



Private Contracts, Public Services: Weighing the Choices

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November 1995

Executive Summary

Contracting with private service providers occurs at all levels of government. Virtually every government service has been contracted out by some governmental entity. Tennessee is no exception, having contracted some areas of government with private providers for many years. For example, Tennessee currently contracts for the collection of child support payments in eight counties, and for design and engineering work for the construction of roads, bridges and buildings. In eight municipalities, private firms manage water and wastewater operations and numerous cities contract for various professional services.

According to the Reason Foundation, state and local governments in the United States currently contract for over \$100 billion in services every year. Many services traditionally provided by governments are now delivered by private enterprises, including prison management, fire management, emergency management services, and wastewater operations.

Cost savings and the ability to hire experts in a particular field are cited as the leading reasons that governments seek private services. A 1990 study by the International City Management Association indicated that 40 percent of local governments have saved more than 20 percent from previous outlays; another 40 percent of local governments saved 10 to 19 percent. Some governments have reported cost savings as high as 40 percent of previous outlays.

But not every state and local government has good news to report about the venture into privatization. From education to transportation, there are stories about how services have deteriorated once in private hands; how private companies were less responsive to citizen needs; and how costs skyrocketed once the initial contract with a contractor expired.

The intent of this report is to provide an understanding of privatization and assist state and local governments in deciding what issues and concerns should be addressed before privatizing services, facilities, or operations. The report also examines some cases in Tennessee where attempts to privatize services have succeeded and failed. A list of questions governments should consider before privatizing services is provided in Appendix A. The report contains the following conclusions:

State and local governments should follow guides, plans, or models that could help them examine the merits of further privatization and determine whether they should contract services. Most privatization efforts are done on a piecemeal, ad hoc basis. As a result, many privatization efforts are unsuccessful because of factors that were not considered before the decision was made to privatize services. If the entities had examined some elementary issues on privatization, some problems could have been avoided or lessened. *(See page 13.)*

Government entities should identify all of their needs and the risks associated with privatization. Governments that do not consider all the

consequences of privatization increase the chances for problems, such as poor service, high prices, and mismanagement. As with any business arrangement, there is a certain amount of risk involved in privatization. Private companies that provide public services will sometimes reduce salaries and benefits to their employees to make a profit or improve their profit margin. Governments need to be aware of this practice and incorporate provisions in the contract to ensure that private businesses bear the full cost of providing a service after the contract is awarded. Also, government entities in Tennessee need to have a clearer understanding of what their costs, needs, and expectations are before deciding to privatize. This information can then be incorporated into a request for proposal (RFP) and the contract. *(See pages 13-14.)*

Government could increase support for privatization by educating affected parties about privatization ventures. Government entities frequently experience internal and external opposition when they are considering privatization. Opponents often view privatization as a threat to existing jobs. If governments address this issue and other issues of concern candidly, resistance to privatization may be lessened. *(See pages 14-15.)*

Government officials should determine the number of qualified contractors to provide a particular service. Before a governmental entity decides to go to the private sector, it needs to have information on the amount of competition or market strength that exists. Governments should invite adequate competition for providing a service to ensure better pricing for a service. *(See pages 15-16.)*

Governments should consider essential elements that need to be included in private contracts. Most occurrences of abuse, fraud, poor service, and mismanagement are a result of poorly constructed contracts. Usually governments enter into contracts only contemplating the bottom line costs and not essential contractual elements, such as assurances, performance standards, monitoring provisions, penalty clauses, contingency plans, staffing patterns, capital depreciation, etc. Each party involved needs to discuss expectations about what the contract should cover before drafting a contract. *(See pages 16-21.)*

Governments should monitor contract performance. Governments that fail to adequately monitor contract performance run the risk of waste, fraud, and poor service delivery. In most cases after the contract is signed, government officials “trust” the contractor to do a good job without setting up periodic reviews to ensure compliance with the contracts. Many state and local governments are understaffed or have few resources to monitor performance. Governments that choose to enter into private contracts often find that tracking performance on how contractors spend money is nearly impossible. In these cases, oversight consists only of self-reporting by contractors. Provisions for monitoring need to be included in all contracts. *(See pages 21-22.)*

Governments should consider all legal constraints before deciding to privatize. If all legal requirements are not considered beforehand, the governmental entity may run the risk of legal challenges that would impede the service from being considered for privatization. Legal requirements set by federal law, state statutes, local ordinances, and charters may hamper or limit privatization efforts. Some local governments in Tennessee are often reticent to contract services if an employee may lose his/her job. Legal constraints may range from statutes that prevent utility districts from selling their systems to those that limit the number of prisons that can be privatized. *(See pages 22-23.)*

Governments should specify the quality and quantity of service they want to maintain once the private company takes over the service. Private companies have a profit motive and will usually cut services to lower costs and increase the profit. Governments need to weigh the costs and potential benefits of various services to meet the required community needs within the available resources. Therefore, they should take steps to ensure that this level of service is specified in any contractual agreement. *(See page 24.)*

Governments should consider how much control they are willing to relinquish to private firms. There is general unwillingness by some government officials to allow a private company to perform a service even when it has been proven to be more cost-effective. Some assume that if a governmental entity does not provide a service with its own employees it has lost control. Governmental employees will react directly to the wishes of the public officials whereas a private producer of services has no motivation to do so. Governments need to address these issues before deciding to privatize. *(See pages 24-25.)*

Governments should examine what resources are required to deliver a service. Local and state governments sometimes lack expert staff and equipment to enforce federal regulations. Often, a government cannot afford a full-time person to perform necessary compliance measures, thus increasing the probability of being fined or sued. Therefore, privatization may be one option to supplement existing staff and budgetary resources. *(See pages 25-26.)*

Governments should consider all costs of privatization. Although government entities are usually aware of the costs associated with providing a service, they seldom prepare detailed cost comparisons to help them make sound decisions on whether to privatize government services. Government officials should also consider the interest and taxes they would save if they were to finance a public project themselves. Persons interviewed for this report agreed that cost comparisons were rarely done unless a service was large and extremely political in nature. Often the cost of providing a service is spread across many accounting categories or merged with other functions making it difficult to determine the true cost. *(See pages 26-29.)*

Recommendations

This report contains several administrative recommendations that might encourage greater success in privatization. *(See pages 35-37.)*

- Governments should follow guides, plans, or models that could help them examine the merits of privatization.
- Governments could decrease opposition to privatization by addressing job security issues and educating affected parties about privatization.
- Government officials need to determine the quality and quantity of service required and what key elements should be included in the contract such as assurances, performance standards, monitoring provisions, penalty clauses, contingency plans, staffing patterns, capital depreciation, etc.
- Government officials need to determine the legal constraints of privatization, and the number of qualified contractors willing to provide a service.
- Governments should compare in-house costs with contracted costs before privatizing services.
- Governmental entities should develop monitoring systems that will ensure compliance with the terms of their contracts.
- All governments should develop a contingency plan in the event a contractor defaults on a contract, and may wish to consider establishing a capital reserve fund or adding a buy-back provision into all contracts.
- Government entities need to specify the quality and quantity of service they want to maintain and how much control they are willing to relinquish to private firms.

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Introduction

Despite the recent emphasis nationally on privatization, Tennessee has contracted with private service providers in some areas for many years. State office buildings from the Capitol to Gateway Plaza have been designed by, constructed by, or leased from private businesses. Since the early 1900s, the state has also contracted out the design and construction of roads and bridges. An official with the Tennessee Department of Transportation estimated that 40 percent of the department's fiscal year 1994-1995 budget was earmarked to design and construct roads and bridges.

Former Governor Ned Ray McWherter touted Tennessee as a leader in privatization, ahead of privatization leaders Vermont and Massachusetts.¹ In the spring of 1994 Tennessee began privatizing food services in its prisons, mental health institutions, state parks, and youth development centers by beginning construction of a central processing kitchen. Private vendors are expected to provide more than 60,000 meals a day to inmates, mental health patients, clients, and visitors when the kitchen is fully operational. The state currently has private contracts for the

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collection of child support payments in eight counties and has privatized the case management of its \$3.4 billion state health care program called TennCare. Presently, there are eight municipalities that contract water and

wastewater operations and numerous cities that have contracted out ambulance services, something that was unheard of a decade ago.²

Contracting out services continues to be common. Findings from a survey conducted by the Mercer Group in 1990 indicated that virtually almost all governments contract out at least one service to a private company.³ The Reason Foundation⁴ estimates that state and local governments currently contract for over \$100 billion in services every year, and that interest in contracting is increasing.⁵

Many services once delivered exclusively by governments are now being contracted out to the private sector. In 1980, no prisons in the United States were operated by private companies. Today there are 73

¹ Gael Stahl, "Governor Touts His Eight Years Of State Gains," *Tennessee Town & City*, July 18, 1994.

² Interview with Edward Young, Associate Executive Director, Tennessee Municipal League, June 2, 1994.

³ Donald F. Kettl, *Sharing Power: Public Governance and Private Markets*, Brookings Institute, Washington, D.C., 1993, pp. 157-158.

⁴ The Reason Foundation is a nonpartisan, nonprofit public policy research and education organization dedicated to advancing the principles of a free society.

⁵ Lawrence Martin, "How to Compare Costs Between In-House and Contracted Services," *Policy Insight*, Reason Foundation, March 1993.

prisons across the nation managed by private companies, and the number of states that plan to privatize prison operations is increasing.⁶

The privatization of infrastructure projects has accelerated with governments searching for new ways to finance public works projects. An annual survey conducted by Public Works Financing in October 1993 found that 115 projects worldwide worth \$58.4 billion had been financed since the mid-1980s.⁷

Privatization appears to be embodied in the Clinton Administration's plan to "reinvent" government. In August 1993, the Washington Bureau News Service reported, "The Clinton administration's plan to reinvent government would force agencies to compete with private companies for much of their work." The article cited examples from a draft of the plan such as: "Hire private collection agencies to recover \$241 billion in back taxes ... owed to the federal government."⁸

The intent of this report is to provide an understanding of privatization and assist governments in deciding what issues and concerns should be addressed when considering privatizing services, facilities, or operations.

Methodology

The findings in the report are based on:

1. Interviews with government officials and private sector business executives with expertise in government services and programs. (See Appendix B for a list of those interviewed.)
2. A review of state statutes, reports, memoranda, and documents from government agencies.
3. Information received from news reports, newspaper clippings, journal articles, books, and literature on problems affecting privatization.

⁶ Charles Thomas, Director of Private Corrections Project, *Biannual Report*, University of Florida, 1993.

⁷ *Public Works Financing*, Annual Survey on Privatization, Westfield, N.J., October 1993.

⁸ Ron Webster, "Boogeying with the Bear," *State Government News*, Council of State Government, February 1994, p. 24.

Understanding Privatization

Definition

Simply put, privatization occurs when government engages private businesses to produce public goods and services, or operate government programs. The definition of privatization of service varies from one person to the next. Government services performed under contract or by formal agreement with private companies are generally considered privatized services. Services performed by private companies without any formal agreement in place are not always perceived as privatization.

Concept of Privatization

The concept of privatization is based on two assumptions. The first is that while government is responsible for setting public policy, it does not have to produce or provide goods and services that the private sector is capable of delivering. Many private companies, for example, are capable of providing trash collection at competitive rates. When this is true, there is no need for government to set up its own trash collection business. However, even persons who embrace this assumption may argue that some government functions should not be privatized, including the operation of correctional facilities, public schools, and other services with a direct bearing on the public's welfare.

The second assumption, which is more controversial, is that private companies can provide services more efficiently than government bureaucracies without a loss in service quality.⁹ Proponents of privatization argue that the public sector is inherently less efficient than the private sector because of the absence of the profit motive, and that government operations are inefficient without the discipline of the market.¹⁰ Moreover, they argue that competition makes the delivery of public services and goods more efficient by setting the level of production, minimizing costs, and regulating quality of services and goods. Critics of privatization argue that private companies will often reduce services or jeopardize the quality of service in an effort to reduce costs and maintain a profit margin. To support this point, critics often cite examples of privatized mass transit systems that have reduced service to maintain profit margins.¹¹ In addition, private companies must pay taxes and higher interest costs not required of the government—costs that will be charged

Simply put, privatization occurs when government engages private businesses to produce public goods and services, or operate government programs.

⁹ International City Management Association, Baseline Date Report, *Trends and Issues in the Use of Intergovernmental Agreements and Privatization in Local Government*, Vol. 21, No. 6, November/December 1989, p. 1.

¹⁰ Jonas Prager, "Contracting Out Government Services: Lessons from the Private Sector," *Public Administration Review*, March/April 1994, p. 179.

¹¹ Robert Kuttner, "Privatization Is Not a Cure-All," *Wall Street Journal*, April 30, 1992, A13.

to the contracting entity. Thus, privatization may or may not provide the benefits touted by many.

Primary Objectives of Privatization

According to an article by John Miller and Christopher Tufts in *American City & County*, there are four main objectives or aims of privatization. The importance of each of these objectives varies according to the circumstances surrounding the decision to privatize a service and the nature of the service.

- The first objective of privatization is to improve the use of scarce resources. This can be done by reducing the cost of providing public services, particularly where private enterprise is strong and government is assured of more effective services at lower costs. This allows government to spend scarce resources on other needed programs or services. Governments that are able to keep costs down are in a better position to prevent an increase in taxes needed to finance public services.
- Second, privatization seeks to modify the role of government from that of a primary producer of goods and services to that of governing. Governments that restrict their role to governing may require fewer employees to provide public services.
- Third, privatization should enable governments to meet responsibilities that might otherwise be abandoned because they are too costly. Many infrastructure projects require large capital outlays that are difficult for municipalities to finance. Private companies may be in a better position than a government to finance a project. Also, governments may be able to pass cost savings on to the public by shifting the responsibility and debt burden of providing a service to the private sector.¹²
- Fourth, governments are often required to perform certain functions when they lack the technical expertise or resources. Privatization allows governments to hire companies with technical expertise for a specific time period.¹³

Forms of Privatization

Privatization typically implies the contracting out of government services to the private sector. However, there are several forms of privatization which include contracts, franchises, grants and subsidies, vouchers, public-private partnerships, and divestitures.

Contracts are agreements that governments enter into with private firms, for-profit or nonprofit firms, to manage a government program, provide services or construct a project with public financial assistance. Contracting out, by far the best known and most widely used form of

¹² However, shifting the debt burden can also increase costs because of taxes and interest required that are not required of governmental entities.

¹³ John Miller and Christopher Tufts, "Creative Management Through Privatization," *American City & County*, September 1988, p. 80.

privatization, offers a great deal of control over the delivery of services. Extensive guidelines have been developed by governments for the procurement of goods and services.¹⁴ A contract may be in the form of a lease, lease-purchase, build-transfer contract, formal contract, or similar agreement. The government determines in the contract what services it will support, at what level, to whom the service will be provided, when the service will be delivered, and how all these specifications will be ensured. In the case of contracting, a government pays a contractor to deliver the service and then monitors the performance of the contractor. Officials may also decide to contract with a single company or, in order to induce more competition, with several companies.¹⁵

The scope of services that are contracted out is very broad. Practically every imaginable service has been contracted out in some community.

The scope of services that are contracted out is very broad. Practically every imaginable service has been contracted out in some community.¹⁶ There are many examples of contract services on both the state and local level, such as the Department of Correction contracting with a private company to manage correctional facilities and local governments contracting for trash collection. Some of the most commonly contracted services in Tennessee include ambulance services, towing services, highway and bridge construction and maintenance, building construction, health care, legal services, architectural services, consulting services, accounting services, and other professional services. Several have always been handled through contracts; others are more recent.

A *franchise* is created when a state or local government determines that only one or a few producers should have the legal right to offer the service in a particular geographic area. This determination is usually made to allow for more efficient delivery of service by restricting competition and allowing a company to capitalize on the benefits of large-scale production.¹⁷

By definition, once the exclusive right to provide a service is granted to a company there is no competition until the franchise period expires.¹⁸ The length of a franchise is largely dependent on the service provided and may vary from one year to more than 30 years. Local governments commonly grant private transit systems franchises to provide transportation services to the public. Cable television, utilities, or towing

¹⁴ Kenneth W. Clarkson, "Privatization at the State and Local Level," ed., Paul W. MacAvoy, W. T. Stanbury, George Yarrow, and Richard J. Zeckhauser, *Privatization and State-Owned Enterprises*, Kluwer Academic Publishers, 1989, p. 169.

¹⁵ *Ibid.*, p. 145.

¹⁶ Lawrence K. Finley, *Public Sector Privatization: Alternative Approaches to Service Delivery*, Quorum Books, 1989, p. 7.

¹⁷ *Ibid.*, p. 7.

¹⁸ *Ibid.*, p. 7.

services are also examples of services for which franchises often exist.¹⁹ In some cases, decision makers must make trade-offs between benefits of competition and public accountability.²⁰ Franchise agreements differ from contracting by requiring that the users pay the contractor directly for providing a service. The government's role is to monitor the franchisee's compliance with the contract. Most governments charge a franchise fee to defray the cost of monitoring.

Grants and subsidies are financial or in-kind contributions to not-for-profit companies to provide government services to consumers. Grants and subsidies, often used for government activities such as public safety, health and human services, and recreation/cultural arts,²¹ are provided to producers to increase supply and may increase usage by lowering costs and prices. Many governments use this form of privatization to support operations of day-care programs, programs for the elderly, and nonprofit health clinics. Local governments often subsidize private recreation/cultural programs for the benefit of all citizens. In Milwaukee, some 400 inner-city students plan to enter private schools with \$2,500 grants from the state of Wisconsin.

Vouchers are used by governments to allow eligible recipients to purchase government services from private firms in the open market. Governments issue vouchers to citizens who need a service. Voucher recipients then select the company from which to buy goods and services using the voucher to partially or fully offset the cost of the service.²² Vouchers are then returned by the seller of a service to the government for payment. An example of the system is the Food Stamp Program implemented by the federal government. Also, World War II veterans were given vouchers under the GI Bill that could be used at any accredited school that would admit them.²³ Local governments have issued vouchers to low-income homeowners or apartment dwellers to help them meet contractors' fees for garbage collection.²⁴

There are advantages and disadvantages to using vouchers. The system allows the user to choose among providers of a service and is effective in stimulating competition among service providers. One criticism of vouchers is that they can reduce the amount of funds available to the government which still has fixed costs for providing a service. For example, vouchers used for education may actually increase the costs of education: first, if they are issued to all children to attend a school of their choice, then presumably they also would be issued to those children already enrolled in

¹⁹ Ibid., p. 7.

²⁰ Ibid., p. 7.

²¹ Clarkson, p.147.

²² Ibid., p. 17.

²³ O'Neill, David, "Voucher Funding of Training: Evidence from the G.I. Bill," *Journal of Human Resources*, v. 12, Fall 1977, pp. 245-255.

²⁴ ICMA, *Service Contracting: A Local Government Guide*, 1992, p. 13.

private schools. Second, the school systems would retain responsibility for maintaining public school buildings and other fixed costs, even though they might lose state and local revenue generated for those children currently enrolled in public schools who choose to enroll in private schools. Another drawback for governments is the difficulty in determining the total cost for vouchers because consumers determine the level of supply for the service and the full cost of the service is borne by the government entity. Also vouchers are only effective when there are numerous providers of a service.

Public-private partnerships are formed when a government conducts a state project with the private sector, sharing resources and the responsibility to make the project a success. This type of privatization is dependent on establishing an on-going, long-term service that requires a considerable degree of effort to implement.²⁵ The advantage of a public-private enterprise is that governments retain control over the operation of a facility or program. A drawback to partnerships is that they often involve expending considerable resources and effort to implement. Public-private partnerships are commonly used to design and operate public infrastructure facilities like water and wastewater treatment facilities.

In the early 1980s, the city of Auburn, Alabama, entered into a public-private partnership agreement with a firm to construct, operate, and own two wastewater treatment plants. The city's decision came after it had been cited for numerous compliance problems with its aging wastewater facilities and after 12 years waiting for a federal construction grant it had little likelihood of receiving. City officials also believed that this partnership could construct the plants at lower costs and could attract private equity.²⁶

Divestiture, more commonly referred to as service shedding, is the most pure form of privatization. Governments no longer interested in providing a service may divest themselves of that service and sell assets used to provide the service. Park and recreation services are often shed to private concerns.²⁷

History of privatization (1920s to 1980s)

A look back through time indicates that privatization is really not such a new concept. In seventeenth-century Britain, taxes in the form of duties were collected by "privateers" who were essentially pirates commissioned by the crown to control the high seas.²⁸ In the United States,

²⁵ Harvey Goldman and Sandra Mokuvos, *The Privatization Book*, Arthur Young, 1984, p. XVI.

²⁶ Environmental Protection Agency, *Public-Private Partnership Case Studies: Profiles of Success in Providing Environmental Services*, Chapter IV, September 1990.

²⁷ Clarkson, p. 150.

²⁸ David Hebb, *Piracy and the English Government, 1616-1642*, Brookfield, Vt.: Ashgate Publishing Company.

privatization predates the U.S. Constitution in the postal service field and was common throughout the nineteenth century.²⁹

1920s In the early part of this century, local governments turned to private companies to operate local street car systems; to collect garbage; to provide fire protection; and to perform other basic services.³⁰ Services weren't always performed without problems. Many contractors were known to overcharge municipalities while others made payoffs and provided poor service to the public.³¹ Only after reports of widespread abuse were documented in the early 1920s did a reform movement begin

Only after reports of widespread abuse were documented in the early 1920s did a reform movement begin to professionalize the delivery of government services. Public workers then began to deliver these services.

to professionalize the delivery of government services. Public workers then began to deliver these services.³² Progressive reformers, worried that corruption was undermining the efficiency and integrity of government, developed formal procedures for government contracts that carefully spelled out what was to be contracted out and the

bidding process to be followed to eliminate favoritism.³³ Efforts were again intensified with the passage of New Deal and Great Society programs to extend services by public servants to a greater number of citizens.

1950s After World War II, the pendulum began to swing towards privatization.

1960s The federal government began to contract out defense projects construction of the interstate highway system, and high technology projects to the private sector. Privatization was further spurred in 1967 when the Bureau of Budget passed Circular A-76, requiring federal agencies to determine how much they were paying for services and to transfer to the private sector activities that could be performed at a lower cost. However, the policy lacked clear instructions and did not state how federal agencies should conduct cost comparisons. Many problems with A-76 were remedied later under both the Carter and Reagan administrations when agencies were required to follow detailed methodologies in conducting cost comparisons and were ordered to follow specific bidding procedures. The revisions to A-76 required federal workers whose work

²⁹ Linda Lamplin, "Contracting Out: Public Employees' Group Contends the Practice has Serious Shortcomings," *American City & County*, February 1984, p. 49.

³⁰ *Ibid.*, p. 49.

³¹ *Ibid.*, p.49.

³² Renee Loth, "Putting Public Work in Private Hands," *Boston Globe*, June 2, 1991, p. 69.

³³ Donald Kettl, "The Myths, Realities, and Challenges of Privatization," *Revitalizing State and Local Public Service*, National Commission on the State and Local Public Service, 1993, p. 248.

could be contracted out to compete against private companies for their jobs.³⁴

1970s In the mid-1970s a surge began in privatization at the local level largely as a result of tax revolts. The most noteworthy revolt was California's referendum on Proposition 13, which sharply limited local governments' ability to raise property taxes.³⁵ Proposition 13 focused on the key issues: government was too big; government was inefficient; government size and inefficiency were rooted in the lack of competition; government monopolies replaced with private competition would improve everything about government.³⁶ Other municipalities passed similar measures that severely restricted the taxing authority of local governments. The tax revolt coupled with runaway inflation and a sharp economic downturn in the late seventies, plus major cuts in federal aid to state and local governments, were all factors.³⁷

The results of Proposition 13 and other tax revolts in the '70s forced state and local governments to question their role as producers of goods and services and whether they should even provide these services. These tax revolts helped make governments more aware of the limits of raising taxes to pay for public services and more accepting of privatizing public services to reduce taxpayers' costs.

The surge of privatization at the local government level is evident in the number of contracts let by local governments. From 1972 to 1982 the value of contracts let nationwide by local governments to private firms tripled from \$22 billion to \$65 billion, after adjustment for inflation.³⁸ Some experts estimate, in fact, that contracting out from 1972 to 1982 grew at the rate of 16 percent per year.³⁹ The renewed interest in privatization also occurred as states began experiencing hard economic times in the late '70s and early '80s and again in the early '90s.

1980s The enactment of the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982 made the privatization of infrastructure projects attractive to the private sector. These acts allowed private companies to depreciate equipment and machinery over five years and structures over fifteen years, half the time

³⁴ Donald Kettl, *Sharing Power: Public Governance and Private Markets*, Brookings Institution, 1993, p. 41.

³⁵ Peter Holmes, "Taking Public Services Private," *Nation's Business*, August 1985, p. 19.

³⁶ Kettl, *Revitalizing State and Local Public Service*, p. 246.

³⁷ Peter Holmes, "Taking Public Services Private," *Nation's Business*, August 1985, p. 19.

³⁸ Donald F. Kettl, *Sharing Power: Public Governance and Private Markets*, The Brookings Institute, Washington, D.C., 1993, p. 156.

³⁹ National Commission for Employment Policy, *Privatization and Public Employees: The Impact of City and County Contracting Out on Government Workers*, Washington, D.C., U.S. Government Printing Office, 1988.

previously allowed.⁴⁰ Along with the accelerated depreciation and tax credit, these acts allowed private companies to deduct interest payments on projects that were financed with debt, which usually encompassed the majority of the total project costs.⁴¹

In the '80s, a basic philosophy behind the Reagan administration was to reduce government spending by allowing the private sector to provide services to the public that were normally reserved for governments.

The Reagan and Bush Administrations made reforms to the A-76 regulations in order to accomplish this objective. The Office of Management and Budget stated these reforms saved the government \$696 million from fiscal years 1981 to 1987 and freed 45,000 federal employees to perform other functions.⁴² Critics, however, stated that savings attributed to A-76 were fleeting and in some cases cost the government more money than if it provided the service itself. The regulation also created serious morale problems among government workers and was criticized as lengthy, slow, and disruptive to government.

In 1986, the Reagan administration dismantled the federal revenue sharing program, thereby eliminating billions of dollars of funds used by state and local governments to finance programs and services. This action touched off a wave of privatization ventures by state and local governments because of their difficulties in financing the growing federal mandates. Also, an Executive Order issued in November 1987 required all federal agencies to identify by April 1988 programs with potential for privatization.

Passage of the 1986 Tax Reform Act also changed the way governments finance public and private projects. In the past, state government entities could issue tax-exempt bonds for public or private development without limit. The Act changed this practice by placing a cap on the volume of tax-exempt bonds that could be issued by a state to be the greater of \$50 per capita or \$150 million within such state during a calendar year.⁴³ Most private activity bonds that are tax-exempt are subject to these volume limitations.⁴⁴ Also under the Act, a municipal obligation is subject to complex arbitrage rebate over its life in order for the bonds to remain tax-exempt.

As a result, this Act has made it more difficult for governments to finance projects than in the past and has encouraged more governments to consider privatization projects financed with taxable bonds.

⁴⁰ Goldman and Mokuvos, pp. 16-17.

⁴¹ Ibid., pp. 16-18.

⁴² Ibid., p. 47.

⁴³ Mudge, Rose, Guthrie, Alexander & Ferdon, *An Analysis of the Tax-Exempt Bond Provisions of the Tax Reform Act of 1986*, October 1986, p. 18.

⁴⁴ Under the 1986 Tax Reform Act, the volume limitation does not apply to the following private activity bonds: 1) qualified 501(c)(3) bonds; 2) veteran mortgage bonds; 3) any exempt facility bonds for airports, docks or wharves; and 4) solid waste disposal facility bonds.

Trends of Government Privatization

A 1992 survey of state governments conducted by Apogee Research⁴⁵ found that 90 percent of state agencies had been involved in some privatization venture and that 85 percent expect privatization to become a major tool in the coming decade.⁴⁶ Over 20 percent of states have or are working on a statewide or agency-wide privatization plan, including California, Maryland, Massachusetts, Michigan, and Mississippi.⁴⁷

Cities have also become more active in privatizing services and projects that were traditionally reserved for government.⁴⁸ The trend can be explained in part by rising health care costs for employees and more federal unfunded mandates placing increasing strain on local budgets.⁴⁹ A 1992 Reason Foundation survey of the 24 largest cities in the United States showed that all of them contract for some municipal services, which indicates that privatization is not a new phenomenon.

Programs most likely to be contracted out are those for which services are readily available in the private market.⁵⁰ A study of more than 1,000 city managers conducted by Touche Ross in 1987 revealed that the most popular areas for privatization are trash collection, building maintenance, car towing and garage services, engineering services, legal services, and medical services, which are all readily available in the private market.

Programs most likely to be contracted out are those for which services are readily available in the private market.

Governments are least likely to contract out programs or services at the core of their mission. Prison management, fire and police protection, code enforcement, emergency communications, child care, education, and housing are all fundamental programs that protect the public health and safety and have not traditionally been privatized.⁵¹

Among the several officials interviewed in Tennessee, there appears to be no definitive answer on the amount of privatization occurring at the local government level, but all agree that every state and local government typically privatizes some government services. Most officials agree that the most commonly privatized services are natural gas services, building and

⁴⁵ Apogee Research, based in Washington, D.C., is an independent, non-profit organization devoted to research in public affairs. Its purpose is to aid in the development of sound public policy and promote understanding of issues of national importance.

⁴⁶ Reason Foundation, *Seventh Annual Report on Privatization 1993*, p. 5.

⁴⁷ *Ibid.*, p.5.

⁴⁸ Yolanda Kodrzycki, "Privatization of Local Public Services: Lessons for New England," *New England Economic Review*, May/June 1994, p. 35.

⁴⁹ Reason Foundation, *Privatization 1994*, p. 5.

⁵⁰ Kettl, *Revitalizing State and Local Public Service*, p. 250.

⁵¹ *Ibid.*, p.250.

school maintenance, solid waste management, health care services, maintenance of parks and public golf courses, construction monitoring, school psychological services, accounting services, trash collection, building and maintenance of roads and bridges, and building construction.

Analysis and Conclusions

Elements of Privatization

Few states or local governments follow any guides, plans, or models that could help them examine the merits of privatization. Most privatization efforts are done on a piecemeal, ad hoc basis. As a result, many privatization efforts by state and local governments have been affected by problems that were not considered before the decision to privatize services was made. If public sector entities had examined some elementary issues prior to privatizing services, some problems could have been avoided or lessened. For example, in the course of several years, Tennessee has purchased similar social services for several health centers across Tennessee that varied widely in unit costs. If the state had developed a plan or guidelines for purchase of contract services, costs for similar services might have been lower and more uniform across the state.⁵²

Many privatization efforts by state and local governments have been affected by problems that were not considered before the decision to privatize services was made.

While researching this report, staff reviewed literature about privatization and interviewed persons in both the public and private sectors. Both sources of research indicated several elements that public sector entities should examine before privatizing functions or services: the identification of needs and risks, sources of opposition, market strength, contracts, monitoring, legal considerations, quality of service, control and accountability, resources, and cost efficiency.

In each section below, these factors are discussed along with how governments should manage risk and overcome obstacles, as well as opinions of officials and case studies on privatization. A consolidated list of questions that government entities should consider before privatizing services is in Appendix A.

Identification of Needs and Risks

A governmental entity that is considering contracting out services or entering into public/private partnership should begin by identifying its needs, so this information can be incorporated into a request for proposal (RFP) and the final contract. Much of this information can be gathered from government policies and procedures, regulations, job descriptions, and employees and supervisors who are currently performing the tasks being considered for privatization. These answers will define what quality of service is needed and what is expected of the service providers, whether they are civil servants or private sector employees.

As with any business arrangement, there is a certain amount of risk involved in privatization. Private businesses that provide public services can

⁵² Interview with Charles Harrison, Assistant to the Comptroller for Management Services, Comptroller of the Treasury, June 29, 1994.

suffer from the same problems that sometimes occur in public sector institutions: poor service, high prices, and corruption.⁵³ As a result, governments that do not consider all the consequences of privatization may not improve their results simply by privatizing services.⁵⁴ Private companies that provide public services may reduce salaries and benefits to their employees in order to break even or to improve their profit margin.

Governments that do not consider all the consequences of privatization may not improve their results simply by privatizing services.

Governments need to be aware of this practice and incorporate provisions in the contract to ensure costs of providing a service are not shifted to the government after a contract is awarded. But, risk can be minimized by clearly defining all liability in contractual agreements, identifying legal constraints and responsibilities, costs, and setting performance standards for the involved parties before privatizing functions. These assurances will not eliminate all future problems, but they will provide each party with a clear understanding of what is expected of them and help protect the community from financial burdens and ineffective service delivery. (See identification of risks and needs section in Appendix A on page 38.)

Sources of Opposition

As in any new approach to changing the delivery of public services, individual reactions to privatization range from approval or skepticism to outright opposition.⁵⁵ Resistance can come from the public, users of public services, interest groups, unions, and public officials.

Strong opposition to privatization frequently arises from public employees whose jobs appear to be at risk. The mere perception of jobs being eliminated is enough to initiate staunch opposition to any privatization proposal. For this reason, it is often in the best interest of governments to safeguard employee incomes or find employment for displaced workers in other departments or with the private company. Private companies interested in reducing staffing levels can do so through attrition or can offer employees incentives to terminate their employment with the company.

Professional Services Group, Inc., a private company that operates water and wastewater treatment plants for several municipalities in Tennessee, has managed to circumvent this opposition by agreeing not to displace any employees when they are awarded a contract. The company maintains in its contracts that all former employees of a facility will be

⁵³ Albert Shanker, "The Pros and Cons of Privatization: A Pragmatic View," *New York Times*, March 15, 1992.

⁵⁴ Jeffrey L. Katz, "Privatizing Without Tears," *Governing*, June 1991, p. 38.

⁵⁵ Paul W. MacAvoy, W.T. Stanbury, George Yarrow, and Richard J. Zeckhauser, *Privatization and State-Owned Enterprises*, Rochester Studies in Managerial Economics and Policy, 1989, p. 176.

given the option to work for PSG at their present salary. Staff reductions are usually achieved through attrition.

Generally, the most outspoken critics of privatization are persons who are not informed about privatization and its potential benefits.⁵⁶ For some communities, privatization may be completely new and there may be a lack of understanding about the concept. When this occurs it is essential that a community become educated about the potential benefits of privatization, if it is expected to succeed. Public officials more willingly support privatization if they believe these activities are supported by their constituencies.⁵⁷

A case in 1985 illustrates the fear that privatization invokes in persons who are not informed about the issue. The case involved a private company, Rural/Metro, that sought to provide fire services to a community of about 25,000 in Florida. Rural/Metro was contacted by the city officials following failure of prolonged negotiations with the city's union fire department.⁵⁸ The city firefighters union responded to the news that the city was considering contracting out this service to a private company by protesting in front of city hall and launching a petition drive to amend the city charter not to allow privatization of emergency services. Though the union was unsuccessful in its petition drive, it did succeed in instilling fear in the community. Union officials charged that if a private company received the bid, fire losses would increase, some services would cost more, the private company would use inexperienced personnel, and public safety would be threatened.⁵⁹

In response to the negative advertising and protests by the firefighter's union, Rural/Metro ran several advertisements to educate the community about the benefits of privatization and held a press conference to answer citizens' questions. Though Rural/Metro did not receive the final contract, the community became more receptive to the idea of contracting out the service.

Often the timing of privatization will affect the level of opposition to privatizing services. An event such as an election may raise concerns about privatization efforts. When this happens, it is generally advantageous to postpone privatization efforts until there is less opposition to privatizing services. (See opposition section in Appendix A on page 38.)

Market Strength

Before work begins on a contract, government officials need to determine the number of contractors in the marketplace qualified to provide a particular service. This information will reveal the amount of

⁵⁶ MacAvoy, et al., p. 177.

⁵⁷ Goldman and Mokuvos, p. 122.

⁵⁸ Lawrence K. Finley, *Public Sector Privatization: Alternative Approaches to Service Delivery*, Quorum Books, 1989, p. 86.

⁵⁹ *Ibid.*, p. 86.

competition or market strength that exists and help officials determine if a service should be privatized. Without adequate competition, there is often no point in proceeding with contract planning.⁶⁰

As a general rule, the more private companies that are interested in providing a service, the greater the chance these firms will have the necessary qualifications and cost savings will be passed on to the government.⁶¹ In the case of trash collection, market strength is high, and most local governments that privatize this service experience significant cost savings.⁶² Conversely, there are few firms interested in managing public schools in Tennessee and these firms are new to the business. As a result, the market strength for this service is very weak and there is much uncertainty as to whether these firms would save governments money while providing quality education in public schools. Metropolitan Nashville Education Association President Brent Hurst stated in the *Nashville Business Journal* that only one company had proposed to operate a public school in Nashville and it had no track record.⁶³ (See market strength section in Appendix A on page 38.)

Contracts

Developing a contract is the most important factor in ensuring that governments and private companies will honor their commitments. A

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contract is a legally binding agreement between two parties stating the terms and conditions of providing a service or task. The contract is the only document that governs performance and price during the term of the contract. No oral or written communication between the contractor and the government will affect performance or

price unless incorporated into the contract.⁶⁴

Governments that privatize services without reflecting first on what should be included in a contract are more susceptible to problems and misunderstandings with contractors. The contract is designed to limit the occurrence of problems by specifying what is expected of each party and the risks each will assume before a service is provided. Sharon Rollins, senior public works consultant for Municipal Technical Advisory Service, noted that the first mistake most local governments commit is failing to

⁶⁰ International City Management Association, *Service Contracting*, 1994, p. 7.

⁶¹ Jonas Prager, "Contracting Out Government Services: Lessons from the Private Sector," *Public Administration Review*, p. 181.

⁶² Interview with Randall Williams, Senior Consultant for Municipal Technical Advisory Service, May 24, 1994.

⁶³ Rhonnda Kerr, "Privatization: Panacea or Pandora's Box," *Nashville Business Journal*, February 7-11, 1994, p. 37.

⁶⁴ International City Management Association, *Service Contracting*, 1994, p. 126.

take the initiative to draft the contract.⁶⁵ Instead, the contractor usually drafts the contract, thereby placing him/herself in an advantageous position.⁶⁶ Governments should take the initiative to draft the contract before negotiating with a contractor to provide a service.⁶⁷ This practice will ensure that the contractual agreement is tailored to meet the needs of the government and is not designed solely to benefit a contractor.

Most occurrences of abuse, fraud, poor service, and mismanagement are a result of poorly constructed contracts. It is important that governments develop contracts that are not open to interpretation by contractors and do not contain ambiguous wording. Problems can result when two parties fail to communicate the important elements that need to be in a contract. For example, the Tennessee Department of Youth Development agreed to contract out operations of a youth detention center in Dandridge, Tennessee, in 1990. The contract did not contain a comprehensive discussion of how performance and service quality were to be measured, specific statements regarding expectations of staffing and programs, or adequate enforcement mechanisms.⁶⁸ When the private company operating the facility was cited with numerous contract violations, company administrators responded that they were under no obligation in the contract to meet state policy guidelines. Moreover, the state was unable to take disciplinary action against the company short of terminating the contract.

Most occurrences of abuse, fraud, poor service, and mismanagement are the result of poorly constructed contracts.

Generally, all contracts should contain the following elements: scope of work; assurances; performance standards; incentives; penalties; contract costs; and details of a contingency plan.

Scope of Work—A well-constructed contract should specify the terms and scope of work to be rendered by the contractor. This section of the contract should contain a list of all responsibilities of the contractor, activities the contractor is expected to engage in, a list of products to be produced, and a timetable for completion of all activities. The section should also include a complete list of the activities and responsibilities required of the government, and both the effective date and expiration date of the contract.

Assurances—A government should require that a private firm maintain an insurance policy to guard against cost overruns, contract suspensions, unforeseen site problems, and natural catastrophes. If a government enters

⁶⁵ Interview with Sharon Rollins, Consultant for Municipal Technical Advisory Service, July 28, 1994.

⁶⁶ Ibid.

⁶⁷ Ibid.

⁶⁸ Memorandum to William Snodgrass, Comptroller of the Treasury, from the Division of State Audit, May 1994.

into a public/private enterprise to finance a wastewater treatment plant, the contract should stipulate that the government retains the right to review and change any project designs. A contract should also identify the corrective actions that can be taken when a private company is found in noncompliance with the contract. Governments may wish to incorporate provisions in the contract requiring the contractor to provide relevant operational data and ensure the validity of the data provided.

Performance Standards—Performance standards are established by governments to evaluate the quality and quantity of service provided by a private company. The standards are used to ensure the successful operation and delivery of a service. When establishing performance standards, a government should adopt a specific range of acceptable performance. Too often a government will adopt a zero-mistake standard that is impossible for a contractor to meet. As a result, both sides to the contract believe the other party is being unreasonable, which may lead to a termination of the contract.

Incentives—The use of incentives is one of the most effective methods of inducing a contractor to perform a desired service. Governments that offer incentives usually do so to reward contractors for quality service or work, for the completion of a project ahead of schedule, or for saving the government money. According to Pat Weiland, Director of the Office of Compliance for the Department of Correction, incentives are invaluable tools for strengthening contracts. Ideally, incentives should be high enough to reward good performance. Incentives that are not high enough provide little inducement for a private company to perform beyond normal expectations.

Governments that develop incentive provisions in contracts must first determine what constitutes superior performance. Contractors that achieve this level of work may be paid on a percentage basis for good performance or on a lump sum basis.

In the spring of 1994, Los Angeles was shaken by an earthquake that caused massive amounts of damage and required government officials to close the Santa Monica Freeway to commuters for repairs. In an effort to complete freeway construction early, government officials included incentives in contracts awarded to contractors. Contractors were offered monetary compensation for every day they completed construction ahead of schedule. As a result of these incentives, the contractors completed construction three months ahead of schedule.

Contracts with renewal clauses also provide incentives to contractors to invest in equipment and provide quality services.⁶⁹ Contractors may be reluctant to invest in expensive equipment or additional manpower when there is no guarantee that they will provide this service in

⁶⁹ Interview with Randall Williams, Senior Consultant for Municipal Technical Advisory Service on May 24, 1994.

the future. Edward Young, associate executive director for the Tennessee Municipal League, stated that local governments cannot expect contractors to invest heavily in equipment and resources if there is no certainty that they will provide services in the future. Contractors expect this guarantee to come either by inclusion of a renewal clause in the contract or extension of the length of a contract to cover any start-up expenses and capital costs.

Penalties—Penalties written into a contract provide government entities with the ability to take disciplinary action against a company that fails to comply with contract terms. Generally, the threat of a penalty is sufficient to encourage a contractor to improve performance or comply with the terms. But, governments should stand ready to impose financial penalties if a problem is not corrected after sufficient notification is given to the contractor.

The most common penalty imposed by governments on contractors is liquidation damages. When a contractor's performance is not acceptable and the government is overpaying for the service, the government is entitled to receive compensation for the loss. Liquidation damage quantifies the loss to the government and is usually deducted from the next payment to the contractor. The penalty is usually based on a formula stated in the contract, and for each day of noncompliance the amount paid to the contractor is reduced by that amount.

Floyd Clift, director of Property Services for the Tennessee Department of General Services, indicated that liquidated damages are the most effective way to encourage contractors to comply with contract terms and improve performance. He stated that in 1994 his office withheld payment to two janitorial companies that did not meet minimum performance standards in their contracts. Both of these companies are now in compliance with the terms of their contracts.

Another penalty that is effective but more severe is partial takeover of operations. This allows the state to take over that part of the facility's operations found in noncompliance and charge the cost of operating this area against the amount paid to the contractor.

Finally, governments may terminate a contract with a contractor who fails to comply with terms of the contract. This penalty is used only as a last resort, when a contractor has been warned repeatedly about noncompliance with contract terms, and requires parties to the contract to sever the contractual arrangement.

Contract Costs—Many contracts involve several different types of prices for contractors' services. All prices should be included in the contract and

should be described in terms of how and when they will be paid to the contractor. Most contracts begin with a base contract price that states the cost of the total contract or the first year of the contract. Otherwise, the base contract cost is expressed in terms of cost per unit of service delivered during the contract term. Governments that negotiate multi-year contracts should also list the cost that will be paid to the contractor for each year. A common practice for multi-year contracts is to tie the costs paid to contractors to the inflation rate or consumer price index. Costs for providing additional services or approved reimbursement services also should be clearly stated in unit costs or as a lump sum.

Contingency Plan—The importance of a contingency plan is often overlooked by governments that privatize services, though developing such a plan is rather simple. Governments without contingency plans in place risk interruption of services when contractors default on their obligations, and may pay additional costs for taking back services.

A number of options are available for a default contingency plan:

Governments without contingency plans in place risk interruption of services when contractors default on their obligations, and may pay additional costs for taking back services.

contracting with the next lowest bidder from the original solicitation; using another current contractor; in-house delivery of the service; and intergovernmental contracting.⁷⁰ The International City Management Association recommends that at least two possible courses of action be included in any default contingency plan, allowing a government to

implement the option that best suits its needs at the time of the default.⁷¹

To a large degree, the contracting environment and resources available to a government will dictate what options may be used if a contract is terminated. Many governments with limited resources (personnel, equipment, and supplies) will contract with the next lowest bidder of the original solicitation. This option is best used when the next lowest contractor is well-qualified to provide the service. Governments that use this option should have a backup contract with the next lowest bidder at the time the original contract is awarded. This option allows a government to award a contract to another firm at a pre-determined price without having to go through the time-consuming bidding process a second time.

In other cases, governments may elect to use current contractors to absorb the additional work. This option allows a government to avoid having to rebid a contract on short notice. Some governments will opt to take over operations or delivery of a service after a contract is terminated. This option requires governments to have sufficient personnel and equipment to provide the service. Also, a government may sign an

⁷⁰ International City Management Association, *Service Contracting*, 1994, p.174.

⁷¹ *Ibid.*

intergovernmental agreement with a neighboring government to provide a service until it can be bid out.

An example of what may happen if a contingency plan is not developed recently occurred in Kentucky. The state contracted with a private company to build and operate a 500-bed correctional facility. From the time the private company began operations, it has been cited with numerous contract violations and has been penalized repeatedly for not correcting the problems. Though these violations continue to occur, the state has chosen not to terminate the contract because it does not have an alternative plan in place for housing the inmates since the facility is owned by the contractor.⁷²

In 1993, the State of Tennessee awarded the Marriott Food Services Corporation a contract to provide food to 20 correctional facilities, mental health institutions, special schools, and state parks in Tennessee. The contract stipulated that the food would be prepared, refrigerated, and transported to these facilities. The signed contract contained a contingency plan that allows for the headquarters in New York to ship quantities of food to these facilities in the event that the central quick/chill processing center located in Tennessee is unexpectedly closed for operation. (See contract section in Appendix A on page 39.)

To ensure that performance is satisfactory, governments should develop a system that provides needed information without interfering with contractors' work.

Monitoring

Contractors sometimes protect their own interests by selectively reporting good news and hiding bad news from government officials.⁷³ This hinders government officials from fully knowing contractors' performance and makes it imperative that a monitoring system be developed.

To ensure that performance is satisfactory, governments should develop a system that provides needed information without interfering with contractors' work. The system should be agreed to before a contractor begins. Governments that fail to adequately monitor contract performance risk mismanagement, waste, fraud, and poor service delivery by contractors.

The contract should stipulate that the contractor will provide information on a monthly or quarterly basis to determine if performance standards have been met. Also, government officials should conduct random inspections of contractor records and the delivery of services to ensure all terms of the contract are being fulfilled. Randall Williams, senior management consultant for Municipal Technical Advisory Service, cautions governments on monitoring haphazardly. He recommends that monitoring

⁷² Interview with Pat Weiland, Office of Compliance, Tennessee Department of Correction, September 8, 1994.

⁷³ Kettl, *Sharing Power: Public Governance and Private Markets*, p. 29.

be done on a continuous basis and that it involve the collection of information useful for determining the quality of service provided. Governments that fail to continuously monitor contractors' performance may allow problems to persist and may send signals to contractors that poor performance is permissible.

Regularly scheduled meetings between all parties of a contract can provide feedback to contractors and improve rapport between all parties of the contract. These meetings are useful for discussing actions contractors have taken to remedy noncompliance with a contract, whether the contract should be modified, and penalties for noncompliance. Williams perceives regularly scheduled meetings with contractors as an opportunity to address problems early and build good relationships with contractors so they are comfortable in allowing officials to examine operations.

Problems between the Corrections Corporation of America, which operates the South Central Corrections Facility, and the Tennessee Department of Correction began to surface shortly after the facility opened because few monitoring provisions were incorporated into the contract. It was years later that the problems were addressed and both parties came to some agreement.⁷⁴ The Mountain View Youth Development Center in Dandridge, Tennessee, experienced a similar fate. The contract between the management firm, CCA, and the Department of Youth Development failed to include provisions necessary to monitor operations. As a result, the state was never able to obtain all the information needed on the operations of the detention center and CCA was under no obligation to provide the information.⁷⁵ (See Mountain View Youth Development Center Case Study on page 30.)

Legal Considerations

Before a governmental entity decides to contract out a service, the entity needs to determine if there are any legal challenges that may hinder or prevent a private company from taking over the service. Some legal constraints are the result of past problems and are in place to protect governmental entities from future liability issues. Government is charged with delivering a number of services in a particular manner by law and this must be taken into account even if it is determined that costs may be lower when performed by a private company.

Legal requirements are set by federal law, state statutes, and local ordinances and charters. At the federal level, legal stipulations range from requiring contractors to pay the prevailing market rate to requiring the use of minority contractors. However, in Tennessee, some legal constraints could pose real problems.⁷⁶ These legal challenges to privatization range

⁷⁴ Interview with Jeff Reynolds, former Commissioner the Department of Correction, June 22, 1994.

⁷⁵ Interview with Randy Griggs, Assistant Commissioner for Department of Youth Development, June 13, 1994.

⁷⁶ Ibid.

from a Tennessee Supreme Court ruling⁷⁷ that forbids utility districts from transferring all assets to a private company to laws that limit the number of prisons that may be privatized. The utility district ruling is further supported by Attorney General Opinion 94-066, which states “...that a public utility district established under the Utility District Law may not sell all its assets to a private company and go out of business, regardless of how it disposes of the proceeds.”⁷⁸

The success of privatization hinges, in part, on the legal environment. At all levels of government, legal constraints may conflict with privatization efforts. Private firms, however, are not bound by state laws that require them to purchase parts and supplies on contract but may purchase any item from a local retail store. Before a service is considered for privatization, a government should determine any barriers that exist.

In the area of corrections, the former Attorney General Michael Cody opined that the custody and control of inmates is a sovereign power of the state and thereby cannot be divested. He cites *Newman v. Alabama*⁷⁹ in which the U.S. Supreme Court stated,

The power to restrict the liberty of persons who commit crimes must be considered an essential attribute of sovereignty, for it deals with the ability of the sovereign to enforce its rules of conduct. It is therefore a responsibility which the state cannot divest by contract.⁸⁰

In a 1987 publication Cody states, “This principle does not forbid private companies to operate private correctional facilities, but it does limit how far the state may go in divesting itself of the responsibility of caring for inmates.”⁸¹ *Tennessee Code Annotated* §41-24-103 states that only one medium or minimum state correctional facility can be operated by a private contractor.

In Tennessee, most local constraints do not pose a problem to privatization and are easier to overcome than those imposed by state and federal governments. Local governments who are interested in pursuing privatization may repeal these ordinances or request a public act be considered by the legislature that supersedes any local ordinance or provision in a city charter. (See legal considerations section in Appendix A on page 39.)

⁷⁷ *United Cities Gas Company v. Wington*, 815 S.W.2d 506 (Tenn. 1991)

⁷⁸ Attorney General Opinion, 94-066.

⁷⁹ 98 S. Ct. 3144, 57 L. Ed. 2d 1160 (1978) cited in Attorney General Opinion 85-286.

⁸⁰ Attorney General Opinion 85-286 and Memorandum concerning privatization of prisons in Tennessee to Governor Alexander from Michael Cody, Attorney General and Reporter, October 18, 1985, pp. 7-8.

⁸¹ W.J. Michael Cody and Andy D. Bennett, *The Privatization of Correctional Institutions: The Tennessee Experience*, January 1987, p.29.

Quality of Service

Like any organization, government places a value on the quality of service. Any compromise in the delivery of a service can have far-reaching implications and can potentially harm the public, which it is entrusted to protect. For these reasons, it is important that governments specify quality standards in the contracts they negotiate.

It is difficult to specify quality standards that should be provided. The quality of a service is affected by many elements: frequency of service, thoroughness, timeliness of response to requests for service, and error rate.

Private companies generally have more latitude than government agencies in tailoring and defining public programs or activities in accordance to each consumer's preferences. The ability to customize services to consumer preferences may allow private companies to achieve better performance in the delivery of goods or services. In markets where competition exists, private firms are compelled to adapt swiftly to market conditions or risk losing future business. Governments do not have as much latitude to tailor programs to improve performance. As a result, the rate of innovation in public operations is much lower, and public services appear to change slowly over time.⁸²

Conversely, contractors in an effort to minimize costs sometimes hire inexperienced workers at low wages, ignore contract requirements, or provide inadequate supervision, which can result in poor services to the targeted population.⁸³ After the Tennessee Department of Youth Development agreed to contract out operations of a youth detention center in Dandridge, Tennessee, in 1990, the company operating the facility

Government is accountable to its citizenry to provide basic services and protect its welfare and resources.

was cited with several contract violations. The company did not provide adequate supervision to students and hired inexperienced workers at below market wages, resulting in poor quality of service. (See quality of service section in Appendix A on page 39.)

Control & Accountability

Government is accountable to its citizenry to provide basic services and protect its welfare and resources. Though some services, such as street sweeping, do not require a great deal of oversight, other functions, like educating children, require more oversight and control by governments. As a general rule, the more control and accountability required by a government to perform a service, the less appealing the service will be for privatization.

In some cases, local governments are reluctant to allow a private company to perform a service even if it has been proven that it will be more cost-effective. There is an assumption that if a governmental unit does not

⁸² Dr. Madsen Pirie, *Privatization*, Wildwood House, 1988, pp. 27-28.

⁸³ Lamplin, p. 50.

perform the service with its own employees it has lost control. Governmental employees will react directly to the wishes of public officials whereas a private producer of services has no motivation to do so.⁸⁴

Contractors are also accountable to the government to provide quality work. Governments have the option of imposing sanctions or terminating the contract with contractors who fail to perform in accordance with pre-determined performance measures. Governments may also reduce their level of risk by requiring that a service contractor maintain sufficient insurance coverage to protect the government against damages or injuries arising from a contractor's negligence. Another method of making a contractor more accountable to a government is to require contractors to post performance bonds. If a contractor fails to perform, then a government may appeal to the surety company for compensation. (See control and accountability section in Appendix A on pages 40.)

Resources

Often governments must perform certain functions when they do not have the technical expertise or resources at their disposal.⁸⁵ This may happen when a government has a hiring freeze in place and must meet a deadline, or must assume a task beyond the capability of its staff. Water and wastewater operations are usually privatized not because of the cost savings to a government, but because governments do not have the necessary technical expertise and often have trouble meeting environmental regulations.⁸⁶

Operating water and wastewater plants requires highly technical staff familiar with treatment policies, environmental regulations, and accounting practices. Finding and retaining operators who possess essential personnel and financial management skills and are qualified to deal with increasing technical and regulatory complexity can be difficult. This is particularly true of smaller systems that are staffed by a limited number of trained operators.⁸⁷ As a result, cities that have difficulty staffing water and wastewater plants often have little choice but to contract out operations to a private company with an experienced staff.

Privatization works exceptionally well in the application of new technology to improve service. For example, on January 1, 1994, Maryland's Motor Vehicle Administration hired a private firm to

⁸⁴ Finley, p. 49.

⁸⁵ Keon S. Chi, "Privatization and Contracting for State Services: A Guide," *Innovations*, The Council of State Governments, 1988, p.3.

⁸⁶ Interview with Sharon Rollins, Consultant, Municipal Technical Advisory Service, July 28, 1994.

⁸⁷ Frank Mangravite and Patrick Moffitt, "A Privatization How-To," *American City & County*, March 1993.

implement a digital imaging driver's license system. The bearer's photograph and signature are digitized and electronically stored, and can be retrieved by the State Motor Vehicle Administration office and by law enforcement agencies.⁸⁸

Privatization often works best when governments contract for professional services that are needed only for a short time, on an irregular basis, or when governments do not have the staff to provide a service. For example, the Tennessee Department of Human Services contracted out the collection of child support payments in Bradley County when the county district attorney's office was unable to handle the backlog of pending cases. The Department of Human Services stated it could not provide additional personnel to the county district attorney's office, so it was agreed that the service, paid for by the department, should be contracted out to a private provider.⁸⁹ (See section on Child Support Services on page 31.)

Sometimes, however, governments may not have the capital to underwrite public projects. In those cases, the formation of a public-private partnership can help governments avoid having to commit large amounts of capital to finance public projects. Private companies can provide the needed capital and financial expertise to governments, though the cost of this service may be higher because of interest and taxes on privately financed projects. Gatlinburg city officials privatized construction and operation of a wastewater treatment plant to avoid having to commit large amounts of capital to finance the project and because the city lacked a staff with the necessary technical expertise to operate the plant.⁹⁰ (See resources section in Appendix A on page 40.)

Cost Efficiency

Although there are many considerations that enter into the decision to privatize services, cost is unquestionably among the most important.⁹¹ Governments are generally unwilling to risk a change in service delivery unless they can expect to save money. In 1992 state officials announced that Tennessee would not accept bids from private companies to operate a state correctional facility unless they could provide equal or superior service at a lower cost than the government.

Factors related to costs will also influence government officials' decisions to privatize a service. Local governments that operate water and wastewater facilities found in noncompliance with environmental

⁸⁸ Ibid., p. 29

⁸⁹ Interview with Joyce McClaran, Director of Child Support Services, Department of Human Services, July 15, 1994.

⁹⁰ Interview with Sharon Rollins, Consultant, Municipal Technical Advisory Service, July 28, 1994.

⁹¹ Lawrence Martin, "How to Compare Costs Between In-House and Contracted Services," *Policy Insight*, Reason Foundation, March 1993.

regulations often privatize operations to avoid paying future penalties for noncompliance.⁹²

Many governments that have contracted out operations have reported significant cost savings.⁹³ A 1990 ICMA survey indicated that 40 percent of local governments have saved more than 20 percent from previous outlays; another 40 percent saved 10 to 19 percent.⁹⁴ Some governments have reported cost savings as high as 40 percent of previous outlays.

Private companies often can provide a service at much lower cost than the public sector because private firms have more flexibility to reduce staff size to optimal levels; can pay lower market wages; provide fewer benefits; and are more inclined to employ technology to reduce the size of staffing. Conversely, the Davis-Bacon Act requires contractors who work on projects funded by federal dollars to receive prevailing, market wages. In Tennessee, the state also pays prevailing wages to contractors as required by T.C.A. §12-4-401 et. seq. By privatizing a public service, governments, in effect, circumvent their own prevailing wage laws and are not required to pay market wages or benefits to laborers, thereby lowering their costs for providing a service. This practice raises important public policy questions.

Often, it is difficult for government officials to determine the real cost of providing a service. Some activities such as payroll and personnel hiring are provided by other departments and are not considered when estimating the cost of providing a service in-house. Although these services will be provided regardless of whether a service is contracted out, it is important to include these costs in a true comparison between providers of a service. Also, governments fail to consider costs associated with contracted services, such as contract administration and performance monitoring. For these reasons, it is important that government officials take care in calculating these costs, so as not to skew the results of the cost analysis.

Although private sector contracts may appear to be less expensive, the cost of administration, training, supervision, and capital depreciation can make contracting for services more expensive.

Although private sector contracts may appear to be less expensive, the cost of administration, training, supervision, and capital depreciation can make contracting for services more expensive.⁹⁵ Because these costs are usually hidden, they are often overlooked when governments consider privatizing services or facilities. Other hidden costs include health,

⁹² Interview with Ken Baker, Regional Manager of Quality Assurance for Professional Services Group, Inc., September 9, 1994.

⁹³ Kettl, *Sharing Power: Public Governance and Private Markets*, p.160.

⁹⁴ *Ibid.*, p.160.

⁹⁵ Legislative Audit Bureau, State of Wisconsin, *An Evaluation of Privatization of Government Services*, June 1990, p. 7.

retirement, and other benefits that private sector businesses do not provide to their workers. For example, Los Angeles County hired a private firm to provide janitorial services to its county hospitals with the understanding that its own janitors would be hired by the firm. Once the firm took over cleaning tasks, it cut janitorial wages to half of what the county paid and eliminated all fringe benefits to staff. In the end, the responsibility of providing health care to these workers returned to the taxpayers, diminishing cost savings to the government.⁹⁶

Some businesses engage in a practice called low-balling that drives costs up for delivering public services. The practice occurs when private firms offer a low bid to receive government contracts and then raise their prices shortly after beginning operations. Other times, contractors will raise the price for providing services to a municipality after a city has sold off the equipment it would need to perform this service. For these reasons, it is important that all costs be considered before a service is privatized. In some instances, a government may determine it can provide a service for less than the private sector.

Although government entities are usually aware of the costs associated with providing a service, they seldom prepare detailed cost comparisons to help them make sound decisions on whether to privatize government services. Persons interviewed for this report agreed that cost comparisons were rarely done unless a service was large and extremely political in nature. When the State of Tennessee considered privatizing food service in correctional facilities, mental health facilities, and special schools and parks, the Department of Finance and Administration hired a consultant to determine the estimated cost savings because of the political nature and enormous size of the contract. As a result of the study, the department awarded contracts to private vendors to provide all food service to these institutions.

Before a government privatizes services, it should prepare a detailed cost analysis to determine if the private sector can provide a service for less than the public sector. An analysis should begin by identifying in-house expenses to deliver a certain service. These might include:

- Salaries and other personnel expenses
- Equipment outlays
- Services and supplies

Contracting costs should be comparable to in-house expenses. In addition, the cost of monitoring the contract and other relevant costs need to be considered. These expenses are:

- Bid preparation
- Staff training

⁹⁶ Harry Bernstein, "Privatization Can Hurt More Than Help," *Los Angeles Times*, August 6, 1991, p. D3.

-
- Monitoring system development
 - Unemployment liability
 - Continued health insurance
 - Leave benefits payout
 - Depreciation write-off
 - Sale of surplus property

(See detailed costs analysis section in Appendix A on pages 40-41.)

Case Studies

As contractors and services vary widely in the manner and nature of their operations, so too does the experience governments encounter when privatizing services. Below is a discussion of seven services privatized or considered for privatization in Tennessee.

South Central Correctional Facility

The Department of Correction entered into a contract with the Corrections Corporation of America (CCA) on January 24, 1992, to manage a medium security correctional facility in Wayne County. Under the contract, CCA is responsible for operating the facility for three years whereupon the state has the option to renew the contract. The state assigned two monitors to the correctional facility to oversee the contractor's compliance with the contract.⁹⁷

Shortly after this facility opened problems began to emerge. CCA had difficulty meeting staffing requirements stipulated in the contract, and communication between the Department of Correction and CCA broke down. CCA contended that the contract did not provide enough flexibility to implement efficiencies and reduce unnecessary costs. Officials with the Department of Correction indicated that CCA experienced normal start-up problems and had some difficulties meeting all terms of the contract because they had promised more than they could deliver. They also indicated that most of the concerns they had with operating the South Central Correctional Facility have been resolved after a year of operation.

The General Assembly passed a resolution on October 13, 1992, authorizing the Select Oversight Committee on Corrections and the Fiscal Review Committee to comparatively evaluate the South Central Correctional facility operated by CCA with two similar correctional facilities operated by the state. According to Claire Drowota, Executive Director of the Select Oversight Committee on Correction, and Don Morton, former director of the Fiscal Review Committee, this was the only comparative evaluation of correctional facilities recently conducted by a state in the U.S. The committees compared the costs of the contractor with the state's cost of operating similar facilities and found they were relatively

⁹⁷ Interview with Claire Drowota, Executive Director of Oversight Committee on Corrections, June 14, 1994.

close.⁹⁸ This analysis, however, did not look at the full cost of contracting this function out to a private firm. The cost of monitoring the contract and preparing the contract were never considered in the evaluation. The average annual cost of the two state facilities was \$12,111 per inmate versus an annual cost per inmate for the facility managed by CCA of \$12,330, or a difference of 1.02 percent.⁹⁹ In addition to cost considerations, the committees considered if services provided by CCA were superior, essentially equal, or poorer than services provided at state managed facilities.¹⁰⁰ The Select Oversight Committee on Corrections evaluated professional, safety, security, and program and activity standards of each facility. It found that all three facilities were operated at essentially the same level of performance.¹⁰¹ Subsequently, the legislature agreed to renew the contract with CCA to manage the South Central Correctional Facility for another three years.

Mountain View Youth Development Center

The Mountain View Youth Development Center is a juvenile correction center that opened in April 1990. The complex is located in Dandridge, Tennessee. Prior to January 1993 it consisted of a 120-bed male center and a 24-bed female center. Now, the center is used to house 144 male offenders. Aside from incarcerating offenders, the center provides educational instruction, rehabilitation programs, and other enrichment programs.

Management of the facility was contracted out to CCA for a period of five years beginning on April 1, 1989. The contract allowed for CCA to build the complex in the first year and manage operations for the remaining four years of the contract. The contract for the operation of this facility was terminated by CCA with the Department of Youth Development (DYD) in June of 1992 and CCA's operation of the facility ceased in December 1992, 15 months ahead of schedule.¹⁰²

The operation of the facility by CCA was fraught with problems attributed to poor communications and lack of coordination and cooperation between CCA and DYD.¹⁰³ DYD issued notices of severe deficiencies to CCA because they believed the terms of the contract had

⁹⁸ Memorandum from William White, Executive Director of the Fiscal Review Committee to Judiciary Committee Members, *Cost Comparison of Correctional Centers*, January 30, 1995.

⁹⁹ *Ibid.*

¹⁰⁰ Resolution Adopted by the Select Oversight Committee on Corrections on "Private Prison Contracting, Comparative Evaluation Approach" adopted October 13, 1992.

¹⁰¹ Select Oversight Committee on Corrections, *Comparative Evaluation of Privately-managed CCA Prison and State-managed Prototypical Prisons, Executive Summary*, February 1, 1995, p. x.

¹⁰² Memorandum to William Snodgrass, Comptroller of the Treasury, from the Division of State Audit, May 1994.

¹⁰³ *Ibid.*

not been fulfilled. However, the contract between CCA and DYD did not stipulate how performance and service quality would be measured and did not contain intermediate sanctions that could be used to ensure that CCA would comply with the terms of the contract.¹⁰⁴ Therefore, DYD had no avenue to enforce compliance short of terminating the contract. Dana Moore, Assistant Director of Business Development for CCA, stated that most problems could have been avoided if the contract had contained substantive performance standards, program guidelines, sanctions, and flexibility to make adjustments to the operations of the facility. She also stated that the problems fostered a distrustful relationship between DYD and CCA regarding the facility.

Trash Collection

Trash collection is one of the most commonly privatized services in the country. In Davidson County, about two-thirds of trash collection is handled by private companies. The city retains operation of trash collection in the urban services district, but almost all trash collection outside the district is operated by private companies. The policy of the Metropolitan Public Works Department is to retain control over a third of all trash collection operations in the county. Marlin Keel, Director of Metropolitan Public Works Department, stated that this policy is designed to ensure that the government, "...maintains partial capability so the government won't be at the mercy of the private sector." Moreover, the city has set a policy that forbids any one contractor from receiving more than a quarter of the total trash collection operations in the county.

According to Keel, contracting trash collection has saved the Metropolitan Government of Nashville and Davidson County between 10 and 30 percent in operating costs per year. He said that contracting out trash collection generally has been successful because of the ease of providing the service, the large number of companies available to bid, and the assurances built into the contracts. The private firms, however, also reduced services from those previously provided by Metro by requiring residents to place their trash at the curb. The only complaints that Metro Public Works has received about trash collection has come from residents who were upset about reduced service and restructured pickup times.

Child Support Services

A primary responsibility of the Department of Human Services (DHS) is to oversee the collection of child support payments. The state agency has fulfilled this responsibility in the past by contracting with the district attorneys' offices in Tennessee to collect child support from delinquent parents. But as demand for the service has increased and the resources to collect payments have remained constant, some district attorneys' offices have opted not to provide the service.

¹⁰⁴ Ibid.

In June 1993, DHS contracted out the child support enforcement services in Davidson county to two private companies.¹⁰⁵ One company that was awarded the contract, Maximus, Inc., promised to have all backlog cases (50,000 cases pending) resolved within six months. Joyce McClaran, director of child support services, stated that both companies have performed exceptionally well and the state has resolved all its backlogged cases. The state presently oversees four private contracts that collect child support payments in eight counties in Tennessee.

Health Care in Tennessee--TennCare

After years of unchecked growth, the federally mandated Medicaid program cost the State of Tennessee \$3 billion in 1993 to operate, six times as much as it did in 1987. Medicaid's rising cost has consumed a greater portion of Tennessee's budget each year, with health care for the poor growing at a rate of 15 percent annually.¹⁰⁶ Tennessee's answer to health care reform was to receive a Medicaid waiver from the federal government and set up its own health care program called TennCare. The program capped federal and state spending on health care in Tennessee. In November 1993, the waiver was approved by the federal government and TennCare went into effect on January 1, 1994.

TennCare is set up as a public-private enterprise between the state and the medical community. The state contracts with 12 managed care organizations (MCOs), such as health maintenance and preferred provider organizations, to provide health care and case management to indigent patients. The state pays these organizations a flat rate for each patient who decides to enroll in the program. Managed care organizations in turn contract with physicians to provide care to persons eligible for TennCare. Under the Medicaid program, the state contracted with physicians rather than MCOs to provide health care to indigent patients.

By the beginning of 1997, TennCare will assign every indigent person a family doctor who ensures that all children are immunized, pregnant women receive prenatal care, and patients receive necessary care and advice. These doctors will act as gatekeepers for all health care services as well as an intensive care management system.¹⁰⁷ As of July 21, 1995, TennCare provided health insurance to 1.2 million people or 92 percent of all eligible Tennesseans—400,272 who are uninsurable or have no insurance and 803,265 who would otherwise be on Medicaid.¹⁰⁸ Medicaid recipients and persons whose income is below 101 percent of the poverty level pay no premium for TennCare. Persons at or above this level must pay a premium based on a sliding scale with a maximum amount of

¹⁰⁵ Interview with Joyce McClaran, Director of Child Support Services, Department of Human Services, July 15, 1994.

¹⁰⁶ Joe Klein, "How Tennessee Has Managed Care," *Newsweek*, February 21, 1994, p. 23.

¹⁰⁷ State of Tennessee, *TennCare, A New Direction in Health Care*, p.32.

¹⁰⁸ Information provided by Kay Moore, Bureau of TennCare, July 28, 1995.

\$342 per month for family coverage.¹⁰⁹ In addition, the program has reduced the use of emergency rooms by indigent patients and made it easier for indigent persons to move from welfare to work by allowing them to retain their health insurance.

Opposition to TennCare developed shortly after it was introduced as legislation before the Tennessee General Assembly. The medical community was most vocal in its opposition to the program. They stated that the program did not give eligible enrollees enough notice before the government put the system into effect, that it segregated the poor and denied them choice, and that it pressured physicians by threatening to cut them out of other more lucrative state-paid health insurance plans if they did not sign up for TennCare.¹¹⁰ Other concerns expressed by the medical community included a perceived low per capita rate of reimbursement or capitation rate paid to physicians who treated TennCare eligible patients. The medical community also contends that their concerns and reservations about TennCare could have been alleviated had the McWherter administration provided ample time for comments before the program was put into place.

TennCare has reduced the use of emergency rooms by indigent patients and made it easier for indigent persons to move from welfare to work by allowing them to retain their health insurance.

The McWherter administration responded that ample time was given to the medical community for comment and any additional time delays in implementing TennCare could have cost the state money in lost savings.

Public Schools

In recent years, educational reform has received much attention as a vehicle to improve student performance and reduce inflated public education costs. A few cities have experimented with privatizing public schools in an effort to improve operations and performance. The Minneapolis-based Education Alternatives, Inc., has taken over the management of nine public schools in Baltimore and one in Miami. In Chicago, several large corporations have created a company that runs an inner city school, and in Detroit, Wayne State University has taken over the management of an inner city public school.¹¹¹ Schools in Washington, D.C., Dallas, and several other cities are considering privatizing underachieving schools.

¹⁰⁹ M. Lee Smith, "New Governor Has No Ownership in TennCare," *Tennessee Town and City*, November 21, 1994.

¹¹⁰ Kirk Loggins, "TennCare Survives Doctors' Challenge," *Tennessean*, August 9, 1994, A1, and Joe Klein, "How Tennessee Has Managed Care," *Newsweek*, February 21, 1994, p.23.

¹¹¹ Rhonnda Kerr, "Privatization: Panacea or Pandora's Box: Private Management Faces Uphill Battle From School Officials," *Nashville Business Journal*, Feb. 7-11, 1994, p. 36.

In Nashville, the Metropolitan Public School System recently considered a proposal by a private firm, Alternative Public Schools, Inc., to manage a multicultural magnet school. After much discussion the school board voted 5-4 to reject the proposal. The proposal met with much opposition from the director of the Metro School System and members of the Metro School Board. The director of the school system voiced concern over privatizing a school after Metro government had experienced problems with private contractors responsible for cleaning the schools. Some school board members felt this proposal might lead to the company “skimming the cream off the top.”¹¹² Other members had reservations about allowing tax dollars to be paid to a private company to make a profit and felt the proposal by the company was vague.¹¹³ The teachers’ association also vehemently opposed the proposal and expressed their views to local politicians up for reelection this year.

Professional Services Group, Inc.

Ever-tightening environmental regulations and increasing capital costs for expansions and upgrades to water and wastewater treatment facilities have compelled many municipalities to privatize facilities. The U.S. Environmental Protection Agency reported that the cost for governments to comply with the 1986 Safe Drinking Water Act (SDWA) amendments may be as high as \$49 billion.¹¹⁴ The Reason Foundation reported that nationally local expenditures for the operation and maintenance of wastewater facilities increased by 50 percent from 1980 to 1987, forcing many municipalities to reconsider their need to manage treatment facilities. In the past, few municipalities would have considered privatizing operations. Today, there are eight large treatment facilities in Tennessee operated by private concerns and countless other small facilities such as power stations.¹¹⁵

One of the leading companies that operates public water and wastewater treatment facilities is Professional Services Group, Inc. PSG operates more than 260 water and wastewater treatment facilities in the U.S., including six wastewater and one water treatment facility in Tennessee, and several other small operations for municipalities.

PSG has been successful in winning contracts by adopting a consumer friendly approach to providing services. In every PSG contract, it is clearly stated that the company will hire all municipal employees who were responsible for operating the city treatment plant at comparable wages and benefits. Training is also provided to the employees. Another

¹¹² Ibid., pp. 33, 36-37.

¹¹³ Ibid., p.37.

¹¹⁴ U.S. Environmental Protection Agency, Administration and Resource Management, *A Preliminary Analysis of the Public Costs of Environmental Protection: 1981-2000*, May 1990.

¹¹⁵ Interview with Edward Young, Associate Executive Director for the Tennessee Municipal League, June 2, 1994.

provision in all PSG contracts is a guarantee that the company will assist the city in assuming operations upon termination of the contract, and return the facility to the same condition it was in before the facility was privatized. As a result of these provisions and quality service, PSG has been able to avoid opposition to privatization.

Recommendations

Tennessee's state and local governments may find privatization a useful alternative to improve cost efficiency and productivity. A major objective of privatization is to reduce the costs of providing public services, particularly where private enterprise is strong and government is assured of more effective services at lower costs. However, once privatization opportunities are identified, government agencies need to evaluate all their needs and risks before deciding to privatize. This report provides a list of factors that state and local governments should consider before using the private sector in the delivery of government services.

Governments should develop guidelines or models that could help them examine the merits of privatization and determine if they should privatize services. The guidelines should cover the usual steps in contracting out a service from preparing a request-for-proposal to contract monitoring and evaluation. The guidelines should also address issues such as specific reasons for contracting, cost comparisons, and employee relations. Government entities that use guidelines are more likely to examine all factors in the decision to privatize a public service and are thus more likely to successfully implement privatization.

Government officials could reduce opposition to privatization by educating concerned parties. Research has shown that employee resistance is one of the major impediments in expanding the contracting of government services. Some government employee organizations view privatization as a threat to job security and have led fights against privatization efforts at all levels of government. Therefore, governmental entities may not be able to contract out work with employee approval. Governments could safeguard incomes by requiring all contractors to hire displaced government workers in similar jobs. If necessary, private companies can reduce staffing levels through attrition or by offering employees compensation who find employment elsewhere.

Also, it is essential that all affected parties become educated about the potential benefits of privatization. Government agencies contemplating contracting out should keep their employees and the affected community fully informed of activities from the beginning. Public officials may be more willing to back privatization activities if they believe these activities are supported by their constituents.

Government officials need to determine the number of qualified and capable private providers before deciding to privatize a service.

Government officials who are aware of the amount of competition or market strength that exists can make more sound decisions on whether to use the private sector. An underlying assumption is that the private sector is capable of providing the same or even better services with less red tape and bureaucracy. Economic theory suggests that competition among producers strengthens the bargaining power of the purchaser. When the public sector is given a choice of providers and services, privatization can often improve the quality of services. As a general rule, the more companies that are interested in providing a service, the greater the chance that these firms will have the necessary qualifications and that the cost savings will be passed on to the government.

Governments should compare costs before privatizing services. Studies have shown that privatization may be a more efficient and less costly way of delivering services. However, cost comparisons allow governments to accurately compute and compare in-house and contract service delivery costs to determine how great the cost savings should be and how soon the cost savings should be achieved. Often the costs of providing services are spread across many accounting categories or are merged with other functions making it difficult to know the true cost of providing a service without preparing a detailed cost analysis. This information can be used to make an informed decision about whether to privatize a public service.

Government contracts with private companies should contain some key contractual elements. Government entities need to specify the quality and quantity of service they want to maintain before a private company takes over a service. These requirements need to be clear and measurable, and should be included in the contract. These specifications will increase the likelihood that a service will be successfully implemented. Often governments enter into contracts only contemplating the bottom-line costs without considering essential contractual elements such as assurances, performance standards, monitoring provisions, penalty clauses, contingency plans, staffing patterns, capital depreciation, etc. Each party involved needs to discuss these components and cover all expectations before signing the contract.

Governmental entities should develop monitoring systems that will ensure compliance with contract terms. To be effective, government officials should develop monitoring systems that provide information on whether contractors are meeting performance standards and all other terms outlined in the contract. Contractors should be required to provide information to government officials on a monthly or quarterly basis. Government officials should also conduct random inspections of contractors' records and the delivery of services.

Governments should develop a contingency plan in the event a contractor defaults on a contract. A contingency plan should be included in all contractual agreements in the event a contract is terminated. Many options are available for a default contingency plan such as contracting with the next lowest bidder from the original solicitation, using another current contractor, in-house delivery of the service, or intergovernmental contracting. The plan may also include establishing a capital reserve fund that would allow governments to set aside capital for the purchase of equipment or include a buy-back provision in contracts to guarantee their access to necessary equipment. The International City Management Association recommends that at least two possible courses of action be included in any default contingency plan.¹¹⁶ This allows a government to implement the option that best suits its needs at the time of the default.

Governments need to consider all legal constraints before deciding to privatize. It is important that government agencies identify the potential restrictions to privatization before investing time and money. The identification of all legal constraints will provide governments with valuable information on what legal challenges exist that could impede privatization efforts and what legal barriers must be addressed.

Governments need to consider how much control they are willing to relinquish to a private firm. Because government officials are delegated certain responsibilities by statute to deliver services, it is important that government retain decision-making responsibility. The amount of control governments retain is often dictated by the type of service that is being considered for privatization. Some services, such as street sweeping, do not require a great deal of oversight, while other functions, like educating children, require much more oversight and control. As a general rule, the more control and accountability required to perform a service, the less appealing this service will be for privatization. And, if government finds it can provide a service more efficiently than a private company, it should do so.

¹¹⁶ International City Management Association, *Service Contracting*, 1994, p. 174.

Appendix A

Questions for Governments to Consider About Privatization

Privatization is not a new or complex idea, but there are many issues to address in determining its feasibility and planning its implementation. To ensure the greatest probability of success, an orderly approach is needed to determine whether privatization is feasible. The questions listed below will help governments determine the level of feasibility. Most of the questions and information in the detailed cost analysis section are cited with permission from a 1989 document published by the Colorado State Auditor's Office entitled *Privatization Profiles and Detailed Cost Analysis*.

Identification of Risks and Needs

A government considering privatizing services, operations, or facilities needs first to define its needs and the risks involved in privatization.

- What level of service is needed?
- How will performance and quality be measured?
- How often will tasks be performed?
- What equipment, supplies, facilities, and utilities are needed?
- What staff skills and qualifications are needed of personnel to perform the work?
- Are there fluctuations in demand for services or workload?

Opposition

Opposition is the amount of resistance to change service providers. Opposition to privatization can come from the public, users of the service, interest groups, or public officials.

- Would the public, users of services, interest groups, or elected officials be highly resistant to changes in provision of the service?
- Is the service a new or existing one? New services are easier than existing services to privatize, but not necessarily more appropriate to privatize.

Market Strength

Market strength is the level of competition that exists between companies interested in providing a service. The strength of the market helps governments ascertain the risk of privatizing a service.

- Does the private sector provide the service?
- Can the private sector provide the service?
- Are there multiple providers for this service?
- Have the providers been in business for a long time?
- Is the financial commitment so large that providers will not want to deliver the service?
- Would privatization result in a monopoly situation?

Contracts

Contracts are agreements governments enter into with private, for-profit, or nonprofit firms, to manage a government program, provide services, or construct a project with public financial assistance. Before a government privatizes a service or function it should consider the following.

- Does the contract contain a renewal clause?
- Does the contract contain intermediate sanctions and incentives?
- Does the contract contain a termination clause?
- How is the contract monitored?
- Does the contract contain measurable performance standards?
- Can service objectives be well defined in the contract so that both parties understand what is expected?

Legal Considerations

Legal considerations include any laws or policies that affect the decision to privatize. In order to determine the legal limits, a government should answer the following questions.

- Are there any laws that mandate who should provide a service?
- Are there any laws or regulations that would have to be changed before the private sector could provide a government service?
- Are there interrelationships with other programs, prescribed by law, that could inhibit or prohibit privatization?
- Are there federal grant restrictions that may interfere with privatization?
- Is privatization compatible with legislative intent?

Quality of Service

Quality of service is the effect that privatization will have on the effectiveness, timeliness, and thoroughness of the service provided. Before a government privatizes a service or function it should consider the following.

- Will the overall quality of service increase or decrease with privatization?
- Would privatization threaten preservation of confidentiality or impartiality towards clients?
- Will the level of accountability to the government or citizens, or consumers of service decrease or increase?
- Will privatization compromise public trust, confidence, safety, or welfare?

Control and Accountability

Before a government decides to privatize a service or function, it should answer the following questions concerning control and accountability.

- How important is it for a government to control the delivery of services? The more important control is, the less likely the service will be privatized.
- Does the government have the ability to maintain control over the privatized service? If control can be maintained then the service may be considered for privatization. If not, then this service may not be a good candidate for privatization.
- Is the quality and quantity of service easy to measure? If not, then this service may not be a good candidate for privatization.

Resources

Below is a list of factors and questions that governments can use to determine whether private sector resources are sufficient to privatize a service.

- Does the private sector have expertise that cannot be developed easily or maintained by a government agency?
- Are there any time constraints that may favor or impede privatization?
- Does the private sector possess needed equipment and facilities not currently owned by the government?
- Are there any resource advantages government has over the private sector?
- Will privatization change the projected completion date?

Detailed Cost Analysis Section

If a government wishes to contract out a service, how does it know whether any savings will result? To answer this question, a government entity must compare the costs of providing a service in-house to the costs of contracting out a service. The cost factors below may be used to complete the cost comparison. Some privatization candidates may have cost factors that are not listed here. These additional cost factors can be added at the bottom in the “other cost factors” category.

Cost Factors for Government Performing the Service

Salaries and fringe benefits of personnel	_____
Operating costs (include service, supplies, and maintenance)	_____

Equipment (capital outlay and interest cost)	_____
Operation and Maintenance of Buildings	_____
Administrative costs (costs not covered under operating costs)	_____

Overhead costs (from other departments or agencies)	_____
Other cost factors	_____
Total Government Costs	_____

Cost Factors of Contracting Out A Service

Development and implementation of RFP and contract	_____
Bid preparation and selection	_____
Development of contract monitoring system	_____
Unemployment benefits for displaced workers	_____
Leave benefit buy-outs	_____
Disposal of unused equipment by government	_____
Transition costs, such as duplication of effort	_____

Other start-up costs	_____
Annual contract price	_____
Estimated allowance for cost overruns	_____
Loss of state revenue and grants	_____
Salaries and fringe benefits of contractor monitors	_____
Services and supplies for contract monitors	_____
General operating costs of contract monitors	_____
Operation and office space for monitors	_____
Equipment utilized by contract monitors	_____
Other overhead costs (not included in other categories)	_____
Other cost factors	_____
Total Contracting Costs	_____
Total Government Costs	_____
Total Contracting Costs	_____
Difference Between Costs	_____
Percent of Cost Savings or Loss	_____

Appendix B

Persons Interviewed for Report

Claire Drowota, Executive Director
Select Oversight Committee on Corrections

Wayne Williams, Director
Office of Local Finance
Comptroller of the Treasury

Marlin Keel, Director
Metro Public Works
Metropolitan Government of Nashville/Davidson County

Randy Williams, Senior Management Consultant
Municipal Technical Advisory Service
University of Tennessee

Sharon Rollins, Senior Public Works Consultant
Municipal Technical Advisory Service
University of Tennessee

Nelson Griswold, Executive Director
Andrew Jackson Institute

Joyce McClaran, Director of Child Support Services
Tennessee Department of Human Services

Randy Griggs, Assistant Commissioner
Tennessee Department of Youth Development

Jeff Reynolds, Former Commissioner of Department of Correction
Tennessee Housing Development Agency

Ed Young, Associate Executive Director
Tennessee Municipal League

Charles Harrison
Assistant to the Comptroller for Management Services
Comptroller of the Treasury

Tony Allers, Code Enforcement Inspector
City of Gallatin

John Reece, Director of Business Development
Corrections Corporation of America

Dana Moore, Assistant Director of Business Development
Corrections Corporation of America

Pat Weiland, Director of the Office of Compliance
Tennessee Department of Correction

Kenneth Baker, Regional Manager of Quality Assurance
Professional Services Group, Inc.

Richard Norment
Assistant to the Comptroller for County Audit
Comptroller of the Treasury

Dennis Dycus, Director
Division of Municipal Audit
Comptroller of the Treasury

Aaron Miller, Contract Specialist
Office of Contract Administration
Tennessee Department of Finance and Administration

Floyd Clift, Director
Division of Property Services
Tennessee Department of General Services

Ope Oshomoji, Food Services Manager
Tennessee Department of Correction

Mike Fitts, State Architect
Department of Finance and Administration

Mike Shinn, Fiscal Officer
Tennessee Department of Transportation

Robert Wormsley, Executive Director
Tennessee County Services Association