Contracting Out As a Vehicle for Privatization: Half Speed Ahead

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Privatization in its broadest sense entails a simultaneous retrenchment of the government sector and an expansion of the private sector. Although privatization is often thought of as synonymous with government sales of state-owned enterprises (SOEs), divestiture is far from the only privatization option. In the former Soviet bloc countries, for example, the rapid growth of newly-formed private businesses has reduced the public to private sector ratio, even though the sale of the many state-owned industrial behemoths has proceeded at a snail's pace. Liquidation of obsolete and uncompetitive government production units also has reduced the relative importance of the public sector. Similarly, the government's reach can be cut back by contracting out its functions to the private sector, replacing public production facilities and employees—though not ultimate responsibility—with private sector counterparts.

The government sets the overall framework and specifies the objectives, while the contractor is responsible for service delivery.

This article contends that while contracting out or outsourcing can be an invaluable component of a privatization program, it needs to be implemented judiciously. The pragmatic case for turning over government activities to private organizations rests primarily on the consequent savings; the public sector benefits by capitalizing on the private sector's presumed greater efficiency. The government sector, however, is not always less efficient. Moreover, even when the superiority of private enterprise

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is evident, contracting out is not always the less expensive alternative when all costs are fully allocated. Hence, a case-by-case analysis must replace crude generalizations of questionable merit.

The first section of this article examines the overall appropriateness of government contracting out: what types of government activities are good candidates? It also explores some non-economic motives used to legitimize outsourcing services that were long thought to lie solely within the realm of government. The second section considers issues that ought to be raised by government authorities contemplating contracting out. This article then examines the growing practice of outsourcing infrastructure projects known as Build-Operate-Transfer (BOT), which resolves many of the questions that arise in the contracting context, but which raises some of its own. The penultimate section examines open competition, whereby in-house suppliers are permitted to compete with external contractors. The final section concludes with a few observations generated by the concepts and examples embedded in the article.

Candidates for Contracting Out

Downsizing is hardly a welcome activity either for the political authorities, especially ministers whose fiefdoms are shrunk, or the civil service whose members lose influence if not employment. Yet even though the case for reducing government intervention in the economy is often warranted, the implication that this be accomplished through divestiture is not always compelling. Thus, while it is not difficult to justify the sale of an SOE that survives only through subsidies or special regulatory advantages, such arguments would not apply to divesting a government company that holds its own in the marketplace. Similarly, the rationale for converting a monopoly SOE into a private monopoly is far from obvious, especially when the regulatory apparatus is itself undeveloped or underdeveloped.[1]

Furthermore, selling SOEs is not always possible; their

[1] While a combination policy of economic liberalization to stimulate competition and privatization to convert public to private ownership would be optimal, such competition is not likely to emerge in many low income, low population countries. Especially in manufacturing, the optimum size of a firm may be too large to support more than one or perhaps a few profitable firms in the domestic market. Similarly, in countries controlled by a ruling oligarchy, divestiture merely turns over national assets to well-connected private entrepreneurs, with domestic and foreign competition forestalled by government restrictions.

potential profitability may be so uncertain as to induce apathy among prospective private owners. Although the government might just eliminate such operations, non-economic goals often overrule the adverse budgetary impact, at least for a while. Finally, some governmental activities, such as formulating laws or appointing judges, are by nature non-commercial and are obviously dubious candidates for removal from the government ownership rolls. Yet, the efficiency of SOEs and non-commercial public activities can be improved even when divestiture is either ruled out or delayed.

It is useful to distinguish among two types of outsourcing: macro-contracting and micro-contracting. In macro-contracting, an entire public activity is contracted out. Government-owned hotels can be operated by private hotel management companies as they are in Egypt and Jamaica.[2] Productive facilities, such as a steel mill or a port authority, can be leased to a private firm as happened respectively in Togo and Malaysia. Most of the administrative functions of the internal revenue or customs service—design and distribution, collection, even adjudication of conflicts—could be handled by private agents, thereby reverting to a more sophisticated version of the tax farming that was common in ancient times and medieval Europe.[3] Similarly, the educational system's operation could be removed from government hands (except for the setting of guidelines and standards), a less radical step than tax farming given that private educational establishments are common in much of the world.[4] In fact, most public sector functions could be contracted out to the private sector in

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2 The World Bank discovered 202 management contracts in the developing world, of which hotel contracts were the most numerous (44). The survey also found that Sri Lanka led the LDCs with 24 management contracts, with 22 involving tea and rubber plantations. See World Bank, *Bureaucrats in Business: The Economics and Politics of Government Ownership* (Oxford: Oxford University Press, 1995) pp. 133 - 137.

3 See, for example, Eugenia F. Toma and Mark Toma, "Tax Collection with Agency Costs: Private Contracting or Government Bureaucrats," *Economica*, 59, no. 233 (February 1992) pp. 107 - 120. More general information may be found in Carolyn Weber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World* (New York: Simon and Schuster, 1986).

4 The Bolivian government contracted with a non-profit organization to manage a number of public schools. See Jacques van der Gaag, *Private and Public Initiatives: Working Together for Health and Education* (Washington, DC: World Bank, 1995) p. 22. Use of educational vouchers, whereby individuals are provided with a subsidy that can only be used to enroll in either a public or a private school, can be seen

principle, leaving to the government only those activities that are "inherently governmental functions"— which, in the words of the United States Office of Management and Budget, require either the exercise of discretion in applying government authority or the making of value judgments in making government decisions. Government functions normally fall into two categories: (1) The act of governing, i.e., the discretionary exercise of government authority, and (2) monetary transactions and entitlements.[5]

Clearly, one would be uncomfortable leaving the nation's defense in the hands of a mercenary army or local safety to a police force that the government had acquired from the lowest bidder. One might balk at a criminal justice system wherein contracted out judges were empowered to impose capital punishment or even significant losses of personal freedom. Would the public feel comfortable with privately-operated *maximum* security prisons and their population of dangerous criminals?[6]

In contrast, micro-contracting can be employed even in inherently government functions, for micro-contracting applies to only specific activities rather than entire functions. Thus, even a government-owned and operated criminal justice system in which judges are state employees could contract out court facilities maintenance.[7] Micro-contracts can be small and of brief duration such as the British local authority catering contracts, with an average

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as a variation of contracting out. A brief description of the voucher program in Colombia may be found in van der Gaag, pp. 40 - 41, while a more lengthy, critical examination of U.S. experience with a variety of programs is available in Carol Ascher, Norm Fruchter, and Robert Berne, *Hard Lessons: Public Schools and Privatization* (New York: Twentieth Century Fund, 1996). However, neither educational contracts nor voucher schemes have been used extensively in any economy.

5 "Policy Letter on Inherently Governmental Functions," *Federal Register*, 57, no. 190 (30 September 1992) p. 45,100.

6 That is not to claim the absence of precedents. Certainly mercenary armies have been employed even in contemporary times, but rarely if ever by a democratic government. Similarly, one can find instances of private police, but rarely have modern governments felt comfortable with such manifestations. (The bounty hunter who operated under the "Wanted: Dead or Alive" option seems to have disappeared with the proliferation of state-operated police forces.) Private prisons for individuals with a low security profile are expanding in the U.S., but Allen reports that "No private vendor operates a *maximum* security prison for adults." (italics in original; citation on p. 29) See Joan W. Allen, "Use of the Private Sector in Corrections Service Delivery," in Joan W. Allen, et. al., *The Private Sector in State Service Delivery: Examples of Innovative Practices* (Washington, DC: The Urban Institute, 1989) pp. 13 - 44. See David Shichor, *Punishment for Profit: Private Prisons/Public Concerns* (Thousand Oaks, CA: Sage, 1995) for a survey of the history of

annual value slightly exceeding £161,000 and an average duration of four and a half years.[8] Or they can entail substantial outlays over very long time periods as in the case of Britain's Inland Revenue Service £1 billion, 10-year contract in 1994 with EDS, a global information services company, to design advanced tax collection programs as well as to maintain and operate the national tax authority's information systems.

Both macro- and micro-contracting reduce government power and often the potency of public employee unions as private employees replace civil servants. There is little doubt that the Thatcherite privatizations in Great Britain during the 1980s were not only ideologically based, but were also aimed at organized labor, and, through the labor unions, at the Labour Party itself. Indeed, revenue maximization and cost effectiveness were not primary objectives. Shares in the initial public offerings of the companies to be privatized were underpriced, thus limiting the government's income from the sales. At the same time, the undervalued stock prices induced millions of Britons to become shareholders, anticipating virtually certain profits. As their expectations materialized, they either realized their gains or conserved their paper profits. In either case, they would be expected to be grateful to their Conservative benefactors.[9]

Yet privatization in its various manifestations is not always attributable to conservative parties. In New Zealand, for example, the major liberalizing reforms occurred between 1984 and 1992, years when the Labour government reigned supreme. It is quite clear that the motivations underlying privatization differ. Ideology energizes the right, while pragmatism reluctantly drives the left. Market-oriented ideologues advocate a minimal

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private and public penal institutions as well as an analysis of the arguments for and against prison privatization.

7 Even professional activities can be contracted out. In some U.S. jurisdictions, public defenders, the attorneys who defend indigents accused of criminal acts, are private contractors.

8 CCT Information Service, *Survey Report No. 10*, December 1994 (London: Local Government Management Board, 1994) p. 12.

9 Vickers and Yarrow include "gaining political advantage" among their seven objectives of the British Conservative Party privatization program. They comment that while this goal was only "implicit...it has shaped a number of key policy decisions." John Vickers and George Yarrow, *Privatization: An Economic Analysis* (Cambridge, MA: MIT Press, 1988) p. 157. See chapter 7 on government underpricing of the shares of the privatized companies.

government presence, an attitude strongly rejected in principle by left-of-center thinkers. Nevertheless, even socialist-oriented governments have been forced to cope with fiscal crises that are the inevitable outcome of rising expenditures and the increasing reluctance of taxpayers to finance government activities. For the left, as well as for the right, a rethinking of the role of government has perforce implied greater use of contracting out. E.S. Savas, author of the seminal *Privatization: The Key to Better Government*,[10] states it succinctly:

> The job of government is to steer, not to row the boat. Delivering services is rowing, and the government is not very good at rowing.[11]

In other words, the government can provide the services without having to *produce* them. Contracting out, more than other privatization options, epitomizes this attitude. The government sets the overall framework and specifies the objectives, while the contractor is responsible for service delivery.

Contracting out is hardly a new idea. It is common in less-developed countries characterized by deficiencies in certain technical specialties such as the design, construction, and even the operation of hydroelectric power systems and communication networks. Transfer of technology normally is accompanied by employment contracts to expatriate managerial personnel, at least until a core of local professionals can be trained to replace them.

Outsourcing is no less common in the industrialized world, although the reasons for it differ. In the developed world, governments choose contracting out not for lack of skilled workers, but because many projects are finite and do not warrant permanently enlarging the public payroll or acquiring specialized equipment that is unlikely to be used again. Moreover, outsourcing is cost-effective when production efficiencies require a critical mass of employees, but the government entity is too small to warrant employing even the minimum number. Thus, a private fire com-

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10 E.S. Savas, *Privatization: The Key to Better Government* (Chatham, NJ: Chatham House, 1987).

11 Cited in David Osborne and Ted Gaebler, *Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public Sector* (Reading, MA: Addison-Wesley, 1992) p. 25.

pany provides protection and firefighting equipment to a number of small communities in parts of the western United States, since each locality cannot justify financing a significantly underemployed municipal fire department.[12]

Privatization in recent years has itself been privatized, especially with the current transformation of East European socialist economies into market-based systems. Governments in Africa, South America, and Asia have vaulted onto the privatization bandwagon as well. In many of these countries domestic resources proved inadequate to advise and manage governmental reform and divestiture programs. The demand for consultants of all sorts—business planners, accountants, economists, marketing specialists, investment bankers—was partly met by teams from multilateral and bilateral agencies. However, the overwhelming demand far exceeded available free supplies, leaving fertile fields for Western consultants. When Argentina decided to privatize its state-owned petroleum conglomerate, the government called in two U.S. investment banking firms—First Boston and Merrill Lynch—initially to advise it in preparing Yacimientos Petroliferos Fiscales (YPF) for the sale and then to price and market the equities to prospective international purchasers.

In short, both macro and micro-contracting reduce the scope of the government, although in distinct ways. The range of commercial activities operated by contemporary governments, be they in the form of businesses ideologically unrelated to the public sector (coffee plantations and container production) or the typical public utilities (water, electricity, telecommunications), can be privatized through divestiture. However, when outright sale is blocked either by political or economic considerations, macro-contracting becomes a possible vehicle for improving efficiency while retaining government oversight. Similarly, classical government functions such as fire protection and solid waste collection can be, and have been, contracted out. But even those activities inherently governmental in nature are open to micro-contracting options, since the inherently governmental nature of

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12 In Israel, local and regional governments have banded together to form an umbrella organization, Local Government Economic Services, Ltd., to address the small size issue. LGES provides a host of services including procurement, financial and budgetary planning and transportation planning that can be obtained more economically through combining resources.

any particular public activity is limited. Police officer patrol functions, for example, rely on a range of ancillary services such as clerical, broadcasting, vehicle repair and equipment procurement that can be privatized without violating any principles of good government.

Stating that outsourcing is possible does not, of course, mean that it is desirable. Officials and the electorate alike must address a practical question: under what conditions does it make financial sense for governments to contract out?

The Practical Economics of Contracting Out

The conventional wisdom that equates the private sector with efficiency and the public sector with inefficiency is not entirely unfounded. As with most sweeping generalizations, however, this one is stretched a bit too far. Furthermore, cost comparison studies normally do not indicate the reasons for the discrepancies, a crucial element in any decision to contract out. In addition, lower-cost private production does not necessarily mean a financial saving to the government unit buying the product from the private contractor. Finally, even when savings are apparent, the persistence of such savings is not assured. Each of these points is elaborated upon below.

Perhaps the most extensive comparison of private to public sector production is found in Boardman and Vining, who summarize over 50 studies in a variety of industries ranging from electric utilities to airlines to health-related services.[13] Only six of the studies found that public corporations were more efficient, in stark contrast to the 32 that found the private sector more productive. The authors note, however, that the heavy weight of regulated industries bias these conclusions, so that they cannot easily be generalized to the more typical non-regulated environment. Moreover, Boardman and Vining point out that SOE goals may be less directed towards profitability than are privately-run businesses. Poor SOE productivity may reflect the greater diversity of firm objectives rather than inherent SOE inefficiency.

In fact, not only are government objectives complex, but

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[13] Anthony E. Boardman and Aidan R. Vining, "Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed, and State-Owned Enterprises," *Journal of Law and Economics*, XXXII (April 1989) pp. 1-33.

profitability or efficiency is rarely a priority. Government compensation plans highlight this neglect of cost-consciousness. Public servants typically lack the financial incentives common to both hourly and salaried employees of private firms, even where that is possible. While government employees cannot be offered stock options in a wholly-owned government enterprise, they can be, but rarely are, offered a share in cost savings. Furthermore, top management is likely to be evaluated less on the basis of performance than on its willingness to bend to the wills of the political masters. In addition, the state's budget allocation mechanism frequently confiscates the profits of stellar performers to fund the deficits of the inefficient, thereby introducing perverse incentives into the structure of state-owned enterprises.[14]

General employment terms also account for some of the cost differences. While the presumption that the lower production costs of the private sector stem from greater efficiency—which, to the economist, means more output for the same amount of resource input—observation suggests that the public sector may be a more generous employer in terms of wages and/or fringe benefits. Moreover, government often serves as the employer of last resort in countries that have a negligible social safety net for the impoverished. The evidence here is inconclusive, although it suggests that private providers are more efficient while employing workers at less favorable terms.[15]

One uncontestable conclusion emerges both from the analysis and the available data: government production is often more costly. Of the two reform options—revamping an institutional structure and contracting out—outsourcing is almost always politically more palatable.

It is incorrect, however, to merely compare the costs of public versus private production.[16] Contracting out itself is costly,

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14 See Jonas Prager, "Is Privatization a Panacea for LDCs? Market Failure Versus Public Sector Failure," *Journal of Developing Areas*, 26 (April 1992) pp. 301-322, especially pp. 306 - 309 for an elaboration of these points.

15 See Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies —Draft Report* (Australia, 24 October 1995), Appendix E. The Commission summarizes its extensive review of empirical cost comparisons as follows on page E29: "The available evidence on the sources of cost savings from contracting is mixed. It appears that the cost savings may be due to a combination of productivity improvements, the use of better combinations of the factors of production, and transfers (mainly from labour). The importance of each of these sources to the overall cost savings appears to vary from case to case."

and these costs, too, must be considered prior to deciding in favor of external supply. Consider two distinct aspects of this cost comparison—the additional costs of contracting and the implicit costs of maintaining the status quo.[17] Both macro- and micro-contracting involve a host of administrative and legal costs—specifying the terms of the transaction, arranging for inspections, determining and implementing a contract bidding competition, negotiating loose ends—even before the contract takes effect. Then, depending on the integrity of the contract award process and the degree of litigiousness of the losing parties, the government may face court battles over its procedures, with the resulting costs calculated not only in monetary terms but in project-initiation delays. And it is not over once the contract is put in place. The government would be derelict not to monitor the contract, thereby mandating further resources for contract administration, quality control and dispute resolution. It has to consider the possibility of unsatisfactory contractor performance, and expect additional costs and delays if it employs another contractor or takes over the privatized operation itself.

Reliable contract administration cost data are presently unavailable. Estimates based on anecdotal information range from three to 40 percent of contract value, although these reflect only actual costs, which may either exaggerate or understate the desirable degree of contract administration. On the one hand, recorded costs may overstate optimal costs, for if governments are inefficient producers, they may be equally inefficient contract administrators. On the other hand, anecdotal experience from the United States suggests that financial constraints are typically imposed on contract administration, hobbling its effectiveness. Consider the "paradox of monitoring" in this connection. Monitors of contractor performance, like police officers, are of-

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16 A significant problem concerns the inability of most governments to calculate their costs on an activity basis rather than on a departmental one. In connection with contracting out aspects of Britain's National Health System (NHS), Bennett and Ferlie write, "Existing NHS information systems were simply not adequate to provide the detailed data on costs, caseloads, quality of provision, outcomes and future needs required." See Chris Bennett and Ewan Ferlie, "Contracting in Theory and in Practice: Some Evidence from the NHS," *Public Administration*, 74: no. 1 (Spring 1996) pp. 49-66.

17 The concepts in the next few paragraphs are expounded at greater length in Jonas Prager and Swati Desai, "Privatizing Local Government: Lessons from Federal Con tracting Out Methodology," *Public Productivity and Management Review*, 20, no. 2 (December 1966) pp. 185-203.

ten more effective as deterrents than as apprehenders. Yet, when examining crime data and discerning low crime rates, policymakers tend to overlook the deterrent impact, and are likely to suggest spending cutbacks, alleging that the crime problem has been resolved. The same logic applies to monitors. Proficient monitoring will preserve quality and will leave purchasers satisfied with their contractors. The appearance of smooth sailing will lead policymakers to wonder why they should allocate money to monitoring. Hence the paradox—the more effective the monitors are, the more superfluous they seem. And so their budgets are cut, not only compromising monitoring effectiveness, but also undermining any meaningful estimation of optimal monitoring outlays.

One could apply the fundamental privatization argument to monitoring itself. Why not contract out monitoring? If government monitoring efforts either suffer from a shortage of funds or are performed incompetently, then an efficient private monitor could provide the desired degree of quality control more economically. To be sure, the government would have to monitor the monitors, but presumably at a lower cost than project monitoring.[18] Indeed, this option is often chosen by governments that contract out. For example, a local Colombian firm is employed by the Bogota municipal administration to monitor both the private contractors and the city department responsible for collecting Bogota's solid waste.[19] Third party monitoring is especially common in major construction projects where government staffs have limited expertise or simply are spread too thinly to undertake the task. Thus, multinational institutions such as the World Bank will normally insist that the primary contractor employ an independent engineering firm for monitoring purposes.

Efficient contracting out requires resolving another issue: output measurement. Contracts with external suppliers are most effective when they specify performance objectives, permitting contractors to select the appropriate means to attain their goals. Hence, the government agency must define operationally the output standards the winning contractor is expected to meet. This

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18 In addition to the general problem of quality control, the government must monitor to prevent collusion between the contractor and the private monitor.

19 See Sandra Cointreau-Levine, *Private Sector Participation in Municipal Solid Waste Services in Developing Countries*, Volume 1. The Formal Sector (Washington, DC: World Bank, 1994) pp. 22, 26. The cost of the monitoring contract is 2.5 percent of the waste collection contract.

may be relatively simple when specifying physical outputs as in the case of hospital construction and water quality or even in such service areas as urban transportation and road repair. It becomes quite complicated where standards are ill-defined or when performance depends on a multiplicity of forces, only some of which are directly subject to contractor control.

Consider the example of contracting out mental health services. Even well-trained and experienced professionals may disagree on the appropriateness of releasing a particular institutionalized patient. At the same time, health professionals can contribute to, but not determine, a patient's mental health. Hence, contract design is in a quandary. Leaving the decision entirely to the clinicians employed by the contractor—and paying per diem for treatment—invites delaying the release of the institutionalized. Paying a fixed sum per annum reverses the incentive, as the contractor gains by releasing patients as fast as possible. Nor will the issue be resolved by employing qualified third-party monitors to second-guess the contractor's professionals. Yet, setting objective standards in advance and then holding professionals to those standards is practically impossible in light of the nature of a medical field in which every case is unique.

A typical solution is monitoring inputs rather than outputs. One might examine such measures as staff to patient ratios, staff quality as indicated by percentage of staff that holds advanced certification, space per patient, and expenditures per patient on recreation. Unfortunately, the focus on inputs is counterproductive, and is analogous to hiring a conductor to perform a Mozart symphony and then dictating the number and composition of instrumentalists. When the objective is to enjoy a masterful performance, the knack is to hire the right leader, giving him or her maximum freedom, and evaluating the conductor on the final product. Success is measured by the performance, not by the size or configuration of the orchestra.[20]

In any case, all contracting costs must be added to the product supply cost of the contractor. At the same time, the

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20 See Chapter 6, "Quality of Care," in Bradford H. Gray, ed., *For-Profit Enterprise in Health Care* (Washington, DC: National Academy Press, 1986) for a discussion of some of these issues and their application to hospital and nursing home care. The Committee on Implications of For-Profit Enterprise in Health Care noted that past "monitoring efforts [focused] primarily on structural and procedural measures—staffing patterns, requirements for obtaining staff privileges, existence of certain facilities and procedures, and the operation of institutional quality assurance sys-

comparison to in-house costs must be performed appropriately. Not all in-house costs will be saved by contracting out. To be sure, the government can pull out its staff entirely when a hotel is leased to a contractor. But if the employees are tenured civil servants and other productive employment cannot be found, then the salaries of such employees ought not to be counted in the in-house versus external supplier cost comparison. These committed outlays will persist whether the contract is awarded or not. Hence, present government expenditures may well overstate the true economic costs of continuing production in-house.[21]

An additional consideration that needs to be entertained in the contracting out decision pertains to contractor failure. To underscore the importance of this concern, especially in the macro-contracting context when the government places an entire activity in the hands of a contractor, consider the contracting out of emergency ambulance service or the aforementioned computerization contract of the British tax service. A failure of the contractor, even when performance bonds protect the financial interests of the government, leaves the public bereft of the service until alternative arrangements can be made. While tax collection delays will hardly be greeted with much dismay, the same cannot be said about heart attack patients unable to obtain speedy ambulance service. The problem is, of course, much less intense in micro-contracting situations, especially as many governments have contracted out without entirely dismembering their own operations.[22] The Bogota garbage collection case mentioned earlier is an excellent example. Ensuring that the selected contractors are able to meet their commitments is an indispensable precaution, but also one that entails additional contract administration expenses in the pre-bidding stages and contract management and monitoring outlays during the life of the contract.

Two conclusions seem inescapable at this point. First, the cost-saving nature of contracting out can only be determined when

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tems." They then note the "need to supplement [existing measures] with more ongoing monitoring mechanisms that focus on utilization patterns and outcome measures." (p.137)

21 This issue is not, to my knowledge, dealt with in any of the comparative cost studies.

22 This is an especially effective solution when the service areas can be distinguished geographically. Phoenix, Arizona, for example has divided itself into six solid waste collection zones and bids them out individually, but always makes sure that the municipal garbage collection department is not shut out entirely.

the government properly calculates the total costs of outsourcing. On the one hand, contract management costs must be added on to the price bids of contractors. On the other hand, the decision-makers must be presented with a true picture of the savings achieved from eliminating government production of the activity in question. Both macro- and micro-contracting out make economic sense only when the properly-calculated evaluations indicate a saving for the government. At the same time, the risk of contractor failure must be programmed into the calculations. Second, generalizations about government versus private sector performance may prove useful in directing attention to government functions that could be contracted out. But actual decisions to contract out should be taken only after a case-by-case examination.

Build-Operate-Transfer

In recent years, macro-contracting of major infrastructure projects, especially in the Third World, has become popular as governments have come to rely increasingly on private sector initiative.[23] Build-Operate-Transfer (BOT) programs appear to involve minimum government input, limited primarily to preparing a wish list of worthwhile projects. In return for a long-term lease or concession, private firms are expected to finance, construct, own, and operate—hence, build and operate—the infrastructure venture. At the terminal date of the lease, the private owners turn over the project to the government—the transfer phase.

Clearly, private entrepreneurs' interests lie in the profitability of the enterprise over the duration of the lease. Revenues must suffice not only to recoup investment and operating costs, but to yield an adequate profit rate as well. The advantages to the host governments are equally evident: scarce government funds need not be allocated either initially or during the concession period, internal government power plays cannot slow down the project, conflicting political interests that must be mediated or

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23 Variations of BOT, such as BTO (build-transfer-operate), ROT (rehabilitate-operate-transfer), and LRO (lease-rehabilitate-operate) are outlined in Pierre Guislain and Michel Kerf, "Concessions—The Way to Privatize Infrastructure Sector Monopolies," *Private Sector* (June 1996) pp. 21-24. In truth, even BOT projects are not uniform in terms of contract provisions.

appeased by the government do not inhibit progress, contractors need not be monitored for they bear the burden of poor quality output, and in general the risk of the project's failure is shifted onto the private providers. Finally, when the lease has expired and the presumably profitable venture is transferred to the government, the government's revenue stream is permanently widened. The project can either be operated by the state itself or be leased out once again following a new bidding competition.

Such projects are under way on every continent and encompass public utilities in the transport, telecommunications, power, gas and water sectors. The best known, most expensive and longest-lived BOT project documented by the World Bank is the Channel Tunnel (Chunnel), with a 55-year concession and a cost approaching $20 billion. Thailand's communications network comes in at a more modest $4 billion and a 30-year duration until transfer, equal in duration to a Malaysian toll road BOT and a water and sewage system Rehabilitate-Operate-Transfer project in Buenos Aires.[24]

Conclusive evidence of BOT's net benefits will be delayed for at least another generation, when the first projects will be transferred to their respective governments. Nevertheless, a reasonable conjecture suggests that BOTs' potential benefits are overstated for at least four reasons. First, while contractor freedom is substantial, the government's hand is frequently visible. Governments forestall public contentiousness by setting rates on electrical and phone service, tolls on roads and service quality standards. Indeed, some lease agreements spell concession terms that will generate losses, with the private owners being compensated by government payments. Second, governments must ensure that BOT projects conform to national standards, such as working conditions, minimum pay scales, import constraints and environmental impact. Third, the transfer provision implies that as the date of transfer approaches, profit-driven owners will lose the in-

[24] Jae So and Ben Shin, "The Private Infrastructure Industry—A Global Market of US$ 60 Billion a Year," *Private Sector* (June 1996) p. 6. Details on the Buenos Aires program may be found in Emanuel Idelovitch and Klas Ringskog, *Private Participation in Water Supply and Sanitation in Latin America* (Washington, DC: World Bank, 1995) pp. 27-50. Readers may obtain a sense of a BOT project by reading the audit of Canada's Northumberland Strait Crossing Project, a bridge linking Prince Edward Island to the mainland, available at the World Wide Web address: www.gc.ca/oag_95/oag95/1995e/ch15/ch15e.html

centive to maintain the assets over which they will soon yield control.[25] Fourth, private monopoly concessions are typically accompanied by government regulation. Consequently, perversion of the laissez-faire attitude that is presumed to characterize BOT must correspondingly attenuate the expected benefits. Although BOT harnesses private initiative to the public wagon and alleviates much of the monitoring issues and risk concerns occasioned by contracting out, it also introduces a number of new issues that await resolution. With these caveats in mind, however, BOT remains a potentially vital contracting out instrumentality.

Open Contracting

Contracting out can be destructive. Whether or not contracting out saves government funds, it does upset the status quo. Complacent government agencies and their civil service employees, who have had a virtual monopoly on the production of typical government services, come face-to-face with an alternative provider, who has a real possibility of supplanting them.[26] Indeed, the focus on competition in outsourcing encourages efficiency by challenging the in-house agency to improve its productivity.

The scenario runs as follows. All costs considered, a government operation is found to be more expensive than likely outsourcing alternatives. A proposal for bids is prepared and solicitations are invited not only from potential outside purveyors but also from the government entity itself. The contract is then awarded to the most qualified, lowest bidder.

This type of contracting out, called managed or open competition in the United States, Compulsory Competitive Tendering (CCT) in Great Britain, and Competitive Tendering and Con-

[25] Kikeri, et. al. write in connection with finite-lived management contracts: "Unless proper legal safeguards are developed and enforced by monitoring, there is a risk that the contractor may run down the assets." Sunita Kikeri, John Nellis, and Mary Shirley, *Privatization: The Lessons of Experience* (Washington, DC: The World Bank, 1992) p. 50. A similar point is made in connection with concessions in World Bank, *World Development Report 1994: Infrastructure for Development* (Oxford: Oxford University Press, 1994) pp. 61-63.

[26] "In many cases, local authorities have re-examined, and reorganised, services that had received little organization and managerial attention for many years." Kieron Walsh and Howard Davis, *Competition and Service: The Impact of the Local Government Act 1988* (London: Her Majesty's Stationary Office, 1993) p. 145.

tracting (CTC) in Oceania, has found its most extensive expression in the local government service area, although substantial inroads have been made only in the United Kingdom. Since the 1988 Local Government Act, Great Britain has mandated CCT of its local authorities in services ranging from leisure management to vehicle maintenance, and the list is expanding. Despite the fact that the majority of contracts have gone to in-government teams, estimated savings were found to equal six to seven percent.[27]

"There is strong evidence that it is the competition introduced to government service delivery which provides the driving force for improved performance," wrote Australia's Industry Commission, which examined CTC in that nation.[28] Savings on the order of 16 percent (net of contracting costs) were found on the national level, with the percentage saved varying over other jurisdictions and over time. The Commission remained convinced that CTC would generate significant savings whether or not the contract was awarded to an external provider.

A second and ancillary consequence of contracting out has been the need to specify and, where feasible, quantify objectives. Whereas a parks department administration was typically charged with keeping a park in good repair, with the meaning of "good repair" left to the on-site managers, the term had to be defined precisely once a contract was to be awarded. The contract had to specify issues such as the elapsed time between the reporting of a hole in the pavement and its completed repair, as well as the quality of materials to be used. The British CCT experience has not only vindicated the value of such specifications, but has led to a reassessment and a general improvement in quality levels.[29]

In contrast, the Australian evidence on service quality is ambiguous. The Industry Commission reported that CTC leads to quality improvements "because of a much clearer focus on what is required in the service," and added two other reasons, "improved performance monitoring, and the ability to choose between alternative providers." However, it also recognized quality deteriorations as well, an observation that is hardly surprising since service quality is likely to vary directly with monitoring effective-

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27 *ibid.*, pp. 142-143.

28 Industry Commission, p.150.

29 Walsh and Davis, p. 140. They summarize, "Authorities had generally raised or maintained existing standards, and were achieving the standards set."

ness.[30]

The U.S. experience is limited to a few cities. Phoenix, Arizona has experimented with open competition for nearly two decades and Indianapolis, Indiana is a relative newcomer.[31] Both report significant savings with no quality deterioration, but encompassing a very limited range of services.

In Australia as well as in the United Kingdom, open contracting is still in its infancy, and hence, ambiguous conclusions are perhaps the best that can be expected at this juncture. One should anticipate that as governments invite more competition and become more adept at writing, administering and monitoring contracts, cost-savings and quality improvements will become more prevalent. Indeed, efficiency in the government service will improve most when competitive forces are unleashed, when government agencies are given the opportunity to test their mettle against outside suppliers, and when appropriate contract administration safeguards are employed.[32]

Conclusions

Contracting out can enhance the effectiveness of government service delivery. But as with all policy instruments, it can be used productively or it can be abused. Effective outsourcing must be predicated not on rhetoric or undocumented assertions, but on a balanced presentation of the benefits and drawbacks of both macro- and micro-contracting out.

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30 Industry Commission, Part B; citation is from p. 117. On the other hand, Domberger and Hall present anecdotal evidence suggesting savings without quality erosion. See Simon Domberger and Christine Hall, "Contracting for Public Services: A Review of Antipodean Experience," *Public Administration*, 74, no. 1 (Spring 1996) pp. 129-147, especially pp. 141-144.

31 See Jim Flanagan and Susan Perkins, "Public/Private Competition in the City of Phoenix, Arizona," *Government Finance Review* (June 1995) pp. 7-12 and the City of Indianapolis, *The Indianapolis Experience: A Small Government Prescription for Big City Problems* (undated).

32 This is not to claim that these conditions will emerge spontaneously. Consider the following citation: "The con of contracting out is that in the developing countries, government officials and ruling elites tend to give the contracts to their business associates, friends and family members. During our research, we found this to be the case in Malaysia, Indonesia, Kenya, Zaire, Cote d'Ivoire, Peru, and Chile." Jacques V. Dinavo, *Privatization in Developing Countries: Its Impact on Economic Development and Democracy* (Westport, CT: Praeger, 1995) p. 7. Nepotism and favoritism are not unknown in the developed world either.

Macro-contracting of full-service government operations will work best for commercial-type enterprises such as hotels, textile plants, or telecoms that the government either cannot or does not wish to sell outright. It can also be employed with many administrative types of government operations, although on philosophic grounds many would not contract out national defense, policing or similar activities that employ the state's coercive powers. On the other hand, many functions that take shelter under the umbrella of "inherently governmental" are not inherently so. There is nothing particularly governmental about using public sector employees and equipment for maintaining noncombat vehicles or tending to the health needs of the imprisoned, despite the fact that the military and the police easily fall within the rubric of inherently government services. For these sub-activities, then, micro-contracting is an alternative option to government production. Value for money is the driving force in such decisions.

Contracting out shifts the government's focus from producer to manager without, however, ceding ultimate decision-making authority over societal goals to contractors. The new relationship does not deny government's supervisory role as it works to assure contractor compliance with its own objectives. However, even supervision does imply that government restrain itself from hands-on management. Extensive government intervention will subvert the motive for turning to outside suppliers—to benefit from the cost efficiencies of the private sector, a direct consequence of its freedom to determine the most productive means of achieving those objectives.

Yet it is not axiomatic that private sector production will be more cost-effective than public sector operation. Much depends on the competitiveness of the market in which the government activity functions. A government-owned and operated hotel can be just as efficient as its privately-owned neighbor, provided that both face the same market conditions and incentives, including liquidation when profit prospects evaporate. However, more expensive public production will not always justify contracting out, for outsourcing itself is not costless. The savings derived from employing outside suppliers may not compensate for the costs of awarding, administering, and monitoring contracts. Other issues that need to be resolved in the outsourcing context include cost measurement, output specification, contractor regulation and contractor failure.

Some of the contract administration and failure issues can be resolved in major infrastructure projects by turning over primary responsibility to the private sector via Build-Operate-Transfer (BOT) or similar mechanisms. While governments often dictate the fundamental operating terms, the private sector entrepreneurs finance, operate, and shoulder the risks in return for prospective profits. Early indications of BOT success are encouraging. Open contracting, in which the public and the private sector compete for the contract, also seems worthy of further exploration. Again, initial results seem promising, with governments using this method reporting cost savings and, by and large, no deterioration in service quality.

Yet "proceed with caution" remains the order of the day. The transfer phase of most BOT projects, which will take at least another decade or two, means that it is premature to assess and comment about BOT's ultimate effectiveness. Similarly, most activities currently subjected to public-private competition are relatively simple to perform and monitor. The cost-effectiveness of open contracting under more complex contracts remains to be seen.

Pragmatism demands treating contracting out on a case-by-case basis. Undoubtedly, many types of government activities are prime candidates for contracting out initiatives. Foremost among them are functions with relatively limited contract administration costs or ventures that are relatively open to entry in most countries and whose impact is easily monitored either by the public or the press, such as solid waste collection, street repair, and parks maintenance. Moreover, the very threat of outsourcing can perform wonders, inducing productivity-enhancing modifications in existing public management and employee behavior. For that alone, contracting out deserves to be considered wherever and whenever feasible.