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## Privatization Pitfalls Update, 2008

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# **P**rivatization Pitfalls Update, 2008

*“Like most promises of a free lunch, privatization of government services – also known as ‘contracting out’ – has rarely delivered on its promises, with most studies showing little gain and often substantial losses for the public.”<sup>1</sup>*

## **Introduction**

Policymakers at the local, state, and federal government levels often struggle to balance the imperatives of providing necessary public services with the constraints of shrinking funds to pay for services such as transportation, prisons, and human services. Among the many possible solutions public entities may consider is the strategy of privatization, defined as “any process that is aimed at shifting functions and responsibilities, in whole or in part, from the government to the private sector through such activities as contracting out or asset sales.”<sup>2</sup> This briefing paper is an update to an earlier publication by the Bureau of Labor Education on the “pitfalls and problems” of privatization (1998).<sup>3</sup> As with the previous paper, this update will focus primarily on privatization as it concerns the provision of public services by states and localities in the U.S., rather than on federal levels or in other countries. While the complexities of privatization need to be explored in much greater depth by policymakers, this briefing paper explores some major issues, and offers some further resources.

Many state and local governments, the U.S. government, and public sectors such as higher education, turned to various forms of privatizing services over the past two decades, especially during the 1990’s.<sup>4</sup> However, both planning experts and local governments are increasingly questioning the effectiveness of such conventional privatization. In an extraordinary turnaround of policy, many local governments are actually beginning to reverse their privatization experiments, due to the host of problems that have arisen, according to Cornell University’s planning expert Mildred Warner.<sup>5</sup> For all of these reasons, a closer examination of the actual consequences and implications of privatization is critically important before adopting what is increasingly viewed as a failed strategy.<sup>6</sup>

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<sup>1</sup> Progressive State Network, “Privatizing in the Dark: The Pitfalls of Privatization & Why Budget Disclosure is Needed;” December, 2007; under “Resources” at: [www.progressivestates.org/](http://www.progressivestates.org/); “Introduction” (p. 1).

<sup>2</sup> U.S. General Accounting Office (GAO), General Government Division; “Privatization Questions State and Local Decisionmakers Used When Considering Privatization Options,” April 1998; p. 1, Preface. [www.gao.gov/special.pubs/gg98087.pdf](http://www.gao.gov/special.pubs/gg98087.pdf)

<sup>3</sup> “Problems and Pitfalls of Privatization: Costs, Efficiency, Accountability, and Quality;” Bureau of Labor Education, University of Maine, Orono; 1998.

<sup>4</sup> U.S. General Accounting Office (GAO), *ibid.* The GAO reports: “A 1997 Council of State Governments’ survey found that state agencies responsible for transportation, corrections, higher education, and social services had all increased privatization activities since 1988. According to the International City/County Management Association, city governments have also increased the number and types of services contracted, such as child welfare programs, health services, street maintenance, and data processing.” (p. 1, Preface).

<sup>5</sup> Warner, an Associate Professor in Cornell University’s Department of City and Regional Planning, describes the growing trend in “reverse privatization,” saying: “The last decades of the 20th century witnessed a profound experiment to increase the role of markets in local government service delivery. However, that experiment has failed to deliver adequately on efficiency, equity or voice criteria.” In response to these failures, “U.S. local government managers began to bring previously contracted services back in house in a process of reverse privatization.” (p. 1). Source: Mildred Warner, “Reversing Privatization, Rebalancing Government Reform: Markets, Deliberation and Planning,” presented as a paper in 2007. Accessed on 3/10/08 from: “Recent Papers by Mildred Warner,” at Cornell University’s “Restructuring Local Government” site on privatization, <http://government.cce.cornell.edu/warner/paperlist.asp?List=recent&ShowAbstracts=true>

In this briefing paper, we will provide an overview of five important issues in privatization:

- 1) Costs: Does privatization through contracting out result in lower costs for public services?
- 2) Accountability and Control: Does contracting out of public services provide adequate accountability and control?
- 3) Effectiveness and Quality of Services: What issues have arisen regarding the effectiveness and quality of public services provided through contracting out to private sector contractors?
- 4) Economic and Employment Impacts: What are the economic impacts of contracting out public services to the private sector, particularly regarding impacts on jobs and employment?
- 5) Constitutional Rights: What are the potential threats to constitutional rights posed by the transfer of public authority to private groups, regarding the provision of public services?

Here are some points and examples that policymakers should seriously examine before leaping to the conclusion that privatization is the answer to the challenges in providing public services efficiently.

**1) Costs**: The existing research on the comparative costs of private vs. public provision of services is limited, inconsistent and often biased. Advocates of privatization focus on the evidence for cost savings,<sup>7</sup> while critics of privatization point out many documented cases where the costs of privatized operations are substantially higher than comparative costs for the public provision of such services.<sup>8</sup>

It is especially difficult to obtain reliable comparative data on the costs of privatization, given the complexities of measurement and comparison. For example, a recent report on state trends in privatization argues that there is “little reliable data on the benefits or costs of privatization,” with most studies based on anecdotal evidence rather than systematic comparisons.<sup>9</sup> Other recent studies on cost reduction through privatization have concluded that “the evidence is mixed and no systematic relation between private production of public services and costs savings can be proven.”<sup>10</sup>

However, there are many specific examples in which contracting out to the private sector for various services have resulted in expensive costs far outweighing what it would have cost using public sector employees. For example, a legislative audit in Alaska found that the costs of a contract to Alaska Supply Chain Integrators for state procurement services were \$1 million more than it would have cost if in-house state employees had carried out the same work.<sup>11</sup> In another example, the Florida Department of Children and Families “was overcharged by at least \$1.6 million for services related to mental health care and drug treatment in Miami-Dade County over a 2.5 year period,” according to a

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<sup>6</sup> The Cornell site, “Restructuring Local Government,” also has links to many other relevant studies on privatization. Accessed on 3/10/08 at: [http://government.cce.cornell.edu/doc/viewpage\\_r.asp?ID=Privatization](http://government.cce.cornell.edu/doc/viewpage_r.asp?ID=Privatization)

<sup>7</sup> John Hilke, “Cost Savings from Privatization: A Compilation of Study Findings,” online publication from the libertarian Reason Foundation; [www.reason.org/htg06.pdf](http://www.reason.org/htg06.pdf)

<sup>8</sup> AFSCME, “Government for Sale: An Examination of the Contracting Out of State and Local Government Services,” 8th Ed.; AFSCME (American Federation of State, County and Municipal Employees – AFL-CIO), accessed on 3/10/08 at: <http://www.afscme.org/publications/10040.cfm>

<sup>9</sup> This report also states, “Reports tend to have a systematic bias since they focus on programs that for whatever political reasons have been privatized, while having little data on the comparable programs not privatized, so they usually lack a good baseline for accurate comparisons.” Progressive State Network, “Privatizing in the Dark,” *ibid.*

<sup>10</sup> These studies are summarized by Germa Bel and Mildred Warner, “Challenging Issues in Privatization,” from a forthcoming publication, *Environment and Planning C: Government and Policy*, 2008. Mildred Warner, Cornell website on Privatization; *ibid.*

<sup>11</sup> AFSCME, *ibid.*; p. 3; based on an article in the *Anchorage Daily News*; “Audit Shows Outsourcing Costs More,” 3/31/06.

report by the Florida inspector general.<sup>12</sup> As one report concludes, “It’s unsurprising that the major justification usually given for contracting out public services – saving the taxpayer money – is rarely attained.”<sup>13</sup>

**2) Accountability and Control:** Another set of problems closely related to cost issues are those of accountability and control, including the problem of corruption. There are some notorious instances of corruption in the contracting out of public services, often associated with increased costs far beyond the original contract estimates. In Wisconsin, for example, two construction companies and four company executives “were indicted on charges of conspiring to rig bids on at least 30 state of Wisconsin projects, totaling more than \$100 million of work,” including public works projects ranging from highways to bridges and airports.<sup>14</sup> And in 2004, a *Cincinnati Enquirer* investigation found that “lax controls and casually administered contracts are common,” in contracting out by state and local governments.<sup>15</sup>

Such problems in the privatizing of public services raise serious problems of direct democratic accountability, since there are generally few clear avenues through which private contractors can be held accountable. In some cases, contractors themselves are responsible for the oversight of their own work, as in the notorious, multibillion-dollar “Big Dig” project in Boston, where the Bechtel Corporation was responsible for much of the oversight as well as a substantial portion of the engineering design.<sup>16</sup> As one critic puts it, “Public accountability is diminished because complaints from citizens cannot be directly and quickly addressed by the state or local government. In addition, private companies are not subject to the same public scrutiny as public entities, which are required to operate in an open arena.”<sup>17</sup>

**3) Effectiveness and Quality of Services:** Once again, the evidence shows that the contracting out of public services does not necessarily result in more effective or higher quality services. While there are numerous case studies documenting problems of effectiveness and quality by private contractors providing public services, one widely cited “poster child” for disastrous privatization by the states is the case of Texas, which contracted with the now-infamous private contractor, Accenture, LLP, to administer its public assistance eligibility system. As one report states, “Computer systems failed, costs

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<sup>12</sup> Cited in AFSCME, *ibid.*; p. 2; based on an article by the Associated Press; “Report: DCF was Overbilled \$1.6 Million,” 8/20/2004.

<sup>13</sup> Progressive State Network, “Privatizing in the Dark,” *ibid.*, p. 3.

<sup>14</sup> AFSCME, *ibid.*, p. 3; based on an article in the *Milwaukee Journal Sentinel*, “Fees, Fines Total \$1 Million in Bid Rigging,” 9/2/2004.

<sup>15</sup> AFSCME, *ibid.*, p. 3; based on an article in the *Cincinnati Enquirer*, “Weak Contracts Waste Tax Money,” 5/19/2003. The AFSCME report on this case adds: “Between 2000 and 2003, at least 116 state audits and inspections found that contractors misspent \$97.7 million in tax money.”

<sup>16</sup> Progressive State Network, “Privatizing in the Dark,” *ibid.*, p. 2. A 2003 Massachusetts State Senate report cited in this study criticized the secrecy, conflicts of interest and weak state supervision of the Big Dig project. In July 2006, falling concrete ceiling panels from the Big Dig tunnel crushed and killed a woman motorist. Later investigation showed that the collapse of the ceiling tunnel was probably due to the inferior bolts and epoxy used in the construction. As reported by the Associated Press, “The project was plagued by delays, leaks, falling debris and cost overruns. Its cost was initially estimated at \$2.6 billion but ballooned to \$14.8 billion, making it the costliest public works project in U.S. history.” (Steve LeBlanc, “Year After Tunnel Death, Motorists Relax;” Associated Press, July 8, 2007; <http://www.washingtonpost.com/wp-dyn/content/article/2007/07/08/AR2007070800533.html>

<sup>17</sup> AFSCME, *ibid.*; p. 2. This report adds that such conditions can “create opportunities” for corrupt practices such as “bid-rigging, bribery and kickbacks.”

mounted and 30,000 children ended up being dropped from the children's health insurance program (CHIP) because of administrative bungling."<sup>18</sup> Poor quality and failed projects by Accenture have also been experienced in Colorado, Florida, Ohio, Ontario, and New York, among others.<sup>19</sup>

**4) Employment Impacts:** Although many state and local governments look to privatization as a good alternative option for providing public services because of potentially reduced labor costs, this argument should be critically examined for a number of reasons. First, as cited above, the costs for privatized services may not be less than the cost of such services provided directly by public sector employees. As documented by the Progressive States Network and other critics of privatization, the transaction costs of "contracting out" are often overlooked in cost comparisons, which are problematic to begin with. Secondly, by definition, usually private contractors expect to make a profit by the provision of such services, so that a certain portion of the public funds used to pay for privatized services goes to a profit margin for the provider. This in turn reduces the funds available for service recipients as well as employees, in terms of adequate wages and benefits. And thirdly, there may be unforeseen costs of a shift in employment from full-time jobs with benefits, to more use of part-time labor, typically without benefits. For example, a recent study by Indiana University found that "outsourcing" work to for-profit firms by county and local governments led to a replacement of many full-time employees by part-time workers.<sup>20</sup> Workers with lower wages and without health care benefits are more likely to rely on public services for assistance and health care, and are contributing less in taxes to public revenue, thus increasing public sector costs indirectly.

**5) Threats to Constitutional Rights:** One very troubling trend in privatized public services is the fact that private contractors can be given the authority to determine initial eligibility for, and hence access to, public services and benefits. There may be limited avenues for appeal in such cases. For example, the task of determining eligibility for TANF (the current version of "welfare" for children and families, entitled "Temporary Assistance for Needy Families") has sometimes been contracted out to private contractors, who are not accountable to the public. Texas and Florida have also privatized their prescreening for public benefits such as food stamps and Medicaid.<sup>21</sup> To further complicate matters, some state contractors have moved their call centers (e.g., for questions regarding benefits) to offshore locations such as India. Ultimately, assigning such critical governmental functions to private sector contractors raises profound threats to the constitutional rights of U.S. citizens. As Harold Sullivan argues, "By turning 'production' of public services over to private groups, governments can effectively evade constitutional restraints."<sup>22</sup>

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<sup>18</sup> Progressive State Network, "Privatizing in the Dark," *ibid.*, p. 2. The report adds that "The results were so bad that the Republican State Comptroller, Carole Keeton Strayhorn, investigated the deal and declared, 'The Accenture contract appears to be the perfect storm of wasted tax dollars, reduced access to services for our most vulnerable Texans, and profiteering at the expense of our Texas taxpayers.' Faced with the evidence, the state Health and Human Services Commissioner Albert Hawkins had to return to older procedures and the state began using state workers who were slated to be laid off to clean up the mess." (p. 2).

<sup>19</sup> AFSCME, "Safety Net for Sale: The Dangers of Privatizing Social Services," p. 16-17; 2006; [www.afscme.org/publications/1242.cfm](http://www.afscme.org/publications/1242.cfm)

<sup>20</sup> Indiana University, "Outsourcing in local governments leads to fewer full-time employees and more part-timers," January 23, 2007; <http://newsinfo.iu.edu/news/page/normal/4720.html>

<sup>21</sup> AFSCME, "Safety Net for Sale," *ibid.*; p. 3. In some cases, private contractors may have built-in incentives to deny eligibility for services, hence increasing their profit margins. The privatization of eligibility determination is also problematic, says the AFSCME report, since in most states, "freedom of information and open records acts do not apply to contractors, making it difficult to determine how public funds are being spent." (p. 2).

<sup>22</sup> Harold J. Sullivan, John Jay College of Criminal Justice, CUNY; "Privatization of Public Services: A Growing Threat to Constitutional Rights." Public Administration Review: Vol. 47, No.6, pp. 461- 467; 1987.

## **CONCLUSIONS AND RECOMMENDATIONS:**

State and local policymakers and governments who are seeking to provide public services effectively and in a cost-efficient manner need to consider the larger implications of privatization, and to explore alternatives. Here are some specific suggestions:

1. When considering privatization proposals, it is imperative for state and local governments to consider and include the full range of **costs** in their planning, including transaction costs, and to ensure budget transparency in the process. For example, there are a number of legislative reforms being explored by various states, such as requiring that the costs of privatization be measured, and requiring budget disclosure for privatization.<sup>23</sup>
2. It is important to ensure adequate **public accountability and control** in the provision of services.
3. Policymakers and governments must consider the actual or likely **effectiveness** of public service providers and the quality of services, not only in terms of total costs, but whether social needs are being met.
4. It is critical to consider **longer term economic consequences** and indirect impacts, including loss of resources and expertise in the public sector, and the impacts of losing public jobs with benefits.
5. It is extremely important to consider both the **constitutional** and the **ethical implications** of transferring responsibilities for obtaining access to services to the private sector.<sup>24</sup>
6. Last, it may be useful for policymakers and governments to consider **innovations** in providing public services, such as using publicly-owned firms, and inter-municipal partnerships. For example, inter-municipal cooperation has been used by rural and small towns “as an alternative to privatization to exploit economies of scale.”<sup>25</sup> Similarly, there is increased interest in exploring innovative models of joint labor-management initiatives between state or local governments and public employee unions, with promising results.<sup>26</sup> These offer alternative strategies for maximizing effectiveness, efficiency and quality of government services while protecting employee rights and job security.

In sum, there are many possible options to address the concerns of state and local governments in providing public services efficiently and effectively, while ensuring accountability, transparency, and protections for citizens, workers and the public itself. This briefing paper demonstrates that there are many available resources to explore such options.

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*A member of the University of Maine System*

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<sup>23</sup> Progressive State Network, “Privatizing in the Dark,” *ibid.*, p. 7.

<sup>24</sup> Harold Sullivan, *ibid.*

<sup>25</sup> These strategies and others are discussed in Bel and Warner, “Challenging Issues in Local Privatization,” *ibid.*, p. 3.

<sup>26</sup> Allyne Beach with Linda Kaboolia; “Public Service, Public Savings: Case Studies in Labor-Management -- Initiatives in Four Public Service,” The Public Sector Labor-Management Committee and The John F. Kennedy School of Government at Harvard University; 2003; accessed 3/10/08 at: <http://www.afscme.org/docs/pslmc.pdf>