

Privatization: You Don't Always Get What You Pay For

An Exclusive Extract from the New Book by Elliott D. Sclar

Over the past two decades, government's role in providing basic public services has been sharply challenged. In the name of improved managerial efficiency and effectiveness, conservative political leaders have built unprecedented support for privatizing everything from public hospitals, schools, and transit systems to police forces and prisons. Advocates have captured general media backing for the view that, while millions of public sector workers may suffer job or wage losses in the process, privatization consistently benefits most taxpayers by increasing competition and business-like practices among service providers.

In his important new book, *You Don't Always Get What You Pay For: The Economics of Privatization*, (Cornell University Press), Columbia University economist Elliott Sclar examines a wealth of case studies and concludes that the results achieved thus far from privatization have often fallen far short of the results promised. He scrutinizes the economic reasons why privatization as a reform strategy in the form of public contracting often bogs down. His book shows, in an accessible and non-technical style that, to understand the strengths and weaknesses of public sector privatization it is necessary to understand the theory behind the policy. The competitive contract market that privatization advocates rely on derives from the standard model used in economics textbooks since the 19th century. But, this outdated view grossly oversimplifies many important connected issues of economic and political power. Sclar develops an alternative model that replaces the textbook assumption that markets are level playing fields with a more realistic economic and political topography, providing a clearer view of the possibilities and limitations of privatization. With a clearer modern perspective and detailed knowledge of past problems, it is possible to construct solutions – the aim of the chapter excerpted here.

Newark, March 21 -- Jackie R. Mattison, the former chief of staff to Mayor Sharpe James of Newark was found guilty today of taking bribes from an insurance broker in exchange for lucrative contracts.¹

The more things change. . . The Old New York County Courthouse, opened for business in 1872. Located in Lower Manhattan and faced in an exterior of fine Massachusetts quarried marble, although forlorn and boarded up now, it is an exemplar of mid-nineteenth century American public architecture. The interior contains a soaring rotunda which encases an elegant spiral staircase leading from the street level entrance up to its second floor courtrooms. Although the mundane process of dispensing justice to scruffy local miscreants has long been removed to other precincts, popular interest in the restoration of this relic abides.

Some of it is far from aesthetic. The courthouse was commissioned in 1858 by the New York Board of Supervisors. The project began with an initial appropriation of \$250,000. By the time the edifice was completed, 14 years later, the final cost had ballooned at least fifty-fold. Historians estimate it at between \$12 and \$15 million – nearly \$2 billion in today's dollars. While there is architectural justification for the restoration of the building, its claim on history has even greater merit as a physical memorial to the power of corrupt public contracting. Never before had so few been able to pocket so much public money at such a sustained and rapid pace.

The notorious Tweed Ring, who supervised the creation of this cathedral of criminality, was perhaps the best known of the late nineteenth century political machines. Their courthouse project is to ordinary public contract abuse what high art is to street level graffiti. Boss William Marcy Tweed and his band of Tammany Hall rogues were not unique. Every city of significant size had its own version. Although beaten back by a generation of dedicated reformers, the epidemic was abated even as the underlying disease never can be fully eradicated.

Among Boss Tweed's contemporary progeny, are the well tailored, coifed and compensated corporate executives who, routinely stand side-by-side before the bar of justice with their less sartorially splendid or amply compensated public sector partners, to have their public-private wrists ceremonially slapped for exposed transgressions. Looking appropriately contrite, these officials typically and routinely plead no contest to the charges of bribery and price fixing that are by now an all too ordinary and ingrained part of the day-to-day practice of public contracting. Fines, occasional "community service" and some sternly and judicially uttered "tsk tsks" are viewed by all the participants as merely the downside risks in one of the American Republic's oldest professions. With the collapse of the cold war perhaps \$600 toilet seats are no longer vital to national security, but the same corporate "skills" and creative energy that crafted them are now focused like a laser on state and local officials empowered to create highly remunerative contracts for the privatization of other public responsibilities.

Some recent forays of the Lockheed Corporation, the nation's largest defense contractor, into privatization in the nation's largest city is a textbook lesson about the incidence and prevalence of moral hazard and influence peddling in the practice of public contracting.² Lockheed brings a particularly checkered international reputation in terms of bribery of public officials, price fixing and the art of defiantly pleading no contest to such charges when they become public. Twice during the 1980s Lockheed's use of undue and perhaps illegal influence to convince key high level New York City officials to privatize their parking enforcement activities via a contract to the company became a major political scandal.³ The repercussions of the two separate incidents were sufficiently severe that they contributed to the downfall of two mayors, Edward Koch and David Dinkins. The Mayor who succeeded Dinkins, Rudolph Giuliani, was a United States Attorney at the time of the first scandal. He was well aware of the company's modus operandi in pursuit of public contracts. As one of his first official acts, Mayor Giuliani barred Lockheed from any business dealings with the City for four years.

Despite that ban, Lockheed secured a contract to work in the City via its ability to influence contracting decisions at the state level. To pursue a contract to privatize the management information system of the city's public transportation it worked through the regional transportation agency, the Metropolitan Transportation Authority (MTA). Lockheed hired as a state lobbyist, at a cost of \$10,000 per month, an individual with no previous lobbying experience. Douglas Rutnik, is however the companion of Zenia Mucha, one of Governor George Pataki's closest advisors.⁴ The company maintains that its pursuit of a privatization contract and the hiring Mr. Rutnik as a state legislative lobbyist are unrelated. Regardless of the details, this episode serves to point up the unavoidable ties between influence peddling, the awarding of public contracts and privatization. These linkages are especially apparent for companies such as Lockheed which have built the vast portion of their corporate wealth on contracting with the public sector.

While the specific linkages between influence peddling and contracting have changed in style between the time of Boss Tweed and the present, nothing has changed in terms of substance. For the generation of muck raking national, state and local political reformers who came to power in reaction to the abuses of the Tweed Ring and its brethren elsewhere, the reality of the immutability of the problem was clear. The nation needed a cadre of public employees not beholden to political power brokers to carry out the people's business. To the extent that public contracting was needed, it was a necessary evil to be contained and limited.

In many ways the contemporary debate over contracting is a replay of one that took place over 100 years ago. In a recent important historic paper, economist Moshe Adler investigated the on again/off again privatization history of New York City's approach to cleaning its streets. He found a deeply ambivalent Common Council (the forerunner of the modern City Council) never quite making a decision between public and private. Between the 1820s and the 1890s they would first conclude that contracted private street cleaning was less expensive. But then they would soon conclude that the streets were not being cleaned. They would bring it back as a public service and then decide that, even though it was effective, it was too expensive. The City would then once more seek to contract out the work. Shortly thereafter they would again bring it back in-house because of contractual nonperformance. Each time they revisited the issue of contracting out, they would assert that this time they really knew how to write a fool-proof contract. But they never really did. Adler found that every single argument pro and con that is used to today to debate privatization was used then. Every single trick to overcome principal-agent problems was tried. But, then as now, no one found a way not to pay the contractors when the work was shoddy or nonexistent. The New York debate was similar to ones that raged in other major cities during that same time period. Finally in the 1890s at the dawn of the progressive era, a strong national consensus developed that professional municipal service was the better answer. In the ensuing years we have learned much about how to contain the worst overt abuses of public contracting, or at least dampen their visibility. But we have not been able to solve the inherent fundamental accountability problem. Because public money is everyone's money, in practice it is always up for grabs by those with the quickest hands. Almost as soon as one egregious abusive crack in the edifice of public accountability is exposed and patched over by a new layer of regulatory red tape, another invariably appears. But red tape is always easy to slice through if the stakes are sufficiently tempting, as was the case in Washington County, New York. When the requirement for competitive bidding appeared to hinder the money grab, the state legislature obliged the privateers with a waiver. Ditto for the competitive contracting requirement in the Colorado bus privatization legislation. Almost every day at least one newspaper article appears somewhere in the country that reports on the loss of public money or degraded

public service resulting from public contracting. Invariably the story ends with a report of an intention to file either criminal or civil charges against the contractor and/or the public official who awarded the contract. Almost as invariably the charges peter out to virtually nothing in the way of penalties.

The bottom line is that public contracting will always be a cumbersome and expensive instrument for the delivery of public service. There is an ongoing cost tradeoff between the inherent risk of moral hazard and the cost of effective oversight. Furthermore because the moral hazard is almost invariably compounded with an information imbalance which favors contractors over public officials, it becomes easy to see why, as a matter of economics, and not politics, direct public service continues. It is often less expensive than contracting, despite its own set of problems. Although once a contracting scandal erupts it becomes a political fact of life, it is still the underlying economic incentives which brought it to life in the first place. In the final analysis, Americans are a conservative people. Anything that the private sector can do better than the public sector is, in all likelihood, already being done privately. The reason we have so little privatization despite two decades of an ideological full court press to change that is because Americans are also pragmatists. The public sector in all its complexity abides because it is simply too expensive to underwrite effective private contracting to replace it. In the end the existing distribution of public activity between contracted work and direct service is far more understandable as a matter of economic rationality than of politics.

Public Management by Remote Control

Despite the well-documented and rich history of the serious systemic moral hazards and informational asymmetries in public contracting, over the past two decades a conservative political consensus has emerged which asserts that the extensive use of contracts to provide public service is “the key to better government.” Proponents of this view either ignore the transactions costs or essentially argue that the last generation of reformers did not know how to write a good contract. They in essence hold that not only is it possible to write an almost self-enforcing public contract for services, but it is easy. Relabeled “privatization,” this new push for expanded public contracting is touted as the ultimate public management tool. Privatization advocates dismiss the notion that it is possible to improve the organizational flaws of direct public service.

Viewed by the light of the textbook theory of perfect competition, privatization is effectively advocated as a process of wholesale remote control organizational change. Without getting into the messy issues of either the politics of contracting or the gritty service and personnel problems of effective public sector leadership, these proponents promise a quick, easy and almost dream like solution to all that ails public service. They exhibit a fundamentalist faith in the imminent arrival of a competition that always proves to be just beyond reach. They believe it will compel the lazy and/or devious individuals who they see as occupying public jobs to either figure out on their own how to mend their ways efficiently or forfeit their livelihoods to more energetic and wholesome private providers. Lost in this crusade is any substantial understanding of the systemic, and largely economic, forces that shape contemporary public work and limit the effectiveness of public contracting.

The experiences recounted here are just that: experiences. The very nature of case analysis as a research method means that by themselves they can neither “prove” nor “disprove” anything. However they do powerfully illuminate the otherwise unseen organizational dynamics of contractual relationships and hence the several pitfalls to be fully considered if privatization were to be adopted as routine and widespread public policy. At a most general level, these experiences call into question the notion that the accountability problems of public contracting are easily or inexpensively solved. It is important to remember three things. Most of the contracting will occur in the context of a high degree of uncertainty about both product and process. All the players will act with bounded rationality. Most will act with a sense of opportunistic guile. The almost childlike faith that an “invisible hand” will somehow guide contractors to pursue the public’s best interest even as it pursues its own pales in the harsh light of these realities.

There is no competitive remote control technique to magically make the challenge of good public management disappear. A self-enforcing and competitively renewable contract to perform work for the public sector is like the notion of the perfectly competitive market; an ideal. The reality of public work is that much of it is complex to perform, complex to administer and complex to evaluate. While contracting will always have an important role to play in public service, the wisdom of the older government reform movement, to focus energy upon the improved operation of public agencies as they exist, and the insights from contemporary privatization experience converge on one conclusion. The role of contracting in public service production must be balanced with a major investment of resources in the development of good public management. There is no easy market tested method for ensuring that citizens get the public services they want in a cost-effective manner.

The lesson of the privatization experiences recounted here is especially powerful. All of these experiences are drawn from the class of “blue collar” services thought to be the easiest to privatize because they are the easiest to visually inspect. Yet problems of accountability and control persist. These findings do not augur well for calls to privatize the larger and more complex and less easily

evaluated services such as public safety, education, corrections, health, human services and welfare. But it is these services which comprise the bulk of the public budget.

Conclusions: Eight Rules for Improving the Public Sector

About one-half of all public money is dispensed via contracts. That is unlikely to change. Consequently even if the ideological calls for privatization disappeared tomorrow, public contracting would still loom large in the life of society. If our goal is to improve the functioning of the public sector rather than ride one of the “either/or” horses in a political race, we need to move forward on two tracks: improve the environment of public service and improve the public contracting process. The issue is not what to privatize and what to keep public. The real issue is how do we reorganize the agencies that provide public service and within that context, improve the use of contracting. To that end, I conclude by proposing the following eight guidelines for a process of public sector reform.

Guideline One: Carefully Delineate the Output of Any Public Service Considered for Reorganization.

A public service, especially if it is a publicly supplied service rather than a pure public good, is almost invariably a far more complex product than is the private sector counterpart to which it is compared. As the comparison of postal service and private package delivery service illustrated, public services almost always have both equity and direct service outputs implicit in their mission. Unless this complete service mission is fully understood, a hasty plunge into contracting stands a large risk of creating the wrong product. Local post offices fulfill community service functions as well as mail delivery. While the former may be implicit and the latter overt, both are highly prized by the general public. The maintenance of low cost and high quality first class mail service is still a vital social function.. To be sure in an age of television and internet service, that role has perhaps changed, but it has not disappeared. It is noteworthy that the Tory Government in Great Britain was forced to quickly back away from its proposal to privatize the British postal service. The popular reaction was both swift and unequivocal. Much of this had to do with the high value most citizens place upon the informal parts of the agency mission.

Process and product often can't be separated. Albany, New York came to grief because it failed to see vehicle maintenance as part of a larger public service delivery system. Indianapolis, Indiana understood this. Municipalities maintain varied fleets of motorized vehicles. They include everything from sedans for city officials to heavy packers for waste collection. The exact size and configuration of any fleet is determined by the size of the municipality and the functions for which it is responsible. Regardless of fleet size and composition, the economics of fleet maintenance are straightforward. Maintenance cost varies directly with the average age of the fleet and with the intensity of use. If a city elects to run one vehicle 36,000 miles in a year rather than use two at 18,000 miles each, its capital costs will be lower but its maintenance costs will be higher, all else equal. The point at which a municipality decides to invest in new equipment rather than pay more for maintenance will depend upon the relative time and money costs of the alternative. Alternatives reflect the costs of borrowing for capital versus the costs of sustaining higher maintenance levels.

Because these functions are so intertwined with the core service mission of governments, in-house fleet maintenance operation is typically the norm. But there are many ways in which the work can be organized. It can be provided by a centralized facility as in Indianapolis, or it can be done with smaller facilities within each operating department as had been the case in Albany before privatization. Facilities can be comprehensive or partial. Should all the maintenance work be done by the in-house staff or should specialized work, such as body work, be contracted out to local shops? There are no readily apparent answers to these questions. Much will depend upon the relative costs of the various alternatives. But it is a mistake to isolate the vehicle maintenance function from this larger system for purposes of privatization. That is inviting a mistake which is not easily reversed and running the risk of overusing maintenance when fleet management might be more cost effective.

Guideline Two: Know Your ABCs

In this case ABC stands for activity based cost accounting. Most public operating budgets and financial statements breakout cost data on the basis of department; police, fire, etc. Within departments they divide spending on the basis of personnel and other than personnel services (OTPS). This breakout tells us little about how particular services generate costs for government. Absent an understanding about the linkage between service provision and its costs, there is no justification for claiming privatization saves money or is even cost-effective. Similarly there is no basis to justify in-house operation.

The major flaw in the rush to privatize highway maintenance services in Massachusetts was that the Weld Administration failed to fully understand the real costs of its existing in-house operation. When the Goldsmith Administration came into office one of the first tasks it set for itself was to institute activities based cost accounting for all departments. An important reason for the success of the fleet service restructuring was that it had historically had a good cost accounting database. The value of good costing models and

management information systems are too often underestimated as are their costs. But if over the long run, regardless of whether there is contracting or direct service provision, good public management is the key, then the costs of good information systems and cost accounting systems is a high return investment.

Guideline Three: To Compare Privatization with In-House Operation, Use Avoidable Cost Accounting

Although ABC accounting is an improvement over the financial books, it cannot by itself reveal if change is cost saving because it includes both overhead and direct operating costs. In essence it is a fully allocated accounting system. As we saw in the case of the Foothills [California] Transit Zone that leads to a misleading overstatement of savings. As the situation in Santa Barbara demonstrated, a fully allocated cost accounting process can even make it possible for a privatization to actually increase public expenses and still be claimed as a savings. There is widespread professional agreement that cost comparisons in situations of privatization should be made on an avoidable cost basis. If there is no avoidable cost savings in the short run, it is unlikely, though not impossible, given the systemic reality of public contracting dynamics, that there will ever be any real savings from the privatization in the long run.

Guideline Four: Fully Address the Reality of Transactions Costs

The economics of organization teaches us that when a service is frequently or regularly used, it often pays to provide it internally because of the transaction costs generated by supervising outside providers. This is especially true if the service requires highly specialized equipment and/or especially skilled labor. Once these specific assets are controlled by the outside service provider the public agency loses the ability to bargain for an efficient price or more effective service. The greater is the degree of control over the needed assets, the more will the contract price diverge from the actual cost of production. New York City pays the highest price in the country for contracted municipal school bus service. New York City has no cost-effective way to obtain access to alternative bus service. The assets, drivers and vehicles are controlled by the contractors.

The more uncertain the service environment, the more difficult will it be to create a contract with low transactions costs. Where risk is a major factor it becomes almost impossible for government to avoid paying a risk premium (contingency cost built into the contract) to get competent work. However in situations in which the government must pay such a risk premium, it should carefully consider in-house production as a preferable alternative.

That much said, it is also important to bear in mind that we are not talking about a simple “either/or” situation. Technology changes and so do contract possibilities. Moreover in an age of low cost communications and information processing, it is especially the case that efficient network alternatives are viable possibilities. It is therefore vital that the full range of these possibilities be scrutinized in making decisions based on an evaluation of transactions costs.

Guideline Five: Recognize that Public Contracting is Different from Private Contracting.

One appeal of public contracting is its apparent similarity to private contracting. But the similarities are just that; more apparent than real. The comparison is misleading. Public contracting will always be tightly constrained by accountability rules designed to ensure, to the extent possible, that public money is spent on the intended public purpose. It can scarcely be otherwise. Absent tight regulation money spent in the name of the people can easily be diverted to the pockets of the public officials or power brokers fashioning the contracts as well as the contractors rather than to added value for the citizenry. That is the abiding story from the time of the construction of the New York County Courthouse down to the construction of the Westchester County medical center parking structure.

As a result public agencies are not free to pursue deals with the flexibility of the private sector. Public agencies must always be prepared to justify the contracts into which they enter. Losing bidders have the right to challenge the winning bid and even force the agency’s decision to be reversed, even when the initial decision is in the best interests of the citizenry. Officials and contractors frequently bemoan the ways in which red tape ties their hands. We need to recognize this inflexibility as the price to be paid to avoid moral hazards and give all bidders a fair opportunity to win public contracts. As a result even in the best of circumstances public contracting for services is a second best option. It will always be more problematic than would be the case in the private sector. The costs of these constraints should be honestly estimated in any privatization decision.

Guideline Six: Compare Three Alternatives

Too often the public decision on privatization is treated as an “either/or” decision. When that occurs it essentially involves casting up the policy choice as a comparison between a government agency as it imperfectly exists and a contract market as it could ideally exist.

As the experiences recounted in this book have demonstrated, contracting is at least equally as imperfect as is existing service. The relevant comparison must be between the agency as it now exists, contracting as it is likely to exist and direct service provision as it can feasibly be improved (termed “best practice”).

Once the choice is cast in that way, it no longer has to be a matter of a zero sum game that politically pits public employees against private contractors. Instead it can be one in which rearrangements and permutations are possible. Rye Brook, New York went down the “either/or” path two years ago. It has pulled back from that untenable position. It found it had an improved set of options for providing itself with fire service. It chose some of both. Instead of continuing to see itself as the passive purchaser of service from an outside party, Rye Brook became an active manager of a vital municipal service. That decision has given Rye Brook a richer menu of future options than the narrow ones it thought it had when its initial feud with neighboring Port Chester led it to hastily try privatization.

Guideline Seven: Make Meaningful Employee Participation Possible

If best practice as the third alternative is to add to productivity or cut costs, employees must be integral to the reorganization process. The experiences in Fort Lauderdale and Indianapolis illustrate this well. Although this type of change can be initiated in several ways, in an era in which privatization is popular, it will most likely be done via the format of the competitive bid. If public officials seek to facilitate reorganization by staging a competitive bid, the Indianapolis model is the correct precedent. Employees were brought into the managerial decisionmaking process in a manner that genuinely respected their knowledge and experience. That was also true in Fort Lauderdale where labor-management cooperation was the change method. Although the form was different, the collaborative substance was identical. By way of contrast the “sink or swim” approach used by the Weld Administration in Massachusetts in which employees were essentially left on their own to construct a bid is ultimately a sham. It does not build collaboration in pursuit of efficiency and high quality. It is at best a war of attrition. No one wins in this latter case.

Employees must participate in the process from the very beginning. Often the most crucial decisions are made by the team that defines the scope of the restructuring task. Employee participation is critical at this stage because they, more than senior management and the political leadership, understand the qualitative and quantitative portions of the service.

The employee team members asked to take part in the scoping decision must be chosen, not by management, but by the employees themselves. This is very important. In the best of circumstances institutional change is difficult on everyone. If the restructuring is intended to include a competitive bidding process at some point, the issue of trust becomes even more crucial.⁵ Recognize that no matter how much the leadership tries to avoid it, there will inevitably be a high degree of mistrust and suspicion built into the initial stages of any institutional change process. If all parties believe that they have played a meaningful role right from the start they will be more willing to take risks and identify with the result, no matter how painful some of the short-term adjustments.

Management is a learned skill. The employees who are asked to take part in a bidding process for their work must be trained to view their unit’s work in an analytic top down manner along with the bottom up manner intuitive to their everyday work situation. The government should underwrite this training. It is an investment in the human capital of its workforce that will more than repay itself in the quality of both the bid process and subsequent work.

Once the employees are brought on board, they must be encouraged and permitted to look at all aspects of the task. They must be free to use the special knowledge that they have about the work and the agency to redesign work as they see fit. The knowledge of public employees is an untapped resource that can produce significant and rapid gains in agency performance. In a very real sense the most valuable capital asset that any organization possesses is the knowledge and experience of its members. In effect the stock of the most productive asset for good public service walks out the agency door every night. Only a leadership that is respectful of its employees can access the full productivity of that capital.

Once the process starts, management must be attentive to employee complaints about the ways in which existing rules and procurement practices hinder them in the performance of their jobs. The political leadership must be prepared to help the restructuring committee cut through any red tape that it is possible to cut.

A corollary to the above point is that overhead must be on the table. It is frequently the case that it is not direct service costs but overhead which makes public service more costly. One reason that restructuring can often be more effective than privatization is because it can provide ways to meaningfully reduce overhead. Contracting without internal reorganization simply replaces direct service costs with outside resources. Above the level of the most unskilled service work, there is little or no wage savings margin in

that tradeoff. But public services with a high proportion of low skill labor are a small proportion of the total cost of public service. It is in the tasks performed by more highly skilled labor that the bulk of public costs reside.

Within those services, it is often within the overhead of the agency that the largest potential for savings can be found. Public bureaucracy, like sedentary people, tends to accumulate fat around the middle. I recall a consulting job I undertook at a major transit agency several years ago in one of America's largest cities. Labor and management were sitting around the table attempting to redesign work in the mold of best practice. One of the union officials noted that when he began work at the agency ten years earlier he reported to one supervisor. Today he directly reported to five different people! Cutting this type of overhead can be difficult. It means confronting middle managers, some of which are also political appointees. These are individuals who have become powerfully entrenched in mid-range positions, many of which serve no useful organizational purpose. Crucial to Mayor Goldsmith's winning over the line workers in the IFS to his competitive bidding style of restructuring was his demonstration to them of his willingness to take on these positions even when it meant confronting political appointees of his own party. If the powers that be are willing to permit the line employees to look at overhead, it is frequently the case that they will uncover some of the greatest sources of immediate savings.

Guideline Eight: Remove Politics from Contracting

While restructuring is fundamental, contracting will remain an integral part of public work. It is important that to the degree possible, public contract markets are made as efficient as possible. The most important step to be taken in this regard is to separate public contracting from politics as much as possible. Although it is unlikely that this can ever be done completely, it is also the case that the situation can be vastly improved. One of the worst maladies of modern contracting is the corrosive impact of influence peddling on public officials. The potential for gain through short cuts never abates. There is a special burden on those who espouse privatization to ensure that they are an equally strong voice in the battle against corruption and influence peddling. Nothing will destroy a privatization more quickly than problems of this sort. Blame for the failure of the hospital parking garage privatization in Westchester County must be laid at the feet of the Former County Executive Andrew O'Rourke. Whether intentionally or inadvertently, he apparently looked the other way as one of his chief fundraisers and dealmakers, Albert Pirro, played both sides of the arrangement for personal gain. Staunch privatization advocates can't have both contracting business as usual and reform. That is a lesson Mr. Goldsmith fully absorbed, but one that too many other advocates fail to grasp.

A simple first step is to require that any firms and their principals who engage in public contracting are not free to contribute money to politicians who can influence contract policy or buy gifts for officials important to the contracts decisions. After all it is a free choice to engage in public contracting as a means of livelihood. It also implies a moral responsibility on the part of the contractors to keep the contracting system above board. Consequently the issue of political free speech should not loom large. A meaningful firewall that can effectively divide contracting from politics is thus a vital necessity. If a contractor feels such restriction to be an infringement on their political right of free speech via influence pedaling, they are always free to switch their line of work.

At minimum, public officials in other places should be made aware of the track record of firms with which they might potentially do business. Firms found to have violated the law or pled no contest should be, if not completely barred from all future public contracting, at least well known to public officials in the future. If a firm is innocent then it should fight the charges. A national registry should be established by the states to track firms and their principals either found guilty or who pleaded no contest to charges related to public contracting.

One of the worst aspects of public contracting is the revolving door syndrome. Officials who award lucrative public contracts leave public service shortly thereafter to work for the contractors to whom they awarded the contract. At times legislation is put in place which requires a "decent interval" between the award of the contract and the new employment. Typically it is a one-year hiatus. That is inadequate. These rules need to be tightened significantly. Three years between public service and employment in an industry in which the official formerly awarded contracts and five years before employment by a firm to whom a contract was awarded, would provide adequate protection to the public treasury.

A major problem with privatization is that it is too often pushed as an ideological proposition, with little or no basis in good agency management. It is important that the management of public services be removed from the ideological battle over the size of government. They are properly two different realms. For our purposes, the issue of size is distinct from the issue of good management.

A simple way in which to separate the two is to mandate that before a privatization proceeds, it passes muster as a cost-effective comparable quality alternative. In that regard one of the most successful pieces of legislation is a Massachusetts Law (Chapter 296 of the Acts of 1993). Popularly known as the Pacheco or more formally the Pacheco-Manard Act, it requires that all proposed privatization be subjected to a cost-benefit analysis.⁶ The Office of the State Auditor carries out the work.⁷ The law has permitted many

privatizations to proceed. But it has also stopped some that would have been costly errors. The existence of the law essentially forces decisionmaking officials to move beyond the notion that privatization might work or that they thought it would be nice. It requires them to do some real managerial homework. It permits impacted employees to submit proposals to reform work. In general it forces the issue of privatization out of the realm of the ideological and into the realm of the practical.

These rules summarize a broad range of initiatives that must be undertaken if genuine public sector reform is the goal. To be sure all are feasible, but all are not equally probable, at least in the short term. Politics and economics will always constrain the possible. Nonetheless we must take heart from the experience of the progressive reformers who at the dawning of this century helped to fashion a workable if not perfect public sector. The reformers who will carry out the work of building a responsive public sector in the next century always need to think just one step beyond the conventional wisdom about what is possible.

The Myth of the Overpaid Public Worker

Proponents of privatization view themselves as champions of a policy change which they are confident will lead to a quantum drop in public service costs and, perhaps even lower taxes. They contend this will happen because competitive market economics will be permitted to trump politics. As a result costs will have to drop below those of, what they label as, the "monopoly" environment of direct government production. Privatization proponents are forced to directly confront the question of public sector wages.

To make their case, privatization advocates typically produce studies which compare gross public and private sector compensation and conclude that rates of increase in public sector compensation far outstrip its private sector counterpart. Cox and Brunelli (1992), for example, found that between 1980 and 1989 public sector compensation, adjusted for inflation, rose 14.6 percent. In comparison, private sector compensation over the same period only rose 3.4 percent in inflation adjusted terms; about one-fourth the amount. They conclude from this that the public sector working class is what they call a "protected class." The difficulty with studies such as these are that they fail to adjust for education, skill level and job tenure. In comparative studies of public and private sector wages that control for these, public sector employees are paid 4 to 5 percent less than their private sector counterparts. Whereas approximately 20 percent of private sector workers have college educations almost 44 percent of public workers are so educated. In a society in which unskilled labor has become less crucial such educational differences explain much of the apparent recent rise in public sector wages relative to those in the private sector. It is only among the lowest skilled and lowest paid occupations that public employees enjoy a significant cost advantage over their private sector counterparts.

It is wrong to generalize from the relatively higher rates of compensation at the low end of the pay scale to all public workers because at the highest levels public compensation lags behind the private sector. Lawyers in the public sector, for example, earn significantly less than their counterparts in private employment. Hence as the nature of public service work subjected to privatization becomes more skill- and education-intensive, the utility of private-sector wage differentials as a source of savings diminishes rapidly. Labor market realities are such that the issue of public workers as a protected class is less the problem than is the challenge of paying enough to attract competent well-educated workers away from private employment. This is especially true in the most costly areas of the public budget such as education, and human services.

Case Study: School Bussing in New York City

With over one million students, New York City is the nation's largest school district. It also has the most expensive municipal school busing system in the country. The main reason it is so expensive is because it is privatized but not competitively contracted. It is not competitively contracted because it is too immense and complex to permit the kind of continual churning of service providers that competition requires. Although the initial intention of the system's creators was to foster competitive contracting, the disruptions to school schedules and risks to child safety that frequent changes of providers would entail proved unacceptable in a system of 3,800 routes. The key to reliability and safety is the continuity of the personnel who transport the children. Drivers, dispatchers, and bus monitors personal acquaintance with their charges year-in and year-out is crucial to knowing where children are during transit between home and school. Continually changing drivers, bus monitors and dispatchers creates confusion and unnecessary risk to children.

The system had become a de facto system of franchises by 1979, when a bitter strike put to rest any lingering pretense of competitive bidding. To ensure labor peace and reliable service, the school board agreed to pay its contractors prices sufficient for them to peg the wages they paid to whatever settlement the New York City Transit Authority (NYCTA) arrived at with its bus operators. Since public transit wages are far higher than those typically paid to private school bus drivers, costs ballooned.

For twenty years the school board has awarded contracts for the same routes to the same companies. Prices are determined by underlying costs plus a profit for the contractor. By all accounts the system runs smoothly. High wages ensure low labor turnover and therefore a good safety record. The contractors have no incentive to keep a lid on salaries because they are paid what amounts to a management fee proportionate to operating costs. The higher the costs, the higher the fee. Thus everything in this arrangement conspires to drive up its costs.

As part of his campaign to reduce municipal spending, Mayor Rudolph Giuliani decided in the spring of 1995 to take on school bussing. He wanted to return to competitive contracting. Since the owners, the employees and even the parents had no reason to favor such a change, he would have to impose it from the top. However, the size and complexity of operation made his threat to open the contracts to new bidders an empty one. There was no effective outside private competition, and no public school buses or drivers, to whom he could turn in order to challenge the entrenched system. Every viable operator in the area already had a piece of the action. As a result the Mayor suffered one of his first political setbacks. He obtained a substantial cut in the costs of the next contract and persuaded the vendors and their unions to uncouple their wages from those of the NYCTA, but the noncompetitive structure of the market remained in place. Even if competition could be reinstated, given the nature of the service, the market would more than likely evolve once again in exactly same manner.

An alternative would be for the city to begin to create its own school bus fleet. Given its cost and the inevitably fierce opposition from contractors, this alternative is hard to imagine. Had it been a public system all along, the mayor would have enormous leverage in controlling its costs. The workers would be public employees, and as such they would not have a right to strike. The city could redeploy its own vehicles and routes as it saw fit without negotiating with outside contractors, a far more efficient management tool.

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NOTES

¹ Smothers 1997: pg. 25.

² In the economics literature, a "moral hazard" arises when the provider's best interest and the client's may potentially clash.

³ See *The Recommended Award of the Parking Violations Bureau Privatization Contract to Lockheed I.M.S.*, prepared by the New York City Department of Investigation, August 1993, for the official account. See Wayne Barrett "The City Scandal that Won't Go Away," *The Village Voice*, April 13, 1993, for historic background.

⁴ See Andrea Bernstein "M.T.A. Thwarts Giuliani And His Investigation Into Lockheed Contract," *The New York Observer*, June 30-July 7, 1997.

⁵In terms of adjustments it is important that management make clear to workers from the outset that if the process leads to a very fundamental change in the organization they personally will not be hurt. No one rationally assists in cutting their own throat.

⁶ For background on the Pacheco Bill, see Wallin 1997.

⁷It is worth noting that for purposes of cost comparison the State Auditor in Massachusetts requires the use of avoidable cost accounting. See Rule Three above. (For more detail see *Guidelines for Implementing the Commonwealth's Privatization Law*,² prepared by the Massachusetts State Auditor, March, 1994.)

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Elliott D. Sclar is Professor of urban planning and public affairs at Columbia University. He holds senior academic appointments in the Graduate School of Architecture, Planning, and Preservation and the School of International and Public Affairs. He has been on the Columbia University faculty since 1978 and is currently the director of graduate programs in urban planning. He has been on the Columbia faculty since 1978. His latest book “You Don’t Always Get What You Pay For: The Economics of Privatization,” has won two major academic prizes, the Louis Brownlow Award for the Best Book of 2000 from the National Academy of Public Administration and the 2001 Charles Levine Prize from the International Political Science Association for a major contribution to the public policy literature. He is presently the coordinator of a global task force established in conjunction with the UN’s Millennium Development Goals. The task force’s mission is to devise global strategies to improve the lives of at least 100 million people living in urban poverty by the year 2020.

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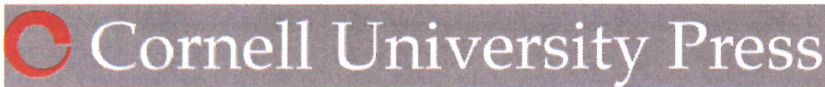
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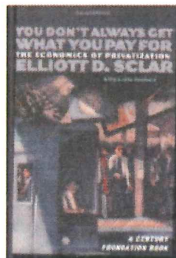
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Today, nearly all public services—schools, hospitals, prisons, fire departments, sanitation—are considered fair game for privatization. Proponents of privatization argue that private firms will respond to competitive market pressures and provide better service at lower cost. While this assertion has caused much controversy, the debate between both sides has consisted mainly of impassioned defenses of entrenched positions.

In *You Don't Always Get What You Pay For*, Elliott D. Sclar offers a balanced look at the pitfalls and promises of public sector privatization in the United States. By describing the underlying economic dynamics of how public agencies and private organizations actually work together, he provides a rigorous analysis of the assumptions behind the case for privatization.

The competitive-market model may seem appealing, but Sclar warns that it does not address the complex reality of contracting for government services. Using specific examples, such as mail service and urban transportation, he shows that ironically privatization does not shrink government—the broader goal of many of its own champions. He also demonstrates that there is more to consider in providing public services than trying to achieve efficiency; there are issues of equity and access that cannot be ignored.

Sclar believes that public officials and voters will soon realize the limitations of "contracting out" just as private corporations have come to understand the drawbacks of outsourcing. After examining the effectiveness of alternatives to privatization, he offers suggestions for improving public sector performance—advice he hopes will be heeded before it is too late.

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