

### Public Profits From Private Contracts: A Case Study in Human Services

*On July 29, 1997, Pioneer Institute hosted a conference on social service delivery in the Commonwealth. **Robert Melia**, author of Pioneer's White Paper entitled *Public Profits From Private Contracts* and former vice president of Policy Studies, Inc, used child support enforcement as a case study to compare private versus public delivery of human services. Melia argued that competitive contracting is often a more effective way of delivering services not because public employees are inefficient or private companies pay less, but because bureaucratic checks and balances are inherent in government. Commenting on the issue were:*

*The Honorable Marc Pacheco, State Senator,*

*Frederick Laskey, Senior Deputy Commissioner, Department of Revenue*

*In the following pages, Pioneer Institute has reproduced an edited transcript of the conference.*

**Robert Melia:** Thirteen states have elected to contract with a private company to run the child support systems part of their states, thus there is enough data to draw meaningful comparisons with states where child support enforcement is government run. There are about 20,000,000 child support cases in this nation and about 50,000 people working in child support enforcement programs. The load is growing by about ten percent a year. There is general dissatisfaction with the program, including in the federal government, which reimburses states for the cost of the program and dictates most of the rules. In addition, about 100 pages of the 1996 welfare reform law were devoted to requiring that states work their cases faster, better, and more intensively. When I started working in the area of child support in Massachusetts, the Revenue Department had 350 people devoted to child support enforcement. Today that number is 800.

Twenty years ago, agencies collected four dollars for every dollar spent on child support. Today, despite the billions of dollars spent on more advanced computer systems and several waves of legislation making it easier to collect, there has been no improvement. For every dollar we spend, we still collect four dollars. In desperation, some states are turning to private companies to deal with this problem.

Policy Studies, Inc. runs child support programs under contract in six states. Private companies obey all the same rules and regulations as state agencies. They do not run the entire state program, but in certain cities, counties or judicial districts, the program has been essentially transferred to a private company. Comparatively, private companies spend about 35 percent less to run these programs than do publicly-run organizations. But what about quality?

The United States General Accounting Office (GAO) was asked by a couple of congressmen to investigate this very issue. They saw privatized child support enforcement as potentially promising but wanted to be sure that private agencies and companies were not achieving results by creaming. The GAO looked at private contracts in Virginia, Arizona and Tennessee. They selected a publicly-run control office and a private office dealing with the same demographics, same per capita income in the communities, same racial makeup, and roughly the same caseload to worker ratios. To isolate the difference between a government-run agency and a privately-run agency, the selected offices were as similar as possible. In all three cases, the GAO concluded that the quality of the service delivered by the private company was as good or better as that delivered by the government-run control office.

The data indicates that private companies can get comparable quality for 35 percent less. How do they do it while earning a profit and incurring marketing costs? Opponents of private contracting argue that the private sector attracts better managers. But in the case of child support enforcement, private companies have gone into public agencies to recruit managers. Opponents also claim that government does not attract the best and the brightest front line staff. But some states, when they put out a contract, require that jobs be offered to all the existing employees. Other states, in order to increase the level of service in a given area without impacting current service, require a program director to hire all new people. Regardless, the performance difference and the cost advantage are the same.

Opponents of private contracting often argue that the cost advantage comes out of front line employees, because private companies cut wages and eliminate benefits. I compared the total compensation level, (salary, pensions or 401(k) contributions, health care benefits) paid to PSI employees in the six states where we operate with what employees on the public payroll are paid. They are virtually identical, within a percentage point or two. To attract people who have the right skills, you pay the market level, which is established by government. It is no surprise that we are paying the same level.

The private company advantage comes from technology, performance incentives, and the overhead needed to run a government versus a private agency.

**Technology.** When a private company wins a contract to run a child support program, it typically installs computer systems that enhance the productivity of case workers for the lowest cost, like a document generation system that minimizes time spent producing the necessary paperwork, or a system that matches social security numbers against IRS records to track people down if they have left the state. Government programs cannot do that. If a government agency wants to build a computer system, it must go to the Legislature or to Congress and ask for a special appropriation. Because it competes with other agencies to get on the Legislative or Congressional agenda, the agency dramatizes the problem. A public agency knows that it has a chance at this kind of appropriation once a decade, so it asks for everything it might possibly need for the next ten years. The resulting system is enormous, complicated and almost unbuildable. The federal government now requires all states to build computer systems for child support. Virtually all states have hired a big systems integration company like IBM to build the systems. These systems are so complicated that typically a second computer company is hired to monitor the work of the first one.

In 1988, Congress required the states to build case management systems, agreed to pay 90 percent of the cost, and established a seven-year deadline. When the deadline came in 1995, only one state had managed to build an acceptable system. Many of these systems are just now coming on line. According to the GAO, the total cost so far is \$2.6 billion. In addition, for the past ten years child support case workers have not had the benefit of smaller scale, useful systems that could have been built six or nine months.

**Performance Incentives.** At PSI, if in the course of a quarter a team meets predetermined goals, give a bonus. It amounts to 10 percent or less of their salaries, but it gives people an incentive. They understand what the agency's priorities are, and they like that their work is recognized by management. It is very difficult to give these kind of incentives in government. Collective bargaining agreements prevent most agencies from paying bonuses. In many states, you cannot even set performance rules for employees to meet. Lack of incentive is a significant contributor to the performance gap.

**Overhead.** At PSI, for every 100 people actually doing child support work, there are nine in the back office providing administrative support. In public agencies, the number of support people is often double or higher. Public agencies are tied down by a thousand strands of regulation and overzealous checks and balances. It takes a large number of support people to snip through those strings and allow the agency to actually do its job.

If it is possible to get the same quality service for a third less money, why do we still have these big state agencies? In 1993, the Massachusetts Legislature passed a law, known as the Pacheco Law, designed to inhibit or slow down the process of competitive contracting. Under the law, an agency determines the internal cost of performing a particular service, and then takes a bid from a private company. The State Auditor examines both proposals, and determines whether the outside bid is less expensive.

It is not as straight forward as it sounds. When we read in the newspaper that the budget of a particular state agency went up from \$300 million to \$320 million, or down to \$290 million, it is hard to figure out what those numbers mean practically. We never see anything comprehensible, like it costs the state highway department \$25 on average to fix a pothole, or what it costs the state Department of Revenue (DOR) to conduct a meals tax audit. Nobody knows what those costs are, because government accounting systems are not set up to produce that kind of information. The necessary information is scattered throughout a whole myriad of agencies. There are so many indirect and allocated costs that reasonable people disagree over how to allocate them.

The State Auditor has enormous discretion when it comes to approving a proposal, a fact that has a very chilling effect on competitive contracting. Enormous effort goes into preparing an RFP and evaluating the responses. If someone has essentially an arbitrary veto over whether a proposal can go forward, you lose motivation to submit one. You can put in the effort, but chances are you will never be allowed to let the contract. Since all state agencies have crowded agendas, and there is a remote, often perceived as hostile entity that has veto power, it is no surprise that few proposals are submitted.

**Fred Laskey:** If PSI came forward with a proposal to do business with the Department of Revenue, I would be interested in talking. I do not think PSI could run the entire child support enforcement program in Massachusetts, but I am confident that they could run portions of it. In state government, however, you cannot simply identify an appropriate vendor and hire them. You have to put out competitive bids and get different proposals. I am sure that there are functions that we could run more efficiently through contracting out, but that basically cannot occur under the Pacheco law.

It is virtually impossible to take a current service provided by state employees and contract it out. Competitive contracting is not the answer to all government's problems, but it surely should be a powerful tool to push managers to take a comparative look at how to do business.

The State Auditor issued a 43-page list of guidelines for implementing the Commonwealth's privatization law. First, you must prove that the vendor's proposal to privatize is more cost effective than the most efficient way that government could provide that same service. It does not take into account whether government is actually providing the service in the most cost effective way. You have to do a management study that proves it could not be done more efficiently in-house. Salary requirements must be matched and you must hire employees who will be laid off as a result of the proposed contract. It takes a lot of the flexibility away.

The Legislature sets the ground rules, and it believes that when in doubt, public employees can do it better. As a result, there has been no real debate over whether private entities can do it better than government. That is unfortunate. The more ideas and options we have, the better. The concept that competition is healthy and monopolies are unhealthy is a basic one. We abide by and accept the law, but it ties our hands. You have to make a business decision about whether you want to enter the fight for a proposal, because it creates a lot of disruption and uneasiness among your staff for something that may not be winnable.

I am not a zealot who thinks that everything that is private is good and everything with public employees is bad. I work in an agency with 2500 employees, the vast majority of whom are hard working. Sometimes privatization simply is not a good idea. For instance, we had a proposal that came in to hire private auditors to conduct tax audits. They would get paid a percentage of what they brought in audit assessments. To have a profit incentive for tax audits is not a good dynamic. Tax information is guarded with healthy paranoia. Having citizens' private tax records or private employment records accessible would undermine the foundations of the tax operation. Putting that information in private hands would be detrimental to our overall operation.

I support a case by case, function by function comparison with a real cost benefit analysis, as is done all the time in the private sector. Private companies decide whether to outsource various parts of their business by doing a cost benefit analysis and examining where they are going.

**Senator Pacheco:** A study of human services done by the Beacon Hill Institute conducted prior to the so-called Pacheco law found that on average the megacompetition system only solicited 1.7 bids per contract award. Less than two bids on average per contract award for human services in Massachusetts tells me that we are handing out contract awards instead of encouraging competition. It gets to a point where you can also point to some collusion taking place. There are a limited number of people in the businesses responding to the RFP's, and most of them know each other. When you have less than two bidders per contract awarded, the time has come to set some standards and examine the system.

It is easy to point to our present system and play the blame game. We can all look at public sector systems and find a department or agency where there are problems, just as we can find problems in private sector contracts which have been awarded. The intent of the privatization law was to make sure we had standards in place so that the public interest would be protected.

I came to be familiar with this situation in my region when a public health facility, the Lakeville Hospital, was privatized and closed and all the services contracted out to a private, non-profit health care provider. We were told that tax payers would save money, and that the cost and quality of the service would be equal to what patients had been receiving. After the State Auditor looked at it, we discovered that literally millions of taxpayers' dollars that had been paid to the public health care facility could not be accounted for. The average cost per patient increased, and access to care was totally different from the previous standards.

This caused the Legislature to re-examine the system. We enacted a statute to take the promises of e administration and put them into law. The law requires that private contractors be subject to a cost-benefit analysis, and that it be documented. Secondly, it ensures standards of quality.

People may not like the idea that there is an internal, in-house bid process. The reason it exists is because in the public or private sector, most times the views of front line workers are not integrated into the whole system. Under this legislation, workers have the opportunity to change their own contracts. If they decide that in order to be competitive with an alternative contract, they need changes in work rules, they can change them. But they have to put their work force hours and wages on the line.

As for the proposals that have been submitted to the Auditor, DOR submitted their proposal on mail opening services. They estimated a savings of \$200,000 and eventually it was approved by the Auditor's office. The Department of Employment and Training (DET) proposed privatizing storage and retrieval services. He approved that. The proposals that he has not approved are MBTA bus lines, MBTA bus shelter maintenance are the ones that could not come up with the cost benefit analysis. The Massachusetts Highway Department put in a road maintenance proposal that was rejected. According to the Auditor's office, the information requested had not been provided.

People say this law stops privatization, but I have just given you evidence that it does not. There have been plenty of privatization contracts allowed. There will be more allowed if the executive agencies are thoughtful, make sure they do their cost benefit analysis, and look at the public interest. In the final analysis, the legislature came to the table because we had to. We were forced to respond to constituent groups, to the abuses, and sometimes to proven fraud and corruption in the system. We are not saying that we can never have privatization. We are saying there need to be standards. There have been a number of success stories in which privatization has worked, but there are also literally hundreds of stories out there where it has not. You need to have a framework within which these decisions are made to ensure that the public interest, not the public employee interests or the private corporation interests, are examined.

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