

Advantages and Disadvantages of Privatization

The merits and drawbacks of privatization have been subjects of considerable debate among business-people, city leaders, and public employees alike. Indeed, each element of privatization—from its apparent cost-saving properties to its possible negative impact on minority workers—provokes strong reaction. About the only thing that everyone can agree on is that the trend has been enormously beneficial to owners of small- and mid-sized businesses. Following are some privatization issues that communities, public providers, and private providers all need to consider

Costs and Productivity

Proponents of privatization argue that whereas government producers have no incentive to hold down production costs, private producers who contract with the government to provide the service have more at stake, thus encouraging them to perform at a higher level for lower cost. The lower the cost incurred by the firm in satisfying the contract, the greater profit it makes. On the other hand, the absence of competition and profit incentives in the public sector is not likely to result in cost minimization. Of course, small- and mid-sized companies also need to make sure that they do not sacrifice an acceptable profit margin in their zeal to secure a contract.

Although private firms may pay lower wages and fringe benefits than local governments, the major cause of the cost differences between the private and governmental sectors is employee productivity. Lower labor costs may arise either from lower wages (which means that the government was paying wages higher than necessary for a given skill) or from less labor input (which means that the government retaining more employees than necessary to fulfill need). Private firms have more flexibility than governmental units to use part-timers to meet peak periods of activity, to fire unsatisfactory workers, and to allocate workers across a variety of tasks. Moreover, critics of municipal governments argue that they are less likely to reward individual initiatives or punish aberrant behavior when compared with their private sector counterparts.

Finally, supporters of privatization argue that the trend has spurred improvements in performance by public service providers. "Evidence shows that public agencies should be allowed to bid on contracts along with private operators," wrote Blackstone and Hakim, "since this exposure to competition has led many public agencies to improve their service delivery and significantly reduce costs."

Service. Expected quality of service varies from community to community, depending on a wide range of factors such as historical service levels, local taxation, and possible changes in service requirements. Moreover, *Public Works* observed that good service is sometimes defined differently by citizens, public service providers, and private service providers. "Response time and public confidence need to be taken into account when judging the pros and cons of private/public," stated *Public Works*. "Stability may be a concern in the eyes of the public; a government agency cannot walk away at the end of a contract period."

Operating Philosophies. Proponents of privatization state that private firms may be more likely to experiment with different and creative approaches to service provision, whereas government tends to stick with the current approach since changes often create political difficulties for elected officials. In addition, private firms may use retained earnings to finance research or to purchase new capital equipment that lowers unit production costs. On the other hand, government may not be able or willing to allocate tax revenues to these purposes as easily, given the many competing demands on the government's budget.

Regulatory Realities. In some cases, local, state, and federal regulations may determine whether a service can even be handed over to a private provider. Moreover, "the ultimate responsibility (in the eyes of the public, if not the courts) rests with the public agency that assigns operating rights to a private concern," stated *Public Works*. "The local government will still be held responsible for the cost and quality of the service under contract."

Competition. Supporters of privatization often cite the competitive environment that is nourished by the practice as a key to its success. Private owners have a strong incentive to operate efficiently, they argue, while this incentive is lacking under public ownership. If private firms spend more money and employ more people to do the same amount of work, competition will lead to lower margins, lost customers, and decreased profits. The disciplining effect of competition does not occur in the public sector. Still, even advocates of privatization agree that private ownership produces the public benefits of lower costs and high quality only in the presence of a competitive environment. Privatization cannot be expected to produce these same benefits if competition is absent. Given this reality, analysts strongly encourage municipal governments to make sure that the bidding process is an ethical one.

Monitoring and Enforcement. Critics of privatization of government services contend that problems sometimes arise in various aspects of the process, including the bidding process, the precise specification of the contract, and the monitoring and enforcement of the contract. For example, some observers have raised concerns that potential suppliers may initially offer a price to the government that is less than actual production costs to induce the government to transfer the service to the private sector or to win the contract. Subsequently, the contractor would then demand a higher price after the government has dismantled its own production system. Such "low-balling" in the bidding process may be reduced if the local government requires relatively long-term contracts, or constructs contracts that give them flexibility in hiring and firing outside firms.

Public Personnel Management magazine also noted that governments need to take several important precautions before handing out a contract in order to avoid litigation and legal liability. These precautions include detailed performance specifications for service providers, guidelines for the evaluation of competitive bids, and labor relations strategies. For their part, private bidders need to make certain that these precautions are reasonable ones that will not unduly impact their ability to perform both profitably and professionally.

Commonly utilized methods of contract monitoring, meanwhile, include performance appraisals, tracking complaints, citizen satisfaction surveys, reports from contractors, field observations, and ongoing cost comparisons.

Employment. Privatization is understandably viewed as an alarming trend by public employee groups. In some cases, privatization results in layoffs of public sector employees, although governments often reassign them to other government jobs, place them with private contractors, or offer them early retirement programs. These possibilities have been particularly upsetting to public employee unions, which have been at the forefront of efforts to block privatization. Indeed, one of the principal objections to privatization is that it replaces positions that featured compensation that could be used to support a family with private sector spots that offer modest compensation. Indeed, critics such as the *Journal of Commerce and Commercial's* David Morris contend that private companies are only able to promise meaningful financial savings over public agencies because of the comparatively low salaries they pay their workers. Another charge leveled at privatization initiatives is that they too often have a disproportionate impact on minorities. "Governments often hire minorities in larger proportions than other workers," wrote Blackstone and Hakim. "Thus, if government size is reduced, relatively more minority workers are likely to lose their jobs." In recognition of these fears, some service contracts now require private contractors to hire affected public employees or give them hiring preference.

Demographic and Geographic Factors.

Smaller municipalities may incur relatively high unit costs if they operate their own services as a result of not being able to achieve economies of scale. These localities may benefit from turning to a contractor that serves multiple communities. Privatization is also more acceptable in fast-growing communities. If services are being expanded to cover new residents, private contractors are less likely to displace existing public sector employees. Finally, contracting out varies with the number of services provided to residents. As the number of services increases, differences in the cost and effectiveness with which they are provided become more apparent. Therefore, municipalities providing diverse services may be more open to exploring private sector options than those localities where services are more limited.

Political Dictionary: privatization

The transfer of public assets to the private sector, by sale, or contracting out. After some hesitant and small-scale experiments by the Heath Government of 1970-4, UK privatization on a large scale was undertaken by the Thatcher Government after 1979 with the electricity, gas, and telecommunications industries being sold. The advantages of privatization from the government's perspective included: raising large sums of money to offset public borrowing; weakening the power of public sector trade unions; widening share ownership; giving the management of former nationalized industries normal commercial autonomy; and reducing the burden of decision-making imposed on government by public ownership. Critics of the British privatizations argued that they

were undertaken so that maximizing competition was sacrificed in the interest of ensuring the greatest possible revenue from the sales and protecting the monopolistic positions of the existing enterprises. The perceived policy success of privatization in Britain led to its imitation in many other countries. In particular, organizations such as the World Bank encouraged developing countries to dispose of their loss-making state-owned industries. Privatization in the former Soviet Union has occurred more slowly than anticipated and has often involved acquisitions of enterprises by the managements on favourable terms.

Pro-privatization and anti-privatization arguments

Pro-privatization

Proponents of privatization believe that private market actors can more efficiently deliver many goods or service than government due to free market competition. In general, over time this will lead to lower prices, improved quality, more choices, less corruption, less red tape, and quicker delivery. Many proponents do not argue that everything should be privatized; the existence of problems such as market failures and natural monopolies may limit this. However, a small minority thinks that everything can be privatized, including the state itself.

The basic economic argument given for privatization is that governments have few incentives to ensure that the enterprises they own are well run. One problem is the lack of comparison in state monopolies. It is difficult to know if an enterprise is efficient or not without competitors to compare against. Another is that the central government administration, and the voters who elect them, have difficulty evaluating the efficiency of numerous and very different enterprises. A private owner, often specializing and gaining great knowledge about a certain industrial sector, can evaluate and then reward or punish the management in much fewer enterprises much more efficiently. Also, governments can raise money by taxation or simply printing money should revenues be insufficient, unlike a private owner.

If there are both private and state owned enterprises competing against each other, then the state owned may borrow money more cheaply from the debt markets than private enterprises, since the state owned enterprises are ultimately backed by the taxation and printing press power of the state, gaining an unfair advantage.

Privatizing a non-profitable company which was state-owned may force the company to raise prices in order to become profitable. However, this would remove the need for the state to provide tax money in order to cover the losses.

- **Performance.** State-run industries tend to be bureaucratic. A political government may only be motivated to improve a function when its poor performance becomes politically sensitive, and such an improvement can be reversed easily by another regime.

- **Improvements.** Conversely, the government may put off improvements due to political sensitivity and special interests — even in cases of companies that are run well and better serve their customers' needs.
- **Corruption.** A monopolized function is prone to corruption; decisions are made primarily for political reasons, personal gain of the decision-maker (i.e. "graft"), rather than economic ones. Corruption (or principal-agent issues) during the privatization process - however - can result in significant underpricing of the asset. This allows for more immediate and efficient corrupt transfer of value - not just from ongoing cash flow, but from the entire lifetime of the asset stream. Often such transfers are difficult to reverse.
- **Accountability.** Managers of privately owned companies are accountable to their owners/shareholders and to the consumer, and can only exist and thrive where needs are met. Managers of publicly owned companies are required to be more accountable to the broader community and to political "stakeholders". This can reduce their ability to directly and specifically serve the needs of their customers, and can bias investment decisions away from otherwise profitable areas.
- **Civil-liberty concerns.** A company controlled by the state may have access to information or assets which may be used against dissidents or any individuals who disagree with their policies.
- **Goals.** A political government tends to run an industry or company for political goals rather than economic ones.
- **Capital.** Privately held companies can sometimes more easily raise investment capital in the financial markets when such local markets exist and are suitably liquid. While interest rates for private companies are often higher than for government debt, this can serve as a useful constraint to promote efficient investments by private companies, instead of cross-subsidizing them with the overall credit-risk of the country. Investment decisions are then governed by market interest rates. State-owned industries have to compete with demands from other government departments and special interests. In either case, for smaller markets, political risk may add substantially to the cost of capital.
- **Security.** Governments have had the tendency to "bail out" poorly run businesses, often due to the sensitivity of job losses, when economically, it may be better to let the business fold.
- **Lack of market discipline.** Poorly managed state companies are insulated from the same discipline as private companies, which could go bankrupt, have their management removed, or be taken over by competitors. Private companies are also able to take greater risks and then seek bankruptcy protection against creditors if those risks turn sour.
- **Natural monopolies.** The existence of natural monopolies does not mean that these sectors must be state owned. Governments can enact or are armed with anti-trust legislation and bodies to deal with anti-competitive behavior of all companies public or private.
- **Concentration of wealth.** Ownership of and profits from successful enterprises tend to be dispersed and diversified -particularly in voucher privatization. The

- availability of more investment vehicles stimulates capital markets and promotes liquidity and job creation.
- **Political influence.** Nationalized industries are prone to interference from politicians for political or populist reasons. Examples include making an industry buy supplies from local producers (when that may be more expensive than buying from abroad), forcing an industry to freeze its prices/fares to satisfy the electorate or control inflation, increasing its staffing to reduce unemployment, or moving its operations to marginal constituencies.
 - **Profits.** Corporations exist to generate profits for their shareholders. Private companies make a profit by enticing consumers to buy their products in preference to their competitors' (or by increasing primary demand for their products, or by reducing costs). Private corporations typically profit more if they serve the needs of their clients well. Corporations of different sizes may target different market niches in order to focus on marginal groups and satisfy their demand. A company with good corporate governance will therefore be incentivized to meet the needs of its customers efficiently.

Anti-privatization

Opponents of privatization dispute the claims concerning the alleged lack of incentive for governments to ensure that the enterprises they own are well run, on the basis of the idea that governments are proxy owners answerable to the people. It is argued that a government which runs nationalized enterprises poorly will lose public support and votes, while a government which runs those enterprises well will gain public support and votes. Thus, democratic governments do have an incentive to maximize efficiency in nationalized companies, due to the pressure of future elections.

Opponents of certain privatizations believe certain parts of the social terrain should remain closed to market forces in order to protect them from the unpredictability and ruthlessness of the market (such as private prisons, basic health care, and basic education). Another view is that some of the utilities which government provides benefit society at large and are indirect and difficult to measure or unable to produce a profit, such as defense. Still another is that natural monopolies are by definition not subject to competition and better administered by the state.

The controlling ethical issue in the anti-privatization perspective is the need for responsible stewardship of social support missions. Market interactions are all guided by self-interest, and successful actors in a healthy market must be committed to charging the maximum price that the market will bear. Privatization opponents believe that this model is not compatible with government missions for social support, whose primary aim is delivering affordability and quality of service to society.

Many privatization opponents also warn against the practice's inherent tendency toward corruption. As many areas which the government could provide are essentially profitless, the only way private companies could, to any degree, operate them would be through contracts or block payments. In these cases, the private firm's performance in a particular

project would be removed from their performance, and embezzlement and dangerous cost cutting measures might be taken to maximize profits.

Some would also point out that privatizing certain functions of government might hamper coordination, and charge firms with specialized and limited capabilities to perform functions which they are not suited for. In rebuilding a war torn nation's infrastructure, for example, a private firm would, in order to provide security, either have to hire security, which would be both necessarily limited and complicate their functions, or coordinate with government, which, due to a lack of command structure shared between firm and government, might be difficult. A government agency, on the other hand, would have the entire military of a nation to draw upon for security, whose chain of command is clearly defined. Opponents would say that this is a false assertion: numerous books refer to poor organization between government departments (for example the Hurricane Katrina incident).

Furthermore, opponents of privatization argue that it is undesirable to transfer state-owned assets into private hands for the following reasons:

- **Performance.** A democratically elected government is accountable to the people through a legislature, Congress or Parliament, and is motivated to safeguarding the assets of the nation. The profit motive may be subordinated to social objectives.
- **Improvements.** the government is motivated to performance improvements as well run businesses contribute to the State's revenues.
- **Corruption.** Government ministers and civil servants are bound to uphold the highest ethical standards, and standards of probity are guaranteed through codes of conduct and declarations of interest. However, the selling process could lack transparency, allowing the purchaser and civil servants controlling the sale to gain personally.
- **Accountability.** The public does not have any control or oversight of private companies.
- **Civil-liberty concerns.** A democratically elected government is accountable to the people through a parliament, and can intervene when civil liberties are threatened.
- **Goals.** The government may seek to use state companies as instruments to further social goals for the benefit of the nation as a whole.
- **Capital.** Governments can raise money in the financial markets most cheaply to re-lend to state-owned enterprises.
- **Lack of market discipline.** Governments have chosen to keep certain companies/industries under public ownership because of their strategic importance or sensitive nature.
- **Cuts in essential services.** If a government-owned company providing an essential service (such as the water supply) to all citizens is privatized, its new owner(s) could lead to the abandoning of the social obligation to those who are less able to pay, or to regions where this service is unprofitable.

- **Natural monopolies.** Privatization will not result in true competition if a natural monopoly exists.
- **Concentration of wealth.** Profits from successful enterprises end up in private, often foreign, hands instead of being available for the common good.
- **Political influence.** Governments may more easily exert pressure on state-owned firms to help implementing government policy.
- **Downsizing.** Private companies often face a conflict between profitability and service levels, and could over-react to short-term events. A state-owned company might have a longer-term view, and thus be less likely to cut back on maintenance or staff costs, training etc, to stem short term losses. Many private companies have downsized while making record profits.
- **Profit.** Private companies do not have any goal other than to maximize profits. A private company will serve the needs of those who are most willing (and able) to pay, as opposed to the needs of the majority, and are thus anti-democratic.

Outcomes

Literature reviews ^{[1][2]} find that in competitive industries with well-informed consumers, privatization consistently improves efficiency. Such efficiency gains mean a one-off increase in GDP, **but without** economic growth. The type of industries to which this generally applies include manufacturing and retailing. Although typically there are social costs associated with these efficiency gains^[3], many economists argue that these can be dealt with by appropriate government support through redistribution and perhaps retraining.

In sectors that are natural monopolies or public services, the results of privatization are much more mixed, as a private monopoly behaves much the same as a public one in liberal economic theory. In general, if the performance of an existing public sector operation is sufficiently bad, privatization (or threat thereof) has been known to improve matters. Changes may include, inter alia, the imposition of related reforms such as greater transparency and accountability of management, improved internal controls, regulatory systems, and better financing, rather than privatization itself.

Regarding political corruption, it is a controversial issue whether the size of the public sector per se results in corruption. The Nordic countries have low corruption but large public sectors. However, these countries score high on the Ease of Doing Business Index, due to good and often simple regulations, and for political rights and civil liberties, showing high government accountability and transparency. One should also notice the successful, corruption-free privatizations and restructuring of government enterprises in the Nordic countries. For example, dismantling telecommunications monopolies have resulted in several new players entering the market and intense competition with price and service.

Also regarding corruption, the sales themselves give a large opportunity for grand corruption. Privatizations in Russia and Latin America were accompanied by large-scale corruption during the sale of the state-owned companies. Those with political connections

unfairly gained large wealth, which has discredited privatization in these regions. While media have reported widely the grand corruption that accompanied the sales, studies have argued that in addition to increased operating efficiency, daily petty corruption is, or would be, larger without privatization, and that corruption is more prevalent in non-privatized sectors. Furthermore, there is evidence to suggest that extralegal and unofficial activities are more prevalent in countries that privatized less

