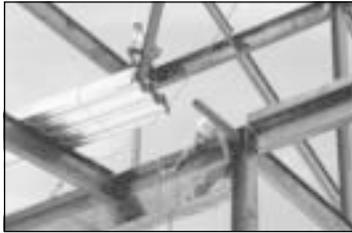


Competition & Government Services



Can Massachusetts Still Afford the Pacheco Law?

By
GEOFFREY F. SEGAL
ADRIAN T. MOORE
ADAM B. SUMMERS

affordable government

www.pioneerinstitute.org

85 Devonshire St., 8th floor
Boston, MA 02109
617-723-2277 | Tel
617-723-1880 | Fax

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EXECUTIVE SUMMARY

When faced with insufficient revenues, state governments typically have four options: increase taxes, scale back expenditures, spend down reserves, or seek ways to provide services more efficiently through contracting with private providers. Massachusetts, however, has only the first three options available; it is the only state in the nation that has virtually outlawed the privatization of public services.

The Pacheco Law was enacted by the Massachusetts legislature in 1993. The law, now M.G.L. ch. 7 sections 52-55, set up a series of tests that a state agency must pass before it can award a contract to a private company to perform services that had been previously performed by state employees. The law presents both statutory and political roadblocks to efficient government operations. Its provisions essentially slam the door on many opportunities that have been shown to improve services and save money in other places, as the law disregards all potential benefits other than lower costs.

Reducing costs is only one of many reasons agencies in other states choose to contract with private service providers. Well-designed contracts allow agencies to improve quality, accommodate peak demand, speed project delivery and meet deadlines, gain access to expertise, improve efficiency, spur innovation, and manage risk more effectively.

The Pacheco Law essentially prohibits Massachusetts agencies from contracting out to improve service quality, increase the number of people served, or reduce an existing backlog. A proposal to contract out cleaning and maintenance of bus shelters—which would have brought several million dollars annually to the state from new advertising revenues—was rejected because the contractor did not specifically calculate the difference in cleaning costs.

When a Massachusetts agency entertains bids for the right to deliver a service, public employees have the opportunity to submit bids to keep the work in-house. The Pacheco Law gives state workers significant advantages.

- The cost and quality of service offered by private contractors must be compared not to existing cost and quality but to the hypothetical situation of public employees working in the most cost-effective manner and providing the highest quality possible. At no time are state employees held to these standards. If public employees win the contract, they are not held to any concessions made as part of the bid.
- The contractor must add lost tax revenues to the cost of the bid if any work is to be performed outside Massachusetts. No such adjustment is made to the public sector bid for the loss of tax revenues that would be realized if the work were to be performed by a private business subject to state taxes.
- Private bids must also include estimated costs of monitoring contractor performance, while no such monitoring takes place in the public sector. The likely benefits of monitoring are not considered.

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The Pacheco Law essentially slams the door on many opportunities that have been shown to improve services and save money in other places.

Even if a private contract scales these hurdles, the State Auditor may reject any proposal he deems not to be “in the public interest,” without providing a definition or reason. The rulings are final and may not be appealed.

Prior to the passage of the Pacheco Law, the Weld administration issued 36 privatization contracts, saving taxpayers an estimated \$273 million. The procedure Massachusetts agencies must follow under the Pacheco Law is so onerous that only eight proposals have been submitted to the Auditor since its adoption in 1993. Only six were approved.

Over the last decade, federal, state, and local government agencies nationwide have contracted with private vendors to provide services from data processing to prison operations to adoption. According to the Government Contracting Institute, the value of federal, state, and local government contracts to private firms is up 65 percent since 1996 and exceeded \$400 billion in 2001. Massachusetts law should not continue to prohibit agencies from taking advantage of this tool for reducing the cost and increasing the quality of state services.

Recommendations

Ideally, the Pacheco Law should be repealed. Short of repeal, it should be amended such that privatization can become a useful policy tool for legislators and agency managers.

1. Allow for best-value contracting, in which clear value to taxpayers replaces cost savings as the sole criteria. When costs are compared, the cost of the private bid should be compared to the current actual cost of public employees delivering the service rather than to a hypothetical cost.
2. Require that agencies use a uniform set of thoughtful assumptions in calculating costs that are clearly explained and transparent in their implications.
3. Require that all contracts, with private firms or state employees, be performance-based, specifying what will be accomplished, how it will be measured, what incentives will be used, and the consequences for performance failure.
4. Hold public employee groups accountable to their bids. If a union chooses to bid on a contract, public workers should be expected to provide services at the cost and level of quality indicated in the bid. In practice, this also means 1) requiring union bids to include contract monitoring and its associated costs and 2) including in contracts with winning employee groups provisions for re-competition if the performance goals and cost savings are not met, with a specific length of contract and re-bid schedule.
5. Hold agencies accountable for managing successful privatization projects that meet agency performance goals. Enforce accountability through agency budgets.
6. Remove the elements of the law that dictate the process agencies must follow to privatize.
7. Shift the Auditor’s role to reviewing privatization proposals for clear violations of the law, and create an appeals process for disagreements between the Auditor and agencies, paid for out of both budgets to reduce incentives to appeal.

Ideally, the Pacheco Law should be repealed. Short of repeal, it should be amended such that privatization can become a useful policy tool for legislators and agency managers.

General and service-specific surveys of privatization all reach the same conclusion. The use of contracting by government agencies is growing. Cost savings are always a key motive, if not the sole one; states with privatization experience are achieving their goals and generally plan to expand their use of it.

As January 2003 approaches, Massachusetts faces its worst fiscal crisis in over a decade. Contracting with private providers for services should be an option for agencies as they adapt to tighter budgets. Amending the Pacheco Law would free agency managers to provide public services in keeping with the law's stated intent, to "ensure that the citizens of the Commonwealth receive high-quality public services at low cost, with due regard for the taxpayers of the commonwealth and the needs of public and private workers."

COMPETITION AND GOVERNMENT SERVICES

Can Massachusetts Still Afford the Pacheco Law?

Geoffrey F. Segal, Adrian T. Moore, and Adam B. Summers

INTRODUCTION

The 1990 election of William Weld as governor of Massachusetts marked the end of a 16-year period in which Democrats held that office. What prompted a normally liberal electorate to turn to an avowed fiscal conservative was a state budget deficit caused at least in part by a dramatic increase in the size of the public payroll under Democratic administrations. Governor Weld promised to bring “entrepreneurial government” back to Massachusetts, or as one newspaper put it at the time, to bring competition to stale, sluggish state workers.¹

The Weld administration faced a deficit of up to \$1.8 billion out of a budget of \$13 billion. The economy had also been very weak, and Massachusetts—like the rest of the country—was in a recession. The administration borrowed \$1.4 billion in 1992 to cover the deficits.²

Within months of Weld’s arrival in office, the governor formed a privatization task force of 20 to 30 individuals from the public and private sectors with a mandate to identify state services that could be contracted out to private operators. Six months into the governor’s first term, his administration offered three criteria for selecting privatization projects:

- The service involved must be distinctly definable in an RFP.
- The privatized function must have measurable performance.
- There must be more than one vendor able to perform the service.³

To many, including legislators and public employees, these criteria were evidence of a “rush to privatize.”⁴

Support for the new administration severely lacked in the Democrat-led state legislature and among public employees and their unions. Opponents pointed to some of the administration’s early initiatives, including the closing of state psychiatric hospitals, institutions for the mentally retarded, and a public hospital for the chronically ill, as

Faced with a state budget deficit, newly elected Governor Weld promised to bring “entrepreneurial government” back to Massachusetts.

For endnotes to the *White Paper*, turn to page 24.

evidence that Weld was unfeeling and out of touch with what Massachusetts wanted or needed. The Weld administration pressed on, and the legislature soon sought to slow it down.

Debate over the fate of Taunton’s Dever State School, a residence for some of the state’s most severely retarded citizens, was a turning point. State Senator Marc Pacheco represented Taunton. During the 1970s and 1980s, parents of residents had fought for reform and won—making the school a better place to live. Happy with the results of their efforts, the parents were already on the side of state workers. But by 1991, the Commonwealth’s public hospital system, which was built to accommodate more than 35,000 individuals, housed fewer than 6,200 clients. These largely empty facilities were very expensive to operate and maintain; moving clients into privately run, community-based facilities was considered both fiscally and clinically appropriate.

Debate on legislation known as the Pacheco bill, after the bill’s author and principal champion, began in early 1993, once the 1992 election had passed and Republican losses left the governor unable to uphold a veto.

By then the state’s budget situation had begun to turn around—under Weld the state enjoyed surpluses for three straight years. Weld had also cut supplemental spending down to \$250 million—well below the \$400 million and \$900 million approved the previous two years.⁵ Still Senator Pacheco battled Weld at nearly every turn.

Weld hit the airwaves in defense of his initiatives, billing himself as an outsider fighting for the taxpayer against the Beacon Hill establishment. He suggested that the legislature was trying to protect patronage, while the unions wanted to keep their membership intact.

The political battle also brought to light some potential conflicts of interest with Weld’s staff and private companies that had won state contracts. Accusations of Republican patronage and “revolving-door arrangements” followed.⁶ So much attention and fire was drawn to his administration that Weld issued an executive order banning “revolving door” hiring by private contractors of state officials who had given them contracts.

Eventually, the Weld administration conceded the need to monitor the transition from public to private service provision and created a comprehensive 50-point review process. By then it was too late. The popularity of the Pacheco bill increased until it was enacted over a gubernatorial veto.

The Pacheco Law set up a series of tests that a state agency must pass before it can award a contract to a private company to perform services that had been previously performed by state employees.

PART 1. WHAT IS THE PACHECO LAW?

The Pacheco Law was enacted by the Massachusetts legislature in 1993. The stated purpose of the law was to review proposals to contract out the provision of state services in order to “ensure that the citizens of the commonwealth receive high quality public services at low cost, with due regard for the taxpayers of the commonwealth and the needs of public and private workers.” To that end, the law, now M.G.L. ch. 7 sections 52-55, set up a series of tests that a state agency must pass before it can award a contract to a private company to perform services that had been previously performed by state employees.

Among the law's more significant provisions are the following:

1. The purchasing agency must establish quantitative performance measures that the contractor must meet in the areas of quality, timeliness, and effectiveness.
2. Contractors must pay wages not lower than the lesser of the minimum wage rate that had been paid to state employees or the average private sector wage rate for comparable positions. The law also limits the compensation of the private company's officers and managers to the wage rates of comparable state managers.
3. The law requires the private contractor to pay at least the same percentage of its employees' health insurance premiums as the Commonwealth.
4. The contracting agency must add lost tax revenues to the cost of the private bid if any part of the work is to be performed outside Massachusetts. No such addition is made to the public sector bid for the loss of tax revenues that would be realized if the work were to be performed by a private business subject to state taxes.
5. Displaced public employees who are qualified must be offered jobs with the private contractor.
6. The private bid must be compared not to the actual cost of providing the service, but to the cost that would result if public employees were working in the most cost-effective manner. At no time are state employees actually held accountable for performing to this level.
7. The contracting agency must also demonstrate that the quality of service likely to be provided by the private contractor will equal or exceed, not the existing quality of service, but the quality that "could be" provided by public employees. As with costs, at no time are state employees actually held accountable for performing to this level.
8. The State Auditor has interpreted the meaning of the law regarding cost savings to mean strict comparison of costs and does not allow for privatization based on revenue flows. Hence only privatizations that cut costs, not ones that enhance revenues are allowed, despite their similar effects on the state's financial bottom line.
9. The State Auditor is charged with reviewing all proposals for compliance with the law and can strike down the contract if it fails to satisfy any of five different tests, the most basic being that the adjusted private cost be lower than the hypothetical public cost. This rigid requirement prevents an agency from paying more to improve service quality, increase the number of people served, or reduce an existing backlog. Also, the auditor may reject any proposal deemed not to be "in the public interest," without providing a definition or reason. The rulings are final and may not be appealed.

The requirements of the Pacheco Law have discouraged private firms from seeking contracts in Massachusetts—and the cumbersome process has created a disincentive for agencies to attempt privatization. Since the bill became law in 1993, only eight proposals have gone through the entire process and been submitted to the Auditor; six services have been contracted out to private firms.

Sen. Pacheco states that he wouldn't change anything in the law and that it has prevented a race to the bottom in terms of labor standards. However, he does concede, "there are services that can be [privatized] and that could save money...there are places to achieve efficiency and make gains...there are always opportunities."⁷

Since the bill became law in 1993, only six services in Massachusetts have been contracted out to private firms.

"There are services that can be [privatized] and that could save money...there are places to achieve efficiency and make gains...there are always opportunities."

—Senator Pacheco

PART 2. WELD ADMINISTRATION PRIVATIZATION INITIATIVES

Prior to the Pacheco Law's passage, the Weld administration issued 36 privatization contracts. The Office of Administration and Finance compiled a report documenting \$273 million in savings in just two years of privatization.⁸ The report also noted that the state was receiving better service at a lower cost—in care for the mentally ill, running skating rinks, maintaining certain highways, and providing medical care in prisons. (See table 1.)

Table 1. "Getting Results"

Selected Privatization Initiatives	Savings (as of 11/93)
DMR food and housekeeping service	\$10,000,000
Essex County road maintenance	\$3,000,000
Ice rink management	\$1,300,000
Prison health and food service	\$8,000,000
DOT building maintenance	\$1,200,000
Mental health and substance abuse	\$33,000,000
Mental retardation to private care	\$49,700,000
Closure of eight state hospitals	\$143,000,000
Pharmaceuticals	\$3,000,000

Source: Executive Office of Administration and Finance, Commonwealth of Massachusetts, "Privatization in Massachusetts: Getting Results," Boston, MA, November 1993.

One of Weld's early initiatives was contracting privately for food and housekeeping services at the Fernald State School for the mentally retarded. The contract resulted in "food that tastes better and buildings that are clean and smell fresher."⁹ A walk through the school revealed shiny linoleum and cabinets without dust.

Even with better service, costs were much lower. Housekeeping and foodservice costs at Fernald declined by \$900,000 a year. The Department of Mental Retardation (DMR) awarded contracts that reduced food and cleaning expenses at all five state schools from \$23 million a year to \$13 million.¹⁰

The contracts gave state employees preference in filling private contractor jobs; Marriott offered jobs to any displaced Fernald workers who wanted them. According to the administration report, only 39 of 1,241 employees lost their jobs when three state health departments privatized housekeeping and food service at state hospitals.¹¹

The Weld administration achieved similar success by bringing competition to routine highway maintenance. The first project, in Essex County, saved \$2.1 million according to the highway department; an independent analysis by Coopers & Lybrand concluded that the savings were likely greater and another by Harvard's Kennedy School put the savings at 21 percent.¹² The reports also confirmed that highways were better maintained and swept more often.

The Weld administration also contracted out the operation of the state's ice skating rinks, and private management produced results that were applauded by the principal users of the rinks—the parents of youth hockey players and budding figure skaters. At a legislative hearing on the issue, Senator Pacheco's support of public management was roundly criticized by parents who had seen higher standards of cleanliness and increased ice time for skaters after private managers took over. Privatization of the 12 skating rinks saved the state \$1.3 million a year, while keeping the rinks open longer hours, and without an increase in fees.¹³

Health care and some food services for inmates in state prisons were privatized. Before the initiatives, Massachusetts had the highest prison health care costs in the nation—\$4,300 per inmate, and none of the prisons met national standards for health care services.¹⁴ Annual savings of \$8 million were realized, but more importantly, health care at half of the state's facilities received full accreditation by the National Commission on Correctional Health Care for the first time—something that very few facilities achieve. Also, outside trips to hospitals dropped to one-seventh their previous rate.¹⁵

The state's purchasing of pharmaceuticals was also privatized with savings of \$3 million. Private management of the state transportation building saved \$1.2 million.¹⁶

By far the largest savings were seen in three areas: the privatization of managed mental health care and substance abuse services (\$33 million); shifting of 2,000 mental health, mental retardation and other patients to private care (\$49.7 million); and avoided repair costs of eight closed state hospitals (\$143 million).¹⁷

PART 3. WHY PRIVATIZE?

During the nine years since the Pacheco Law passed, the state’s budget has grown by about 50 percent, from \$15.5 billion to more than \$23 billion. While every state, except Alaska, increased per capita spending between 1990 and 1999, only three states (Delaware, Hawaii, and Wyoming) spent more per capita than Massachusetts did.¹⁸ Furthermore, growth of the budget far outpaced increases in population. The annual budget in Massachusetts has grown on average 6.11 percent every year since 1993, while population growth has averaged only 0.64 percent per year. Other states—like Arizona, Texas, and Florida—that saw similar growth in their budgets had substantial population growth as well.

While every state, except Alaska, increased per capita spending between 1990 and 1999, only three states spent more per capita than Massachusetts did.

Today’s budget picture looks similar to Massachusetts in the pre-Weld and pre-Pacheco Law days:

THEN	NOW
Large deficit—FY91: More than 10 percent of state budget.	Large deficit—FY03: Nearly 10 percent of state budget.
Borrowed money to cover the deficit.	Spent down the rainy day fund.
Little or no money in rainy day fund.	Little or no money in rainy day fund.
Rapid growth in recent state budgets.	Rapid growth in recent state budgets.
Massachusetts and the nation face slow economic growth.	Massachusetts and the nation face slow economic growth.

To close the \$2.5 billion FY03 deficit—nearly 10 percent of the Commonwealth’s budget—the governor and legislators chose a combination of raising taxes and spending down rainy day funds. Lawmakers enacted the largest tax hike in state history—\$1.14 billion—the average, non-smoking resident is expected to pay an additional \$317 taxes next year.

With depleted rainy day funds, legislators may have to consider other alternatives. A third policy tool is available: using private contractors to make service delivery more efficient. While not a panacea, experience indicates that when done right privatizing public services can simultaneously save money and improve service quality. The opportunity is ripe for reviewing the Pacheco Law and reintroducing competitive contracting to Massachusetts.

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Costs and Benefits

As a rule of thumb, privatization can typically lower costs 10 to 20 percent while maintaining or improving service levels. According to the U.S. Office of Management and Budget, the federal government has historically realized cost savings in the range of 20 to 50 percent.¹⁹

Cost savings are not the only benefit of privatization. A review of state practices around the country found that flexibility, access to personnel or skills not available in-house, and tapping private-sector innovation are all important factors in a state’s decisions

Requiring the state to always buy the cheapest assumes all other things are equal—which they rarely are. The more complex the privatization, the greater the importance of issues other than cost.

to privatize services.²⁰ Indeed, what are considered best practices for government procurement and service contracting are steadily moving toward “best-value” techniques, where, rather than selecting a private partner based on low cost alone, governments choose the best combination of cost and quality.

The federal government’s privatization guidelines, after which the Pacheco Law was purportedly modeled,²¹ are undergoing a review. The Office of Management and Budget Circular A-76 sets federal policy and the procedures for determining whether commercial activities should be performed under contract with commercial sources or in-house using government facilities and personnel. In its report, the Commercial Activities Panel (the presidential panel recommending changes to A-76) encouraged the adoption of a best-value contracting approach.²²

The ascendance of best-value selection criteria is rooted in the concept of value—recognizing that the cheapest is not always the most desirable. Requiring the state to always buy the cheapest assumes all other things are equal—which they rarely are. The more complex the privatization, the greater the importance of issues other than cost.

Privatization Goals

1. **Improve quality.** With increased private responsibility comes the incentive for companies to produce high-quality work and to ensure proper performance of facilities. According to data from the Council of State Governments, more than 18 percent of state agencies indicate that high-quality service is one reason they have outsourced.²³
2. **Accommodate peak demand.** Private companies can accommodate fluctuating demand more easily than government departments with flexible staffing policies—they can be “turned off and on.” Many state services exhibit natural ebbs and flows, but public employees, protected by civil service, remain at steady levels. When staffing exceeds the workload, the space between the workload curve and staffing levels represents waste—staff with nothing productive to do. When the workload exceeds staffing levels, the space between the workload curve and staffing levels represents projects not being completed, delays, backlogs, and costs imposed on would-be users.

With private contracts, consultants are a resource pool that can be used to adjust to changes in staffing needs. A 1990 study by the Wisconsin Legislative Audit Bureau concluded that privatization was used primarily for two reasons: to provide expertise unavailable to in-house staff, and to meet short-term, or “peak,” demand levels, for which the addition of permanent staff would be uneconomical.²⁴
3. **Speed project delivery and meet deadlines.** CSG data show that speedy implementation is an important reason for privatization.²⁵ A study of consultant use on transportation projects agreed: “Consultants represent a larger reservoir of manpower resources...and consultants usually have greater freedom to marshal resources at short notice.”²⁶
4. **Gain access to expertise.** More than 32 percent of state agencies reported lack of state personnel and expertise as important reasons for privatization.²⁷ The Wisconsin Legislative Audit Bureau study attributed much privatization to need for special skills,²⁸ and a study for the Texas DOT found that one of the key reasons given for privatization was lack of in-house expertise.²⁹

A review of state practices around the country found that flexibility, access to personnel or skills not available in-house, and tapping private-sector innovation are all important factors in a state’s decisions to privatize services.

5. **Improve efficiency.** With proper contracts, privatization projects have tighter time, budget, and scope-of-work constraints than in-house projects. Besides inadequate monitoring, in-house projects often show changes in scope, unforeseen design complications, and unexpectedly high levels of public involvement—in contrast to contracted work, which tends to be better defined in project scope and relatively predictable as to potential problems that could increase costs.³⁰
6. **Spur innovation.** Competitive contracting can produce innovative solutions to public service delivery. The freedom to invent “allows for old processes to be discarded in favor of entirely new ones—processes that integrate relevant technological advances and streamline communication channels.”³¹ According to CSG data, at least one in five state agencies says that increased innovation is one of the top reasons for privatization.³²

Why is privatization necessary for innovation? One answer is that the public system does not always reward government employees for innovative ideas. Consider the plight of a government employee with an innovative idea. She can face crushing institutional barriers to change.³³ Government agencies rarely face competition; government employees have no property rights in their jobs or missions and rarely have independent authority to make changes. A professional or political committee, sometimes more than one, often must approve an innovative new approach. At the end of the day, even if the employee’s idea is accepted, she is not likely to reap any professional reward—and one of the individuals or committees higher in the decision process may well have stolen credit for the idea. Individuals in private firms have far more opportunity and incentive to develop and pursue innovative ideas at all levels than their public-sector counterparts.

7. **Manage risk more effectively.** Privatization allows governments to shift risks to contractors, which helps achieve the most efficient risk allocations and allows risk to be used as a management tool, rather than just something to fear. The power of the contract is often overlooked by public officials, who thus ignore the opportunity to build quality assurances and/or quality controls into project delivery as a means of managing risk.³⁴
8. **Cut costs.** Research shows that cost saving is not always the motivation for privatization, that it is becoming less central as governments become more adept at privatization,³⁵ and that acquiring the best value for public dollars is increasingly the goal of privatization. Still, the issue of cost saving often dominates the debate over competitive contracting. There are a fair number of studies of cost savings from privatization projects, as well as a great deal of case study evidence. Cost savings will depend on the service, size, and scope of the project.

Acquiring the best value for public dollars is increasingly the goal of privatization.

PART 4. PERFORMANCE-BASED CONTRACTING

Performance-based contracts have emerged as an important tool, providing government managers with better control over contractors and greater assurances of accountability.

Typical privatization contracts emphasize inputs: procedures, processes, the wages to be paid, amount or type of equipment, or time and labor used. But forcing contractors to emulate in-house procedures eliminates many of the reasons to privatize. Such micro-

managing limits opportunities for the contractor to innovate, be flexible, or offer enhanced or different types of service. More and more, governments are using performance-based contracts—an output- and outcome-based approach to contracting.³⁶

*A performance contract is one that focuses on the outputs, quality and outcomes of service provision and may tie at least a portion of a contractor's payment as well as any contract extension or renewal to their achievement.*³⁷

Performance contracts clearly spell out what is expected of the contractor, but the manner in which the work is to be performed is left to the contractor's discretion. Performance-based contracts promote the broad range of privatization goals that go beyond simple cost savings. They allow governments to purchase results, not just process, rewarding the private firm only if specified quality and performance goals are met. With performance-based contracting, governments are purchasing something fundamentally different from in-house services.

Performance-based contracting addresses the problems and challenges used to justify the Pacheco Law. Rather than setting up a regulatory system and audit plan, it requires agencies to set clear performance goals for privatization contracts and holds them accountable through their budgets for meeting them.

Using performance-based contracts can be challenging, as is any management change based on performance and accountability. Officials must choose services suitable to performance-based contracts and devise ways to tie payment to performance and performance to the results the public expects of the agency. Performance contracting is not a magic wand—it can be done well or poorly, and hence come out well or poorly. The key to using performance-based contracting to serve the public good is the practical, not political, matter of understanding what has worked and what has not—doing the homework.³⁸

Learning from examples is instructive. A number of cities and states—Indianapolis, New York City, Connecticut—contract with a private company called America Works to place welfare recipients in jobs. America Works is paid about \$5,000 for each person placed in a private-sector job. America Works receives no payment for the time it puts into training, counseling, and job searches for clients unless they are placed in a job for at least six months.³⁹

Along with performance contracting comes greater need to monitor contractor performance. As more agencies rely on private companies to deliver public services, monitoring and assessing these outside partnerships become vital to achieving the government's goals. While monitoring and measurement systems are becoming more refined, state agencies need to continuously improve purchasing and oversight of service delivery. Effective monitoring pays for itself by improving the quality, transparency, and accountability of services.⁴⁰

How many people are needed to monitor contracts? What should they be doing? What kinds of internal structures are needed as governments shift from service provider to service facilitator and purchaser? These are the types of questions that must be addressed in a systematic way as state agencies embrace competitive service delivery.

Forcing contractors to emulate in-house procedures eliminates many of the reasons to privatize.

PART 5. U.S. TRENDS IN PRIVATIZATION

So just how much privatization has Massachusetts been missing out on? According to the Government Contracting Institute, the value of federal, state, and local government contracts to private firms is up 65 percent since 1996, and reached a total over \$400 billion in 2001. The Government Performance Project at Syracuse University reported that at the end of 2000 contracting consumed on average about 19 percent of state operating budgets.⁴¹

A 1998 survey by the Council of State Governments found that 60 percent of state agencies had expanded their use of privatization in the past five years, and 55 percent expected to expand their use of privatization further in the following five years.⁴² CSG asked state agencies about past and future privatization and the use of privatization. Not all states or agencies responded, so the results are only suggestive. (See table 2.)

Table 2. Survey of State Agencies' Use of Privatization

Department/ Agency	# of states reporting privatizing functions	% of agencies reporting an <i>increase</i> in the 1990s	% of agencies reporting a <i>decrease</i> in the 1990s	% of agencies expecting an <i>increase</i> in the 2000s	% of agencies expecting a <i>decrease</i> in the 2000s	Dominant reasons reported for increased privatization
Administration/ General-Services	22 (architectural, building- construction, facility- maintenance) 23 (custodial) 14 (printing)	77	0	69	0	<ul style="list-style-type: none"> • Cost savings • Flexibility (versus red tape) • Lack of agency personnel and expertise
Corrections	24 (medical) 14 (entire prison operations)			60		
Natural Resources/ Environmental Protection	18 (engineering)	78		80	2	<ul style="list-style-type: none"> • Cost savings • Increased support of political leadership • Increased innovation • Lack of agency personnel and expertise
Social Services	15 (child care) 9 (child welfare)	> 87		75		
Parks/Recreation	19 (construction of new parks) 7 (operations of at least one park)	72		> 72		
Transportation	34 (highway design, road/bridge construction, road maintenance, architectural, airport projects ^a)	76	0	97	0	<ul style="list-style-type: none"> • Lack of agency personnel and expertise • Cost savings • Increased support of political leadership

^aMassachusetts has privatized some of its highway maintenance services.

Source: Keon Chi and Cindy Jasper, *Private Practices: A Review of Privatization in State Governments*, Council of State Governments, Lexington, KY, 1998.

A 1998 survey found that 60 percent of state agencies had expanded their use of privatization in the past five years, and 55 percent expected to expand their use of privatization further in the following five years.

A variety of other studies confirm the CSG findings:

- A survey of competitively contracted bus transit services in the United States found average cost savings of 30 to 35 percent.⁴³
- According to the Gartner Group, 70 percent of firms in the US either have or are considering outsourcing HR management.⁴⁴
- That trend has started to reach into government as well, as local and state agencies look to professional HR firms to manage HR services. This year Florida completed the first-ever statewide outsourcing of HR services.⁴⁵
- Nearly 30 states outsource some welfare services.⁴⁶ The CSG survey also found that social service agencies were the most likely to raise their level of privatization among the 15 types of agencies surveyed.⁴⁷ A 2002 review of studies on privatizing welfare services found a general trend towards privatization.⁴⁸
- A 1996 report by the U.S. General Accounting Office found that 20 states had already privatized one or more child support services statewide, and 18 states had privatized services at the local office level.⁴⁹ The study also identified 21 contracts for full-service child support operations, 40 other contracts for collections and related location services, 8 contracts for locations only, and 9 contracts for payment processing services.

Three states have established in-house programs designed to make state government operations more efficient.

The Texas Performance Review

Texas is the nation's leader in one particular model of government reform—the performance review process. The e-Texas Performance Reviews, a commission under the state comptroller, started off in 1991 with a comprehensive report detailing almost 200 proposals to improve and streamline state government.⁵⁰ Recommendations included internal reengineering, privatization, and sometimes adding new services or redirecting resources to other areas. In the end, around two-thirds of the recommendations were implemented, saving the state \$2.4 billion. The next three years saw the TPR repeat its success, conducting in-depth examinations of state government functions and devising hundreds of specific legislative or administrative reforms—ranging from commonsense to revolutionary—which if implemented would have saved over \$1.2 billion.⁵¹

Realizing that its methods had become a national model, the TPR published “Home Improvements: A Manual for Conducting Performance Reviews” in 1998.⁵² It provides detailed guidance on conducting performance reviews, drawing on a wealth of real-world experience.

Florida Privatization Plans

Governor Jeb Bush has ambitious plans to reduce the size of Florida's state government. His plans would cut 3,023 state jobs, though many would shift to contractors.

- The Department of Transportation may turn over all toll collections on state turn-pikes to private companies.
- Nearly \$13 billion in state employee pension funds managed by the state may be opened up for private investment companies to control.

- Privatization of mental health counseling, foster care placement and other child welfare services may be expanded.
- Under a pilot program, private firms will take over maintenance and concessions at six of the state's 153 parks.
- The state's welfare-to-work program is already privatized and the governor would like to expand the program by devolving job-training programs to regional councils who will then contract with private firms to deliver services.⁵³

Virginia's Commonwealth Competition Council

The Commonwealth Competition Council (CCC) was created by the General Assembly as a part of the Virginia Government Competition Act of 1995 and is an outgrowth of recommendations of Governor George Allen's Commission on Government Reform. The CCC is charged with finding better and less costly ways to provide government services to Virginia's citizens. Their efforts are focused on reducing the size and scope of government activity, especially in areas where the services or products of government can best be provided by private sector organizations, through privatization.

In 1996, various state agencies transferred 495 functions to the private sector, with net savings to the state of more than \$3 million. That estimate jumped to more than \$100 million in 1997 after accounting for revenues from asset sales. Unfortunately, the council has not kept a running total of the savings from all of their initiatives, but even seven years after its creation, CCC Executive Director Phil Bomersheim estimates that the Council is saving Virginia taxpayers \$40 million annually.

The council is charged with taking an annual inventory of state jobs, to identify jobs that are commercial in nature that are being conducted by state employees. At last count the council has identified 205 commercial activities being performed by over 37,000 state employees.⁵⁴

General and service-specific surveys of privatization all reach the same conclusion. It is growing. Cost savings are always a key motive, if not the sole one, and states with privatization experience are achieving their goals and generally plan to expand their use of it.

PART 6. EFFECTS OF PRIVATIZATION ON EMPLOYEES

The perception is widespread that privatization is so harmful to public employees that it is not good policy. This has generated intense opposition to privatization from public employee unions at all levels of government.

Comprehensive examinations of privatization initiatives have found that privatization has resulted in few, if any, layoffs and that public employees can actually benefit in the long term from private-sector management. The literature on employment effects consistently finds that private contracting mostly shifts, rather than displaces, employees:

- A 1995 study of privatization in Illinois municipalities found that only 3 percent of the 516 responding cities reported layoffs due to contracting. Nearly two-thirds (64.9 percent) of the cities reported no displacement of affected employees, while 10.8 percent transferred workers to other government jobs, 5.4 percent reported that

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employees were hired by the private contractors, 5.1 percent said the affected employees retired, and 9.8 percent reported a combination of these results.⁵⁵ In late 1999, a follow-up survey of 220 Illinois cities of more than 5,000 in population found roughly the same percentage (only 3.8 percent) of cities reporting that employees were laid off as a result of privatization.⁵⁶

- Researchers examining privatization by cities in Wisconsin in 2000 also asked what happened to employees after privatization. The most common response was transfers to other government jobs (42 percent of municipalities), followed by retirement and taking jobs with the private contractor. Only in 6 percent of cases were workers laid off. Roughly two-thirds of municipalities did not keep data on what happened to employee wages and benefits. Of the municipalities that could report on changes in wages and benefits, approximately one-third reported that private firms paid wages that were higher than the municipality paid, one-third paid similar wages, and the remaining third paid employees lower wages than the municipality had paid.⁵⁷

A 2000 study examining the effect of welfare-to-work privatization on state employees in Arizona found that none of the 160 employees involved were laid off; the contractor hired most of them, while the rest transferred within the state Department of Economic Security (DES). The contractor raised salaries for former DES employees by on average 31.5 percent, and over one-third of former DES employees received at least one promotion in the first year after privatization. One year after privatization, most former DES employees who responded to a survey were satisfied with post-privatization benefits packages—38 percent rated the benefits better than the state’s, 41 percent rated benefits the same, and 21 percent rated the contractor’s benefits worse. They were evenly split on whether they felt more or less job security with the private contractor. Finally, only 43 percent of former DES employees were “highly satisfied” while working for the state, but 91 percent reported being “highly satisfied” one year after privatization.⁵⁸

Layoffs are a very real concern to public employees when the issue of privatization is raised. However, there is little evidence to suggest that privatization results in massive layoffs and hardship for public employees. Because privatization runs counter to the interests of public employee union leaders, they are very successful at rallying rank and file resistance.

The real policy implication is that it is incumbent upon state agencies to manage employee transitions as part of the privatization process. There are well-understood procedures for coping with the challenges of employee transitions—best practices and hard lessons learned that should be embraced.⁵⁹

The Pacheco Law is unique in erecting substantial barriers to contracting out.

PART 7. OFFICE OF STATE AUDITOR’S REVIEW OF PRIVATIZATION PROPOSALS

In recent years, many states have introduced regulations or legislation to improve the outcomes of privatizing state services. Typically, such measures aim to improve the transparency and accountability of the privatization process and address the challenges agencies face in implementing contracts.

The Pacheco Law is unique in erecting substantial barriers to contracting out. The law and its accompanying regulations and procedures, as well as the State Auditor's review, require a false comparison of costs, hold government workers to lesser standards than private contractors, presume state agencies guilty of fraud and waste and require them to prove their innocence. The law essentially slams the door on many opportunities that have been proven to improve services and save money in other places. The Auditor need not prove anything in order to deny a privatization proposal. The Pacheco Law created a process so obviously hostile to privatization that agencies have every incentive to avoid it no matter the fiscal and performance woes they face.

This year, as many states face fiscal crisis, there has been a renewed focus on privatization as a strategy for managing costs and maintaining service quality.⁶⁰ Massachusetts will spend millions of dollars in the next budget that could have been saved through competitive contracting. The two privatization initiatives that the Auditor rejected would alone have saved the state at least \$25 million.⁶¹

The State Auditor's Guidelines

Agencies seeking to privatize services must demonstrate to the Auditor the following:

*a) the agency complied with all provisions of Chapter 7, Section 54, of the General Laws and all other applicable laws; b) the quality of the services to be provided by the designated bidder is likely to equal or exceed the quality of services that could be provided by regular employees; c) the total cost to perform the service by contract will be less than the estimated in-house cost; d) the designated bidder has no adjudicated record of substantial or repeated noncompliance with relevant federal and state statutes; and e) the proposed privatization contract is in the public interest in that it meets applicable quality and fiscal standards.*⁶²

The Auditor published a set of guidelines that flesh out the requirements to meet the law.⁶³ They specify the forms that agencies need to submit and establish the regulatory standards for determining the specific details of cost comparisons, etc., to comply with the general language of the law.

The Fundamentals of Cost Comparisons

The central problem with the approach the Pacheco Law takes is making cost savings the sole requirement for privatization to be approved. The law compounds the problem by imposing a procedure for assessing these savings that is false—it compares what a vendor is willing to charge to perform services by force of contract with an entirely fictional conception of state provision that has not been realized and for which state employees will not be held accountable. That requirement chokes off opportunities for beneficial privatizations and further suggests that a mathematical process can determine policy choices. If that were true, a computer could decide whether or not to privatize, and we would not need elected officials. But the decision is not a mathematical one—it is deliberative and requires weighing a number of factors, of which knowledge of costs is but one.

Comparing the cost of privatized services to government services is a complex undertaking that requires making initial assumptions that partly shape the outcome, and for which there is no one generally accepted process and set of assumptions. A survey of the

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contracting practices of 120 cities, counties, and district governments nationwide found that half the respondents had no formal method for analyzing and comparing costs.⁶⁴ And it is widely recognized that government cost accounting often does not provide adequate data to make accurate comparisons with private-sector costs. Government's inability to estimate its own true, fully allocated costs makes meaningful comparisons rarely available. Hence, cost comparisons can *always* be legitimately critiqued on their technical merits. "Analysts must apply professional judgment. Because of the subjective nature of these decisions, it is inevitable that these conclusions will be challenged."⁶⁵

Cost comparison is more an art than a science⁶⁶—a fact that pains many who would like cost comparisons to be simple matters of data analysis. Studies of privatization cost comparisons almost always discuss the lack of agreement on a single acceptable way to measure and compare costs.⁶⁷ In the absence of a single agreed upon manner to measure and compare costs the Pacheco law created an inherent conflict. It substitutes the judgment of an agency head with that of the auditor. All too often legislation or policy directives related to cost comparisons require that "appropriate adjustments" be made to the data. But such adjustments are necessarily matters of judgment based on assumptions—in effect, policy decisions—and as a result the meaning of a cost comparison is often muddled.

But cost comparisons need not be hopelessly muddled. Cost comparisons can and should use a uniform set of thoughtful assumptions that are clearly explained and transparent in their implications. That will allow decision makers to give cost savings estimates the appropriate emphasis relative to other criteria in making privatization decisions.

Costs That Are Not Costs

If the primary art of cost comparison is to make management and policy judgments, the secondary art is to keep the process from being cluttered by costs that are not relevant to the privatization decision. The Pacheco Law, and to an even greater extent the process that the Auditor has established, loads into the analysis so many irrelevant costs as to nearly obscure the basic service cost data.

For instance, the Auditor's evaluation process fails to account for the realities of human resources management, how cost structures shift as service delivery changes, or how the public benefits from public services. And the Pacheco Law itself errs in how it factors contract administration costs into the analysis.

1. Avoidable Costs. The Auditor excludes certain indirect costs from the cost comparison, arguing that many indirect costs will continue over the life of the contract and are therefore not "avoidable." Costs become avoidable because through privatization, governments are able to shift or reallocate resources once a program is terminated or shifted to the private sector. Governments can hope to realize two types of avoidable costs: First, any up-front capital or investment can be avoided. If the decision to privatize is made prior to construction or investment, the cost of initial capitalization is shifted to the private sector and the government avoids the cost. The second type of avoidable cost is overhead for administration and support of the program. Privatizing service delivery can lower the demand for administrative and support services—consequently some of these fixed, overhead costs may be eliminated.

Full-cost-accounting (FCA) “provides the basis for comparing costs with those in the private sector and assisting in the decision-making process for privatization.”⁶⁸ FCA, unlike cash-flow accounting, considers direct, indirect (overhead), up-front (past), and back-end (future) expenses.⁶⁹ It enables officials to make more-informed decisions, as it illustrates the “full cost” of operation against alternative options. The Federal Transit Administration (FTA) recommends that transit agencies determine in-house costs on a full-cost rather than an avoidable cost basis.⁷⁰ The FTA reasons that if the full cost of the first, small-scale private contract is compared to a less-than-full in-house cost, the private-sector alternative will never be selected. If private contracting is in fact less expensive than the full in-house cost, and its use is gradually expanded, then over time the contracting agency will indeed be able to reduce management, rent, and other costs that at first appear unavoidable. These savings will never be realized if the first attempt to introduce private contracting is denied because the private contract is compared to an in-house cost that does not take into account costs that will be avoided in the long term.

In general, agencies must first determine what level of overhead can be avoided—to identify and measure what costs will become avoidable if the service is privatized. Government officials have free reign to estimate what level of support or administration (basic overhead) will be freed up by privatization. This determination easily becomes a political one—and flies in the face of the purpose of competitive contracting. Opponents of privatization will argue that costs are difficult to avoid and will suggest that few if any can be.

But all such costs become avoidable over time—this is especially true of administrative and management support. Immediately following privatization, civil service protections may prevent governments from removing excess staff. Over time though, staff can be reassigned to other government agencies. When conducting cost comparisons, government officials should take this stance and undertake a long-run analysis before rejecting privatization.

In 1994, for example, the Department of Revenue proposed to privatize mail opening during the rush of tax season. Traditionally, DOR used auditors and collectors to open mail during the rush season. Each year they did that, the auditors and collectors were unable to collect the \$986,000 they normally would have during that time period. The DOR consequently counted the \$986,000 as a benefit of privatization. The Auditor removed that money from the cost analysis arguing that since collections were not written off nor audits cancelled, no money was lost.⁷¹ But since DOR does not hire additional staff to make up the backlog, collecting that money is essentially permanently deferred, which is no different from writing it off.

Whenever resources are shifted from one activity to another there is work that is not getting done. Shifts in the allocation of human resources must be considered in the estimation of avoidable costs. When an agency privatizes a service—be it bus routes, highway maintenance, the campus store, or mail opening—there are many areas of the agency that lose workload. The managers have fewer personnel to manage, payroll has fewer checks to cut, the lawyers have fewer staff to advise or represent, maintenance has fewer vehicles to fix, and so on. It is up to the agency whether to reallocate staff resources. If they are simply left in place, their costs are not avoided. If they are redeployed to other

The Pacheco Law, and to an even greater extent the process that the Auditor has established, loads into the analysis so many irrelevant costs as to nearly obscure the basic service cost data.

priorities, then there is a benefit from the privatization. This is true even if none of the support or overhead staff are removed, but are able to turn to other necessary tasks. If the agency is well-managed and serves a real public purpose, the public will benefit.

Policy choices drive the avoidability of a cost. In his *Guidelines*, the Auditor argues that privatization could leave an agency overstaffed but legally unable to lay off employees, and hence the cost of those employees would not be avoidable.⁷² But that is just plain wrong. It is not the privatization that makes those costs unavoidable, but rather the law that forbids layoffs. The *policy* decision to forbid layoffs creates a static cost in the face of a more efficient way to deliver services.

The County of Los Angeles has taken a unique approach to accounting for avoidable costs in contracting. When considering privatization, the County bases its analysis on avoidable costs and limits “unavoidable” costs to a maximum of 20 percent of the total cost. All other costs are considered avoidable.⁷³

2. Transition Costs and Unavoidable Costs. A second issue concerns the calculation of transition costs. Take two examples:

- The MBTA included in its bus privatization proposal a provision for age-related repairs to a heavy maintenance facility to be done at the MBTA’s expense, not the contractor’s, and the Auditor counted those costs against privatization savings.⁷⁴ But with no privatization, the building will still age and MBTA will still have to pay for repairs. Those costs are unrelated to privatization.
- If privatization results in some employees losing their jobs or retiring, the retirement costs, accrued vacation payout, and other post-employment benefits are counted by the Auditor as costs of the privatization.⁷⁵ These are part of the employees’ benefits package, and the state is obligated to meet them regardless of privatization. Those costs are unrelated to privatization.

The agency proposing to privatize a service should be able to exclude costs that are not related to privatization. The goal ought to be to make the cost comparison as simple, transparent, and focused on the relevant variables as possible.

3. Contract Administration. The language of the Pacheco Law requires that contract administration costs be considered a cost of privatization. These costs cover the process of establishing the privatization and monitoring and managing the contractor. The problem with this is that it does not at the same time factor in the *benefit* of contract administration. With in-house services, there is no third party monitoring performance and ensuring accountability. With privatization there is. While the cost is factored in, the benefits are usually not included in the analysis. Indeed, under the Pacheco Law, which forces the evaluation to be about the cost of *existing* services, there is no way to include the benefit of performance monitoring, because that is not part of the existing service. Monitoring and its benefits are added by privatization, but under the law only the costs of privatization influence the decision.

The Auditor’s guidelines make no distinction between estimating the cost of monitoring private grass cutting and estimating the cost of monitoring a private prison, for example. Since agencies have no past monitoring costs, they must use the cost of a set number of staff, depending on the size of the function being privatized.⁷⁶ Yet monitoring costs can vary greatly depending on management choices, technology, and the degree of customer interaction with services. When customers immediately notice service problems

Cost comparison is more an art than a science—a fact that pains many who would like cost comparisons to be simple matters of data analysis.

and are motivated to complain, monitoring is fairly simple and less costly—the customers do most of the monitoring themselves. Highly technical services, or support services with little customer interaction, require more skilled monitors and more expense.

Public Costs

The most common type of privatization is contracting of services, in which there is a change in the party that provides services to the public; an employee of a private company, instead of the city or state, now drives the garbage truck at your curbside. The costs of service delivery are borne by the public regardless of whether service is provided in-house or by a contractor. The Auditor's guidelines argue that private contractors should be made to pay rent if they use unused public facilities to deliver such services.⁷⁷ This makes no sense if the agency was not paying rent, nor receiving rent, on the facility when it was using it, especially if it would otherwise be unused, and the cost of the rent will simply add to the public cost of the service.

Similarly, the Auditor went to battle with the MBTA over the state taxes on gasoline for privatized bus services.⁷⁸ The Auditor objected to the contractor getting fuel for the buses from the MBTA without paying state fuel taxes. But the MBTA was not paying fuel taxes before, as they were using the fuel for public purposes. Those fuel taxes would be borne by the state's taxpayers, who subsidize MBTA riders.

Privatized services still serve a public purpose, and artificially adding costs to outside vendors' bids only burdens taxpayers further.

In-House Concessions and Bids

In response to a privatization initiative, public employee unions may offer up collective bargaining concessions or put together in-house bids to lower costs and compete to keep services in-house. The Auditor has repeatedly raised concerns about the veracity of agency plans to improve services via privatization, demanding proof today of all possible future cost savings. But the Auditor's guidelines make no such demands on the in-house cost estimate or on employee bids or concessions. Nor does the Auditor ask for verification of quality assurance, a track record of prior performance, or legal compliance in the in-house bid.

Once the competition has been won by state employees there are no mechanisms in place to ensure public employees deliver on the agreement. Indeed state employee bids do not have to include contract monitoring costs because there will be no contract monitoring. If a service is privatized, it must be periodically rebid under a schedule of review and a set contract length, keeping pressure on the contractor to deliver. But if the state employees win there is no future review, no contract length and no rebid. Indeed, there is no assurance at all that the changes and cost savings offered in the employee bid will materialize. If the private bidder backs out, the public employees are not required to deliver on the bid that they put together.

Cutting Costs or Increasing Revenue: The Bottom Line Is the Same

The cost-driven focus of the Pacheco Law and the Auditor's guidelines rule out initiatives with potential public benefits. In the private sector, service delivery is not structured the same way everywhere. Yet any privatization initiative that *changes the way services are delivered* and thus changes the cost structure is unlikely to meet the Auditor's criteria.

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When the MBTA proposed privatizing cleaning and maintenance of bus shelters, the authority wanted to partner with a private firm to manage the advertising on the bus shelters and garner \$9 million in revenue in the process. The firm would also take over the cleaning and maintenance of the shelters, clean them more often, and charge the state nothing. The two MBTA employees who had been doing the cleaning would move to other MBTA jobs. The Auditor required the firm to break out its costs for maintaining and cleaning the shelter in the way the MBTA tracks its costs.⁷⁹

Since the difference between the private firm's cost of having people clean the shelters and MBTA's cost of having two employees do it is so trivial compared to \$9 million in expected revenue for the state, the proposal did not dig into those numbers. The Auditor rejected the privatization because the proposal had no cost savings analysis.⁸⁰

PART 8. PRIVATIZATION IN MASSACHUSETTS UNDER THE PACHECO LAW

Six privatization initiatives have been approved under the Pacheco Law:

Mass. Highway Department. In the early 1990s the highway department launched a pilot project, contracting for all routine highway maintenance in Essex County.⁸¹ The contract was quantity-based, i.e., the state continued to determine what work would be done and paid only for those specified tasks. The contract greatly improved highway conditions, delivering considerably more work for the same amount of money. The contract has saved \$2.5 million annually.⁸² According to a Kennedy School analysis, the contractor was 21 percent more cost-effective than the state had been.⁸³

The highway department expanded the program to the entire eastern part of the state in 1993. Private firms and existing employees bid on seven contracts—private firms won four, public employees three. With the three union victories, the highway department was able to keep layoffs down to 150 people. The seven contracts save the state \$7.5 million the first year and delivered \$10 million more in additional services.⁸⁴ Since the highway department pays only for services it specifies, and the contracts made the firms and employees more productive, both sides won by getting more work done. In one case of drawbridge operations, the new highway maintenance system brought other improvements as well, as competition changed in-house management practices: workers' compensation claims fell 60 percent, overtime decreased 70 percent, and sick leave decreased 50 percent.⁸⁵

The expanded program went so well that in 1996, the highway department moved to competitive contracting of highway maintenance statewide. It offered 14 contracts; half were won by public employees and half by private firms. In 1998, the highway department rebid all 14 of its maintenance contracts and is currently reviewing 5 additional contracts. The contracts were all rebid with no media attention, no opposition from employee unions, and no significant controversy. The bottom line for the highway department is that between 1991 and 1999, the annual highway maintenance budget fell from \$40 million to \$25 million, while the amount of maintenance performed grew.

Department of Employment and Training (DET). In 1996, the Department of Employment and Training proposed contracting out for records and storage management. Each year 420,000 Massachusetts residents lose their jobs and apply for unemployment.

Competitive contracting of highway maintenance went so well that between 1991 and 1999, the annual highway maintenance budget fell from \$40 million to \$25 million while the amount of maintenance performed grew.

For each claim, a batch file is created stored for three years. A second type of file is created about half the time and is stored for four years. Approximately 18,000 files are retrieved and returned each year for reasons such as internal quality audits, hearings, appeals, and fraud investigations. With about 620,000 files being created each year, nearly 97 percent of all files are never touched again once they have been created. The auditor approved the proposal for a three-year period at a savings of \$264,434⁸⁶—a nearly 30 percent savings over in-house operation.

University of Massachusetts, Amherst. In 2000, the auditor approved a privatization proposal by the University of Massachusetts, Amherst, for the operation of the University Store. The contract includes managing all aspects of the operation, including personnel, merchandising, marketing, purchasing, security, administration and maintenance.

Before the bookstore operations were privatized, in-house operation was losing money. According to the auditor's estimate the store was losing upwards of \$441,000 each year.⁸⁷ Privatizing resulted in additional revenues to the state in excess of \$879,000—a total revenue enhancement of \$1.32 million.⁸⁸

Mass. Bay Transportation Authority. Perhaps one of the best stories about how competitive contracting can improve service quality concerns the management and development of real estate belonging to the Mass. Bay Transportation Authority (MBTA). A 1995 audit found that 80 percent of leases were underperforming; one lease had not been adjusted since its execution in 1906, and more than 190 agreements had not been updated for 50 years; over 50 agreements had rental rates of \$1 to \$5 per year, and more than 145 were billed for less than \$20 per year.⁸⁹ The situation came to a head when the MBTA attempted to purchase a tract of land it already owned!⁹⁰

In 1996 MBTA decided to privatize real estate management, and the auditor approved the procurement. The initial contract saved the state over \$200,000.⁹¹ In the first year after privatization, rent receipts increased by 50 percent—bringing in an additional \$1.9 million.⁹² Successive years brought the T an average \$7.2 million in annual net revenues, twice what the division had earned prior to privatization.

The implementation of MBTA's contract with Transit Realty brought the T some negative publicity and the State Auditor's continued scrutiny, and the MBTA in re-bidding the work offered a "radically different contract proposal."⁹³ Even so, the original contract established professional management of the T's real estate holdings and brought in substantial revenues for the state.

Holyoke Community College. Providing food service at Holyoke Community College was costing the state more than \$25,000 a year. In 1996, the auditor approved a proposal to privatize food service. The contractor only received revenue from food sales and shared revenue with the College. Thus, while the state didn't pay anything the increased food sales brought the state nearly \$30,000. The total financial benefit to the state is more than \$55,000.⁹⁴

Department of Revenue. Each year at tax filing time the Department of Revenue receives roughly 500,000 tax returns. Traditionally, DOR used auditors and collectors to open mail during the rush season. In 1995, the Auditor approved a DOR plan to privatize the opening and sorting of the returns, a move DOR estimated would save them nearly \$1.2 million per year. The Auditor approved the plan in spite of disagreeing about the total savings, arguing that DOR could not count as in-house cost the \$986,000 auditors and collectors were unable to collect while opening mail, and that real savings were roughly \$205,000.⁹⁵

Perhaps one of the best stories about how competitive contracting can improve service quality concerns the management and development of real estate belonging to the MBTA.

PART 9. MOVING BEYOND UNREASONABLE CONSTRAINTS

Privatization as a Policy Tool

Privatization can offer cost savings, time savings, project delivery guarantees, increased innovation, and combinations of these and other benefits. Like any policy tool, privatization delivers benefits only if it is properly conceived and structured. Cost alone should not be used to determine whether work should be outsourced. Factors such as service quality and the ability to accommodate peak demand and meet deadlines are often key reasons for privatization, even if the cost is higher. Furthermore, the private sector has the ability to specialize; access to specialized skills often motivates privatization—again, even if the cost is higher.

Most Massachusetts agencies deliver with public employees services that have been privatized in other states. Among those agencies are several that have seen substantial budget growth since the Pacheco Law was passed in 1993: Department of Labor and Workforce Development, Department of Transitional Assistance, Department of Social Services, Division of Capital Asset Management, Department of Corrections, Board of Library Commissioners, Department of Environment Management, Metropolitan District Commission, Department of Mental Retardation, Department of Revenue, Information Technology Division. Contracting with private providers for carefully selected services would save Massachusetts taxpayers millions of dollars each year.

Most Massachusetts agencies deliver with public employees services that have been privatized in other states. Contracting with private providers for carefully selected services would save Massachusetts taxpayers millions of dollars each year.

Examples from Other States

A few case studies showing results from other states demonstrate the possibilities privatization holds for Massachusetts.

Human Resources

Florida. In August 2002, the State of Florida and the Department of Management Services signed a seven-year contract with Convergys Corporation for human resources services. The goal of the contract is to improve the quality of personnel services for state employees, making the system more efficient and less costly.

The contract enables the state to avoid the cost of replacing its antiquated technology and hardware; provides state-of-the-art technology for maintaining and accessing personnel information; permits redeployment of personnel to “higher talent uses”; and automates routine transactions. The contract includes transactional processes but not policy and management responsibilities.

Initial savings from not replacing the existing system are estimated at \$65 to \$90 million. Over the course of the seven-year contract, savings could reach \$173 million.⁹⁶

Information Technology

Pennsylvania. When Tom Ridge took office as Pennsylvania’s governor in 1995, only 5,000 of the state’s 80,000 employees had computers, and technology added little to the management of state agencies. So the state government privatized management of the state’s data centers. Now the American Electronics Association ranks the state as one of the nation’s top 10 “Cyberstates,” and it is among the top five states for attracting IT and biotech companies.

The partnership is expected to save the state’s taxpayers more than \$110 million in its first five years. Benefits from the partnership are already being realized:

- **Speed and flexibility.** Unisys can implement a mainframe upgrade in two weeks, while the state’s procurement procedures previously mandated a minimum of 30 days before government employees could even begin the process of choosing an information technology provider.
- **State-of-the-art hardware and software.** Where before state agencies could rarely get the capital budget lines to upgrade hardware, pay for backup systems, or fund new software, now Unisys keeps all systems up to date and manages backups and disaster recovery. Unisys can also select off the shelf software and avoid long procurement processes leading to proprietary systems.
- **Funding flexibility.** Unisys has been able to backload or frontload costs in response to state funding status and budget changes, thus allowing the project to cope with unexpected hurdles and opportunities.
- **Agency Focus.** With Unisys managing the data centers and the technology, the 180 state workers who formerly performed the work are able to focus on core state technology planning, implementation, and management projects.

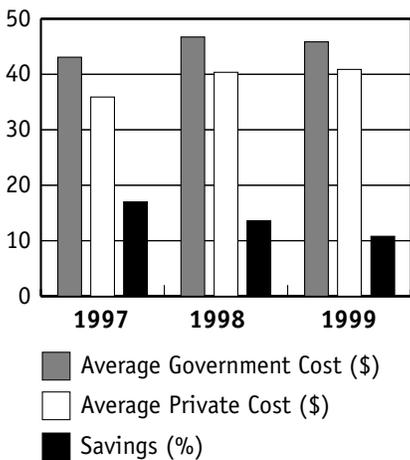
The Outsourcing Journal selected Pennsylvania’s partnership with Unisys to manage the state’s data centers as a 2001 Editor’s Choice Award winner.⁹⁷

Corrections

Prison privatization has grown significantly over the last 10 years. Private companies in the U.S. now operate more than 119,000 beds. A recent study by the Reason Foundation found that prison privatization not only improves the quality of prisons but also saves between 5 and 15 percent.⁹⁸ In Texas, Arizona, and Florida, competition from the private sector has driven down the cost of public operation, resulting in further savings.

Arizona. A 1997 report compared the cost and performance of a 444-bed private prison to 15 government-run prisons in Arizona. The study, controlling for indirect costs, found average cost per inmate per day was \$43.08 in the government prisons and \$35.90 in the private prison. Estimated savings: 17 percent.⁹⁹

Table 3. Arizona Department of Corrections Average Per Diem Costs



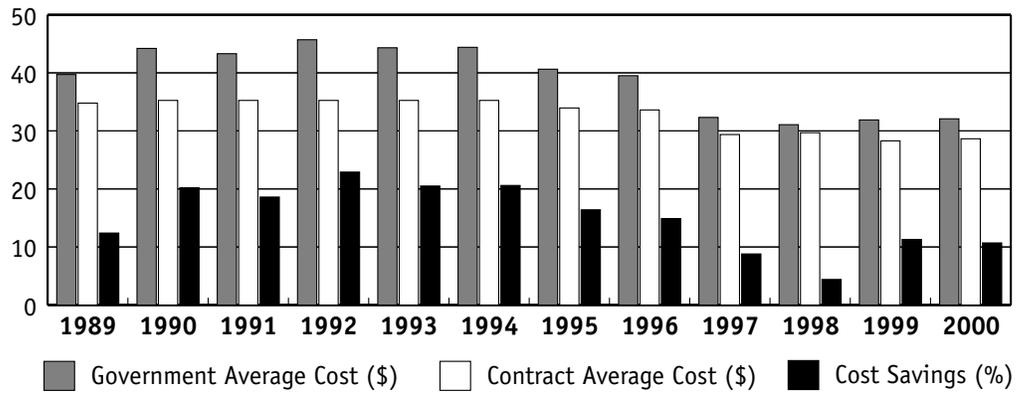
Though a formal cost comparison was not required by law until 2002, the Arizona Department of Corrections in 2000 used available data to assess costs (see table 3). They found average per diem costs of \$46.72 and \$45.85 for state facilities in 1998 and 1999 versus \$40.36 and \$40.88 for private facilities—savings of 13.6 percent and 10.8 percent respectively. Estimated average savings over 1998 and 1999: 12.23 percent.¹⁰⁰

Texas. The State of Texas mandates that any privatized facility show evidence of at least 10 percent cost savings compared to a similarly operated government facility. Various agencies of the Texas state government conduct studies to measure compliance with the privatization cost-

A recent study found that prison privatization not only improves the quality of prisons but also saves between 5 and 15 percent.

savings requirement. The Texas Criminal Justice Policy Council conducts a biannual review of the average cost per day of government facilities and the average contract price at private facilities. The first study was published in 1991 and studied 1989 and 1990. Subsequent studies have been conducted every other year since, with the latest published in 2001 (see table 4). These data represents the best longitudinal evidence of cost savings. The average contract price has consistently been between 4.4 percent (1998) and 22.9 percent (1992) lower than the average cost of government facilities. Estimated savings: 12.4 percent (1989), 20.0 percent (1990), 18.6 percent (1991), 22.9 percent (1992), 20.5 percent (1993), 20.6 percent (1994), 21 percent (1995), 14.9 percent (1996), 8.8 percent (1997), 4.4 percent (1998), 11.3 percent (1999), and 10.7 percent (2000).¹⁰¹

Table 4. Texas Criminal Justice Policy Council Time Series Data



Focusing Privatization on Commercial Activities

Most states begin contracting out for functions that are widely available from commercial sources. Research on privatization and case studies of state activities highlight a number of areas where privatization is often used and provide estimates of cost savings that have been realized (see table 5).

Table 5. Potential Cost Savings from Privatizing Various State Functions

Commercial Activities	Cost Savings Range	Commercial Activities	Cost Savings Range
Maintenance of Public Buildings	13% to 60%	Prison Construction	30% to 40%
Highway Maintenance	15% to 30%	Prison Operations	10% to 15%
Legal Services	30% to 50%	Hospitals	15% to 25%
Fleet Maintenance	17% to 38%	Libraries	10% to 25%
Nursing Homes	5% to 45%	Parks and Recreation	20% to 30%

Sources: Case studies compiled by Reason Foundation through 2002; John Hilke, "Cost Savings from Privatization: A Compilation of Study Findings," *Reason Foundation How-to Guide #6*, 1993.

Recommendations

The Pacheco Law should ideally be repealed. Short of repeal, several amendments would free state managers to use privatization as a useful policy tool.

1. Allow for best-value contracting, in which clear value to taxpayers replaces cost savings as the sole criteria. When costs are compared, the cost of the private bid should be compared to the current actual cost of public employees delivering the service rather than to a hypothetical cost.
2. Require that agencies use a uniform set of thoughtful assumptions in calculating costs that are clearly explained and transparent in their implications.
3. Require that all contracts, with private firms or state employees, be performance-based, specifying what will be accomplished, how it will be measured, what incentives will be used, and the consequences for performance failure.
4. Hold public employee groups accountable to their bids. If a union chooses to bid on a contract, public workers should be expected to provide services at the cost and level of quality indicated in the bid. In practice, this also means 1) requiring union bids to include contract monitoring and its associated costs and 2) including in contracts with winning employee groups provisions for re-competition if the performance goals and cost savings are not met, with a specific length of contract and re-bid schedule.
5. Hold agencies accountable for managing successful privatization projects that meet agency performance goals. Enforce accountability through agency budgets.
6. Remove the elements of the law that dictate the process agencies must follow to privatize.
7. Shift the Auditor's role to reviewing privatization proposals for clear violations of the law, and create an appeals process for disagreements between the Auditor and agencies, paid for out of both budgets to reduce incentives to appeal.

As January 2003 approaches, Massachusetts faces its worst fiscal crisis in over a decade. Contracting with private providers for services should be an option for agencies as they adapt to tighter budgets. Amending the Pacheco Law would free agency managers to provide public services in keeping with the law's stated intent, to "ensure that the citizens of the Commonwealth receive high-quality public services at low cost, with due regard for the taxpayers of the commonwealth and the needs of public and private workers."

As January 2003 approaches, Massachusetts faces its worst fiscal crisis in over a decade. Contracting with private providers for services should be an option for agencies as they adapt to tighter budgets.

ENDNOTES

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- ² According to the 2001 Massachusetts Comprehensive Annual Financial Report, in 1992 Massachusetts raised \$721 million in proceeds from general obligation bonds, \$100 million in proceeds from special obligation bonds, and \$574 million in proceeds from refunding bonds for a total of \$1.395 billion (http://www.state.ma.us/osc/Reports/01cafr/pages_140_141.pdf). Debt service in 1992 totaled \$901 million (http://www.state.ma.us/osc/Reports/01cafr/pages_144.pdf).
- ³ Internal memo from Department of Administration and Finance, Commonwealth of Massachusetts, p. 2.
- ⁴ Bruce A. Wallin, *Privatization of State Services in Massachusetts: Politics, Policy, and an Experiment that Wasn't* (Washington, DC: Economic Policy Institute), p. 11.
- ⁵ At the end of FY 94, the state closed its books with a \$28 million surplus (the fourth straight year) and increased the rainy day fund to more than \$280 million. By 1995, the administration had saved enough to implement ten tax cuts totaling over \$1 billion.
- ⁶ At least two staff members left to work for private companies they had supervised while on the state payroll. One was the Secretary of Public Safety.
- ⁷ Author interview with State Senator Marc Pacheco, June 2002.
- ⁸ Executive Office of Administration and Finance, Commonwealth of Massachusetts, "Privatization in Massachusetts: Getting Results," Boston, MA, November 1993, p. 1.
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- ²² *Commercial Activities Panel Final Report: Improving the Sourcing Decisions of the Government* (<http://www.gao.gov/a76panel>).
- ²³ Chi and Jasper, *Private Practices*, p. 8.
- ²⁴ Wisconsin Legislative Audit Bureau, *Evaluation of Use of Engineering Consultants: Department of Transportation*, 90-9 (Madison, WI: State of Wisconsin, April 1990), p. 10.
- ²⁵ Chi and Jasper, *Private Practices*, p. 8.
- ²⁶ Chester Wilmut, Donald Deis, Helmut Schneider, and Charles Coates Jr., "In-House Versus Consultant Design Costs in State Departments of Transportation," *Transportation Research Record* 1654, Paper No. 99-1403, p. 158.
- ²⁷ Chi and Jasper, *Private Practices*, p. 8.
- ²⁸ Wisconsin Legislative Audit Bureau, *Evaluation of Use of Engineering Consultants*, p. 10.
- ²⁹ PricewaterhouseCoopers for Texas Department of Transportation, *Highway Design Cost Comparison* (Austin: State of Texas, February 1999), p. 55.
- ³⁰ Wisconsin Legislative Audit Bureau, *Evaluation of Use of Engineering Consultants*, p. 3.
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- ³² Chi and Jasper, *Private Practices*, p. 8.
- ³³ Sandford Borins, *The Challenge of Innovating in Government* (Washington, DC: PricewaterhouseCoopers Endowment for the Business of Government, 2001), pp. 18-21.
- ³⁴ Author interview with Corey Boock.
- ³⁵ Chi and Jasper, *Private Practices*, pp. 4-5.
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ABOUT THE AUTHORS

Geoffrey F. Segal is the director of Privatization and Government Reform Policy at Reason Public Policy Institute and a research fellow at the Davenport Institute at Pepperdine University School of Public Policy. The author of many reports and articles on privatization and government performance, he is also editor of Reason's monthly newsletter *Privatization Watch* and *Annual Privatization Report*. Mr. Segal has a master's in public policy, with specializations in economics and regional/local government, from Pepperdine, and graduated cum laude from Arizona State University with a bachelor's in political science.

Adrian T. Moore is executive director of Reason Public Policy Institute. The author of many studies and articles on privatization and government management, he is a co-author of *Curb Rights: A Foundation for Free Enterprise in Public Transit*, published in 1997 by the Brookings Institution Press. Mr. Moore has a Ph.D. in economics from the University of California (Irvine), a master's in history from California State University–Chico, and a master's in economics, with specialization in public choice, urban, and transportation economics, from the University of California–Irvine.

Adam B. Summers is a visiting policy analyst at the Reason Public Policy Institute. He has written extensively on privatization, government performance, and law and economics. His articles and studies have been published by the Reason Foundation, the *Los Angeles Times*, and the American Institute for Economic Research. Mr. Summers is formerly the producer of “The Capitalist Defender,” a radio talk show in San Diego, California. He has a master's degree in economics from George Mason University and bachelor's degrees in economics and political science from UCLA.