



The Berkshire Advisors Approach To...

EVALUATING PRIVATIZATION ALTERNATIVES FOR STATE AND LOCAL GOVERNMENTS

Three Precepts Guide Berkshire Advisors' Approach To Evaluating Privatization Alternatives

Berkshire Advisors does not believe that privatization is a panacea that can be used to solve all ills associated with government. We do believe, however, that privatization can be an effective tool for improving a government agency's performance. A central challenge, therefore, is to determine when, from a strategic and management perspective, privatization can be used to improve service quality and/or reduce costs. Berkshire's approach to evaluating privatization as a strategic tool for improving state and local government performance has a foundation of three basic precepts:

- Under most circumstances, well-managed government should be able to out-perform private sector service providers
- Privatization is an important tool that managers can use selectively to improve performance
- Privatization's costs and risks should be carefully evaluated before a decision to outsource services is made.

Under Most Circumstances, Well-Managed Government Agencies Should Be Able To Out-Perform Private Sector Service Providers

Government agencies have a built-in cost advantage that gives them a

significant edge over their private sector "competition." Governments pay no taxes, have no marketing or sales expenses, have no shareholders who expect to earn a profit, and are able to take advantage of tax-exempt financing. Given these advantages - which can easily equal 50 percent of a private firm's expenditures - an affirmative case must be made for why outsourcing a function or service makes management sense. If a private firm is able to outperform a government agency simply because the agency is mismanaged, policy makers must decide whether efforts to improve management should be undertaken before considering privatization. On the other hand, if private firms have capabilities that allow them to outperform a government agency regardless of the government's built-in advantage, privatization is almost always the preferred option

Privatization is an important tool that State and Local Government managers can use selectively to improve performance.

Privatization may make sense for selected functions and services, despite the government's significant built-in advantages. Berkshire's experience suggests that privatization can be beneficial if:

- Contracting out non-core services allows managers to focus more attention on improving core service offerings

- Private firms have structural advantages that allow them to outperform even the best government agencies (for example, private firms may be able to take advantage of economies of scale)
- Outsourcing allows a government agency to manage random fluctuations in workload and seasonal workload peaks more effectively
- Privatization can be used by State and Local government managers to overcome barriers to change
- By observing contractor operations, managers can identify ways to improve performance
- Not enough time is available to improve performance by changing existing operations
- Private firms have more flexibility in acquiring needed equipment and hiring needed staff in a timely manner
- Risks associated with technological change can be shifted to the contractor

Privatization's Costs And Risks Should Be Carefully Evaluated Before A Decision To Outsource Services Is Made.

For functions and services for which an affirmative management case for outsourcing can be made, the costs and risks of privatization should be evaluated.

The costs associated with privatization may be grouped into a number of broad categories: transaction costs; costs associated with loss of synergy; and organizational costs. Likewise, the risks associated with privatization may also be grouped into categories: risks associated with loss of control; non-performance risks; lack of competition; lack of information. Each of these types of costs and risks should be systematically considered when considering whether to outsource a function or service

After considering these costs and risks and the implications of implementing associated cost- and risk-control strategies, one can assess whether the potential benefits of privatization outweigh the costs and risks.