

The Origins of Governmental Production:
Cleaning the Streets of New York by Contract During the 19th Century

Book in Progress -- manuscript available upon request

Comments Welcome

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Introduction

Will the debate about contracting out ever be resolved? Each side presents cases that support its point of view, but it is difficult to make policy decisions based on case studies. And at any rate, aren't the failures of contracting out just points on the learning curve? Can't the system be perfected over time?

In fact, contracting out passed its developmental stage more than one hundred years ago. Contracting out was the way American cities carried out their governmental business ever since they grew beyond their small village beginnings. In 19th century New York, for example, the City Charter itself mandated contracting out for all work done for the city. By the end of the 19th century contracting out was a mature system that was already as good as it could possibly be. And it was precisely then that governmental production came to America. The realization that every possible improvement to contracting out had been tried led city after city to declare its failure.

In 1892 the head of the Chicago Board of Health declared: "There are few if any redeeming qualities attached [to the contract system]. No matter what guards are placed

around it, the system remains vicious."¹ In 1895 Mayor Pingree of Detroit expressed the same view: "Most of our troubles can be traced to the temptations which are offered to city officials when franchises are sought by wealthy corporations, or contracts are to be let for public works."² Practically all American cities discarded contracting out at that time and switched to governmental production.

Since all of this happened more than a century ago, it is not surprising that our experience with contracting out has faded from public memory. Curiously, it is often the current advocates of contracting out who refer to its history. Unlike their predecessors, they know how to make contracting out competitive, they assert. But was the contracting out of the past really not competitive? Are there any devices to make privatization effective that can be tried today that were not tried in the 19th century? These are the questions that will be explored in this book.

As we will see, every device that modern economists suggest as necessary to make contracting out successful was well-known at the beginning of the 19th century. At some periods during the century all of these devices were in place, while at other times some were deliberately avoided. But whatever combinations of devices were in place, contracting out invariably failed. In fact, there was no combination of devices that made a significant difference.

Just how did contracting out fail in spite of all these devices? To answer this question this book follows the contracting out of one service, street cleaning, in one city, New York, during the course of its final 59 years before it was discarded in 1881.

Several factors led to the choice of street cleaning for investigation. In the first place, no other governmental service could be more easily contracted out: The required

¹Melosi, Martin, *Garbage in the Cities: Refuse, Reform, and the Environment, 1880-1980*, College Station: Texas A&M University Press, 1981, p. 29.

²Melvin G. Holli, *Reform in Detroit: Hazen S. Pingree and Urban Politics*. New York: Oxford University Press, 1969, p. 163.

equipment was inexpensive, making the number of competitors for each contract large. And the condition of the streets could be readily observed by all voters, making collusion between the city government and contractors to conceal poor performance virtually impossible. As a result, in no other service was it easier to hire a contractor by competitive bidding and to fire him if he failed to perform, a practice that the government in fact used repeatedly. If competition could ever tame the temptations that contracting out creates, in street cleaning in the 19th century it had its best candidate.

Second, in 1826 the City Council decided to transfer street cleaning to government employees on a permanent basis, a decision that was to be reversed in 1840. Street cleaning provides, therefore, the unique opportunity to examine not only why contracting out was abandoned in favor of "big government," but also why governmental production was abandoned in favor of contracting out.

The availability of sources was another reason to choose street cleaning. When transportation was powered by horses and when toilet basins were often emptied into the streets, the appropriation for street cleaning and garbage collection was the second largest budgetary item after the alms house. In the alms house, however, the expenses were for supplies, not employees. It was, therefore, the department of street cleaning which was the focus of all the attempts to reform the city government, and it was in that arena that the issue of patronage was debated most intensely.

Street cleaning was a constant subject of debate throughout the 19th century, but the intensity of these debates increased significantly during, and immediately after, the Civil War. Street cleaning provided the grounds for a 13 year battle (1857-1868), first between the Democratic City Council and the Republican State Legislature, and then between reformers and workers. Gettysburg, we shall see, had a direct impact on the way that the streets of New York were cleaned (or not cleaned), and the passions that were involved were strong. The responsibility for street cleaning went back and forth several times between contractors and city employees, each time coming under intense scrutiny in

official investigations instigated by the side that opposed whatever was then the status quo. These investigations exposed the most intricate details of the workings of both contracting out and governmental production, resulting in a wealth of information. (These investigations also reveal that the lines between the Tweed Ring and those who are generally credited with bringing its demise were not always clearly drawn. The Citizen Association's occasional support of the Ring is normally depicted as the result of honest mistakes. It turns out that important members of the Association were street cleaning contractors who benefited directly from the Ring actions that the Association supported.)

Finally, street cleaning in 19th century New York has already been impressively researched by historian John Duffy in his book *A History of Public Health in New York City* , and by Martin Melossi in his book *Garbage in the Cities: Refuse, Reform, and the Environment, 1880-1980*. However, these books do not investigate the key issue in the public vs. private production debate: why did contracting out fail? Was one or more of the devices that would have made it work absent?

The picture that emerges from the record is that contracting out failed because enforcement failed. There were no technical reasons for these repeated failures: All the devices that are recommended today to make enforcement effective were in place. Nor was there a breakdown in values: Corruption was more often than not exposed by the government itself, and it is clear that many, perhaps most, government officials were upstanding. If enforcement did not take place it was because the city government did not go beyond protests to impose meaningful penalties on the guilty. Every breach of contract brought about a study of how to fix the system, but rarely did it bring about the punishment of the corrupt. This behavior, which cannot be explained either by a profit motive or by moral feebleness, may be impossible to fix.

After each failure of a contract the cleaning of the streets was passed to city employees as a stop-gap measure. During these intervals, as well as during the period

1826-1840, when city employees had an on-going, if not permanent, responsibility for street cleaning, the cleanliness of the streets improved significantly: Complaints about the service simply disappeared. There were complaints, however, about the cost of governmental production, which was much higher than the cost of the contracts (that failed).

Temptations existed also in governmental production, but as will be seen, these were very different in their nature. The head of a city department could not enrich himself by delivering shoddy services. But this was often the way private contractors enriched themselves. Even when corruption in governmental production was present, its damaging effects were judged negligible in comparison to the damages caused by contracting out.

The roughly sixty -year period that will be investigated can be divided into three sub-periods. During the first, from 1823 until 1826, street cleaning was performed by contractors. Every competitive measure that economists advocate today to make contracting out successful was already used at that time. What *was* missing during this period was a legal prohibition of self-dealing. Nevertheless, it appears that none of the officials in charge had a direct interest in street cleaning during that period. And yet contracting out failed and its failure was so severe that the service was taken over by the city government.

In the second period, from 1826 until 1840, street cleaning was the responsibility of government employees. This transition was largely successful: Cleanliness of the streets disappeared as an issue before the city government for the entire period, although the heads of the department, did attempt some thefts.

The last and longest period is from 1840, when street cleaning was returned to contractors, until 1881, when street cleaning was permanently transferred to government employees. In 1829 a charter amendment barred city officials from having a personal interest in the business of the city. All the conditions that should have made it successful

were, therefore, in place and the city repeatedly attempted contracting out. Each attempt resulted in streets that were filthy and almost all the contracts were rescinded before they expired. Each and every failure was analyzed, and each new contract contained some competitive devices that were absent in the immediately preceding one; the fact that the same devices had already been tried and had proved to be ineffective in the more distant past was ignored. In the intervals between contracts the streets were cleaned by government employees as a stop-gap measure. During these intervals cleanliness was not an issue before the City Council, but the cost of governmental production, which was always about twice the cost of the failed contracts, was.

It is of course not possible to know how clean or unclean a city's streets were in the 19th century. But the condition of the streets under contracting out and under governmental production was a constant subject of discussion at the common council, and this permits us to gage the relative cleanliness of the streets under the two systems. Of course, one must be aware that the discussants were often interested parties.

The pattern that emerges is that whenever the streets were cleaned by contractors there were vigorous complaints by the Council members that they were unacceptably filthy, and in almost all cases the contracts were abrogated. These complaints are particularly credible because, as will be shown, the Council exhibited a strong bias in favor of contracting out and in favor of contractors, frequently paying the contractors even when they abrogated their contracts. When the streets were cleaned by government employees, in most instances there were no complaints at all about the cleanliness of the streets, not even when the Council was deliberating the transfer of the service back to contractors. The explanation given for transferring the service to contractors in almost all cases was either that the cost of governmental production was higher than the cost of contracting out, or simply that contracting out was mandated by the City Charter. We will also see that on several occasions the choice between governmental production and

contracting out was presented by mayors and legislators as a choice between cleaner streets at a higher cost and filthy streets at a lower cost.

Conclusion

Governmental production was introduced for the first time in the U.S. at the end of the 19th century, when Americans came to realize that contracting out had an extraordinary record of failures. But since private parties then, as today, entered into innumerable contracts that were successful, it is no wonder that 19th century Americans asked why government contracts were so different. Their answer was that in governmental contracting out corruption is impossible to avoid.

Why is corruption a bigger problem for the government than it is for private corporations, though? Because they could not answer this question, 19th century Americans let contracting out continue for decades after they had already concluded that it did not work. Only after innumerable fixes had failed did they give in, conceding the reality of the failure of contracting out even though they could not explain it.

This book has presented no theories, only the historical record. I do believe, however, that an explanation does exist and that it is a variation of the "agency theory." According to the economic theory of agency, when the ownership of a company is diffused among many shareholders the managers of that company can get away with serving themselves at the expense of the shareholders. The reason is that with so many shareholders, each individual shareholder lacks the incentive to do the work necessary to discipline the errant managers. Knowing that they are not likely to face discipline, managers can abuse their positions without much fear.

If we think of the government as the management of a firm and of voters as the shareholders of that firm, then it would appear that punishing managers is much easier in the political arena than it is in the private sector. After all, at no cost to them, voters can

"kick the bastards out" at each elections. But the fact is that they don't. The New York City mayoral elections of 1997 offer a telling illustration.

In 1995 New York City signed a contract with a private company, US Servis, to provide a billing system for the city's health maintenance organization Metro Plus. The contractor failed to install and maintain the system, and after a year of non-performance in July of 1996 the New York City Health and Hospital Corporation considered either terminating the contract or at least stopping the payments until the contractor fulfilled its obligations. At this point, however, a non-paid aide close to the Mayor--someone who sat in on cabinet meetings and who was a paid lobbyist for US Servis--intervened. According to the vice president of the City Health and Hospital Corporation, the mayor's aide explained "how important this was to the mayor" and the plan to terminate the contractor was dropped. Instead the contractor was immediately paid an additional \$2.11 million plus another \$3.5 million eight months later, even though the contractor still had not provided the service. The Hospital Corporation's own vice chairman of the board "didn't understand how [US Servis] received \$3.5 million for not doing their job," but was powerless to stop the payment. In February 1997 the President of the corporation declared that "it would take almost a miracle not to default on the company." But the mayor's aide intervened again. Interestingly, the matter was never pursued by the city newspapers although the story was initially covered by the *New York Times*. US Servis was never penalized for its breach of contract.³

The year in which this scandal was disclosed, 1997, was an election year, and the contract with US Servis wasn't the only corruption scandal that the city newspapers exposed. In March 1997 the *New York Times* reported that penalties were lightened for two contractors who had failed to fulfill their contracts. In one case a construction

³NYT, 4/2 p. B1, 1997.

company that was involved in the collapse of a Housing Authority building was permitted to continue to work for the city after intervention by the same mayoral aide who, as it later became evident, lobbied in behalf of US Servis. The authority's staff demanded that the contractor be held in default of its contract, which would have permanently barred it from city contracts.

In a second case a construction contractor performed such shoddy work in a school renovation project that the School Construction Authority tried to terminate its contract "for cause." This classification would have not only affected the penalties for that contract, but also hampered the contractor's effort to get future contracts as well. The same mayoral aide also intervened in this case, and instead of paying a fine the contractor received an additional payment, leaving it with \$7 million of the \$8 million contract. The termination was classified as "for convenience" instead of the potent "for cause." The school's students were not so lucky. Another contractor had to be hired to do the job, and the school opened a year late.

The list does not end here. In March of 1996 the *New York Times* reported that a \$43 million contract to check the eligibility of welfare recipients was awarded by the mayor's top aide (a paid aide this time) to a company that submitted the highest bid (\$8 million over the next highest bid) and was ranked only second by the city evaluation committee.⁴ The winning contractor did offer one advantage: it hired several previous city officials and the son of a close friend of the mayor. In a move that is reminiscent of nineteenth century mayors, Mayor Giuliani declared that his administration would move to bar any and all lobbying of city agencies. To his chagrin he later had to report that he had discovered, after examining the issue, that such a ban would be unconstitutional. A

^NYT, 3/30/96, A27.

month later the *New York Times* reported that a sub-contractor who had been barred from doing business in the State for earlier violations, had been hired to repair fire houses.⁵

If politics worked the way the proponents of contracting out claim it does, Ruth Messinger, Mayor Giuliani's opponent in the elections of 1997, would have made corruption an election theme. The mayor would have then been voted out of office, and a strong message would have been sent to all dishonest contractors and politicians who support them. Even though Messinger's campaign by all accounts lacked a cause, she did not turn corruption in the Mayor's office into an election issue. The focus group she no doubt employed may have told her that voters were willing to forgive the mayor for the corruption of his administration because some liked the clean streets that they believed his administration provided, while others liked the lower crime rates for which they gave him credit. U.S. history is replete with examples of mayors who get re-elected when their corruption is public knowledge. Shareholders of private companies are interested in the bottom line. But voters don't share a single bottom line.

Even voters who are willing to forgive corruption do not have to live with it, however. Replacing contracting out with governmental production eliminates the temptations that are apparently so difficult to resist. This is the lesson that Americans learned one hundred years ago after almost as many years of trying to make contracting out work.

^NYT, 4/30/1996, B1.