CHAPTER 6

MAJOR ISSUES RELATING TO PRIVATE SECTOR ASSISTANCE IN MUNICIPAL SERVICES
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This chapter analyses the major issues that need to be considered while contemplating privatization of municipal services. The issues covered in this chapter include: various views on privatization, unbundling, matters related specific country conditions, marketability of the services to private sector, and capacity building required in private sector.

Central Issues of Privatization

Economic Efficiency: The proponents of economic efficiency argue that privatization is economically more efficient than government delivery of services because of economies of scale. Private companies can perform the same service for several municipalities, justifying their sunk costs in necessary equipment and the use of specialized labor. Labor costs are lower because labor productivity is higher in the private sector. Public employees are "overpaid" and have higher benefits. Hiring part-time and seasonal workers who do not receive benefits lowers labor costs and provides more flexibility for private firms. The public sector will save money by avoiding large capital outlays for specialized equipment. Finally, the private sector can avoid legal restrictions imposed on the public sector, and thus operate more cost effectively.

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**Economic Inefficiency:** Opponents see privatization as economically inefficient. The cost of contracting out is high. Municipalities must prepare and administer the bidding process, write contracts, and monitor performance. The public sector often must train contractor employees and loan capital. The public sector remains responsible for service provision. If the service is not carried out satisfactorily, either the municipality must step in to perform the job or go through a new bidding process. Other hidden costs are often ignored, such as public equipment and services provided to contracts, and hiring or training technicians and managers to monitor the private sector. Government can be more cost effective because it does not pay taxes on profits and has easier access to low interest rate long-term capital than the private sector. Worker longevity and training make government workers more efficient, and new management techniques are making the public sector more efficient.

**Quality of Service:** Proponents see improved service effectiveness due to competition. Since the contractor faces the discipline of the market -- there is always the danger of not being renewed--strict attention to business is assured. Any competition will increase quality of service over the public sector, because government is a monopoly. Opponents point out that quality is hard to monitor in some service areas. To make a profit, private firms will need to cut labor costs, which may result in employment of less competent or experienced workers. Maintaining consistent quality across the entire service area or population may be undermined as private firms seek to maximize returns by focusing service delivery on those populations easiest to serve. Many public services lend themselves to monopoly provision due to obvious economies of scale. In such cases, privatization is quite risky, as the municipality will have little choice if the private contractor's quality is not acceptable. As the municipal unit's expertise and familiarity with some services declines, it will not be able to take over these functions if the private contractor proves unsatisfactory.

**Social Equity:** Proponents of social equity consider privatization as a means of increasing social equity. Money saved from increased economic efficiency, instead of being paid in taxes, will be spent by consumers on items of their choice. An increase in consumer spending will lead to more job opportunities for minorities in the marketplace, as well as benefit them directly through the equal basis upon which
contract bidding can be run. Opponents argue that it is the role of government to assure equitable distribution of services. Since it may be less profitable to deliver services to lower-income areas, equity could be de-emphasized in a privatized system. In addition, women and minorities could be hurt disproportionately by privatization. Employment opportunities for women and minorities are greater in the public sector because of anti-discrimination policies. Their career potential is based on their ability to enter the ranks of middle management in government, yet middle management would likely be cut under privatization.

**Labor issues:** Proponents claim that public sector workers benefit from privatization. Displaced workers can be hired by contractors or transferred to other government positions. Those hired by the private sector can receive meaningful job feedback not found in the government bureaucracy. The threat of strikes will be diminished because services will be decentralized and the power of public service unions reduced. Opponents believe that privatization undermines organized labor and results in jobs without health, pension, and other benefits. Communities with workers without benefits and job security are not better off.

**Long-term Implications:** Privatization raises questions about the nature of service provision and the role of government. Increased reliance on the private sector may free government to focus on other aspects of government leaving service delivery to the rigors of the market place. Efficiencies and economies of scale could be achieved while building the tax base through private provision of services. Privatization raises questions about the conditions of work. Public sector jobs open to the lower skilled will shrink as government reduces direct service delivery and relies more on highly trained technicians who can serve as contract negotiators. These and other long-term implications deserve serious consideration in the decision to privatize or make public service provision itself more cost effective.

**Views on Privatization:** John D. Donahue (1989) views that private sector monopolies and corruption call into question the reliability of markets for many government services. Government must maintain the powers reserved for its sovereign role as overseer of the public good. Critics of privatization question the means used by the
private sector to achieve efficiency. Opponents raise concern about the loss of public jobs with benefits, their impact on the local economy and on women and minorities who have found career tracks in the public sector. Opponents also fear privatization will lead to widespread corruption leading to public distrust of the democratic process. E. Sclar, K. Schaffer, and Robert Brandwein (1989) detail the potentially harmful impact on society of privatization policy based solely on economic analysis. Markets cannot be used as the sole measure of allocable efficiency. Only in certain clear-cut circumstances should government give up its role as provider of public services.

Unbundling of Services

Privatization is reduction in the level and degree of government’s involvement in a given service or industry. It can range from total divestment in government owned enterprises to allowing involvement of a private person in any government’s activity with or without remuneration. According to Walker (1989) “Privatization is said to take place when responsibility for a service or a particular aspect of service passes, wholly or partially, to the private sector and when market criteria such as profit or ability to pay are used to ration or distribute benefits and services.”

While dealing with unbundling it is important to consider the concept of natural monopoly. This exists when one provider can serve the market at a lower cost than two or more providers could. This will happen when costs of producing and delivering a service decline with increasing output. This situation is referred to as economies of scale. There can also be situation when it is cheaper for a single provider to produce and deliver two or more services jointly than separate entities provide services individually. This is called economies of scope. It may be justified to promote bundled forms of industries on conditions where economies of scope are significant and where cross subsidies among services have been applied. Unbundling can take place after isolating natural monopoly segments. Unbundling promotes new entrants and competition into the sector as numerous activities within the sector can be undertaken competitively. This is desirable as it makes cross-subsidies between different lines of business more transparent, identifies more precisely the subsidies needed to deliver services to the poor. This results in improved management
accountability. There are technical and economic constraints on unbundling. In addition legacy of history and institutions limits the possibilities even where technology permits unbundling. Closely interdependent activities should not be separated as it can increase transaction and markup costs.

There are two types of unbundling, vertical and horizontal. Vertical unbundling takes place when different functions of one sector are carried out by separate agencies, as power sector can be unbundled into generation, transmission, and distribution. Similarly in the natural gas industry, the wellhead, pipeline, and local distribution systems can be owned and operated separately. Horizontal unbundling takes place when demarcations take place with respect to markets, geographical locations, service categories, etc. In Japan, the national railway was reorganized and split into six regional passenger operators and one freight operator that rents track time from the regional railways. After unbundling takes place competition can be used to increase efficiency. Four types of competitions are advised (i) competition from substitutes, (ii) competition from market, (iii) competition for the market and (iv) privatization of monopoly.

Alternative Institutional Forms for Services

There are four types of institutional forms for management of municipal services. The major ingredients for good performance vary according to the type and service.

- **Public ownership and public operation:** In this form the enterprise is owned and controlled by the central, state, or local government. The roles of the government need to be defined in terms of ownership, regulation and operation without government interference in detailed management. They should operate on a level at par with private enterprises in terms of commercial management. This would mean tariffs should recover costs, achieve consumer satisfaction, comply with accounting and audit requirements, and introduce professionalism in management.

- **Public ownership and private operation:** In this form although government owns the enterprise private sector is allowed to operate through agreements. These could be performed through the media of concessions, leases, contracts, etc.
Leases and concessions permit private sector management and financing without the reconstruction of the existing organizations. It will be effective if there is legal framework for contract law and enforcement mechanism. There should be mechanisms for fixing responsibilities of owner and operator, measuring performance targets, resolving disputes. Award of contracts should be through transparent selection process.

- **Private ownership and private operation:** This should be applicable where there is least commercial and political risk. This entails that restructuring should have taken place that allows competition in the sector or adequate regulation should be in place to protect public interest when competition is insufficient.

- **Community self-help arrangements and user provision:** This refers to services that are managed through self-help arrangements that require low scale infrastructure. These will be effective when the primary beneficiaries are those who contribute to the cost. Also they need to be selected and implemented locally without outside imposition. Participation of beneficiaries needs to be ensured through organizational means and monetary contributions. The user group should be supported through training and assistance from outside agencies like non-governmental organizations.

**Country Conditions for Privatization**

One of the important requirements for reforms in the provision of infrastructure facilities is to understand the county conditions. In terms of capabilities countries can be grouped into four country types: low-income countries, countries in transition from central planning, middle-income countries undergoing economic reform and high growth countries. The possibilities of reforms are determined in terms of the following three-dimension of capacity of the country:

- Institutional capacity for commercial and competitive services,
- Managerial and technical capabilities in the public and private sectors, and
• Ability of government for private activity and the private sectors’ interest and response.

In low-income countries all three dimensions of capacity are typically low. All the same there are large countries, which have technical capacity and private sector interest. In the socialist economies in transition, technical capability is high, but private sector capacity is developing. In middle-income reforming countries, technical and managerial capabilities are generally high, and the enabling environment is reasonably well established. All the same low growth restricts private sector capacity. In high-growth countries there are favorable conditions for reforms and can take advantage of institutional options.

Differences in country capacity affect the choice of reform. Where the economic environment is uncertain or evolving as in low-income and transitional economies, private sector induction could be through contracts as there is less private capital at risk. The introduction of competition is in many cases the most important step in creating conditions for greater efficiency by both private and public operators and the performance of the public sector enterprises. In high-growth countries, public agencies perform well and private sector has capacities but the urgency for reform may be less.

Marketability of Services

The choice of public provision or private provision depends on its potential for market failure. Generally private markets function effectively if the goods and services are consumer oriented based on the propensity to consume. Further private markets thrive if there are growth prospects. Considering this aspect in the following situations private markets cannot provide efficient service:

• **Natural Monopoly:** This is the case of the market when economic activity is carried out most efficiently by a single provider. As there is an absence of competition private provider will tend to exploit consumer. The single provider has to be the public authority that will be politically responsible to beneficiaries. All the same public agencies tend to incur higher cost due to inefficient
functioning and due to political considerations. The only way to induct private sector is to promote regulatory authorities to monitor quality of service and price.

- **Economy of Scale:** This takes place when large-scale production results in decrease in cost. This happens due to use of specialized equipment and other factors of production. In such situation monopoly conditions will prevail and private sector can exploit consumer. Therefore a private-public enterprise is better than full privatization.

- **Externalities Affecting Private Operations:** These are costs and benefits that occur during exchange of goods and services. These affect the operations positively or negatively depending on the nature of externalities. Supply of safe drinking water is beneficial to health and can benefit positively. Inadequate sewerage brings negative externalities. Therefore in the absence of government action, goods and services involving negative externalities will be overproduced and those involving positive externalities will be under produced. In such cases provision of goods and services by public authority will be more beneficial to consumer.

- **Provision of Public Goods:** These are goods and services, which will benefit all even non-payers such as street lighting. This is provided as a public service irrespective of its utility to the consumer and there is no way individuals can be charged on the basis of utilization the service. In such cases the private market will not provide such services, as it will not be profitable. Therefore it will be the responsibility of the government to provide such services.

- **Provision of Merit Goods:** These are goods and services to which society attributes merits. Private sector will provide such services only at high costs or may provide insufficient quantities. Health, education, etc. are merit goods. Consumers will not buy merit goods voluntarily if found unaffordable. This will reduce the positive impacts of these goods in the society. It is therefore necessary that public authorities need to be associated with such goods and services.
Goods and services can fall into four categories (i) government is producer and consumer (compulsory education, public broadcasting, law courts), (ii) government is producer and private sector is consumer (railway transport, telephone, electricity, water supply, housing), (iii) private producer and government consumer (road construction, petroleum) and (iv) private producer and private consumer (consumer goods, education, housing). The category of the services can change according to context and policy changes in the country.

Private sector participation will depend on the marketability of the services. The following characteristics of infrastructure services determine their marketability: (i) potential for competition due to either absence of scale of economies or sunk costs or existence of substitutes, (ii) public nature of consumption, (iii) constraints on cost recovery, (iv) constraints on distribution and (v) spillover effects or environmental issues.

**Requirements for Privatization**

To resolve the functional issues in the provision of municipal services there is need for agreement on the scope for separating the responsibility for service provision vested to an agency and for execution by another agency through contract or delegation. This has to be vested by legal provisions. Enabling provisions for entrusting municipal functions to the private sector or the community are required in the municipal laws. The following are some of the various actions need to be done by central and state governments for promoting various forms of privatization:

- It is essential that governments formulate policies and legislative amendments in respect of privatization. This will provide political commitment and give clear message to the city’s political and bureaucratic systems. Support from governments is essential for building up the capacity of local government and urban agencies for the entrepreneurial role, contracting and BOT arrangements.

- Simplify procedures and permissions required for providing the services and facilities. Support citizen and consumer forms to provide feedback on service provisions to protect consumer interests. Regulate prices and quality of services by contractors through setting up of standards.
• Disseminate the experience of alternative service provision and implications of privatization and clear misunderstandings. Correct information base should be available on costs of services provided by public, private and community sectors in various cities to determine what is acceptable.
• Tackle labor unions through transparent management, positive dialogue regarding alternate deployment of staff, training in alternate jobs, offer of contracts to retired labor or their families.
• Standardization of contracts involving bidding and tendering process. This involves design of the contract document with specifications, service levels, measurement of output, monitoring, default clauses, etc.
• Build up private sector capacity through the various chambers of commerce and assist in their participation. The scope for involving private sector and community groups in the construction and provision of services should be built into the design of the infrastructure network for large areas in order to generate decentralized options for water supply or sewerage or to enable the cluster level services to be entrusted to resident cooperatives, or to enable the construction and operation of social facilities.
• Explore possibilities of inter municipal cooperation in a region for the execution of projects and maintenance of services. Private companies can do this in BOT through the pooling of resources and common agreement on tariffs and sharing of facilities, exploitation of development rights, etc. In U.S. municipalities use the services of neighboring municipalities for performance of various civic functions on a contract basis. The Turkish union of municipalities undertakes water supply and electricity schemes. The British associations of municipalities disseminate information, publish service level and costs, and provide supportive services. In India the individual municipalities tend to relate directly to the government and the sectoral agencies rather than on a collective basis, and so their efficiency is rate on one to one basis rather than on the basis of the scope of shared expertise.
ULBs should be encouraged to un-bundle some of their activities such as water supply, sewerage, solid waste management, urban transport services and revenue collection and contract out / privatize them. In order to be able to do this, municipal laws need to be suitably amended to create scope for separating out the responsibility
for provision of a service (which would be vested with ULBs) from its execution by any agency other than ULBs. Besides creating and enabling legal environment, the following actions would be needed:

- Announcement of a policy for privatization of municipal services,
- Simplification of procedures for speedy clearance of private projects,
- Providing up-front subsides (financial or in terms of land or easing of zoning regulations) to make private projects financially viable,
- Providing avenues for consumers to express their preferences and air their grievances, and establishment of regulatory structures for setting prices and quality standards.

Some of these activities may have to be planned and controlled by autonomous bodies.

It is not necessary that capacity building is considered unavoidable for public agencies before they launch into any form of partnership arrangement or contracting of services. It is possible to start with structured learning, or learning by doing process. There will be greater benefits from a well-managed process of privatization compared to the small additional costs of contract supervision.

It is necessary that legislation be reviewed for facilitating private sector participation in urban sector, as the present legislative scenario does not encourage private sector participation in this field. This review should include modification and simplification of Municipal bylaws, provision for enhanced borrowing, allowing the entry of private sector and authorizing concessionaires to penalize users for non-payment of tariffs.

The existing Municipal accounting system does not provide enough information for analyzing the financial performance and status of an Urban Local Body. In addition, the single entry cash-based system used by most Urban Local Bodies has several defects resulting in misappropriation of assets, non-preparation of profit and loss statements and balance sheets. It is, therefore, felt that a double entry accrual based system, which enables the preparation of reliable, detailed financial statements subject to checks and balances, needs to be introduced. This is being done in collaboration with the USAID assisted Financial Institutions Reform and Expansion (FIRE) Project under which the Institute of Chartered Accountants of India brought out in October,
Central Government needs to develop guidelines for involvement of the private sector in municipal administration, which will ensure competitive bidding process in a transparent manner. These guidelines will not only protect the consumers but also ensure integrity of the process.

There is a need for an Urban Academy, which should be a center of excellence in Urban matters such as urban water supply, sanitation, urban transport, urban governance, municipal finance, etc. This will provide academic inputs into urban management, can audit the functions of private sectors’ functioning in municipalities and give inputs for improvement and revise the operational guidelines for municipal administration. It will also function as focal point for the recourse of affected private sector for guidance and improvement.

Main Findings and Conclusions

Based on the foregoing analysis, the following are the main findings to be applied appropriately for induction of private sector assistance in municipal service:

- There is a need for policy formulation and development of appropriate legislation and guidelines at the national level on privatization including the redefinition of the role of local authorities. There is also need to carry out privatization potential studies to identify and prioritize specific municipal services that are appropriate for privatization in each city. It is advisable to undertake a thorough assessment of the likely impacts of privatization before embarking on it.

- From the experiences of this research, the potential areas for privatization include transport, bus parks, public toilets, water kiosks, street cleaning, road maintenance, schools and health centers, water and sanitation, colony maintenance, etc. In addition the services provided by municipal councils themselves like, land valuation, physical planning and general revenue collection have a potential for the contracting out mode of privatization.

- Mechanisms and guidelines should be developed and put in place to ensure that privatization does not exclude or impose undue burden on the poor. These may
include some safety nets and cross-subsidization. In addition, municipalities may find it necessary to provide some basic services in low-income areas, especially health-care, education and collection of garbage. Cross-subsidizing such service provision to the poor would be seen to be more feasible through the "contracting" mode of privatization but not through pure privatization.

- There is need for greater public education on privatization. The general public as well as stakeholders, including municipal councilors and officers, and urban communities need to be sensitized and informed on the rationale and benefits of privatization, as a system of providing municipal services. Where privatization results in retrenchment of employees, innovative approaches such as retraining programs should be put in place.

- Privatization seems to have worked better in areas where consumers can pay the costs of privatized services thus leaving the poor and low-income areas that cannot afford to pay for the privatized services. Privatization of municipal services should however be encouraged to cover the whole city, including low-income areas. Appropriately designed cross-subsidization could be used to take care of those who are unable to pay the market prices for services. Indeed, the study shows that most households including poor ones are prepared to pay for the services (such as solid waste collection) within reasonable fee ranges.

- Initiatives by informal sector entrepreneurs should be encouraged and supported by local authorities through enabling laws and other administrative incentives. The latter should take advantage of the former in order to increase access to basic services. This could start by recognition of the many current private operators in waste collection and disposal, for example. There should also be due recognition and encouragement of other self-help initiatives, partnerships, community-based organizations and other associations, which have proved capable of providing services.

- Capacity building and training for local government officials is essential part of the privatization process. Collaboration with training institutions for collaborative training needs assessment; development and execution of training would greatly enhance the privatization process.

- The establishment of data banks and management information systems in local municipalities is essential. This will facilitate effective monitoring and
management of service delivery by all actors involved in the process and thereby insures sustainability in service provision.

- **Decentralization of decision making with the local authorities:** It is a necessary framework for privatization. It entails giving decision-making power with corresponding financial resources to the local level. Greater decentralization should be encouraged and implemented in practice as a way of dealing with the expansion of municipal services, development and provision. Greater devolution of decision-making authority, responsibilities and commensurate resources should be given to local authorities in the true essence of "subsidiary" principles.

- **Pre-qualify, empanel and train private service providers:** This is a role to be undertaken by the State governments. Prospective vendors should be able to meet the cost of this training. Inadequate experience of the operators in specific civic services is a major hindrance for private participation.

- **Redeploy municipal staff to create space for private participation:** There is high representation of class IV employees (sweepers, and gardeners) unionism in municipal bodies is aggressive. Urban Local Bodies should redeploy staff across functional and locational boundaries. The municipal staff could concentrate on certain services or locations leaving space in other services or locations to be managed by private sector operators. It is better to let reforms take place at one go if the positive results are certain. On the other hand if resistance is high and there is risk of sabotage and complete collapse of the new system the option is to implement reforms in a phased manner.

- **Develop model contracts for private sector:** State Governments should provide support to Urban Local Bodies through development of model contracts. Consultants could provide support in implementation of the contracts. The contract should be a deed that formalizes the relationship of the parties. It should be a formalization of set of rules of conduct that assists the two parties to work together and to focus on solving problems when they arise. It is important to recognize that the contract should be for obligation of ‘results’ and not of ‘means’ to be employed for getting the results. This will help to focus on both parties on the outputs that are required and leave the professional operation the freedom to employ the methods that are most appropriate.
- **Political Activism in Municipal Management:** Municipal Bodies are different from normal government departments in the sense that they have a large number of elected councilors who are mostly full-time politicians and interact with the officials in almost every transaction. Possibility of sabotage of reforms in municipal management is high due to political interests.

- **Role of media:** To generate a strong public opinion in favor of reforms regular media briefings should be carried out. This helps in allaying unreasonable fears, which are projected by vested interests against the reforms. Once a strong public opinion is generated it becomes very difficult for politicians to go against public opinion.

- **Need for Public Sector Presence:** Transition of provision of services from municipal agents to private sector needs to incorporate risk covers. The profit motive of private sector could lead to exploitation of the public. There is a danger that the private company will go out of business or fail to provide the service in extreme situations, which can be extremely detrimental in case of essential services. The introduction of the private sector may lead to conflict situations among existing labor unions. A good solution is to maintain a public sector presence long enough for confidence to be established.

- **Costs and benefits of Privatization:** The fundamental argument in favor of privatization asserts that markets, competition, and private ownership are essential for an efficient economy. This view is grounded in neo-classical economics and Adam Smith's concept of the "invisible hand": Individuals pursuing their own self-interest will maximize the well-being of society as a whole, as if guided by an invisible hand. The moderate forces behind privatization are pragmatic politicians and public administrators who must deal with the daily problem of satisfying citizen demand for public service in the face of resistance to taxes. Cautious and selective use of privatization can be a tool to help government run efficiently. Those skeptical of privatization are generally opposed or at least must be convinced of its merits as a political or economic policy. Skeptics believe that it is necessary to go beyond strict economic efficiency in evaluating the merits of privatization. By looking at such non-monetary processes as how things are produced and distributed, service delivery can be assessed in terms of accountability to a set of "public values."