



## ASSESSING PRIVATIZATION IN STATE AGENCY PROGRAMS

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A continuing issue in government reform is the option of privatizing public services. Privatization is often proposed as a way to improve public services. Proponents claim that privatization can cut government fat, increase employee productivity, and save tax dollars. However, concerns have also been raised that privatization can cost more than it saves, can lead to the loss of public control over government services, and may reduce service quality. Experience has shown that privatization can work well in some cases, produces mixed results in others, and can raise a variety of problems if the process is not well managed.

Privatization in Florida is occurring in a host of public services, ranging from delivery of social services to building roads. A 1998 Senate Government Reform and Oversight Committee study concluded that 30% of state appropriations in Fiscal Year 1997-98 were for purchased services. Privatized activities include road design and maintenance, toll operations, prisons, welfare employment services, and building maintenance. Florida is also outsourcing government programs and services through public-private partnerships. In these partnerships, which are an alternative to full privatization, the private sector and government assume joint responsibility for the design and delivery of public programs and services. For example, in Enterprise Florida, Inc., the state's largest public-private partnership, the private sector is expected to help pay for program operating costs in exchange for significant influence on how the organization operates.

### Why Privatize — Claimed Advantages

There are several potential advantages that can be gained from privatizing certain public services.

- **Cost savings.** Fiscal pressures are the major reason why governments privatize services. In theory, the private sector can perform services at a lower cost than government for several reasons.
  - ◀ **Lower labor costs.** In general, the private sector has lower labor costs than government, primarily due to more limited employee benefits; salaries may be higher. This is particularly true for entry-level positions in areas that are frequently privatized (e.g., custodial and grounds keeping functions).
  - ◀ **Reduced regulatory requirements.** Due to accountability concerns, government agencies have to jump through more hoops than do private sector

firms to get things done. Thus, while an agency must use competitive bids and document its decisions, a private sector firm isn't under the same degree of public scrutiny and can streamline its operations.

- ◀ **Reduced overhead.** Government agencies pay the cost for various support functions (e.g., personnel, legal, fiscal, and management units) in addition to program-related costs. Smaller private contractors may be able to reduce this overhead to lower costs.
- ◀ **More personnel flexibility.** Private sector employers have more flexibility in rewarding, motivating, and terminating their employees than do public agencies, whose employees are subject to career service protection.
- ◀ **Better equipment.** Private firms can adapt to new technologies faster than can public agencies. This is partly due to their ability to invest in equipment or technology on a cash flow basis rather than waiting for an annual appropriation.
- ◀ **Faster reactions to changing conditions.** Private sector providers can react faster to changing situations than can government agencies. For example, private contractors can readily shift money to pay unexpected expenses, where agencies are restricted in their budget transfer authority. Also, private contractors can expand operations faster than can agencies, which must obtain approval to create new positions.
- **Staffing flexibility/obtain needed expertise.** At times, agencies need to obtain specialized expertise. If the need is a one-time or occasional project, it can be more cost-effective to hire a consultant than to place an expert on staff that may not always be needed. Many agencies contract out for architecture, legal, and medical services.
- **Political factors.** Using private experts can lend credibility to certain tasks (such as studying a divisive issue) and reduce the size of government.
- **Shift start-up costs to private sector.** Contracting for a service, particularly capital-intensive ones such as prisons, can avoid the need to appropriate up-front funding for service infrastructure.

## Disadvantages of Privatization

There are also potential disadvantages to privatization that must be considered.

- **Reduced public accountability.** There is less agency control of a function when performed by a private entity. Problems can arise relating to public access to service and financial records maintained by the provider, as well as variations in the quality of services provided to citizens. Also, if the term of the contract is too long, changing conditions can result in the state finding itself locked into a contract that is no longer desirable. Finally, the state's recourse in the event of poor performance may be limited to terminating the contract. This can be problematic if the contract is with a sole-source provider or if no service disruptions can be tolerated. These problems can be addressed through careful crafting of the contract with the provider.
- **Service quality problems.** Contractors may reduce costs by cutting corners. This can include creaming clients (serving only those who don't have many needs) and/or using lower quality materials. In some areas such as maintenance, cutting corners can result in higher costs later to replace poorly maintained equipment more frequently. To address this, the contract must carefully define the contractor's responsibilities, establish service quality performance measures, and include penalties for non-performance. The agency should closely monitor contractor performance and have contingency plans.
- **Higher long-term costs.** Contractors may not be able to provide services at a lower cost than the state. Firms may low-ball their initial bid to get a contract, then substantially increase the cost in subsequent years when the agency no longer has the staff or authority to perform the service. Also, many agencies do not know how much it costs to provide services in-house because their accounting systems do not allocate all direct and indirect (overhead) costs to services. As a result, they can accept a bid price that looks low but is in fact higher than their in-house costs.

These problems can be addressed by carefully assessing agency costs to provide services in-house, including direct and indirect costs. Competition for bids should be maximized through aggressively advertising; in some cases agency staff should be allowed to compete to retain the service. The Request for Proposals that solicits bids for the service can mandate that contractors achieve a specified level of savings, and future price increases can be limited in the contract.

- **Workforce issues.** Privatizing services, particularly if it involves employee layoffs, can cause morale problems or be challenged by unions. Additionally, career service bumping rights could cause disruptions if affected employees assume jobs in other areas. Also, state employees who are members of minority groups generally perform many services that are commonly contracted out, such as maintenance functions. Removing these employees from state payrolls could affect agencies' ability to meet state EEO goals and could be challenged as discriminatory.

These issues can be addressed by considering employee leasing, carefully implement bumping rights, being sensitive to EEO concerns and who gets displaced, and by requiring contractors to guarantee jobs and wages for limited time period.

## Privatization Considerations

When assessing privatization potential, the best candidates are programs where there are clearly defined tasks to be done, good unit cost data can be developed for comparison, good quality and quantity measures are available so that service delivery can be monitored, and private sector service providers already exist.

It must also be recognized that it may be difficult to privatize many state functions. For example, many regulatory programs probably are not good candidates for privatization because they involve the state's police power; issues of fairness and equity are critical in these activities. However, certain aspects of regulatory programs, such as laboratory analysis or legal services, could be privatized.

Finally, it should be recognized that market competition, rather than privatization itself, produces cost savings. Private companies have incentives to reduce their costs to increase profits and market share. Government agencies commonly do not face such competition. However, when agencies have been placed in a competitive situation, they have frequently improved their performance and were able to under-bid private vendors.

In summary, three decisions should be made when considering privatization.

- **Is it appropriate to privatize the service?**
- **Is there reason to believe that privatization saves money or improve service?**
- **Did it work?** After privatization is done, a study should be done to decide whether desired effects were achieved.