

PRIVATIZATION PROCESSES IN OTHER STATES

PROGRAM REVIEW & INVESTIGATIONS COMMITTEE

JOSEPH FIALA, Ph.D.

Assistant Director

SHEILA MASON BURTON

Committee Staff Administrator

PROJECT STAFF:

Lowell Atchley

Project Coordinator

Alice Hobson

Research Memorandum No. 481

LEGISLATIVE RESEARCH COMMISSION

Frankfort, Kentucky

Committee for Program Review and Investigations

November 19, 1997

**PROGRAM REVIEW AND INVESTIGATIONS COMMITTEE
1996-1997 INTERIM**

**SENATOR
JOEY PENDLETON
Presiding Chair**

**REPRESENTATIVE
JACK COLEMAN
Co-Chair**

Senate Members

**Charlie Borders
Paul Herron
Nick Kafoglis
Vernie McGaha
Tim Philpot
Larry Saunders
Dan Seum**

House Members

**Adrian Arnold
H. "Gippy" Graham
Susan Johns
Jim Lovell
Ruth Ann Palumbo
Charlie Siler
Tommy Turner**

Office for Program Review and Investigations

**JOSEPH F. FIALA, Ph.D.
Assistant Director
SHEILA MASON
Committee Staff Administrator**

*** * * * ***

The Program Review and Investigations Committee is a 16-member bipartisan committee. According to KRS Chapter 6, the Committee has the power to review the operations of state agencies and programs, to determine whether funds are being spent for the purposes for which they were appropriated, to evaluate the efficiency of program operations and to evaluate the impact of state government reorganizations.

Under KRS Chapter 6, all state agencies are required to cooperate with the Committee by providing requested information and by permitting the opportunity to observe operations. The Committee also has the authority to subpoena witnesses and documents and to administer oaths. Agencies are obligated to correct operational problems identified by the Committee and must implement the Committee's recommended actions or propose suitable alternatives.

Requests for review may be made by any official of the executive, judicial or legislative branches of government. Final determination of research topics, scope, methodology and recommendations is made by majority vote of the Committee. Final reports, although based upon staff research and proposals, represent the official opinion of a majority of the Committee membership. Final reports are issued after public deliberations involving agency responses and public input.

**SENATE MEMBERS**

Walter Blevins, Jr.
President Pro Tem
David K. Karem
Majority Floor Leader
Dan Kelly
Minority Floor Leader
Nick Kafoglis
Majority Caucus Chairman
Richard L. "Dick" Roeding
Minority Caucus Chairman
Fred Bradley
Majority Whip
Elizabeth Tori
Minority Whip

LEGISLATIVE RESEARCH COMMISSION

State Capitol

700 Capital Avenue
Frankfort, Kentucky

502-564-8100

Capitol FAX 1-502-223-5094
Annex FAX 1-502-564-6543

Larry Saunders, Senate President
Jody Richards, House Speaker
Chairmen
Don Cetrulo
Director

HOUSE MEMBERS

Larry Clark
Speaker Pro Tem
Gregory D. Stumbo
Majority Floor Leader
Danny R. Ford
Minority Floor Leader
Jim Callahan
Majority Caucus Chairman
Stan Cave
Minority Caucus Chairman
Joe Barrows
Majority Whip
Woody Allen
Minority Whip

MEMORANDUM

TO: Don Cetrulo, Director
Legislative Research Commission

FROM: Joseph F. Fiala, Ph.D.
Assistant Director

SUBJECT: Research Memorandum on Privatization Processes in Other States

DATE: November 19, 1997

In April 1997 the Program Review and Investigations Committee directed staff to study the processes and procedures used by other states when privatizing government functions. This memorandum presents the results of that study.

The study found that before states undertake privatization initiatives, they need to review the statutory and constitutional implications, consider the impact on government employees, be vigilant that quality of services and cost levels are not adversely affected, and retain the ability to resume service delivery in case privatization falters. The study found that in many states, privatization is one part of an overall strategy for improving government operations and efficiency. Finally, the study identified four basic steps that states go through in putting privatization initiatives in effect--identifying potential privatization projects, analyzing the cost and benefits of privatizing particular services or programs, implementing privatization initiatives, and conducting performance monitoring and review.

The study contained no recommendations. The Committee approved the study at its August 14, 1997 meeting.



Legislative Research Commission

Joseph F. Fiala, Ph.D.
LRC Assistant Director

Sheila Mason Burton
Committee Staff
Administrator

Committee For Program Review and Investigations

Sen. Joey Pendleton
Presiding Chair

Rep. Jack Coleman
Co-Chair

Senate Members: Charlie Borders, Paul Herron, Nick Kafoglis, Vernie McGaha, Tim Philpot, Larry Saunders, Dan Seum

House Members: Adrian Arnold, H. "Gippy" Graham, Susan Johns, Jim Lovell, Ruth Ann Palumbo, Charlie Siler, Tommy Turner

LRC Program Review Staff

Room 026; State Capitol Annex; Frankfort, KY 40601; 502-564-8100

Research Memorandum: Privatization Processes in Other States

Research Staff: Lowell Atchley and Alice Hobson

Introduction

The Legislative Program Review and Investigations Committee requested staff to determine what processes and procedures were used in other states to make privatization decisions. Fifteen states identified as states with processes or commissions or states active in privatization were surveyed.

Privatization Defined

Privatization denotes a process or a variety of activities or techniques aimed at reducing the size of government by shifting service provision to the private sector. Advocates of privatization argue that the private sector is more cost-efficient and effective in administering public services and programs. Even though privatization continues to be used in most states, increasingly the watchword now is "competition." Many states are giving public employees an equal chance to develop a proposal and bid against the private sector for privatization-type contracts.

Privatization Concerns

Privatization is not just a dollars and cents issue and it is not a panacea. To ensure success, there are several concerns that need to be addressed. One is the impact on employees. Because privatization often eliminates or reduces government jobs, good communication needs to be established with employees, to reduce resistance. Some states involve employees in the planning and implementation. Most provide employees with retraining, transfers or job placement services. Another concern is maintaining the quality and cost of service. Although services or programs are privatized, governments remain responsible and accountable to the taxpayers. Finally, governments must be ready to resume service delivery should a privatization fail.

INTRODUCTION

"Privatization" generally denotes a wide variety of strategies and approaches aimed at shifting the provision of services, either in whole or in part, from government to the private sector. Privatization of programs and services has increased among governments during the last several years, but took on significant impetus in the 1980s. At the same time, privatization is only one of a variety of strategies for making government operate more efficiently and effectively.

The Program Review and Investigations Committee requested staff to report on the policies, processes and procedures used by other states when privatizing government functions. Central to this study is a discussion of the basic elements of a privatization process. The general methodology used for the study included a review of relevant studies and literature, and interviews with employees of various state agencies and associations, the defunct Kentucky Privatization Commission, the Council of State Governments (CSG), the US General Accounting Office (GAO) and the Reason Foundation, a national organization that tracks privatization. Program Review staff also selected for more intense review a judgmental sample of 15 states, most of which have agencies, commissions, boards or agency-administered procedures in place to guide, monitor and oversee privatization. (Attachment A contains a listing of states and the rationale for their use in this report.) A telephone interview survey with officials in those states dealt with privatization policies and procedures, implementation and administration of privatization agreements, and monitoring and evaluation of privatization initiatives.

This memo discusses how privatization is defined, what issues need to be addressed before privatization is undertaken, how other states approach privatization, and Kentucky privatization initiatives.

WHAT IS PRIVATIZATION?

Privatization is a variety of activities and techniques aimed at reducing the role of government and enhancing the role of the private sector in areas traditionally handled by government. Contracting is the most common form of privatization. Even though states are continuing to use privatization, many are focusing on creating competition by encouraging public employees to compete with the private sector. This strategy is commonly known as managed competition.

Privatization Shifts Government Services to Non-government Entities

Although most states are engaged in some form of privatization, few states are defining it in their statutes. Even though the word "privatization" is not defined, the concept still exists under terms such as "government competition" or "competitive government."

Numerous definitions exist in the literature. One of the most all-encompassing definitions is found in a 1993 Council of State Governments (CSG) study:

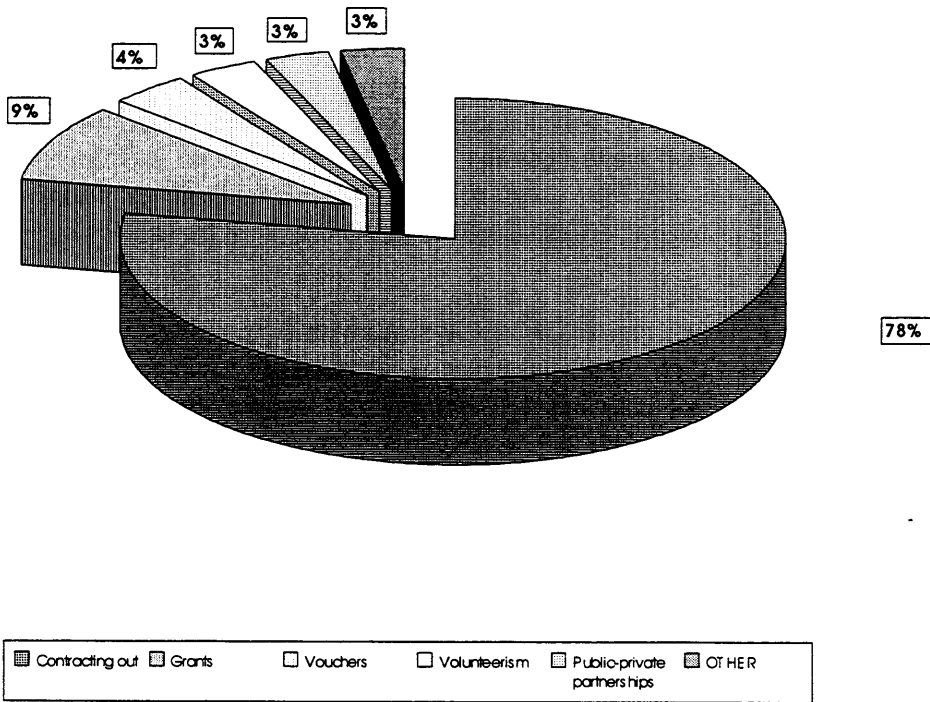
The term privatization has been defined variously as the transfer of government functions or assets to the private sector; the shifting of government management and service delivery to private providers; a shift from publicly- to privately-produced goods and services; and government reliance on the private sector to satisfy the needs of society. In essence, however, privatization means the use of the private sector in government management and delivery of public services.

Privatization is the general label for a variety of activities or techniques aimed at reducing the role of government and enhancing the role of the private sector in areas traditionally handled by government. Common forms of privatization include contracting out, vouchers, franchises, grants and subsidies, asset sales, public-private partnerships, private donations, deregulation, volunteerism and service shedding. (A list of forms and definitions appears in Attachment B.)

In the face of increasing financial pressures and taxpayers' calls for less government, states are looking for ways to save money without sacrificing service delivery. Privatization advocates argue that because government is not driven by the profit motive, it is potentially less efficient than the private sector. In other words, government is monopolistic and non-competitive. Of 39 states responding to a 1993 CSG survey, the majority indicated that the primary motivation behind turning to the private sector was cost savings and the ability to hire experts in particular fields. They noted other benefits, such as a private company's ability to get a job done more quickly because it can bypass government red tape and bureaucratic inflexibility. However, a representative of the Kentucky Association of State Employees (KASE) has a different view regarding privatization. He said privatization is not in the best interest of taxpayers and that a well-managed government agency which operates on a non-profit basis can always outperform contracting out on a cost basis.

Many view privatization as synonymous with contracting. This view is validated by the 1993 CSG study, which cited contracting as the most prevalent form of privatization. Figure 1 shows various forms of privatization and the frequency of their use in states' programs and services. Contracting amounted to 78.06 percent of privatization among states surveyed, ranking well above grants, the next most prevalent form, at 8.48 percent. Vouchers made up 4.11 percent, volunteerism 3.32 percent and public-private partnerships 2.95 percent of the remaining forms.

**FIGURE 1
FORMS OF PRIVATIZATION AND FREQUENCY OF USE IN STATES'
PROGRAMS AND SERVICES**



SOURCE: Created by Program Review staff from data in State Trends and Forecasts: Privatization, The Council of State Government, November 1993.

Privatization is being considered for a variety of core and ancillary government functions. These include: state mail services, prisons, mental health programs, child support collections, motor vehicle inspections, welfare disability determinations, state printing, highway maintenance, computer maintenance, and state tax returns processing. Most privatization efforts occur in ancillary areas rather than in core areas. Governments tend not to privatize certain core areas because of the risks involved. These include law enforcement, certain procurement functions, sensitive accounting functions, and judicial functions.

Privatization Definition Expanding to Include Managed Competition

Although current trends point to privatization, the driving force behind the shift by many states to alternative service delivery is competition. Hence, these states are broadening their view of privatization and encouraging competition between public employees and the private sector. This strategy, commonly labeled as "managed competition," gives public employees the opportunity to compete with private sector contractors to provide services. The underlying theory is that competition should tap into all potential providers, thus improving services and leading to more efficient and effective operations. Six of the survey states--Arizona, Colorado, Maryland, Massachusetts, Texas, and Virginia--use or are considering using managed competition as an integral part of their privatization process. Maryland calls its process "competitive re-engineering." Arizona calls its system the "competitive government program."

Advocates for managed competition maintain that it presents a win-win situation for both government and employees. For government it helps mitigate public employee concerns. At the same time it enables many employees to retain their jobs and become more efficient. This was illustrated in New Jersey. When that state contemplated privatizing some state nursing homes, employees proposed enough cost savings to keep the operation in-house. States using this strategy are cautioned to ensure a level playing field between the public and private sector. This may include removing special privileges for the public sector to assure a fair bidding process, or freeing public employees from some of the government processes which make it harder to procure operating assets or hire personnel. In Massachusetts, bids from public employees and the private sector are kept at "arms length," so there is no perception of bias in favor of agency bids. In-house estimates remain secret until bids are opened.

WHAT ISSUES NEED TO BE ADDRESSED

BEFORE PRIVATIZATION IS UNDERTAKEN?

Privatizing government services is not simply an economic decision and it needs to be a well thought-out process. It is commonly understood that privatization decisions should be legally sound and not prohibited by constitutional or statutory provisions. However, other concerns or issues need to be contemplated. These include such key issues as mitigating the impact on employees, maintaining the delivery and quality of services, guarding against artificial cost increases, and determining the degree to which government should retain an ability to provide the service in the case of private provider failure.

Impact on Employees

The greatest resistance to privatization often comes from government employees whose jobs are threatened. In Virginia, officials said the strongest resistance to privatization generally comes from middle managers. Because of the potential for resistance, the welfare and cooperation of employees are key considerations for states initiating privatization projects. The employee impact concern is not only a fairness issue, but in some states has become a legal issue as well. For example, employees in Colorado successfully challenged privatization on constitutional grounds. To improve success, states are including employees in privatization planning, implementation and oversight processes.

States surveyed for this report are undertaking various strategies to ease the impact of privatization on employees. They offer this advice:

- Be proactive and think about pending employee issues up front.
- Establish good lines of communication with employees and employee groups.
- Involve employees and their union groups wherever possible in the privatization process.

- Consider strategies to assist displaced employees.

As an example of a proactive stance, two survey states require agencies to assess employee impact when contemplating privatization. Arizona asks agencies to develop general plans for affected personnel before carrying out a privatization initiative. Arizona agencies are to assess various options (such as hiring freezes, use of temporary employees, buyout plans, layoffs, and transfers) before contracting. Montana has established numerical criteria as a guide for agencies with employees who may be affected. If a privatization project affects five or more employees, the agency must prepare an employee impact plan.

Arizona, Utah and Colorado have been successful in opening lines of communication between the state and employees and their unions. Arizona involved employee unions in drafting its competitive government law and a resulting handbook. In Utah, employee unions now have full representation on the state's privatization board. Colorado's Commission on Privatization hears testimony from employee groups as it prepares privatization reports for the legislature.

Other states provide examples of ways to lessen the impact on employees by involving them in the process or assisting displaced employees. Kansas is developing an education plan to inform employees about their options to move to the private sector, or be retrained or re-deployed. It is also training some displaced employees to monitor privatization contracts. Virginia eliminated a "bumping" system, in which employees affected by privatization were moved to lower grade positions, and replaced it with an "employability program," under which an employee being displaced either gets hired by the contractor, retrained for other work or re-deployed.

In the face of increasing privatization, Massachusetts included a comprehensive package of employee protections in its privatization statute. These include a requirement that contractors offer jobs to qualified employees affected by privatization and that contractors pay employees minimum calculated wages and contribute to employees' health insurance. Also, state agencies contemplating privatization must encourage employees to bid on the contract and then consider their bids.

Georgia dealt with the employee impact issue differently than other states. It repealed its statutory civil service system altogether, so that managers attempting to run efficient and effective operations utilizing privatization can hire and fire at will. On the other hand, Georgia privatization policies call for minimizing the impact of privatization on employees.

Maintaining Quality, Cost of Service

A government's transfer of the responsibility for service delivery to the private sector does not relieve it of its accountability to taxpayers for the quality and level of the service. Therefore, states need to weigh the costs/benefits expected from privatization against the potential risks of diminished services or higher costs to the citizens. This may be more of an issue when states decide to privatize core mission areas. They also need to determine whether there are enough vendors available to make privatization cost-effective. The larger the number of potential service providers, the better the state's chances for acquiring a cost beneficial contract.

Sometimes government entities encounter the practice of "low-balling," a technique whereby companies bid low to obtain a contract and then increase costs later. Governments need to be on guard that the costs of privatized services do not artificially inflate over time because of a lack of competition or the loss of the state's ability to provide the service. In addition, private companies are profit-driven and are naturally concerned with reducing costs. These pressures may run counter to the commitment to public service and may leave some groups under-served, as a consequence of providing services to those groups allowing, instead, low costs and high profits.

Privatizing a service does not mean that all costs to the state are eliminated. There are government costs associated with privatization, such as contract preparation and bidding, administration, and oversight. Contract monitoring requires personnel and facility costs. There are also potential future costs, including equipment replacement, reversion and rebidding. Thus, savings must be offset by the costs associated with administering privatization.

Quality also is tied to costs. Privatization initiatives are generally not meant to decrease the quality of service; rather quality should be the same or exceed pre-privatization levels. Privatization-type contracts should specify levels of service or standards to be met, and agencies privatizing services or programs should place an emphasis on quality control. In addition, confidentiality or impartiality toward clients, public trust, and safety and welfare should not deteriorate with privatization. Accountability to the legislative and executive branches and to the taxpayer needs to be maintained.

Retaining Ability to Resume Service Delivery

Even though a particular government service or program may be privatized, governments should ensure they have the ability to resume delivery of services or programs if necessary. Officials in some of the survey states said they have experienced privatization failures, but most involved services and no capital assets. Thus, it was relatively easy for the state to take back the service. Regardless of the nature of privatization, the potential for reversion is an issue. The CSG Trends Center Director suggests that states have "claw-backs," provisions in contracts which enable them to easily take control of once-privatized services.

The ability to resume services is twofold. One aspect deals with the government having a strategic plan of action for resuming service delivery. The other aspect is more focused on the government's physical preparedness to resume the service delivery. The consequences of not being prepared for both aspects could result in the interruption of expected, if not vital, services to citizens, or in unanticipated costs associated with reversion of the service to the public sector. *The Final Report on Privatization*, by the Florida House of Representatives Committee on Government Operations, advises that these concerns can be avoided by appropriate selection of privatization initiatives, following a valid and effective bidding and selection process, executing a comprehensive contract that includes performance expectations and measurements, and establishing sound oversight and auditing systems.

Two states surveyed for this report offer examples of foresightedness in this regard. Georgia's administrative policy and procedures for privatization prohibit privatization if only one vendor is capable of providing the service in question or if the state agency cannot assume provision of the service at a later date. Georgia also requires a contingency plan (along with a list of alternative providers) for every state service that is privatized. Finally, the Florida House report includes reversion costs as a subcomponent of the potential future costs that should be considered before privatizing a service.

The question facing governments on the second aspect of this issue is the extent to which the physical capacity to resume provision of a service in-house should be maintained. A key decision in this instance is what to do with state assets and the infrastructure established to provide the service. Selling related assets may make it difficult to take over the service delivery from the private service provider. Yet, some question the future value and utility of old equipment that has been held for an extended amount of time. States surveyed for this report also addressed this issue in various ways. Georgia's policies require that decisions to divest the state of selected assets be based on sound financial analysis, which could include market value, present and future costs, and projected savings and cost avoidance. In some

cases, states enter into management contracts and retain state ownership of the assets. For example, Virginia breaks up contracts to make sure that a state presence remains. In an interstate highway maintenance contract, that state retained all of its road equipment and diverted its use to other roads. Arizona and New York both held on to state assets when privatizing state airports. Generally these agreements involve management contracts or "government owned-contractor operated" agreements wherein the contractor leases the equipment or at least pays maintenance costs. Ironically, Arizona attributes the failure of its airport privatization initiative to the fact that the management contract constrained the contractor from making physical changes that may have made operation of the airport more efficient. Georgia avoided this pitfall in its long-term privatization of the operation of a recreational area by inserting lease provisions in the contract that all property reverts back to the state, even property put there by the private contractor, if the company defaults.

HOW DO OTHER STATES APPROACH PRIVATIZATION?

Many states privatize as part of an overall strategy for improving government operations and efficiency. Although privatization is executive-driven in most states, the legislature and the private sector do have roles to varying degrees. In the majority of states surveyed, agencies initiate and carry out the privatization initiatives. Privatization boards and commissions are primarily advisory. Their primary functions are identifying potential areas for privatization, establishing analytical frameworks, and reviewing agency analyses and plans. Regardless of the structure established within a given state, the privatization process is relatively standard.

Privatization Is Mainly Executive-Driven

Privatization in most of the survey states is carried out with input from both the executive and legislative branches. Some states also involve the private sector in a formal way. Table 1 shows how the role of each of these three entities varies from state to state. The implementation of privatization initiatives is an administrative function of the executive branch. Administrative policies and procedures are the most prevalent guidelines for privatization available within the states, and executive branch employees are responsible for day-to-day implementation.

However, in nine of the 15 states surveyed, the governor is either a strong advocate for privatization, or privatization as a component of overall statewide efficiency efforts. In six of

the states, the governor is closely involved with an overall board or commission on privatization.

In Texas, the Governor plays a key role in privatization by chairing the Competitive Government Council, which decides what services will be considered for privatization. In Florida, the Governor and the Cabinet comprise the state's Council on Competitive Government. But in a few states, the governor takes a less active role. For example, the Colorado Governor's Office apparently has little hands-on involvement in privatization, although legislation has been proposed to alter that.

Legislatures also assume a role in privatization in the survey states, but to a lesser extent than the executive branch. Most legislative involvement in the states consists of enacting legislation to enable or facilitate specific privatization initiatives. Six of the overall privatization boards and commissions in the survey states were established by legislation. In addition, many of these states have legislators as members of these bodies. The most extensive legislative involvement occurs in Montana, where the legislature plays a prominent role in privatization by actually commenting on individual projects. Montana agencies seeking to privatize certain programs must submit a privatization plan to the Legislative Audit Committee for staff review and a hearing. After conducting a public hearing, the Committee makes a non-binding recommendation on the proposal and sends it back to the agency. Although the Committee has endorsed most proposals it has reviewed, it has only reviewed a small number.

**TABLE 1
Privatization Roles**

STATES	GOVERNOR'S ROLE	LEGISLATIVE ROLE	PRIVATE SECTOR ROLE
Arizona	Governor's Office for Management and Budget established the statewide competitive government program Has little daily input	Created the competitive government process	Input through the Private Enterprise Review Board
Colorado		Enacted legislation which codified a court decision limiting privatization	Not formalized
Florida	Governor and the Cabinet constitute the Council on Competitive Government Created and operates the Commission on Privatization	Created the council and has final approval through appropriations Approved elimination of the civil service system	Council is statutorily required to consult with private sector Serves on commission
Georgia			
Kansas	Appoints the board members	Created and chose the Michigan PERM process	Board receives input on candidates
Maryland	Established privatization policy	Created the council and has involvement through appropriations	Serves on council
Massachusetts	None indicated	Enacted protections for employees Minimal current legislative involvement Has a minimal role	Not formalized
Michigan	Created the commission that recommended PERM and required its use		Not formalized
Montana	Has limited executive involvement	Audit Committee reviews projects Has statutory processes	Not formalized
New Jersey	Issued guidelines	Has input through the budget process Has no statutory framework Has a limited role	Not formalized
New York	Directs the policy		Participates in Research Council on Privatization
Tennessee	Encourages privatization when appropriate	Passes enabling legislation when necessary	Not formalized
Texas	Chairs the Competitive Government Council None indicated	Created the council	Not formalized
Utah		Created the board Has input through appropriations and setting employee levels	Serves on board
Virginia	The council reports to the Governor	Created the council Council reports to legislature and legislators serve on the council Passed major legislation in such areas as transportation Reports to the Small Business Commission created by the legislature	Four from private sector--two citizens members and two serving in place of legislators

Source: Compiled by Program Review staff from interviews with officials from other states.

Most of the survey states formally involve the private sector in some form of their privatization process. Private citizens serve on privatization boards and commissions in Georgia, Arizona, Maryland, New York, Utah, and Virginia. Two other states, Florida and Kansas, have a formal process for receiving input from the private sector. Extensive involvement of the private sector occurs in Arizona and Utah. Arizona's Private Enterprise Review Board is made up of private sector business owners who conduct hearings to get private sector input. Private citizens serve on Utah's Privatization Board along with members of state management and employee union representatives. The Board acts as a hearing panel for those in the private sector who want to compete for government service delivery. In Virginia, the Commonwealth Competition Council reports to the Small Business Commission, created by the Virginia legislature this year.

Most Privatization Boards are Advisory

Most of the states surveyed have some type of privatization commission or board. As shown in Table 2, the powers and composition of these vary widely. However, most are advisory, providing guidance and education, but making no final decisions on what services or programs will be privatized. There are exceptions. The Texas Competitive Government Council can approve or reject privatization initiatives under its statutes. Virginia's council may attempt to gain more decision-making authority in their 1998 legislative session.

State boards or commissions in Florida and Virginia have responsibility for identifying services or programs which have the potential for privatization and may require agency action. The Virginia Commonwealth Competition Council has an overall mission to promote service provision through the private sector and through competition. While final privatization decisions are made at the agency level, the council develops an inventory of potentially privatizable functions and services, performs cost/benefit analyses and evaluates performance. Texas' state Council on Competitive Government and Florida's state Council on Competitive Government also identify services that may be better provided through competition with other state agencies or the private sector. Texas' council acts on privatization suggestions from other agencies, such as the office of Texas Performance Review, or the private sector. Both states may require agencies to do analyses and engage in competitive bidding.

The role of privatization boards or commissions in Georgia, Maryland, Kansas and New York is to provide technical assistance and training. The Georgia Governor's Commission on Privatization of Government Services works with agencies to teach them how to undertake privatization projects and how to use privatization as a tool.

The role of privatization boards in Kansas, New York, and Utah is primarily advisory. The Utah Privatization Board acts as a "sounding board," but only recommends privatization projects to the executive and legislative branches. At the same time, state agencies can pursue privatization independently in Utah. In contrast, Colorado also has a privatization commission,

but its purpose is to study privatization policy issues and report its findings to the Colorado legislature.

Board or commission composition varies in size and the representation of the executive and legislative branches, private sector, and state employees. Arizona's Private Enterprise Review Board is large and even includes members from community colleges and the university boards of regents. Florida's state Council on Competitive Government is an administrative commission, with membership comprised of the Governor and members of the cabinet. The New York State Research Council on Privatization is exclusively private sector members appointed by the governor.

Some States Have Formal Privatization Processes

Many of the states surveyed have formalized analytical processes for evaluating the cost and benefits of privatization. Processes in Michigan, Virginia and Arizona guide privatization decisions from the initial stage of determining what areas will be privatized through implementation, monitoring and evaluation.

Michigan uses a process called "PERM" (Privatize, Eliminate, Retain or Modify), to evaluate individual programs, including all support processes and component activities (See Attachment C-1). "Privatize" describes any action, ranging from outsourcing to total divestiture of assets or functions, which reduces the role of government and/or increases the role of the private sector. "Eliminate" refers to any action resulting in the total cessation of an activity by government. "Retain" means to keep a program within state government, operating in exactly the same manner as it did prior to the analysis. "Modify" refers to any change in the operation of the program remaining in state government, including re-engineering the process.

Virginia has the "Commonwealth Competition Council" process. After services or programs are targeted, agencies conduct "public-private performance" analyses to determine which should be opened to the private sector (Attachment C-2). Agencies then request proposals from private sector firms and sometimes from state agencies. Once they receive sealed proposals from private firms--and from public employees if managed competition is used--agencies decide to award the service or program to an outside bidder or keep it in-house. The final step in the process involves on-going monitoring and evaluation.

TABLE 2

Privatization Boards in Other States

State	Privatization Boards, Commissions	Powers and Duties	Composition
Arizona	Private Enterprise Review Board	Evaluates potential projects to contract with the private sector; Evaluates exemptions and restrictions on competition with the private sector and reports to the governor and the legislature; Allows the private sector to complain that a state project is illegally competing against them; Allows the private sector to indicate interest in providing certain state government functions.	Chief executive officer of the state agency; Member for the community colleges; Member appointed by the Arizona board of regents; Member to represent state employees; 6 private sector members; 3 from small business; Two advisory members from the House and Senate.
Colorado	Colorado Commission on Privatization of Personal Services	Studies privatization issues; Reports to the legislature on such issues as efficiency, cost savings, employee bidding for state agency services and the amount of competition.	3 gubernatorial appointees, 3 members appointed by the speaker and 3 appointed by the president of the Senate; Representatives from 3 employee groups.

State	Privatization Boards, Commissions	Powers and Duties	Composition
Florida	Florida Council on Competitive Government	<p>Identifies potential candidates for privatization; May require agencies to conduct feasibility analysis including cost/benefit; Recommends projects to implement, requires legislative approval; May authorize a state agency to engage in competitive bidding; May prescribe specifications and conditions of purchase procedures; Can stipulate that bids include an analysis of health care benefits and worker's compensation insurance.</p>	Governor, members of cabinet serve as an administrative commission
Georgia	Georgia Commission on the Privatization of Government Services	<p>Reviews programs or services suggested for privatization; Acts in support capacity, giving agencies ideas and suggestions; Support staff provides guidance and technical assistance.</p>	Members of Georgia's House and Senate, chief executive officers appointed by the governor, Executives from the private sector.
Kansas	Kansas Performance Review Board	<p>Reviews governmental functions and recommends that they be: <u>P</u>rivatized, <u>E</u>liminated, <u>R</u>etained or <u>M</u>odified; Tries to reduce costs while maintaining service quality; Conducts research and recommends legislation to promote efficiency.</p>	Bipartisan board support staff provide guidance and teaching assistance

State	Privatization Boards, Commissions	Powers and Duties	Composition
Maryland	Governor's Advisory Council for Management and Productivity in the Department of Budget and Fiscal Planning	Solicits ideas and proposals to promote efficiency, quality and service delivery; Evaluates the organization and management of government; Evaluates and recommends public-private partnership alternatives concerning real property assets; Examines contracting processes; Provides technical assistance and advice to agencies.	13 people, including representatives of labor, local government and nonprofit organizations; 2 members of the Senate and House 2 members of the judicial branch; 2 representatives of business; 4 representatives of the general public.
Massachusetts	None		
Michigan	None		
Montana	None		
New Jersey	None		
New York	New York State Research Council on Privatization	Reviews feasibility and other studies; Analyzes existing legal barriers; Evaluates the advantages and disadvantages of privatization; Conducts feasibility studies, including cost benefit analyses; Identifies candidates for privatization.	People from private sector appointed by governor

State	Privatization Boards, Commissions	Powers and Duties	Composition
	Advisory Commission on Privatization, of the New York State Empire Development Corporation	Evaluates council's report and makes recommendations to the governor.	High level executive branch officials and others appointed by Governor
Texas	Council on Competitive Government	<p>Considers privatization projects identified by other agencies or the private sector</p> <p>Requires agencies to conduct feasibility and cost estimates;</p> <p>Requires agencies to engage in competitive bidding to select a provider;</p> <p>Requires use of a cost analysis that it developed;</p> <p>Remains exempt from purchasing laws.</p>	Governor, Lieutenant Governor, Comptroller, Speaker of the House, presiding officer of the council, Commissioner of the Texas Employment Commission

State	Privatization Boards, Commissions	Powers and Duties	Composition
Utah	Utah Privatization Board	<p>Identifies potential program candidates;</p> <p>Reviews and comments on agency privatization proposals and adopts priority list of candidates;</p> <p>Publishes an annual report to the legislature, governor, and the public;</p> <p>Acts as a sounding board for the private sector to suggest areas for privatization.</p>	Private sector, management, employee union representatives
Virginia	Virginia Commonwealth Competition Council	<p>Developed a statewide competitive program;</p> <p>Monitors and promotes competition in government;</p> <p>Determines the privatization potential of a program;</p> <p>Performs cost/benefit and public and private performance analyses;</p> <p>Devises evaluation criteria for performance reviews;</p> <p>Reports to the Governor, legislature and executive branch, and the Small Business Commission.</p>	<p>4 executive branch employees;</p> <p>4 legislators (2 of 4 are private citizens);</p> <p>2 private sector representatives.</p>

SOURCE: Compiled by Program Review Staff from information received from various states.

Under Arizona's "Competitive Government Program," agencies identify "target functions," those services, programs or functions that may benefit from the introduction of competition (See Attachment C-3). Agencies conduct in-house cost analyses, which remain sealed until requests for proposals are issued to private contractors. Then a public or private sector provider is selected, based on the agency's in-house cost analyses. In that state, the competitive government process is viewed as a helpful tool when considering privatization opportunities. The process is set up to help agencies assess their current functions and determine the most cost-effective entity to deliver "target functions."

While processes in all survey states exhibit differences and similarities, generally four steps are involved.

1. Identification of potential privatization projects
2. Analysis of cost and benefits of privatizing particular services or programs
3. Implementation of privatization initiatives
4. Performance monitoring and review

Identification of Potential Projects

State agencies or privatization boards and commissions are generally the entities for identifying potential privatization. However, some states provide the mechanism for others to make proposals. Individuals, businesses, non-profit organizations, governmental entities, trade or union groups or other interested parties may bring specific state services to the attention of the Florida Council on Competitive Government. These groups may submit a proposal which describes the current method of providing the service, proposes improvement or cost savings measures, and identifies the agency currently providing the service. The Council makes recommendations on what to privatize but final action is contingent upon legislative appropriation. Agencies may pursue privatization independently and offer their own initiatives as part of the executive budget.

In New York, the philosophy is that anyone may initiate privatization projects. Most ideas are directed to the Advisory Commission on Privatization or to state agencies. The Texas Council on Competitive Government may hold periodic public hearings, during which suggestions and ideas from interested members of the public are solicited. Anyone may submit written suggestions to this council.

Analysis of Cost and Benefits

After creating a standardized process and identifying potential areas for privatization, states must analyze specific projects. This usually involves identification of alternatives, determination of current costs, assessment of competition and cost/benefit analyses. Such factors as cost savings, maintenance of quality, efficiency and effectiveness, employee impact, and asset usage are considered. In survey states with formal privatization processes, agencies are required to analyze the cost/benefits of privatization. Some processes are more formalized than others.

According to the surveyed states, cost is one of the most important factors considered in determining whether to privatize a government service or activity. In making a privatization decision, administrators compare costs incurred when the government provides an activity with costs incurred if the service is provided under contract. (For a more detailed analysis of cost methodologies, see Attachment D.) Performing a cost analysis and using a cost comparison methodology safeguards against personal bias influencing the decision to privatize.

Most states require the interested agency to perform the cost analysis. However, some of the survey states, such as Michigan and Virginia, have a central agency that either oversees this process or provides an independent cost analysis to ensure agency costs are complete, accurate, and reasonable. Michigan's Privatization Division developed cost models which were available for agency use. The Privatization Division was available to review agency cost models and PERM analyses, but agencies chose whether to use the services. The timing of the cost comparison varies across states. Some survey states, like Arizona and Massachusetts, compare in-house costs to private contractor costs only after a particular contractor has been selected through the competitive bidding process. Other states, such as Texas and Virginia, prefer to calculate in-house costs and to estimate contractor costs before obtaining bid proposals. Florida prefers to perform a cost analysis on all contract proposals that have been submitted and that meet its qualifications, assigning scores to the proposals, and letting the Council choose a contractor.

Arizona, Florida, Massachusetts, Michigan, Texas, and Virginia use a step-by-step approach in their cost methodologies, and are fairly uniform in the elements they identify to determine the cost of a function or service. Cost analyses for these states involve a checklist of specific cost items for judging the feasibility of privatizing. Differences exist in terminology, or in the organization of cost factors, but states generally examine direct and indirect costs of the service provision, contract administration costs, and service transition costs. Of the states reviewed here, the only major difference in cost methodologies is in the way states calculate indirect costs.

To complete a cost analysis, the total in-house cost of providing a government service must be determined. From here, one can calculate avoidable cost, the cost that would be avoided if the service is privatized. Next, the total cost related to contracting out the service is

calculated. With these calculations, the cost savings can be determined and a decision made to privatize or not. These figures are usually calculated over five performance periods or five fiscal years, to provide historical cost information, current cost data, and future cost estimates.

Several states establish a cost-savings threshold that justifies a decision to change the mode of service delivery. The federal government and Arizona have a threshold level of 10 percent, which must be met before they will consider privatizing a function. That is, there must be at least a 10 percent savings between contracting out and performing the service in-house before privatization occurs. Virginia also has a threshold, called the "conversion differential," which is based on personnel costs and ranges from 2 percent at no personnel cost to a high of ten percent for personnel costs over \$1.5 million.

Implementation of Privatization Initiatives

In practically all the survey states, agencies handle implementation, including contract negotiations and implementation oversight. Boards or commissions generally have no role in the actual implementation, other than offering advice or guidance. Privatization-type contracts are generally implemented in much the same way as other contracts in the survey states, following the various state procurement codes. Many of these states use fixed-price contracts, in the case of prisons, for example, paying a contractor an agreed-to amount per day to house prisoners.

Officials in the survey states said privatization-type contracts are no different than others. They all have standard "boilerplate" language, with the usual guarantees and protections. It is important that the duties of contractors be spelled out, with all expectations included. That is critical for addressing problems once the contract is executed.

Michigan has a general PERM implementation plan that includes specifying steps needed to make the transition to a new structure, the identification of those involved in each step and the status of employee positions. If the implementation includes contracting, agencies identify and select vendors, identify specific tasks to be performed and discuss other contractual provisions.

Performance Monitoring and Review

Contract monitoring and review are vital parts of successful privatization initiatives. However, many of the states surveyed admit that this is one of the weakest parts of their privatization efforts. In most cases, monitoring is done at the agency level. Officials in survey states indicate that it is relatively easy to privatize a service or program, but agencies need to maintain a quality control function to ensure that quality is maintained.

Contract monitoring generally takes place at the agency level because most contracts are agency specific, although some may cross agency lines. Some larger contracts, such as those for social service delivery or for prisons, require on-site monitors. Officials in survey states said contract monitoring often is erratic, performed well in some agencies and not so well in others. The Georgia Commission on Privatization of Governmental Services has a guidebook for contract administration. Both Arizona and Virginia's processes also stipulate contract monitoring. Michigan is considering training courses in contract and project management.

Michigan, Virginia, and Arizona require an on-going review of privatization initiatives. Virginia's process calls for the Commonwealth Competition Council to conduct a "post performance" review at the end of the contract period. Texas is more formalized than other states, with the oversight function performed by an agency's contract administrator, who reports to the Competitive Government Council. The administrator monitors contracts to make sure that they are complying with contract provisions and that the price is within agreed-to terms. The cost of the contract administration is placed in the contracts. Contracts may be administered by whomever the agency wants, particularly if the contract is a cross-agency agreement.

HOW DOES KENTUCKY DEAL WITH PRIVATIZATION?

In the mid-1990s, Kentucky had a Privatization Commission. The commission estimated that almost \$400 million was being spent on privatization at that time. Kentucky has a model prison privatization statute but no general statutes governing privatization in other programs. Privatization is not a focus of the current EMPOWER Kentucky re-engineering effort.

State Commissions Studied Quality, Efficiency, and Privatization

Kentucky's short-lived Privatization Commission resulted from a recommendation by an earlier commission, the Governor's Commission on Quality and Efficiency (Q&E Commission). During its tenure, the Q&E Commission targeted over 30 candidates for privatization in the state. The Q&E Commission found that Kentucky had no systematic, comprehensive, statewide strategy to assess which government services would benefit most from privatization. As a result, opportunities for flexibility, savings, increased employee efficiency and improved morale through privatization were being lost. Those findings led to two recommendations: to create a Privatization Commission, and to require that agencies seeking funding for new programs analyze privatization as an alternative to the state's operation of the program.

The Privatization Commission, composed of five public and five private sector members, existed from 1994 to 1996. It identified existing privatization activities and recommended privatization policies and procedures to be used by state agencies. A pre-privatization analysis guide for making privatization decisions was developed for agency use. The guide included analytical activities to help identify candidate services and to identify the capability to manage the contract. The policies and procedures recommended by the commission were never implemented, however, in law or regulation.

EMPOWER Kentucky Initiative

Like other states, Kentucky government currently is undertaking its own re-engineering effort, under a program called "EMPOWER Kentucky." EMPOWER Kentucky is the Governor's initiative for state employees to outline improvements in service delivery and to identify cost savings in state government. State workers are analyzing and re-designing both short-term and long-term processes to improve efficiency and effectiveness.

According to the EMPOWER Kentucky Director, privatization is not a specific focus of the re-engineering effort, because of the potential adverse impact that privatization can have on state employees. The primary focus is to give workers the tools to become more efficient and effective.

Privatization Prevalent Throughout State Government

Kentucky has become increasingly involved in the privatization movement, although it may not be labeled as such. Contracts include Medicaid billing and processing, the operation of state psychiatric hospitals and prisons by private firms, operation of state park concessions, highway rest area concessions, janitorial services, highway photogrammetry, and others.

The Privatization Commission surveyed all state agencies and universities and determined that almost \$400 million was being spent on privatized projects at that time. Included in that figure was over \$220 million in the human services area, mainly the former Cabinet for Human Resources, over \$88 million in Natural Resources and Environmental Protection, and over \$29 million in the Justice Cabinet. The survey included many different types of contractual relationships with private and quasi-private organizations, including memorandums of understanding, memorandums of agreement, personal service contracts, interagency agreements, and program administration contracts.

Kentucky Statutes Govern Privatization of Prisons

Even though Kentucky does not have a general privatization statute, it has a comprehensive prison privatization statute that could be used as a broad-scale model for any future agency-specific privatization. The 1988 General Assembly enacted KRS 197.500-530 to deal with privatizing state prisons. Kentucky is recognized nationally for being the first state to undertake prison privatization, having opened the first such prison in the nation in 1986.

The statute allows the state to enter into contracts with a private provider to establish, operate and manage prisons. The statute sets out certain contractual provisions that the private provider must meet. In all these contracts, the state must maintain supervisory and monitoring powers over the operation and management of the facility. The statute also requires:

- Industry standards;
- Compliance with the state model procurement code;
- A written budget for the facility;
- An on-going fiscal system that accounts for all income and expenditures;
- An annual independent audit report;
- Written fiscal policies and procedures;
- A written policy for inventory control of all property and assets;

- A plan for disseminating information to the media;
- Background investigations of all employees prior to employment; and
- Unannounced inspections of the facility.

Recent Legislative Initiatives

Legislative efforts in 1994 aimed at promoting contractor accountability and establishing uniform procedures for privatization as part of the Kentucky Model Procurement Code were unsuccessful. The legislation:

- Defined privatization broadly to include contracts to provide goods or services, or construct, lease or operate facilities for a state agency;
- Established a process for privatization which included written determinations, justifications, assessments and other statements, a feasibility study, submittal of privatization plans to the Attorney General, Auditor, LRC and the relevant legislative committee, and oversight of the privatization plan, contract and contract compliance by the Finance Cabinet;
- Stipulated certain contractual provisions, including annual independent audits and performance evaluations;
- Prohibited privatization if competition, staff or contract monitoring was inadequate; and
- Promoted contractor accountability and changes in the Open Records Law to allow public disclosure of records.

The legislation contained many of the same provisions found to have worked in other states, including a cost analysis and personnel plans to assist employees adversely affected by the privatization. Additional protections for employees included efforts to place the employees in vacant positions in other state agencies, emphasis on retraining and, if possible, contract provisions requiring the contractor to hire displaced employees at wages and benefits comparable to those paid state employees.

ATTACHMENT A

ATTACHMENT A

SURVEY STATES SELECTION CRITERIA

STATES	CRITERIA FOR SELECTION
Arizona	Has statutory competitive government process to analyze privatization contracts Has executive agency to develop and operate process
Colorado	Has a temporary Commission on the Privatization of Personal Services
Florida	Created the State Council on Competitive Government
Georgia	Has the Governor's Commission on the Privatization of Government Services
Kansas	Has legislatively created Kansas Performance Review Board Uses defined process: PERM (Privatize, Eliminate, Retain, Modify)
Maryland	Has the Governor's Commission on Management and Productivity
Massachusetts	Has process that protects employees and oversight by the state auditor
Michigan	Developed and implemented the PERM process Has a Privatization Division in the Department of Management and Budget
Montana	Legislative Auditor screens and oversees the privatization plan
New Jersey	Has its impetus in the Governor's Office
New York	Has two commissions (one in the private sector and one in the executive branch)
Tennessee	Prison privatization is similar to Kentucky's
Texas	Has the Texas state Council on Competitive Government Uses a defined process
Utah	Has the Utah Privatization Board (since 1988)
Virginia	Has the Commonwealth Competition Council Uses a defined process

SOURCE: Compiled by Program Review staff from other state reports.

ATTACHMENT B

ATTACHMENT B

TEN COMMON FORMS OF PRIVATIZATION

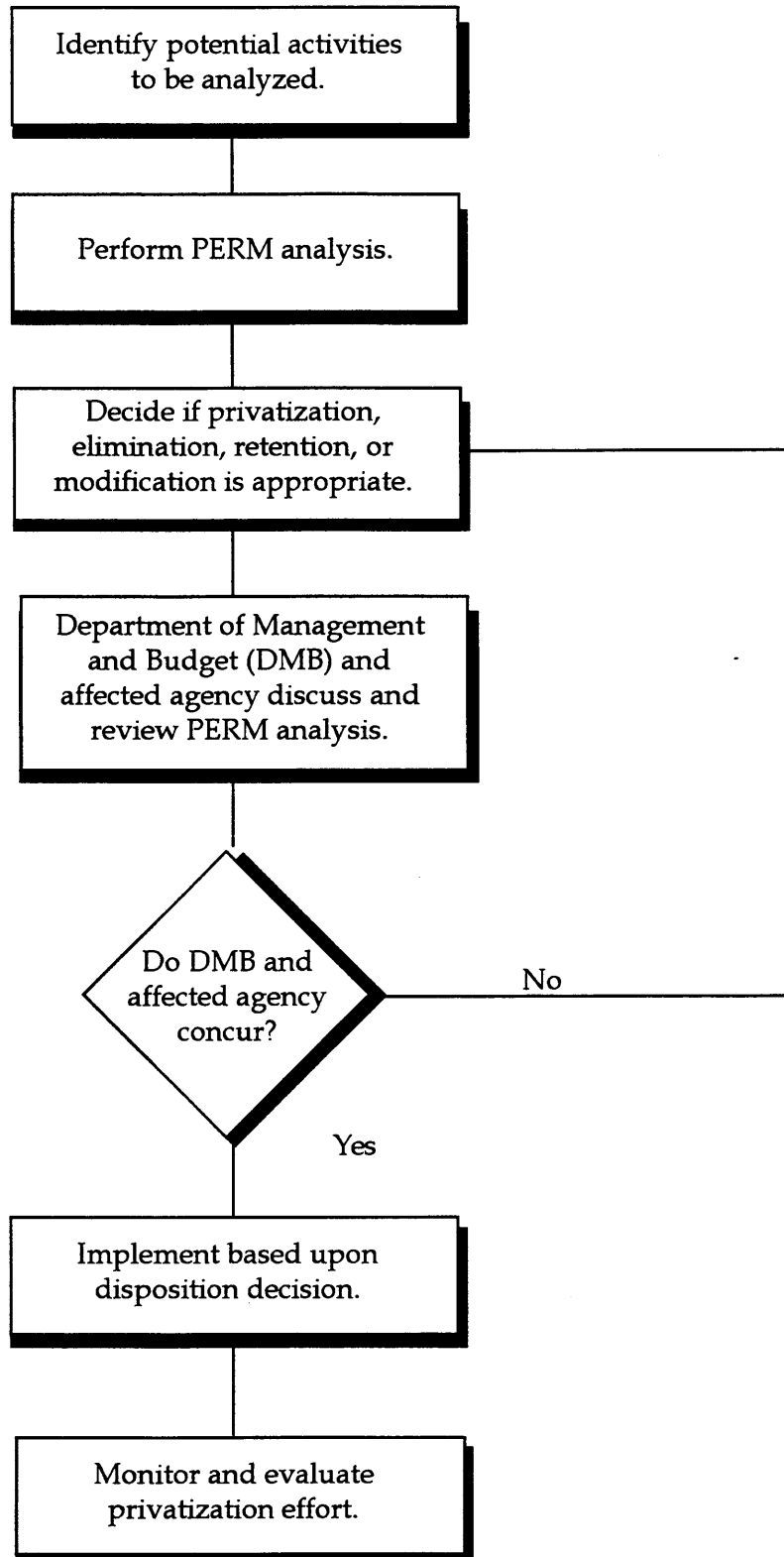
Form	Definition
Contracting Out	The state enters into agreements with private firms, for-profit or not-for-profit, to manage state programs, provide services and conduct public projects with state funds. This form includes leases, lease-purchases, build-transfers, and similar agreements.
Vouchers	The state allows eligible clients to purchase state services or programs from private providers available in the open market.
Franchises	The state gives a private firm monopoly privileges to manage state programs or provide state services in given geographic areas.
Grants and Subsidies	The state makes monetary contributions to help private firms provide state services or state programs.
Asset Sales	The state sells its assets to private firms or individuals to raise sales revenues or enlarge its tax base.
Public-Private Partnerships	The state conducts state projects in cooperation with the private sector, sharing ideas and resources or relying on private resources instead of spending state funds.
Private Donations	The state relies on private resources, such as personnel, equipment or facilities, to manage state programs or provide services to the public.
Deregulation	The state removes its regulations from services previously provided by state workers to allow private provision of the services.
Volunteerism	The state uses volunteers to help manage state programs or deliver services to the public.
Service Shedding	The state drastically reduces the level of a state service or stops providing a service so the private sector can assume the function with private resources.

Source: State Trends and Forecasts: Privatization, The Council of State Governments, November 1993

ATTACHMENT C

ATTACHMENT C-1

Michigan's PERM Process for Analyzing Functions and Services



Source: Compiled by Program Review staff with information received from Michigan Privatization Division.

Virginia's Commonwealth Competition Council Process

Step 1

Input

- Gather input from
 - Public hearings
 - Business interests
 - Government agencies.

Inventory of competition/ privatization opportunities.

Step 2

Selection

- Further determine the feasibility of the competition/ privatization candidates by conducting a public vs. private performance analysis.

Step 3

Competition

- Under the VA Public Procurement Act, conduct cost comparisons through the issuance and evaluation of requests for proposals.
- Have independent reviewers conduct evaluations.

Step 4

Award

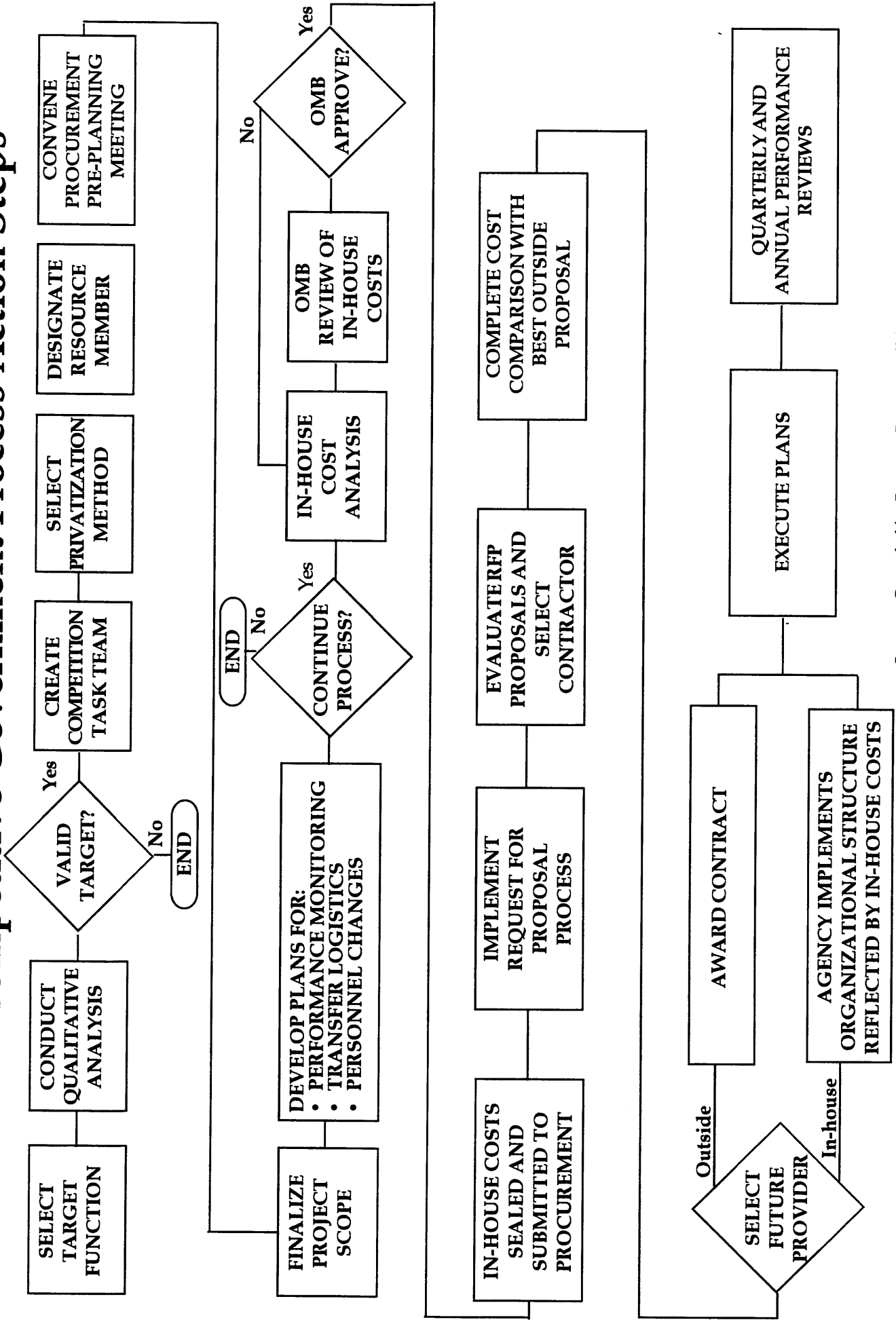
- Make decision to continue in-house performance or award a contract to a private-sector bidder. *(These decisions are tentative and are subject to review and appeal by all affected parties.)*
- Award contracts for no more than 5 years.

Step 5

Monitoring

- Establish an ongoing quality assurance program to ensure required standards of quality and cost effectiveness.
- CCC must conduct a postperformance review at the end of the contract period.

Arizona Competitive Government Process Action Steps



Source: Compiled by Program Review staff with information received from Arizona Office for Excellence in Government.

ATTACHMENT D

ATTACHMENT D

Privatization: Cost Methodologies

By Kim Burch

One of the most important factors considered in determining whether or not to privatize a government service or activity is cost. In making a privatization decision, administrators compare costs incurred when the government provides an activity with costs incurred by the government if the service is provided under contract. Performing cost analysis and using a cost comparison methodology safeguards against personal bias influencing the decision to privatize or not. A cost analysis is performed when a state agency is interested in privatizing a particular function or service, or interested in soliciting a bid to acquire or retain a particular function or service.

Most states require the interested agency to perform the cost analysis. However, some states have a central agency (Michigan) or a council (Virginia) that either oversees this process or provides an independent cost analysis to ensure agency costs are complete, accurate, and reasonable. Lawrence Martin, of the Reason Foundation, suggests that it is best to have a private accounting firm calculate the full government costs, in order to ensure greater objectivity in the process. Michigan is one state that has contracted out to have PERM (privatize, eliminate, retain, or modify) studies conducted. Particularly when an agency is bidding on a contract, it is best to have a disinterested third party, such as another government agency or an outside consultant, perform the cost analysis.

The timing of the cost comparison varies across states. Some states compare in-house costs to private contractor costs only after a particular contractor has been selected through the competitive bidding process (Arizona, Massachusetts). Other states prefer to calculate in-house costs and to estimate contractor costs before obtaining bid proposals (Texas, Virginia). Florida prefers to perform a cost analysis on all contract proposals that have been submitted and that meet their qualifications, assigning scores to the proposals, and letting a council choose a contractor. William Eggers, of the Reason Foundation, suggests that because the process of conducting detailed and accurate cost comparisons is time-consuming and complicated, it should be attempted only after a specific privatization recommendation has been made.

Calculating Cost

The most common reason for privatizing a government service is to save money. However, because government activities are usually funded through several departments, administrators are often unaware of the complete cost of providing a given service. Several guides exist that list the elements that should be considered when calculating the true cost of service provision.

The states examined here (Arizona, Florida, Massachusetts, Michigan, Texas, and Virginia) use a step-by-step approach in their cost methodologies, and are fairly uniform in the elements they identify to determine the cost of a function or service. Cost analyses for these states involve a checklist of specific cost items for judging the feasibility of privatizing. Differences exist in terminology, or in the organization of cost factors, but states generally examine direct and indirect costs of the service provision, contract administration costs, and service transition costs. Of the states reviewed here, the only *major* difference in cost methodologies is the way states calculate indirect costs.

In order to complete a cost analysis, the total in-house cost of providing a government service must be determined. From here, one can calculate avoidable costs, the costs that would be avoided if the service is privatized. Next, the total cost related to contracting out the service is calculated. With these calculations, the cost savings can be determined and a decision made to privatize or not. These figures are usually calculated over five performance periods or five fiscal years, in order to provide historical cost information, current cost data, and future cost estimates. These steps are outlined as follows:

1. **IN-HOUSE COST = DIRECT COSTS + INDIRECT COSTS**
2. **AVOIDABLE COST = DIRECT COSTS + PORTION OF INDIRECT COSTS**
3. **CONTRACTING COSTS = CONTRACTOR COST + ADMINISTRATION COSTS +
CONVERSION COST - NEW REVENUE**
4. **COST SAVINGS = AVOIDABLE COST - CONTRACTOR COST**

In estimating the savings to be realized by contracting out, it is not appropriate to merely examine the difference between in-house costs and contracting costs. The amount of money likely to be saved is not simply the difference between in-house costs and total contracting costs--contracting out does not generally result in a dollar-for-dollar reduction in governmental overhead costs. It is better to use avoidable cost to compute cost savings.

Direct Costs

Direct costs are the cost of items specific to the target service, the government activity being considered for privatization. It is the cost of employees working exclusively on the target service, and cost of building and supplies for those employees. Direct costs include:

- 1) **personnel costs**, such as salaries, insurance, longevity bonus, retirement contributions, unfunded pension payouts, staff training, transportation, and costs associated with contractual employees assigned to target function, including supplies and materials;
- 2) **purchased or leased equipment costs**;
- 3) **property costs**, such as rental fees for work and storage space, finance costs for service and interest on bonds, and insurance costs for fire, theft, and casualty protection;

- 4) **depreciation costs** of equipment or property;
- 5) **contingent liability costs**, such as guarantees, pending law suits, judgments under appeal, unsettled disputed claims, unfilled purchase orders, and uncompleted contracts; and
- 6) **support costs**, which include materials, supplies, phones, printing, communications, postage, uniforms, and employee parking.

Indirect Costs

Indirect costs include the same items as direct costs, but relate to departments other than the immediate department providing the target function. Indirect costs include costs incurred by the supervisory workforce one level above the target function, as well as costs incurred by the executive office and central service offices. For example, costs associated with the agency director, legal support, computer support, data processing services, or security services would be considered indirect. Also included are costs incurred by other agencies, such as the Attorney General's Office, General Services, Comptroller's Office, State Auditor's Office, and Information Resources. Sometimes referred to as *overhead*, indirect costs are calculated differently than direct costs. This is because the target function utilizes only a portion of the time and service offered by administrators and staff in these other departments.

Many states have automated accounting systems capable of identifying, tracking, and allocating overhead costs. States lacking such systems encourage agencies to develop their own methods to capture indirect costs. An *activity-based costing method* assigns indirect costs to departments or services based on their use of resources. For instance, if the type of service being provided is accounting, then indirect costs are proportional to the number of accounting transactions processed. An alternative is the *personnel-cost method*, where indirect costs are proportional to the number of full time employees dedicated to the target service, or the *total direct cost method*, where overhead is proportional to the budget of the target service. The *step-down method* divides all of an agency's departments into either support or production departments, and allocates all the costs of support departments to the other entities they serve. For greater accuracy, the *step-down method* can be combined with *activity-based costing*, which permits the cross-allocation of indirect costs to other indirect services. While more accurate, this latter approach is more time consuming and requires greater effort than the other methods.

Avoidable Costs

Avoidable costs are those in-house costs that will not be incurred if a target service is contracted out. **All** direct costs are considered to be avoidable, but only a portion of indirect costs are avoidable, depending on how much overhead can be eliminated and whether the short or long term is being considered. The more services privatized in addition to the target service, the greater the likelihood for a reduction in overhead. Also, many costs cannot be avoided in the short term that may be avoidable in the long term. For example, contracting out a service may leave an agency holding a lease for more space than is necessary; however, the cost is not avoidable until the agency can decline to renew the lease.

To compute avoidable costs, one must determine whether at least one supervisory position would be eliminated at the level immediately above the level of the target service. Then one must determine whether at least one position would be eliminated in any of the other agencies or departments that provide definable support to the target service. If no positions would be eliminated, then the avoidable indirect costs are zero. If positions would be eliminated, one must identify the personnel costs and other costs solely in support of positions to be eliminated. This process is repeated for executive offices and central service departments.

Contracting Costs

In order to determine the cost of a contractor providing the target service, agencies consider contractor cost, contract administration cost, transition costs, and new revenue. The contractor cost is simply the cost proposed by the contractor to charge for performing the target function.

The second factor, contract administration costs, involves all those activities that take place from the time a decision is made to hire a particular contractor until the contract is fully executed and final payment is made. Elements that should be considered in calculating the costs of administering and monitoring a contract include: performing compliance reviews and audits, reviewing submitted reports, processing contract amendment and change orders, handling complaint and dispute resolution, processing contractor invoices, performing citizen surveys for assessing program satisfaction, performing on-site visits, examining contractor work records, and performing periodic cost comparisons. These costs also include office costs (such as facility, supplies, communications, and furnishings), transportation costs to perform contract inspection and liaison activities, and legal support and services costs.

Two major methods for estimating the costs of contract administration are 1) informed judgment and 2) federal Office of Management and Budget (OMB) guidelines. Under informed judgment, a reasonable estimate of contract administration costs is between 10 percent and 20 percent of contractor costs. Lawrence Martin, of the Reason Foundation, suggests that a general rule of thumb would be to move toward the higher end of the range for small dollar contracts and toward the lower end of the range for large dollar contracts. OMB guidelines assume that the best indicator of contract administration costs is the number of people engaged in providing a service. The number of staff needed to be budgeted for contract administration is based on the number of in-house staff currently providing the service.

The third factor in contracting costs is transition cost, also known as one-time conversion cost. This is the cost incurred during the process of converting a government service to privatization. For the purpose of cost analysis, conversion costs are amortized over the life of the contract, in order to avoid "front end loading." Conversion costs include:

- 1) agency personnel costs for displaced employees, such as unemployment compensation, accrued annual and sick leave benefits, relocation, retraining, or other severance items;

2) material-related costs, such as costs associated with the preparation and transfer of government property or equipment to the contractor, or the costs for disposing of or storing existing equipment; and

3) other costs, such as penalty fees for terminating leases or rental agreements, costs of unused or underused facilities and equipment, and costs of redirecting the public to the new provider.

The fourth factor in determining the total cost of contracting out a target function is whether any new or enhanced revenue that will accrue to the government as a result of contracting out a service will off-set the total contractor cost. Examples of off-setting revenues include money generated from the collection of user fees or money earned from the sale of government property. Also, potential future costs should be considered, such as equipment replacement and upgrade, contractual disputes, reversion of the program to the agency, growth in workload, modernization efforts, and rebidding or transferring the contract.

Several states include the costs associated with developing, advertising, and reviewing a request for proposal and for reviewing submitted bids as transition costs. The federal government does not include these items as contracting costs, but rather, treats them as in-house administrative costs, as part of the process of improving government service.

Threshold Level

Several states establish a cost-savings threshold that justifies a decision to change the mode of service delivery. The federal government and Arizona have a threshold level of 10 percent that must be met before they will consider privatizing a function. That is, before privatization occurs, there must be at least a 10 percent savings in contracting out over keeping the service in-house. Massachusetts does not establish a particular level, but requires a cost savings to exist (the cost of the contractor must be less than the in-house avoidable cost).

As stated above, avoidable costs are typically used instead of in-house costs for cost comparisons. However, occasions exist where the fully allocated in-house cost should be used. For instance, when comparing the operating efficiency of service delivery before and after privatization has occurred, one should use in-house costs. Also, when a government agency is competing with industry for providing a new service, fully allocated costs of the government agency must be used in the comparison with the total cost of contracted service.

One final note, the federal government grants cost comparison waivers if the privatization will result in a significant financial or service quality improvement, and it will not significantly reduce the level or quality of competition in the future award or performance of work. The agency seeking the waiver must establish why in-house or contract offers have no reasonable expectation of winning a competition where a cost comparison would be conducted. Since cost comparisons by federal agencies generally take eighteen months for a single activity (or thirty-six months for multiple activities), a waiver can significantly decrease the time it takes to privatize a government function. The states examined for this portion of the study did not offer waivers for cost comparisons.

