Policy Dialogue

No. 51 • Dec. 2002

Massachusetts' Privatization Law

Necessary Guardrail or Roadblock to Competition?

Massachusetts is home to the most restrictive state privatization law in the nation. Since the so-called Pacheco law was enacted in 1993, only six state services have been contracted out to private service providers, while similar efforts have dramatically expanded in other jurisdictions. A Pioneer Forum on competitive contracting was held to mark the release of a new White Paper *"Competition and Goverment Services: Can Massachusetts Still Afford the Pacheco Law?" Speakers included two co-authors of the paper,* ***Geoffrey Segal*** *and* ***Adrian Moore*** *of the Reason Public Policy Institute,* ***Senator Marc Pacheco****, author of the law,* ***John Parsons****, general counsel and director of privatization for the state auditor's office, and* ***Charles Chieppo*** *of Pioneer's Shamie Center for Restructuring Government. The remarks of each are excerpted below.*

Privatization: Massachusetts in Comparison to Other States

Geoffrey Segal: The debate over privatization began during Gov. William Weld's administration. In his first two and a half years, Weld contracted out 36 government services and saved roughly $273 million, according to the Office of Administration and Finance. Shortly thereafter, in 1993, the Pacheco Law was enacted. Its stated purpose was to review proposals to contract out the provision of state services in order to "ensure that citizens of the Commonwealth receive high quality public services at low cost, with due regard to the taxpayers of the Commonwealth and the needs of public and private workers."

The law put into place several steps that departments had to follow to get an initiative passed. These included a rigorous cost comparison analysis and a final say by the state auditor. Since the law was passed, only eight initiatives have gone to the auditor and six of those were eventually passed. So depending on your definition, it's either been a roadblock or a guardrail.

The Massachusetts Highway Department achieved significant savings in road maintenance contracting. (Public employee groups that bid on these projects ended up winning about half of them.) A Department of Employment and Training initiative saved roughly 30 percent. The University of Massachusetts actually had a revenue enhancement of roughly $900,000.

Perhaps one of the best stories about how competitive contracting can improve service quality and management is at the MBTA. A 1995 audit found that 80 percent of the T's leases were underperforming; one lease had not been adjusted since its execution in 1906 and more

Read the complete study, "Competition and Government Services: Can Massachusetts Still Afford the Pacheco Law?" at **www.pioneerinstitute.org/research/whitepapers/wp19cover.cfm.**

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

PIONEER INSTITUTE for Public Policy Research
Putting ideas into action for Massachusetts

than 190 agreements had not been updated for more than 50 years. In the first year after privatizing the leasing operation, rent receipts increased 50 percent, bringing in an additional $1.9 million. Since then it's brought in an additional $7.2 million in annual net revenues.

Other than this, privatization has been at a standstill in Massachusetts, while other states have been utilizing it as an effective policy tool. 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 of over $400 billion in 2001. The Syracuse University Government Performance Project reported that at the end of 2000, contracting consumed, on average, about 19 percent of state budgets. The Council of State Governments found that 60 percent of state agencies have expanded their use of privatization in the last five years, and 55 percent expect to expand their use of privatization in the next five years.

Privatization is growing. More state and local governments—even the federal government—are doing more of it today than five years ago. Cost savings can be achieved and are significant. ***—Geoffrey Segal***

Most states began by contracting out functions that are widely available from commercial sources. Several states actually classify their jobs as either governmental or commercial—identifying things that are done by the private sector as opportunities for outsourcing. Surveys and case study evidence show the potential savings in these commercial activities are tremendous. Somewhere between 13 and 60 percent can be saved in the maintenance of public buildings; in prison operations, between 10 and 15 percent. Hospitals, libraries, fleet maintenance are all commercial in nature and can be outsourced to achieve significant savings. Massachusetts should consider privatizing activities that are commercial in nature.

General and specific surveys of privatization all reach the same conclusions. First, privatization is growing; more state and local governments—even the federal government—are doing more of it today than five years ago. Second, cost savings can be achieved and are significant. Finally, employees also win; privatization is not on their backs. Less than six percent of employees are laid off, but survey after survey says that employees are left with a good position in a private firm, ending up with comparable wages, comparable benefits, and greater opportunity to grow.

Hurdles to Privatization by the Pacheco Law

Adrian Moore: There are laws in most states that regulate privatization. For the most part, they are aimed at increasing the transparency and accountability of the privatization process, but focus on trying to create a competitive situation. Massachusetts' privatization law is different in that it clearly establishes a pretty robust set of barriers to privatization.

The requirements of the Massachusetts law and its implementation by the state auditor are, in many ways, the crux of what the outcome has been. The heart of the law is the requirement of a cost comparison. It's a very problematic cost comparison on several levels. Instead of being a performance-based process that drives a competition between state employees and the private sector towards a common end, it really holds the state workers and the private sector to very different standards.

It also sets up a situation—counter to our way of government—in which government agencies are assumed to be guilty of abusing privatization and forcing them to prove their innocence. So the judge—the state auditor—has to say, "Yes, I believe you are innocent of wrongdoing" before the agency can go forward with privatization. Instead, in every other state, the auditing body is charged with finding malfeasance and stopping improper privatizations.

The Massachusetts law makes privatization strictly a matter of cost savings. No matter how great the benefits might be, if it doesn't save money, it doesn't pass. That's fundamentally contrary to every purchase you make in your daily life. How many things do you buy where cost is your only criteria? The last time you bought a car did you shop until you found a $200 car and bought that because it's the cheapest car on the market? Or did you have a set of criteria for what you wanted in a car and you looked for the best deal within that set of criteria? Forcing these decisions to be made strictly on a cost basis, without any consideration of other factors, is out of step with how purchasing works in the real world.

The process that the auditor has established also requires trying to determine all the production costs. But comparing in-house production costs to those in the private sector takes you down a path to which there is no end. Again, when you go shopping in your day-to-day life, you don't get into production costs—you don't know what it costs to make a box of Cheerios versus a box of cornflakes.

Finally, relying on a cost comparison does not allow for changes in the way services are delivered. If you're going to do a cost comparison between in-house and private sector delivery of services, you must compare the identical delivery of services or it's not a meaningful cost comparison.

The Massachusetts law makes privatization strictly a matter of cost savings. That's fundamentally contrary to every purchase you make in your daily life. —*Adrian Moore*

But the part of the reason for privatizing is to do something differently. That's how you get innovation, quality improvements, and cost savings. The problem is you're blocking all that out to force an identical comparison of process.

In relying on cost comparisons, the Massachusetts law worships at the false altar of mathematics because comparison of costs, in the case of privatizations, is not a simple mathematical exercise. Judgment is involved; the reason it's in the political realm is because it can't be done by computer.

Increasing Competitive Contracting

We recommend a common sense approach. Privatization is no panacea. Most privatizations work well if people do their homework; some go bad. Privatization is a policy tool; the emphasis ought to be there. Focus on competition, not on predetermined outcomes. Determine what the commercial activities of the state are so you know where the opportunities are and you don't wind up focusing in a lot of areas that aren't very fruitful.

Focus on best value and the way you purchase goods in your life. You use a best-value process which says, "I'm going to combine price and quality to decide what I want to buy." A simple cost comparison model can give you some data to work with, but don't drive the decisions based on that alone. Use performance-based contracts, not cost-based contracts—contracts that require performance and pay for performance.

Make the public employee bids accountable. Create a contract mechanism for the public employees so that the results and the performance are just as accountable as they are for the private sector. Hold the agencies themselves accountable for performance.

Eliminate a lot of the process requirements from the existing Massachusetts law. Make it about accountability and outcomes, and not about dictating process. Shift the auditor's role to that of an inspector general, looking for problems and malfeasance and exposing that. They have done a pretty good job at exposing a lot of things in these privatization proposals. Let's take advantage of that upside and try to remove some of the process hurdles that have gummed up the works.

The Law Has Worked Well

Marc Pacheco: Let me begin by getting back to reality. I'm going to get into the real history that brought about the privatization law but first I'll touch on the alleged savings. I say "alleged" because in the report that has been put out, and any previous report that I have seen, there has been a total lack in ability to document one penny of savings. There are only estimated savings. That's not the way I want to see hundreds of millions of dollars of taxpayers' money contracted out. I want to have a more oversight when dealing with our taxpayer funds.

Let's turn the clock back a bit, pre-privatization law. We had a "revolving door" culture in Massachusetts—executives on the public payroll finding themselves on the payroll of private companies to which they had previously contracted out services. It got so bad that Governor Weld had to issue an executive order prohibiting the practice from taking place.

The *Globe* did a five-part series. *Boston Herald* did a series criticizing the fraud, waste, abuse, and corruption that plagued the way privatization was being done in Massachusetts. I think the only thing we may agree on is that there are good and bad privatization efforts. It largely depends upon the management in place—if they are managing properly.

I'd like to refer to a book titled *You Don't Always Get What You Pay For: The Economics of Privatization*, by Elliott Sclar, a professor at Columbia University. It presents an in-depth analysis of privatization throughout the United States. Dr. Sclar points to both good and privatization efforts on the local, state, and federal levels. I'm very proud that in the final chapter, in giving an overview as to how—if one is going to do it—we should be doing privatization, he points to the Pacheco Law as the best piece of legislation on the books in any state in America. Let me quote from Dr. Sclar.

> One of the most successful pieces of legislation is a Massachusetts law popularly known as the Pacheco Act that requires that all proposed privatizations be subject to a cost-benefit analysis. The Office of the State Auditor carries out the work. The law has permitted many privatizations to proceed, but also stopped some that would have been costly errors.

I think the only thing we may agree on is that there are good and bad privatization efforts. I do not blindly oppose real competition that includes fair, responsible bidding.

—*Sen. Marc Pacheco*

I think it's important for the general public to understand that I as well as members of the Democratic legislature and most public employees do not blindly oppose real competition that includes fair, responsible bidding. As a matter of fact, Massachusetts was, prior to the passage of the law, and still is one of the most privatized states.

Just take a look at our Medicaid system. Almost all of that money is contracted out. We buy most of our services. Are we doing it just upon ideology—one way or the other? That is, "I think private is better, so it's always going to be best." Or, "I think public is better, so that's always going to be best." Both these arguments are ridiculous. The only way you know for sure is by measuring them, by making sure you have a standard. The law sets forth fair, rational, and measurable standards—a yardstick by which to judge privatization plans and to ensure their fair implementation.

There are a number of points in the Pioneer *White Paper* that are not accurate. For example, the paper references that the State Auditor's Office can stop a privatization contract solely because it does not meet the "public interest." Not true. That was amended within the same week of the passage of the statute, and it doesn't exist any longer. The same thing exists with the $273 million dollars worth of savings. Where are the columns that add up to those savings? They're all estimates.

There are things called best practices, and we all need to pay attention to those standards. The authors reference the fact that there have been only eight proposals put forth and only six approved. The reason why is that since the passage of the law we have had executive branch folks—Paul Cellucci and Jane Swift—who quite frankly have not wanted to do the work associated with justifying the numbers for two reasons. Because it takes some management, rolling up your sleeves, and doing some work, and there was a political price to pay, which they were not willing to do after the loss of Bill Weld. I cannot be responsible for the laziness of administrations not wanting to put forth privatization proposals if they think they're going to save some money.

So the law has worked. We have prevented some reckless actions from continuing to take place. And now, instead of a deal being done in the back room, the light of day is shined on the process. If it can be justified, it can be privatized. If it can't be justified, it cannot.

Misconceptions About the Pacheco Law

John Parsons: While the *White Paper* makes some very valuable points, there's a statement in its executive summary that claims "privatization has been virtually outlawed in Massachusetts." Chicken Little couldn't have said it better. It's time to put some perspective into this argument.

The state has a purchase of service system, which amounts to $3.5 billion. It's primarily a network of private human service providers serving Massachusetts citizens who need such services. In addition, as Senator Pacheco noted, the majority of the state's Medicaid budget is made up of services provided by private organizations. These two items alone are roughly 20 to 25 percent of the state's budget. The *White Paper* estimates that states across the nation average 19 percent privatization. So by that estimate, we are above average. Plenty of privatization takes place on a daily basis in Massachusetts.

Six of the eight proposals that have come to us have been approved. In many circles that would be viewed as a pretty good average.

—John Parsons

I would also note that there are a number of exceptions to the types of contracts that the privatization law applies to. It doesn't include legal, planning, and design services and, most especially, doesn't include consultants, which make up one of our favorite industries in Massachusetts. Contracts that were in place before the Pacheco law passed were not affected by the law, and incrementally the state has expanded those contracts on a regular basis. In addition, the law does not apply to any new services started by an agency nor to services that are restructured. Under Paul Cellucci, the state reorganized unemployment and job placement services into so-called career centers, and hundreds of millions of dollars were spent on this endeavor. This should put some perspective on the so-called virtual outlawing of privatization in Massachusetts.

The auditor's record in implementing the law is another topic that I'd like to touch on. As the authors have pointed out, six of the eight proposals that have come to us have been approved. In many circles that would be viewed as a pretty good average.

There are a number of misnomers attached to this law that have arisen over the years. Senator Pacheco referred to one of them—that the auditor is omnipotent and can reject proposals because they're not in the public interest. Anyone who has looked at the law, anyone who has spoken to me—the authors included—know that's not true. It's not in the law and it's never been used. This fallacy has been attached to this law to give it a negative connotation.

A second one is that when we do our comparisons we compare the bid of the private vendor with some sort of nebulous, mythical in-house cost that public employees

could meet if they had all the resources. As explained to the author, every single review by the auditor's office has compared actual historical costs of a state agency with a vendor's bid. At no point have mythical costs been used to make an in-house cost estimate look better.

There's another misnomer in the report that the auditor's office does not count increased tax revenue that is brought to the table by a private bid for performing a service. The State Auditor's guidelines allow for that. It's been included in most of the comparisons that we have conducted. It's simply not true that we don't recognize increased state tax revenues.

It doesn't matter who provides a service. There are good and bad programs in the public and the private sector. I've been in the auditor's office for 16 years and we see it all the time. One of the things that the authors talked about is that contracts in state agencies have to be monitored. But since the last fiscal crisis this state has done away with monitoring.

I would end by pointing out that repeal or amendment of this law is somehow held out as a solution to the fiscal crisis, at least in part, but cities and towns in Massachusetts are not subject to this law. They can privatize; they can contract any way that they want. Yet cities and towns are in no better shape than state government at large.

Answering Supporters of the Law

Charles Chieppo: In view of what's been claimed, it would be helpful to go through what this law actually says. It does indeed set up a comparison that asks the cost of a private bid to be compared—not to the actual cost of public service delivery—but to what the cost would be were public employees to work in the most cost-efficient manner. What does that mean? No one knows.

The law also says that before this comparison even happens, a variety of "adjustments" must be made. Each one of them adds to the cost of a private bid. It mandates a pay range for frontline employees and even mandates what the private company's officers and managers can earn. The law also mandates exactly the percentage of healthcare costs that need to be paid by the private contractor on the contract.

In addition, if any part of the private contractor's work is performed outside of Massachusetts that foregone tax revenue needs to be added to the cost of the private bid. But there is no provision in the law to add to the cost of a public bid the fact that all of the work would be taxable, and taxpayers would reap the benefits of that, if it were done by a private company.

Senator Pacheco talked about fair, rational, and measurable savings, claiming that's where's any independent analysis comes up short. MassHighway gave a number for what the privatization of highway maintenance saved us. When the Kennedy School looked at it, they said, "No, that's wrong. It actually saved us a good deal more." There are plenty of examples about savings.

I also want to get into the auditor's role and the claim that supposedly the auditor cannot strike down a contract because he determines it's not in "the public interest." Section 54.5 of the law says a proposed privatization

Competitive contracting has gone dramatically beyond where it was when Weld was doing these privatization contracts. Massachusetts should reduce or eliminate the hurdles to privatization that the Pacheco Law erected.
—Charles Chieppo

contract that is otherwise in the public interest must be certified to the auditor. And a May 16, 1997, letter from the auditor to the then-general manager of the MBTA, denying an attempt to contract out the operation of bus routes, states, "In our opinion, any contractual provision that is not in the public interest is a matter within the purview of our mandated view of proposed privatization contracts." It goes on to say, "The payment for projected profit for services not performed is clearly not in the public interest, and accordingly, not in compliance with the referenced statutory provision." I don't know how you can say that "the public interest" is not an issue that that allows the auditor to strike things down.

Finally, I would agree that many of the Weld privatizations, in many ways, were flawed. But in terms of its sophistication, this whole area of competitive contracting has gone dramatically beyond where it was when Weld was doing these privatization contracts. The benefits are far greater. The losses to public employees, at this point, are virtually non-existent. Massachusetts should reduce or eliminate the hurdles to privatization that the Pacheco Law erected.