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When Public Outperforms Private in Services

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The remnants of a BP refinery in Texas City after a 2005 explosion. BP had a string of accidents following its privatization. Credit William Philpott/Agence France Presse — Getty Images

Few corporate sagas capture the virtues and vices of state-owned companies and private enterprise better than the drama of BP's roller-coaster ride between failure and success.

Ten years ago, BP was the darling of the energy world — the unprofitable duckling transformed by privatization under the government of Margaret Thatcher into a highly profitable swan.

The London civil servants of the 1960s and '70s who all but ignored profitability as they issued directives across British Petroleum's bloated corporate network were replaced by highly motivated managers who were rewarded for cutting costs, reducing risk and making money. The company's more incongruous businesses — food production and uranium mines, for instance — were sold. Payroll was cut by more than half. Oil reserves jumped. The time it took to drill a deepwater well plummeted. Profits soared.

But then, in 2005, a BP refinery in Texas City blew up, killing 15 and injuring around 170. In 2006, a leak in a BP pipeline spilled hundreds of thousands of gallons of oil in Prudhoe Bay, Alaska. And in 2010, an explosion on the Deepwater Horizon oil rig killed 11 and resulted in the biggest offshore oil spill in the history of the United States. These days, BP's stock trades about 25 percent below where it was before the disaster off the coast of Louisiana, about the same place it was a decade ago.

BP's bumpy ride is recorded in "The Org: The Underlying Logic of the Office," a compelling new book by Ray Fisman, a professor at Columbia Business School, and Tim Sullivan, the editorial director of

Harvard Business Review Press. “The Org” aims to explain why organizations — be they private companies or government agencies — work the way they do.

The book offers telling insight on a topic that has ebbed and flowed across the world over the last 30 years, as governments of all stripes have set out to privatize state-owned enterprises and outsource services — what does the private sector do better than government, and what does it do worse? Long dormant in the United States, the debate has acquired new urgency as governments from Washington to statehouses and city halls around the country consider privatizing everything from Medicare to the management of state parks as a possible solution to their budget woes. One of the authors’ chief insights is that every organization faces trade-offs — inherent conflicts between competing objectives. The challenge is to manage them. This is way more difficult than it sounds.

While in government hands, British Petroleum paid too little attention to profitability, constrained by its need to please elected officials who often cared more about keeping energy cheap and employment high. But in private hands, it may have cared about profits far too much, at the expense of other objectives. “BP veered from being a company that made sure nothing blew up to one focusing on cost-cutting at all costs,” Professor Fisman said.

The success or failure of an organization often depends on whether it can clearly identify its goals and align the interests of managers and employees to serve them. Yet whatever reward structure an organization picks can skew incentives in an undesirable way.

“The Org” tells us of the sociologist Peter Moskos, who joined the Baltimore police force to study police behavior. The police hierarchy demanded arrests, so police officers arrested people: 20,000 in one year in the Eastern District alone, out of a local population of 45,000. One officer set a record by locking up people for violating bicycle regulations. Unsurprisingly, perhaps, Baltimore’s murder rate continued to climb.

“The more we reward those things that we can measure, and not reward the things we care about but don’t measure, the more we will distort behavior,” observed Burton Weisbrod, a professor of economics at Northwestern University who was a pioneer in research on the comparative behavior of nonprofit institutions, corporations and government organizations. As Professor Fisman and Mr. Sullivan put it: “If what gets measured is what gets managed, then what gets managed is what gets done.”

Rewarding teachers for how well their students perform on standard math and reading tests will encourage lots of teaching of reading and math, at the expense of other things an education might provide. Private prison operators who bid for government contracts by offering the lowest cost per inmate will most likely focus on cutting costs rather than tightening security. Unsupervised apple pickers who are paid by the apple will probably pick them off the ground.

This insight is important to the debate over the competence of public and private organizations because it underscores a significant difference in how they meet their goals. Profit is one of the most potent incentives known to man — a powerful tool to align managers’ interests with corporate goals. But it also has drawbacks. With earnings as the overriding, nonnegotiable priority, private enterprise often has little wiggle room to handle the tension between conflicting objectives.

There are instances in which privatization can help achieve broad social goals. After Argentina privatized many of its municipal water supply systems in the 1990s, investment soared, the network expanded into previously underserved poor areas and the number of children dying of infectious and parasitic diseases tumbled. (Most water companies were nonetheless renationalized by a later government.)

Still, our recent memory of mortgage banks blindly offering risky mortgages to shaky borrowers and bundling them into complex bonds to sell to unwary investors should dispel the notion that the profit motive inevitably aligns incentives in a socially desirable way.

The pursuit of financial rewards, by private companies or even nonprofit organizations, can directly undermine public policy goals.

A recent study found that private universities and colleges collect higher fees from poor students who receive Pell Grants, absorbing over half the value of federal aid. Public colleges, by contrast, do not discriminate against those who get aid.

This suggests a good rule of thumb to determine when a private company will outperform the public sector: if the task is clear-cut and it's possible to define concrete goals and reward those who meet them, the private sector will probably do better. "If I can write a perfect contract in which I pay for a concrete observable outcome, can rule out cream-skimming and can ensure the measure is not gamed, there is no reason that the private sector can't do it better," Professor Fisman said.

But if the objectives are complex and diffuse — making it difficult to align profit with goals without undermining some other desirable outcome — the profit motive could well make conflicts more difficult to manage. In these cases, privatization is probably not the best solution. In their rush to save money by outsourcing services, governments might forget that.