



## **STRATEGIES FOR BEST PRACTICE: EXECUTIVE SUMMARY**

A decision to privatize a government service requires thorough analysis of the advantages and disadvantages of privatization to determine whether the public is better served by government or the private sector. The process of privatizing a service has three phases:

- Determining if it is appropriate to privatize a service,
- Determining the level of service desired from a contractor and conducting an open, competitive contractor selection process, and
- Negotiating the contract with the selected contractor and monitoring performance over the term of the service agreement.

In all phases, best practices call for transparency, open communication with stakeholders, impartial and unbiased analyses, and the development quantifiable expectations and measures for service delivery.

The decision-making process should ask: What are the problems with the existing service? What will be gained by turning to the private sector? Are there alternatives to privatization?

Privatization can be successful for services with competitive markets, with clear service delivery goals and performance criteria, and where the services involve transactions that are not irrevocable. It requires decision-makers open to the idea of privatization, a government with established privatization policies, a transparent public review process, comprehensive service transition plans, active contract management and a "recovery" plan to take over service if the contractor fails to perform.

When services such as utilities, transportation systems or parks are privatized it should be clear who owns and maintains the public facilities, infrastructure and assets. If "human services" such as child protective services or welfare services are privatized, sensitive client information must be protected and cost savings should not be achieved in ways that are detrimental to vulnerable clients. There must be contractual procedures to assure that the financial statements of the contractor are audited and reviewed on a regular basis and become part of the public record. In all cases, the public must have a way to lodge complaints about the service to the government agency overseeing the private contractor.

The Best Practices paper identifies these and other broad questions and strategies to ensure principles of good governance are followed and to enable stakeholders to participate in a meaningful way.

*Cathy Lazarus and Ted Volskay*

## **STRATEGIES FOR BEST PRACTICE**

By Cathy Lazarus and Ted Volskay

### **INTRODUCTION**

In an era of shrinking resources, federal, state and local governments will continue to view privatization as a potentially viable strategy to sustain services traditionally provided by the public sector. Best practices suggest that the decision to privatize public services should be made after comprehensive review of the advantages, disadvantages and alternatives to privatization, and only after broad based community/stakeholder outreach and comment. The decision to privatize must be based on factual information, principles of good governance, and careful planning for contractor selection and oversight.

This paper is a review of the essential factors to consider in deciding whether or not to privatize a government service. It outlines key questions to ask policy makers and important policy areas to evaluate before and after making a decision to transfer a public service to the private sector. Links to Pdf attachments to this paper, found after the endnotes, include two tables highlighting the potential advantages and disadvantages of privatization, and a recommended checklist of questions to ask decision-makers throughout a privatization initiative (Appendices 1-4).

### **MAKING THE DECISION TO PRIVATIZE**

#### **Can Any Public Service or Public Asset be Privatized?**

One of the first questions to ask when considering privatization is whether the public interest is protected and served by the privatization of a service or a public asset such as land, buildings, equipment and information. "Economists and others conclude that certain services can only be provided effectively by government; for example, where continuity of service is essential, where no profits are generated, and where no competition exists or can exist. "<sup>1</sup>

#### **Conditions for Successful Privatization**

Research suggests that, absent extreme circumstances such as default or non-performance by a contractor, there is no definitive way to evaluate whether or not a privatization initiative is a success or a failure. For example, privatization may be viewed as a success by some stakeholders if it reduces service cost; other stakeholders may view the initiative as a failure if it results in a loss of public accountability or a loss of public control. A privatization process may also be considered successful if government self-review leads to improvement without actually transferring services to the private sector. There are, however, private market and government agency characteristics that, when in place, increase the potential for successful privatization. Privatization typically works best for services that have the following characteristics:

- The services are in growing and competitive markets;
- Information associated with the delivery of the service is abundant and public accountability (transparency) is not a limiting issue;
- The service involves transactions that are not irrevocable;

- Externalities that can affect the profitability of a service are limited; and
- Service efficiency can be achieved in ways that are not contrary to the public interest. In addition, privatization works best for services that are limited in scope and complexity and the contracting government agency has:
  - Officials open to the idea of privatization;
  - Clearly defined goals and criteria;
  - Established privatization policies;
  - Conducted an open public review process;
  - Worked closely with affected employees and developed employee transition plans;
  - Reliable cost data to accurately compare public service costs to private service costs; and the pricing of public assets to the pricing of private assets;
  - A contract monitoring and management system; and
  - Performance-based criteria against which the private contractor will be regularly evaluated.<sup>2, 3</sup>

### **Accounting for Public Property, Assets and Information**

Privatization often requires private contractors to use public assets (land, buildings, equipment) and information (police records, utility billing information, child welfare files). Whether and how the public agency is compensated for the use of public assets (especially those that generate income) as well as how confidential information is used and protected are major considerations. Also, when service contracts are terminated, thought needs to be given to how the assets will be returned to the public agency. Transactions involving the return of tangible assets are relatively straightforward; however, the return of confidential electronic data and assuring that copies of sensitive electronic files are not retained and used in the future by the contractor are more problematic.<sup>4</sup>

### **Comparing Government and Private Contractor Cost**

Cost savings is a common justification for privatizing government services. Consequently, it is important to accurately compare the total cost of services provided by the government to the projected total costs to the public if a private contractor provides the same service. In comparing the cost of government service to a privatized service, decision-makers must consider not just the cost of the contract but also the cost to transition the service from a public to private provider. The transition costs should include the costs associated with displaced public employees, the cost of contract negotiations and the cost of performance oversight by the government.<sup>5</sup>

### **Is Privatization the Only Option?**

Finally, in making a decision to privatize, decision-makers should be certain that privatization is the best way to provide lower cost services. Sometimes government service delivery can be made more efficient with investment in technology or new delivery methods. Or a "managed competition" process, where the

public agency submits a bid to compete with private bidder, can be a good way to determine the most cost effective method of service delivery. As noted in a U.S. Government Accountability Office (GAO) report: "According to Indianapolis officials, competition in the marketplace rather than privatization per se produces the most value for the taxpayer. This view was shared by most state officials we spoke with. . . the primary advantages of managed competition were reduced costs, improved services, improved employee morale and increased innovation."<sup>6</sup>

### **AFTER THE DECISION TO PRIVATIZE**

What happens **after** the decision to privatize is critically important to the success or failure of the initiative. To maximize the probability of success, it is important for decision-makers and stakeholders to remain vigilant throughout the contractor selection process, contract negotiations and approval phase. Once privatization has occurred, it is important for decision-makers and stakeholders to monitor contractor performance throughout the term of the agreement.

There should be open meetings and public hearings about the key terms of all agreements, the selected contractor and the ultimate service contract.

### **Managing the Contractor Selection Process**

Most public agencies have guidelines and procedures regarding the selection of contractors and standard contract language for liability, insurance coverage requirements, payment and other technicalities. Commonly, the public agency will issue a Request for Proposals (RFP), Request for Qualifications (RFQ) or other documents outlining the contractor selection process, the scope of services desired and minimum standards expected of the contractor. It is important to decide contractor selection criteria in advance. Will selection be based on the lowest cost proposal or on proposed service quality, or on a combination of the two? Will potential contractors undergo a thorough screening to verify they have accurately represented themselves, and are reputable and financially stable? Will criminal background checks be conducted on all private contractors?<sup>7</sup>

*Patronage* is a potential problem that involves the assignment of jobs or the offer of favors to public officials.<sup>8</sup> For example, it is alleged that Interior Department personnel responsible for overseeing deep-water drilling in the Gulf of Mexico routinely accepted gifts from private oil companies and conducted negotiations for future employment prior to the Deepwater Horizon oil spill.<sup>9</sup> Policies should be in place to minimize the potential for abuse by public officials and contractors.

A common method to avoid patronage and assure an open selection process is to have an independent panel screen, interview and rank proposers for the contracting agency. The policies and procedures of the City of Mountain View, California, for example, go further by explicitly stipulating that low-bid pricing is not the primary award criteria in a Request for Proposals.<sup>10</sup> Cost proposals are not opened until after the proposals are reviewed, the interview process is complete and prospective contractors have been ranked by an independent selection committee.

### **Negotiating the Contract**

Government agencies face significant legal risks when a private contractor does not fully honor the contract, declares bankruptcy, or commits fraud or other criminal activity. The governing agency may be liable for the misdeeds of private contractors and is often responsible for making up contractor

shortfalls. It is important that protections and remedies for contractor non-performance or illegal activity be addressed before any contract is signed.

One contractual protection is to require contractors to post a surety bond and/or secure insurance payable to the government agency in the event the contractor is unable to meet the conditions of the contract. This provides an incentive for the contractor to meet the conditions of the contract and also provides financial resources for the agency to intervene quickly and ensure continuity of services if the contractor cannot fulfill the contract.<sup>11</sup>

A second potential remedy is to include in the contract language that establishes the non-performance criteria or conditions that give the government agency the right to immediately terminate the contract and take responsibility from the contractor.

In the case of a renewable, long-term contract, various fees may need to be renegotiated periodically. Specifying key aspects of this procedure, such as the frequency of audits or allowable profit will assure the initial intent of the contractual relationship is not changed over time. Open meetings requirements as well as the accessibility of public records and government documents must not be compromised over the term of the agreement.

Enforcement options and backup plans also should be thought through before the contract is finalized: Who will enforce penalties, and how will they be paid? Are there written legal protections for whistleblowers? When should mediation or arbitration be prescribed? Should these be open meetings?

### **Employee Considerations**

Private contractors often reduce the cost of a service by offering lower wages and fewer benefits than their public counterparts. Private contractors may rely on part time employees who are not offered benefits. "Low waged work is the type of work most prone to frequent turnover, but many public services need long-term workers with historical knowledge of clients, methods and services. Wage levels affect and reflect the quality of worker an employer can attract."<sup>12</sup> To provide a level of protection, some government agencies require contractors to provide employees with competitive wages and to comply with all federal and state equal employment and anti-discrimination laws.

Conversely, as services are privatized, protections need to be in place for displaced public workers. Sometimes displaced employees are provided other positions, if available, or are offered training for new professions. The public agency may require the contractor to initially hire the existing public employees but at private sector wage and benefit levels.

### **Managing the Contract and Overseeing Performance**

"Oversight must take place on a regular and frequent basis to ensure work is done, quality is maintained, and an early warning system is in place in order to prevent a subcontractor's absconding or engaging in financial improprieties. If oversight is not frequent and regular, problems that could have been prevented may become serious and even irreparable. The oversight process must give the public easy access to lodge complaints, ask questions and get responses. If the public cannot find someone to whom problems can be reported, then no one can be held accountable . . ." <sup>13</sup> The GAO report found that in all but one agency surveyed, officials reported that monitoring was the weakest link in the privatization process.<sup>14</sup>

"There are areas of government services where measures of success can be easily stipulated and efficiently monitored."<sup>15</sup> Maintenance services with clearly defined operational procedures and maintenance cycles are perhaps the easiest examples. Are the traffic signals working? Have the trash cans downtown been emptied? What percent of the police vehicles were serviced on schedule? Have the water mains been flushed on schedule?

More difficult to measure are human services where achieving standardized performance measures of success or failure is more challenging. "It is especially difficult to identify and measure desired results for social services. This is because the objectives of many social services, including improved family and child well-being, are often difficult to define simply and clearly."<sup>16</sup> In addition, many social service programs involve goals other than pure cost efficiency and require long timeframes to measure success.<sup>17</sup> An example would be a job training program where it could take years to determine whether clients become successful, long-term members of the workforce.

Despite the difficulties, it is essential to establish metrics in the contract that reflect industry best practices as well as local goals and objectives. It is also imperative that public agencies provide experienced staff to conduct meaningful oversight to assure that goals and objectives are achieved and the public interest is served. Auditors and inspectors may need specialized financial, legal or technical expertise.

## **SUMMARY**

Privatizing a government service is a complex undertaking that requires a major commitment of resources. It involves careful definition of the goals to be achieved, assurance that all efficiencies have been implemented with the existing service model, evaluation of the service "market place" to assure a competitive bidding environment, expert contract negotiation and a thorough understanding of the potential impacts to service customers. Most importantly, the process requires transparency, oversight and ongoing communication with stakeholders to understand their concerns about privatization, because, in the end, the public bears the success or failure of privatization.

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**For Tables 1-2 and Appendices 1-4, see pdf attachments on webpage below.**

## **ENDNOTES**

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<sup>1</sup> Ellen Dannin, "To Market to Market: Caveat Emptor," in *To Market to Market Reinventing Indianapolis*, ed. Ingrid Ritchie and Sheila Suess Kennedy (Lanham: University Press of America, Inc. 2001), p. 8.  
[http://archive.epinet.org/real\\_media/010111/materials/dannin2.pdf](http://archive.epinet.org/real_media/010111/materials/dannin2.pdf)

<sup>2</sup> Mark J. Rosen, Researcher, "Privatization in Hawaii," pp. 25-26 (Honolulu: Legislative Reference Bureau, December 2007) <http://www.hawaii.gov/lrb/rpts97/priv.pdf>

<sup>3</sup> United States General Accounting Office, "PRIVATIZATION Lessons Learned by State and Local Governments," GAO/GGD-97-48, March 1997. <http://www.gao.gov/archive/1997/gg97048.pdf>

<sup>4</sup> See endnote 1, pp. 18-20.

<sup>5</sup> See endnote 1, pp. 11-13.

<sup>6</sup> See endnote 3, p. 9.

<sup>7</sup> Gordon P. Whitaker, "Service Delivery Alternatives," in *Managing Local Government Services A Practical Guide*, ed. Carl W. Steinberg and Susan Lipman Austin (Washington, D.C.: ICMA Press, 2007) pp. 380-381.

<sup>8</sup> See endnote 1, p. 10.

<sup>9</sup> Office Of Inspector General U.S. Department Of The Interior, "Investigative Report Island Operating Company et al." <http://pogoarchives.org/m/nr/doi-oig-report-20100331.pdf>

<sup>10</sup> City of Mountain View, California, Purchasing Policy NO: 2-10 (Effective Date: July 1, 2000, Revision Date: January 2, 2007), p. 4.

<sup>11</sup> See endnote 1, p. 11.

<sup>12</sup> See endnote 1, p. 21.

<sup>13</sup> See endnote 1, pp. 36, 38.

<sup>14</sup> See endnote 3, p. 6.

<sup>15</sup> John A. O'Looney, *OUTSOURCING STATE AND LOCAL GOVERNMENT SERVICES Decision-Making Strategies and Management Methods* (Westport: Quorum Books, 1998), p. 6. [www.questia.com/PM.qst?a=o&d=23328610](http://www.questia.com/PM.qst?a=o&d=23328610)

<sup>16</sup> Pamela Winston, Andrew Burwick, Sheena McConnell and Richard Roper, "Privatization of Welfare Services: A Review of the Literature", Mathematica Policy Research, Inc. (May 2002), p. 26. <http://aspe.hhs.gov/hsp/privtizations02/Chapter2.htm>

<sup>17</sup> See endnote, 15, pp. 219-226.