

# In the **PublicInterest**

## **Backgrounder Brief**

### **The High Costs of Privatization**

One of the most popular reasons for privatization and contracting out is the promise of cost savings. **But research and the repeated experiences of cities and states across the country have shown that cost savings often fail to materialize or are much lower than originally projected.** This trend is prevalent in privatization contracts in many different sectors. Contracts related to health and human services, municipal services, information technology, school support services, prisons, and transportation are just a few of the areas where rampant cost overruns and vastly overstated cost savings projections have been documented.

In these economic times, governments simply cannot afford the risk of losing money through ill-conceived privatization contracts. Before making the decision to privatize, governments must require rigorous analysis of proposed deals. This should include the full costs of contracting, such as the costs associated with the contracting process, indirect costs, shifted costs such as employee health care when workers become eligible for public healthcare assistance programs, change orders, cost overruns, and other types of costs that are often left out of the decision making process. In this backgrounder brief, we provide examples of recent research that examine the costs associated with privatization, share experiences from cities and states, and conclude with an overview of the various types of costs that make privatization a risky and expensive gamble.

#### What Research Shows:

Numerous reports, surveys, and studies show that privatization frequently involves costs to the government that are not included in the actual written contract. These additional costs can create a significant burden on public budgets. The research greatly supports the recommendation that cities and states should look at all costs related to contracting before deciding to privatize a public function.

#### **Cost savings are elusive.**

Below are several reasons that research has identified why privatization costs more – hidden costs, inaccurate cost-benefit analyses, cost overruns, and change orders are all factors that make privatization a poor fiscal choice for many cities and states. Functions that are privatized are often taken back by government due to the lack of cost savings.

- *Hidden and indirect costs* – Governments often fail to account for hidden costs, like contract monitoring and administration and the contractor's use of public equipment and facilities. These costs can add up. The Government Finance

- Officers Association estimates that indirect and hidden costs can add up to 25% to the price of the contract, often making privatization an uneconomical choice.<sup>1</sup>
- *Inaccurate cost-benefit analyses* -- Research shows that cost overruns are fairly common in privatization contracts due to misleading cost-benefit analyses and projections, loopholes, and high indirect costs. This was especially apparent in a recent study that examined contracting in school districts. In a review of cost-benefit analyses that school districts used to justify their contracting decisions, researchers found that financial figures were based on faulty assumptions, old data, or no reason at all, making cost savings appear probable. In reality, these school districts often lose money instead of saving money.<sup>2</sup> Indirect costs that the school district must incur, such as preparation time for the Request for Proposal (RFP), contract management, and attorney hours for contract review are often not included in the cost-benefit analysis either.
  - *Cost overruns and change orders* -- Many contracts do not place caps on costs and/or allow the contractor to charge higher rates for additional services that crop up in the course of the contract. These provisions allow the contractor to bill the government for more than the base amount. This causes “sticker shock” to the government when bills from the contractor come due.<sup>3</sup>
  - *Bringing public functions back in-house* -- Governments that privatize often report insufficient cost savings. According to a 2007 survey by the International City/County Management Association, the main reason local governments consider private service delivery is to decrease costs. However, 52% of local governments that brought services back in-house reported that the primary reason was insufficient cost savings.<sup>4</sup>

**Long-term studies of contracting show little or no cost savings for governments.**

Numerous studies that examine contracting in a wide range of sectors have similar findings: privatization does not lead to cost savings and can often cost the government more than public service provision. A few examples are below.

- In 2006, the California Research Bureau examined contracting practices at state agencies over time and determined that it costs most agencies 50% more to use outside contractors than public in-house staff.<sup>5</sup>
- In 2006, Germa Bel and Mildred Warner reviewed all studies related to costs for waste collection and water distribution. They found that the majority of studies reported no difference in costs and efficiency between public and private provision and some studies even concluded that public provision of the services was cheaper.<sup>6</sup>

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<sup>1</sup> AFSCME, *Government for Sale*, Eighth Edition.

<sup>2</sup> Great Lakes Center for Education Research and Practice. “A Guide to Contracting Out School Support Services: Good for the School? Good for the Community?” 2008

<sup>3</sup> Ibid.

<sup>4</sup> [http://icma.org/en/results/surveying/survey\\_research/whats\\_new](http://icma.org/en/results/surveying/survey_research/whats_new)

<sup>5</sup> <http://inthepublicinterest.org/sites/default/files/CA%20IT%20Report.pdf>

<sup>6</sup> Germà Bel and Mildred E. Warner. “Challenging Issues in Local Privatization,” *Environment and Planning C: Government and Policy*, 26(1)(2008): 104-109

- Similarly, in 2007, Roland Zullo found in his research that governments gained no immediate or long-term economic benefit from contracted bus services.<sup>7</sup> This finding was substantiated in 2009 by Suzanne Leland and Olga Smirnova who found that privately owned and managed transit systems are not more efficient or more effective than government owned agencies.<sup>8</sup>

#### What Experience Shows:

The actual experiences of cities and states that have privatized public functions mirror the findings presented in the research above. This section provides examples of various types of cost-related problems in privatization contracts from the following sectors: health and human services, information technology, municipal services, school support services, prison services, and transportation.

#### **Health and Human Services**

Both Texas and Indiana have recently experimented with the privatization of their public benefits eligibility systems to dismal results. Both states cancelled their contracts, which cost millions of dollars in legal fees. Indiana paid \$5.25 million to a law firm to represent the state in the costly fight against former contractor, IBM.<sup>9</sup> In Texas, contract cancellation left the system in disarray, and the state struggled to rehire case workers after laying them off at the start of the privatization initiative. As a result, Texas was fined \$3.96 million by the federal government for not adhering to federal timeliness standards.<sup>10</sup> The costs of contract cancellation and related fines for poor service provision are often not taken into consideration in cost-benefit analyses. But, these unanticipated expenses resulting from poor privatization schemes can cost cities and states dearly.

#### **Information Technology**

In 2005, Virginia signed a 10-year, \$2.3 billion contract with Northrop Grumman to consolidate and modernize its information technology system. Many problems ensued, including missed deadlines, poor performance, and numerous complaints by state agencies. In an attempt to fix these problems, the state revised the contract to pay the company over \$100 million more than originally envisioned.<sup>11</sup> The state was effectively forced to pay for cost overruns to ensure a functioning system. The high costs of contracting information technology functions are evident in California too. In 2005, CalSTRS found that the agency's dependence on IT contract staff increased costs by about 84%.<sup>12</sup> At the local level, New York City signed a \$63 million contract for a private contractor to computerize the city's timekeeping system in 1998. From 1998 to

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<sup>7</sup> Roland Zullo, "Transit Contracting Reexamined: Determinants of Cost Efficiency and Resource Allocation." *Journal of Public Administration Research and Theory*, Vol. 18, Issue 3, pp. 495-515, 2008.

<sup>8</sup> Suzanne Leland and Olga Smirnova. "Contracting Out Transit Services: Evaluating the Link between Organizational Form and Effectiveness." *Presented at the 2008 Midwest Political Science Association Annual Meetings*, April 6, 2008.

<sup>9</sup> <http://www.businessweek.com/ap/financialnews/D9IVMTN01.htm>

<sup>10</sup> *Ibid.*

<sup>11</sup> <http://inthepublicinterest.org/case/virginia-statewide-information-technology-system>

<sup>12</sup> <http://inthepublicinterest.org/sites/default/files/CA%20IT%20Report.pdf>

2010, the contract costs ballooned to over \$700 million. Even after these massive cost overruns, the system is still unfinished and riddled with problems.<sup>13</sup>

### **Municipal Services**

As recent as February 2011, cities have found that private provision of municipal services are often more expensive. Yuma, Arizona solicited bids from private companies interested in taking over city trash operations. They were given quotes from \$30,000 - \$80,000 per month for the services. Public officials determined that this range was much greater than what public provision costs, and residents would probably pay almost double to a private company what they currently pay to the city for the same service.<sup>14</sup>

### **School Support Services**

An examination of food service privatization at Ann Arbor, Michigan schools uncovered that “cost savings” claimed by the contractor were largely a result of cutting employees’ wages and serving low-quality food with little nutritional value.<sup>15</sup> Improvements in the budget were actually a result of increases in revenue from the federal school lunch program and USDA commodity program, both items that were completely outside of the contractor’s control. Without these boosts from the federal government, the school district would have experienced a budget deficit following the privatization effort. In another recent example, large food services management companies, such as Sodexo, Inc., Compass Group, and Aramark Corp. overcharged 10 New Jersey school districts for workers compensation and liability insurance and withheld rebates from the USDA that were supposed to go to the school districts. These represent hidden costs that take away needed funds from districts.<sup>16</sup>

### **Prison Services**

Prison service contracts are riddled with cost problems. In November of 2010, the Arizona state auditor examined the costs of private and public prisons. The audit found that inmates housed in public prisons cost the government \$48.13 per day, while those housed in private prisons cost \$55.89 per day.<sup>17</sup> This finding was echoed in South Carolina where it was estimated that the private provision of health care to prisoners would cost the state \$20,000 more per person per year than the public system.<sup>18</sup> In Massachusetts, the state auditor accused its contractor of \$1.5 million in overcharges by inflating the numbers of AIDS patients in an 18-month period in the early 1990s. Several years ago in Florida, another prison contractor was under investigation by the Florida Attorney General’s Office for \$3.25 million in Medicaid overcharges.<sup>19</sup>

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<sup>13</sup> <http://inthepublicinterest.org/article/citytime-contract-1000-over-budget>

<sup>14</sup> <http://www.yumasun.com/news/city-67409-wilkinson-private.html>

<sup>15</sup> <http://inthepublicinterest.org/sites/default/files/AAPS-FoodServices.pdf>

<sup>16</sup> Clarion Group, “Hard to Swallow: Do Private Food Services Contractors Shortchange New Jersey Schools?” March 2010.

<sup>17</sup> <http://inthepublicinterest.org/article/audit-private-prisons-cost-slightly-more>

<sup>18</sup> <http://inthepublicinterest.org/sites/default/files/SC%20RX%20Disaster.pdf>

<sup>19</sup> Ibid.

## Transportation Services

An audit report from the Wisconsin Legislative Audit Bureau revealed that the state's department of transportation wasted more than \$1 million by outsourcing almost half its engineering work to private contractors over a period of five years. The audit found that about 60% of these outsourced jobs could have been done at a lower cost by state workers, which would have saved the state \$1.2 million.<sup>20</sup>

## Conclusion

As research and the experience of cities and states around the country demonstrate, privatization often fails to provide promised cost savings. For private companies to make a profit, they must ensure their margins and charge higher fees, or cut costs in areas like worker wages and service quality. As a result, governments often do not save money by privatizing and contracting out public functions. By charging governments when a project takes longer than anticipated (even if the contractor provided the time estimate) or if another variable in the project changes, the private company is able to minimize their financial risk and ensure that their bottom line is not compromised.

Governments need to take extra precaution to ensure that their bottom lines – the public's interest, the quality of the programs and assets they provide, and their budget are not compromised through privatization. Before a government decides to contract out or privatize a public function, it should ensure a rigorous cost benefit analysis that encompasses all relevant costs. These include costs associated with holding hearings, drafting bid documents, analyzing proposals, monitoring the contract, training private contractors' staff, moving equipment, the contractor using public resources, possibly engaging in litigation arising from contracting failures or procurement problems, and much more. The chart below details some of the costs associated with privatization that are important to consider and accurately estimate before deciding whether to privatize. Accounting for the full costs of contracting will help determine whether privatization is really the public's best option for controlling costs.

## Selected Cost Categories Associated with Contracting

Type of Costs	Description	Examples
Transition Costs	Cost associated with the transition from in-house provision to contracting provision, or costs associated with changing contractors	Costs associated with development of RFPs, public hearings, evaluating bids
Hidden Costs	Indirect costs that may not be immediately apparent <i>Note: Some examples that fall under other categories could also be considered hidden costs as well</i>	Costs of contractors using public resources, training private contractors

<sup>20</sup> [http://www.legis.state.wi.us/LAB/reports/09-dotconstructionengineering\\_ltr.pdf](http://www.legis.state.wi.us/LAB/reports/09-dotconstructionengineering_ltr.pdf)

Monitoring Costs	Costs associated with monitoring the contract and contractor performance	Costs of government staff required to monitor contract, review and audit process
Shifted Costs	Costs that are shifted from the contractor to the government (sometimes numerous levels of government)	When a contractor fails to provide living wages or health care to employees, these costs can be shifted to government through public assistance programs, such as Medicaid and food stamps
Cost Overruns	Costs that are more expensive than originally anticipated	Contractor takes longer than anticipated time to complete project and government is charged for additional time by the contractor
Change Orders	Costs associated with activities outside the original scope of the service or project (Note: Keeping functions within the public domain allows government more flexibility when changes affecting programs or projects occur)	A new law is passed and the government needs to change the activities of a contractor accordingly, but this constitutes a change outside the scope of the original contract and government must pay for the change