YOU DON'T ALWAYS GET WHAT YOU PAY FOR: THE ECONOMICS OF PRIVATIZATION. BY ELLIOT D. SCLAR. A CENTURY FOUNDATION BOOK. ITHACA, N.Y.: CORNELL UNIVERSITY PRESS. 2000.

Elliot Sclar's book *You Don't Always Get What You Pay For: The Economics of Privatization* presents an empirical analysis of privatization that he thinks has been lacking. He uses several case studies to explain the merits and downfalls of trying to privatize "public services." After examining several case studies he concludes that privately producing "publicly provided goods" is not always beneficial to society.

The book is easy to read and the data are clearly presented, but his conclusions are disappointing. Like many mainstream economists, Sclar does not understand market process theory. The book emphasizes two major points. First, that privatization will not lead to greater and more efficient production across the board. He argues that every situation is unique and that the decision to privatize should be made on a case-by-case basis. Second, the conclusion that privatization is the cure for the ills of government services comes from economists and politicians dependent on the standard neoclassical model of competition. According to Sclar, this model is too simple and uncharacteristic of the situations confronting government in its decision to privatize. While I agree with Sclar on the second point, I find myself in disagreement with him on the first point.

There are at least two major problems with the author's framework. First, he defines three types of goods: private, public, and publicly provided. Few economists would disagree with how he defines the first two, and in Sclar's defense, he admits there exist few "pure public goods." However, he defines publicly provided goods as goods that can be produced by the private sector, but where private provision of these publicly provided goods leads to externalities and only more problems for government to solve. Sclar's confusion, like that of most neoclassical economists, occurs because he does not fully understand the problem of externalities. Externalities break down into two types, technological and pecuniary. Pecuniary externalities are numerous but are easily corrected in the marketplace without government intervention. In fact, most externalities are pecuniary and government intervention only makes matters worse. Technological externalities are a potential problem, but like

pure public goods, there are few if any cases of this type and no government intervention exists to correct them.

The second and more important problem is that Sclar defines privatization as government contracting with private-sector firms to provide a "publicly provided good." This is how politicians and economists commonly define the term, since this method of privatization is the only one that governments have attempted. Austrian economists would agree that this method of privatization is common but also flawed. To discuss privatization in any meaningful sense, one must go beyond government contracting and remove government from the production process completely, returning the assets to private individuals or firms to use, as they desire. Only by restoring private property can entrepreneurs fully function in their capacity of serving the consumer.

I agree with Sclar that the neoclassical view of competition is too naïve to explain the competitive landscape, but it is clear from his presentation of the model that he is no supporter of free markets. "The economic playing field is more realistically conceived as mountainous terrain that includes several high peaks from which well-endowed corporate and individual warriors swoop down to seize targets of opportunity" (p. 9). Clearly, Sclar views the economy as monopolistic with the wealth concentrated in the hands of a few, but nowhere does he explain how these corporations or individuals acquired their endowment or monopolies.

He does not even mention the possibility that success and wealth may be the result of satisfying the desires of consumers. He lacks any understanding of the Austrian view of competition, where both value and cost are subjective and where entrepreneurs compete with each other in a rivalrous manner evaluating the market landscape and risking capital on what they believe to be the best profit opportunities. There is no mention in Sclar's analysis of the consumer being the sovereign in a market economy, or that an entrepreneur can only earn profits by satisfying the demands of the consumer and developing new competitive advantages. Instead, Sclar holds government and the services it provides in high esteem and warns us that we should be hesitant to remove government from the production process. He argues that the services government provides are valuable to society and that it would be unwise to dismantle the welfare state "Because the services provided by these workers remain valuable, the continued public employment seriously impedes the larger laissez-faire goal of shrinking both the size and role of the state in society" (p. 4).

Sclar's analysis of privatization boils down to a "make or buy" decision for the state. In his view, government production is not inherently more or less efficient than competitive markets. Therefore, he reduces the problem to one of management organization rather than economic analysis. In the absence of the alternative of true privatization, there is some merit in his case studies and the many problems he identifies with "contracting out." First, it is not easy to completely identify the service that the private company is to provide in a simple

contract. Second, how does one judge whether private or public production of a good is better? Third, competition has very little to do with how goods are produced. Fourth, the production of goods and services depends more on the organizational structure of the producer than whether they are public or private. Finally, the solution is not as simple as private or public production, but involves recognizing that you can use both methods to improve public services. Thus, he wants his reader to conclude that we should not privatize or reduce the role of government in the economy, but merely improve the methods of public production.

One obvious problem with his argument is his implicit assumption that all government services are valuable to society. He completely leaves out the entrepreneur—and, more importantly, the consumer—in determining whether a good is valuable or not. He never acknowledges that in the absence of government provision, private companies would fill the void if the good were valuable. Another flaw from the perspective of true privatization lies in his argument that the complexities of government services make defining the responsibilities of the private providers highly difficult. If government truly privatized in the laissez-faire sense, then the expertise and experience would be part of the private sector, and private-sector firms would have every incentive to meet their "responsibilities."

So how does Sclar evaluate whether or not privatization is successful? He argues that the goal should be to reduce the cost of production and that it does not follow that private production automatically reduces cost. The idea that prices provide information to consumers and producers on how to allocate resources is too simple. According to Sclar, there exist additional costs, such as monitoring and contractual costs incurred by the government agency that supporters of privatization fail to recognize. In addition, one must evaluate the costs of the entire agency, not merely the contracted portion. "The state must absorb overhead regardless of privatization. The issue for taxpayers is getting the most output for the money that is spent. Therefore, the correct way to compare in-house work with contracted work is on the basis of avoidable cost" (p. 63). To Sclar, this method of accounting shows the benefits of privatization to be negligible. However, he seems oblivious to the fact that it also suggests that government management and contracting out should be replaced with true privatization, which has all the benefits of private-sector production but without all the monitoring costs and corruption associated with contracting out. Furthermore, the economic cost of redistributing income from the individual to the public sector is never examined. If the cost of producing a good privately and publicly is the same, then the publicly produced good will always cost more because of the economic costs of redistributing wealth.

Sclar thinks that private competition imposes high costs on consumers. For example, in his analysis of the medical industry, he states "We pay a steep price for this competition. In the United States, about 25 cents of every health-care

dollar is spent on administration and *profits*. In Canada, which has national health insurance, the comparable overhead figure is 15 cents" (p. 92; emphasis added). Neither quality of the product nor implicit costs seem to be of concern to Sclar. The Canadian system of socialized medicine has created shortages, high waiting costs, and the rationing of medical services—exactly the expected consequences of such regulatory practices (Richman 1994). Sclar's remedy would not cure the problem, not because the free market lacks competition as he suggests, but because the contracting remedy does not provide true market incentives. Firms awarded government contracts do not have to satisfy individual consumers who will purchase more or less of the product due to the quality of the product or service. Instead, private firms become de facto public firms that will be paid by the government regardless of the type of service they provide.

Sclar argues that the answer to the public production of goods and services is not the private sector, but the reorganization of the bureaucratic agency.

> For those of us who believe that a responsive and efficient public sector is the lifeblood of a progressive democracy, there is now only one way to move forward; we must embrace the opportunity afforded to us by new organizational forms. Our goal should be to reconstitute and improve how public agencies serve the public. (p. 95)

To show how our economy can reach this lofty goal, Sclar uses a combination transaction cost and institutional view of economics. Austrians would agree that institutional arrangements in an economy are important and while Sclar acknowledges some interesting problems in the area of contracting services such as agent-principle problems, asymmetric information, and moral hazard, he seems unaware of the many ways developed in the private sector to mitigate these problems. He also spends a good bit of time assessing the risk and uncertainty of contracts, but again he ignores the basic economic insight that mistakes in the private sector are costly and not often repeated, but in the public sector such mistakes are rarely corrected so long as taxpayers' money funds the agency. His suggestions that agencies could use incentives to improve performance are weak and unconvincing.

The author points out that contracts between public and private organizations have a history of graft and political corruption and he suggests this corruption is the result of failing competitive forces.

> The core privatization argument is that the pressure of external competition forces internal reorganization. However, market-based competition has little to do with most of the work that most people do everyday. They work more or less productively depending on how well their immediate work environment is structured. (p. 145)

I would argue that this corruption is the result of bringing the private sector into the public fold, and not a systemic problem of competition or organization.

Sclar's book is a mixture of criticism of the neoclassical model of competition and an argument that politicians and bureaucrats can produce goods and services as well as and perhaps better than entrepreneurs in the private sector. While I agree with him on many of the shortcomings the neoclassical model of competition, his mistakes demonstrate an ignorance of Mises's explanation of the problem of economic calculation and his theory of bureaucracy. In bureaucracy there exists no private property, no profit motivation, and no market prices based upon the decisions of consumers and entrepreneurs. Therefore there is no rational economic calculation, and Mises describes the core problem of bureaucracy very clearly:

> The public enterprise's duty is to render useful services to the community. But the problem is not as simple as this. Every undertaking's sole task is to render useful services. But what does this term mean? Who is, in the case of public enterprise, to decide whether a service is useful? And much more important: How do we find out whether the services rendered are not too heavily paid for, i.e., whether the factors of production absorbed by their performance are not withdrawn for other lines of utilization in which they could render more valuable services? (p. 60)

According to Sclar, solid economic analysis and organizational structure, not ideology, should determine the best means of production. He claims that conservatives and libertarians are too focused on ideology and limiting the size of government that they push blindly for privatization whether or not it is the cheapest means of providing "public services." The contracting approach does indeed have systemic problems and at best may reduce the cost of government, but it is not true privatization. I would contend that the Austrian theory of competition as a market process requires that privatization transfer ownership of resources and responsibilities from government to the private sector to be completely successful. This is not a purely ideological position for smaller government, but one based on sound economic analysis.

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