How To Guide #1
January 1993

DESIGNING A COMPREHENSIVE STATE-LEVEL PRIVATIZATION PROGRAM*

by
William D. Eggers

EXECUTIVE SUMMARY

Many states now face serious fiscal problems. The cumulative deficit of the states in 1991 was $31 billion. According to one estimate, over half the states are afflicted with ?structural? budget deficits that will persevere long after the economy improves.[i]

The fiscal crisis is prompting state policymakers to examine ways to fundamentally reshape and ?rightsize? state government. Privatization, by injecting competition into service delivery and turning physical assets into financial assets, has emerged as a key component in such programs to rightsize state governments.

To obtain the full value from privatization, states should design comprehensive, forward-looking privatization programs rather than adopting piecemeal approaches. A comprehensive program achieves greater benefits in terms of cost savings, efficiency gains, and reining in the growth of government. It also puts the full weight of the governor and/or legislature behind privatization.

State policymakers should follow nine basic steps when designing a systematic, comprehensive privatization program.

The steps are: 1) Develop the institutional structure for privatization; 2) Set up a program of adjustments and incentives for public employees; 3) Identify privatization techniques; 4) Identify state services and assets that offer opportunities for privatization; 5) Determine the legislative and executive barriers to privatization and revise or rescind these; 6) Consider introducing mandatory competitive incentives into the delivery of certain state and local services; 7) Evaluate the feasibility of privatizing identified privatization opportunities; 8) Determine the potential cost savings from privatizing services and assets selected for privatization; and 9) Prepare a plan for implementing privatization.

Comprehensive privatization programs incorporate a variety of privatization techniques and identify numerous privatization opportunities in all aspects of state government. Such programs can save taxpayer dollars and permanently establish competitive incentives to keep the costs of government down in the long term.

Part two of a two part series on State Government Privatization. See also Reason Foundation Policy Study #154, ?Privatization Opportunities for States.?

I. INTRODUCTION: THE NEED FOR RESTRUCTURING STATE GOVERNMENT

States are in the midst of the worst fiscal budget crises since the Great Depression. Over the last two years, well over half the states have experienced substantial budget deficits. In 1991 alone, 31 states faced a cumulative deficit of $31 billion.[ii]

California, in particular, has experienced staggering deficits for three successive years. The $11 billion deficit in fiscal year 1992 follows the previous year's $14.3 billion spending gap. Many states in the Northeast are little better off. Connecticut, Massachusetts, New Jersey, and New York have all recently experienced major fiscal problems. Also in deep trouble are Illinois and Florida.

Over half the states have structural budget problems that will persist well after the recession is over, according to Ronald Snell, fiscal program director of the National Conference of State Legislatures.[iii] Many states in the 1990s will be making a fundamental overhauling of state government: all aspects of state government will have to be reexamined, including what services should or should not be provided directly by state governments.

Against this background, the buzzword for state and local governments in the 1990s is ?rightsizing,? or restructuring and reevaluating the nature, size, and mission of state and local governments. Rightsizing means developing a long-range plan for making government leaner, more efficient, and more effective. For instance, the private sector can provide some services entirely, without direct government participation. For other government services and functions, the government may continue its role as financier but let the private sector deliver the service. Some government infrastructure can be sold off to the private sector. These concepts?all forms of privatization?are important elements of any state rightsizing program.

II. A COMPREHENSIVE APPROACH TO PRIVATIZATION

Until recently, most state-level privatization was implemented on a piecemeal, ad hoc basis. Few states have systematically identified and implemented privatization across the range of state departments and agencies. Many state agencies individually contract-out at least some services, but until recently privatization was not a major or even minor policy goal of any governor or state legislature. However, state fiscal problems and growing favorable experiences with privatization are changing this.

Numerous state legislatures and/or governors have created special privatization commissions or task forces to explore the possibilities for privatization across a wide range of government services. In a recent survey on state privatization by Bethesda, Maryland-based Apogee Research, Inc., over 20 percent of responding state agencies said they have or are preparing a state-wide or agency-wide privatization strategy.[iv]

One of the first states to release a comprehensive report on privatization was Virginia, which released, ?Contracting Services in Virginia,? in 1984. Since then numerous other state privatization reports and commissions have appeared. (see Figure 1)

By 1992, several governors had made privatization a significant part of their approach to governing and had developed comprehensive approaches to implementing privatization throughout state government. For example, William Weld of Massachusetts made privatization a centerpiece of his program to restructure and downsize Massachusetts government. John Engler of Michigan and Jim Edgar of Illinois both appear ready to embark on wide-ranging privatization programs.

Figure 1

Notable State Privatization Task Forces

·Utah created a Privatization Policy Board in 1989 to

·The Texas Comptroller of Public Accounts in 1991 the ?Privatization Approval Council of Texas,? in a study

·The House Republican Caucus in Michigan and r of 1992 reports recommending extensive privatization.

·The New York State Senate's Advisory Commission n for New York: Competing for a Better Future.?

WHY A COMPREHENSIVE APPROACH? Adopting a comprehensive approach to privatization offers a number of advantages over privatizing on a piecemeal basis. First, it increases the likelihood that privatization will be successfully implemented. Strong backing for privatization from the governor or the legislature makes it more difficult for agencies to oppose streamlining. Second, more extensive privatization is likely to be implemented through a comprehensive approach, thereby increasing government cost savings. Third, by encouraging numerous departments of government to become more efficient, a strategic privatization program ensures that cost savings in one department from privatization are not used to simply prop up inefficiencies in another area of government.

In designing comprehensive privatization programs, policymakers should set certain goals and then tailor the privatization program accordingly. Such goals may include, for example; 1) bringing down service delivery costs by instilling competition in providing public services; 2) moving the state out of providing services that can be provided by the private sector; and 3) selling off certain state assets to the private sector.

While the specifics of each comprehensive privatization program will differ in each state, certain standard guidelines can be followed. These consist of nine main steps. The nine steps are shown in Figure 2.

Figure 2

The Nine-Step Privatization Program

1. Develop the institutional framework for privatization.

2. Design public employee adjustment and incentive program.

3. Identify privatization techniques.

4. Identify privatization opportunities.

5. Identify legal and regulatory barriers to privatization.

6. Consider introducing mandatory competitive contracting for the delivery of certain
ıd local services.

7. Evaluate the identified privatization opportunities.

8. Conduct a financial feasibility assessment of privatization opportunities.

9. Prepare a plan for implementing privatization.

STEP #1: DEVELOP THE INSTITUTIONAL FRAMEWORK FOR PRIVATIZATION

In comparison to municipalities, states have been slow to implement privatization. In general, municipalities faced greater fiscal pressures in the 1980s than states, often due to the passage of tax increase-limiting measures such as Proposition 13 in California and Proposition 2 1/2 in Massachusetts. Nevertheless, some state-level privatization has occurred over the last decade. States embarking on privatization programs should carefully review the experiences of other states in order to learn from past mistakes and successes.

Experience in the United States and throughout the world has demonstrated the advantage of designating a single individual to oversee a government-wide privatization program. This individual, sometimes unofficially referred to as the ?privatization czar,? ensures that the privatization goals are systematically carried out. The privatization czar is also responsible for coordinating the privatization efforts of various state agencies and acting as executive liaison on privatization to the legislature.

The privatization czar must have wide authority to require reluctant bureaucracies to comply with the privatization program. Therefore, this role requires someone widely perceived as having the authority to speak directly for the governor or the legislature. Massachusetts Governor William Weld's program provides an instructive model. Up until he resigned from office in the summer of 1992, John Moffit, Governor Weld's chief of staff, headed up the governor's privatization programs. Moffit had worked alongside Weld for many years and his authority and commitment to carrying out the governor's program were unquestioned.

BUILDING SUPPORT FOR PRIVATIZATION. At the initial stages the governor or legislature should also bring together all interested parties, including key legislators, business leaders, public employee representatives, mid-level government managers, civil service professionals, and cabinet members to explain fully the goals and means of the privatization program.

Governor Weld, again, provides a useful model. Early in his administration, he brought together all cabinet secretaries and top officials from the various agencies of the Massachusetts government to participate in a ?privatization summit? sponsored by the Boston-based Pioneer Institute. The message was clear: this was a top priority of the governor's, and he wanted the full support and cooperation of all his field lieutenants and the agencies they commanded. Furthermore, he made it known that he was prepared to highlight and champion the privatization activities of department heads.

The next step is to set up an advisory commission composed of individuals representing different relevant interests such as business, government agencies, taxpayer groups, public employees, the governor, and the legislature. The advisory group is usually charged with making policy recommendations on privatization, identifying privatization opportunities, and analyzing the different issues involved in privatization. Typically these committees hold public hearings on privatization in order to gain input from a variety of viewpoints. By bringing in different interest groups from the outset, fierce battles may be avoided or at least constrained.

PUBLIC EDUCATION CAMPAIGN. Critically important to the ultimate success of the privatization program is to fashion strategies to gain widespread public support. A comprehensive public education campaign is necessary to convey to the public all the issues involved in privatization and rebut any misleading and false statements that may surface.

Private-sector coalitions that will actively support the privatization program should also be brought together. The business community should be made aware of the opportunities privatization creates and its positive impact on the financial health of state government. Coalitions of business and taxpayer groups, in turn, can generate pressure on state lawmakers to back privatization.

STEP #2: DESIGN EMPLOYEE ADJUSTMENT AND INCENTIVE PROGRAM

One of the foremost obstacles to privatization is resistance from state employees who fear the loss of their jobs. A key lesson learned from past privatizations around the world is that the anxieties and interests of public employees need to be addressed for privatization to be successful. Numerous privatization attempts have failed due to resistance from public employees and their unions. Given the incentives involved, it is unrealistic in the overwhelming majority of cases to expect to gain the full-fledged support of state employees for privatization. However, there are ways to gain the support of some affected state employees and lessen the resistance of others to privatization. (see Figure 3)

The first option is simply educating public employees about the effects of privatization. Most state employees do not lose their jobs as a result of privatization. A 1989 survey by the National Commission on Employment Policy (NCEP) of 86 city and county officials reviewed the effects of privatization on public and private employment. A total of 2,213 government workers were affected by contracting out 34 city and county services.[v] Of these employees, only 7 percent were laid off; 58 percent went to work for the private contractor; 24 percent were transferred to other government departments; and 7 percent retired.

Los Angeles County, which has one of the most extensive contracting programs in the country, eliminated 2800 positions between 1982 and 1987 through contracting out, but laid off only 34 public employees.

Figure 3

Employee Adjustment and Incentive Techniques

One-time Bonus. Public employees receive a one-time cash bonus for implementing privatization and relocating to another department or finding alternative employment.

Intercapital Funds. Supervisors are rewarded financially for the cost savings or profits they are able to generate by contracting out services to the private sector.

Pension Plans. Public workers could transfer pension credit to the private contractors' pension plan or could ?rollover? retirement credit into an IRA. Alternatively public employees could be allowed to ?cash out? their pension credit and receive a one-time lump sum.

First Consideration by Private Contractors. States can require or encourage private contractors to give first consideration to public employees for new positions. In Los Angeles County, for instance, bonus points were awarded to bidders who furnished public employee accommodation plans.

Severance Pay. Another way to ease the transition for public employees is by distributing severance pay to workers who are displaced by privatization. British Airways, which was privatized in 1987, offered voluntary severance pay to its employees. Many then used the severance pay to start their own businesses.

Employee Buyouts. Another possibility is to give public employees the opportunity to gain a positive stake in the privatization by allowing them to take their departments private. Employees could purchase public services/departments through Employee Stock Ownership Plans (ESOPs) and operate them as private enterprises. Employee buyouts of government enterprises and services have been successfully conducted in Britain and British Columbia and are now being widely employed in Eastern Europe and Russia.

Many of the employee buyouts in Britain were of public transit lines. Yorkshire Rider and Grampian Transport, for instance, were both spun off from local governments. In the late 1980s, British Columbia privatized all highway maintenance by dividing the road system into 28 areas and contracting maintenance out to private firms. Encouraging employees to form their own firms was a major goal of the highway maintenance privatization. Employee groups were given five-percent preferences and the opportunity to bid first on contracts. The result: of the 28 multi-year contracts, ten were granted to companies composed of former state employees.

Governments can assist and encourage public employee buyouts in other ways. For instance, the new employee-owned firms could be allowed to use government warehouses, storage areas, and/or repair facilities for a fixed time period. This temporarily postpones the financial obstacle of immediately having to purchase expensive machines or buildings. Other forms of assistance to encourage employee buyouts include, guarantee of first-round contract, one-time loans, and debt write-offs.

It is often claimed that the unemployment compensation paid by government for layed off employees negate any cost savings from privatization. This claim is refuted by available evidence. The General Accounting Office, for instance, conducted a survey titled the ?Costs and Status of Certain Displaced Employees.? This study tracked Defense Department workers that were displaced through privatization and monitored how many of them applied for unemployment compensation, food stamps and other government relief programs. The study found that the costs of providing displaced workers with unemployment related services amounted to only one percent of the total budget savings from contracting out.[vi]

MINIMIZE JOB LOSS THROUGH ATTRITION. The principal strategy employed to minimize public employee job loss is to rely on normal yearly attrition, which averages around 5 percent in most jurisdictions.[vii] After contracting with a private firm to provide a service, public employees currently performing that function are transferred to other departments and no new workers are hired. In many cases, generous early retirement incentives are also offered to workers to reduce the size of the current workforce.

Policymakers can employ a number of other techniques and incentives to facilitate the transition of public employees and diffuse their opposition to privatization.[viii] Figure 3 presents several such techniques.

STEP #3: IDENTIFYING PRIVATIZATION TECHNIQUES

In designing and implementing a comprehensive privatization plan, a combination of different privatization techniques can be used. To achieve maximum gains from privatization, careful attention must be paid to the privatization method chosen. Over 20 different privatization techniques have been identified, and some methods will be far more appropriate than others depending on the area of privatization.[ix]

CONTRACTING OUT. Contracting out the provision of public services to the private sector is by far the most common form of privatization, and there are substantial contracting out possibilities in nearly every department of state government. In the past, departments of human services, general government support services, and transportation have been the most likely to contract with the private sector. In recent years, however, states have begun to explore contracting out possibilities in previously off-limit areas of government such as corrections and education. The operation of state facilities such as computer data centers, parks, and recreational facilities can also be contracted out to private firms.

VOUCHERS. In government functions where outputs and performance standards are subjective and not easily identifiable, vouchers often make better sense than contracting out. In such human services as day care, employment training, housing, education, and care for the disabled, for instance, vouchers are often the most appropriate form of privatization.

ASSET SALES AND LEASES. Another privatization option for cash-strapped state governments is selling or leasing governmental assets such as roads, airports, or other state-owned enterprises. This form of privatization is more prevalent in Europe and Latin America than in the United States because national governments have owned many enterprises that have always been run by the private sector in the United States. Nevertheless, cities and states own substantial infrastructure assets that could be sold to the private sector. An April 1992 Reason Foundation study found that cities and states own over 90,000 infrastructure assets that could be sold off, ranging from airports and wastewater treatment plants to parking structures and turnpikes. The total value of these assets is estimated at more than $220 billion. (see Table 1)

EXECUTIVE ORDER ON INFRA-STRUCTURE PRIVATIZATION. Previously, federal regulations served as a major barrier to selling infrastructure like airports because local governments were required to pay back the lion's share of the proceeds from the sale to the federal government as repayment of grants. However, President Bush's April 30, 1992 Executive Order on Infrastructure Privatization removed many of the obstacles and financial disincentives for selling off city and state assets that were financed in part with federal money. With the new order, the state or city first recoups all its project costs, the federal government gets back its grant awards minus depreciation, and the state or city keeps the remainder.

VOLUNTEERS. Many states rely heavily on volunteers for different services provided at state parks. Volunteers can also be used for social and health services.

SERVICE SHEDDING. State policymakers, now forced to take a hard look at all levels of government, are concluding that states over the last 30 years have gotten involved in providing many services and activities that could be left to the private sector to provide. Shedding services to the private sector is often a good management technique for policymakers.

Table 1

SALABLE STATE AND MUNICIPAL ENTERPRISES

Enterprise Type	Estimated Number	Estimated Market Value (Billions $)
Airports (Commercial)	87	29.0
Electric Utilities	2,010	16.7
Gas Utilities	800	2.0
Highways and Bridges	n/a	95.0
Parking Structures	37,500	6.6
Ports	45	11.4
Turnpikes	8	7.4
Water Systems	34,461	23.9
Wastewater Facilities	15,300	30.8
Waste-to-Energy Plants	77	4.0
TOTAL ESTIMATED		**$226.8**

SOURCE: Reason Foundation, ?Mining the Government Balance Sheet,?

SELF-HELP. Community groups and neighborhood organizations take over a service or government asset such as a local park. The new providers of the service directly benefit from the service.

PUBLIC-PRIVATE PARTNERSHIPS. The private sector forms partnerships with the public sector by providing facilities, infrastructure, or services for or in conjunction with a government entity. Example: providing equipment, buildings, maintenance services and utilities or land to government enterprises such as schools.

PRIVATE INFRASTRUCTURE DEVELOPMENT AND OPERATION. The private sector builds, finances and operates public infrastructure such as roads and airports, and recovers its investment through user fees.

DEREGULATION. State regulations are eliminated from a government-monopolized service to allow private delivery of the service.

STEP #4: IDENTIFY PRIVATIZATION OPPORTUNITIES

Hundreds of distinct areas and functions of state government could feasibly be privatized. A recent draft report from the Michigan Department of Management and Budget, for instance, identified over 200 government functions that could be privatized.

Options for state governments range from contracting out the provision of government support services such as data processing, auditing, and printing, to selling off government assets such as airports, buildings and turnpikes; though it would be unrealistic to attempt to privatize all such functions at once. Furthermore, in some instances, circumstances may make privatization inadvisable. Nevertheless, before embarking on a privatization program, state officials should consider all privatization opportunities.

While not exhaustive, Table 2 presents functions of state government represent privatization possibilities worthy of detailed study by state government officials.[x]

Table 2

STATE PRIVATIZATION OPPORTUNITIES							
Government Function	Privatization Techniques						
	Build Operate Transfer	Contract/Manage-ment Contract	Public-private partnerships	Sale/ Lease	Service-Shedding	Volunteers	Vouchers
Administrative and General Support Services							
Accounting		_					
Auditing		_					
Building Construction		_					
Computer Maintenance		_					
Computer Systems Design		_					
Data Processing		_					
Engineering Services		_					
Facility Management		_					
Museums		_		_			
Real Estate, Buildings & Facilities		_		_			
Pest Control		_					
Printing		_		_	_		
Security		_					
Stadiums		_		_			
Telecommunications		_					
Trash Removal		_					
Corrections							
New Facilities	_						
Existing Facilities		_		_			
Health Care		_					

Table 2

STATE PRIVATIZATION OPPORTUNITIES							
Government Function	Privatization Techniques						
	Build Operate Transfer	Contract/Manage-ment Contract	Public-private partnerships	Sale/ Lease	Service-Shedding	Volunteers	Vouchers
Mental Health Services		–					
Food Services		–					
Educational Instruction		–				–	
Transportation		–					
Surplus Prison Property			–	–			
Jail Inspections		–					
Education							
Generalized Instruction		–					–
Schools		–	–				
School Districts		–	–				
Bus Transportation		–					
Custodial Services		–					
Food Services		–					
Specialized Instruction		–					–
Drop-out Education		–					–
Physical Infrastructure		–	–				
Educational Infrastructure		–	–				
Higher Education							
Stadiums	–	–	–	–			
Restaurants		–		–			
Theaters	–	–	–	–			
Dormitories	–			–			

Table 2

STATE PRIVATIZATION OPPORTUNITIES							
Government Function	Privatization Techniques						
	Build Operate Transfer	Contract/Manage-ment Contract	Public-private partnerships	Sale/ Lease	Service-Shedding	Volunteers	Vouchers
Maintenance		—					
Food Services		—					
Custodial Service		—					
Health Care		—					
Facilities Management		—					
Student Retention		—					
Facilities	—		—	—			
Transportation							
Road Maintenance		—					
Rest Area Maintenance		—					
Mowing		—					
Public Transit		—					
Motor Vehicle Registry		—					
Fleet Maintenance		—		—			—
Fleet Management	—						
Airports	—	—		—			
Highways	—						
Bridges	—						
Bridge Inspections		—					
Tunnels	—						
Turnpikes				—			
Ports		—		—			

Table 2

STATE PRIVATIZATION OPPORTUNITIES							
Government Function	Privatization Techniques						
	Build Operate Transfer	Contract/Manage-ment Contract	Public-private partnerships	Sale/ Lease	Service-Shedding	Volunteers	Vouchers
Agriculture and Environment							
Agricultural Export Program		–			–		
Climatology		–			–		
Fish Hatcheries				–			
Food Inspections		–			–		
Laboratory Testing		–	–				
Management of Laboratories		–	–				
Environmental Inspection		–					
Soil Survey		–			–		
Toxic Waste Cleanup		–					
Waste Collection		–					
Water Facilities	–	–		–			
State Parks and Recreation							
Conference Centers		–	–	–			
Golf Courses		–		–			
Marinas		–		–			
Parks, Campgrounds, and Docks	–			–			
State Fairgrounds				–			
Park Maintenance		–					
Park Management		–			–		
Park Food Services		–			–	–	
Tours		–			–	–	

Table 2

STATE PRIVATIZATION OPPORTUNITIES							
Government Function	Privatization Techniques						
	Build Operate Transfer	Contract/Manage-ment Contract	Public-private partnerships	Sale/ Lease	Service-Shedding	Volunteers	Vouchers
Recreational Programs		–			–	–	–
Liquor Sales							
Liquor Sales and Distribution				–	–		
Workers Compensation							
Workers' Compensation Insurance Programs				–			
Health Services							
Clinics		–		–		–	
Medicaid		–					–
Medicaid Processing		–					
Hospitals		–		–			
Mental Health Institutions		–		–			
Social Services							
Welfare Administration		–					
Job Training		–	–		–	–	–
Child Support Collections		–					
Day Care Programs		–			–		–
Delinquent Youth Institutions		–		–		–	–
Drug and Alcohol Treatment		–	–		–	–	–
Housing					–		–
Children with Disabilities		–				–	–
Programs for the Elderly		–	–		–	–	–
Technical Assistance to Community		–	–		–	–	–

Table 2

STATE PRIVATIZATION OPPORTUNITIES							
Government Function	Privatization Techniques						
	Build Operate Transfer	Contract/Manage-ment Contract	Public-private partnerships	Sale/ Lease	Service-Shedding	Volunteers	Vouchers
Groups							
Vocational Rehabilitation		_				_	_
Weatherization		_					_

Source: *Reason Foundation*

STEP #5: IDENTIFY LEGISLATIVE AND EXECUTIVE BARRIERS

The next step is to identify state laws that act as barriers to privatization. Legislative and bureaucratic restrictions to privatization should be eliminated or revised early in the privatization process. Though privatization often requires changes in existing laws, it is unrealistic to attempt to change every law that poses an obstacle to privatization all at once. More important is to draw up and pass enabling legislation that gives broad sanctions for permitting privatization. A majority of states have now passed enabling legislation on privatization.

Once enabling legislation is passed, individual laws that act as barriers to privatization can be examined and revised or revoked. Identifying these laws and regulations is no simple task. They are often buried in omnibus laws or government procurement codes. Figure 4 presents some common legal barriers.

Figure 4

Common Legal and Regulatory Barriers to Privatization

Type of Barrier	Example
Federal	Tax laws Grant repayment terms Other requirements/restrictions
Statutory	Lack of clarity/consistency with regard to statutory provisions of privatized public works and utilities.
Procurement Guidelines	Issuing standard procedures conducting cost comparisons that fail to e all costs of government services delivery.
Civil Service Regulations	Prohibitions against contracting out civil service positions, ng wage rules.
Contracting restrictions on local governments	Usually with regard to specific services: ie, public safety, education.
Labor Law Issues	Collective bargaining. Duty to bargain.

A number of guidelines in the California procurement code, for example, impede privatization. One standard allows contracting out only if the contractor's wages are at the industry's level and do not significantly undercut state pay rates.[xi] This serves largely to restrict competition and protect state workers at the expense of the taxpayer, impeding efforts to use whatever provider can most cost effectively perform the service.

Another article in the California code asserts that the state's indirect overhead costs shall not be used when conducting cost comparisons between the public and private service.[xii] This rule prevents the accurate use of cost accounting and encourages state agencies to underestimate the cost of government-provided service.

Similar restrictions and obstacles are present in many states. For example, the Michigan Department of Education has placed numerous restrictions on the ability of local governments to contract out school lunch programs. These restrictions have nearly ended the use of privatization for this service in Michigan, thus resulting in higher costs for local school districts. In the state of Washington, civil service law disallows contracting for services that have been ?customarily and historically provided by civil servants.?[xiii]

STEP #6: INCORPORATE COMPETITIVE INCENTIVES INTO PUBLIC SERVICES

PETITION OF INTEREST. In addition to passing broad enabling legislation for privatization and eliminating existing legislative barriers, state policymakers should consider adopting more sweeping legislation to spur increased competition and privatization. One option proposed by the American Legislative Exchange Council (ALEC), an association of state legislators, is to allow and encourage private firms to make unsolicited bids to provide some state services in a more cost effective manner.[xiv] Government agencies would be required to initiate a ?make or buy? analysis when presented with a ?petition of interest? by a private firm proposing to provide a public service. The petition would include: the private firm's cost of providing the service; financial information about the firm; and a description of the firm's technical capability of providing the service.

The government entity would then have 90 days to certify or deny the petition of interest. If the petition is certified, the government unit would conduct a make or buy analysis and open up the bidding process by issuing a Request for Proposals (RFP) or Invitation to Bid (ITB) to interested parties.[xv]

The petition-of-interest process would not only speed the privatization process, but also encourage tremendous innovation and competition in public service delivery. The threat of competition with private firms would force in-house units to cut costs, increase efficiency and serve their customers better. Bills have been proposed, but not passed, in Arizona, Colorado, and Nevada to introduce a petition-of-interest process into state service delivery.

MANDATORY COMPETITIVE BIDDING. State legislation requiring local governments to competitively bid out the delivery of some services offers another way to spur competition in public service delivery. Competitive contracting has been mandated in one form or another in the state of Colorado, the United Kingdom, New Zealand, Denmark, Norway, Sweden, and Finland.[xvi] Mandatory competitive contracting legislation could be modeled after the 1988 British Local Government Act, which requires local governments to competitively contract for six local services: food services, grounds/building maintenance, janitorial, refuse collection, street sweeping and vehicle maintenance. Local government units are allowed to compete for the contract.

Several detailed studies have documented cost savings resulting from the Local Government Act. Cost savings have averaged 22 percent for local governments that have contracted out refuse collection and 34 percent for hospital cleaning. Even when the services have been retained in-house, cost savings have occurred. Competition from the private sector has forced in-house units to cut costs and become more efficient. In-house units that won contract bids were able to cut costs by 17 percent for refuse collection and 22 percent for hospital cleaning.[xvii] There were no declines in quality of service reported.

If enacted by the states, such programs could have similarly profound results. A Reason Foundation study of California found that requiring cities and counties to competitively contract for emergency medical services, street lighting, street repairs and maintenance, parks and recreation, public transit, and solid waste disposal, could save California state government $874.9 million. Such sizable local government savings would allow the state to cut back on state aid to municipalities without local government service reductions.[xviii]

STEP #7: EVALUATE PRIVATIZATION OPPORTUNITIES

The next step in the privatization process is to evaluate the near-term privatization potential of each identified privatization opportunity and determine which privatization technique is best suited for the government service function or asset. In theory, all the activities identified earlier, in addition to many other state government programs, are prospects for privatization. In practice, however, numerous factors such as political feasibility and current efficiency levels of government delivery mean that some functions will have much better near-term privatization prospects than others.

Figure 5
Evaluation Criteria

·Whether the function has been successfully
ıer states or jurisdictions.
·Degree to which objective standards and
ɛasures can be described.
·Degree to which contractor's performance can be
ɔvernment after contracting out.
·Presence of two or more private contractors able and
rm the service.
·The ability to replace the private provider if service
ndards set forth or the firm goes out of business.
·Degree of potential political opposition to the
activity.
·The impact on current employees.
·Legality of privatizing function or entity.
·Time schedule required to structure and implement

The different privatization techniques that are feasible for each privatization opportunity should be determined at this stage. In most cases, several privatization techniques could be used to implement each privatization opportunity. During this stage, it is not necessary to make a concrete decision on the most appropriate form of privatization. However, the privatization options should be narrowed down.

The most significant factor in the decision to privatize is likely to be potential cost savings. Unless it can be reasonably demonstrated that privatization will lead to significant cost savings, most state officials are unlikely to privatize a state service. The first step is to conduct a very rough, preliminary cost comparison between the present costs of government delivery versus the potential costs of private delivery of all functions identified as privatization opportunities. One method of doing this is presented in the appendix.

In addition to cost savings, other factors should be considered in evaluating privatization opportunities. These are listed in Figure 5.

Another model for evaluating privatization opportunities is the systematic approach developed by the Colorado State Auditor's office. In 1989, the office published a privatization assessment workbook to assist government agencies in making decisions about privatizing public services.

As shown in Table 3, various criteria were developed to evaluate the privatization potential of different public services. Each service is rated according to criteria such as political resistance, legal barriers, and others on a scale ranging from +3 to -3. The greater and more positive the number, the greater the service's privatization potential.

FEASIBILITY STUDY. It is impossible to determine precisely the costs and benefits of a sale or long-term lease prior to the actual implementation. However, a feasibility study should be performed in order to better gauge the desirability of privatization. In addition to estimating the approximate market value of the entity, the feasibility study should address the following issues:

- The presence of private sources of finance;
- Potential for improved operational efficiency and performance;
- Required potential capital expenditures;
- Existence of legal restrictions which may prevent or obstruct private finance, ownership and operation;
- Financial options for lease or disposition of entity;
- Potential impact on government revenue streams and expend-itures; and
- Impact on current employees.

Table 3

PRIVATIZATION PROFILE SUMMARY FORM

	Pro-Gov't Provision			Pro-Private Provision		
Market Strength	-3	-2	-1	+1	+2	+3
Political Resistance	-3	-2	-1	+1	+2	+3
Cost Efficiency	-3	-2	-1	+1	+2	+3
Quality of Service	-3	-2	-1	+1	+2	+3
Impact on	-3	-2	-1	+1	+2	+3
Legal Barriers	-3	-2	-1	+1	+2	+3
Risk	-3	-2	-1	+1	+2	+3
Resources	-3	-2	-1	+1	+2	+3
Control	-3	-2	-1	+1	+2	+3

SOURCE: Colorado State Auditor's office, *Privatization Assessm*

STEP #8: FINANCIAL FEASIBILITY ANALYSIS

By now, the list of privatization opportunities has been narrowed down considerably. The next step is to conduct a complete financial analysis of the selected privatizations.

IN-HOUSE COSTS. In order to conduct a ?make or buy? analysis for service delivery, the full government and private-service delivery costs must be estimated. Because the process of conducting detailed and accurate cost comparisons is time-consuming and complicated, it should only be attempted after the governor, an executive task force, or legislative commission has analyzed the range of privatization opportunities and made specific privatization recommendations.

It is beyond the scope of this paper to detail the complete process for conducting cost com-parisons between in-house and contracted services. However, it is important that the direct and indirect costs of government and contract delivery be computed. This step is made more difficult by the fact that most state governments do not have a system for easily assessing all of the costs of government service delivery. Result: substantial direct costs of government service delivery are frequently omitted when measuring the cost of government provision. (see Figure 6)

These and other omissions often lead to significant underreporting of the actual cost of government service provision. A study of 68 jurisdictions found that such inaccurate or inappropriate accounting techniques resulted in the costs of government service delivery being frequently underestimated by up to 30 percent.[xix]

The current accounting structure used in most state governments, termed ?fund accounting,? not only fails to assess many of the costs associated with government service delivery, but the costs that are recorded are often located in two or more cost centers, thus making it even more difficult to identify the actual cost of delivering the service.

Frequently omitted when comparing government and contract service delivery are new or increased revenue streams that result from contracting out a service or selling an asset. These include state and local income taxes, sales taxes, property taxes, and user and license fees. These revenues should all be subtracted from the total cost of contract delivery. This also includes the proceeds from the sale of equipment, facilities, or other assets that are no longer needed by the government due to contracting out the service. Moreover, in order to maintain integrity and credibility, the entire process should be transparent, open and public.

If possible, it is best to have a private accounting firm calculate the full government costs. An outside assessment ensures greater objectivity in the process.

Figure 6

Government Provision Costs Often Overlooked

- Interest
- Pensions
- Facility costs
- Equipment (Capital Outlay and

- Rent

- Utilities
- Travel
- Printing
- Fringe Benefits
- Cost of labor borrowed from other
- Maintenance and operation costs of
- Management/supervision/oversight
- Cost of liability and fire insurance
- Depreciation

The easiest part of this phase is determining the cost of contract delivery. A Request for Proposal (RFP) or an Invitation to Bid (ITB) is sent out. Alternately, state officials can informally query contractors to determine the approximate cost of private delivery. The bids subsequently received plus the cost of contract administration and monitoring constitute the estimated cost of contract delivery.

Figure 7

Contracting Costs

Cost Factors

- ·Request for proposal; development, and implementation
- ·Contract development
- ·Bid preparation
- ·Bid selection
- ·Contract monitoring system development
- ·Unemployment benefits liability for displaced workers
- ·Leave benefits buy-out; severance pay, and accrued liabilities for displaced workers
- ·Disposing of unused equipment write-off depreciation, under-utilization of space (Note: There ıefits or gains if sold; if so, subtract rather than add this amount.)
- ·Transition costs, such as duplication of effort
- ·Other cost factors

SOURCE: Colorado State Auditor's office, *Privatization Assessment Workbook*, 1989.

It is also important that the costs of administering and monitoring contracts, and relocating, training, or retiring public employees are added to the cost of contracting out. Such costs usually range from 7 percent to 20 percent of total contract costs. (see Figure 7)

STEP #9: IMPLEMENT PRIVATIZATION

The next step is to design appropriate implementation procedures.

For contracting out, a standard set of procedures has evolved over the years. Some of these are listed in Figure 8.

Figure 8

Contracting Implementation Checklist

_Notifying public employees and citizens.

_Drafting the Request for Proposal (RFP) or Invitation to Bid (ITB).

_Writing performance bids for the private contractors and government agencies.

_Pre-bid conferences.

_Feedback from vendors.

_Setting up and conducting the bidding process.

_Setting up dispute-resolution techniques between the government and the private sector.

_Setting up the contract monitoring process. Monitoring techniques should include: nspections; citizen questionnaires and complaints; cost-benefit analysis; and performance

Most unsuccessful experiences with privatization result directly from government mistakes in implementing and monitoring privatization. These mistakes can be avoided. A substantial body of literature exists that outlines how to contract out services and avoid frequent mistakes. Numerous ?how-to? books and guides written by privatization experts, for instance, provide step-by-step instructions for implementing contracting out on a day-to-day basis.[xx] A number of state governments, such as Colorado and Oregon, have also published comprehensive guidelines for contracting out.[xxi] These reference sources should be obtained and distributed to state officials involved in the privatization process.

A few standard, but important, guidelines emerge from these sources:[xxii]

- Contracts should be competitively bid, whenever possible, in an open, public environment with periodic rebidding to assure continued competition;

- Performance standards should be clearly stated and agreed upon in advance;

- Careful attention should be paid to ensuring that current government service costs and the full workload required, for the job are not underestimated;

- Widely publicize bid awards and maintain a record of the search for contractors; and

- Make on-site inspections of contracted service, monitor all complaints, survey citizens about quality of service, and compel contractors to provide periodic reports.

ASSET SALES AND LEASES. The financial mechanisms that will be used for the sale or long-term lease of government assets must be determined in this phase. This requires extensive financial and legal analysis and frequent interaction and direct negotiation with private investors. Possible financial mechanisms include: direct sales; long-term leases; leasebacks; and asset swaps.

Other financial and legal issues to be thoroughly analyzed regarding sales and leases include:[xxiii]

- Terms of the agreement;
- Debt/equity ratio of the facility;
- Security package for debt; and
- Availability of tax exempt vs. taxable debt.

III. CONCLUSION

Local governments have significantly reduced program costs through the extensive use of privatization. Up until very recently, however, state governments have been slow to follow the lead of local governments by making much greater use of privatization. Privatization that has occurred at the state level has been sporadic and limited.

This is changing. State policymakers are discovering that comprehensive privatization plans provide a powerful kit of tools to rightsize government, cut budget deficits and taxes, and increase efficiency and competition in service delivery. State privatization programs also offer an attractive alternative to common short-term solutions to budget shortfalls such as accounting gimmicks, tax increases and across-the-board spending cuts.

ABOUT THE AUTHOR

William D. Eggers is Director of the Reason Foundation's Privatization Center, a national clearinghouse on state and local privatization. He is the former Policy Analyst for East European and Russian Economic Affairs at The Heritage Foundation in Washington, D.C. where he coordinated workshops on privatization for senior government officials of Russia, Latvia, and Lithuania.

APPENDIX A

The substantial body of literature that exists comparing government service provision with contract service (over 100 studies) can be used to estimate the savings that could be generated through contracting out state services. In 1987, the Reason Foundation and the University of Miami's Law and Economics Center, did a thorough review of the literature comparing the cost of government and contract service delivery.[xxiv] Based on this review?as well as case studies of individual jurisdictions, surveys of private firms, and major federal government studies?the researchers arrived at ?low? and ?high? percentage cost savings rates from privatizing different service functions. The figures are presented in Table 4.

This range of savings can be used to make rough estimates of the cost savings that may be realized by privatizing state government services.[xxv]

The savings estimates for each privatization opportunity identified can be obtained by following the steps in Figure 9:

Figure 9

Cost Savings Estimate Process

1. Identify the total budgetary expenditures for the

2. Deduct from these amounts either current or
ned major contracting activity. This is done to ensure that potential

3. Multiply the lower and higher range savings estimates
Economics Center study by the number obtained in step two. If the
ıot included in Table 4, savings rates can be based on a number of
t Procurement; the 1983 President's Private Sector Survey on Cost
mpetition in Government-Financed Services, by John Hilke.

Figures generated from this stage provide only rough estimates or ?ballpark? yardsticks of the potential cost savings from privatization. The purpose is simply to get a better idea of the financial impact that privatization could have on different state programs, thereby assisting in evaluating the best opportunities for privatization.

ASSET SALES AND LEASES.
It is more difficult to roughly estimate the possible revenues from asset sales during this stage because there is far less empirical evidence of sales of U.S. government assets to use as a rule of thumb.

One option is to use data from specific asset sales of a similar nature that have previously taken place overseas. This data can be used to make first approximations of the market values of the assets. Example: two small British ports sold in 1990 for $8 per annual ton handled while the 22-port Associated British Ports sold in 1983 and 1984 for $12.07 per ton. This range can be applied to the tonnage handled by a U.S. port in order to generate market value estimates for the port. Additionally, state officials could survey private investors about the value of the asset.

Source: Reason Foundation, *Savings A.S.A.P.: An Alternative Delivery Assessment Project*.

Table 4

ESTIMATED RANGE OF PRIVATIZATION COST SAVINGS		
Public Service Category	Expected Savings Range	
	Lower %	Upper %
Public Works and Physical Environment		
Solid Waste Collection: Residential	22	30
Solid Waste Collection: Commerical	22	30
Solid Waste Disposal	22	30
Street Repair	25	50
Street/Parking Lot Cleaning	15	39
Meter Maintenance/installation	15	33
Tree Trimming/Planting	16	35
Cemetery Management & Maintenance	15	33
Inspection & Code Enforcement	10	25
Parking Lot/Garage Operation	14	31
Recycling Solid Waste	8	30
Wastewater Treatment	8	30
Flood Control	8	30
Conservation & Resource Management	10	25
Utility Meter Reading	10	25
Utility Billing	10	25
Street light Operation	10	25
Electric Utility	10	25
Gas Utility	10	25
Water Utility	10	25
Transportation		
Road/Street Operation/Maintenance Repair	25	50
Airport Management/Control Tower Maintenance	15	40
Bridge Operation/Maintenance	15	40
Port & Water Operations	15	40
Rail Transit Systems Operation/Maintenance	20	60
Bus Transit Operation/Maintenance	20	60
Traffic Signal Maintenance/Installation	20	40
Fleet Management/Maintenance: Heavy Equipment	20	40
Fleet Management/Maintenance: Emergency Vehicles	20	40
Fleet Management/Maintenance: All Other Vehicles	20	40
Public Safety		
Crime Prevention or Patrols	20	55
Police/Fire Communication	20	40
Fire Prevention	17	40
Emergency Medical Services	28	77
Ambulance Service & Rescue	24	66
Traffic Control/Parking Enforcement	20	50
Vehicle Towing & Storage	15	40
Correction Facilities Management	13	40
Adjudication	10	25
Protective Inspections	10	25

Source: Reason Foundation, *Savings A.S.A.P.: An Alternative Delivery Assessment Project*.

Table 4

ESTIMATED RANGE OF PRIVATIZATION COST SAVINGS		
Public Service Category	**Expected Savings Range**	
	Lower %	Upper %
Consumer Protection Services	10	25
Air/Sea Rescue	20	40
Health & Human Resources		
Sanitary Inspections	10	40
Insect/Rodent Control	10	40
Animal Control	10	40
Animal Shelter Operations	10	40
Operation/Management of Day-Care Facilities	10	40
Child Welfare Program Management	10	40
Elderly Program Management	10	40
Operation/Mangement of Public Housing	10	40
Operation/Management of Hospitals	20	55
Public Health Program Management	10	40
Drug/Alcohol Treatment Programs	10	40
Operation/Management of Mental Health Facilities	10	40
Educational Services	10	40
Nursing Home & Special Services Management	10	40
Parks & Recreation/Cultural Arts		
Recreation Services	19	52
Recreation Facilities Operation/Management	19	52
Park Landscaping & Maintenance	10	28
Cultural Arts Operations	10	28
Convention Center/Auditorium Operations	13	35
Operation of Libraries	13	35
Operation of Museums	13	35
General Government & Support Services		
Building/Grounds Maintenance	30	42
Building Security	34	59
Payroll	0	36
Tax Bill Processing	21	36
Tax Assessing	21	36
Data Processing	23	40
Delinquent Tax Collection	18	30
Legal Services	18	30
Secretarial Services	15	25
Personnel Services	15	25
Labor Relations	8	24
Public Relations/Information Services	8	24
Cafeteria/Food Service Management	21	36
Grant Administration	8	24
Law Library	8	24
Property Control	18	30

Source: Reason Foundation, *Savings A.S.A.P.: An Alternative Delivery Assessment Project*.

ENDNOTES

i.. ?Financial Squeeze May Pressue States Into Sweeping Budget Overhauls,? *Los Angeles Times*, July 26, 1992, A5.

ii.. *Ibid.*

iii.. *Ibid.*

iv.. ?State Government Privatization 1992: An Updated Survey of State Governments and Their Use of Privatization,? Apogee Research, Inc., Bethesda, Maryland, 1992.

v.. *The Long Term Employment Implications of Privatization: Evidence from Selected U.S. Cities and Counties*, prepared by Dudek & Company for the National Commission for Employment Policy, Washington, D.C., March 1989.

vi.. United States General Accounting Office, ?DOD Functions Contracted Out Under OMB Circular A-76: Costs and Status of Certain Displaced Employees,? July 12, 1985.

vii.. National Commission for Employment Policy, *Privatization and Public Employees: The Impact of City and County Contracting Out on Government Workers*, May 1988.

viii.. A fuller explanation of these techniques can be found in: *SAVINGS A.S.A.P.: An Alternative Delivery Assessment Project*, Reason Foundation and The University of Miami Law and Economics Center, November 1988, Chapter 7.

ix.. Kenneth W. Clarkson, and Philip E. Fixler, Jr., *et al. The Role of Privatization in Florida*, Law and Economics Center, University of Miami and the Reason Foundation, (Tallahassee, FL: Florida Chamber of Commerce, 1987).

x.. For a detailed look at state privatization opportunities please see: William D. Eggers, ?Privatization Opportunities For States,? Reason Foundation Policy Study, January 1993.

xi.. California Government Code Section 19130, code 2.

xii.. *Ibid*, code 1(C).

xiii.. In *State Employees v. Community College*, 90 Wn.2d 698, 702-703, 585 P.2d 474 (1978) the State Supreme Court upheld the provision finding that:

?...where a new need for services which have been customarily and historically provided by civil servants
ere there is no showing that civil servants could not provide those services, a contract for such services is unauthorized and in viol
e Higher Education Personnel Law.

This is so regardless of the cost savings which might be made through such a contract...?

xiv.. American Legislative Exchange Council (ALEC), ?Competitive Contracting of Public Services: Draft Model Legislation,? unpublished, Washington, D.C., 1990.

xv.. *Ibid.*

xvi.. Wendell Cox and Jean Love, ?Controlling the Demand for Taxes through Competitive Incentives,? American Legislative Exchange Council *State Factor*, Washington, DC, December 1991.

xvii.. Adam Smith Institute, *The Tender Traps*, London, 1990, 30.

xviii.. Philip E. Fixler and William D. Eggers, ?Addressing the 1990?91 California Budget Shortfall: Alternatives to Service Cuts and Tax Increases,? Reason Foundation *Policy Insight*, No. 209, June 1990, 17.

xix.. E.S. Savas, ?How Much Do Government Services Really Cost?? *Urban Affairs Quarterly*, Vol. 15, No. 1, 23-42.

xx.. See for instance: John A. Rehfuss, *Contracting Out in Government* (San Francisco: Jossey-Bass, 1989); Lawrence L. Martin, ?Contracting for Services,? Florida Atlantic University, Institute of Government, 1990; and John Tapper Marlin, ed., *Contracting Municipal Services: A Guide to Purchase from the Private Sector* (New York: John Wiley & Sons, 1984).

xxi.. See, for instance: Oregon Department of General Services and Executive Department, ?Guidelines for Contracting State Work,? 1987; and Colorado Office of State Auditor, ?Privatization Assessment Workbook,? Denver, Colorado, 1989.

xxii.. For a detailed guide to conducting the bidding and monitoring process, see a forthcoming Foundation Privatization Center *How-to Guide* by John Rehfuss, titled, ?Designing a Bidding and Monitoring Process that Minimizes the Opportunities for Collusion and Corruption.

xxiii.. Some of these steps are outlined in a forthcoming Reason Foundation Privatization Center ?How-to? Guide titled ?Financial Mechanisms for Mining the Public Balance Sheet? by Roger D. Feldman and Thomas M. Ingoldsby. Also see: William H. Payson and Steven A. Steckler, ?Expanding Airport Capacity: Getting Privatization off the Ground,? Reason Foundation *Policy Insight*, No. 141, July 1992, 19.

xxiv.. *The Long Term Employment Implications of Privatization: Evidence from Selected U.S. Cities and Counties*, prepared by Dudek & Company for the National Commission for Employment Policy, Washington, D.C., March 1989.

xxv.. Clarkson and Fixler, *op.cit.*, 176.