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BRINGING EFFICIENCY TO THE THIRD WORLD THROUGH PRIVATE PROVISION OF PUBLIC SERVICES

INTRODUCTION

Less developed countries today face the challenge of trying to raise their living standards while contending with debt burdens and economic stagnation. The resultant need to hold the line on government spending threatens to hinder the delivery of many essential services. Yet this should not be viewed as a catastrophe. To the contrary. The situation offers less developed countries an opportunity to adopt policies that will deliver these services more efficiently and, at the same time, ease the pressure on government budgets. The way to do this is by creating the mechanisms and incentives for the private sector to provide these services that now are supplied exclusively by government bureaucracies.

That this can be done is now beyond dispute. The private provision of public services has proved successful in most of the developed world and is attracting the attention of many less developed countries.

Public Goods. In a free market economy, most goods and services can be provided by individuals and businesses. Yet those who wish to increase governments' role in the economy often maintain that certain sectors must be the responsibility of the state. Water and roads, for example, are said to constitute a "natural monopoly" where only one supplier is possible or where multiple suppliers would be inefficient. Street lighting and national defense, it is said, cannot be financed by charging a fee to individual users. Some services, such as education, are believed to be good for society as a whole, yet might not be adequately supplied at market prices. In such sectors, it is maintained, government must provide the good or service, often using taxpayer funds as the source of finance.

Yet public provision has serious problems. Because there is no market competition with the government supplier, and because taxpayer funds can be used to cover expenses, there is insufficient incentive for such suppliers to be efficient or to render the best service possible to the customer. In less developed countries, the problem has been especially serious. With fewer avenues for personal advancement, jobs in state industries are much sought-after and are then protected by those who have them and by the political leaders they support. Corruption and bribery commonly result.

Further, these inefficient state industries often are money losers, requiring billions of dollars in subsidies. A significant part of the Third World debt goes to cover such losses.

Bringing In Market Forces. In such areas as public transportation, wholesale and retail marketing, and the production of consumer goods, the private sector can be the best supplier. Governments would do well to keep out of these areas and privatize all such state-owned enterprises. In areas where the state feels it necessary to be involved, market forces can be brought to bear for the private provision of public services. Example: governments can contract with private firms to construct roads, public facilities, and similar capital assets. Private companies can maintain and clean public buildings and administer state facilities. In the case of a public utility like water, a long-term monopoly franchise can be granted to a private firm. Services such as education can be provided by private schools with the government issuing vouchers to citizens to pay the fees of the institution of their choice. And private citizen cooperatives can be established to oversee and pass along savings for public utilities such as electricity.

All countries' economies can benefit from the introduction or strengthening of market forces. The private provision of public services, however, is especially useful for less developed countries in which a weak service sector hinders economic development. Private provision of services can help countries suffering from economic inefficiency, poor infrastructure, costly government budgets, and huge debt burdens. The United States Agency for International Development (AID), which is charged with promoting economic growth in less developed countries, as well as such international development organizations as the World Bank, Inter-American Development Bank, and African Development Bank, should make privatization of state-owned enterprises a central element of their general development policies. As important, when some state involvement is still required, these organizations should encourage private sector involvement wherever possible. They can do this by providing information on the successful privatization of public services and by not funding public sector providers that compete with private providers in less developed countries.

MARKETS FOR GOODS AND SERVICES

Societies need numerous goods and services. These include food, shelter, clothing, electricity, running water, transportation, education, entertainment, police protection, and law courts to name but a few. In a market system, individuals or businesses produce goods and services which they trade for other goods and services. Thus the quantities and prices of goods and services on the market are the result of all the individual acts of buying and selling. Customers seek the best values from competing suppliers, while suppliers attempt to make the best possible deals with customers.

Some governments, however, feel it is necessary for certain goods and services to be produced or consumed by the state. In Western society these services traditionally have included police protection, law courts, and armies. The government uses taxpayers' money to produce these services. The government in a sense is also the consumer of these services, which it utilizes to maintain an orderly society. The quantity of these services is determined not by the market demand but rather by political decisions.

ARGUMENTS FOR GOVERNMENT INVOLVEMENT

There are a number of reasons why it is believed that the state rather than the private sector should produce or consume certain goods or services in addition to police and legal systems. These include:

1) Natural Monopolies

Some services, it is maintained, can be supplied only by means of source or a factor of production that cannot be duplicated. A city's water supply, for example, may come from just one source. In such circumstances, a private owner of the water source would not face direct competition; he would, therefore, be able to exploit those who want water by charging prices considerably higher than his costs of extraction and distribution. A public agency providing water in this situation, however, would be politically responsible to the beneficiaries and would do so at nonmonopolistic prices.

2) Economies of Scale

The efficiency of an enterprise can often be increased by enlarging its scale of production. Using costly specialized equipment, for instance, might be profitable only for large production runs; or inputs for a business might be purchased more cheaply in large quantities. If economies of scale are so great that only a few firms, or perhaps only one, can operate profitably in a given market, there is a danger of monopoly power. Some economists cite early electrically powered public transportation systems that required a single, expensive electrical generating system as an example of such an industry.

3) Externalities

Cases frequently occur when buyers and sellers who exchange goods and services create costs and/or benefits, usually called externalities, for people not directly involved in the exchange. A widely recognized negative externality, for instance, is the pollution caused by factories or automobiles, while a positive externality would be the beautiful gardens enjoyed by nonpaying passers-by. Some economists argue that, in the absence of government ownership or control, there is overproduction of goods or services involving negative externalities and underproduction of those involving positive externalities. Some suggested remedies include taxes to discourage negative externalities and subsidies to encourage positive ones.

4) Inability to Charge, or the Free Rider Problem

Some goods and services have to be provided to a group as a whole and cannot be subdivided for the benefit of particular individuals. Typical are national defense, street lighting, lighthouses, and conventional radio or TV broadcasting, often called "pure public goods." The same level of service is available to everybody, regardless of the extent to which each individual chooses to avail himself of it. There is no way, it is claimed, by which individuals can be charged for the service, or excluded for nonpayment. Because of the impossibility of charging, or of excluding nonpayers, the private market would not find it profitable to supply these pure public goods. Hence, it is said, the government must act to ensure their provision.

5) Merit Goods

Economists use the term "merit goods" to describe goods and services thought to enhance society as a whole that, if left to private markets, would be produced or consumed in insufficient quantity. The assumption is that many people would spend money on immediate needs and neglect long-term betterment for themselves or their children. Health and education are often thought of as merit goods, at least up to a certain level. As people might not voluntarily buy sufficient merit goods, it is suggested that they should be provided free by public agencies.

THE PROBLEM OF "GOVERNMENT FAILURE"

When private markets cannot by themselves provide the range, quality, or quantity of services considered desirable, governments often consider alternative methods. One alternative might be direct production of a good or service by government employees such as policemen, mail carriers, and public health experts. Yet, the possibility of government failure as well as market failure, must be considered. The private market may be faulty, but the government "remedy" is often worse.

First, governments tend to make decisions concerning public enterprises based on political considerations, granting favors to one interest group at the expense, and to the detriment, of another interest group or of society as a whole.

Second, because such enterprises are in fact government monopolies, they suffer many of the same problems attributed to private sector monopolies. Due to lack of competition, government enterprises are prone to inefficiency. Employees have insufficient incentive to provide the best service possible to customers.

Third, lack of competition often leads to huge financial losses, which taxpayers are forced to cover. The need of governments in poorer countries to cover billions of dollars in such losses from their budgets has diverted enormous resources from other crucial social needs and contributed to huge debts. In Argentina, for example, the state railroad requires a subsidy of $3 million per day.

Fourth, because taxpayers ultimately cover such losses, and because of the considerable political power of workers employed in government enterprises, such enterprises rarely shut down even when they fail to meet public demands.

And fifth, government economic forecasts are usually based on relatively few "scenarios" or projections of demand and are divorced from market processes. Thus government management of any given industry tends to be based on incomplete or outdated information. For example, the Indian Railroad Board failed for 25 years to come anywhere near the correct projections for how much coal to carry. Railroad officials explained to a commission of inquiry that their projections were based on official government economic forecasts.

In contrast to government enterprises, the private sector, taken as a whole, has an excellent information base. Market prices, the result of all economic exchanges in an economy, communicate information concerning the real demand for goods and services and the costs of producing them. Private provision, subject to market forces, thus helps to determine the real costs of goods and services. Further, the private provision of public goods and services introduces competition and thus avoids many of the problems of government monopolies. Services must meet customer demands and therefore tend to be of appropriate quality. And production tends to be in the most cost-effective manner.

Thus, production of goods and services by state enterprise, especially in less developed countries with extensive government regulation of the economy, usually would be better left to the private sector. Returning such enterprises to private citizens is often wise. Governments therefore would do well to become involved only in sectors where there is virtually no possibility of private provision. Yet even when the government still desires a role in a particular sector, it is possible to keep the private sector and market forces involved in the provision of public services.

METHODS FOR PRIVATE PROVISION

The private provision of services can be carried out in different ways, including:

1) Contracts from Public Agencies

In some situations, government is responsible for a certain sector and wishes to own and operate the material assets necessary to provide the required service to the public. The government also may wish to finance the service out of general tax revenues. Typical of such a sector are transportation infrastructure, government buildings, and military hardware. Yet even here, market forces can lead to greater efficiency if the government contracts out to the private sector to provide the service. Road and building maintenance, for example, is carried out by private contractors in numerous countries. These contractors are selected by a process of bidding on the basis of work specifications prepared by the road or building authorities. In some U.S. and British cities, private companies are paid to provide bus services.

2) Monopoly Franchising

Where natural monopolies or problems of economies of scale are believed to exist, a private company can be appointed by a public authority to provide services on a monopoly basis. Under such an arrangement the government defines the level and kinds of services to be provided, to whom the services must be offered, and the means by which the prices for the services will be determined. The company is required to make the capital investments necessary to provide the service.

Private companies compete for the monopoly contract. The winner of the competition has autonomy over the day-to-day operations of the enterprise. The contract would be for a sufficient length of time to allow the business to meet expenses, realize a return on large capital investments, and make a profit. Periodically the contract would be up for renewal. Other businesses could bid on the contract at these times. This would provide an incentive for the businesses with the monopoly contract to provide the best possible service to the customers. The provision of piped water in France is one example of such a contract. Another is a contract by the government of Indonesia with a private firm to run the country's customs service.

3) Management Contracts

When the government owns the material assets needed to provide a service and pays for the service from general revenues, it is still possible to introduce market discipline through management contracts. Rather than government employees running an operation, private companies bid for the opportunity. The winning private company provides the personnel to perform service functions in exchange for a set fee from the government. Employees are hired, promoted, and dismissed by the private contractor. New capital investments are still the responsibility of the government. In the U.S., many urban bus companies are municipally owned but operated by private management firms. Also in the U.S., the private Corrections Corporation of America operates prisons for state governments.

4) Vouchers

Vouchers constitute an array of systems that enable consumers to get free or reduced-cost goods or services while retaining the power of choosing between competing suppliers. Usually, the government gives individuals a voucher, worth a certain amount of money, which the recipient must "spend" to secure a certain service. After the individual gives the voucher to a private supplier or even a competing public supplier of his choice, the supplier turns it in to the government in exchange for its value in cash.

The vouchers best known in America are Food Stamps, which enable the poor to receive subsidized food directly from private supermarkets. This means the government does not have to open special low-price food shops. An earlier example of vouchers were the cash grants given to discharged GIs after World War II, which they could spend at any approved higher educational establishment of their choice. Housing vouchers today are used in Britain and in the U.S. to enable low-income individuals to obtain rental accommodations at free market rents.

5) Consumer Cooperatives

Consumer cooperatives, which range in size from a few dozen to hundreds of thousands of members, are self-governing, voluntary organizations, run by their members. Unlike shareholders' companies, which distribute surpluses in proportion to share ownership, consumer cooperatives distribute surpluses to members in proportion to their purchases. The consumers themselves ultimately control the policies and management of the coop. Designed to serve the interests of their members, consumer cooperatives are particularly acceptable in monopoly situations, like village electricity, where consumers may not be able to benefit from competition among suppliers.

EXAMPLES OF PRIVATE PROVISION

Water Supply

In many times, places, and circumstances, the private provision of water for drinking, cooking, washing, and industrial use has been the rule. In pre-industrial times, vendors carried water from a river or lake for sale to consumers. Yet in industrialized or more economically complex societies, problems arise. In some cases, only a single water source, perhaps a lake, is available. If a single business controls access to the lake it is feared that a natural monopoly might exist with no competing water suppliers and no alternative source. To supply water through pipes, moreover, in many cases is so massive and expensive an undertaking that competition for customers might make it impossible for any suppliers to operate. Negative externalities also might exist, such as individuals depleting a common supply. Finally, clean water, free of disease-causing bacteria, might be considered a merit good for society.

In the case of ground water extraction from wells, the danger is that, if all wells tap a single source, no user will have an incentive to conserve water. As with children using straws to drink from a single glass, the one who drinks slowest gets the least.

The problems caused by the private extraction of water could be avoided by following the example of the oil industry. Through the use of contractual arrangements and rules, many different operators can pump oil from a single source. Such arrangements might be developed for water.

Concession System. In the case of extracting water from a single source that cannot be divided, or where separate distribution systems are too expensive, market mechanisms still can be employed. In France, many municipal areas grant monopoly concessions to private suppliers for the extraction and distribution of water.

In the concession system, the public authority contracts with a single private operator who finances, constructs, and operates, at his own risk, all the facilities to supply drinking water. On termination of the concession, the system must be returned to the public authority in perfect condition. This means that during the life of the concession the franchise holder must replace worn-out equipment as well as recover the invested capital. To realize a return on investment, the concessionaire sells the water to the consumers in accordance with the concession contract, which typically allows prices to be charged taking account of inflation, economies of scale, taxation, and other economic factors.

The concession contracts also fix the level of service to be provided by the concessionaire: water quality and source; quantity of water to be supplied without charge to the public authorities (standposts, sewer flush, fire hydrants, and street cleaning); obligations and terms of connecting up consumers. To enable the amortization of the concessionaire's investment over a long period, concession contracts are generally for a long term, usually 30 years. Yet because concessionaires are in competition with one another to obtain contracts in various cities, and because the contract might be transferred to another supplier if the concessionaire does a poor job, the concessionaire has a strong incentive to provide the best and least costly service to the consumer.

Electricity

There are three stages involved in supplying electricity to the public: generation; transmission, usually over high-voltage wires; and distribution to individual or industrial users.

On a small scale, all three steps can be handled by the private sector. Small generators can be employed for personal or industrial use. The development of electrical generating capacity and distribution in North Yemen is an example of how the market can work in less developed countries. In the mid-20th century, private individuals and families provided for their own needs with small diesel-powered generators and sold excess power to nearby homes. In 1963, many of the small generators were combined to form an independent company with both government and private shareholders. In 1975, after Yemen's civil war, the government took over this and several other electric companies, but still permitted private electrical generation by license. Between 1975 and 1981, the proportion of the population with electricity went from 4 percent to 33 percent. The share of electricity provided by the private sector went from 57 percent to 66 percent.

The transmission and distribution of electricity to large numbers of users in a more advanced society poses the problem of economies of scale. Setting up a distribution network of cables, wires, utility poles, and substations can be so expensive that no more than one supplier can realize a profit in a given geographical region. Thus the state might wish to use a monopoly franchise or perhaps contract out for construction of the electrical grid, using tax dollars, and then offer a management contract to a private firm to run and maintain the grid and collect user fees from customers.

Local distribution of electricity also can be handled by a consumer cooperative rather than a state-owned enterprise. In this case, consumers purchase their electrical service by joining the coop. The management of the coop ultimately is accountable to the owner-members. Thus, better service is provided, the costs kept down, and savings passed on to the users.

Converting Heat to Electricity. Even with a publicly owned grid, the generation of electricity can be handled in part or whole by the private sector as in cases where the private transmitter or distributor can purchase electrical power on the free market. For instance, industries producing goods for the market can convert heat, generated by the regular production process, into electricity for their own use or for sale. For example, Orly Airport, which serves Paris, uses this "cogeneration" to heat its terminals. In the 1970s, cogeneration produced 18 percent of Italy's electrical power, 16 percent of France's, West Germany's, and 12 percent of the Netherlands'.

Private companies generating electricity solely for sale to distributors also can increase the supply and cut the costs. In the U.S., Virginia Electric Power Corporation (VEPCO) announced in March 1988 that it was willing to buy all of its future power from such private contractors, including power from plants burning wood or coal, plants burning municipal waste, and power produced by industrial cogeneration. As a result, VEPCO had offers from suppliers willing to sell 20,000 megawatts, the equivalent of some 20 new large-scale plants with the capacity to bring power to two million homes.

In India, the Tata Electric Companies have a long history of generating power for public use. They own generators with a capacity of more than 11,000 megawatts and serve, among others, 114 industrial operators.

Telephone Service

Economies of scale and natural monopoly are usually the arguments used to make a case for government to provide telephone services. Yet in less developed countries, with state-owned phone systems, service is usually extremely poor. It often takes months or years to get a phone installed or repaired. State telephone companies tend to run huge deficits. Therefore, the introduction of market competition could help improve service and cut costs.

Most telecommunication systems today are centrally controlled as government monopolies; yet phone systems were first developed by the private sector. In 19th century America, service was provided by thousands of companies, some large, some small, which adopted common standards voluntarily that enabled a national interconnected network to be formed. Even today, there are over 1,500 separate private telephone companies in the U.S. providing local service, and some 40 companies providing long distance service. Europe has dozens of different telephone networks, all interconnected though almost all publicly owned. Private sector providers are to be found in the U.S., on some of the Caribbean islands, and in a few countries in which telecommunications have recently been privatized, like Malaysia and Britain. Competition, in the sense of consumers being given a choice in telephone service, exists only in the U.S. for long distance calls. Telephones owned by local cooperatives are to be found in Bolivia, Chile and Finland.

In less developed countries, even if the government must provide the capital for construction of a system, management contracts can be put out for bids to the private sector. In Botswana, for example, the government has employed Cable and Wireless PLC, a British firm, to modernize its system and to train its staff. In Argentina and Brazil, the compilation of telephone directories is contracted out to private firms.

Education

Education is not a service with the characteristics of a natural monopoly, nor are economies of scale a major problem for teaching. There is no free-rider problem since the service can be charged for. Nor are there negative externalities associated with education. Most governments justify their involvement in education on the grounds that it is a "merit good." Yet if the cost of education is too high, parents, especially those in poor financial condition, will be tempted not to spend money on their children's education, but rather to use available funds to meet immediate family needs. Furthermore, in many poor countries, parents keep their children out of school so that they can be employed in agriculture, vending, or other economic activities to supplement family income.

Throughout much of history, education has been a matter of private provision. In China in the 19th century, for example, people of a neighborhood would pool resources to hire a teacher for local children. It is estimated that during that time, in the rural districts of Kwantung province, 50 percent of the men could read.

Private tutors have been a means of educating children as far back as ancient times. Private schools, supported by fees and gifts, are widespread in the U.S. and are found in many European countries as well.

Parental Choice Through Vouchers. Governments concerned that all people, even the poor, have the opportunity for education can still retain the element of market competition in making the service available. Parents can be issued government vouchers for a certain sum of money, which they then can spend at the school of their choice to pay for their children's education. The school cashes in the vouchers with the government. Even where most or all schools are public, this technique allows parents to reward the best schools by enrolling their children in them and to "punish" the less effective schools by avoiding them. If a school is run so poorly that not enough parents send their children, the school will shut down. This gives parents control over the quality of their children's education and gives teachers and school administrators an incentive to do the best job possible. A variant of this system is used currently in Chile, where children go to the primary schools their parents chose, and the government pays the bill.

Other Public Services

There are many services, often identified as government functions, which can be delivered completely by the private sector. Other services that do require some form of government involvement still can utilize the private sector or market forces. These include:

♦ ♦ Governments contracting with the private sector to construct and maintain roads rather than maintaining a government highway department.

♦ ♦ Governments allowing private toll roads, as is done in Thailand.

♦ ♦ Private buses providing public transportation. In many less developed countries, and even in the U.S., extensive informal or illegal private carriers compete with inefficient, subsidized government systems.

♦ ♦ Private health maintenance organizations and competition between health care practitioners to keep down medical care costs.

♦ ♦ Local private cooperative banks to provide personal and small business loans.

♦ ♦ Choice for workers of enrolling in private pension plans rather than mandating the government system, as in Chile.

♦ ♦ Delivery of intercity mail, as is done illegally in India.

CONCLUSION

Governments, especially in poor, less developed countries, understandably desire to see their people's living standards raised quickly. In the past, these governments have felt that direct state responsibility for the provision of various goods and services was the best means to this end. Yet decades of experience, in both developed and developing countries, show that this typically leads to poor quality goods and services, huge financial losses and government debts, corruption of government officials, and declining living standards.

Keeping Suppliers Accountable. In many cases, such as production of most consumer, industrial, and agricultural goods, as well as such services as education, banking, public transportation, and medical care, the private sector is the most efficient and cost-effective means of satisfying popular needs. Competition between suppliers keeps costs low and makes the suppliers more responsive and accountable to public demands. Whenever governments can allow the private sector to provide these services, they should do so. But even where the government must have a role in the provision of certain goods and services, the private sector and market mechanisms should be used whenever possible.

The authority to involve the private sector in the provision of public services rests with the governments of the less developed countries themselves. But the U.S. Agency for International Development and such international organizations as the World Bank and Inter-American Development Bank can play a role in such reforms.

Searching for Innovative Solutions. First, AID and other organizations can provide information to less developed countries about successful cases of private provision in other countries and how to go about changing from complete state sector provision to partial or complete private provision. In many cases, the governments of less developed countries are not aware that such options are available, much less of how to make use of them. Second, AID and other development organizations should not provide funds to government-owned and operated public service providers that compete with private providers. The very existence of private providers indicates that the government service is not meeting market demands and that greater private provision would be possible.

Government officials in less developed countries should be imaginative, creative, and innovative in searching for ways to carry out such policies. Contracting out to the private sector for goods and services, offering monopoly franchises for a limited period of time to private suppliers based on competitive bids, issuing vouchers to individuals for purchase of services such as education from the private sector, or forming consumer cooperatives in certain situations are some very effective ways of ensuring that the demands of the public are met.

Prepared for The Heritage Foundation by
Gabriel Roth
a Washington, D.C.-based consultant, formerly an economist with the World Bank's Economic Development Institute*

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