City Club of Portland Report: Privatization of Government Services

City Club of Portland (Portland, Or.)

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The City Club Membership will vote on this report on Friday, June 11, 1999. Until the membership vote, the City Club of Portland does not have an official position on the recommendations included with this report. The outcome of this vote will be reported in the City Club Bulletin dated June 18, 1999, (Vol. 81, No. 3).
THE CITY CLUB OF PORTLAND MISSION:
To inform its members and the community in public matters and to arouse in them a realization of the obligation of citizenship.

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EXECUTIVE SUMMARY

While contracting out government services is not a new idea, it has become the focus of renewed interest in recent years, particularly at the state and local government levels. Governments are inviting private contractors to provide services in many areas traditionally served directly by public employees—examples include prisons and municipal water services. Some commentators assert that nearly every service performed by state or local government is being contracted out somewhere. The challenge for government leaders and the public is how to decide which public services are appropriate for contracting out and how to ensure that the public is well served by these contracting decisions.

The City Club directed our committee to review the arguments for and against contracting out, identify types of services appropriate for contracting out, examine mechanisms to ensure that the public’s goals continue to be met, and identify criteria to help citizens and public leaders decide when and how to contract out public services. We focused on state and local government and did not examine contracting out at the federal level. We did not review in detail any particular program or jurisdiction but directed our attention to contracting as a public management strategy.

We found important differences between the cultures and purposes of the public and private sectors that citizens and decision makers should consider in contracting decisions. These include the following:

**Government is legitimately focused on accountability for financial assets and has numerous checks both to avoid corruption and to ensure that funds are spent as directed by the legislative body.** Government accounting systems, therefore, do a better job of tracking how money is spent rather than providing detailed, service-specific cost information commonly available in private businesses.

**Government is concerned with “fairness”—which in practice often translates into procedures and processes that demonstrate “equal” treatment.** Often rules that support equal treatment are codified in law and restrict the latitude of public managers. Government contracts typically specify what will be done and how, in detail, and vendors compete on price. The flexibility to negotiate over what service to provide and how is more characteristic of the private sector than the public sector.

**Government is generally risk averse while the private sector is more supportive of risk taking.** The public, news media, or political opposition are more likely to become irate over failed government strategic decisions or investments than mere under performance. In many private sector settings, prudent risk taking is expected and there is greater tolerance for the inevitable stumbles that come as a result.
Government programs often have multiple objectives. While private businesses are generally more narrowly focused on maintaining their financial health, government programs often must serve a variety of legislatively established public policy objectives—sometimes conflicting objectives. Public services need to meet these objectives whether a government provides them in-house or through a contractor.

The reasons for contracting are many, but the predominant rationale is to save money. Not surprisingly, public managers who have contracted out services usually report savings. Because many state and local government services are labor intensive, the source of savings is often the ability of vendors to manage human resources with greater flexibility. Depending on the circumstance, this can mean lower wages and benefits, reduced managerial levels, greater flexibility in work assignment and so forth. Not surprisingly, public employee unions are among the most likely to be skeptical about contracting out.

A New Contracting Strategy—Marketization

Although contracting out is not new, the recent push to use this management tool has led to an entirely new contracting strategy—marketization—which permits public employees to bid against outside vendors to provide public services. The focus of the strategy is to harness competitive incentives to improve the quality and efficiency of public services whether they are provided in house or by an outside contractor. The City of Indianapolis is the current “poster city” for marketization. Indianapolis Mayor Stephen Goldsmith has found that the public workforce, when given a chance and the flexibility to compete, can often successfully bid against private contractors and significantly improve service efficiency and quality. A second important finding from the Indianapolis experience is that even public programs that appear to be very well run can do better when exposed to competition. It is not necessary—or desirable—to wait until a program is failing before considering whether it should be contracted out—or contracted in.

As used in this report, “marketization” means a strategy in which services are screened in a systematic process to determine whether individual services should be provided directly by government, contracted out to private vendors, or “contracted in” to existing employees in competition with outside vendors.

The Status of Marketization in Oregon

In Oregon, as elsewhere, a great deal of government work is contracted out. But—with the exception of a modest experiment being considered in the Portland Water Bureau—we did not find any public executive promoting marketization. Witnesses were very knowledgeable about contracting and marketization, but no public manager indicated that engaging the forces of competition was a front burner issue for them. Typically the decision to
contract out or bring a contracted service back in house is stimulated by a problem that needs fixing, not by a commitment to a public management strategy.

In the 1997 Oregon legislative session, efforts to privatize prisons, DEQ automobile emissions testing, and some state parks function failed. After the session, legislators held interim hearings on prison privatization. The 1999 Oregon Legislature is likely to consider a bill to build at least one private medium security facility. In 2000, voters may have the opportunity to vote on a proposed state ballot measure that would require government entities to accept the bid of a vendor that could provide any government service at savings exceeding 20 percent. This proposed initiative offers a definition of cost which voters may view as reasonable, but which we believe would drive up government costs rather than lower them as the initiative’s proponents claim.

Elements of a Successful Marketization Program

Our review of contracting out and marketization in Oregon and around the country led us to identify certain key elements as essential to the success of any government contracting/marketization program. These include:

Leadership and Commitment from Political and Executive Leaders. The implementation of any management strategy—marketization included—requires leadership and political will. Nothing will happen unless key leaders want to make it a priority and expend political capital in the pursuit of the agenda.

An Effective Screening Process: Success requires a jurisdiction to screen all public services to identify candidates for: (1) contracting out; (2) marketization, and (3) provision by in-house public sector employees. The decision not to contract out should be made as thoughtfully as the decision to contract out. The screening criteria should include:

• Policy vs. Implementation: Activities related to the development of public policy (e.g., developing laws and regulations, budget development) are not good candidates for contracting, but a wide range of implementation activities (e.g., printing, payroll, utilities) should be considered for contracting. Many jurisdictions distinguish between “core” services that government should retain an ability to perform (and therefore could be marketized) and ancillary services, where government should be comfortable relying entirely on the marketplace.

• Competition: Are there three or more prospective private sector bidders? Can the work be structured and can contracts be written that will nurture and maintain competitive incentives?

• Cost: Is the fully allocated cost of the service 110 percent or more of the price charged by vendors? The fully allocated cost is used for identifying
candidate services for further analysis. “Avoided cost”—never higher than the fully allocated cost and generally lower—is used for making a final decision to contract or not.

• **Ability to Evaluate Performance:** It is easier to contract for services where it is possible to evaluate the success of the contractor. Contracting is difficult when it is not possible to define successful performance in writing or to recognize it when it occurs.

**Information on the Cost of Providing Public Services:** Public managers and decision makers need to have access to accurate information on what it costs to provide public services. Most jurisdictions have a hard time determining their own service costs, because government accounting systems have been designed with other legitimate objectives in mind. Public managers need to know the fully allocated costs of services (the direct program cost plus the cost of related general support services) as well as the “avoided cost” (the true savings of contracting out versus providing a service in house). It is the avoided cost, not the fully allocated cost, which vendors must beat in order to save the government money.

**Involvement of the Public Workforce:** Where marketization has worked best, governments and contractors have been careful to protect the jobs and careers of existing government employees. Contractors sometimes hire government employees, and additional government positions are eliminated through normal attrition. Where marketization strategies bring employees completely into the process, they often lead the way in restructuring work and organization to make themselves more competitive than outside vendors. The lesson is that management should focus on incentives—not on contracting per se. With proper incentives and given the flexibility to modify organization and work practices, public employees can reduce costs and improve performance.

**Effective contract negotiation and management:** The success of contracting often depends on the quality of the contracting process and the contract itself. Governments that contract out must trade in their skills as direct program managers and instead become skilled contract negotiators and contract managers. Good contract negotiation and management includes the following elements: (1) Be clear on outcomes; (2) Tie payments and other incentives to performance; (3) Acknowledge that contracts can fail and be prepared to resolve a failure; (4) Acknowledge that conditions may change and be prepared to respond to changes; (5) Protect public policy preferences; (6) Have the capacity to monitor and evaluate performance; (7) Nurture competitive incentives; (8) Make public contract management be as efficient as possible; and (9) Negotiate rather than specify means and ends when possible to tap vendor creativity.
CONCLUSIONS AND RECOMMENDATIONS

Contracting out and marketization are powerful strategies for reducing government costs. While most, if not all, Oregon jurisdictions use outside contractors to provide some public services, Oregon jurisdictions lag behind in the adoption of marketization strategies. We therefore recommend that:

All Oregon public policy decision makers and political leaders should actively examine how marketization policies could most effectively be used in their jurisdiction.

Government marketization policies should have the following fundamental features:

• Screening criteria and a systematic screening process to identify which services should be provided by government in the traditional way, which services are candidates for marketization, and which services should be contracted out.

• Employee involvement to give employees the incentives and flexibility to show what they can do.

• Accounting systems that are modified, as resources realistically permit, to provide reliable, fully-allocated cost information.

• Training and analytical assistance for public managers that helps them make well-founded decisions concerning services to provide in the traditional manner, services to contract out and services to marketize.

• The use of “avoided costs”—not total or “fully allocated” costs—as the basis for analyzing contractor bids.

• Implementation that is strategic—picking easier opportunities first and allowing time to learn from mistakes that may occur.

• Monitoring and evaluation procedures to confirm that the marketization strategy is producing results.

Areas worthy of further study:

While we did not make any particular program or jurisdiction the focus of our study, we did become sufficiently familiar with two program areas—state prisons and county social services programs—to conclude that more extensive examination by the City Club would be useful.

The City Club should study the specific issue of private prisons for Oregon. Although a number of private prisons are operating in the United States, there are none in Oregon. The state is likely to require additional prison capacity in the future. We believe the question is ripe in Oregon and that a
focused City Club study would contribute to the public policy discussion. The City Club would perform a useful service by keeping the focus on contracting and marketization strategies regardless of the final conclusions and recommendations of such a report.

The City Club should also consider a study to evaluate Multnomah County’s strategies for the management of not-for-profit social service contractors: We believe Multnomah County’s very large and diverse community of 300 not-for-profit social service contractors invites a study to recommend the appropriate management strategy for this program area. Some public officials took comfort in the idea that goals of non-profit contractors and the goals of government were sufficiently congruent to make close supervision unnecessary. We are not comfortable with this notion. While the literature, and our assessment, suggests that this is not an area of government where contracting out or marketization is likely to generate any useful competitive incentives, management of these programs presents an interesting challenge.
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I. INTRODUCTION

A. The Charge: What this report is about.

All levels of government—federal, state, and local—are under pressure to provide more cost effective services with fewer dollars. Taxpayers are now less willing to pay for government services than anytime in the recent past. Oregon’s tax limiting measures of recent years reflect citizen concern with the cost of government.

The prescription many suggest is “privatization:” letting the private sector do the work now done by government. Privatization takes many forms. Deregulation of the airlines twenty years ago or of utilities today is a form of privatization. The creation of public corporations such as the Oregon Health Sciences University is a form of privatization. School voucher programs are a version of privatization. But the most prevalent form of privatization is simply “contracting out” the public’s work to the private for-profit or non-profit sectors. Although each of the many aspects of privatization is worthy of study, the City Club Research Board charged this committee with an examination of “contracting out” because it represents a more immediate set of concerns. State legislators have expressed significant interest in having private vendors operate state prisons and proposals to privatize the Department of Environmental Quality (DEQ) vehicle inspections have been discussed. An initiative petition to require contracting out was circulated last year and did not qualify, but has been filed again for the November 2000 election.

The City Club directed this Committee to examine the cases for and against contracting out; to describe the appropriate criteria for contracting out government work; to identify the types of services or programs that would be appropriate to contract out, and to identify and explore other relevant issues. We were asked to focus on state and local government and did not examine contracting out at the federal level.

B. What we did.

We interviewed representatives of the state, the legislature, Metro, Multnomah, Washington, and Clackamas Counties, the City of Portland, public employee unions, the Portland-based Cascade Policy Institute, and Oregon private contractors to gain an understanding of what is happening in Oregon. We also read widely in the literature and interviewed representatives of the City of Indianapolis, the United Water Company, and the Los Angeles-based Reason Foundation, entities noted for their advocacy and successful use of privatization. We did not evaluate the performance of any particular government agency or jurisdiction nor did we study any particular program or service to determine whether or not it was appropriate to contract out. A list of interviewees and a bibliography of sources appears in Appendices A and B.
C. Report Structure.

This report begins with background on important current trends in contracting out and a summary of the major arguments of privatization proponents and opponents. We then identify key criteria for success for contracting out government services, and describe privatization issues in different areas of public services. The report closes with the committee's conclusions and recommendations.
II. BACKGROUND

The following sections offer an overview of the history and current trends related to contracting out government services.

A. Contracting out is not a new idea.

Government contracting out is as old as the republic—older in fact. George Washington complained about waste, fraud, and abuse in defense contracts before the end of the Revolutionary War. Naval privateers—non-governmental agents—took in customs duties for a commission. The original Secret Service was the Pinkerton Detective Agency. Although the tide has run both ways, with government sometimes pulling services in house in response to failures of the market, government reliance on private contractors has always been a common dimension of many federal, state, and local programs.

This report is not a history of public contracting. Instead, our focus has been narrower. We have focused on new thinking about the old idea of contracting for public services.

B. Contracting out is receiving renewed emphasis, particularly at the state and local government levels.

At the federal level, privatization initiatives have been driven largely by policy preferences and ideology. At the state and local level they have been more often spurred by expediency. Over the last three decades, squeezed by demands of constituents on the one hand and declining federal assistance and tax protests on the other, state and local officials have looked more frequently to contracting as a way to control costs. Controlling cost is the primary reason given by witnesses for contracting out at the state and local level.

In 1997, a Council of State Governments survey found that 58.6 percent of states reported an expansion of privatization activities (in this context, "contracting out" public services) in the previous five years. Only one state reported a reduced reliance on private vendors during that time. A survey of state budget directors, auditors, or controllers found that 68.6 percent believe the next few years will bring increased privatization. Across the country, 73 percent of local governments use private janitorial services and 54 percent use private garbage collectors—up from 52 percent and 30 percent, respectively, a decade ago, according to a survey by Mercer Group, an Atlanta consulting firm.

The private market currently enjoys a good reputation. Internationally most of the world’s planned economies are en route to, or are being redesigned with, free market architecture. Democratic capitalism is on the rise.
In our own country, deregulation of telephone and electric utilities continues. The 1990 Clean Air Act stepped back from command and control regulation to grant tradable emissions permits. In 1992, a Democratic President led the fight for the North American Free Trade Agreement, and in 1996, he announced "the end of big government." Both parties agree on a balanced budget. In this context, contracting out is not the partisan issue it once was. The emphasis now is more often on doing it right than on whether it should be considered at all.

C. Profit-making companies are now moving into many areas thought to be the preserve of government.

The municipal water and waste water treatment markets have attracted huge international companies such as United Water Services which are competing aggressively by offering contracts to municipalities that guarantee savings of as much as 50 percent. One in eight community hospital beds is now in a private hospital. Thirty-seven states now have at least one for-profit prison. Michigan has privatized foster care and adoption placement services. In New York, the private non-profit Bryant Park Restoration Corporation renovated and operates a public park on a 15-year lease. Rancho Palos Verdes, California contracts out the functions of its prosecutor. A private company runs air traffic control in Farmington, New Mexico. John Donahue, in *The Privatization Decision*, reports one Dallas suburb with 2,500 citizens that has no city workforce at all except for a secretary to handle the contracts that constitute the town's public sector. Donahue reports that nearly every function of local government has been delegated to the private sector at some time, in some city.

However, even as privatization gains popularity, there are reasons to regard it with caution. In 1997, a *Wall Street Journal* article documenting the privatization of America observed, "...[h]ere in the U.S., still the cutting edge of capitalism, the early stirrings of backlash against the market are in sight....As market forces push into new frontiers, Americans wonder: Where should the line be drawn?" *The Wall Street Journal* illustrated this observation with the story of a community that had satisfactory private ambulance services but balked at having the same company provide fire protection. For this community, retaining direct control proved more important than the potential economies involved.

D. The push to contract out has led to a new public management strategy—"marketization."

Historically, the decision to contract out (or to retrieve a service that has already been contracted out) has been stimulated by a performance failure, a budget crisis, a need to raise fees or some other specific stimulus. Generally, it has been the manager with the problem who looks to contracting out as a potential solution when "something is broken."
Today, however, a growing handful of governments have made a new approach to contracting a jurisdiction-wide policy. Their motivation is to use the incentives created by competition to encourage economy and performance whether the work is ultimately done outside by vendors or inside by an efficient government workforce. Indianapolis and Phoenix are examples of jurisdictions where public policy requires the consideration of contracting whether or not “something is broken.”

Proponents of top-down, jurisdiction-wide contracting out policies were quick to understand that working with the existing public sector workforce could actually be the best solution if that workforce was permitted to use its expertise and if there was a management decision to support eliminating political, regulatory, or personnel-oriented internal obstructions. In addition, in many jurisdictions, law or union agreements require union consultation and prohibit firings if work is contracted out. These realities have led to opening the bidding on work to the existing public workforce as well as to outside contractors. This strategy is called marketization.

The focus of marketization is not on contracting per se, but on using competition to create incentives to get the work done more efficiently whether it is performed by outside vendors or by government employees. The work can be contracted out—or contracted in. Our witnesses and the literature all made it clear that competition is the key to assuring the highest value for the lowest cost.

In brief, three steps are involved in marketization:

Step One: Screen services in a systematic process to determine whether individual services are candidates to be provided directly by government, contracted out to private vendors, or “contracted in” to existing employees in competition with outside vendors.

Step Two: Establish costs for services so managers can see how their costs compare with non-profit or private providers, or even with other similarly-situated government providers. Just having this information can be powerful.

Step Three: Ensure that the work gets done by the most effective provider. The provider could be a for-profit or non-profit entity or it could be—and often is—a government agency that has modified its practices to meet the competition. Services should be periodically rebid to ensure that the work continues to be done by the most effective provider.

Proponents say, “structure the incentives correctly, and the people who know the work best—government employees included—will find ways to do it better.” They point to examples in which auditors or consultants could not identify savings which were later realized by the workforce itself—given proper support and incentives.

As used in this report, “marketization” means a strategy in which services are screened in a systematic process to determine whether individual services should be provided directly by government, contracted out to private
vendors, or "contracted in" to existing employees in competition with outside vendors. (Government employees bid on work being done for the government—not in competition with private vendors for the business of other non-governmental clients.)

E. Indianapolis—The "poster city" for marketization.
Currently, Indianapolis is regarded as a pioneer in establishing a successful jurisdiction-wide marketization strategy. The effort to privatize government services in Indianapolis began in 1992 with the election of Stephen Goldsmith as mayor. Goldsmith campaigned for office on a platform to privatize many city services. Once in office he acted quickly to turn campaign rhetoric into public policy. But when confronted with the practical issues of implementation, Goldsmith's strategy evolved from one of privatization to one of marketization in which public employees can bid against outside vendors. This compromise brought peace with the public employee unions and excellent results.

At the time Goldsmith was elected, 25 garbage collection districts were allocated among Department of Public Works (DPW) crews and four contract haulers. DPW had franchise agreements with the various trash haulers that gave each a monopoly in its own area. Not surprisingly, haulers' prices increased every year.

When the time came to renew hauler contracts in 1993, the City reduced the number of districts from 25 to 11 and bid them out. DPW was guaranteed one district so that the City could retain the ability to collect trash if problems arose. Any one collector was limited to three districts to prevent monopolistic situations and predatory pricing.

Empowered and cost conscious, City crews won the maximum allowable three districts. Competition for trash collection resulted in more that $15 million dollars in savings over the following three years.

The unions, early critics of the Goldsmith strategy, have become strongly supportive. No union member has been laid off during the Goldsmith administration and, according to local union president Steven Quick, "City workers are no longer asked to park their brains at the door when coming to work." The Indianapolis contracting strategy has created incentives for government employees to restructure the way work is done and how the government is organized to do it.

Indianapolis has also discovered that changed incentives may produce savings even in well-run operations. When Goldsmith looked to privatize the Indianapolis Water Treatment Facility, the opposition of elected local officials as well as the unions prompted the Mayor's Office to hire an outside accounting firm to perform an audit of the Water Treatment Facility. The audit showed that among publicly-run water treatment facilities, Indianapolis was among the best run in the nation. Notwithstanding that the audit
suggested that there were no great opportunities for savings, the Mayor decided to allow any entity to compete for the job of running the facility, including the current government employees. The result was a contract from a private-sector entity that resulted in a 44-percent saving over five years—with the savings passed on to consumers.

Overall, Indianapolis reports that these efforts have been a financial and service-level success. So far, over 70 municipal services have been opened to competitive bidding. Between 1993 and 1997, Indianapolis has reduced its operating budget by seven percent, cut taxes twice, reduced non-public safety workforce personnel by 40 percent (through early retirement and natural attrition). These savings, in addition to being returned to the taxpayers, have been invested in increases in public safety budgets and service-level increases in public goods such as parks and community recreation facilities.

To assess the ripeness of any particular public activity for marketization, Indianapolis analysts use a preliminary screen that evaluates the activity as to whether it is a “core” or “ancillary” service on the one hand and whether it is “policy making” or “implementation” on the other. See the resulting four quadrant grid in Exhibit I below. Activities in quadrant IV are good candidates for simply contracting out. Activities in quadrant III, non-policy core services, are prospects for having government employees bid against outside vendors. Activities in quadrants I and II are not as likely to be good marketization candidates. Of course other considerations must be taken into account in making final decisions concerning contracting, but the grid helps get the analytical process going.

### Exhibit I.

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<tr>
<th>Quadrant I</th>
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<td>Courts</td>
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<td>Printing</td>
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<td>Crack Sealing</td>
<td>Microfilm Archives</td>
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Source: Office of the Mayor, Indianapolis, Indiana
Because good cost information is the essential foundation of a marketization strategy, Indianapolis also created and implemented a new activity-based costing system to help managers understand the cost of all government services.

**F. Cultural differences between public and private entities.**

It is useful in a discussion of contracting to understand how contracting fits into the culture of government. Contracting is not about turning over responsibility for services to the private sector—government remains responsible to see that the services are provided. The discussion is always about government and whether it should do its work directly or through others.

Some witnesses viewed contracting as a way to selectively gain relief from some of government's legal or cultural characteristics. Others believe a contracting out or marketization strategy creates incentives to change government itself. But others cautioned realism concerning just how many of government's characteristics could or should be changed or avoided by contracting.

Four basic themes rose from our interviews and research—these are general observations and do not apply to all public agencies or private businesses:

**Government is legitimately focused on accountability for financial assets and has numerous checks both to avoid corruption and to ensure that funds are spent as directed by the legislative body.**

Public budgets are major instruments of policy and legislative control. Accounting systems carefully relate funds to the programs for which they were appropriated. Since governments do not need to price most services, the detailed, service-specific, cost information that is common in most private businesses is often unavailable. Government managers may know the cost of an entire program like road maintenance, but not the cost of filling a pothole. The differences between government and business are hardly surprising. Each is focused on its source of revenue. Business must correctly price its products and services in the market. Government managers must present information to legislatures that concern themselves more with establishing the direction in which the government should go than with the management strategies for getting there. The bottom line is that the cost information needed to make intelligent contracting decisions may be difficult to assemble both because accounting systems do not routinely produce it and because government managers may not always be familiar with the appropriate costing methods. We discuss costing issues at greater length later in this report.

**Government is concerned with "fairness"—which in practice often translates into "equal" treatment.** As a result, government has a strong focus on procedures and processes that demonstrate equal treatment.
Often the rules that support equal treatment are codified in law and restrict the latitude of public sector managers. In contrast, most private businesses do not have to serve "all comers" and they often try to give tailored "unequal" treatment to customers, to make each one feel special. In contracting, it is typical for government to specify what will be done and often how it will be done, in detail. Vendors are invited to compete on price only. The idea that vendors might negotiate the "what" and the "how" as well as price invites charges of unequal treatment and is, therefore, less common in government than in the private sector.

**Government is risk averse and the private sector is more supportive of risk taking.** This is not surprising given the nature of politics in which government has its roots. Failed strategic decisions or investments are more likely than mere underperformance to invite public ire or the attention of the media or political opposition. In many private sector settings prudent risk taking is expected and there is greater tolerance for the inevitable stumbles that come as a result.

**Frequently, government programs have multiple objectives.** Sometimes they are the result of legislative compromise that may not fit well together. In contrast, private businesses are generally more narrowly focused on maintaining financial health. Whether it contracts or not, government must still pay attention to its other objectives, such as the protection of individual rights. Sometimes contracting will give government a more narrow focus than it wants. For example, it may be cheaper to contract out prison food services than provide them in house. However, food quality is an important factor in managing prison populations. If contracting out leads to lower food quality, the broader tasks of managing inmate morale and prison security may be made more difficult. Money saved in the kitchen may be lost many times over elsewhere in the prison. However, we do not imply that the lowest cost provider will always lead to the lowest quality service, just as a high-cost provider does not necessarily always provide superior quality service.

In summary, contracting does not buy government managers an exemption from: the demands for asset accountability; the protection of individual rights; requirements for demonstrable fairness; the political and media oversight that makes risk aversion rational behavior; or the burden of multiple and sometimes conflicting objectives. The government can be better. Government cannot be private business. Contracting out will not, and should not, make government function like business.

**G. Marketization isn't a passion among Oregon's leaders.**
We did find many Oregon government witnesses knowledgeable about marketization strategies being employed elsewhere. In fact, much of the business of the state and local government is already performed by contractors. But in general, case-by-case pragmatism appears to be the rule. Where something is not going well, consideration is given to contracting it
out—or bringing it back in house. We did not find a great deal of interest in marketization strategies, in which government workers and outside vendors compete for the same work.

Washington County is one jurisdiction we encountered which has a stated philosophy on contracting out. Its "County 2000 Strategic Plan" states, "Every effort will be made to purchase those services which can be more effectively provided by the private sector or other community organizations through contractual agreements or grants to these providers." Although there is no formal county-wide framework for evaluating whether or not to contract out any specific service, the county, in fact, contracts for more than 200 services on an ongoing basis. Attention is given to costs, the capacity and expertise of vendors, convenience and internal workloads. There are no formal guidelines. Contracting out has been rejected for some road maintenance tasks even where outside vendors exist. And some work—groundskeeping, electrical maintenance, computer support, and housing maintenance for example—which had been contracted out, has been brought back in-house.

The Portland Water Bureau has cautiously considered testing a marketization approach that would let employees bid on some work traditionally contracted out and let contractors bid on some work traditionally done internally. This was the only consideration of marketization we encountered in Oregon.

The Portland Bureau of General Services puts itself in the marketplace by being a major contractor to other governments for printing and communications services, which it provides at competitive prices (though its administrator acknowledges he probably would not have taken on in-house printing had it not already been a function of the bureau when he took over). The Bureau manager believes being a provider in even this somewhat limited market helps him evaluate performance and use competition to discipline his internal costs.

But efforts to privatize prisons, DEQ automobile emissions testing, and some state park functions foundered during the 1997 session of the legislature. Interim hearings have been held on prison privatization, and it is likely that a bill will be introduced in the 1999 legislative session to build at least one private medium security facility.

A ballot initiative to compel contracting out was circulated but failed to qualify for the November 1998 ballot. A new version of that proposed measure, entitled "The Efficiency in Government Act," has been filed for the November 2000 election.

We met many public managers, several of whom were quite impressive, but among them we did not find a champion like Indianapolis Mayor Goldsmith promoting jurisdiction-wide marketization. In general, witnesses described contracting out in Oregon as occurring in response to very specific problems facing particular programs recently or in the historic past, and not driven by
a strong philosophical preference or strategy of public management.

A 1997 survey of state officials by the Council of State Governments found respondents in the western United States reporting more modest benefits from privatization (in this context, contracting out) than respondents in other regions of the country. For example, 8.3 percent of respondents in the west reported that privatization efforts had resulted in savings greater than 15 percent. In the east, 18.5 percent of respondents reported savings greater than fifteen percent. In the South 19.8 percent reported savings of this magnitude. It may be that the savings opportunities—real or perceived—are not as compelling in our region as elsewhere.

We did find, as appears common in many other jurisdictions, a strong dose of criticism, if not outright opposition, from public employee labor organizations to more contracting out. But, with few exceptions, witnesses are prepared to leave what is alone. Accordingly, there are some jurisdictions that find themselves relying extensively on contractors for certain services, while nearby jurisdictions perform the same services in-house. But unless something is clearly not working, the inclination of decision makers, public managers, and unions in Oregon appears to be: leave the status quo alone.

III. PROS AND CONS—
THE ARGUMENTS WE HEARD OR READ ABOUT
FOR AND AGAINST CONTRACTING OUT.

A. Pros—the principal arguments for contracting out.

**Cost Savings:** Because state and local officials choose to contract out primarily to save money, it is no surprise that they report getting what they are looking for: savings. Proponents are armed with specific examples where contracting out strategies worked; opponents have case studies to prove that sometimes contracting out does not work. In general, surveys of public officials and studies report savings.

In 1987, Touche Ross and Company surveyed cities and counties concerning 18 different local services, from snow removal and streetlight maintenance to running day care centers. Most reported cost savings in the range of 10 to 20 percent. Two-fifths reported savings in excess of 20 percent and one tenth of the respondents reported savings of 40 percent or more.

How do contractors do it? Researcher Donald Kettl concluded that “private contractors improve efficiency through more flexible use of labor, a richer array of incentives and penalties and often, a more precise allocation of accountability.”
A study performed by economist Barbara Stevens, for the Department of Housing and Urban Development in the five counties of the Los Angeles metropolitan area, highlights differences between contractors and government in the management of people. She studied 121 different units of local government, delivering 38 different services, either directly or by contract.

The results: For every service except payroll preparation, Stevens found large and statistically-reliable cost advantages for private contractors. While quality of service did differ from jurisdiction to jurisdiction, quality differences did not correlate either with total cost of service or with whether contractors or governments provided the service.

Exhibit II below illustrates how agencies and contractors differ in workforce characteristics and workforce management.

Exhibit II.

<table>
<thead>
<tr>
<th>HOW AGENCIES AND CONTRACTORS DIFFER</th>
<th>Cities Using Private Contractors (by percent)</th>
<th>Cities Using Private Contractors (by percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of direct labor in total cost</td>
<td>49.0</td>
<td>60.2</td>
</tr>
<tr>
<td>Workforce unionized</td>
<td>20.0</td>
<td>48.1</td>
</tr>
<tr>
<td>Average age of workers</td>
<td>32.1</td>
<td>36.1</td>
</tr>
<tr>
<td>Average job tenure (in years)</td>
<td>5.80</td>
<td>8.10</td>
</tr>
<tr>
<td>Vacation days per worker</td>
<td>10.1</td>
<td>14.0</td>
</tr>
<tr>
<td>Average absenteeism (all reasons)</td>
<td>8.80</td>
<td>12.9</td>
</tr>
<tr>
<td>Management layers above laborers</td>
<td>1.50</td>
<td>1.90</td>
</tr>
<tr>
<td>Foreman can fire workers</td>
<td>53.7</td>
<td>16.0</td>
</tr>
<tr>
<td>Written worker reprimands used</td>
<td>33.8</td>
<td>72.5</td>
</tr>
<tr>
<td>Employee incentive systems</td>
<td>26.9</td>
<td>12.3</td>
</tr>
<tr>
<td>Workers maintain own equipment</td>
<td>92.5</td>
<td>48.1</td>
</tr>
</tbody>
</table>


Not surprisingly, the different management approaches contractors and governments take toward their workforce can drive very significant cost differences for most services.

But it is not just the way service employees are managed. Pay and benefits are also different. For six of the seven services for which Stevens collected usable wage information, contractor employees were also paid less than municipal employees according to John Donahue, author of
The Privatization Decision. “A good deal of what taxpayers stand to gain from privatization comes at the expense of municipal employees,” according to Donahue.

Access to expertise or special capacity: A good reason to contract is to obtain expertise you may lack. For example, a school board, which views itself as being in the education business, might choose to contract for food service, an area where it lacks expertise or focus. Private vendors in the water and wastewater treatment areas claim expertise born of experience running dozens of systems. One successful vendor in the municipal water market told us, “We have more Ph.D. engineers than most cities have employees.” Economies of scale favor some contractors who serve many jurisdictions. And of course there are consultants who do things routinely, say compensation studies, that a government does only once in a while.

Flexibility: Private contractors can often implement programs more rapidly, and can be laid off more conveniently when programs shrink. It is not unusual for governments to repair and maintain roads themselves but to draw on contractors for major construction that comes and goes. There is, for example, no building construction department in any Oregon government. And the Oregon State motor pool, which routinely changes oil for its fleet, looks to outside contractors when transmissions need repair.

Marketization—bringing the incentives of the competitive market to the workplace: Indianapolis Mayor Stephen Goldsmith says “Public employees are an easy scapegoat . . . When union workers are given the freedom to put their own ideas into action, they can be as innovative, effective, and cost conscious as their private sector counterparts—and they can prove it in the marketplace.”

Letting outside vendors and government employees bid brings the competitive incentives of the market to bear, no matter who ends up doing the work.

Governmental bodies have difficulty implementing many of the incentives that work in other sectors: we found few pay-for-performance and bonus programs and heard of several that withered under political criticism. It is difficult to convince the public that government employees should get “extras” just for doing their jobs well. In contrast, the incentives created by “marketization” strategies seem to pass muster politically, making “marketization” an even more valuable tool than would otherwise be the case.

Selective suspension of government rules: Generations of legislatures have layered on rules to make government accountable and fair but the result is not always efficient or effective government. Proponents of contracting out argue that contracting out permits government to selectively suspend its own rules to improve efficiency or effectiveness. For example, a government that has tangled procurement regulations might contract out work to a contractor who is unencumbered by government purchasing restrictions.
B. Cons—The principal arguments against contracting out.

**Cost Savings:** In some cases governments have strong competitive advantages. They don’t need to make a profit, and they pay no taxes. In the case of construction programs, governments generally pay lower workers’ compensation rates than private construction contractors. The government’s rate is calculated based on the entire government workforce. Much of this workforce is usually made up of clerical workers and other workers who face little risk of on-site injuries.

Government generally enjoys significant limits on tort liability that are not available to private sector contractors. In Oregon, government liability is limited to: $100,000 per person with a $300,000 limit per incident, punitive damages are not allowed, and claims must be filed within six-months of the incident. Private sector contractors have unlimited liability, are subject to punitive damages, and claims can be filed up to two years after an incident. This disparity may give some governments a cost advantage over private contractors, although private prison contractors say their greater liability exposure simply makes them more sensitive to doing the job right in the first place.

Government may indeed be the low-cost alternative, or at least no more costly than the private sector, if the only private sector alternative for a service is a single vendor in a monopoly position. The vendor’s monopoly position shields it from the incentives of a competitive market. It is these incentives that usually generate cost savings.

Where program objectives are complex and possibly inconsistent, and where process and fairness are important, the government’s high contract-preparation and monitoring costs will erode—and may cancel out—any savings generated by using an outside vendor.

**Focus on costs to the exclusion of other legitimate public objectives:** Where end products are easy to define—transmission repair or janitorial services, for example—and results are easy to measure, contracting out may be appropriate. But legislatures have given most government programs multiple objectives, and some are defined more by process than by output. The Wall Street Journal, certainly a friend of businesslike approaches to government management, bridled at the suggestion that collection costs be given priority at the Internal Revenue Service where fairness and due process are more important to that newspaper’s constituency than the efficiency of agency operations.

But even where services lend themselves to contracting out, some governments choose to do the work themselves: At one point, Metro chose to save money by contracting for security services at the Zoo and at Metro headquarters. The contract security force turned over frequently and did not integrate well with the rest of Metro’s workforce or relate knowledgeably to the public on non-security issues. Metro decided to bring this service in-house again, despite a somewhat higher cost. The Oregon Department of
Corrections (ODC) found private food service contractors to be cheaper, but insufficiently sensitive to the importance of satisfactory food to prison morale and safety. ODC also decided to go back to providing food services in-house to achieve better integration with their overall program.

**Loss of Control:** This was the concern we heard most frequently from witnesses. The more complex the service, the more a service requires managers to fill in the details with in-process judgments, the more managers agonize about how to control programs through contracts.

Ironically, where the vendors were non-profits—as in Multnomah County where county human services are provided by over three hundred highly-specialized, non-profit contractors—some public sector managers are comfortable with very limited control, relying largely on the motivations of the non-profit service providers to see that a good job is done at a reasonable price.

**Impact on workers:** People represent over 50 percent of state and local government costs, so cost savings are likely to come at the expense of jobs, wages, or benefits. One senior official interviewed resisted contracting out because of a belief that it should not be government policy to replace higher paying jobs with lower paying employment in the private sector. Not surprisingly, the greatest skepticism concerning contracting out came from the labor union representatives interviewed.

Some witnesses emphasized that government has a legitimate role in providing employment to many who would have difficulty elsewhere—employment in government has been an important pathway to the mainstream economy for waves of immigrants and minorities. To insist that nothing matters in public service delivery but the raw dollar cost is to adopt a needlessly narrow view of government, they noted.

**Contracting out jeopardizes other approaches to good management:** Some we spoke with pointed out that marketization or contracting out were not the only pathways to good management. A willingness to contract out services traditionally done by government could create morale problems which would undermine otherwise satisfactory management approaches. Even proponents of contracting out and marketization caution that no-layoff policies and workforce involvement are important to ensure success of any strategy to expand contracting out.

**Excessive profits:** There is a sensitivity—we encountered in interviews and in the general literature—concerning high salaries and large profits per se as inappropriate, particularly in human services programs, which are perceived to be underfunded. "Why should money that would be better spent on recipients line the pockets of private entrepreneurs?" is the question asked. The perception that some contractors—profit and non-profit—are enriched at the expense of needy people does not sit well with many citizens. Some states do not permit for-profit entities to bid on human services work for this reason.
Contractors play politics: As much as private entities extol competition, many expend a great deal of energy to sidestep it. It is not uncommon for contractors to lobby, mount public relations campaigns or make political contributions, or propose or support legislation—all legal activities—to influence government outside the bidding process. (Of course, public employee unions often use the same political tools to pursue their interests and protect public sector jobs.)

Historically, many services came to be performed by the government directly because reliance on contractors had created fertile ground for corruption. New York City created its street cleaning department after decades of failure by corrupt contractors and public managers. It is no accident that many services are performed by politically insulated civil service employees rather than contractors who are more likely to play politics and, in the extreme case, buy favor illegally. It is not surprising that government procurement and management practices tend toward risk aversion, cumbersome process and fairness at the expense of—critics say—economy and results. We were cautioned not to walk away from the existing system without understanding the legitimate values it was created to protect.

Competition may be a fiction: Even relationships that begin with the competitive selection of a vendor can migrate toward monopoly once the contract is signed. If a jurisdiction loses its ability to do a certain kind of work, it is no longer able to compete prospectively with its own vendor. We heard, for example, that asphalt prices rose sharply when the City of Portland closed its own asphalt plant some years ago. The price provided to the City by asphalt contractors was more than what was available when the City ran its own plant.

And if critical assets, e.g., water works, fire equipment or even school buses, are owned by the vendor—competition may provide no protection because the government may be able to sever its ties to the vendor only at the high cost of replacing assets. Contracting out may be straightforward, but creating and maintaining competitive incentives is more problematic.

Contracting out is often just a way to side step regulations government created with a good reason in mind: Contractors are not bound by all the rules restricting government, but this is not good news to everybody. Using contracts to get out from under government personnel, procurement, or other rules is not good news to constituencies that fought to get the government to impose the rules on itself in the first place.
IV. Getting it Right—FINDINGS ON HOW TO SUCCEED.

Done right, contracting out and marketization strategies produce benefits including cost savings. But it isn’t automatic. This chapter addresses our findings concerning “getting it right.”

A. Criteria for selecting services appropriate for contracting out, as suggested by witnesses and by the literature.

Policy or Implementation. Is the work policy-making or implementation? No one we interviewed challenges the idea that “policy making” belongs to government. Of course government should “steer the boat,” but activities that implement established policy are candidates for contracting out or for marketization, in which government employees also bid on the work.

In many cases, the distinction between policy and implementation is straightforward: the decision to keep certain streets clear of snow is policy; clearing the snow is implementation. But when a police officer or welfare caseworker makes a discretionary decision concerning a member of the public, is that “policy” or “implementation”? In some programs, policy making is embedded in day-to-day implementation.

Before exempting a program from contracting out on the grounds that policy and implementation are hopelessly commingled, proponents of contracting out recommend that the tasks the work entails be analyzed to separate implementation from policy. For example, all would agree that civil courts deal with “policy,” but in Multnomah County much of their work is successfully diverted to a pre-trial mediation process in which mediators (unpaid volunteers in Multnomah County) resolve many disputes without trial. This strategy separates the work that needs to be done by the courts from that which can be done by a private workforce.

Is the work at the “core” of what government exists to do, or is it ancillary? “Core” public services are the basic responsibilities for which government exists. Examples include police, courts, fire protection, garbage collection, road repair, provision of clean drinking water, and waste water disposal. Many are reluctant to contract out what are regarded as “core” services, but some of these (e.g., garbage collection and road repair) have been contracted out with benefit to the public so long as a government entity provides oversight. But core services are often excellent candidates for marketization—in which a government workforce bids against outside vendors. This is particularly attractive where work can be segmented—garbage collection would be an example—so that some of the service can be performed in-house and some can be done by contractors.

Ancillary services, such as printing, janitorial services, and fleet maintenance are generally viewed as candidates for contracting out. If there is a
competitive marketplace with multiple vendors interested in bidding on government work, the contracting out of ancillary services may be very attractive.

However, what is "core" and what is "ancillary" depends a great deal on the philosophy and politics of any particular jurisdiction. Scottsdale, Arizona, for example, has a long-standing contractual relationship with Rural-Metro, Inc. for the provision of fire services. But most jurisdictions balk at contracting out for a fire department. The Indianapolis decision grid described earlier in the report is a good guide that decision makers can use to identify services that they regard as "policy making or implementation" on the one hand, and "core and ancillary" on the other.

Proponents encourage analyzing the tasks the function involves to separate "ancillary" from "core" services. Police patrols might be regarded as "core"—but servicing police cars may be "ancillary" and a good candidate for contracting out.

**Measurability.** How will you know if a vendor does it right? Work that leads to clearly measurable outputs and where evaluation standards can be specified in advance is a clear candidate for contracting out: water supply, garbage pickup, paving, or park maintenance are examples. So called "hard" services, where it is clear what the product is, lend themselves to either contracting out or a marketization strategy.

**Does the service stand alone?** Services that do not involve continuous or frequent interaction with other activities are excellent candidates for either contracting out or marketization. Food services in a school may be sufficiently independent of other activities to make it a candidate for contracting, but we heard that food quality in a prison affected morale and security and was not a good candidate for contracting out.

**Can the service be segmented?** Marketization—where public employees bid against outside competitors—works particularly well where a service can be broken up by districts. Phoenix, Arizona has separate competitions in each of four solid waste districts. Houston, Texas has public/private competition in one of four solid waste collection districts. These approaches permit competition, but the cities also retain capability to perform essential public services.

**Has anyone done it before?** Services that have been successfully contracted out—or targeted for public/private competition—are preferable to services that have not. Fort Lauderdale's decision to experiment with public-private competition for fleet maintenance services was influenced by the fact that several other governments in Florida had already broken ground in this area.

**Are the markets competitive?** Can competition be created and maintained? If the markets are not competitive, the principal benefit of contracting out, cost savings, may be unavailable. A private monopolist generally has no more incentive to be efficient than a public monopolist, witnesses agreed.
There may be other reasons to contract out, but as a screen to prospect for opportunities to save money, many suggest, literally, a look in the telephone Yellow Pages. Services that are likely to generate two—preferably three—private sector bids are candidates for contracting out or marketization.

Evaluations of contracting efforts in both the United States and the United Kingdom have found a positive relationship between the use of multi-year contracts and the level of private sector interests. One of the reasons suggested is that multi-year contracts allow contractors more time to recover start-up costs. Accordingly, some commentators would say services for which multi-year contracts can be awarded are generally better candidates for contracting than services that can only be purchased on short-term contracts.

Lawrence Martin, writing in the MIS Report of the International City Managers Association, suggests that private sector vendors are likely to be the most competitive when their salary, wage, benefit, sick leave, and vacation packages are competitive with those of government. He also suggests that vendors making use of part-time workers are more likely to be competitive than those that do not.

Government can also create competitive situations where the market has not provided them. Work can be split between a contractor and a competing government work force. Or government can make a market where none exists, using its requests for proposal to stimulate the emergence of new vendors.

**Is the fully allocated cost significantly higher than outside vendors charge?** Where the accounting system produces fully-allocated cost information, it can be used as part of the preliminary screening process. A Reason Foundation paper suggests that 110 percent of vendor prices be used as a preliminary rule of thumb. If the process moves to the point of contracting out, the “avoided cost”—almost always a lower number than the “fully allocated cost”—is what the contractor must better, but a high, fully allocated cost is an invitation for further analysis. (Costing is discussed in greater detail later in this report.)

**Consider the internal market when planning marketization.** When considering contracting out most of the focus is on the external market. But when considering marketization—where government employees bid on work—it is necessary to consider internal market conditions as well. Entrepreneurial management will do better than managers who are uncomfortable with competition. Giving employees and unions the ability to influence work rules, process design, and organization is important. In-house departments will generally be more competitive where salary, wage, and benefit scales are competitive with those of outside vendors. Departments that can make use of part-time employees may be more competitive than those that do not. Activities where there are opportunities for restructuring or reengineering of service delivery systems are good candidates for marketization. But because the point of marketization is to bring about
change that would make in-house units better performers. The fact that they are not competitive at the outset is no reason to shield them from marketization. It is, however, a reason to give in-house departments the time and flexibility they need to become competitive.

**Be Strategic:** Would successful contracting out or marketization make a difference? Pick significant targets. Programs where the costs are significant are candidates; but also programs where the prospects of success are good regardless of size may be important. A contracting-out or marketization strategy can benefit from early successes and good examples.

"If it isn't broken, fix it anyway." There is no question that it is easier to overcome resistance to change when there is general agreement that "something is broken"—that a program is working poorly or exhibits obvious opportunities for restructuring that existing management is unable to grasp. We observed that many contracting decisions are stimulated by a crisis where something is not going well and a change is needed. But "something is broken" does not make most criteria lists. This is because proponents of contracting out and marketization believe it is important to look for opportunities before "something is broken." While jurisdictions may differ in how they interpret or weigh criteria, proponents argue that it is important to have a systematic screening program that looks at all of the programs of a jurisdiction—the successful and the unsuccessful alike—in a search for opportunities to bring market incentives to bear. "If it isn't broken, don't fix it" is not the slogan of contracting out or marketization proponents.

**B. A bedrock issue—determining the cost of service.**

We found widespread agreement in principle that knowing the costs of public services is, by itself, important management information even if it does not lead to contracting out.

Complaints about cost methodology are frequent among the opponents in the privatization debate. We became quite cautious about accepting at face value the claims of proponents or opponents concerning costs or savings since a great deal turns on how government costs its services for comparison with vendor prices.

Ironically, most government accounting systems make it difficult to know what a particular service costs. They have been designed with other legitimate purposes in mind.

Government accounting systems are generally on a "cash" basis because of the importance of knowing whether current year tax revenues will cover current year expenditures. Private sector accounting practices are generally on an "accrual" rather than a "cash" basis, which allocates revenue and expenditures over multiple periods to more accurately reflect economic performance.
The budget in government is an expression of public policy and a principal instrument for control. Accounting systems are designed to assure legislators and others that money is spent on the activities for which it was appropriated. The prevalence of inter-governmental revenues creates a greater emphasis on dollar tracking as each contributing government wants to be assured that its funds are spent for the intended purpose. “Fund accounting,” found in the public and non-profit sectors, is an example of a device frequently used to demonstrate that dollars were spent only on the appropriate activity.

Since governments do not charge fees for most of their services, there may be no incentive to routinely allocate overheads to determine what users should pay to cover the full cost of the service. Since many of government’s capital investments, such as physical structures like City Hall, are not generators of revenue, what costs should be allocated to what services to get to apples-to-apples comparisons with private sector prices is often the subject of legitimate debate.

Providing information on service efforts, costs and the accomplishments of a government entity is an important objective of financial reporting. But in practice, most financial systems have given much greater weight to accountability for dollars and to cash reporting than to cost-of-service information.

Determining the cost of service is further complicated when a program receives dollars from multiple funding sources, each concerned that its dollars get to the right place, and each pleased that its own dollars have “leveraged” the dollars of others. In this environment it is easy to lose sight of the overall cost of service.

Of the jurisdictions that have explored service cost, many do so on a special project basis, because the accounting systems are not designed to make cost of service self-evident. A number of governments, the City of Portland among them, have published analytical handbooks to guide the analysis.

Witnesses told us that it is reasonable, given the sophistication of computer technology, to expect future evolutions of government accounting systems to become significantly more helpful for the costing of services. While the idea of having cost-of-service information easily available is widely supported, it comes at a price. We did not hear calls for the immediate overhaul of government accounting systems, although jurisdictions such as Indianapolis have rebuilt systems to support their strong commitments to contracting out.

Indianapolis asked an outside accounting firm to help introduce activity-based costing into city government. Activity-based costing is an accounting and financial management tool that identifies costs of city activities and services on an outcome basis. Direct costs, the depreciation of buildings and equipment, fixed costs (e.g., idle equipment and building space), and citywide overhead costs are incorporated into the production costs of a unit of output. Unlike other cost-estimating methods, activity-based costing
focuses attention on the cost of producing outputs, as opposed to simply measuring the inputs (hours, tons, etc.).

The Indianapolis activity-based costing system facilitates contracting out, but it is also useful for identifying underutilized resources, spotlighting excessive overhead, and for making comparisons from district to district for the same services. It also helps front-line workers understand costs and allows them to make improvement suggestions based on this cost information.

C. Knowing what to do with the numbers when you get them.

Contractors want a "level playing field," which does not necessarily lead to the best deal for the taxpayer. Governments do enjoy some cost advantages. They pay no taxes. They are not required to return a profit. In the case of construction projects, governments enjoy lower workers' compensation rates than the construction contractors they might employ. Should the costs be adjusted to neutralize these cost advantages? Third party observers say "No." Government and the taxpayers who support it should benefit from the comparative advantages government does have. Costs are what they are.

The first step in cost analysis is determining the total cost or "fully allocated cost" of in-house service delivery. This is described by the equation below:

\[
\text{Fully Allocated Cost} = \text{Direct Costs} + \text{Indirect Costs}
\]

Direct costs are those cost items that only benefit the service being analyzed. Examples are the salaries and wages of the government employees who work exclusively on providing the service. Some direct costs are less obvious but must be included as well. The interest costs on capital items used by the program and pension costs are examples. A depreciation or use allowance factor should also be computed for facility and capital equipment. Even when no actual dollar cost is incurred, a use allowance factor should still be included because the assets—the buildings and equipment—could be used for other government purposes or sold.

Indirect costs, or overhead, include, for example, a program's share of accounting, human resources, and other general agency administrative costs.

Depreciation rates in the private sector are shaped by the Tax Code. Private sector entities have incentives to recover investment costs quickly to generate cash and depress taxable profits as well as to increase the probability that a capital asset will be paid for before its "economic life" expires. Public entities often have no reason to depreciate assets at all and, when they do, may have incentives to stretch the time period of cost recovery over the "physical life" of an asset to hold the cost of service down. Because government cannot go out of business, the case for utilizing a short "economic life" for an asset is
not as strong as it might be for a private business in a competitive environment. The fact that government generally does use longer time periods to depreciate equipment has prompted the Associated General Contractors in Oregon to propose that equipment “rental” rates be established by state law.

The next step is to determine the cost of contract service delivery. This is not the price the contractor bids. Instead, total cost of contract service delivery is the sum of: (1) the contractor cost; (2) the government’s contract administration cost; (3) amortized costs of converting from in-house to contract service; (4) minus any new revenues the program might produce. The equation below illustrates the components of the contract service cost.

\[
\text{Total Contracting Cost} = \text{Contractor Cost} + \text{Administration Cost} + \text{Amortized Conversion Costs} - \text{New Revenue}
\]

The two major methods for estimating the cost of contract administration are informed judgment and federal Office of Management and Budget guidelines. A Reason Foundation policy paper on cost analysis suggests that contract administration costs are likely to be in the range of 10 to 20 percent of the contractor costs.

Cost comparisons using the fully-allocated costs of public services are useful in determining whether the in-house cost of providing a target service is comparable with private sector market prices. The State of Texas compares the fully allocated cost of in-house service delivery with private sector prices on a routine basis. If the fully allocated cost of in-house service delivery is greater than 110 percent of the prevailing private sector price, the state agency must reduce its costs or it may be targeted for contracting out.

Fully-allocated costs are helpful in identifying cost reduction opportunities and identifying services that are candidates for contracting out. But—according to the Reason Foundation—the use of fully-allocated costs is generally inappropriate for estimating the savings to be realized by contracting out. For that, managers must determine the “avoided cost” associated with contracting. The equation below illustrates the importance of determining the in-house costs that would not be incurred—would be avoided—if a target service were to be contracted out:

\[
\text{Savings} = \text{Avoided Costs} - \text{Total Contracting Cost}
\]
Determining which in-house costs will be avoided is rarely a simple task. Direct costs will be avoided, of course, but knowing how overhead costs will change is largely a matter of managerial judgment. Generally three factors come into play:

- **Will power.** The extent to which overhead costs will actually be reduced is a matter of managerial and political will. Incentives to do so are often not great.

- **Amount of contracting out.** Contracting out a small program may not impact overheads at all. On the other hand, if a number of small programs are contracted out it may be easier to reduce costs in government support departments, such as human resources and payroll.

- **Contract length.** Many costs are difficult to avoid in the short run, but may be more easily reduced in the long-term. For example, contracting out a service in the short run may still leave a jurisdiction holding the lease for facilities. And in many jurisdictions—including those in Oregon—contracting out leads to a slow reduction in government positions through attrition and reassignment. It is a rare government that can or wants to fire employees displaced by a contracting out strategy. Some tradeoffs exist. While longer-term contracts permit the government to capture greater savings as the costs that are actually avoided approach the fully-allocated costs, longer-term contracts also relieve contractors of some of the competitive pressures that produce those savings.

When government is contemplating a major expansion of service—rather than contracting out—some commentators suggest using the fully-allocated cost of the proposed service to compare with the costs of contract providers. A business entity intending to take on a new service has the choice to either provide the service in-house or contract out for it. In a competitive business, the additional cost (also called “marginal cost”) of performing the work in-house would be compared with the cost of contracting. Lawrence Martin, writing for the Reason Foundation, suggests that what is a sound practice for business is not necessarily prudent for governments. This is because, unlike a business faced with competitive incentives, governments often maintain excess capacity that tends to make government estimates of the marginal cost of doing something new unrealistically low.

Useful cost analysis involves a great deal of managerial judgment as well as the “hard numbers” that fall out of an accounting system. Actually realizing savings takes political will. Even something as apparently technical as cost analysis requires political leadership and motivated public management.

Cost analysis is both the bedrock for contracting out decisions and a minefield as well.

The Portland Water Bureau, in a test of “contracting in,” permitted an in-house crew to bid on work traditionally done by outside contractors. The in-house crew won and the Associated General Contractors promptly sought an
injunction. In spite of the City’s effort to appropriately identify and allocate its indirect costs in the bidding process, AGC does not trust the City’s cost analysis and is concerned that the City uses different standards in considering inside and outside bids. The AGC intends to take its issues on cost methodology to the legislature if it cannot reach a negotiated agreement with the City. City representatives disagree with AGC and believe that the City properly evaluated its costs.

D. “The Efficiency in Government Act.”

The correct perspective for cost analysis is that of the taxpayer. A current proposed ballot measure offers an interesting illustration of how easy it is to slip into the seductive embrace of “level playing field” arguments and create policies that may be fair to contractors, but not to taxpayers. The good example of this problem is presented by the proposed: “Efficiency in Government Act.” The measure will appear on the November 2000 Oregon State ballot if its proponents gather the requisite number of signatures. This proposed initiative offers a definition of cost which voters may view as reasonable but which would drive government costs up rather than down as the initiative’s title would suggest. The measure would permit voters to require a government entity to accept the bid of a vendor that could provide a service at savings exceeding 20 percent. The measure defines savings exceeding 20 percent as, “a bid to provide a product or service at a price that is more than 20 percent less than the cost of the current government provider including all labor costs including all fringe benefits and actuarial costs of pension benefits; occupancy costs of all buildings and other real property using market rental rates; and all taxes, fees, and licenses a private sector provider would be expected to pay in the same circumstances.” Not only would the measure price government services at their fully-allocated cost rather than the cost that would actually be avoided by contracting out, but the fully-allocated cost would be artificially inflated by adding “taxes, fees, and licenses,” which are not part of the government’s cost of service. The playing field might be leveled from the point of view of a prospective outside vendor, but not from the point of view of the taxpayer who could expect to pay more for government services rather than less if this measure were enacted.

Costing is not an issue that policy makers or voters can safely leave to others to sort out.

E. Involving the existing workforce enhances prospects for success.

Contracting out threatens existing public employees. Jurisdictions that have been successful in contracting out generally have worked closely with their own employees and have “no-fire” rules. Personnel cost savings are achieved by attrition and reassignment within government and by having the
contractor hire displaced government employees. We learned that many private companies now contracting to perform public services employ many former government employees. The heads of the principal private corrections corporations are all former public corrections officials.

Not surprisingly, the sensible practice of engaging the existing workforce has led to permitting employees to bid for work against outside contractors. Knowing the costs, engaging the employees, and being willing to go outside if necessary, can stimulate restructuring of work and organization that makes going outside unnecessary.

In many jurisdictions, law or labor contracts deal explicitly with the rights of employees where contracting out occurs. Article 13 of the State of Oregon’s collective bargaining agreement with the Oregon Public Employees Union requires, among other things, that the Union have the opportunity to submit an alternate proposal, and there are extensive protections for displaced workers.

F. The contract itself can make or break the strategy.

The success of contracting out is often dependent on the quality of the contracting process and the contract itself. Governments that contract out must trade in their skills as direct program managers and instead become skilled contract negotiators and contract managers. It isn’t easy, and sometimes it can be very difficult.

We heard from witnesses that, because governments often are required to accept the lowest bid when contracting out, public sector contract negotiators must do their best to consider, and provide for, all aspects of the product or service they hope to achieve. Early clarification of needs and desired outcomes is essential for both the public body and the contractor.

While contract detail, in terms of final product, is useful, some of the safeguards placed upon the public contracting process can have negative impacts in terms of contractor participation. We heard from witnesses that some prospective contractors choose not to do business with the government at all because the contracting process, the contracts themselves, and the administration of contracts by government is more tedious and time-consuming than contractors face with private sector clients. Complex process cuts off government from some of the talent that is available in the vendor community.

Typical government contracting practices tend to specify in detail the work to be done, which permits contractors to differentiate themselves primarily with respect to price. More open contracting processes—negotiated contracting processes—may permit contractors to differentiate themselves with respect to the work method and product as well as price. An open contracting process taps the talents of the prospective contractors and may help the client redefine his needs before a contract is written.
We did learn about one jurisdiction—Atlanta—which had successfully used a negotiated bidding process in selecting a municipal water system operator. A first round of bidding was used to identify vendors with acceptable prices; a second round—in which every vendor could see every other vendor's proposal—opened the door to negotiation on what would be done and how. But Atlanta appears to be an exception to the rule. Most public jurisdictions, including those in Oregon, require public agencies to select the lowest bidder for many contracts and do not allow more open contracting processes. This inhibits the ability to differentiate contractors on dimensions other than price. Procedural limitations, such as requiring work to go to the lowest responsible bidder, are statutory in Oregon. They probably reflect legislative interest in documented fairness in contracting processes, provide a documented transaction trail for accountability, and honor the public sector's own often well-founded aversion to risk. Accordingly, we did not find a strong case for a wholesale cutting of "red tape" and the encouragement of the adoption of private-sector contracting practices. Private sector practices can be more agile, and trust and relationships between individuals can often stand in lieu of detailed documentation and procedure required by government.

Contracting is an area where there are differences that reflect the legitimate difference in the cultures of government and the private sector.

There are hallmarks of successful contracting programs. Some of the key themes that came to our attention are discussed below.

**Be clear on outcomes.** Contracts get into trouble when there is a lack of clarity about the desired result. Ben Hayllar, director of finance in Philadelphia asks, "If you can't do the job, how can you tell the contractor what to do? How can you write a scope of services when you are clueless?" Clarity about outcomes and results is more important than details about means that in many cases might be left to the contractor. While the contractor might usefully be encouraged to negotiate concerning outcomes, as was the case in Atlanta, problems result when contractors are permitted to define outcomes through performance.

**Tie payments and other incentives to performance.** Yes, it is true that a contractor who has competitors has incentive to perform well, but it is also desirable to build incentives into contracts themselves. Portlanders were impressed in 1997 with the speed of the I-5 Columbia River Bridge repair where the contractor beat the projected completion time by a wide margin to win early completion incentive awards. Incentives can be highly motivating to the contracting community. On the other hand, we learned that there are often objections to the addition of incentives in public contracts on the theory that the contractor is being paid to perform and should not get extra public dollars to do so.

**Acknowledge that contracts can fail and be prepared to resolve a failure.** Be clear about what will occur if contract terms are not met, who will be responsible, and what corrective actions will apply. Address bonds, warranties, liability and proper indemnification.
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Acknowledge that conditions may change and be prepared to respond to changes. What is almost certain is that the future will bring surprises. While it is helpful to anticipate possible changes in conditions in the contract, it is also useful to provide flexibility to respond to unanticipated changes.

Protect public policy preferences. It may be that for public policy reasons a jurisdiction wishes to impose conditions on a contractor concerning a deeply held policy preference. For example, one interviewee felt very strongly that government should not create lower paying jobs by moving government work out for performance by contractors whose employees were paid less than comparable government employees.

Have the capacity to monitor and evaluate performance. Even if contractors perform the work, government still needs to know if performance is satisfactory. Monitoring contract performance must be ongoing and should track the contract schedule, milestones, and budget. Regular meetings with the vendor and mid-course progress reports are essential. The auditing approach should be tailored to the type of contract. In some cases, quantitative information will be sufficient. In other areas, social services for example, it may be necessary to gather more qualitative information through face-to-face interviews. A contractor’s willingness and ability to work closely with service recipients to effectively meet each individual’s needs should be an important criterion in evaluating the quality of these services. In every case, the contract should make clear the standards and expectations for evaluation.

Nurture competitive incentives. The point of much contracting out—particularly under a full marketization strategy in which the government work force can bid against outside vendors for some work—is to benefit from the competitive incentives of the marketplace. Unusually long contracts, or contracts with onerous cancellation penalties, can deny government the benefits of a competitive marketplace. Completely abandoning the ability to perform work in-house also weakens the competitive incentive for the vendor to perform. Certainly there are trade-offs. Longer-term contracts protect vendors from competition, but on the positive side also permit the government’s avoided cost—the cost the vendor must better—to rise, approaching the fully allocated cost.

“Time is money”—Public contract management should be as efficient as possible. Even though government has valid reasons for its procedure and process, recognize that greater agility in making decisions, paying bills, negotiating changes and so forth would make government more attractive as a client. Agility—simply recognizing that in the private sector time is money—may make a greater number of vendors available to government and can improve competition. While some of government’s “red tape” is necessary, some is not and should be pruned away.

Negotiation of means and ends can be a good way to tap vendor creativity. The Atlanta example suggests that the public sector culture can tolerate more structured negotiation concerning the means and deliverables
than is generally the case in public procurement processes where the request for proposals often specify the deliverables and the means to create them as well.

V. Findings — ILLUSTRATIVE CASES.

Next we offer several “case studies” that illustrate key points about contracting out and marketization strategies.

The first case study provides some detail about private prisons, an area that is already part of the public policy discussion in Oregon. The second is about growing privatization of municipal water services, an area that is still over the horizon for Oregon, but which merits attention. The last case study is about not-for-profit social services agencies, an area where even the most enthusiastic proponents of contracting out will agree that it is difficult if not impossible to use contracting out or marketization to bring competitive incentives to bear.

A. Private prisons—a ripe issue in Oregon

The first proponent of private prisons was Jeremy Bentham. In his 1791 book, Panopticon, he proposed a circular prison structure designed for maximum visibility—so that prisoners and their guards might be easily observed from a central “Inspector’s Lodge.” Given this open architecture, he wrote “I would do the whole thing by contract.”

Private corrections are not new in practice. There were private prisons in the United States in the last century. But the marked expansion of the private sector into corrections began to generate interest and much controversy in the mid-1980s. Underlying the recent expansion of private prisons are two seemingly contrary trends. On the one hand, voters have lost patience with criminal behavior and incarceration rates have risen; but, on the other hand, voters have shown no enthusiasm for paying for extra prison beds.

Corrections is one of the fastest-growing state budget items, according to a 1998 report of the Reason Foundation. In the last 15 years, state spending on corrections grew more than 350 percent—compared to a 250 percent increase in spending on welfare and a 140 percent increase in spending on education. More than a third of the states devote 5 percent or more of their revenue to corrections—Oregon spends 7 percent.

Despite the increased spending, 19 state prison systems are 25 percent or more over capacity and at least 10 others could be considered very overcrowded. Some 800 jurisdictions have identified the need for new prison
construction in the next few years. Nonetheless, voters are digging in, approving fewer than half of the referenda to authorize bond financing for new facilities.

The pressure to hold costs in the face of an increasing prison population has opened the door to private corrections. Private corrections companies claim they can cut between 10 percent and 40 percent off prison construction costs because they can proceed with greater speed and agility and are not hampered by the internal red-tape confronting the government. Although cost claims may be debated, what is certain is that having a private firm build and own the facility is politically more palatable for public officials not wishing to put a bond measure for a public facility before the voters. Political convenience may drive some decisions that are publicly justified in terms of expected cost savings.

In addition to savings in up-front construction costs, private contractors claim that they can operate prisons for 10 to 15 percent less than the government. Many privately operated prisons are government owned.

Currently about 15 firms operate adult corrections facilities in the United States. The largest of the prison companies is Corrections Corporation of America (CCA), which operates over half the private prison beds in the country. This company’s services include design, construction and operation of correctional facilities. The company is the industry leader with 62,487 beds in 77 facilities in the US, Puerto Rico, Australia and the UK. Standard and Poor’s expects CCA’s earnings to grow at a 40 percent pace fueled by an aggressive facility opening program and “the trend toward privatization of U.S correctional institutions....” In California, CCA is building a $100 million dollar facility at California City even though the company has no contract with the state. “If we build it, they will come.” says CCA president Dave Myers.

**How do private firms hold down costs?**

Reduction of labor costs is the primary source of operational savings claimed by private contractors. When they have a hand in facility design, they will provide for sight lines and technology that permit fewer people to monitor prisoners. Private prisons are reported to use roughly one-third the administrative staff present in public prisons. Overtime and sick time are more carefully managed and private firms often have greater freedom to manage personnel. Proponents say pay is “nearly the same or slightly lower” but that private firms can employ a wider range of incentives including promotion based on merit rather than seniority.

A second money saving strategy is “incident reduction.” Nearly every incident between inmates or between inmates and correctional officers costs money. Private firms have a strong incentive to manage facilities to minimize incidents. Proponents say this means keeping inmates well fed and occupied with work, education, or recreation as well as establishing and maintaining tight control.
Full utilization of facility capacity is also key to a money-making strategy. Beds not used by prisoners from the local jurisdiction can be made available to other jurisdictions.

Lastly, proponents argue that private firms, unencumbered by government purchasing regulations, are more efficient at purchasing supplies. They also argue that private contractors maintain facilities with greater efficiency. For example, public sector managers who deal with budgets from one appropriation to the next may have difficulty getting funds for major capital investments that will save money over time. Private contractors can look at the numbers without having to worry about the daunting task of instructing a legislature on the long-term benefits of capital improvements.

There are now 120 private facilities in 25 states, the District of Columbia and Puerto Rico. Oregon does not have a private prison, although it has dealt with overpopulation by placing some female inmates in contract beds in other states. The legislature has held interim hearings on the subject, but the governor and the Department of Corrections have remained neutral on the issue. Although no bill was available for examination, one legislative leader of the movement to encourage private prisons in Oregon said she hopes to introduce a bill in the 1999 legislative session that would require that one of Oregon’s next medium security prisons be private. She believes having at least one private facility will provide an opportunity for competing approaches, which, if successful, could be adopted by the publicly-operated system as well as by future private prisons. Her theme was not that private is necessarily better, but that controlled competition is better than the existing public monopoly on prisons.

With so many jurisdictions opting for privatization isn’t the case for prison privatization clear cut? Not necessarily. Here is a sampling of the issues and available information.

On the question of whether private corrections programs are cheaper than public programs, the jury, for many observers, is still out. There are limited “apples-to-apples” comparisons, and the conclusions drawn from them are mixed.

In August 1996, the federal government General Accounting Office (GAO) released its report “Public and Private Prisons—studies comparing operational costs and/or quality of service.” The GAO report assessed the then-extant studies, rejecting some because of concern about the validity of methodology or the appropriateness of the institutions being compared. But three of the studies (California, Tennessee, and Washington) made comparisons of costs between reasonably matched private and public facilities that were operating within each state that was studied. Of the four public-private comparisons reported in these studies, two showed no significant difference in operational costs, one showed a seven percent difference in favor of the private facility, and the other reported the private facility to be more costly than one public institution and less costly than another. “We could not conclude from these studies that privatization of
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correctional facilities will not save money. However, these studies do not offer substantial evidence that savings have occurred." The GAO concluded that the studies they had examined offered little generalizable guidance for other jurisdictions regarding potential cost savings.

In 1996, the State of Washington Legislative Budget Committee "Department of Corrections Privatization Feasibility Study—Report 96-2" stated "Although there are numerous published sources that debate the pros and cons of privatization, there are only a few studies that have attempted to compare costs, and they have reached conflicting conclusions." The report's authors concluded that they did not find any studies from which they could draw general conclusions about the potential for cost savings through the privatization of prisons.

Both the Washington State and GAO studies have drawn fire from proponents of private prisons. The GAO, possibly because of its institutional credibility and the fact that the agency is frequently cited by skeptics, has attracted the most criticism from proponents of private prisons. Proponents argue that the GAO missed an "apples-to-apples" comparison of public versus private prisons in Louisiana that shows 14-percent to 16-percent savings in favor of private prisons. More generally, the GAO is criticized for being too pristine to be of practical use. The GAO attempted to find "apples to apples" comparisons of actual costs in similar comparable situations. Analysts who are willing to make adjustments to account for differences in prisons that are not alike or who are willing to compare actual costs of private (or public) prisons with estimates of what it would have cost to have a public (or private) prison, have had more data to work with than did the GAO. Adrian Moore, a private prison proponent writing for the Reason Foundation, found 14 independent studies, 12 of which found private prison costs to be lower than government prison costs by from five to 28 percent.

In his book, Privatization Decision—Public Ends, Private Means (1989), John Donahue concluded that "...there is enough room for variation in the selection of samples, choice of methodologies, and the definition of quality and efficiency to assure that consensus remains elusive. It seems likely that even many years' experience with private prisons could still leave us without unassailable evidence on efficiency, cost, or quality." Although a decade has passed since Donahue made this observation, reasonable people continue to debate this issue.

Some skeptics who concede initial savings are concerned with the durability of savings offered by contractors bidding for new business. Contracts in this business tend to be long-term—twenty or thirty years—and some require compensation if canceled prematurely. Once in the embrace of a long-term contractual relationship, a jurisdiction may no longer benefit from competition in the industry even if it is vigorous. The contractor has incentives to pass through cost increases, but has no incentive to share savings with the government. Author John Donahue writes, "Nobody expects the prison industry to be competitive in the way that the fast food industry is competitive. But there is some reason to fear that instead of being competitive
like the trash collection industry, it will be competitive like the nuclear submarine industry—which is to say, not at all.”

In addition to cost questions, there are many operational and philosophical issues. Many of these issues flow from the suspicion that the profit motive will lead corrections contractors to do inappropriate things. The list of possibilities is long, but according to the Oregon Department of Corrections there is no evidence to date that the quality of private operations suffers when compared to government run facilities.

Oregon corrections officials note that voters here have given special weight to having prisoners work or engage in on-the-job training. In 1994, Oregon voters passed Measure 17 requiring inmates of state correctional institutions to spend forty hours per week working or engaging in on-the-job training. Currently the state has managed to put only 60 percent of inmates in the required “industries” program. Administrators in Oregon point out that 95 percent of prisoners return to society and 77 percent of all female prisoners return to parenting roles. They take Measure 17 as evidence that voters here understand that there is much more involved than minimizing the costs during incarceration. Although they are carefully neutral on the question of whether private prisons are a good idea for Oregon, they are concerned about the ability of contractors to manage with this larger picture in mind.

Contracts for prison services are necessarily complex and require careful monitoring. With some public services, the government can be concerned only with the outcome and not concerned with how the contractor performs the service. But with prisons, the details of how the services are performed are of interest to the government. Prisoners have rights. The government may have objectives for prisoner rehabilitation and training. How the job is done on a daily basis is a public concern. There are a number of functions that relate to the time a person spends in prison, such as prisoner classification, which cannot be delegated away to a contractor.

In addition, there are many legal issues, because law has evolved with the presumption that prisons will be public facilities. Many of these can be clarified by the state legislature, but some cannot. For example, the United States Supreme Court has ruled that the limited immunity enjoyed by government employees does not apply to contractor employees such as private prison guards. Opponents suggest, then, that privatizing prisons increases the government’s ultimate exposure to prisoner lawsuits. Proponents of private prisons say the Supreme Court decision creates strong incentives for private prison personnel to behave correctly, incentives that are lacking in the public system where employees enjoy limited immunity.

The issues are not insurmountable, but they are very complex, making successful implementation of a private prison program challenging.
B. Local water systems—an issue just over the horizon for Oregon.

Drinking water and wastewater treatment are classic municipal services, usually provided by local government itself. Eighty-five percent of drinking water and 95 percent of wastewater treatment are provided directly by government. But these two markets are opening up to private providers. One witness characterized the market as being “where cable TV was 15 years ago.”

Privatization is most frequently stimulated by the need to expand or modify the physical plant, often to meet environmental requirements. The United States Environmental Protection Agency (EPA) estimates that $138 billion of drinking water infrastructure investments and more than $137 billion of wastewater treatment investments are needed to meet system rehabilitation and expansion needs. The EPA has encouraged municipalities to consider public-private partnerships to finance these infrastructure needs. Standard and Poor’s reports that “[a] drive toward privatization is beginning to sweep through this industry, due to a rising need for capital to repair or replace aged facilities.” Nonetheless, Standard and Poor’s advises that “growth in the industry is likely to be slow.”

There are six major private entrants, along with a number of smaller competitors. The big players are large, well capitalized, and in some cases international. United Water Services, the second largest U.S. operator, privatized the Indianapolis waste water system and is the North American operating entity for Suez Lyonnaise des Eaux, which operates in 130 countries. UWS operates in 13 American states. Its contracts typically guarantee savings to the municipality. UWS guaranteed 34-percent savings to Indianapolis (where independent auditors had declared the municipal operation to be well run) and 56-percent savings to Atlanta over a ten-year period. Our witness from UWS stressed the strong financial condition of the company—illustrated by the company’s “A” credit rating—but conceded that to date “my company is in the red.”

It is clear that the cities that are guaranteed savings realize them. It was not clear to us that the private companies actually reduce the costs by the amounts of the guarantees they make to cities. The market is just opening up, and big players who can afford “loss leader” deals are jockeying for position so it may be that some of the savings to cities represent real cost reductions along with the buying of market share by the big companies. Nonetheless, the possibilities for reducing costs and making money are drawing seasoned companies into the American water and wastewater market. There is something there, at least over the long term. Companies favor 10- to 20-year contracts.

The production of drinking water and the processing of wastewater are essentially manufacturing operations where costs should be easy to measure and cost control should be straightforward. How do private companies do it for less? We were told that long-run savings came from labor efficiencies.
Typically, contracts have “no-layoff” provisions but savings come from attrition over time. The big companies can also cut advantageous deals on energy costs since they operate in more than one jurisdiction and have greater market presence than a single city might. UWS also cited “know-how” as important. While a city operates only one system, UMS operates many and can examine its entire portfolio of operations for “best practices,” and depend on its own potentially greater body of expertise.

Where a private contractor also builds a new facility, it is possible that public decision-makers are attracted to the possibility of building without facing the voters for a bond issue. The public still pays the cost through water and sewer bills but doesn’t vote on the capital improvement financing up-front.

Historically, the most prevalent form of privatization has been operations assistance, where specific functions, “collections” for example, might be contracted out on a one-to-three year contract. The market has now moved to contract operations of an entire existing facility or system, usually under a 10- to 20-year contract. The city still owns the plant and pays for repairs. Prospectively, it is likely that more new facilities will be designed, built, and operated by private firms.

C. Not-for-profit social service providers—not every area is fertile ground for contracting out or marketization.

Non-profit agencies provide an often bewildering array of social services, many of which are geared to the needs of specific populations unique to particular geographic areas—even neighborhoods—within a given governmental jurisdiction. Social service programs deal with disabilities, physical and mental health, alcoholism, drug addiction, parenting skills, job training, employment and the many other needs of typically poor or otherwise disadvantaged persons. Human needs do not lend themselves to uniformity or even comparability of services that may be vital for one population and largely irrelevant for another. Multnomah County has over three hundred non-profit contractors serving various social service niches. Witnesses indicated that contracting out decisions for providing social services are more often driven by proposals from the potential service providers or by negotiations between private agencies and government rather than by governments’ requests for proposals inviting relatively similar providers to submit competitive bids.

Typically, social agencies have come into existence “from the ground up,” because of needs perceived by an individual or group that undertakes to meet them by some combination of private donations and volunteers. The 1960s’ War on Poverty further encouraged formation of grass-roots agencies. Having started with limited resources, non-profits tend to pay their employees less, and provide fewer benefits, than public employers, sometimes resulting in excessive turnover, according to the agency representatives we interviewed.
The low labor costs are a disincentive to prospective private for-profit competitors who would be expected to pay their employees at rates approximating the prevailing wage and therefore could not provide comparable services as cheaply. In addition, some states have laws that prohibit for-profit companies from competing and also exempt social services from the competitive bidding processes applied to other government services.

Once established and shown to have community support, non-profit agencies then propose to government that their services be funded so they can be provided to a larger population or coordinated with other services already available within that government's jurisdiction.

If a particular need is already being met, there is no incentive to form another agency to compete with those already established—the "Yellow Pages Test," referred to above, does not apply to non-profits. One witness observed that when government went out to bid, it was common to get just one offer.

In the absence of competition, contracting out services to non-profit providers may simply replace a government monopoly with a private one. Moreover, in the human services field, even if other providers could be found, a change is likely to be far more disruptive to service recipients than a change in the provider of a service with more clearly defined results such as garbage removal or water treatment. Thus there may be policy reasons for setting different selection criteria for providers of social and human services.

As one writer notes, "If social service contracting is a child of the privatization movement, with its reverence for competition, it is a prodigal child. Virtually no one directly involved in the social service system—government, contractor or client—has any incentive to disrupt the system once it is established." Nothing in our interviews refuted this comment.

Moreover, since quality of social services is far less measurable than that of more concrete services, how could governments ascertain whether a change would result either in better services or in getting services of comparable quality at less cost?

Accountability can be a problem when there are a large number of niche providers of difficult-to-measure services. It is further complicated when contractors are receiving funds from multiple sources, each having its own procedural and reporting requirements. One source characterized social service contracting as often "laden with a morass of regulations." Witnesses acknowledged that tracking clients through such non-profit social service networks is difficult. Governments often cannot determine what works and what does not; and in one case, Multnomah County knew where it sent the checks but had lost track of where services were being provided. Nonetheless, we found government social services directors pleased to be able to contract with non-profits. One official said that we have lost accountability, but we have captured motivated concern for the clients. We did hear that many service providers make use of the resulting flexibility to
provide services tailored to the specific and complex needs of the people they serve.

The Multnomah County official who oversees the county's contracts with human service providers reported that in the past the county used a block grant approach—contractors told the county, "Tell us the desired outcome, and leave it to us how to get to that outcome...we will self police and monitor our own programs." The county was criticized for the difficulty it had in monitoring its contractors and holding them accountable under this system. The county has recently embarked on a new strategy, in which it plans to contract with single non-profit providers for a range of services. A contractor can either provide all the services itself or can subcontract with other providers. The county's initial attempt to use this approach to consolidate the provision of homeless youth services in the county was unsuccessful because no contractor was interested in taking on this role. The county currently is developing seven master contracts for the delivery of the bulk of its anti-poverty services and non-clinical children, youth, and family services. These contracts would consolidate services currently provided through fourteen family centers and community action agencies. The county's intent with this new approach is to increase both efficiency and service quality.

There is comfort that networks of non-profit providers, even if difficult to monitor or control, are well motivated. Flexibility was cited as a major advantage offered by contracting with non-profits. Some non-profits have changed their names, merged with other agencies, and/or modified their menus of services offered, in order to respond to perceived changes in community needs or in the availability of contract funds. Local government officials state that, having once set up a tightly organized in-house network for providing services, they find it difficult to change.

Given the complexities of social service contracting, we might have expected to find a preference for keeping these services in-house. In fact, however, the choice varies according to the circumstances that prevailed when a given county set up a particular service. While Multnomah County relies extensively on non-profit contractors, Clackamas County provides many of the same services, such as mental health, using its own employees. We were told that Clackamas County's decision to keep key services in-house was based pragmatically on the fact that the county did not have the array of established private agencies that exist in its more urban neighbor. Its Human Services Director commented that she might well have made the same choice as Multnomah, had there been comparable resources available. Notwithstanding this objection, Clackamas County cites efficiencies in being able to coordinate in-house programs and sees Multnomah County's contracted services as fragmented.

The Reason Foundation, a usually-vigorous proponent of privatization, acknowledges in one of its publications that the cost savings, efficiency gains, and service improvements associated with the contracting of many government services are not likely in the world of small social services.

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providers. Other privatization approaches such as vouchers may hold greater promise. Vouchers would permit clients, rather than governments, to “vote with their feet” when another non-profit agency exists that they believe can meet their needs more effectively than their present one. Agencies that are about to fall below a critical mass of clients would then have an incentive to change or upgrade their services, merge with agencies that clients find effective, or go out of business entirely.

VI. CONCLUSIONS

Our exploration of public sector contracting out and marketization strategies led us to a number of conclusions.

1. Incentives—not contracting out per se—are what counts.

Contracting out is as old as the Republic and nearly every unit of government contracts out something. The most frequently stated reason is that it saves money.

Recently the focus has shifted from contracting out per se, to incentives. And the focus on incentives has led to the conclusion that a government work force—properly incented—can be competitive with outside vendors. This has given rise to a strategy called “marketization” in which existing government employees are permitted to bid for work against outside providers.

To paraphrase the words of one City of Indianapolis employee, incentives created by marketization invite employees to bring their best ideas to work.

2. Contracting out and “Marketization” in particular are powerful strategies for reducing government costs.

Contracting out is the most common approach for taking advantage of competitive forces. Where two or more vendors exist, government may be able to enjoy the benefits of competition by contracting out work. And in fact, it has long been common for governments to contract for printing, janitorial services, automotive maintenance and other services for which there have been is competitive markets. In recent years, private contractors have begun to provide services traditionally provided by government such as corrections, and municipal drinking and wastewater services. But, simply contracting out does not guarantee that government will benefit from competitive incentives. Our report documents the area of not-for-profit social service providers where there are many contracts, but not much competition. And a private monopolist may have even less incentive than government to control costs. Contracting out works best when it brings competitive forces into play.
Marketization permits existing public employees to bid on government services against outside vendors. With a marketization strategy, some work is contracted out, but other services are “contracted in” to government employees. In the most mature example—the City of Indianapolis—services deemed to be “ancillary”—printing, for example—are contracted out. But other services, characterized as “core,” where the city wishes to maintain internal competence, are offered to both external, private sector bidders and internal, public agency bidders. For example, the city established trash collection districts. Both city workers and private vendors bid on the contracts to service those districts. The result was that some districts are served by private contractors and others are served by public employees. The City of Indianapolis not only benefits from competition at the time the contracts are negotiated, but can continue to compare performance from district to district.

We found many examples where contracting out or marketization produced significant savings. We were particularly impressed with the conclusions of some jurisdictions that even well run public services, in which there were no apparent opportunities for improvement, found ways to reduce costs and improve service when exposed to competition. Incentives unlock ideas known to the people who do the work, ideas that are often invisible within an organization’s budgeting, auditing, and other formal management systems.

3. Oregon jurisdictions lag in the adoption of marketization and pro-active contracting strategies.

In Oregon, as elsewhere, a great deal of government work is contracted out. But in general, the status quo prevails unless a crisis stimulates consideration of a change. Work that has been traditionally contracted out by a jurisdiction continues to be contracted out. Work done in-house, continues to be done in-house.

We encountered some jurisdictions that have adopted formal philosophical statements stating preferences for contracting out. However, we did not encounter any Oregon jurisdiction with a proactive screening program directed at identifying candidate services for contracting out.

We found one instance of a city department in Oregon that was proposing a test of marketization—in which city employees would compete with outside vendors. With this modest exception, we did not find any examples in Oregon of jurisdictions or individual public agencies with marketization strategies.

We found one city department that was itself a contractor to other jurisdictions and provided printing and communication services in competition with other vendors. Management believed costs were more effectively managed because the department could achieve economies of scale and served clients who had some freedom to select other providers.
There has been interest in the Oregon Legislature in authorizing the development of at least one private prison in Oregon and in contracting out some Department of Environmental Quality automobile inspection functions. The legislature has not passed any legislation to this effect, and the executive branch has been neutral on contracting out these services.

4. Jurisdictions with a top down commitment from political and executive leaders are the most likely to enjoy significant benefits from competitive incentives.

Political and executive leadership are essential. Little will be accomplished in their absence.

The proposed state-wide initiative, self-named "The Efficiency in Government Act," would, if enacted by voters in the 2000 election, require government to accept bids meeting certain price criteria. We do not believe taking management strategy out of the hands of management is a prescription for success. Indeed, the evidence we found indicates that the most impressive successes occur not only where government management is engaged but where line employees are fully involved as well.

5. All public sector activities should be evaluated against formal screening criteria.

The most successful marketization programs periodically evaluate all of their activities against formal screening criteria. The screening process identifies activities that (1) should be provided by government directly; (2) activities that should be contracted out; and (3) those that might be marketized—meaning government employees and outside vendors could compete to do the work. Screening criteria may vary from jurisdiction to jurisdiction depending on local values. What is important is that there be explicit criteria and that political leadership support a genuine screening process.

We conclude that the following are among the most useful criteria for the initial screening of activities for either contracting out or for marketization.

* **Policy or implementation**: Policy activities are not good candidates for contracting but a wide range of implementation activities invite contracting.

* **Competition**: Are there two or three prospective outside bidders? Can the work be structured and can contracts be written that will nurture competitive incentives?

* **Cost**: Is the fully allocated cost of the service 110 percent or more of the price charged by vendors? The fully allocated cost is used for identifying candidate services for further analysis. "Avoided cost"—never higher than
the fully allocated cost and generally lower—is used for making a final decision to contract or not.

- **Ability to Evaluate Performance:** It is easier to contract for services where it is possible to evaluate the success of the contractor. Contracting is difficult when it is not possible to define successful performance in writing or to recognize it when it occurs.

The decision whether to simply contract out a service or to marketize it—permit government employees to bid against outside vendors—will vary from jurisdiction to jurisdiction. Many jurisdictions distinguish between "core" services that government should retain an ability to perform (and therefore could be marketized) and ancillary services, where government should be comfortable relying entirely on the marketplace. Core services that are not marketized for one reason or another are still candidates for contracting out if other criteria are met. So-called "core" services such as municipal water and fire protection have been successfully contracted out.

The fact that a program is performing well should not exempt it from being marketized or contracted out. Contracting out and marketization are strategies for reducing costs and improving performance—even of programs that are not in trouble. Improved incentives improve performance.

### 6. Proper cost analysis is essential.

Political and executive leaders and public managers must understand which costs are relevant for making contracting decisions. The government's "avoided costs," as described in this report, are the relevant costs to compare with contractor prices. "Avoided costs" include subjective judgments concerning which costs are in fact likely to be avoided if the government contracts a service. It is unlikely that good analysis (and therefore good decisions) will flow from rigid formulas imposed on managers. The route to good cost analysis involves effective education, training and executive leadership.

The proposed initiative, "The Efficiency in Government Act," is an example of an approach that would impose a detailed and inappropriate cost analysis formula on government managers. The measure's proposed cost analysis formula would make it easier for contractors to gain government business but, in our judgment, would have the unfortunate effect of increasing costs to the taxpayer.

Because the complete costs of a government service—the so called "fully-allocated costs"—are the beginning point for the analysis of decisions on contracting, accounting systems should provide managers with fully-allocated cost information. Even when services are not contracted out or marketized, their fully-allocated costs can be compared to services in other
7. Existing employees should be engaged in the planning and implementation of strategies to either increase contracting out or marketize services.

In Indianapolis, Mayor Goldsmith came into office with the intent to contract out a number of city services. He quickly discovered that he avoided employee opposition—and in fact benefited from employee initiative—by including employees in the discussion. What began as a contracting-out strategy, became a marketization strategy. With proper incentives and given the flexibility to modify organization and work practices, public employees reduced costs and improved performance.

Even jurisdictions limiting themselves to contracting out find it much more effective when employees are engaged. Typically the public workforce is reduced by normal attrition, transfers to other opportunities within government or by offering employees new careers with the contractor. For example, many of the employees and leading executives in the private prison industry are former public employees.

8. Several areas merit further study by City Club.

We were frustrated at times by the broad nature of our charge that asked us to address the general issue of contracting out but did not direct us to study in depth any particular jurisdiction or program. Nevertheless, we did examine several areas in sufficient depth to conclude that further City Club study is merited.

The non-profit social service sector: We were impressed with the limitations of marketization and contracting as management strategies in the not-for-profit social services sector. At the same time, we were not comfortable with the idea suggested by some witnesses that non-profit social service contractors merit limited oversight because their motivations are presumed to be congruent with those of the government. We are not persuaded that being not for profit confers any special immunity against failure or incompetence.

Accordingly, we believe a future City Club committee could usefully evaluate the management of not-for-profit social services programs in Multnomah County and elsewhere and draw conclusions and develop recommendations concerning the management of these types of programs.

Private Prisons: This issue is ripe in Oregon. Because of the general nature of our charge, we did not get into this issue deeply enough to make a definitive recommendation concerning whether or not Oregon should join the states with private prisons. But we do conclude that the argument that Oregon
would benefit from having one of its next prisons constructed and operated as a private facility is very plausible. Substantial national experience exists to draw on. The evidence suggests that the state could benefit significantly and is unlikely to slide backwards by bringing a private facility into its prison system. Even if the Oregon Legislature decides to authorize a private prison during the current session, before a City Club committee could complete its report, implementation would be years away and the debate is likely to continue. We believe a City Club study directed specifically at the question of whether Oregon should join the states with private prisons would be a significant contribution to this debate in Oregon.

VII. RECOMMENDATIONS

Based on our conclusions, we make the following recommendation:

All Oregon public policy decision makers and political leaders should actively examine how marketization policies could most effectively be used in their jurisdiction.

Marketization permits public employees to bid on some of the government's work; other work is contracted out; and some functions—policy setting, for example—are performed directly by government. We wanted to say that all Oregon jurisdictions should "adopt" rather than "actively examine" marketization, but we are aware that success is unlikely where leadership is not committed. We do not believe the acceptance of marketization will be helped by jurisdictions that give it only lip service. Successes, particularly early successes, are important. And for these, committed leadership is essential. Our recommendation, then, is directed to Oregon political leaders and senior public managers, asking that they "actively examine" marketization as a public management strategy. We hope that among them will be some willing to pioneer this strategy in Oregon government.

Marketization policies should have the following fundamental features:

- Screening criteria and a systematic screening process to identify which services should be provided by government in the traditional way, which services are candidates for marketization, and which services should be contracted out.
- Employee involvement to give employees the incentives and flexibility to show what they can do.
- Accounting systems that are modified, as resources realistically permit, to provide reliable, fully-allocated cost information. Public managers and decision makers should know the full costs of all services.
Privatization of Government Services

Recommendations

• Training and analytical assistance for public managers that helps them make well-founded decisions concerning services to provide in the traditional manner, services to contract out and services to marketize.

• The use of "avoided costs"—not simply "fully allocated" costs—as the basis for analyzing contractor bids.

• Implementation that is strategic—picking easier opportunities first and allowing time to learn from mistakes that may occur.

• Monitoring and evaluation procedures to confirm that the marketization strategy is producing results. The fact that a government is contracting, either with an outside vendor or with an internal workforce, is in itself no guarantee of results. It is important to assure that the strategy is in fact working to nurture constructive incentives and that results are satisfactory.

Respectfully submitted,

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Mark Anderson
Sandy Baruah
Peter Belluschi
Kari Bodmer
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Ruth Spetter
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John Wolz
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Cory Streisinger, research advisor
Paul Leistner, research director

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Special thanks to Paul Leistner for his consistently valuable guidance and good humor.

VIII. APPENDICES

A. Witness List

Kristin Angel, director, Unity, Inc.

Brian J. Bemus, administrator, Classification and Transfer Unit, Oregon Department of Corrections

Gary Blackmer, auditor, Multnomah County

Steve Buckstein, executive director, Cascade Policy Institute

Charles D. Cameron, county administrator, Washington County

John Charles, Cascade Policy Institute

Khadim Chishti, director, Family Works

Barbara Clark, auditor, City of Portland

Dan Cooper, general counsel, Metro

Jeff Condit, attorney

Alice Dale, executive director, Oregon Public Employees Union

Benjamin deHann, deputy director, Oregon Department of Corrections

David Douthwaite, Associated General Contractors

Kim Durcheck, director of enterprise development, Office of the Mayor, Indianapolis, Indiana

Steve Fantauzzo, state president, Indiana American Federation of State, County and Municipal Employees

Irene Fisher-Davidson, director, Department of Human Services, Clackamas County

Jon Freedman, United Water Services

Gregory Green, division administrator, Oregon Department of Environmental Quality
Mike Greenfield, deputy secretary of state, State of Oregon

John Junkin, attorney

Phil Keisling, secretary of state, State of Oregon

Carol Ann Kirby, director of operations, Office of the Secretary of State, State of Oregon

Sue Klobertanz, contractor development division manager, City of Portland

Matt Lamkin, policy advisor, Office of the Mayor, Indianapolis, Indiana

Christa Larsen, director, Metropolitan Family Services

John Lattimer, state auditor, State of Oregon

Jeanette M. Launer, attorney

Mary Li, manager, Division of Community Program and Partnerships, Multnomah County

Jane Lokan, Oregon state representative

Marilyn Miller, director, Portland Impact

Adrian Moore, The Reason Foundation

John Mullin, director, Social Services Division, Clackamas County

Dennis George Mulvihill, government affairs office, Washington County

Rich Peppers, political director, Oregon Public Employees Union

Steven Quick, president, Union Local 725, American Federation of State, County and Municipal Employees, Indianapolis, Indiana

Eileen Qutub, Oregon state senator

Michelle Smith, political organizer, Oregon Public Employees Union

Beverly Stein, chair, Multnomah County Commission

Skip Stitt, president, Competitive Government Strategies, (former deputy mayor) Indianapolis, Indiana

Mary Tobias, Associated Builders and Contractors

Richard Tracy, director of audits, City of Portland

Benny Ward, security threat group manager, Classification and Transfer Unit, Oregon Department of Corrections
Bruce Warner, director of environmental regional management, Metro

Madelyn Wessel, chief deputy city attorney, City of Portland

Ed Woods, Vehicle Inspection Program, Oregon Department of Environmental Quality

Jon Yunker, director, Oregon Department of Administrative Services

B. Resource List


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