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BOOK REVIEW

You Don't Always Get What You Pay For: The Economics of Privatization, by Elliot D. Sclar (Ithaca, NY, Cornell University Press, 2000, paperback, ISBN 0801437334, 184 pages, $42.50)

This book is a great read for those interested in the economic implications of privatization and the role of public contracting in the privatization of services. The context of the book is the contracting form of privatization. Contracting involves a principal-agent relationship, with a public organization as principal and a private contractor as agent. An important question involved with contracting is the type of public/private relationship that should be formed. A key focus of Sclar's book is the management challenge involved with establishing a principal-agent relationship.

The author's objective is to show that the traditional legalistic approach to public contracting (the approach involves what Sclar terms either complete or incomplete contracts) is not a suitable approach for many situations. Sclar contends that in the realm of public contracting the requisite conditions for the traditional legalistic approach of abundant competition, adequate information, and low level of service complexity are rarely met. He argues that when competition is low, services are complex, and information is either uncertain or difficult to obtain it is the characteristics of the principal-agent relationship that determines contract cost and quality. Therefore the shape of the relationship is critical to organizational performance.

What type of relationship is most conducive to public contracting when the requisite economic conditions are absent? Sclar's idea is to move the relationship from a traditional legalistic basis to a cooperative basis. He calls the paradigm shift relational contracting, which replaces

an adversarial "arms length" relationship with one of cooperation and mutual benefit.

The author's point on characteristics of the principal-agent relationship impacting overall contractor performance is well taken and often overlooked. Contracts contain many clauses and provisions. Intentionally or unintentionally the impact is to provide an incentive structure that impacts effective contactor performance. Unfortunately empirical data on the impact of incentive structures on contractor performance is lacking. Consequently the components of an incentive structure that work best is an open question.

Chapters 5 and 6 of the book are especially relevant to readers. In Chapter 5 Sclar develops important distinctions between complete contracts, incomplete contacts, and relational contracts. Chapter 6 provides an example of the use of relational contracting.

Classical or complete contracts epitomize the traditional legalistic approach. Complete contracts are short term and involve few transactions. A complete contract works best with services for which it is relatively easy to specify what is to be delivered by the contractor. Ease of specification also means that information about the service is readily available, helps to align the interests of principal and agent and makes it easier for the principal to perform effective oversight of contractor operations. The competitive market shapes the relationship and price is the key determinant of contractor choice. Examples of complete contracts are periodic projects for street repair or replacing roofs. The services are short term, easy to describe, and easy to oversee.

An incomplete contract has a different look and according to Sclar is much more typical of the public contracting experience. While complete contracts epitomize the traditional legalistic approach, incomplete contracts entail adapting contracts to situations in which the key economic assumptions are absent. Incomplete contracts are long term and involve continuous transactions. An incomplete contract typically involves a complex service in which it is difficult to specify what is to be delivered by the contractor. Difficulty in specifying the service means that information about the service is not readily available. Lack of information makes it difficult for effective oversight to be conducted and allows room for the principal-agent problems of adverse selection and moral hazard to enter the relationship.

Sclar (2000, p.107) defines adverse selection as “a situation in which the party with inferior information about the market situation acts first in seeking to establish a contractual relationship”. Moral hazard involves situations wherein the agent acts in ways inconsistent with the goals of the principal. Adverse selection and moral hazard problems are caused by the principal’s inability to obtain or understand information relevant to selection of an agent and to properly monitor the agent’s behavior in carrying out the terms of the contract. Techniques to mitigate the impact of asymmetrical information involve developing contracts with the right performance incentives and penalties to align the interests of principal and agent. The incomplete contract document becomes more complex to accommodate risk associated with the incomplete nature of the relationship. Public bus transit is an example of an incomplete contract situation.

As with an incomplete contract a relational contract involves services that are long term, complex and involve information uncertainty. However unlike incomplete contracting where the response is to add incentive clauses and provisions to manage uncertainty, relational contracting responds with mutual self-interest and cooperation. Mutual self-interest and cooperation mitigate the problems of adverse selection and moral hazard through alignment of interests. Sclar presents the managed competition approach applied by the city of Indianapolis to the Indianapolis Fleet Service as an example of relational contracting. Public personnel eventually won the right to provide fleet services and success of the arrangement was due to the cooperation between labor and management.

Since opportunities for complete contracts are rare and incomplete contracts are costly for government to award and monitor Sclar concludes that a shift towards relational contracting is necessary. Relational contracting replaces the formal legalistic governance structure associated with incomplete contracting with a bilateral governance structure based on trust and cooperation between parties.

A criticism is that the book is strong on conceptual models of public contracting but weak in a prescriptive sense. It does not inform readers of specific contracting methods that are consistent with the three contracting models. Lets use solicitation method as an example. The complete contract seems well suited to sealed bidding because of the focus on cost as the primary selection criterion. The incomplete contract seems to be most consistent with competitive sealed negotiation because the service involves greater uncertainty and price, as well as other factors are important contractor selection criteria. But what specific contracting methods should be employed to actively engage in relational contracting? Also, what specific services are best suited to relational contracting? Would a service such as municipal ambulance services fit the relational model contract? The author is silent on these questions.

That said the book has a lot to offer both the academic and practitioner. For the academic, it is very good on the theoretical basis for privatization and uses empirical data derived from various cases to show the connection between theory and practice. For the practitioner it offers a framework that will stimulate thinking about the appropriate contractual framework to apply. Moreover, relational contracting has a lot of theoretical appeal as public organizations continue to deliberate on what should be contracted and how the contract relationship should be formed. Without hesitation I recommend this book for those broadly interested in the subject of privatization and as well as those specifically interested in how to make privatization happen.

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