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Is the Private Sector more Efficient?

A cautionary tale

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CONTENTS

List of boxes and figures

Foreword

This is the tenth in our series of Discussion Papers, which put forward ideas for, and approaches to improving public service in developing countries, especially with the aim of achieving the UN Sustainable Development Goals (SDGs).

Starting in the 1980s, new approaches to public administration like New Public Management (NPM) were developed with the aim of "fixing government by running it like a business". Implicit in this credo was the assumption that the private sector was more efficient than the public sector, and that privatisation and competition would make public services more efficient.

The consequences of NPM were far reaching in both developed and developing countries, providing a durable and consistent agenda for reform, but with a mixed record of success and failure. The initial euphoria about the efficacy of NPM seemed increasingly misplaced and, since the turn of the century, has given way to concepts like New Public Service (that addressed core issues about the nature of public service, in governance and conflicts around accountability, bureaucracy, efficiency, fairness and responsiveness) and Whole-Of-Government (that addressed problems of coherence and collaboration within government) approaches.

Yet, the argument over the private sector being inherently more efficient than the public sector was never fully settled. This paper makes a strong case challenging the assumption of the primacy of the private sector. It suggests that, first, "no model of ownership (public, private or mixed) is intrinsically more efficient than the others"; and second, that "efficiency of service provision under all ownership models depends on factors like competition, regulation, autonomy and wider issues of institutional development".

Implementation of the ambitious and wide-ranging 2030 SDGs depends on effective public service and public services. Yet public services in most countries are confronted by crises of demoralisation, demotivation, disinvestment and the perhaps the unjustified tag of 'inefficiency' too. If successful delivery of the SDGs is to be achieved, public service needs not only stout arguments in its defence from development practitioners and agencies, but also the genuine empowerment of 'New Public Passion' backed by political will behind it, so as to make public service once more proud of being the rightful custodian of the public good.

Max Everest-Phillips
Director, UNDP Global Centre for Public Service Excellence

Executive summary

Key points:

- No model of ownership (public, private, or mixed) is intrinsically more efficient than the others, but there are efficiency differences within certain service sectors and specific contexts.
- Literature which broadly compares efficiency between public and private models lacks rigour, whereas sectoral literature, especially in health and education, is more rigorous although often inconclusive.
- Efficiency of service provision under all ownership models depends on factors such as competition, regulation, autonomy in recruitment and salary, and wider financial and legal institutional development.

This discussion paper finds no conclusive evidence that one model of ownership (i.e. public, private or mixed) is intrinsically more efficient than the others, irrespective of how efficiency is defined[1]. Instead the literature suggests that the efficiency of service provision is dependent on the type of service (health, education, etc.) and other specific contextual factors (e.g. regulation, market competition).

This paper is not a systematic review but provides an overview of key evidence in the field. It does not assess the methodological rigour of the studies cited, and it should be noted that different studies using the same data have produced conflicting results.

Most literature comparing ownership models looks at specific service sectors: health, education, water, sanitation, and so on. The literature that compares public and private provision in general tends to be made up of opinion pieces and lacks rigour in comparison to academic and policy studies. The rigorous literature that does exist suggests that efficiency depends on factors such as country context, the sector, the market the firm operates in and the firm's organisation, rather than ownership.

The key challenges to comparing efficiency between public and private ownership models are the range of models (including hybrids), and variations in defining efficiency. Different models of service provision vary in the types of goods they deliver and the characteristics of the sector they operate in. This means each model is vulnerable to different causes of inefficiency and like-for-like comparisons are difficult. Efficiency is difficult to measure with certain types of goods and services, especially public goods which are non-rivalrous and non-excludable: that is, where one person's use does not prevent another's use, and it is not possible to exclude those who do not pay from benefiting (e.g. street lighting). The type of market failure, the tasks involved in service delivery and how the service is demanded, also impact on service governance and consequently efficiency.

There are a range of definitions for efficiency. Efficiency can be defined based purely on cost, but also on the degree to which the provision of goods addresses issues of need or equity, and adapts to evolving demands and practices. Most literature identified focuses on cost when referring to efficiency.

Most of the literature identified in this review is focused on the health sector. In this sector there is no conclusive evidence that either public or private provision is more efficient. This finding is replicated across high-, middle- and low-income countries. However, the literature does highlight a difference between private for-profit and private non-profit providers. While private non-profit providers have similar levels of efficiency to public hospitals, many studies find that private for-profit hospitals have lower levels of efficiency than the other two models. Some literature suggests that perverse incentives to over-treat in private for-profit hospitals drives down efficiency.

In the education sector the evidence suggests a difference between high-income countries and others. In high-income countries the limited research shows conflicting results with different studies finding in favour of alternatively public or private ownership. In low- and middle-income countries, the evidence suggests greater efficiency of private schools. Greater efficiency in private provision has been attributed to lower pay, recruitment autonomy, and market-like conditions. There is also some evidence to suggest that teacher absenteeism is lower in private schools and teaching quality is higher. Some studies on public-private partnerships suggest that a combination of public funding with private management can result in greater efficiency than other models.

Studies on water, sanitation and waste present conflicting findings. Country studies find that in some cases private ownership (or private participation) is associated with greater efficiency (e.g. Italy), and in other cases less efficiency (e.g. France). In these sectors, geographic and other service delivery characteristics are more likely to determine efficiency than ownership.

Studies which look at the comparative efficiency of enterprises before and after privatisation (i.e. the transfer of ownership from public to private) find that privatisation can lead to improved efficiency, but this is not always the outcome. A significant number of high-income country studies find efficiency improves following privatisation, though this may be due, at least in part, to additional factors such as competitive pressures (which have been created in some cases without privatisation), regulation, institutional development and property rights enforcement. Enterprises with substantial market power often have not improved efficiency following privatisation, possibly as they are relatively insulated from competition. Evidence from low- and middle-income countries is limited and more mixed. In some cases, privatisation has increased efficiency (e.g. Nigeria), and in other cases there has been no difference (e.g. Iran, Egypt, Bulgaria). The studies suggest there needs to be additional factors (e.g. a developed stock market) or prior reforms (e.g. national banking reforms) for privatisation to improve efficiency in these contexts.

1 Examples of types of efficiency explored within the literature include: productive, allocative, equitable, and dynamic (see section 2.3).

The public/private efficiency argument in context

People have been complaining about 'red tape', idle bureaucrats and indolent 'pen-pushers' ever since government was invented.

In recent decades, efforts to undermine the effective, efficient and equitable public official working for the common good have advanced on seven fronts:

1. **Ideological** – an assertion, regardless of evidence and repeated often enough that it became accepted as a truism, that the public service is inherently incompetent, indolent and unresponsive by its very nature – rather than, if those characteristics were true, it is because political leaders allow this (contrast this with post-independence Singapore: political determination for building a highly disciplined and motivated public service has transformed the city-state).

2. **Intellectual** – a 'Catch 22' conundrum has developed:

   - Public Choice theory posits the idea that the public service is inherently self-serving and needed to be constrained;

   - New Public Management propagates the exact opposite view, that public service is inherently apathetic and needed to be incentivised into being effective.

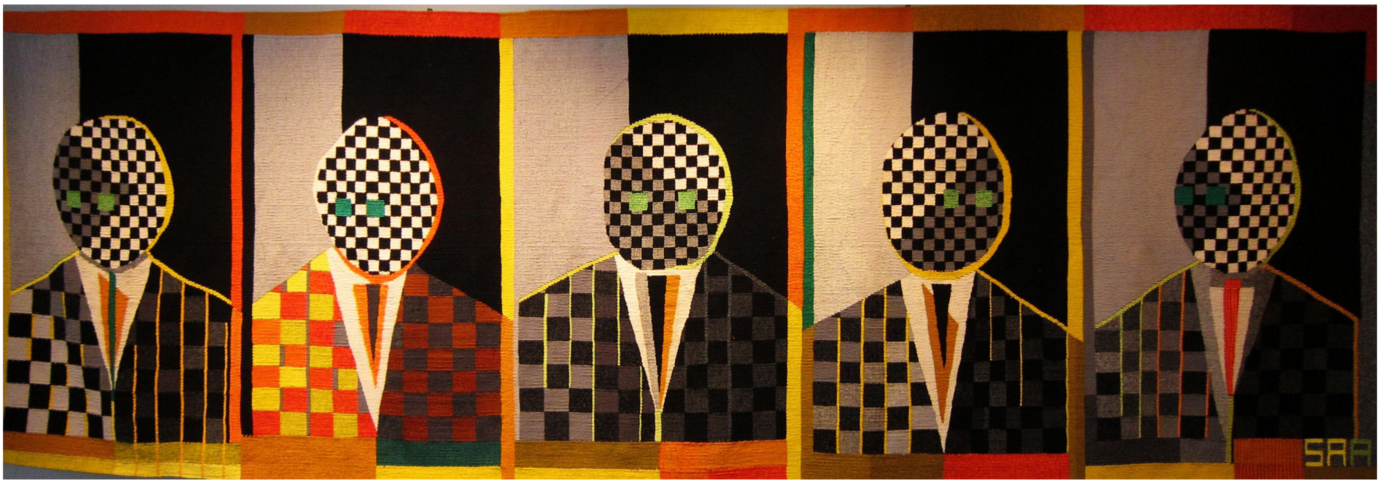
3. **Commercial** – big profits for consultants and business are created by the belief that was fostered by the ideas of New Public Management, of running government more like a business, outsourcing services and promoting public-private partnerships.

4. **Political** – blaming the public service for failure offers a tempting scapegoat for politicians to deflect criticism of their own inadequate leadership and direction.

5. **Financial** – pay levels in professional posts in the public service have lagged behind those of the private sector that either many high-skilled vacancies could not be filled or special pay arrangements were required.

6. **Institutional** – there has been enough (selected) truth in some imagery of obstructive public service unions and unhelpful 'street level bureaucrats' to drown out the much more positive images of devotion to public good, such as was famously demonstrated by the unstinting self-sacrifice of officers of the New York fire service on and after 9/11.

7. **Organisational** – both elected leaders and senior administrators benefit from creating a 'permanent revolution' of ceaseless reforms and reorganisation of the public service. Despite the mounting evidence over the years that many reforms achieve almost no lasting improvements but greatly demoralise staff, the temptation to appear to be shaking up supposedly lazy and incompetent bureaucrats is all too great.



(cc) BY Bosc D'Anjou / *A tapestry titled Even more bureaucrats (1993) by the Norwegian textile artist Synnøve Anker Aurdal.*

Challenges of comparison and defining efficiency

Key points:

- Service provision is increasingly neither purely public nor private, but hybrid.
- Comparing the overall efficiency of public and private models is challenging due to the range of service delivery models and variations in defining efficiency.
- When efficiency is defined in the literature, it is usually based on cost, but it can also be based on how providers meet need or equity, or how they adapt to evolving demand and practices.

This review found that there is limited literature which compares public and private ownership in general. Such literature is predominantly made up of opinion pieces that present selected data and material to support an opinion, and lacks rigour compared with academic and policy studies. This review has not found evidence that demonstrates conclusively that either public or private provision is inherently more efficient. Instead the literature suggests that efficiency is largely dependent on the country context, the sector, and in many cases the specific firms that are operating in the market.

The most rigorous literature comparing public and private ownership examines specific service sectors (e.g. health, education, water) or focuses on privatisation of state-owned enterprises. Literature identified for this review was produced at different times over the last three decades, which reflects shifts in interests in the academic and policy community. This review summarises the evidence and draws tentative conclusions but notes the limitations in such a review and the inherent challenges in comparing efficiency.

Suggestions for future research would be a systematic review of the existing comparative literature. Further research could help identify the key drivers and constraints of efficiency, and how ownership, in conjunction with other political economy factors and service characteristics, impact on these drivers.

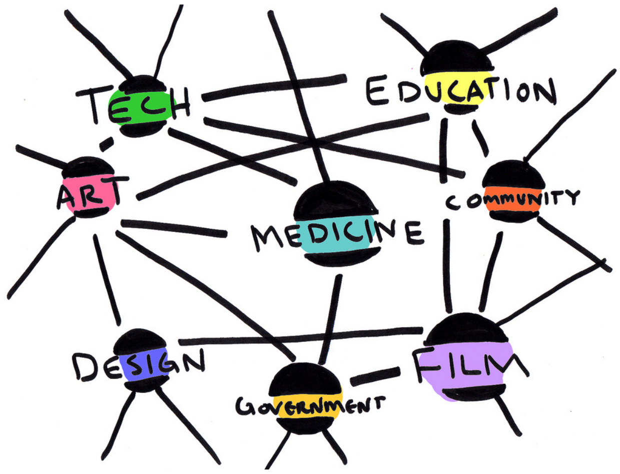
This section outlines the models of service provision in addition to pure public or private delivery. In many cases, service delivery is through a combination, or hybrid, of public and private ownership. This section also highlights the challenges in comparing the varying types of service provision and then provides some ways in which to define and measure efficiency.

2.1 Models of service provision

In the 1970s and 1980s concerns about existing welfare and developmental state approaches led to a shift in consensus on the active role of the state in the economy and the traditional model of bureaucracy (Batley & Larbi, 2004). The 1980s saw a rise in alternative ways of organising and managing public services to give more prominence to markets and competition. Public bureaucracies were increasingly viewed as inefficient, slow, ineffective and unresponsive to service users. There were increasing attempts to bring in management approaches and techniques from the private sector, to the public sector, through what is often termed as 'New Public Management' (NPM) reforms (Hood, 1991). There is no defining set of NPM reforms (Rao, 2013) but there are a number of common features. In particular, the decentralisation and disaggregation of production has led to new forms of public service delivery involving the public and private sectors (Batley & Larbi, 2004; OECD, 2010):

- **Contracting out:** The state pays a non-state organisation to perform a task, set out in a formal agreement (i.e. a contract), which is enforceable by law.
- **Lease and concession of monopolies:** The private sector is given managerial and financial responsibility for a set term. In some cases the contractor covers the running costs from revenues (leases); in other cases the contractor must cover running costs but also invest or contribute towards fixed costs through investment (concession).
- **Licensed competition between producers:** Government intervention aims to ensure equitable access (e.g. even in unprofitable areas) or to mitigate the effects of unrestrained competition on society at large.
- **Joint ventures:** Government enters into contractual relationships with the private sector both in setting up the company and in awarding the company the contract to undertake the work.
- **Co-production:** Government, the private sector and the beneficiaries of public services may collaborate by making complementary but independent contributions to the production and delivery of services, often without any formal or contractual underpinning.
- **Public-private partnership:** A term which is often used loosely to describe any or all of the above arrangements. Partnership may be through joint ownership and investment or through complementary investment where, for example, the public sector may facilitate private action.

Increasingly service provision is not exclusively either public or private. These models of service provision vary in the type of goods they deliver; and the degree to which the goods are excludable (i.e. one cannot exclude individuals from benefiting), rivalrous (i.e. use by one person prevents simultaneous consumption by another), and provide public or private benefits.



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2.2 Challenges of comparing provision of public services

The range of public, private and joint approaches to delivering services makes measuring comparative efficiency particularly challenging. Looking at NPM approaches overall, emerging evidence from the UK suggests that there has been a reduction in consistency and fairness of delivery of services, along with a substantial rise in reported administration costs (Hood & Dixon, 2015). The rise in costs without increase in performance suggests efficiency may not be improved by NPM approaches which combine public and private provision, but there is as yet, limited evidence on this.

There are a number of factors, specific to the model of provision of services, which may affect efficiency (Batley & Larbi, 2004; OECD, 2010). With contracting out, competition between non-state organisations for contracts can increase efficiency of provision, but the transaction costs of setting up and monitoring these contracts may cancel out any efficiency gains. Lease and concession may help manage natural monopolies whilst avoiding the concentration of power in either the public or private sectors, which can have positive effects on efficiency. In the case of licensed competition there may be a trade-off between equity and cost efficiency. For example, providing licences to bus companies that must ensure coverage and similar tariffs in normally unprofitable or less profitable areas would improve equity but also increase costs.

The public sector may compensate for market failures that would otherwise lead the private sector to perform inefficiently or not at all, for example where large scale investment is required, returns are risky or uncertain, or there is difficulty in charging consumers (Batley & Larbi, 2004). Public sector involvement can also address risk by enforcing legal sanctions. In joint ventures there are incentives which can undermine efficiency. Unlike pure contracting out, the government participates on both sides of the contract, leading to possible conflicts of interest. In these situations, governments may acquire an interest in ensuring that partner companies profit to a degree that is at odds with the public interest (i.e. regulatory capture). Privatisation, whether of the ownership of assets or of the management of a public service, is often of the most profitable or efficient enterprises, which makes a straight comparison of public and privatised enterprises unfair.

Different types of public services have specific characteristics which can affect their governance, and ultimately their efficiency. Efficiency is more straightforward to measure with pure private goods (i.e. excludable, rivalrous goods such as food and clothing) than pure public goods (i.e. non-excludable; non-rivalrous goods such as street lighting) where the benefits are more diffuse. Most of the literature on comparative efficiency in service delivery identified in this review focuses on quasi-public goods – health, education and utilities. The nature of the good being produced, the type of market failure encountered, the tasks involved in delivery, and how the service is demanded and consumed, can have powerful effects on the incentives for politicians to commit to the provision of services, on control and monitoring processes between political actors and providers, and on the level of citizen pressure for services and how this is voiced (Batley & Mcloughlin, 2015). For example, services which are less visible to citizens and the government, and less attributable to actors' initiatives, are likely to receive limited political commitment. Service users' ability to organise so as to demand better services is weakened where users are in competition for services (e.g. access to high performing schools), where suppliers have a monopoly of provision (e.g. urban piped water supply), or where the service is used only occasionally and in critical conditions (e.g. hospitals). How these characteristics affect performance factors including efficiency will vary by context.

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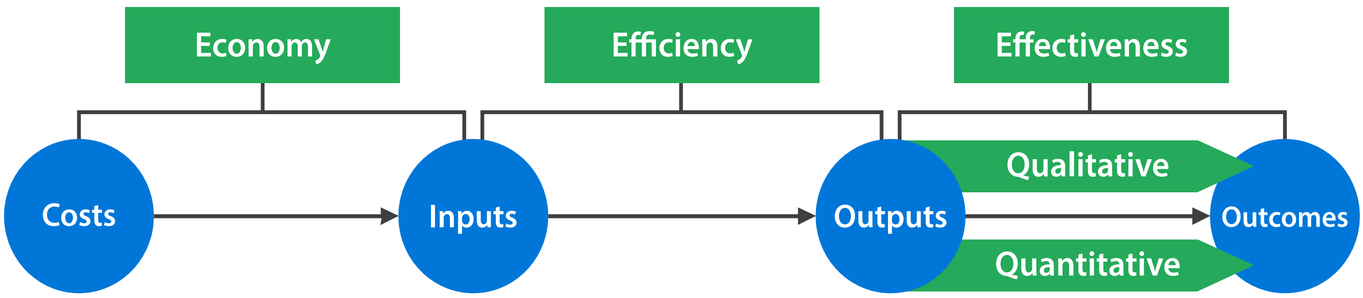
2.3 Measuring efficiency

Across the literature there are several definitions, or approaches, used for assessments of efficiency. Some authors differentiate between types of efficiency based on whether they focus purely on cost, or how well they meet needs or equity, and how responsive they are to changing needs and practices (Andrews & Entwistle, 2013; Stone, 2014):

Figure 1: Value for Money (Vfm) assessment on the Results Chain



Source: DFID (2011)

- **Productive efficiency** – the maximisation of outputs over inputs, or doing the most work with the fewest resources. For example, building a road using machinery rather than picks and shovels can be lower in cost leading to greater productive efficiency. Productive efficiency is also sometimes termed technical efficiency or cost efficiency.

- **Allocative efficiency** – the match between the demand for services and their supply, or allocating resources to the right place to do the right job. This could be building a road where it is most needed. Irrespective of productive efficiency, if a road is in the wrong place, or if an area with more traffic is neglected, this is inefficient in an allocative sense.

- **Equitable efficiency** – the extent to which governments can deliver an equitable distribution of services between citizens within their budget constraints. This would be ensuring transport needs are met even in unprofitable areas. Equitable efficiency is sometimes termed distributive efficiency.

- **Dynamic efficiency** – the balance between present and future consumption or being able to use new technologies and adopt new ways of operating to ensure current and future needs are met. This could be attending to transport needs as opportunities or needs change over time. For example, developing new modes

costs and outcomes, what is termed above as VfM. In literature the term efficiency is rarely used in relation to issues of appropriate allocation, equitable allocation, or adapting for future needs and methods.

3. Health sector

Key points:

- The comparative efficiency of public and private health provision is well studied.

- Studies typically find either no significant difference between ownership models, or are inconclusive.

- Within the private sector, evidence suggests that non-profit providers are more efficient than for-profit providers. This may be explained by incentives to over-treat by private for-profit providers.

In the health sector, there is a broad range of literature comparing the efficiency of public and private ownership models. Studies of high-income countries typically find that the differences between public and private provision are insignificant or inconclusive. Analyses of low- and middle-income country health provision, though based on limited data, find public provision to be as efficient as, or more efficient than private provision. A number of studies differentiate

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