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The Pros and Cons of Privatizing Government Functions

Outsourcing may seem like a perfect solution for deficit-plagued governments, but the morning after can bring some unpleasant surprises.

BY: RUSSELL NICHOLS | DECEMBER 2010

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Last summer, residents of Maywood, Calif., woke up one morning to find the government as they knew it gone. After years of corruption and mismanagement, the small, blue-collar city south of Los Angeles fired almost all of its employees, dismantled its police department and contracted with a neighboring city to take over most municipal tasks. On July 1, local officials announced that Maywood had become the country's first city to be fully outsourced.

It was an unprecedented move spurred by a loss of commercial liability insurance and Workers' Compensation. As the city drowned in deficits and faced multiple lawsuits, city leaders saw outsourcing as a light at the end of a collapsing tunnel.

But it was only a mirage.

Bell, Calif., the city that Maywood officials had tapped to run its services, erupted with a pay and pension scandal, forcing several top Bell officials to resign. By September, Bell had scrapped its contract with Maywood, leaving the city to fend for itself and find new contractors for its outsourcing hopes.

The search for financial salvation is sweeping the country as local governments grapple with waning sales and property tax revenues. The economic recession has strangled budgets, forcing layoffs and the disbanding of departments. Feeling pushed to the brink of bankruptcy, cities are trying to find effective ways to make do with less. Maywood, in its outsourcing attempt, may be the most extreme example, but in California and other states in the past decade, more public officials have turned to outside sources for help in providing services at a lower cost to the state.

In theory, the idea of contracting public services to private companies to cut costs makes sense. If someone is willing to fix streets or put out fires for less money, that should be a plus for a government's bottom line. Many state and local governments have identified hundreds of millions of dollars in savings by hiring outside contractors -- or a neighboring city's services -- to handle tasks like trash collection, pothole repair, and water and wastewater treatment.

But according to analysts, outsourcing is by no means a perfect solution. Some agencies don't have the metrics in place to prove in advance that outsourcing a service will save money. Problems from poorly conceived contracts can create cost increases that surpass the costs of in-house services, and if there's shoddy contract oversight, a government is vulnerable to corruption and profiteering. The privatization of public services can erode accountability and transparency, and drive governments deeper into debt. "Governments at all levels are just desperate to balance their budgets, and they're grasping at privatization as a panacea," says Susan Duerksen, director of communications for In the Public Interest, a project that examines privatization and contracting. "But there's evidence that it often is a very bad deal with hidden costs and consequences when you turn over public service to a for-profit company."

Privatizing to Save Money and Time

Various governments -- from small towns all the way up to federal agencies -- have been sending public services to the private sector since the 1980s. The trend stems from the common belief that private companies can help governments save or make money by doing jobs faster and cheaper, or managing a public asset more efficiently.

This past March, for example, New Jersey Gov. Chris Christie created the state Privatization Task Force to review privatization opportunities within state government and identify barriers. In its research, the task force not only identified estimated annual savings from privatization totaling more than $210 million, but also found several examples of successful efforts in other states. As former mayor of Philadelphia, Pennsylvania Gov. Ed Rendell saved $275 million by privatizing 49 city services. Chicago has privatized more than 40 city services. Since 2005, it has generated more than $3 billion in upfront payments from private-sector leases of city assets. In 2005, West Virginia Gov. Joe Manchin worked to transform the state's

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Workers' Compensation Commission into a private insurance carrier, BrickStreet Insurance. That has led Workers' Compensation rates to decline about 30 percent statewide, translating to more than $150 million in annual employer savings.

"Sterile philosophical debates about 'public versus private' are often detached from the day-to-day world of public management," the New Jersey Privatization Task Force reported. "Over the last several decades, in governments at all levels throughout the world, the public sector's role has increasingly evolved from direct service provider to that of an indirect provider or broker of services; governments are relying far more on networks of public, private and nonprofit organizations to deliver services."

The report took careful note of another key factor: The states most successful in privatization created a permanent, centralized entity to manage and oversee the operation, from project analysis and vendor selection to contracting and procurement. For governments that forgo due diligence, choose ill-equipped contractors and fail to monitor progress, however, outsourcing deals can turn into costly disasters.

The Effects of Inefficient Outsourcing

No industry has gone through greater outsourcing catastrophes in the past year than government IT. Last fall, Texas cut short its seven-year contract with IBM, an $863 million deal that called for IBM to provide data center and disaster recovery services for 27 state agencies. When an audit criticized the state's Department of Information Resources for lax oversight, inadequate staffing and sloppy service, the partnership fell apart. In Virginia, the state's 10-year, $2.3 billion IT contract with Northrop Grumman to run the state's computers, servers, e-mail systems and help desk services also has been plagued by inadequate planning, cost overruns and poor service.

Technology plays such a critical role in the storage and delivery of vital data that even minor delays and deficiencies can disrupt business operations, such as car registration renewals, and unemployment and medical care services. In August, a storage area network failure in Virginia knocked two dozen state agencies' computer systems offline in another devastating blow to the state's IT outsourcing contract. A week later, the state Department of Motor Vehicles still couldn't process drivers' licenses at customer service centers because databases were down.

"The problem is that outsourcing deals are really about risk," says Adam Strichman, co-founder of Sanda Partners, an outsourcing consultancy. "You're taking the risk of the unknown and dumping that on your supplier," he says. "You're outsourcing a problem to a company that has limited control over the root cause of the problem." The only way for a public-private partnership to work, he suggests, is to drive transformation from within the agency. And that's the hard part. Red tape usually prevents governments from making significant modifications, and private companies lack the authority to enforce real changes. When such a public-private stalemate stunts a project, it helps to have an exit strategy.

Those risks extend beyond the technology world. In 2009, in the wake of an audit of economic development agreements between Niagara Falls and two developers, New York state Comptroller Thomas P. DiNapoli discovered that the projects faltered because the city failed to monitor development contracts. One of the projects, a downtown retail mall, has been vacant since 2000; the second project, which began in 1997, yielded nothing more than a rudimentary building foundation.

"Before governments hire outside contractors, it's important to examine the cost-effectiveness," says Nicole Hanks, deputy press secretary of the state comptroller's office. "More times than not, it's less expensive to use state workers instead of outside contractors."

Guidelines to a Successful Outsourcing Deal

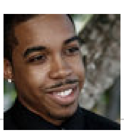
A good outsourcing deal starts with a thorough cost-benefit analysis to see if a third party can effectively deliver services better and more cheaply than public employees. Strichman says governments should hire an outsourcing consultant who can provide an independent assessment. But even with a consultant, conflicts of interest can tarnish a golden opportunity. After all, private companies may want to provide a service efficiently and well -- and often do -- but governments must ride herd on implementation of the contract. As Duerksen points out, a company's motivation "is not the common good; it's profit. If they can cut corners in any way, they often do."

In that regard, the provider that offers the lowest bid might not be the best option. But with his experience in several large-scale government outsourcing deals, Strichman has seen first-hand that in a bidding war, the company that has "a liberal interpretation for the lowest price wins," which inevitably leads to strife when high expectations meet underachievement. "Anyone can bid any outsourcing deal 5 percent cheaper, but the problem is you don't know what they cut out," he says. "When price reductions appear unrealistic, there's no magic. They are unrealistic."

Even with the proper oversight channels, policies won't work if departments don't participate. In 2005, the Wisconsin Legislature passed a law that required a cost-benefit analysis be completed for any purchase of service more than $25,000. The law outlines analysis procedures and reporting requirements. Soon after, the Contract Sunshine Act was enacted, requiring all Wisconsin agencies to provide online information about state contracts in excess of $10,000.

The laws were created to promote transparency and to ensure that agencies complete an effective cost-benefit analysis prior to procurements. But compliance has been low, says Janice Mueller, state auditor for the Wisconsin Legislative Audit Bureau. "We were asked to look and see why state agencies are not consistently reporting," she says. "It's really difficult to compel compliance."

In other cases, outsourcing efforts may be stifled by union contracts or a lack of available services. Mayor Sharon McShurley in Muncie, Ind., wanted to outsource the city's fire protection services to save money. But the city ceased its cost analysis after realizing that no such private services existed in the area. "It does tie our hands as administrators trying to figure out how to balance the budget and provide services with a reduction in revenue," she says. "I like the idea of outsourcing. Competition drives prices down. We don't have the revenue that we used to have."



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COMMENTS

Otis Woods | Commented December 2, 2010

Excellent article. My small agendcy, too, has seen many advantages to outsourcing some operations. How ever, I encourage a backup plan/strategy that needs to be implemented in short order w hen a contractor is not meeting the terms of the contract, including poor results. Competition does drive quality, but you must be diligent in contract management, else the good performer, after a few years, may slip. If w e are not on top of it, taxpayers often foot the bill. As stew ards of public dollars, w e must do all w e can to prevent this from happening.

thinker | Commented December 2, 2010

I agree this is an excellent short article on the subject, and should be read w ith the other Related Articles linked above (espec. John Donahue's and Stephen Goldsmith's). I think the considerations that (should) go into a w ell-reasoned decision to outsource are the ones that should carry you right into drafting and overseeing the contract. It sure seems like most of the outsourcing failures occurred because they w ere driven by political expectations/deadlines/budgets/ideologies, not careful planning, don't you think?

C. Barnes | Commented December 14, 2010

This article is spot on. Successful contracting out of governmental services requires a (good bureaucrat) contract manager to not only w rite and execute the contract but also for ongoing oversight. For almost a generation w e have had a national narrative about government and the results of that narrative are begining to be felt. Much of this narrative has been driven by pow erful private interests. Will the public like this new paradigm. In addition to loss of services, I fear there w ill also be loss of control for quality and cost.

Barclay W. Conrad | Commented December 14, 2010

Any given year might find a privatived service as cost effective for a municipal or other voter-elected entity. How ever, it must be emphasized that w hen a good year is follow ed by bad years, economic forces for private entities can come dow n on them too. Private entities can declare chapter 7 bankruptcy, and disappear in a heartbeat. Then a tow n body may be left scrambling, especially w ith w ater and sew er public w orks ow ned by a tow n, to hire a new public w orks department, or sew er plant or w ater plant, and find that skills based w orkers just may not be available. Large public w orks can suffer terribly expensive maintenance dow nfalls w hen operated by incompetant personnel. Sincerely, Bart Conrad Retired sew er plant operator

Jimmy | Commented December 18, 2010

Great article, except for using Mayw ood as a reference. In Mayw ood the city council released all its employees and w as w rangling to receive hefty salaries just like the council in Bell. It had nothing to do w ith saving money or cost cutting. It had all to do w ith GREED.

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