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Is Privatization a Bad Deal for Cities and States?

Introduction

Stephen Goldsmith, the deputy mayor of New York, recently said that it's time to get rid of costly private contractors and have city employees handle more of the city's technology services. Mr. Goldsmith, known as "the prince of privatization" when he was mayor of Indianapolis in the 1990s, said he found $41 million in immediate savings by taking the work of the city's data center and wireless network back in-house.

Lawmakers and governors in states like Ohio, Florida and New Jersey, however, are hoping to cut spending by outsourcing more public functions. Critics say privatization efforts rarely end up saving money, but can lead to huge cost overruns and delays.

What has been learned from decades of contracting out government work? Which types of outsourcing are particularly vulnerable to mismanagement and which types tend to be cost-effective?

The Pendulum Swings Again

Author: Mildred Warner is a professor of city and regional planning at Cornell University. Her work focuses on local government service delivery and economic development.

Steve Goldsmith has discovered what most city managers have known for a long time. “In-sourcing” services and functions that had previously been contracted out has been going on for as long as outsourcing has existed at the local government level. In many cases, all privatization does is substitute a private monopoly for a public one.

I have been able to track the rates of new contracting out versus in-sourcing over time using the International City County Management Association surveys of local governments in the United States. Privatization peaked among local governments in 1997. From 1992 to 1997 new outsourcing contracts accounted for 18 percent of all service delivery, while in-sourcing was 11 percent. The ratios shifted in the 1997-2002 period with in-sourcing exceeding new contracts out by 50 percent. From 2002 to 2007 the rates were about equal (new contracts out were 11 percent, contracting back in was 12 percent). So the pendulum swings.

Rational city managers recognize the need to manage markets for public services. Contracting out only saves money if there are technological innovations or economies of scale that come from moving functions out. Even if there is a technological gain, as in new information technology, government cannot afford to contract out its core information function and so
governments use outside contractors to upgrade their systems, but then take control back in house. No organization, public or private, would want to have its central information (intelligence) outsourced. That would be irresponsible.

I.C.M.A. also tracks the reasons why local governments bring back in-house previously privatized work. The reasons are problems with service quality (61 percent), lack of cost savings (52 percent), improvements in public delivery (34 percent), problems with monitoring (17 percent) and political support to bring the work back in house (17 percent). It turns out citizens prefer local services to be locally controlled and publicly delivered.

Rigorous quantitative analysis of every published study from around the world of water delivery and garbage collection (the two most commonly privatized services at the local government level) finds no statistical support for cost savings under privatization. Economic theory would predict this result. Private firms have incentives to reduce quality to enhance profits. Hence careful monitoring is required. But monitoring is expensive and it requires continuing knowledge, within government, of how services are produced.

Many public services are natural monopolies. In these cases, monopoly provision is cheaper than competition. But monopolies require public control. Even in services which initially experience competition, a competitive market erodes after the initial contract. Fully 75 percent of contracts are given to the incumbent without rebidding. For most local government services the average number of alternative providers is less than two. Only one third of the 67 most common local government services have two or more alternative providers in the market. So in many cases, all privatization does is substitute a private monopoly for a public one. There is more potential for public control over a public monopoly.

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**Not a Cure for Incompetence**

**Author:** Nicole Gelinas, a contributing editor to the Manhattan Institute's City Journal, is the author of "After the Fall: Saving Capitalism from Wall Street -- and Washington."

Privatization of government services can be a tool for competent governments but it's not a cure for incompetence.

CityTime, New York’s private-sector project for a new payroll system, is an example of privatization gone wrong. The endeavor didn't do what privatizations should aim to do: encourage savings and better service through competition. All New York did with this contract was allow a monopoly contractor to exert immense power over Bloomberg administration officials.

The lesson learned here: privatization doesn't obviate the need for government competence and honesty, as well as for the democratic checks and balances that encourage these traits.
In general, too, whenever cities and states sell or lease a big asset to the private sector to reap some short-term cash to cover budget deficits, as Chicago did with its parking meters, taxpayers get a bad deal. Bidders know when a government is desperate for money. They stand ready to enable government officials to enter into decades-long contracts, which only magnifies the effect of any mistakes in calculating potential profits and costs.

But there are good examples of privatization. Take London, for example. New York would be wise to, like London, competitively contract out public bus service, with transit officials choosing bidders based on the lowest public subsidy they require while maintaining uniform safety standards, schedules and payment from customers. Individual contracts would be for a couple of years and cover no more than a few lines, so no operator could gain a monopoly.

Indeed, done well, such deals help break monopolies. In London, recent transit strikes shut down subways, but bus lines still ran, easing union power over the public.

Such a system here would require more government competence, not less, though, to ensure that corruption, collusion and other risks don’t take New Yorkers for a ride.

When Ideology Drives Decisions

Author: Elliott Sclar is professor of urban planning at Columbia University and director of the Center for Sustainable Urban development in the Columbia University Earth Institute. He is the author of “You Don’t Always Get What You Pay For: The Economics of Privatization.”

We would be better served if cost and quality were the criteria used in deciding to privatize, rather than ideological nostrums about markets streaming out of conservative think tanks. Sadly, the contemporary political scene is governed, with a few exceptions, by an at times overt but more often covert ideological battle to shrink the public sector and expand the private sector in civic life; practical issues of costs, benefits and service quality are secondary. It makes sense to hire a contractor to paint city hall but privatizing a city’s employee record keeping system can be disastrous.

In private organizations ideology does not determine “make or buy” decisions. Should the organization perform a specific function itself or should it purchase that function from an outside supplier?

Three factors drive the decision: the number of interactions required between the service supplier and the purchasing organization; the ability of the purchasing organization to judge the quality of the product; and the nature of control over the physical assets and people involved in delivering the goods.

The general rule of thumb is that when the number of interactions is high, quality is not easily determined and control over assets is required, you should keep the function in-house. If the reverse is true, you can outsource.
That is why, for example, it makes perfect sense to hire a contractor to paint city hall every few years but why attempting to privatize something as complex as New York City’s employee record keeping system has proved to be a disaster.

Why is this the case? Because success or failure is connected to the complexity of the organizational relationship between buyer and seller and the amount of information that the public buyer continually needs to assess in determining how the project is progressing. These two factors explain virtually all of the reported failures of privatization for functions like prison medical services or highway construction.

We would do far better if we started with the recognition that the public sector is a highly complex and socially vital operation staffed by hundreds of thousands of highly trained professionals. Like all organizations, public ones require competent management and continuing investments in improving operating capacity. Utopian schemes to contract away these problems through privatization efforts is a form of magical thinking, which leaves taxpayers to pay for the mistakes.

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**Competition Brings Savings**

**Author:** [Leonard Gilroy](#) is the director of government reform at Reason Foundation.

Former Gov. Mario Cuomo once said, “It is not government’s obligation to provide services, but to see they’re provided.” He’s right: government workers don’t need to be the ones providing many services. Government program budgets are too rarely tied to results, so poor performance is often perversely rewarded with budget increases.

Public sector managers already understand this. For decades, they’ve increasingly relied on contracting out for the delivery of a wide range of services, including waste collection, vehicle fleet operations, road maintenance, child welfare services and many more. A recent National League of Cities and American University [survey](#) of over 300 local government managers found 93 percent support contracting.

This should come as no surprise. Contracting works by introducing competition into an otherwise monopolistic system of public service delivery. Governments operate free from competitive forces and without a bottom line. Agency and program budgets are too rarely tied to results, so poor performance in government is often perversely rewarded with budget increases.

Contracting usually generates cost savings for taxpayers [between 5 and 20 percent on average](#), though the benefits of competition extend far beyond cost control. For example, service quality improvements, improved risk management, innovation, and access to outside expertise are other benefits often cited by satisfied government customers.

Contracting out is simply a policy tool, and like any tool, it can be used well or poorly. There are two critical ingredients to successful government contracting. First, public managers should
think carefully about the service quality standards they want to achieve, and then develop strong, performance-based contracts that hold contractors accountable for meeting them. Measurable performance standards should be built into contracts, along with incentives for exceeding standards and penalties for underperformance.

Second, once a performance-based contract is in place, government managers must monitor and enforce the terms of the contract to ensure that contractors perform.

Government contracting needs to be seen as part of a larger fiscal management toolkit that includes performance assessment, priority-based budgeting, sunset reviews, and many other approaches to reform. But make no mistake — when done with proper care and diligence, competitive contracting is a powerful and widely-used tool to drive down costs, improve performance and, in the end, help governments more effectively serve taxpayers.

**Knowing What to Buy**

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In 2009, President Obama directed federal agencies to use fewer contractors. The Department of Defense, the federal government’s largest purchaser, pledged to reduce the percentage of contractors in its workforce from 39 percent to 26 percent. Other agencies followed suit. All this planned in-sourcing promises better quality, fewer scandals, and even savings.

Maybe.

The costs and risks don’t magically go away when an agency decides to bring the product or service back in-house.

The potential costs and benefits of outsourcing start with the product. If the product is easy to describe and easy to make, the upsides of outsourcing are high. Take office cleaning. Most agencies can easily describe what they want — clean offices — and it’s easy for contractors to provide the service — cleaners don’t require much training. Outsourcing office cleaning can lower costs with little risk of dirty office buildings.

If the product is hard to describe and difficult to make, things get tricky. Take information technology development. Many agencies struggle to identify what they want a new I.T. system to do and contractors have to invest in lots of research and development to help them figure it out and ultimately make it. Outsourcing this type of product risks the agency not getting what it wants and the contractor charging a lot because it can’t sell the specialized system to other buyers.
These same characteristics make in-sourcing challenging too. When an agency decides to in-source something like I.T. development, it still has to decide what it wants the system to do as well as build the system. This requires employees with expertise, who don’t come cheap. And there’s no guarantee that they’ll produce what the agency wants just because they’re on the payroll.

Agencies like the Defense Department are learning these lessons as they wean themselves from contractors. Facing continuing and emerging conflicts around the globe, Defense Secretary Robert Gates has already lowered his goals for reducing contractors’ share of the workforce. It’s proving cheaper and faster to buy rather than make many of the things the department needs.

Outsourcing can save money, if agencies are smart about what they buy. When an agency buys a product that invites risk, and fails to manage that risk through planning and monitoring, things often don’t go as planned. The same lessons apply for in-sourcing. The costs and risks don’t magically go away when an agency decides to bring the product or service back in-house.

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