

# Washington Research Council

= Special Report =

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## Contracting Out in Washington State

### Overview

Contracting out — privatizing — turning to business to provide public services. The Washington Research Council has looked into the issue for nearly a year. The most common form of privatization in this country is contracting out and contracting out is the focus of this report.

When done correctly, and "doing it right" is a key caveat, privatization may save money, result in improved service quality, or both. But, there are also examples of privatization attempts gone awry, resulting in higher costs or lower service levels. On balance, it seems that privatization works more often than not, but it is not a guaranteed success and it requires diligent administration.

We've also learned some ways to improve the chances for successful privatization, and discovered some significant barriers to state government using the private sector in Washington. These barriers will need to be removed before contracting out can be a useful tool to public officials here. And we should emphasize that at best privatization is a "tool, not a rule," as mentioned by a speaker at a recent conference here.

More important, perhaps, than any prescriptions that result from our study, is a general perspective. Privatization infuses competition into public monopolies and competition is often the key to cost savings and improved government efficiency.

### Introduction

In beginning an examination of privatization of government services, it helps to examine first the role and purpose of government. Governments are formed when the people work together to achieve a common purpose or goal: providing a service or protecting a shared resource. It has been argued that quality education for people at all income levels or postal delivery to rural areas would not be available without government initiative.

The presumption all along, from both business and government officials with whom we've discussed this subject, is that advocates of privatization must provide evidence which supports changing our way of doing things, for privatizing. And perhaps appropriately — in debate the rules suggest that the party advocating change carries the burden of proof.

It's useful to turn the question upside down, however. In our economic system, we depend first on free enterprise and competition to deliver most goods and services. So when we deviate from that practice, there should be a compelling rationale. There are times when government must both regulate and deliver, but those ought to be exceptions. The question, then, should not be "why privatize?," as it so often is, but rather there should be a review of all state functions which asks "what business is government in?" Does being in the business of social services, for example, require that public employees be hired to clean and maintain the buildings

in which the social service workers are employed?

Government has a responsibility to provide a set of services desired by most citizens and essential to the public welfare. According to Lyle C. Fitch, chairman of the board and president emeritus of the Institute for Public Administration, "services can be performed by either government agencies in-house or private sector organizations. The basic function of government, which can't be delegated, is choosing the kinds and amounts of services it will provide, given its financial framework and the resources at its command. Once those decisions are made, the next choice is the means by which the services will be produced and delivered."

In deciding how those services are to be delivered, a number of concerns must be satisfied, such as continuity, quality, efficiency, and equity. There are also the issues of the cost and disruption of service which could potentially result if a change in service provision is decided upon.

Where do we look for providers? Clearly, government will hire them, or at least regulate provision of the services — but as employees or as independent businesses under contract? Competition is basic to our economic system. Beyond that there's a further consideration: business pays taxes, broadening the tax base, while government doesn't.

So, first we should look to see if business can provide the service. Then, if it cannot, we turn to government to act as the service provider of last resort. That's consistent with the

economic philosophy which governs this country, and not altogether inconsistent with our practice. But, in various jurisdictions around America, there are dramatic differences in the degree of private sector involvement.

Why, then, do the choices vary? Why are some services delivered by government and others by business?

No fixed set of rules applies in all instances and circumstances surrounding the reasons can change — changing how the rules apply. Some patterns do suggest themselves, however. For example, unique or monopoly services may frequently be provided by government. In those instances where there is no competitive market already in place, government may choose to initiate the service under its own management. Competition is one reason for the savings cited for privatized services; in its absence, the gains may not be substantial.

Public safety considerations may suggest that government play a primary role in both the regulation and administration of some services. Despite some successes around the country, police, fire and corrections services are dominated by public sector providers and there's a general reluctance to turn these services over to the private sector.

And finally, even for those services that seem to be best provided by government, an array of support services should be subject to independent evaluation. For example, incarceration may be a governmental responsibility; but provision of medical care for prisoners may be a role which can be filled by business.

When a business asks what business it is in, it might decide that its expertise is in insurance or banking. It then questions the rationale of also preparing meals for employees or hiring staff to clean the offices. Often it contracts with other companies to run the cafeteria or provide custodial services.

## Privatization: A Definition

So, just what is privatization? It's an alternate method of delivering public services. Simply put, privatization means relying more on the private sector and less on government to provide government services.

E.S. Savas, chairman of the department of management at City University of New York and a recognized expert in the field of privatization, said some forms of privatization have been around for years, although not always recognized as such. Food stamps, for example, let government feed poor people without having to actually produce or deliver the food. Instead, private enterprise is "hired" to do the job through systems already in place.

According to a 1987 survey of cities and counties by Touche Ross, the International City Management Association (ICMA), and the Privatization Council, about 80 percent of those responding had used some form of privatization to provide services in the last five years and about the same

number expected that privatization would be a prominent way of providing government facilities and services in the future.

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## Contracting Out

The most common form of privatization in the United States is contracting out — hiring the private sector to provide a government service. Over 95 percent of those responding to the survey listed contracting services out as one of the kinds of privatization they had used or expected to use.

Examples of contracting out from around the country include hiring businesses to tow automobiles, collect garbage, sweep streets, repair roads and street lights, maintain parks and public buildings, provide security and data processing, manage hospitals, run buses, operate, or own and operate, water and sewer treatment plants, administer Medicaid programs, and own and operate prisons.

## Other Forms Of Privatization

But privatization isn't just contracting out for government services. Franchises, vouchers, and several other approaches to achieving a stipulated public purpose also are covered by this term. (See page 3 for the types of privatization.)

## The Washington State Experience

As the most common form of privatization in the United States, contracting out is the focus of this report. Although most of the recent emphasis on contracting and privatization has been at the local and federal levels of government, states, including Washington, have traditionally contracted many functions.

The state currently contracts with businesses (and, in some cases, other units of government) to provide a variety of services. Contracts for professional or technical expertise have included geotechnical engineering and architectural services related to road and bridge construction (see **Spotlight: State Contracts for Highway Construction**, page 6). Contracts with vendors for the provision of routine functions include areas such as maintenance and repair of computer and telephone equipment, provision of rental cars and advertising for the lottery (see **Spotlight: the Washington State Lottery**, page 9). Contracts for the provision of services directly to agency clients include operation of work release facilities by private sector providers and care of state nursing home clients.

Conversely, state employees are hired to provide a number of services which could be provided by the private sector.

For example, 10 percent of the state's classified higher education workforce and 3 percent of the classified positions with agencies covered by the Department of Personnel are employed in custodial, food service and laundry positions — that's more than 2700 people (see **Spotlight: Institutional Food Service—Some Public, Some Private**, page 5).

### Legal Barriers In Washington

Under current law what can be privatized is limited by a 10-year-old state Supreme Court decision which restricts efforts to contract out government services here. That point was raised during the Research Council's 1987 seminar on privatization and surfaced during the 1988 legislative session. As director of the Department of General Administration, Mary Faulk heads a state agency that provides a variety of services to other state agencies. She said the court decision serves to

limit what can be done through privatization:

"In the state of Washington we probably have less flexibility in the area of privatization than virtually any other state. This stems out of a Supreme Court decision in 1978 that the Washington Federation of State Employees brought against Spokane Community College. This is when the college was new and was seeking to privatize its custodial services. The state federation of employees sued to prevent the college from privatizing the custodial services."

The state Supreme Court overturned a lower court decision, deciding in favor of state employees. It stated that "...where a new need for services which have been customarily and historically provided by civil servants arises, and where there is no showing that civil servants could not provide those services, a contract for such services is unauthorized

## Forms of Privatization

**Contracting out** is a method of alternative service delivery whereby a government pays a private sector organization (or sometimes another unit of government) directly to deliver services based upon a contract which specifies the work to be performed. Commonly contracted services are in the area of public works, such as highway construction and garbage collection.

**Franchise agreements** are exclusive or non-exclusive licenses for private firms to provide a particular service within a specific geographic area. In Washington examples include utilities, cable television service and garbage collection.

Franchises differ from service contracts in two primary ways. First, unlike contracting, citizens make payments directly to the private firm holding the franchise. And second, government plays a regulatory role over service levels and costs to the consumer.

**Subsidies** are financial or in-kind contributions that a government provides to an organization or individual in order to allow services to be delivered at a lower price or to enhance the quality or quantity of the service. Less explicit than a contract, this approach may be limited in Washington, which puts tight restrictions on lending of the public credit.

**Vouchers** are certificates that allow citizens to choose between private service providers while government retains financial responsibility. Food stamps are the most successful and widely used form of voucher system. At the state level examples include day care programs in New Jersey and Massachusetts and employment programs in Illinois.

**Volunteers** can allow government to defray the costs of providing public services if people are assigned to appropriate tasks.

**Self-help programs** allow individuals, neighborhoods or communities to undertake activities that otherwise would require governmental assistance. Home construction, block watch and neighborhood beautification and maintenance projects are examples of self-help activities that can reduce the demand for governmental services.

**Regulatory and tax incentive programs**, like self-help, can help reduce service demand. Requiring trash to be brought to the curb is a common example. Tax exemptions or credits have been used in some states to encourage families to provide care for elderly or disabled family members.

**Asset divestment** occurs when a government sells a "business" which it owns to the private sector. Although vulnerable to criticism, this alternative can provide an infusion of cash to the government. Examples are the sale of Conrail and a number of denationalization efforts, such as public housing, in Great Britain.

**Service divestment** occurs when a government discontinues the provision of a service. The provision of this service may be taken over by a private sector provider or no longer be provided to the community. A common example is the closing of public hospitals or health clinics.

**Public-private partnerships** can range from economic development and projects involving loaned executives to specific, capital-intensive activities, such as resource recovery or waste water treatment.

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***“A contract for such services is unauthorized ... regardless of the cost savings which might be made through such a contract.”***

— Washington State Supreme Court

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and in violation of the State Higher Education Personnel Law. This is so regardless of the cost savings which might be made through such a contract.”

Civil service statute is a creation of the Legislature and may be changed by that body. Before any significant move can be made toward contracting state services traditionally provided by public employees, legislative action and probably further court action will be necessary.

In fact, a bill which would have essentially reversed the statute upon which the state Supreme Court decision was based was introduced during the last legislative session. It failed to win approval.

Several other bills introduced during the 1988 legislative session involved examining government competition with the private sector. An interim committee has been established to look at this issue.

### Reasons to Privatize

Why is privatization important? People, including those in Washington, are starting to take a closer look at privatization because they think it might enable government to serve the public at a lower cost — or alternatively, to offer more services for the same money it's spending now. Others look at privatization as a way of controlling or reducing the size of government.

Proposition 13 in California, approved by the voters in 1978, and the nationwide tax revolt are said to have started the privatization movement. As resources became limited, governments began to look for more cost-effective ways to do business.

There have been numerous suggestions for cost containment. Contracting with private firms for services traditionally provided by government, getting a handle on the soaring costs of caring for the elderly, issuing vouchers for housing or medical services, and evaluating the standards used for determining the eligibility for public assistance are only a small sample. But there has been no systematic or comprehensive evaluation of such suggestions in Washington, and debate often has been based not on fact, but on conjecture.

In its *Annual Report to the Legislature* the Washington State Commission for Efficiency and Accountability in Government listed privatization as priority issue in its workplan. “The issues of equity, consistency and quality of service, accountability, efficiency and effectiveness make this a complex and important topic,” the commission wrote.

In recent years the state's expenditure growth outpaced growth in personal income — a measure of the public's ability to afford the programs and services it desires. And a growing budget crunch in Washington may prompt more analysis of privatization and its merits than any argument for it has in the past.

### Privatization As A Management Tool

Few would argue that privatization can solve all of the problems in providing government services at reasonable cost. But as Savas said, privatization lets government and private enterprise do what each does best.

“Privatization can lead to a better division of work between government and the private sector,” he said. “One can say

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***“The issues of equity, consistency and quality of service, accountability, efficiency and effectiveness make (privatization) a complex and important topic”***

—the Washington State Commission  
for Efficiency and Accountability

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that the job of government is to steer, not to row the boat. The private sector ... is very good at rowing ... that is, producing goods and services efficiently, innovatively, effectively.”

Savas believes government can and ought to make the decisions as to which services are provided using taxpayers' money. But it doesn't have to provide those services using its own employees. What's important is that appropriate public services are provided. Privatization is a tool that government managers can use to help make that happen.

### Competition A Key

Savas discussed privatization at a seminar sponsored by the Washington Research Council last year. He said privatization can save money because it introduces competition — and, therefore, increased efficiency — into the usually monopolistic system of providing government services.

“The real reason...why the private sector through contracting is so much more efficient,” Savas said, “does not have to do with the nature of the people involved but rather with the fact that, by and large, when public services are provided by government agencies they're provided as monopolies, whereas when it's done right, contracting introduces competition. The profit motive results in more efficient operations.”

Not everyone agrees that the competition introduced by privatization is a good idea, however. Unions such as the American Federation of State, County and Municipal Employees and AFL-CIO oppose contracting out, charging that it's unfair to public employees and a bad way to save public

***"The real reason...the private sector ... is so much more efficient does not have to do with the nature of the people involved but rather with the fact that, ... contracting introduces competition."***

— Professor E.S. Savas

dollars. And they also question if contracting necessarily saves money.

According to John Hanrahan, a former *Washington Post* reporter and author of an AFSCME publication entitled *Government for Sale*, "one basic item that should make contracting out more expensive, all other things being equal, is that contractors exist to make a profit, while governmental units have no such motivation. It's logical to assume that if a contracted service and a public worker-provided service are comparable in the number of workers used, the scope of the job to be performed, and in managerial and worker skill, the expense of either operation should be roughly the same." Among the weaknesses in the practice of contracting, Hanrahan lists "higher costs which result from firms seeking to increase profits." And, if offering a service is new to the private sector firm, there is the issue of the time it takes to train employees, develop efficiencies in providing the service, and acquire the necessary equipment.

Proponents of privatization, such as Savas and Robert Poole of the Reason Foundation, take issue with this on the basis of competition. According to Savas "the weakness of traditional government services is that they are operated as monopolies .... Privatization, when done right, eliminates public monopolies and introduces... competition." Poole says that governments have "permanent, guaranteed access to

tax funds and a guaranteed monopoly on the service. There is little incentive for it to be efficient and save money. A private firm, on the other hand, has no long-term guarantee of funds.... If they wish to make money, the firm's managers must price its services low enough to be competitive but high enough to yield a return on its investment. *That*, in turn, *forces* them to figure out better ways of doing business." (emphasis in the original)

### **Economies-Of-Scale May Benefit Large Firms**

In addition to the influence of competition, some proponents argue that large, national chains may have an advantage when it comes to the cost of supplies, allowing them to reduce their costs without cutting corners. This comes from being able to purchase in bulk. According to an article by Martin Tolchin for the *New York Times* and reprinted by AFSCME in *Public Hospital Takeovers: An Uneven Record*, "hospital chains also benefit from their ability to purchase in bulk." The article cited the example of a Corsicana, Texas hospital owned by the Hospital Corporation of America which "purchased a \$1.2 million CAT scanner for \$700,000, ... and can count on at least a 20 percent discount on most equipment."

### **Unions Question Cost Savings**

The unions, however, question how the private sector can deliver services at a lower cost. In *The Privatization/Contracting Out Debate*, another AFSCME publication, Frederick C. Thayer writes "[I]f private entrepreneurs are to deliver public goods or services and simultaneously make profits while reducing public expenditures, they must achieve substantially lower operating costs than either public or nonprofit agencies. The only ways of reducing costs involve cheaper equipment, fewer employees, and lower pay.... With prisons, hospitals and transportation, constant reductions in operat-

## **Spotlight: Institutional Food Service—Some Public, Some Private**

Examples of both private and public provision of institutional food service can be found in Washington.

Food service on the state ferries is provided by Restaura Dining, a division of Greyhound Lines. The company pays the state a percentage of its take for the right to operate.

The Evergreen State College (TESC) has a similar arrangement with Marriott Corporation. According to Denis Synder of TESC, the school has always contracted out its food service. Western Washington University and a few of the community colleges also rely on the private sector for food service. The financial arrangement at Western is more complex than that of TESC and the ferries. Some meals, as at TESC and the community colleges, are sold on a cash basis; however, others are paid for as part of the room and board package. According to Roger Otley of WWU, the amount the college receives from Marriott exceeds the oversight costs. He believes that the costs of the contracted service are traditionally lower, including the cost to the customer.

On the other side of the spectrum are most of the community colleges and the other four-year schools. They rely on state employees to run cafeterias and provide meals, operating on a nonprofit basis.

Synder said that some schools have considered switching to private contractors but ran in to problems along the way, not the least of which were union opposition and worker displacement. The decision in the Spokane Community College case is another barrier (see page 3).

## Spotlight: State Contracts for Highway Construction

Building roads is big business in Washington State and the state contracts out nearly all of it to private sector contractors. Big maintenance projects are also contracted out.

The state expects to spend about \$950 million on road construction during the 1987-89 biennium and, according to Virgil Clarkson of the state Department of Transportation (DOT), nearly all of the construction will be done by private contractors. To put the numbers in perspective, that's equal to about 9 percent of the state general fund budget for the same period.

According to Clarkson, the state also sometimes hires a private sector consultant to manage big projects, although ultimate decision-making authority remains with the DOT district administrator.

Most highway maintenance is done by state employees, but large projects, those costing more than \$30 thousand, are contracted. According to the DOT, historically 11 to 12 percent of maintenance dollars have been contracted. For fiscal year 1987 that amounted to about \$8 million out of \$73 million.

ing costs amount to ongoing experiments to determine just how much costs can be cut before tragedy strikes. And strike it will...."

A close-to-home example of where tragedy could have struck comes from the Naval Submarine Base at Bangor, Washington. United Airlines Services Corp. recently won the base operating services contract, which includes base security, from Pan Am World Services Inc., the the previous contractor. According to an article in the *Bremerton Sun* by Lloyd Pritchett, the new contractor was paying guards \$8.08 an hour, the minimum level set by the Service Contract Act and less than the former contractor. The article also cited Neil Moloney, the former head of the base's security and fire departments, as saying "low wages and a lack of job opportunities were causing excessively high turnover among security police at the base."

Using its own agents with invalid credentials, the Navy initiated a test of the security in January 1988. According to the article, the agents were able to get past security in eight out of 17 tries, including three times into high security areas. In response to the test results, additional emphasis has been placed on the importance of proper security procedures.

So, has tragedy struck? No, it was avoided through administrative oversight and contract monitoring and proponents of privatization agree that these controls are critical to the success of contracting.

### Specifications And Monitoring Are Important

How the contract is written can also help to reduce the likelihood of firms cutting too many corners. For example, in a contract for the provision of transit services, Kitsap County stipulated that drivers be paid at least \$7 an hour in order to reduce turnover and maintain quality service.

According to Kitsap County Commissioner John Horsley, "if privatization only works with tax breaks or low wages, it is not good for the public, but if there are better management

skills in the private sector, then privatization" is an option worth considering.

Critics of contracting, such as Ray Marshall in *When Public Services Go Private*, point to the "hidden costs (of privatization) — things like monitoring of the contracts and the use of public facilities by the private contractor" as adding to the cost of contracting with the private sector. And active contract monitoring and oversight are major commitments necessary for successful relations with private firms. According to John Marlin, editor of *Contracting Municipal Services*, the costs of contract monitoring and oversight are an important component of cost comparisons.

### Job Disruption An Issue

Privatization may result in job loss for government employees, a substantial concern of governmental employee unions. Larry Kenney, president of the Washington State Labor Council, said that workers are hurt when business takes over the task of providing services, because the newly created private jobs often pay less than the government jobs did. An example of this is custodial services where public sector wages can be as much as double those paid to private employees.

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—Mark Brown, WSFSE

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Mark Brown, lobbyist for the Washington State Federation of State Employees points out that this "job disruption" often includes loss of benefits as well as reduced wages, and that "low wages are bad for the economy." Even if it does save money, is it good public policy" to replace higher paying public sector jobs with some benefits with minimum wage private sector jobs with no benefits" Brown asks.

One common suggestion is that the business taking over the provision of a service from the public sector should be required to pay above a certain wage level and to hire the displaced government employees. However, this is not accepted by everyone. According to Ted Nissen, president of Behavioral Systems Southwest, a private corrections firm, "usually ex-government people don't work out" due to a "civil service or union mentality." And the private company may not need as many people to do the job or the same skills as were used when government provided the service.

Phoenix, Arizona has dealt with the issue of job displacement in another way. In conjunction with contracting the city has a "no lay-off" policy. When the city loses a contract to a private organization, it freezes hiring in all positions of the same level. As city positions in other departments open up through growth or attrition, employees from the service being phased out, for example garbage collection, are moved into those positions, such as parks and recreation, and their positions are filled with employees hired on a temporary basis for the remaining period of the service provision.

Although wages of the reassigned employees are frozen, concern has been raised by the union that there is less opportunity for advancement. According to Marilyn Dantico, professor of economics at Arizona State University, opportunities are diminished because "they were already over the pay scale of the top employees in their new agency."

City employees in Phoenix are also involved in the process of improving their work environment while cutting costs to help win the contracts. There is a formal labor-management committee on productivity which works on reducing city costs, thereby increasing the chance that the city employees will provide the service. According to Jensen, "all of this ... has not changed the roles of the unions and the management but it has proven that a "win/win/win" situation can be developed. Winners are the unions, management, and most of all, the taxpayers of Phoenix."

### Improved Service Quality?

In addition to costs and employment impact, is the issue of quality. Proponents of privatization say that competition leads to increased service quality for the same, or lower, costs. According to the Touche Ross/ICMA survey, 74 percent of those responding listed cost savings as an advantage of contracting out and 33 percent listed higher-quality service.

This is not always the case, however. As AFSCME argued above and the example of the Navy base illustrates, cutting costs to get a contract can result in unacceptable service levels.

In the case of Phoenix, one of its early experiences with contracting building maintenance resulted in problems. It had contracted with several small "mom and pop" companies with limited business resources and low paid employees; and these firms experienced high failure rates. The city now tends to contract with medium to large firms to avoid this happening again. In another case, highly publicized by AFSCME, the city of Phoenix contracted with an expanding firm for garbage collection. The firm did not live up to its contract, garbage was not collected for a short period of time, and the city ended up cancelling the contract.

What happens when a private firm fails to provide the service contracted for? If the government has eliminated its ability to provide that service by selling capital assets and laying off or reassigning employees, it may have trouble on its

hands. Recapitalizing and hiring employees can be costly, in some cases prohibitively so, and the lack of service in the transition period is not likely to be appreciated by the public.

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— Ron Jensen, Phoenix Public Works Director

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These problems can be avoided, or at least mitigated, by making contingency plans. And contingency plans are important because private firms do sometimes fail. Maintaining a competitive environment increases the chances that there will be another firm ready to step in and take over a service. Governments can also protect themselves by only contracting out part of service at a time so that they don't lose the capacity to perform the service. For example, Phoenix has made the decision to only contract half of its garbage collection at a time — two of four service areas.

Phoenix also bids contracts a year in advance in order to smooth the transition from city to contractor, contractor to contractor, or contractor to city, and to reduce union opposition. This allows the new service provider to gear up with employees and equipment.

Neil Martin, in talking about problems with contracts in "When Public Services Go Private," wrote, "in nearly every instance, the fault lay in the city's failure to create a competitive environment that would force the private firm to improve its efficiency."

It is possible, however, to learn from past experience and avoid these problems through contracting practices. According to Jensen, in the case of the garbage collection contract failure in Phoenix, the city recovered its costs through performance bonds and penalty provisions. He added "it was a problem, we learned a lesson.... We tightened up the specs and won't allow it to happen again."

### Implementation Not Always Necessary

There may be an additional advantage to introducing contracting and competition into the picture. Some observers say the option of privatization often makes its actual implementa-

tion unnecessary. When governments engage in the detailed cost and management analyses that are a prerequisite to contracting out services, they often find ways to cut costs on their own. And government employees find they can compete with, and even beat, private contractors in efficiency and productivity when given the chance and the incentive. The key is the introduction of competition, not necessarily privatization.

This has occurred in Phoenix, Arizona. Official city policy states: "City operations will be performed at the most economical cost while maintaining desired service levels. As one alternative to meet this goal, the City periodically will call for bids or proposals from private industry for purposes of evaluating the cost of performing selected municipal services."

### The Phoenix Way To Competition: The City Bids, Too

City employees bid against private sector business to provide specific services using a sealed bid process. The city department lost the first contract it bid on in 1978 by a large amount, however, as time went on it became more competitive with the private bids and in recent years the city has won several major contracts.

According to Ron Jensen, public works director for Phoenix, Arizona, the advantage of this approach is not just the competition intro-

duced between private companies. In seeking to reduce costs and become more efficient in order to win a contract, a city department challenges other departments to reduce their costs. That's because the full cost of a city service includes overhead from other departments, such as personnel and other administrative services, as well as the direct departmental costs.

### Other Departments Challenged

In normal city operations the budget department provides cost estimates for overhead services. If competition is not involved, little attention is paid to these estimates. However, if a department is competing with a private firm, the overhead costs become important. The department bidding on the contract looks at both its own productivity and the productivity of other areas of the government in order to submit the lowest cost estimate. These "cost estimates" are then audited by an independent city auditor in order to assure their accuracy and, if the auditor determines they are incorrect, he can, and does, modify them.

Jensen sees privatization as a management tool that can be used to provide the very best in services to the taxpayers at the least possible cost: "Under the competitive concept, there are opportunities for the private sector to approach government with a challenge rather than a 'take-over attempt.' The idea of competition is a truly American method of

determining who is the best one to do the job. When all of this is put together in a package, the taxpayer wins."

According to Jensen: "Productivity improvements are the result of direct competition between the public and private sectors. To date, the City of Phoenix has generated substantial savings with this process. Actual cost savings from contracts awarded to private contractors total approximately \$9 million; cost avoidance from contracts won back by city employees also total approximately \$9 million for a grand total savings of \$18 million (between 1978 and 1987) to the taxpayers of the City of Phoenix." This despite the problems cited above.

And competition can be introduced without the use of contracting. According to Lyle Fitch, "it may not be necessary to turn to the private sector to get the advantages of competition .... Intra-governmental competition may even be encouraged by such devices as educational voucher systems, which allow parents to choose the public school in which their children will enroll."

At a recent meeting of the Washington State Efficiency and Accountability Commission, George Ledbetter, co-leader of the commission's Motor Pool Task Force and an executive from Thermal Efficiency Inc., discussed the task force's report. The task force concluded that when there is a way to compare the

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— Ron Jensen, Phoenix Public Works Director

motor pool costs between 78 different agencies, competition will lead to savings, because agencies won't want to be identified as having the most costly operation.

### More Opposition

As mentioned above, there have been problems with privatization and barriers exist which must be recognized.

Marilyn Dantico and Nancy Jurik in "The Privatization/Contracting Out Debate," argue that privatization has negative impacts on women and minorities. They say that these groups are "over-employed" in the public sector and that "the public sector has served as an opportunity ladder for them." When privatization occurs, they claim, these groups are adversely affected: "to the degree that privatization decreases the size of the government workforce, the work options of women and minorities are likely to be limited."

Yet, here in Washington state, there are regulations which require that women and minority-owned business be invited to bid on contracts. And, if this is an area of concern, a government could give preference to these business in awarding the contracts.

### Will Necessary Services Be Provided?

According to opponents of privatization, the private sector generally only offers those services that are profitable. In *Public Hospital Takeovers: An Uneven Record*, AFSCME



cites the example of what happened to a new city hospital in Louisville, Ky. The hospital was leased to Humana, a private, for-profit hospital firm, which scrapped plans for a burn unit. "The for-profit hospitals avoid services that are not profitable, even though they may be of use to the community," said Dr. Arnold S. Relman, editor of *The New England Journal of Medicine* and a leading critic of hospital chains.

This need not be the case and the opponents of privatization may be confusing the issue. If government determines that a service needs to be offered, it could either require that it be provided by regulation or in the contract, or subsidize the service provision so that it is profitable to the operator.

### **Threat Of Corruption**

Opponents also ask whether we can trust the public officials making the decisions about privatization. "I don't have a lot of confidence in the second tier management that would be making those decisions," Brown said. AFSCME publications cite examples of corruption, bribes and kickbacks in association with contracts.

Anytime you introduce an additional financial transaction there is additional potential for corruption. The greater the dollars involved, the greater the incentive to cheat. According to Fitch, "contracts are probably the most common and lucrative source of corruption in government. The abuse has been only diminished, not eliminated, by public bidding and other formalities designed to improve ... the process."

Of course, dishonesty is not confined to the private sector and having an open, competitive process can be required by regulation or as a provision of the contracts.

### **A Silent Opposition**

Resistance to privatization may come from a silent opponent — managers — who often are in a position to recommend actions to policy boards. According to the Touche Ross/ICMA survey, 26 percent of those responding saw "bureaucratic inertia" as an impediment to privatization in their government. The problem, according to Jensen, is that status and compensation for managers have been based historically on the size of their budgets, number of employees and span of control. If a service provided by their department is contracted out to cut costs and reduce staff, there may be a negative impact on the manager's status and compensation. As a result they see little reason to support contracting.

According to Leonard Nord, director of the state Department of Personnel, factors such as the complexity of the agency are figured into managers' salaries in this state. However, that may not provide an incentive for managers to actively explore privatization opportunities.

### **States Slower To Embrace Privatization**

Although Washington does contract some services, the state has been slow to join the debate on privatization and to examine its potential for cost savings in state government.

Washington is not alone in this. According to a recent article

## **Spotlight: The Washington State Lottery**

The state lottery makes extensive use of private sector businesses. During the 1987-89 biennium about 40 percent of the lottery's operating budget will be spent on personal service contracts and 44 percent on goods and services. For comparison, the figures for the entire state budget are 1 percent and 11 percent, respectively.

Among the services contracted are on-line game design and development, production and delivery of instant lottery game packages, and advertising services. In addition, lottery tickets are sold by the private sector, with the retailer receiving 5 percent of the sales in return.

by Bill Bancroft in *Spirit* magazine, "states have been slower (than other levels of government) to follow suit, in part because the kinds of services they offer are more difficult to hand over to the business sector." Although a few states have begun to look at other areas for contracting — such as the prison system — so far these ventures have been limited and states have not been as fast to embrace less conventional approaches to service delivery.

There is a reluctance to turn over certain kinds of services, particularly those relating to public safety, to the private sector. At a recent legislative hearing on the bill to increase the state's authority to contract, legislators expressed concern over the legislature losing control over the kinds of services that would be privatized, particularly in areas related to public safety, such as prisons and the state patrol.

There may be additional reasons why state governments have been slower to embrace privatization. The resource crunch started by Proposition 13 and related measures may have increased financial pressures on local governments first, since state governments have more control over taxing authority and delegation of services to local governments.

At the local level, it may be quite cost-effective for a small jurisdiction to contract out, for example, its motor pool maintenance, garbage collection or jail food service — it is not large enough to benefit from economies-of-scale which exist at higher levels of government. And at the federal level, with multiple levels of bureaucracy, services may be provided more efficiently if they are divided up into a number of smaller organizations or agencies. But the state's size may make it more cost effective for the state to provide the services itself.

On the other hand, it may make sense for state government to contract out particular pieces of a service. For example, a bill passed during the 1988 Legislative session clarified the authority of the state auditor to contract with private CPAs. According to State Auditor Robert Graham, the audit of a small local government entity in a remote area could be done more cost effectively by contracting with a local CPA, particularly if travel time is extensive.

## Conclusions And Recommendations

The job of government involves deciding what services to offer and determining how those services can best be delivered. Privatization offers an additional tool for public managers to use in service delivery. It can save money and increase government efficiency and effectiveness. The Washington Research Council believes that it should be an option available to government managers.

Privatization is not a panacea. Contracting out does not necessarily guarantee a 20 or 30 percent savings over government provision of a service. Across the country, however, privatization has been found to save money in many cases.

The key to savings through privatization is competition. And, while successful privatization results in a more competitive environment, there are also ways to increase competition within the public sector without privatization.

In evaluating whether a service should be privatized, there are a number of issues to consider: the primary objectives of government; the barriers that inhibit the use of privatization to accomplish those objectives; and finally, once the decision to contract has been made, the way contracts are written will determine the efficiency and effectiveness of the future system.

### What Is the Business of Government?

Government needs to consider "the Law of the Situation," which asks "what business are you really in?" According to John Naisbitt in *Megatrends*, it's "the question for the 1980s."

Once the business of government has been determined, it should focus on doing well what it is in the business to do and seriously consider the feasibility of contracting the rest. Ancillary functions, peak level operational needs and areas of special expertise should be identified for possible contracting.

And, for those activities that government is in the business to do, it should consider if there is a private sector mechanism already established which could be as, or more, efficient and cost effective.

### Clearing the Way

- **Examine statutes and regulations to identify and remove potential barriers** to the further use of contracting and other forms of privatization.

- **Consider incentives to encourage active use of privatization options by public managers.** According to Keon Chi of the Council of State Governments, these incentives could include vocal support by the governor and agency heads, allowing agencies to retain a portion of the cost savings, and linking pay, in part, to program performance.

- **Form a task force to address labor concerns.** Include representatives of labor, management, the legislature and the executive branch. In identifying concerns and opportunities around this issue, a mediator familiar with the issues of contracting and privatization may prove useful.

### Making Contracting Work

- **Establish and maintain a competitive environment.** This could include sending out requests for proposals, using franchise agreements and competitive bidding, and requiring rebidding of contracts on a regular basis.

- **Write contracts for a reasonable length of time:** long enough to make it attractive to a business but short enough to maintain a competitive environment.

- **Pass on to contractors the responsibility for the same laws and regulations** under which the government department or agency operates.

- **Write contracts which specify each step of the activity** in enough detail to avoid "low-ball" bidding and ensure quality service delivery. This could include wage rates or employee training requirements. Savas says that contracting out can actually result in more control over the service by public officials if they write a concise list of specifications to which the contractors must adhere.

- **Require performance bonding** or some other way of demonstrating financial security from the contractor and include penalty provisions in the contract for not meeting contract specifications.

- **Monitor contracts actively** to assure service quality and build monitoring costs into the evaluation of the cost effectiveness of contracting.

- **Bid contracts far enough in advance to allow for a smooth transition** between the government and the private contractor, or between private contractors. Also, where it is practical, phasing in the new provider can help to smooth the transition.

- **Before contracting an activity completely, contract a portion of it to assure the feasibility** without losing the ability to resume the service. In some circumstances, it may also be advisable to contract only a portion of the service at any given time to maintain in-house capacity.

- **Develop comprehensive guidelines or procedures for contracting out.** In addition to the standard steps of contracting — from preparation of Requests for Proposals and contract specifications to contract oversight and evaluation — these guidelines should address the more complex issues of specific conditions under which contracting is or is not undertaken, cost comparisons, and employee union relations.

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906 South Columbia, Suite 350  
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