdicating their responsibility and leaving an opening for an unscrupulous provider to cut corners and lower service quality.
5. They fail to penalize poor performance, perhaps because of failure to monitor properly or because of a cozy relationship between the monitor and the provider.
6. They fail to set and maintain performance standards in a voucher system; agents authorized to accept vouchers and provide services (e.g., schools, private housing) must satisfy certain conditions germane to the service.
7. They fail to maintain a competitive environment after privatizing by delegation (e.g., contracting and franchising), and therefore the incumbent provider gradually acquires and exploits monopoly status. Trading a public monopoly for a private one is not a prescription for better government.
8. They fail to protect current employees adequately.

Privatization advocates counter these concerns by pointing out that while privatization can indeed be mismanaged in these ways, management of ordinary public services suffers from many of these same shortcomings; that is, poor management can sometimes be found whether government is managing public employees or the privatization process. It is not inevitable, however, and it is easier to manage a privatized service than an in-house one,

asserts Mayor Stephen Goldsmith of Indianapolis.<sup>58</sup> (When mismanagement occurs in the private sector, market forces tend to weed it out ruthlessly. This rarely happens in the public sector; public agencies that perform poorly are often given a larger budget in order to improve their performance.)

Paul Starr voices the fundamental ideological and political opposition to privatization:<sup>59</sup>

...[P]rivatization undermines the foundation of claims for public purpose and public service....

...It shifts power to those who can more readily exercise power in the market. It may also shift income and wealth, depending on the specific form of that policy..

...[P]rivate service providers often maximize profits, not by producing services more efficiently but by seeking out the least costly clients [for social services] or by employing lower-wage workers, often on a part-time basis. Since wages tend to be more equal in the public sector, privatization is likely to skew income in the direction of greater inequality. Furthermore, while unions have lost ground in the private sector, they have generally made advances in organizing public employees. Privatization tends to undermine these gains...

### **3.4 Advantages of Privatization**

Successfully implemented, privatization can provide many public benefits including efficiency, innovation, and high quality services, which can yield cost savings as well as streamline government operations. The advantages of Privatization are<sup>60</sup>

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<sup>58</sup> Stephen Goldsmith (1997), *The Twenty-First Century City: Resurrecting Urban America*, Washington, DC: Regnery Publishing, 70.

<sup>59</sup> Starr, *The Meaning of Privatization*, 42–44.

<sup>60</sup> Prof. Mustafa Alshawi, Iraq Institute of Economic Reforms (2009), *Concept and Background to Public Private Partnership (PPP) / Private Finance Initiative (PFI) UK Experience*

- Improved risk management — more rigorous risk evaluation and transfer to the private sector of those risks it is best able to manage;
- Ownership and whole-of-life costing efficiency is improved because design and construction become fully integrated up-front with operations and asset management. Ongoing service delivery, operational, maintenance and refurbishment costs become a single party's responsibility for the length of the concession period;
- Innovation — wider opportunities and incentives for innovative solutions to deliver services requirements; and
- Asset utilization — reducing cost to government, as a sole user, through more efficient design to meet performance specifications and by creating complementary opportunities to generate revenue from use of the asset by others.

### 3.5 Disadvantages of Privatization:

It is clear from what was stated earlier that PFI contributes to the improvement of public services and infrastructure projects; however, like other procurement systems, PFI has not been a total success. There are no comparisons in the statistics to show the percentage of project failure and the effects of some of the disadvantages associated with PFI on public projects or the end users. Some problems reported with PFI procurements (Akintoye *et al.* 2001), such as:<sup>61</sup>

- High costs are used to tender PFI projects;
- Agreements are brought about through complex negotiations;
- Innovation inputs, in both design and construction, could be inhibited,

<sup>61</sup> Ahadzi Marcus and Bowles Graem (September 5-7, 2001), "Public-Private Partnership in UK infrastructure development: The macroeconomic perspective" in Akintoye, A (Ed.), *17th Annual ARCOM Conference*, University of Salford. Association of Researchers in Construction Management, Vol. 1, 971-979.

as contractors become wary of overruns;

- The information of project consortia (SPVs) can be difficult as constituent members have differing objectives;
- There are disparity problems between the private and public sector, in terms of differing modes of operations, decision making and accountability;
- The attitude of government, supportive or otherwise, can ease or complicate the problems;
- The cost of finance is quite high, given that governments can borrow money more cheaply than private firms.

### **3.6 Public Private Partnerships : Concept & Forms**

There is no broad international consensus on what constitutes a public-private partnership (PPP). Broadly, PPP refers to arrangements, typically medium to long term, between the public and private sectors whereby part of the services or works that fall under the responsibilities of the public sector are provided by the private sector, with clear agreement on shared objectives for delivery of public infrastructure and / or public services. It typically does not include service contracts or turnkey construction contracts, which are categorized as public procurement projects, or the privatization of utilities where there is a limited ongoing role of the public sector.

In a PPP, each partner, usually through legally binding contract(s) or some other mechanism, agrees to share responsibilities related to implementation and / or operation and management of a project. This collaboration or partnership is built on the expertise of each partner that meets clearly defined public needs through appropriate allocation of:

- Resources
- Risks
- Rewards
- Responsibilities

As per the Scheme for Financial Support to Public Private Partnerships in Infrastructure, of the Government of India,

*“The Public-Private Partnership (PPP) Project means a project based on contract or concession agreement between a Government or statutory entity on the one side and a private sector company on the other side, for delivering an infrastructure service on payment of user charges.”*

### **3.6.1 Concept of Public-Private Partnerships**

Public private partnerships (PPPs) in infrastructure can be a means to enabling the development or improvement of energy, water, transport and telecommunications and information technology through the participation of private and government entities. Where governments are facing aging infrastructure and require more efficient services, a partnership with the private sector can help foster new solutions, including clean technology.

A Public-Private Partnership is a new way for Government to deliver services to the population. The objective is to achieve more and better services, at a lower cost for society. It can be defined as a contractual arrangement whereby a private party performs part of a Government organisation's service delivery or administrative functions, and assumes the associated risks. In return the private party receives a fee according to predefined performance criteria, which may be:

1. Entirely from service tariffs or user charges
2. Entirely from a Ministry's budget or other budget
3. A combination of both

PPP can have a number of benefits, which include:

1. Operational gains: ensuring that one delivers better or more services for the same price (efficiency gains), or making savings to release money for investment elsewhere. Operational gains can be achieved by focusing on outputs rather than processes, by generating economies from integrated design, building, financing and operating phases.
2. Strategic clarity: partnership contracts enhance accountability by clarifying responsibilities and focusing on the key deliverables of a service. The managerial efficiency of a Ministry can benefit significantly as existing financial, human and management resources can be refocused on strategic functions.

### 3.6.2 Forms of PPP

A PPP project can take two forms: a contract to supply services to the public sector or to sell services or assets from the public sector, or a Joint Venture. The various contractual forms are illustrated below:

- 1) Service Contract: the Government bids out the right to deliver a specific service and sometimes provides the assets needed. Such contracts are of a shorter duration than concession contracts. E.g security services
- 2) Management Contract: The assets of the institution continue to be

public, but operational management becomes private. E.g management of hospital.

- 3) Leasing: under this contract, the private sector finances and builds a new facility which is then leased to the public sector. The public partner makes scheduled lease payments to the private sector and thus acquires equity in the facility. At the end of the lease period, the public agency owns the facility. Under the lease arrangement, either the public agency or the private operator may operate the facility during the term of the lease. E.g equipment
- 4) BOT/BOO: the private sector contract builds a facility in accordance with a design prepared by the public sector. In the case of the BOT, the private sector finances the construction of the facility but the facility is owned by the public sector, while in the case of the BOO legal ownership rests with the contractor until the end of the contract term. E.g of a BOT project is the construction of roads.

One end of the spectrum would be a mere outsourcing of some routine operations such as maintenance of building or provision of office accommodation. The other end would be large infrastructure projects like the Light Railway Transit System, which the private sector undertakes to finance, design, construct, maintain and operate, and takes a considerable proportion of the risk.