

**To Market, To Market:
Caveat Emptor**

Chapter 1 in

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To Market, To Market: Good Practice on Privatization and Subcontracting

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One rainy November day on a visit to Washington, DC, I stumbled into the nearest refuge, which turned out to be the Museum of the Building. No doubt, this is one of the more obscure of the Smithsonian museums and probably least likely to be on anyone's must-visit list. However, what you find inside is a magnificent hall with soaring ceilings, floor and ceiling connected by enormous faux marbre columns. On that first visit, the building was in the midst of renovations after years of neglect. Yet even then, its dignity shone through. What is now the Museum of the Building was built to house workers who processed payments to Civil War veterans, former members of the Grand Army of the Republic. In other words, it was built for public workers who were providing services for former public workers.

So enervated is our opinion of public service today it is a shock to conceive of building this sort of edifice for mere government workers -- bean counters and paymasters at that. At one time, though, and not so long ago, public buildings were important symbols of the might and majesty of our government and, by close connection, of the people. They embodied this country's image of itself as a shining city on a hill. Government service was a calling, and a noble one. Drive through Ohio's county seats, especially in the more rural areas, and you will recapture the sort of buildings once conceived as appropriate for housing government.

Government buildings still symbolize how we view government. Today's government buildings are unaesthetic, bland, even depressing places, built on the cheap. They are demoralizing places to transact the public's business. But, no doubt, if polled, most would agree they are good enough for government workers. Public workers and government work are more likely to be the butt of jokes today than to be held in high esteem. Is it any wonder there is a strong popular movement to shed government work and move it to the private sector? Today the private sector seems to embody our aspirations and is seen as the engine of our nation's prosperity and the best way to improve public services. (Wessel, 1995; Sclar, 2000; Holloway, 1997; Lockheed Martin, 1997; Shays, 1997).

But there is another side to the story of privatization.

On February 20, 1998, the lights went out in Auckland, New Zealand's largest city. It was months before it again had a reliable supply of power. Auckland businesses lost millions of dollars. Businesses tried to stay open by using noisy generators. Diesel smoke filled the air of

fashionable downtown streets. Hundred of companies said they would sue Mercury Energy, the private company that had recently contracted to supply Auckland's electricity. The cause of the blackout and Mercury's lethargic response appear to be the price for that company's drive for increased profits. Once disaster struck, it came to light that Mercury had cut many corners. It failed to do cable maintenance and to have cables in reserve. It allowed cables to remain in place months past their normal life. It had no staff who could do the repairs, because Mercury had disbanded its local squads of cable-jointers who then had left the country in search of work. As a result, Mercury had to locate people with the necessary skills and then fly them in to the country from Australia make repairs. No one in New Zealand with the necessary skills. (Hutton, 1998; Reid, 1998; McNabb & Martin, 1998; Gray, 1998a; Gray, 1998b; Cohen, 1998).

Just a few months earlier, Californians greeted 1998 with the news that a contractor had left the state park reservation system in shambles and absconded with \$1 million of public money. It left no record of reservations, and no new reservations could be made. This was a disaster for a state that depends on tourism. (Tighter Rein, 1998; Phone Line, 1998; Stienstra, 1998; Ellis, 1997). Even when the company was making reservations, its workers were unable to provide callers with information about parks, because it was located outside California, and the reservation clerks had never been in the state.ⁱ

And yet a few months earlier still, the California Supreme Court had found that the Department of Transportation was contracting out engineering work illegally. The court noted the contracted out work cost twice as much as having the work done by public employees. The decision affirms the potential for poorly thought through subcontracting decisions to save no money and to harm the public. Even worse, the circumstances under which the subcontracting decisions were made raise concern that some degree of corruption might have been involved — that the contracts were let in return for campaign donations or on the basis of cronyism.ⁱⁱ Whether these rumors could ever be substantiated, as the Court observed, the cost of subcontracting the work to a private consultant was double that of having the work done by state employees.ⁱⁱⁱ

States may suffer from errors involving privatization in other ways.(Shays, 1997). For

ⁱ Speaking from personal experience, when I had made reservations using these services, the workers were unable to answer any questions about the parks and their facilities, because, at least the one I talked with, were not located in California and had never even been to California. They could provide only the most basic service: making reservations. They could not satisfy other park visitors' needs.

ⁱⁱ The decision in *Professional Engineers* gives the details of a campaign to contract out this work in defiance of law – not only once but again and again.

ⁱⁱⁱ These problems are not isolated. The privatized Denver bus costs increased 100% in same period publicly run lines increased 11%. (Sclar, 2000: 87). In 1991, for example, Los Angeles canceled a five-year vehicle-repair contract after an audit showed it had cost \$1 million more than expected and had not performed up to the contract's standards. (County Cancels, 1991; Pasternak, 1989b; Pasternak, 1989a).

example, Missouri taxpayers faced liability for the beating of Missouri inmates by the employees of a private prison company in Texas and for costs and fees to defend suits. (Rudd, 1997; GAO, 1996: 2 n.4)^{iv}Ill. Comp. Stat. § 140/2 (West 1999). More can be lost than just money. Residents of Ellijay, Georgia learned that three years worth of water quality records were falsified by the private company operating their sewer system.(Rudd, 1997). The British suffered even more: illness and death followed problems linked to subcontracting. In fact, Britain's private water companies put public health at risk on more than 500 occasions over six years. (Poulter, 1999; Private Water, 1997).

These stories have been repeated across the country and around the world. They are mentioned here, not to condemn privatization as inherently bad, but, rather, to raise the need for caution and circumspection in subcontracting. Serious – even deadly – consequences hang on these decisions. Privatization has been taking place for a sufficiently long period of time one would expect the process to be well-regulated. The shocking truth is that it is not regulated in the overwhelming majority of states and barely regulated in the rest. Only Alaska, Colorado, the District of Columbia, Kansas, Kentucky, Louisiana, Massachusetts, Montana, and Utah provide anything approaching comprehensive regulation of government subcontracting. Other states have piecemeal legislation or legislation directed only to specific programs. This is imprudent at best and is a disaster waiting to happen at worst. Despite this, what we have seen since at least the 1980's is a massive movement to privatize public services of all kinds (GAO, 1997:2) without the benefit of uniform and well thought through regulation.

The claims made for the benefits of privatization are many and portentous. Privatization is supposed to have all the virtues attributed to the market and competition: to provide the best service at the lowest price. So strongly held are these assumptions by some that several years ago, and even now, it is possible to claim, and face no demand for proof, that the public sector is always inefficient and more costly and that the private sector always provides superior services. It is astounding that, for such an important area, there have been few useful, comprehensive, nonpartisan studies. Even studies that find lower costs for privatization have, upon investigation, been found to provide no guidance on privatization decisions. The GAO, for example, found that studies concerning prison privatization offered “little generalizable guidance for other jurisdictions about what to expect regarding comparative operational costs and quality of service . . .” (GAO, 1996:3) It found that some focused only on specialized inmate populations; others

^{iv} Illinois has banned privatizing prisons:

Sec. 2. Legislative findings. The General Assembly hereby finds and declares that the management and operation of a correctional facility or institution involves functions that are inherently governmental. The imposition of punishment on errant citizens through incarceration requires the State to exercise its coercive police powers over individuals and is thus distinguishable from privatization in other areas of government. It is further found that issues of liability, accountability and cost warrant a prohibition of the ownership, operation or management of correctional facilities by for-profit private contractors.

had serious methodological weaknesses, such as using hypothetical facilities or nonrandom samples; contexts differed so greatly they might not apply outside that context; and other factors, such as the age of the system, had an impact.(GAO, 1996:3).

Ideas that privatization is always better and can foster any goal have even been incorporated in or at least shaped legislation in some state statutes. For example, the goals to be achieved by privatizing the Arizona works program for welfare recipients are:

1. Fostering the development of responsible and productive citizens through program administration that provides participants with incentives to achieve self-sufficiency.
2. Making certain administrative processes more efficient and cost-effective.
3. Encouraging innovative partnerships with organizations that enhance the Arizona works program.
4. Providing an opportunity for a system that is heavily dependent on human interaction and subjective determinations to offer performance incentives for employees and the flexibility to hire and promote successful individuals.
5. Ensuring that applicants who are qualified for benefits in the department of economic security empower redesign program, including any income disregards, are automatically qualified for the Arizona works program.

Ariz. Rev. Stat. § 46-342 (1999). While some of these may be reasonable goals for such a program, there is nothing about privatizing the program that necessarily would lead to achieving them or to achieving them more successfully than would public administration, in particular numbers (1), (4) and (5).

Logic and a more realistic assessment of market processes suggest that privatization is likely to have the sort of flaws all human institutions do. Indeed, greater experience with privatization has already provided the opportunity for a better, more realistic understanding of public services and contracting out to which an overly simplified theory should long ago have

given way. We know that spectacular privatization failures have occurred, costing taxpayers money and lost services, leading to cost overruns and flouting environmental and other laws. (Shenk, 1995: 16). The question is how to use this knowledge to prevent failures and, where failure nonetheless happens, how to soften its impact.

Even those strongly committed to the market should not be opposed to creating safeguards for subcontracting. Certainly this is an area in which ideological lines are drawn. However, blind ideological commitment to privatization creates an obvious danger of victimization. Much is at stake when public work is subcontracted, so it should be easy to accept that it is wise to be cautious.

On the other side, rigid opposition is not appropriate. Government has always contracted with the private sector for some services and goods it would rather buy than make, such as paper, computers, pens, and many other items readily available on the market. However, although some items can be successfully purchased by the market does not mean all can. The problem is ascertaining which can best be provided by the market and which can not.

Recent experiences with privatization have given us the ability to generate a more realistic -- hence, more complex -- understanding of the nature of government services. Economist Elliott Sclar points out that the debate on how to provide public services offers “a valuable opportunity to meaningfully improve public service. The debate . . . presents us with a rare chance to move the issue of improving the efficiency and effectiveness of public service provision from the policy back burner to the front.” (Sclar, 2000:5)

A. Using What We Know -- Guidelines for Policymakers

Privatization is a blanket term that includes different ways of shifting from publicly to privately produced goods and services:

- (1) the cessation of public programs and disengagement of government from specific kinds of responsibilities;
- (2) sales of public assets, including public lands, public infrastructure, and public enterprises;
- (3) financing private provision of services – for example, through contracting out or vouchers – instead of directly producing them; and
- (4) deregulating entry into activities that were previously treated as a public monopoly.

(Starr, n.d.; *see also* GAO, 1997:1)

Here, the focus will be almost solely on the third -- contracting out or subcontracting -- and, to some degree, on the first.

Beyond soliciting bids and awarding contracts to the lowest bidder, is there anything more that should be considered in subcontracting and, if so, what and why? To answer that question, it is first helpful to step back for a quick overview of some of the economic issues involved in public versus private provision of goods and services. All too often an appealing but overly simplistic model of the market is used as a basis for explaining privatization, one that stops at competition and never goes on to take into account the well-known problems that occur

when markets do not work. For anyone who doubts there are such problems, just consider jokes about military purchases of toilet seats and screwdrivers. In fact, defense department purchases can be thought of as a massive privatization scheme where the government tries to get private companies to meet specifications as to quantity, quality, and price and where there have been constant failures to achieve these. These failures warn us that having the private sector provide will not automatically solve all problems of quality and cost.

Privately provided services are nothing new. In fact, there has always been a tension in U.S. history and elsewhere over whether the government or the private sector can best buy or make a service or product. In other words, privatization is not a big new thing that will remake the world.

Economists and others conclude that many services can only be effectively provided by government, for example where continuity of service is essential, where no profits are generated, and where no competition exists or can exist. Many government services are natural monopolies, where there is naturally no competition and, thus, no market impetus to improved service at lower cost. In addition, in some situations bigger does mean cheaper, so that the first big provider can drive all competitors out of business because it can undercut their prices and still make a profit. Once it has a monopoly, it can then charge whatever price it wishes. Once it has a monopoly, it can then charge whatever price it wishes. In this situation, the public cannot rely on the market but, rather, needs government to run or regulate the natural monopoly.

Indeed, it is for these sorts of reasons that many services came to be provided by the government. Welfare, child protective services, roads, public health, education, and many others began as private services, but problems of corruption, predatory pricing, and poor quality eventually led government to take them over in an effort to promote the public welfare. Other related problems led to establishing the Civil Service and its rules which attempt to prevent corruption and thus a failure to serve the public interest.

It is always a mistake to assume without investigation that the past can teach us nothing. Before engaging in a single-minded pursuit of privatization, it is worth considering whether these problems existed only under very different circumstances or whether we may be blindly heading down a track where we will be condemned to repeat the lessons of the past. We need to ask: when markets are not competitive can the private sector improve on public sector performance even as they fall short of the competitive ideal. (Richards, 1996:141; Sclar, 2000:69-93). Although it is possible to attempt to create a market by dividing a public service into smaller units, this may lead to greater inefficiency, lack of coordination, duplication and thus greater expense. (Sclar, 1989:18, 27) Indeed, competition may not be possible in all parts of the country and may be a particular problem in rural areas and where technical expertise is needed. Privatization of many sorts of services may suffer from cherry-picking, that is, when private companies are allowed to operate only the profitable parts of a service, leaving government with those that are most expensive to serve.

Many public services are public goods. In economists' terms they generate positive externalities, that is, they have positive side-effects which cannot be confined only to those who pay for them. (Heilbroner & Thurow, 1994:186-93). Vaccination, for example, protects both the one vaccinated and others who are at less risk of contracting the disease because the pool of potential carriers is smaller. Street lighting is a classic example. Education benefits not only the one who receives it but also those who gain by having a more educated populace. Public goods

create a temptation to become a free rider, to get the benefits without paying. Under these circumstances, soon no one will be willing to pay for the service or good., so it must be provided by government if it is to be provided at all.^v

In many cases, government services are ones for which price competition is not as important as assuring guaranteed results. We want the Center for Disease Control to track down and prevent threats to the public health far more than we want the CDC to operate cheaply or at a profit. A private vendor may not have as much interest in controlling disease as increasing the price of its stock and returning value to the shareholders.

Finally, a subcontractor's need to add profit and its higher cost of borrowing (Sclar, 2000:105) create a hurdle that make it harder for the private sector to deliver projects and services at lower cost.^{vi} Indeed, a March 1994 General Accounting Office report found government could save millions of dollars by performing certain functions directly rather than by subcontracting the work to private contractors. (Hannah, 1997)

All this is not to say that all work that is currently performed by government must stay with government. Rather, we must recognize that, just as there are things the private sector does well, there are rational reasons why government has come to perform many services, and, if we examine a service objectively, we may decide that these reasons require it to remain publicly provided. The question is how to provide that objective scrutiny.

Subcontracting decisions must take into account both substantive concerns – that is, what are the benchmarks and standards to be applied to measure performance – as well as procedural concerns – what is a fair, honest and reasonable way to make decisions as to subcontracting. Most fundamentally, better decisions will be made by establishing standards and procedures in advance rather than trying to deal with privatization through ad hoc decisionmaking.

Uniform substantive criteria that establish benchmarks subcontracting must assist the decision maker who, otherwise, lacks guidance in making important decisions; mean that reasoned decisions are made; ensure that oversight can be and is exercised; and protect the public welfare if problems arise and a contract must be terminated.^{vii} Indeed, in terminating a contract, as elsewhere with privatization, simple remedies may not be effective. Educational Alternatives (EAI) actually preferred that the Baltimore school district terminate its contract to having to meet its requirements. As a result, terminating the contract -- a common remedy for a breach -- was

^v Elliott Sclar provides a different breakdown differentiating public services from private markets. (Sclar, 2000:23-28).

^{vi} Indeed, the Freedom From Government Competition Act (S 314, HR 716) which was introduced in 1997, implicitly recognized this. It required federal agencies to procure all goods and services from the private sector except for those which are inherently governmental functions or deemed critical to national security, as well as those where the private sector fails to meet government needs or where the government provide the best value. (Flynn, 1997).

^{vii} Terminating a contract may not be a useful remedy if the contractor would prefer that to having to meet the contract's requirements, as was the case with EAI. Craig Richards, et alia, *Risky Business: Private Management of Public Schools* 154 (1996).

not a useful remedy. (Richards, 1996:154) Procedural safeguards provide a reasonable process that ensures decision making is transparent, due process is given, and the public interest is furthered.

Substantive criteria and procedural safeguards foster uniform procedures within a state or city (GAO, 1997:10-11) and allow decision makers to capitalize on an administration which is trained and experienced. Freeing decision makers from having to invent standards in each instance frees them from worries they might have overlooked relevant criteria. As a result, articulated standards make the process of subcontracting more streamlined, less cumbersome, more accurate, and less costly. The processes embodied in state legislation as well as experience provide a useful starting point for exploring what should be included in subcontracting decision making and why it should be there.

Substantive Criteria

Substantive criteria must address problems which experience with subcontracting have revealed. States which have legislated subcontracting standards also provide useful insights into the range of requirements to be included. Once these substantive criteria are developed, they can be inserted throughout the process of making privatization decisions wherever the decision maker feels they are relevant.

Determining policy goals: States which advocate privatization -- rather than taking a more balanced approach -- implicitly assume that privatization will always and automatically achieve improved public service at lower cost. Arizona, for example, requires that the administration of its welfare program be contracted out. (Ariz. Rev. Stat. §§ 46-300.01, 46-342, 46-343 (1999)). This demonstrates a strong faith in the value of privatization but offers no opportunity to test that faith.

Furthermore, it fails to recognize that the goals of public service have always been larger than merely providing a service at the lowest cost. Public education, for example, is intended to do more than merely teach reading and writing or simply prepare students to join the workforce. It is intended to support our democracy by ensuring all citizens can take on the task of self-governance and to transmit a sense of shared identity. The Postal Service delivers mail, but more important is its role in helping knit a very large country together and in promoting productivity and democratic engagement by ensuring all residents in every area, no matter how remote, can communicate. A highway gets a traveler from point A to point B, but a network of public highways that reaches even remote, less traveled areas unites the country and promotes commerce. It is important then to bear in mind that, although discrete parts of these goals can be run at a profit, the whole may not be profitable, because some parts can not be made profitable.

Furthermore, achieving larger goals vital to us as a nation may be priceless but cannot always be done at a profit. Thus, while it is possible to educate people, deliver mail, and operate tollroads at a profit, it is not necessarily possible to educate all people, deliver all mail and provide a network of highways and make a profit. Indeed, for many of these services, the value of having the whole system is far greater than the sum of its parts and particularly of its profitable parts. Although value for money is important, there is no reason to think that these traditional social goals of government are no longer important. Thus, where they conflict, a

decision must be made as to which trumps and how all are to be accommodated.

Some states have taken a more holistic view of privatization and its goals than has Arizona. The District of Columbia, for example, requires a demonstration that privatization involving services essential to health or safety will not adversely affect the recipients. (D.C. Code § 1-1181.5b(a)(9) (1999); *see also* D.C. Code § 1-1191.3(b)(6) (1999)). Massachusetts expresses a particularly wide range of goals in its privatization policy:

The general court hereby finds and declares that using private contractors to provide public services formerly provided by state employees does not always promote the public interest. To ensure that citizens of the commonwealth receive high quality public services at low cost, with due regard for the taxpayers of the commonwealth and the needs of public and private workers, the general court finds it necessary to regulate such privatization contracts

(Mass. Ann. Laws ch. 7, § 52 (1996)). Massachusetts is not at the opposite end of Arizona; it does not forbid subcontracting. But it is at the opposite end in looking at privatization with open eyes rather than blind faith. Taken together the values articulated by these states provide a good starting point for policy makers in establishing their own goals.

Preventing fraud, criminal activities, and the spoils system redux: Government agencies face a number of risks when fraud, criminal activities and neo-spoils systems arise in connection with privatization. They mean services are not being provided, value is not being received, or revenues are being syphoned off. In addition, if care is not taken, the agency may find itself legally liable for the contractor's misdeeds as well as practically liable when it must make up any short fall. These problems must be addressed before contracting out; remedies and other protections must be in place before hand should problems nonetheless arise during the term of the contract.

Most fundamentally, subcontracting decision making must be pro-active. It must bar individuals and companies who have engaged in past criminal activities.^{viii} The vehicle-repair contractor Los Angeles fired for costing \$1 million more than the contract amount and for poor performance was being investigated at the time the contract was entered into for criminal activity

^{viii} The State of Michigan awarded a contract to Correctional Medical Services Inc. of St. Louis., a company that was under indictment for causing the death of an inmate in North Carolina. One of its doctors who lost his license to practice in Michigan for having sex with his patients was hired by the company to run statewide psychiatric services in Alabama. An opinion from an Idaho judge stated that care provided by the company had been more like "physical torture than incarceration" in the case of one inmate. (Putnam, 2000).

in the management of a \$250-million service contract at Redstone Arsenal, the Army's missile headquarters in Huntsville, Alabama, including a 262% overcharge. Despite this knowledge, ardently pro-privatization city council members decided to enter into the contract. (County Cancels, 1991; Merina, 1998). Studies and reports have disclosed instances in which services contracted for have not been performed or outright theft and misfeasance have occurred. Other contractors have violated state and federal wage and safety requirements. Some have been repeat violators. Considering the essential nature of most government services and the sensitive content of others, those entrusted with performing them must not use their positions as an opportunity to loot the public coffers or put the public health and welfare at risk; government cannot turn a blind eye to problems such as corruption and illegality no matter how enticing a low bid may appear. (Sclar, 2000: 151-55)

Other actions, while not crimes, may verge on the fraudulent and thus subvert the intent of subcontracting. Before awarding a contract, an investigation should be made to determine whether a subcontracting situation involving managed competition -- that is an attempt to create a market by dividing a service and offering those parts for bid -- involves real competition rather than private employers dividing up jobs in a way so they do not actually compete with one another. This is easy to do when contracts are offered for different routes or geographic regions. Although the service is provided in parts and by apparently different providers, they do not really compete with one another under these circumstances. Ostensibly independent bidders on bus service in Denver actually had an interdependent relationship at the national level. As a result, bus lines run by differently named companies were a de facto monopoly. (Sclar, 2000:87-88).

Another recognized problem has been that of patronage. Colorado declares its policy concerning privatization to be encouraging the use of private contractors to achieve increased efficiency, however, "without undermining the principles of the state personnel system requiring competence in state government and the avoidance of political patronage." It bases this policy on a recognition "that the ultimate beneficiaries of all government services are the citizens of the state of Colorado" and therefore declares its intent "that privatization of government services not result in diminished quality in order to save money." (Colo. Rev. Stat. § 24-50-501 (1998); Colo. Rev. Stat. § 24-50-503(f)(III) (1998)).

This issue can affect subcontracting in many ways. If contractors employ former government officials this effectively create a vested interests in having contractors, and this can affect whether decisions are made in the public interest. (Richards, 1996:174) Subcontracting standards must thus address whether members of a subcontracting decision-making or oversight body are to be barred from or limited in accepting employment with a contractor. (Ok. Stat. § 595.4 (1999)). They need to consider whether others might be improperly affected if they are allowed to accept employment with a contractor, even though they do not serve on an oversight or decision-making body. An example would be high public officials and administrators of an agency when less than the entire workforce is subcontracted.

Those who continue to administer the part of the agency not privatized should perhaps also be barred from accepting employment with a contractor. (*Cf.* Ky. Rev. Stat. Ann. § 11A.130 (1998); Mass. Ann. Laws ch. 268A, § 5 (1996)). A decision must be made as to whether there should be limits on whether any of these administrators, board members, or officials may work for lobbyists who represent current or potential subcontractors or bodies advocating positions on privatization. Finally, if there are to be bars, details must be worked out as to their geographic,

subject matter, and time limits.

Even with the best prior investigation, it is possible to have missed a problem in this area or to have one arise with no predecessor evidence. That vulnerability can take two forms. One is having to intervene quickly to ensure continuity of service. The second is limiting government liability for the contractor's misdeeds. Government should not leave itself vulnerable to these occurrences.

One obvious method of preventing the first is requiring contractors to impose the sorts of requirements contractors on large building projects face. These can include posting bonds and securing insurance. Other methods of being pro-active about these problems are implicit in the other protections discussed throughout this chapter.

When illegalities or tortious actions take place during the term of a contract, or serious disbaring activity is discovered then, the government should have the right to immediately terminate the contract and step in. (Rudd, 1997). This may need to be negotiated in the contract but should also be provided by law.

Taxpayers must be protected from liability for the actions of subcontractors. Colorado, for example, provides that the contractor bears the liability for its actions and may not plead sovereign or governmental immunity as affirmative defenses for any acts arising from the performance of its contract. (Putnam, 2000). This is not as simple as it may appear. While taxpayers should not be liable, it may be impossible to avoid paying extra -- at least in the short run -- to ensure other taxpayers do not suffer a loss when the contractor proves unreliable. In addition to tort or tort-like liability, a state may find itself ultimately liable for unpaid bills. The State of Michigan terminated a contract with its private prison health care provider but then found itself liable to pay 40% more for the contract of the successor who had paid off \$12 million of its predecessor's unpaid bills. (Putnam)

Apples and Oranges: Making Costs Comparable: Any shopper knows that sales figures, markdowns and discounts can not be taken at face value. The "original" price may be exaggerated, or the item offered may not be of the same quality or offer the full range of features as the comparative. The same ideas apply to subcontracting.

It goes without saying that it is impossible to know if money will be saved without reliable information on the existing service and comparable costs and quality attributed to both the existing service and the subcontracted service. This means there must be a two-step process. A crucial early step is deciding which costs are properly included. Experience has shown that obtaining precise and complete cost data is no simple matter; as a result, most government agencies have used only estimated cost and performance data in subcontracting. (GAO, 1997:5, 12, 13-14) This is unacceptable. Without accurate data, it is impossible to be certain subcontracting benefits the taxpayers. Discussing accounting issues with private firms as part of the process of assessing costs can be helpful in gaining a better understanding of cost and quality issues. (GAO, 1997:13).

Assuming that accurate and complete cost data for the public service is obtained, it is then essential that comparable costs be used in assessing both the public and private provision of the service. Unfortunately, experience has also shown this does not always happen. Problems of comparability can occur when only part of a service is subcontracted -- and especially when that part is less expensive, leaving the government to provide the more expensive part. For example,

it would be inappropriate to compare the costs of running private prisons with government prisons if private prisons are all low security and government runs high security prisons. (Shenk, 1995:16) Thus, part of comparing and determining, just as when individual consumers shop, is determining the quality of the items being compared is the same.^{ix}

One common problem is that overhead costs are included in the public service's costs because they are imbedded in the department's budget but are not included in the contracted-out service's costs, even though those same overhead and oversight costs continue. This means that services could be privatized even though they were actually being done more economically by public sector workers. Indeed, failing to have comparable cost accounting makes it impossible to avoid wasting public money. Thus, overhead and other costs must be included in the cost of providing the privatized service if they would continue with a contractor.

Omitting these costs is more than avoiding mere "bean counting." If they are not included, no oversight may take place, and, as a result services may be improperly performed or not performed at all. For example, in February 2000, the Michigan Auditor General reported that the state had paid \$26 million to United Correctional Managed Care of Anaheim, California, but the company had spent only \$17 million on inmate health care, leaving \$9 million unaccounted for. The contract was terminated and the successor company had to pay out \$12 million to cover its predecessor's unpaid bills. It then negotiated a 40% increase in its contract to reimburse it for these unforeseen costs. (Putnam, 2000). It cannot be said too often that unless there is specific provision for them, oversight costs are easily overlooked. Once the service is subcontracted, they might be omitted from the agency's budget. If there is no money to fund oversight, it will not be done.

Privatization proponents might argue that no oversight is necessary, that the market will ensure performance. Albany's experience with subcontracted vehicle maintenance demonstrated that oversight was necessary and that the associated costs were substantial. They included spending money to re-engineer its voucher and data-processing system, buying additional computers, and employing additional auditors and expert mechanics. (Sclar, 2000:104-05, 116-17)

Proper oversight in the right – or, wrong – circumstances may make the difference between life and death. This is not only a problem in public sector subcontracting but, rather, is imbedded as a problem when different organizations or even departments must coordinate their activities. There is always a danger of things falling through the cracks, and subcontracting creates cracks in the structure of an enterprise. A major cause of the 1996 ValuJet crash was found to be a subcontracting arrangement that failed to provide definitively for oversight of critical functions. (Sclar, 2000:16-18) Oversight was omitted because it appeared to save money;

^{ix} A similar problem can occur when comparing costs from one state to another. Geraldine Jensen, President, of the Association for Children for Enforcement of Support, Inc. contended that Lockheed Martin IMS was receiving seven times as much money in Maryland as Virginia for doing exactly the same type of work. She asked: "Who is responsible for monitoring contracts states have with private vendors?" (Jensen, 1997) Jensen may be correct in her concern, but different states, even adjacent ones, may have different legislative, economic and other considerations that mean the work is not exactly the same.

however, in hindsight we can see that the costs avoided were far less than the financial and human costs of the crash.

Unless oversight costs are included in the budget, this essential function is likely to be overlooked. On the other hand, when it is included – and included at an appropriate level – people can be hired whose work is dedicated to oversight and those paying the bill are more likely to take steps to ensure they are receiving value for money.

Another easily overlooked cost – but a real one nonetheless – is the cost of converting or transferring the service to the private sector. Someone must bear those costs, and they have the potential to be large enough to consume any apparent cost advantage. Arizona includes costs of “conversion, transaction, disruption, contract monitoring costs, and revenue increases and decreases related to a privatization.” (Ariz. Rev. Stat. § 41-2773(6)(a) (1999); *see also* Colo. Rev. Stat. § 24-50-503(1)(a)(II), (III) (1998)). Arizona further defines “total costs” as “all costs borne by an agency to provide a state function including all indirect costs and applicable allocated costs.” (Ariz. Rev. Stat. § 41-2771(9) (1999)). It, however, does not require a preliminary study to ascertain these costs, although such a study may be undertaken. (Ariz. Rev. Stat. § 41-2773(4) (1999)).

The issue of proper cost allocation is complex and, for that reason, alone, can easily be mishandled. Each agency and state must undertake a study to identify and accommodate its idiosyncratic needs. In addition to overhead costs and transfer costs, agencies should include training or retraining costs which will be incurred in any transfer to ensure that the contracted-for level of services is provided, (Ky. Rev. Stat. Ann. § 45A.551(2)(e) (1998)).

Special Problems in Setting Financial Criteria: Privatizing government services is founded on the idea that markets set the proper price, and where there is no market, as when government provides a service or where there is a monopoly, the price will be too high. (Heilbroner & Thurow, 1994:173-205) However, there are a number of reasons that this may not happen. Most fundamentally, there may be no market to provide the sort of services government does, because many government services are public goods. (Heilbroner & Thurow, 1994:186-93) Even where analogous services are provided privately – the “yellow pages” test – they may not be fully comparable. (Sclar, 2000:28-32) Ostensibly similar services may in fact be different because government may have different goals than a private business. With no market for the services to be subcontracted, it becomes difficult to feel assured that a proper price has been set.

Testimony by Geraldine Jensen, president of the Association for Children for Enforcement of Support, Inc. (Aces), exemplifies this uneasiness. Jensen testified that “private vendors appear to vary prices charged for the same services provided. PSI charged Ohio, \$22,130, PA- \$34,190, WV - \$20,082, SD - \$11,800, AR\$10,000 and RI \$7,000 to review and update their child support guidelines. States seem to be unaware of the usual market price for services rendered. This information is needed to negotiate contracts.” (Jensen, 1997) In fact, the differing prices could be the result of truly different services contracted for in these states and different conditions in which the contracts must be performed. On the other hand, price differences of over 50% in adjacent states and as much as 500% from the lowest to highest price could be, as Jensen fears, an artifact of factors other than value provided or cost of rendering the service. With no market to set the price, it is reasonable to feel uneasy.

Special Problems in Setting Nonfinancial Objective Criteria: Government services are often spoken of as essential services -- in fact, so essential that most public employees are not allowed to strike. (Wollett, 1993: 252-87) Whatever the merits of the right to strike, its ban implicitly recognizes that people depend on public services and on their being of high quality. For example, although trash pickup may seem to be mundane, undesirable work, we all know that failure to pick up and dispose of trash properly creates serious health risks. Water is another example. We all depend on access to uncontaminated water supplied in sufficient amounts. It would be absurd to think that people would support privatization -- no matter how much money it saved -- if it meant receiving contaminated water and inadequate supplies, a problem that occurred with privatizing water in England. (Poulter, 1999; Private Water, 1997)

Continuity of service must certainly be included among important nonfinancial considerations. Public agencies must consider how this can be assured when work is performed by a private contractor whose workers have the right to organize, bargain collectively, and strike. Indeed the right of private sector workers to strike was cited by the Justice Department as a reason not to privatize certain prison facilities. (GAO, 1996:1) For those states where public sectors do not currently have the right to bargain collectively or to strike this will entail a major change in relationships.

If public work is indeed essential, this also means subcontracting cannot be done solely or primarily on cost while ignoring qualitative benchmarks. An important step prior to advertizing for bids is setting measurable quantitative and quality standards. These can be developed as part of setting a baseline as discussed below. As difficult as it can be to account for all costs, setting qualitative standards is much more difficult. The GAO's discussion of quality standards applied in studies of prison privatization provides some good examples of the sorts of problems that must be deal with:

The concept of "quality" is neither easily defined nor measured. For example, although the American Correctional Association (ACA) sets accreditation standards for prisons, accredited facilities can vary widely in terms of overall quality. According to ACA officials, such variances occur because ACA accreditation means that a facility has met minimum standards.

Generally, however, assessments of quality can take several approaches. For example, one is a compliance approach, that is, assessing whether or to what extent the prisons being compared are in compliance with applicable ACA standards and/or court orders and consent decrees. Another approach is to assess performance measures. For example, measures of safety could include assault statistics, safety inspections

results, and accidental injury reports.

(GAO, 1996:4-5)

For example, one GAO study reviewed surveys of correctional staff and inmates at one institution concerning quality of services there. The results directly contradicted one another. (GAO, 1996:9) This demonstrates both the difficulty of trying to make quality assessments of complex services objective and thus comparable and also the importance of relying on multiple sources to attain a full assessment. (GAO, 1996:13)

Qualitative measures may also be difficult because professional judgment involves applying conflicting values based on complex, shifting and unpredictable situations. GAO's Mark Nadel observed that "setting clear goals and measuring performance can be difficult. For example, programs may face competing or conflicting goals. In child welfare, program managers and workers must reconcile the competing goals of ensuring the safety of a child, which may argue for removing a child from his or her home, with the goal of preserving the family. As a result, measuring success may be difficult in some cases." (Nadel, 1997) Furthermore, a decision must be made whether quality should be measured based on inputs or outputs. (Richards, 1996:145) It may be argued that public services have functioned without such detailed criteria; therefore, a private provider should also be able to. However, a private provider may not have a clear stake in the service's success but, rather, in its stock's success and in projecting an appearance of success in enriching its shareholders. (Richards, 1996:76)

These difficulties do not mean that quality benchmarks should not be set. While it may be impossible to set perfect standards, it would clearly be an abdication of responsibility to set none and thus to make compliance oversight impossible. The proper standard would be to set quality benchmarks to the best degree humanly possible. Where setting qualitative benchmarks is not possible, this may suggest that privatization should not take place. Indeed, some government agencies have decided not to subcontract certain services precisely because it was too difficult to define and measure performance and then to express those standards in a contract. (GAO, 1997:17)

Once qualitative standards have been set, bidders must be required to demonstrate they could meet or exceed these criteria. National Association of Government Employees legislative director, Christopher M. Donnellan told a congressional panel:

Contractors are able to present the agency with a seductive package of cost reductions by reducing the level of services. Inadequate investigations of the statement of work by the agency allows the contractor to achieve this result. In the interwoven environment of a federal installation, any reduction in support or related services will have a domino effect on the agency's capacity to perform.

(Hanna, 1997) Guarantees -- not mere assurances -- must be required. Documentation -- not mere

statements of good will -- is necessary to prevent low-ball bids^x or awarding contracts to those unable to perform the work -- either because they do not have the expertise or have submitted such low bids they will lack the means to operate. (Sclar, 2000:88 n.14) This means bidders would need to provide sufficient detail as to their sources of financing and how they plan to meet the requirements and to back this up with objective evidence they, in fact, could meet them. Necessary evidence includes the bidder's past track record in performing similar work and compliance with government environmental and labor regulations.^{xi} Agencies may want to be pro-active by sharing information as to price, performance, and vendor qualifications to ensure competitive prices and to guard against subcontracting to poor performers.^{xii}

Massachusetts is a model in this area. It demands supporting evidence and requires the head of the agency and the commissioner of administration to certify in writing to the state auditor, that the quality of the services to be provided by the bidder is likely to satisfy the established quality requirements and "to equal or exceed the quality of services which could be provided by regular agency employees" provided in the most cost efficient manner; that the contract cost will be less than the estimated cost based on best practice; that the contract takes into account compliance with all relevant statutes concerning labor relations, occupational safety and health, nondiscrimination and affirmative action, environmental protection and conflicts of interest; and that the proposed contract is in the public interest. (Mass. Ann. Laws ch. 7, § 54(7) (1996)).

Essential information includes details as to the number of workers who will be performing the work. Only in this way can there be an assurance that the bidder is not low-balling the bid and can actually perform the work. Experience has shown that assurances as to staffing levels cannot be left to the subcontractor on the assumption that it will be disciplined by the market.^{xiii} The market is more likely to discipline the public who will face losing vital services if the subcontractor cannot perform. In other circumstances, the contractor may provide poor services, but this may go undetected if the client population is incompetent or a despised

^x See Colo. Rev. Stat. § 24-50-503(1)(a) (1998). Initial bidding on privatized Denver buslines involved low-ball bids which quickly doubled. (Sclar, 2000:86, 109-13).

^{xi} Wackenhut has received contracts to run prisons, despite having compiled a troubled record. (Kolker, 2000b).

^{xii} Geraldine Jensen, President, the Association for Children for Enforcement of Support, Inc. (Aces), stated, "We are concerned not only about the poor collection performances but with the apparent price gouging. Lockheed Martin IMS is receiving seven times as much money in Maryland as Virginia for doing exactly the same type of work. Who is responsible for monitoring contracts states have with private vendors?" (Jensen, 1997).

^{xiii} When asked about including this information, OMB's acting director for management, G. Edward DeSeve, responded that it was too expensive to collect this information and, in addition, there was no need to. He said that he was not willing to "assume that the competitive process required under the current federal acquisition regulations is insufficient to establish appropriate prices and quality levels." (Hanna, 1997).

and powerless group. If information nonetheless leaks out, the government agency will be in the unpleasant situation of being forced to decide whether to terminate the contract or step in and whether it has the ability to resume operation quickly. Wackenhut, for example, was forced to provide more training for guards and recruit additional employees after a local Michigan newspaper reported dangerous conditions in the youth correctional facility it was running, and the state was forced to route youth offenders to other facilities until the problems were resolved.^{xiv} (Kolker, 2000b). When Educational Alternatives, Incorporated (EAI) was unable to meet educational qualitative criteria, Baltimore was forced to decide among difficult courses of action to prevent the collapse of the school system. (Palast, 2000; Green, 1997; Thompson, 1995).

Just as establishing uniform and reliable standards and procedures for cost accounting can assure good decision making and avoid reinventing processes -- and risk omitting necessary considerations -- for each bid decision, so too should uniform standards be set for ascertaining desired levels of service. To the extent possible, these guaranteed levels of service should specify objective measurable standards and consequences for failing to achieve them. Contracts with performance criteria linked to rewards and penalties provide an incentive for the contractor to do a good job and also mean there can be claim it misunderstood what it agreed to. (Richards, 1996:145) When a subcontractor can determine the level of services it is to provide and must also pay for additional services it finds necessary, it is given an incentive to find them unnecessary. (Putnam, 2000)

Some current subcontracting laws require a subcontractor to demonstrate it can guarantee specified savings and higher level of quality. For example, the District of Columbia requires evidence of a 5% savings. (D.C. Code Ann. § 1-1181.5b(a)(1)(3) (1999)). Florida requires a savings of at least 7%. (Fla. Stat. Ann. § 957.07 (1996)). Arizona does not set a benchmark level but, rather, requires the office in charge of privatization to “develop minimum savings criteria for governing the award of contracts resulting from the competitive government process.” (Ariz. Rev. Stat. § 41-2773(5) (1999)).

Mandating specific savings and requiring the subcontractor to demonstrate its ability to achieve them and the means by which it plans to do so is a prudent and reasonable requirement. There is no reason to subcontract unless there is strong evidence better work can be done at less cost. Subcontracting comes with a cost in terms of upheaval, risk and unforeseen consequences. Therefore, there should be a good reason to do it – demonstrably lower cost and guaranteed better service – unless a legislature has decided that privatization must take place for purely ideological reasons without regard to the public welfare. The factors to be considered in subcontracting are complex and can not be fully accounted for nor reduced to objective criteria; thus, even under the best of circumstances, relevant factors may be overlooked. Mandating a margin of demonstrated improvement is a way of taking these problems into account and is, in reality, a way of ensuring that the service is not worse and costs are not higher than before

^{xiv} One additional problem was that the facility was housing inmates older than seventeen in violation of state law. However, Michigan’s contract with Wackenhut guaranteed an occupancy level that was apparently difficult to meet with available offenders below that age. (Kolker, 2000b); *see also* (Kolker, 2000a).

subcontracting. Otherwise, what appear to be cost savings in a bid may turn out to be cost overruns in reality.

Accounting for Public Property: Public assets can take many forms, including structures, buildings, machinery, systems, land, water rights, easements and rights-of-way, improvements, utilities, landscaping, sidewalks, roads, curbs and gutters, equipment, furnishings, information, paying clientele, money, and employee knowledge and skills. It will increasingly take the form of intangible property.

Property connected with privatization can not only take many forms but be affected in many ways. In some cases, subcontractors have been given or lent materials, equipment, buildings, or money, either directly or in the form of subsidies. Others may acquire, improve or control public assets. Each of these situations creates its own problems. Some subsidies to subcontractors are direct and obvious. For example, New Orleans would have incurred more than \$526,000 in additional annual costs in its contract to operate certain privatized bus routes had the federal government not awarded a grant to subsidize the subcontractor \$1,467,000 each year. (Sclar, 1989:26-27) But subsidies can also take less obvious forms. Allowing a contractor to have public property or its use acts as a subsidy to the subcontractor and means the contractor has not submitted a competitive bid unless it is taken into account. If the subcontract involves the subcontractor's building or acquiring property to perform the service, there needs to be a means of returning the property to the public at a fair price based on the contract expectations. Sclar describes one county which paid 30% over the costs of construction to acquire a privatized parking facility. (Sclar, 200:104-05) Entrusting assets to a subcontractor may mean the government has made itself unable to take over the services when there is evidence of nonperformance or unsatisfactory performance.

However property comes into a contractor's hands, prudence demands protecting assets the public has paid for. Good practice would require accounting for such items at many points in the process. They must be included in cost accounting, protected from injury or waste, and returned to the public in good condition at fair cost at the end of the contract or upon default or breach and in a condition that does not diminish their value. Otherwise, if no provision for their return is made, a contractor may appropriate, sell, transform, or waste assets. (Sclar, 2000:114-15).

Before any public assets are entrusted to a subcontractor, they need to be identified, assessed and properly valued. Montana, for example, requires listing all public assets and their intended disposition under a privatization plan. (Mont. Code Ann. § 2-8-303(1)(d) (1998); *see also* Utah Code Ann. § 63-95-104(1)(a)(ii), (b)(ii) (1999)). Depending on the sort of asset, valuation may either be simple or very complex. Many public assets are unique, and this may be true even of buildings. Thus, there may be no comparable properties to use in setting fair market value. (Sclar, 2000:18-19) Some public assets currently generate revenues or may be privatized in order to generate revenues. Privatizing a revenue-generating asset could mean depriving the public of income; in some cases those revenues mean an asset has greater value to the public if it remains in the public sector.

If managing a public asset requires or entails some investment by the subcontractor, the contract must state how those investments will be treated at the contract's end. Depending on the circumstances, the investment could be removed by the contractor or remain with the asset and

be returned to the public (and potentially to a later contractor). If the latter occurs, there must be some consideration as to whether the government must reimburse the contractor for the investment and, if so, how to value them, or whether the investment was included in the contract price. All investments will be paid for with public funds, but in some cases they might be seen as more appropriately being treated as the government's investment and in others as the contractor's. In some cases, investments may represent real value added, while in others they may have been useful to the contractor but to no one else. Sometimes improvements or investments can not easily be separated from the asset. Certainly, parties will act differently during the term of the contract depending on how assets will be treated at its end. Failing to consider and agree how these assets and investments will be treated at the contract's end ensures a complex and costly dispute whose costs may mean losing anything gained from privatization.

A state considering privatization should also decide whether and how to tax the assets and operations of the subcontractor. A failure to tax when private property or businesses normally would be taxed is a hidden subsidy to a private business. (*Cf.* Kan. Stat. Ann. § 12-5509 (1995)).

If the contractor invests in the asset, there should be a decision as to whether the government will lend the money to the contractor – and, if so, at what rate – or assist the contractor in achieving favorable rates. (*Cf.* Kan. Stat. Ann. § 12-5503 (1995)). If the contractor is allowed to charge the public in connection with the use of the asset, what use will be made of the money collected and who will be entitled to what portion of it. In addition, will the contractor be able to set the rates unilaterally, or will the rates be controlled, approved, or set by the government. If the government pays a service fee to the contractor or becomes obligated financially in other ways as a result of the contract, how will that fee or other money be paid: by a bond, taxes, or otherwise. (*Cf.* Kan. Stat. Ann. § 12-5505 (1995)).

Assets which may be entrusted to the subcontractor include not only tangible items such as buildings and equipment but also fees or other money which the subcontractor collects and is supposed to forward to the public treasury. Money is fungible and easily misappropriated. Californians learned this lesson the hard way when in 1997, a contractor left the state park reservation system in shambles as it absconded with \$1 million of public money. (Tighter Rein, 1998; Phone Line, 1998; Steinstra, 1998; Ellis, 1997) This was a disaster for a state that depends on tourism and also meant tracking down the money to recoup it or writing it off as a loss.

When the assets the subcontractor will acquire include information even more difficult problems arise. Government collects and maintains detailed, personal and confidential information. Considering the sensitive nature of much information government agencies collect, it seems unlikely the public wants it to be marketed to increase a subcontractor's profits. But contractors may feel tempted to use information as the valuable resource it is and sell or rent it. Information, just as with other sorts of property which has been paid for by tax dollars, should not just be given away to subcontractors. In addition, as with other assets, a decision must be made as to its ownership at the contract's end.^{xv}

^{xv} If, for example, a private company is contracted with to publish statutes and judicial decisions and then claims it owns copyright in the material, the government may find itself embroiled in litigation to establish its ownership rights.

While it is easy to know if a tangible asset, such as a building or vehicle, has been returned, ensuring the return of information, and especially electronic information, is more complex. When it is in electronic form -- and with each passing day it is more likely that information will be in this form -- it can also be easily transferred and even broadcast. Unlike most forms of property it can both be returned to the government while being retained by the contractor. Thus, it is not sufficient only to demand its return at the contract's end; the contractor must also be required to divest itself of all copies.

Government may also want to retain physical property and human capital so it can respond quickly to a crisis. It is easy to see that government may need to keep reserves of oil because it is in the national interest to protect the public from price and supply shocks. (Shenk, 1995, 16) But more than this, contracting out can mean diminished government expertise in key areas leading to reduced ability to address future problems. (Hanna, 1997) Maintaining in-house expertise helps set competitive prices, particularly when there is no market; it can be used to test whether a private company can beat the government's price. (Shenk, 1995) Richard Boris, Virginia Private Prison Administrator observed:

If you privatized everything, you would have within about 10 years no expertise left within your department of corrections because they hadn't been running. You learn about running prisons by running prisons. That's one of the reasons.

If you ever had to take over a facility -- now, this is a jail down in Texas, but I think it's Brazzios (ph) or whatever where we heard about the inmates from Missouri being beaten and there were videotapes shown on TV nationwide and all -- where would you get correctional officers to move in quickly if you weren't running some of your own?

(Corley, 1997)

It can be just as important for government to have ready access to expertise and even to develop and foster expertise that has no use in the private market or that might even be seen as leading to an inefficient market. A democratic government has a special obligation to serve underserved populations -- the poor and disenfranchised who are least able to protect themselves or use dollars to have an impact on the market. A private market might find it advantageous not to provide services to these populations. Jocelyn Frye, of the Women's Legal Defense Fund, argues that certain tasks, such as setting eligibility requirements, are not appropriate functions for the private sector. (Fernandez, 1997) These miscellaneous services, expertise and means of providing services can be seen as assets or forms of property which government needs to retain in order to perform its functions.

Worker Protections: Government as employer has always played an important role in

modeling employer behavior by providing disadvantaged groups secure jobs at good pay and making it possible for them to do work vital to the social fabric of this country. The impact of these actions goes far beyond the pay packet of an individual worker who might not otherwise have had a job or as good a job or received a living wage or been able to play an important role in promoting public policy. It has also helped secure a more equitable distribution of government services to all members of the community. Workers who receive pay sufficient to support a family will pay taxes, not require government services, and raise children in the sort of environment more likely to lead them to be contributing members of society. Minority workers may have greater understanding or sensitivity to their communities' needs and may literally be able to talk the language of disadvantaged parts of the community. They help make a government for the people.

An overly zealous cost cutter might not see this larger picture and might focus only on costs directly under its control, ignoring those that can be shifted to other parts of the government. Costs may be lowered and profits generated by cutting wages, lowering benefits, using more part time workers, or eliminating health insurance. In its 1984 study of privatization in the Los Angeles area, HUD found that private contractors' lower costs were explained in part by greater use of part time workers who were paid no benefits, shorter vacations, less experienced workers, lower-skilled workers, and non-unionized workers. (HUD, 1984:16-17, 25, 27, 39, 41-42; Wessel, 1995) But can it be said that the lower costs are due to the virtues of competition such as greater efficiency as opposed to being able to do what government may not be able to do – cut wages and benefits? Is achieving cheapness under these circumstances desirable?

To the extent decisions about subcontracting ignore factors other than the discrete cost of a job, they may end up costing government as a whole more. If, for example, a contractor cuts costs by eliminating health insurance, government on some level is likely to have to pick up those costs – either by subsidizing public hospitals, in welfare payments, through the loss of workers who must care for persons made more seriously ill because they delayed seeking treatment, in increased levels of disease in the population, or through other remediation made necessary by a lack of adequate health care.

It is in the government and the public's self-interest that the standard set by government as employer should continue to be the standard even when the private employer is delivering a public service. Colorado includes this as part of its privatization policy (Colo. Rev. Stat. § 24-50-501 (1998); Colo. Rev. Stat. § 24-50-503(1)(d) (1998)) and reinforces this by providing that, in comparing costs, any savings attributable to lower health insurance benefits provided by the contractor shall not be included. (Colo. Rev. Stat. § 24-50-503(1)(a)(IV) (1998)). This, then, fixes attention on the question whether a better, more efficient service is being provided or just a cheaper one.

Although taxpayers might initially feel pleased to get value for money, in the sense of getting the service at a lower wage cost, workers willing to work for lower wages may not provide the value more highly paid workers would. Low-waged work is the sort of work most prone to frequent turnover, (Sclar, 1989:29-30) but many public services need long term workers with historical knowledge of clients, methods, and services. (Sclar, 2000:110-11) Wage levels affect and reflect the quality of worker an employer can attract. Wages set too low will cause that quality to deteriorate.

Several states' privatization statutes have attempted to address these concerns. Massachusetts requires that every contract must contain a statement that the subcontractor will comply with antidiscrimination laws and will take affirmative steps to comply with equal employment opportunity. (Mass. Ann. Laws ch. 7, § 54(3) (1996)). It further requires a bidder to provide detailed information as to the wages a contractor proposes to pay for each job. (Mass. Ann. Laws ch. 7, § 54(2) (1996)). Montana requires privatization plans to include a list of all employees employed in a program and the estimated effect of privatization on them. (Mont. Code Anno., § 2-8-303(1)(c) (1998)). This ensures comparable services will be provided. In other words, if a subcontractor were to offer a bid based on an average wage, that wage might be based on lower-paid job classifications than those who would actually be capable of doing that sort of work. To remain within the contract price, the employer would have to raise the offered wages but then have too few workers to provide a comparable level of service. Requiring this information reveals whether a service is likely to be provided at the contract price only by relying on too few workers to deliver the service or unqualified workers.

Some might argue that cutting wages is permissible as an exercise of the market. That is, if an employer can attract workers at lower wages, then that is the appropriate wage and any other is a waste of assets. However, if a contractor is allowed not to provide health insurance for its employees and taxpayers have to subsidize the contractor's profits by bearing the cost of health care for uninsured workers, this means that taxpayers are subsidizing an uncompetitive private sector employer. To avoid subsidizing the employer and to ensure it is competitive, the cost of the subsidy would have to be included in the bid so it accounts for all costs of contracting and to make it fully comparable with public sector costs. Making such an assessment, however, would be very difficult. It is simpler merely to require that comparable working conditions continue and thus that no subsidy is needed.

Legislatures also need to consider whether they will permit subcontractors to terminate and replace current workers. Allowing this raises a number of complex issues, including obligations owed to those employees and ensuring continuity of services.

States which have addressed this issue have taken different approaches. Colorado forbids permitting this as part of privatization. (Colo. Rev. Stat. § 24-50-503(2) (1998); Colo. Rev. Stat. § 24-50-504 (1998)) Massachusetts requires the contractor to offer employment to qualified public employees displaced by subcontracting, thus discouraging the practice. (Mass. Ann. Laws ch. 7, § 54(3) (1996); *see also* V.I. Code Ann. § 73 (1996)). The District of Columbia requires that any subcontractor who displaces government employees must offer the employees a right-of-first-refusal to employment in "a comparable available position for which the employee is qualified" for at least six months and, during that time, the employee can not be discharged without cause. If the employee's performance during the six-month transition is satisfactory, the new contractor must offer the employee employment under the contractor's terms and conditions. (D.C. Code § 1-1181.5b(a)(3), (5) (1999)). Florida provides that as part of a privatization project public workers may be leased to the contractor. Those employees are entitled to continue as part of the public employees retirement system. (Fla. Stat. Ann. § 288.901 (1996)). Employees who are to be displaced must be given at least thirty days notice. (D.C. Code § 1-1181.5b(a)(8) (1999)). Montana requires notice be given to an employee and the employee's collective bargaining unit as soon as possible prior to privatization. When twenty-five or more employees are affected, the notice must be given at least sixty days prior to the privatization, and

when fewer than twenty-five employees are affected they must be notified at least fourteen days prior to the privatization. (Mont. Code Anno., § 2-18-1206 (1998); *cf.* N.J. Stat. § 30:1-7.4 (1999)). Arkansas requires agencies which intend to lay off employees as a result of privatization to report those impending layoffs to the Legislative Council and the Office of Personnel Management of the Division of Management Services of the Department of Finance and Administration. The report must include details about the number and grade of employees laid off and how the decision was made. Those positions are then removed from the agency's budget for the next two years. (1999 Ark. Acts 17).

Many public sector workers are represented by unions, and their right to join a union is protected by state law and sanctioned by federal law and policy. It is therefore inappropriate for government to enter into a subcontracting arrangement that subverts workers' legal rights and de-unionizes the workplace. This means the legislature should provide for the continuation of union representation of those employees if they are taken on by the subcontractor. In fact, the NLRA achieves just this result under the successorship doctrine. (*Lincoln Park Zoological Soc'y v. NLRB*).

There are many terms of employment in addition to wages, hours, and benefits which are set by regulations or public sector rules. A determination needs to be made whether and how these will apply to the contract. Furthermore, if they do not apply to the contract, is there any reason they should apply to the work when done in the public sector? Is there a reason to free a private contractor from regulations that might impede doing the work more efficiently in the public sector? Doing so is a subsidy to the subcontractor, means the work is not comparable, and subverts legislative judgment that those regulations are necessary.

One concern that might arise as a result of subcontracting is how to ensure a subcontractor – particularly if it is an out-of-town corporation – is responsive to the community's needs and concerns. Traditionally, city governments have tried to ensure this by imposing residency requirements on public employees. When a service is privatized, those purposes still exist. Consideration should be given to whether the contract should impose residency requirements and, if so, whether they should also apply to all or a percentage of officers and stockholders in the private company. (Rudd, 1997)

In short, in subcontracting it is important not to subsidize uncompetitive employers, and this end can be promoted by requiring contractors be bound by the same laws as government agencies, such as providing a nondiscriminatory workplace and fair working conditions. Assurances with regard to employees' working conditions may mean requiring that bonds be posted, incentives be provided for meeting and exceeding certain benchmarks, and penalties be assessed for failure to meet requirements.

Procedural Criteria – Steps in Making Prudent Subcontracting Decisions

The need to have a special procedure for making decisions about contracting out government services may not be obvious. After all, government at all levels has long purchased private services and goods. However, there are important differences between the sorts of contracting out done in the past and today. Special interest groups lobbying vigorously in its favor. There appears to be public support for it, and a wide range of institutions is being

considered for some degree of marketization. Certainly, there is a qualitative difference between buying toilet paper from the lowest bidder and providing health and disease control services. In the former, decisions are much simpler. Price is likely to be the most important consideration, and it is easy to set quality criteria. In the latter, while no one would want waste or overspending, quality and continuity of the service will be far more important and the criteria to be considered are much more complex. It is far easier to assess whether toilet paper meets specifications and to find another supplier if problems with the contractor arise than is the case for health and disease control. Furthermore, finding a substitute provider for disease control is much more difficult -- and the consequences to public welfare more dire -- if the subcontractor fails to perform satisfactorily.

Establishing specialized procedures for each step of subcontracting -- from soliciting bids to assessing bids to oversight -- becomes far more important as requests to subcontract become more common, the criteria more complex, and the consequences of mistakes more serious. Only experienced, sophisticated, and qualified decision makers can meet these needs. Centralized, established processes can ensure this and accountability as well.

There are a number of necessary steps involved in deciding whether to subcontract. How they are divided is a matter each governmental unit must decide based on its own needs. They could be assigned to one entity which would have complete responsibility for subcontracting, or they could be subdivided among different bodies. In making that decision, it would want to consider whether its goals are more efficiently achieved in one body or by distributing them to more narrowly specialized bodies; whether oversight of the decision making process is more effective with one body or by having separate agencies acting as checks on one another; and whether quasi-legislative or quasi-executive roles are better kept separate or integrated. Finally, the entities need to conform to the existing state governmental structures.

Alaska provides an example of a privatization body with a very broad agenda. Its Commission on Privatization and Delivery of Government Services has an extensive, sophisticated and flexible mandate. It requires addressing the question how most appropriately to deliver a service: to study existing services and determine whether they are more suitably delivered by federal or state government, the public or private sector, or consolidated public agencies. (1999 Alaska Sess. Laws 62; *see also* Ga. Code. Ann. §§ 36-86-4, 45-12-178 (1996); GAO, 1997:2) To achieve these ends, it is to review and evaluate other states' policies and recommendations; solicit public comment; review Alaska's policies and procedures; and identify whether state functions could be more efficiently and effectively provided by transferring them to the private sector, local government, regional service organizations, or the federal government, by retaining them at the state level, by eliminating them, by agency consolidation or other efficiency changes, or by a combination of these. (1999 Alaska Sess. Laws 62).

The basic functions -- regardless of which body or bodies undertakes them -- include (1) proposing regulations; identifying potential functions to subcontract; (3) collecting information; (4) assisting an agency in instituting best practices to establish a baseline; (5) drawing up bid specifications; (6) receiving bids; (7) taking evidence and testimony relevant to the decision; (8) deciding whether to subcontract and, if so, which bid to accept; (9) negotiating the contract; (10) exercising oversight; (11) terminating or renewing contracts; (12) prosecuting breaches and other misfeasance; (13) reporting periodically to the legislative oversight committee.

Proposing Regulations: If there are to be detailed substantive guidelines, some body will have to promulgate them. It might be that the legislature would enact highly detailed statutes spelling out those guidelines in detail after hearings. On the other hand, it is not unusual for a legislative body to enact more general statutes, delegating the duty to be more specific to an agency. In other words, this responsibility could be part of a privatization body's duty. This decision will depend on the degree to which it is desired to subject these decisions to more or less politicized decision making and whether there is a desire to delegate responsibility to an expert body. The decision whether delegation is even appropriate will, of course, depend on each state's administrative agency laws and state constitution. Even if the body does not have the power to regulate, it might provide useful expertise in advising the legislature on future enactments.

Arizona, for example, charges its office of management and budget to design standardized methodology for how the state identifies and evaluates state functions to subcontract as well as determining if future competitive contracting with the private sector and other state agencies is in the best interest of the state. (Ariz. Rev. Stat. § 41-2771(1) (1999)). Thus, the legislature has ceded to this office responsibility not only for identifying services to privatize and to make the decision but also to establish the procedures and guidelines. The same office also reviews petitions forwarded to it by the private enterprise review board. (Ariz. Rev. Stat. § 41-2773(6)(d) (1999)).

Identifying Potential Functions to Subcontract: Government agencies can take either an active or passive role in initiating potential privatization. A body can play a relatively passive, almost judicial role involving only weighing whether to consider subcontracting based on requests by others and on the record others have created. It takes an active role if the body is charged with itself initiating an evaluation of functions to be privatized. The Kansas Board plays a passive role. It initiates a study of the government function and whether it should be or remain in the private only sector after it receives a request from the public or from government employees to do so. (Kan. Stat. Ann. § 75-3739(4)(a) (1996)). In contrast, Arizona is an example of a body that plays a highly active role. It, however, does this with a strong tilt towards promoting privatization. Its legislation declares: "the state's fiduciary responsibility to taxpayers [is to encourage] value in the provision and delivery of state services by identifying and pursuing opportunities for increasing the use of market forces in the delivery of state services, while preventing unfair competition between state agencies and the private sector." (Ariz. Rev. Stat. § 41-2772(A) (1999); Ariz. Rev. Stat. § 41-2773(1) (1999); *see also* Utah Code Ann. § 63-55a-3(1)(b) (1999)).

Most states which take an active role assume a more neutral stance than does Arizona. They focus less ideologically on identifying potential functions to subcontract by using criteria based on cost and quality. For example, Mississippi's Joint Legislative Committee on Performance Evaluation and Expenditure Review prepares a report on the privatization after analyzing all areas of state government to identify programs and services that could be performed by the private sector at lower cost or greater efficiency. It is charged to consider a wide range of outcomes, including contracting-out, competitive bidding and the sale of state assets. (Miss. Code Ann. § 27-103-209(2) (1998)). In contrast, Montana uses a two-way process. The legislative auditor is required to identify subcontracted programs that could be administered

more cost-effectively directly by the public agency as well as the reverse. (Mont. Code Anno., § 2-8-304(1) (1998)). In addition, “[m]embers of the public, elected bargaining agents or employee representatives, elected officials, legislators, and agency directors may submit to the legislative audit committee a request to review programs being conducted under contract by an agency that may be administered more cost-effectively directly by the agency.” (Mont. Code Anno., § 2-8-304(2) (1998)).

The role a body is to play should affect the structure of the body. The more active is the body in seeking out functions to subcontract, the better it is to have a separate body decide whether to subcontract. A body that both seeks out bids and decides whether to subcontract faces either a conflict of interest or the appearance of a conflict. It can not credibly decide whether to subcontract in instances in which it has initiated the process for fear of capture and actual or perceived lack of impartiality. Even the appearance of bias can have a negative effect on the body’s performance and public acceptance of its decisions.

Collecting Information: Both as part of the process of initiating the decision to consider functions for subcontracting and as a vital part of actions once that decision is made, a more in-depth analysis of the existing functions needs to be made. This is the process that ensures information is gathered that permits assessing qualitative and cost criteria. Information plays a role at multiple steps in the process.

Louisiana provides an example of the sorts of sources of information to be sought and also provided during the privatization process. Its legislative auditor is required to:

- (1) Evaluate the basic assumptions underlying any and all state agencies and the programs and services provided by the state to assist the legislature in identifying those that are vital to the best interests of the people of the state of Louisiana and those that no longer meet that goal.
- (2) Evaluate the programs, policies, services, and activities administered by the agencies of state government and identify overlapping functions, outmoded programs or methodologies, areas needing improvement, and/or programs amenable to privatization.
- (3) Evaluate the impact, effectiveness, and cost-effectiveness of all state agencies and of their programs, services, and activities.
- (4) Evaluate the efficiency with which state agencies operate the programs under their

jurisdictions and fulfill their duties.

(5) Evaluate methods agencies use to maximize the amount of federal and private funds received by the state for its programs in order to ensure that the people of Louisiana receive a fair share of the taxes which they pay to the United States government and to provide for the effective efficient use of private resources.

(6) Evaluate the management of state debt.

(7) Evaluate the assessment, collection, and application of user fees.

(8) Make recommendations each year relative to the programs and services the various state agencies provide as well as recommendations for elimination of or reduction in funding for agencies, programs, or services based on the results of performance audits. Such recommendations shall be submitted in a report to each member of the legislature no later than February fifteenth each year.

(9) Make annual recommendations to the appropriate oversight committees of the legislature and the Legislative Audit Advisory Council as to amendments to statutory and constitutional provisions that will improve the efficiency of state government, including, if appropriate, recommendations concerning the reorganization or consolidation of state agencies.

(10) Evaluate the methods used by each agency in the estimation, calculation, and reporting of its performance, and evaluate the actual outcomes of each agency's performance with regard to its performance indicators as defined in R.S. 39:2.

(La. Rev. Stat. § 24:522(C) (1999)). The state auditor is to be assisted in this task by state agencies charged with developing measurable performance criteria, including program goals and objectives. (La. Rev. Stat. § 24:522(D) (1999)).

Public policymakers might want to emphasize other sources of information to be considered at this preliminary step, but Louisiana provides a useful look at the range of informants which can be used, the sort of information to be collected, and the types of reporting to be generated for the purposes of assessing whether privatization is being properly pursued.

Assisting an Agency in Instituting Best Practices to Establish a Baseline: When Joni Mitchell observed: “You don’t know what you’ve got ‘till it’s gone.” she was not advocating this as good practice. It can not be known whether contracting out will improve public services without first establishing a baseline understanding of the existing service. This needs to take place early in the process, before bids are requested. Therefore, privatization should not be consummated until you know what you have, what it costs and how it operates.

As discussed earlier, this cost, quantitative and qualitative determination of the scope and nature of the service is not easy. It must include computing all costs connected with providing it and assessing current workload and performance standards. It must consider the target population and the service’s role in and for that community. Under the best circumstances, undertaking this process can have – and has had – highly beneficial effects. Self-analysis is essential to determining how to reorganize in order to provide the most efficient, economical service. (Sclar, 2000:71) This step alone -- even before and without subcontracting -- will take the agency towards the twin goals of improving service and saving money.

Some might argue that this step of self-analysis is unnecessary, that an inefficient service does not deserve a chance to lift its game and that, in any case, contracting out by itself will bring market forces to bear and result in improved service. Indeed, some state legislatures not only do not require such a process, they essentially forbid it by, instead, mandating privatization. (See Ariz. Rev. Stat. §§ 46-300.01, 46-342, 46-343 (1999)).

Such an inflexible mandate, however, is not in the public’s interest. If this step is skipped, it will never be known whether subcontracting saved any money or provided better service because there will be no comparison with the highest level achievable by the public sector. When a self-analysis and reorganization occurs, any bid that outperforms that best practice will clearly be an improvement.^{xvi} Oklahoma recognizes that the current employees are essential to the process and provides that before state services can be privatized the agency must allow its employees the opportunity to submit proposals to improve the agency’s operations and efficiency. (OK. Stat. § 595.3 (1999)).

Although the public agency’s management and employees will have valuable information about its functions, they will almost certainly need help in rethinking the organization. An expert body which has experience in reorganization and which takes a facilitative role can perform a particularly valuable role. Thus the process of study and reorganization should not simply be left to the agency which performs the work; rather, it should be done under the guidance and

^{xvi} For a detailed analysis of such a process, see (Sclar, 2000:130-50).

assistance of an expert body, in particular by a centralized privatization body. On the other hand, such a body cannot perform a reorganization without the help of the public workers who understand the nuances of their jobs. In other words, the best reorganization is a two-way process.

Drawing up Bid Specifications: Once a reorganization has taken place and cost, quantity and quality standards have been ascertained, the bid specifications can be drawn up. Massachusetts, for example, requires that a specific written statement of the services proposed to be the subject of the privatization contract be prepared. The statement must specify the quantity and standard of quality of the services. This statement is then used as a basis to solicit competitive sealed bids. This statement is a public record which is also transmitted to the state auditor for review. Bids are solicited from any and all parties. (Mass. Ann. Laws ch. 7, § 54(1) (1996)). This means that public workers are allowed to bid on continuing to perform the work.

Although it should not be controversial, some argue that state workers should not be allowed to bid on performing their own work,^{xvii} because they have an advantage as a result of being familiar with the work and of government work's being inherently cheaper because no taxes need be paid. Gary D. Eugebretson, President Contract Services Association of America, testified:

For the private sector, the playing field is not, and likely never will be, entirely level. This is primarily due to the fact that, despite several recent laws, the government does not have cost accounting systems in place to provide accurate or reliable financial data on workloads, does not have to pay taxes, and the methods by which it computes its overhead rates are not comparable with those of industry, nor does the government "pay" for infrastructure (e.g. buildings and land). In addition, the government does not face, either qualitatively or quantitatively, the same risks as a commercial contractor (e.g., on issues relating to termination for default, absorption of cost overruns or potential Civil False Claims penalties).

^{xvii} The Freedom From Government Competition Act S.314, introduced in 1997, and S.1724, introduced in 1996, required federal agencies to procure all goods and services from the private sector with limited exceptions, including where goods or services were inherently governmental functions or critical to national security, where private sector practices failed to meet government needs, or where the government could provide the best value to the taxpayer. It thus virtually mandated contracting out. (Flynn, 1997; Stevens, 1997; Stevens, 1996).

(Eugebretson, 2000)

The better reasoned view is that the public welfare depends on public workers' being allowed to bid. This is the only way to ensure the bidding is truly competitive and that taxpayers' interests are protected. (GAO, 1997) Privatization proponents are not the only ones aggrieved by the processes undertaken at this step. AFSCME Vice-President Joe Flynn complains that in fact much work that should be competitively bid under OMB Circular A-76 is privatized with no competition. He argues:

Currently, most work is contracted out without public-private competition by even DoD--the agency often held out as the champion of OMB Circular A-76. Although DoD contracts out in excess of \$60 billion annually, public employees have no chance of competing for almost all of that work even with the Pentagon's increased reliance on the circular. For example, according to an Army study, only 16,000 contractor jobs out of the service's entire contractor workforce of 269,000 were competed through OMB Circular A-76.

(Flynn, 2000)

If the market is the force that improves service, then it is essential to ensure a market exists. The optimum situation to promote competition and better service can not be subcontracting to one bidder but, wherever possible, finding as many bona fide bidders as possible. The difference between promoting real competition as opposed to transforming a public monopoly into a private monopoly appears to have been overlooked by many. (*See, e.g., Kan. Stat. Ann. § 12-5508 (1995)*). There is nothing about a monopoly -- including a private one -- that is likely to involve competition and thus promote the improvements sought. However, the reality is there may not be many bidders. In many cases, the service may not be one provided by private contractors. Allowing the current workers to bid on their own work thus helps create the best semblance of a market in this situation. If competition is supposed to ensure that services are provided in the most efficient way, it makes no sense to exclude government workers or any group which otherwise meets the substantive criteria, from bidding. Furthermore, excluding the workers who have been providing the service stacks the deck and all but ensures the work must be contracted out, even if no one could do the work better or at lower cost. It seems unlikely most taxpayers would favor contracting out a service if this means higher cost, but this may well happen if current workers are barred from bidding.

There is one other way in which allowing public workers to bid on their own work is essential to promoting the public interest. If workers know they are unable to bid and that the work will be contracted out, they are unlikely to be willing participants in efforts to rationalize and improve their agency's function. In contrast, if they know they have a period of time in which to make their agency the best possible and that if they do so they could retain the work,

they have a strong incentive to put every effort into the process. The beneficiary will be the public.

Indeed, this is already recognized by some jurisdictions. The District of Columbia requires that any solicitation for proposed contracts must include information concerning a procedure by which the current government employees may bid on the contract. (D.C. Code § 1-1181.5b(a)(6) (1999)). Massachusetts has a detailed process of which workers' bidding is a part. (Mass. Ann. Laws ch. 7, § 54(4)-(5) (1996)).

Receiving Bids: Once bid specifications are released, an agent must be designated to receive the bids and process them. Their processing should be a multi-step process. Later steps are considered below, but preliminary functions should include basics such as checking that all requirements have been complied with and initial investigation and assessment of the undertakings set out in the bid. to prepare the bid for the decision making process.

Taking Evidence and Testimony Relevant to the Decision and Deciding Whether to Subcontract And, If So, Which Bid to Accept: Although different steps, these two share many common procedural concerns, making it more economical to consider them together.

It goes without saying that decisions to contract out government services should not be made lightly to ensure there is no interruption of service or poor quality. Despite this, many legislatures stack the deck by limiting the information to be sought or which is allowed to come before the decision-maker; by limiting those included on the decision-making body to less than all interested parties -- or even to limit it only to privatization partisans; and by limiting those to be consulted. Doing any of this ensure that optimum decisions cannot be made.

Legislatures should consider how open the process of subcontracting should be. On the one hand decisions could all be made out of the public's sight. On the other, the process could be an open one complete with notice and an opportunity for all interested parties to be heard. Montana, for example, provides that before privatizing a program, a privatization body is to prepare a privatization plan and release it to the public, any affected employee organizations and the legislative audit committee at least ninety days before the proposed implementation date. Thirty days later, the legislative audit committee must conduct an open hearing at which public comments and testimony must be received. Fifteen days later, the legislative audit committee is to make public a summary of the hearing results and the committee's recommendations. (Mont. Code Anno., § 2-8-302 (1998)).

Certainly providing for sufficient notice, a timely public hearing or other public input in a manner that allows a meaningful opportunity to be heard will help ensure prudent decision making that takes into account a wide range of needs and issues. To some degree, though, the question of how to receive information – by public comment, hearing, or otherwise – will depend on the nature of the service being considered for privatization and practice within the geographical area.

a. Information: Some states limit information to be considered to that in favor of privatizing. Utah's privatization board, for example, is charged with the responsibility of maintaining communication with and access to information from, entities promoting privatization but is not charged to seek out information and maintain access to those opposing or neutral on privatization. (Utah Code Ann. § 63-55a-3(1)(e) (1999); *see also* Va. Code Ann. §

9-342 (1996)). The better practice is to require considering a wider range of evidence, including evidence that does not support privatizing. Montana, for example, requires a privatization plan to include “a narrative explanation and justification for the proposed privatization” as well as:

(1) an estimate of cost savings or additional costs resulting from privatizing the program, compared to the costs of the existing, nonprivatized program, including cost of inspection, supervision, and monitoring of the contract and costs incurred in discontinuing a contract.

(2) estimated economic impacts of privatization on other state programs, including public assistance programs, unemployment insurance programs, retirement programs, and agency personal services budgets used to pay vacation and sick leave benefits.

(3) increases or decreases in costs and quality of goods or public services.

(4) changes in workers’ wages and benefits.

(Mont. Code Anno., § 2-8-303(1)(e)-(i) (1998)). Colorado specifically requires considering “the consequences and potential mitigation of improper or failed performance by the contractor.” (Colo. Rev. Stat. § 24-50-503(1)(f)(I) (1998)).^{xviii} It further demands considering whether privatizing a particular service would mean the improper delegation of a state function. (Colo. Rev. Stat. § 24-50-503(1)(f)(II) (1998)).

These sorts of information should certainly be included, as well as anything relevant from any interested parties.

The Decision-Maker’s Qualifications: If a state or other governmental entity is considering a program of contracting out government services, it is essential that it establish an expert body whose job it is to assess bids and ensure that all procedural and substantive requirements have been met and to create a uniform process. The officer of that entity must have sufficient skills and access to information to be able to assess complex financial and technical

^{xviii} “Asked by Senator David Pryor (D-Arkansas) if other government contractors were performing ‘inherently governmental functions’ -- deciding where and how to spend taxpayer money and exercising judgment on matters of due process -- a GAO report responded with a resounding yes. In just a few agencies it found dozens of examples.” (Shenk, 1995).

specifications and bids. Finally, the decision maker must also be impartial and seen as impartial. Alaska's chief procurement officer, for example, is part of the partially exempt service and must have "at least five years of prior experience in public procurement, including large scale procurement of supplies, services, or professional services, and must be a person with demonstrated executive and organizational ability." (Alaska Stat. § 36.30.010 (1999)).

Again, the legislature should consider at which points such an office would become involved in the process. If the functions are divided among different entities, these would appear to be relevant basic qualifications for each of them. States with existing programs vest this function in a number of different offices. Alaska, for example, vests the power in a commissioner of administration and chief procurement officer who is given power over procurement of supplies, services, and professional services. (Alaska Stat. § 36.30.005 (1999)) To some extent, these reflect political or practical views and the variety of duties vested in the body. The wider the range of responsibilities vested in the agency, the harder it will be to find people competent to perform them all. On the other hand, if they are divided among different agencies, some means of ensuring coordination must be established.

The Membership of the Decision-Maker: One way to ensure access to the best information possible is to include a wide range of interests among members of the body which makes the decision to privatize. The interests represented should include those for and against privatization, public employees, public employee unions, agency clients, the community at large, and business interests. Almost as important as which interests are included is the appointment process.

Utah's Privatization Policy Board, for example, is composed of thirteen members who serve staggered four-year terms. The governor is directed to appoint (1) two senators and two representatives, one each from each political party; (2) two members to represent public employees whose names are to be recommended by the largest public employees' association; (3) one member from state management; (4) five members from the private business community; and (5) one member representing education. (Utah Code Ann. § 63-55a-2 (1999)).

In contrast, Arizona's legislative mandate to privatize the administration of its welfare program is reflected in its "works agency procurement board." Its membership makes it unlikely to have anything other than a pro-privatization bias. The statute states that it is "established to receive proposals and award a contract by January 1, 1999 with a private entity for implementation of the Arizona works program." The board, whose members are appointed by the governor, is to be made up of nine members who will be: "1. The director of the department of economic security; 2. Two people from the private sector who have procurement experience; 3. Two representatives of a major employer in this state; 4. Two representatives from community based organizations; and 5. Two representatives from small businesses in this state. (Ariz. Rev. Stat. § 46-343.) Mississippi charges the body which is to review government functions for privatization to consult with representatives from the private sector, (Miss. Code Ann. § 27-103-209(2) (1998)), a highly skewed and limited directive. Missing from both Arizona and Mississippi's boards are important interested parties, including representatives of employees, unions, and welfare recipients.

Alaska's eleven-member commission not only has a far more representative composition than does Arizona's its members are likely to represent the interests they are appointed to serve.

Rather than being appointed by the governor, they are selected by the interest group. The Commission includes (1) one member of the senate appointed by the president of the senate who serves as co-chair; (2) one member of the house appointed by the speaker of the house who serves as co-chair; (3) one member appointed by the Alaska Municipal League; (4) two public members appointed by the president of the senate, one of whom shall be a representative of a Native corporation; (5) two public members appointed by the speaker of the house, one of whom shall be a representative of a Native corporation; (6) one member appointed by the Alaska State Chamber of Commerce; (7) one member appointed by the American Federation of Labor-Congress of Industrial Organizations; (8) one member from the minority caucus of the house appointed by the speaker of the house; (9) one member from the minority caucus of the senate appointed by the president of the senate. (1999 Alaska Sess. Laws 62). It further expands the input it receives by appointing an advisory council to assist it in carrying out its duties. (1999 Alaska Sess. Laws 62). Compare this with Kansas. Its five-member performance review board must include at least one member with cost accounting experience, and no more than three members may be from the same political party. They are appointed by the governor, subject to confirmation by the senate, for a term of four years. (Kan. Stat. Ann. § 75-3759(2)(a) (1996)).

It might be argued that there is no point in including public employees on such a board, because they will do no more than be obstructionist. However, Representative John L. Mica (R-Fla), chairman of the House Government Reform and Oversight Subcommittee on Civil Service, contends that federal employees should have the chance to challenge cost-saving claims. (Hanna, 1997). Challenging claims in such a context and forcing claimants to upgrade information is a vital way to protect the public interest, as important as providing the information initially.

Indeed, it needs to be recognized, admitted, and taken into consideration that the process of subcontracting is a very political one with strong feelings on all sides of the spectrum, and that public employees eager to save their jobs are not the only ones whose position might have some elements of predictability. This means that, while it is important to have the involvement of partisans who will actively advance their views, if the process is to be free from charges of corruption, incompetence, or favoritism, it is vital that the office and officer charged with making the decision be isolated from political pressures and not be seen as partial. Alaska attempts to do this, in part, by providing that its chief procurement officer is appointed for a term of six years and may be removed by the commissioner of administration only for cause. (Alaska Stat. § 36.30.010 (1999)).

The importance of these firewalls was demonstrated by experience in Massachusetts after it passed a subcontracting law in 1993 designed to save the taxpayers money, ensure continuity of service, and prevent graft and corruption. The “Pacheco law” requires that the state can only contract out government services if it is given written evidence that demonstrates subcontracting will save money and improve the quality of service. (Wallin, 1997).

In 1997, Massachusetts State Auditor Joe DeNucci, the individual charged with administering the law, refused to approve a plan to privatize transit routes because there was no evidence that privatizing them would save any money or improve service. DeNucci’s explained that the private bidders had had “significant performance problems” in other cities, that the plan called for giving them heavy subsidies, that the bid had failed to include important information concerning how the work would be performed and that it distorted other information. DeNucci’s

decision was bitterly attacked by those who argue that public services should be contracted out despite evidence that contracting out would cost more and provide less. Before the Pacheco law was passed countless public services had been contracted out without any requirement to prove this was in the public interest. DeNucci's critics wanted to return to those earlier practices. (Jordan, 1997; DeNucci, 1996).

Utah has taken the initiative to avoid these problems by forbidding certain interactions. (Utah Code Ann. § 63-95-102(7) (1999)). These include forbidding certain individuals, such as officials of the quasi-governmental entity, lobbyists, and entities in which those individuals hold business interests, from receiving specified benefits under privatization contracts. The forbidden benefits include compensation from a quasi-governmental entity if it is conditioned in whole or in part on legislative or executive action related to privatization; assets of the quasi-governmental entity or its successor; and certain forms of compensation related to privatization. (Utah Code Ann. § 63-95-103 (1999)). Violations can result in felony, misdemeanor, and civil penalties. (Utah Code Ann. § 63-95-105 (1999)).

Thus, avoiding real conflicts of interest and the appearance of partiality by the actual decision maker must be made a priority. Decision makers must be protected from undue pressure or temptation. Given the very nature of the undertaking, there are enormous opportunities for corruption, insider dealing, and the like – all of which mean the decision-making process is corrupted and the public welfare is compromised for someone else's benefit. (Sclar, 2000:105-06)

Negotiating the Contract: Once a decision is made to award a contract, someone must undertake the negotiations. Many of the concerns involved at other steps also apply here, including ensuring expertise, avoiding partiality, specifying standards, providing oversight, and including details as to terminating the contract. Virtually all elements discussed above concerning substantive issues come into play in negotiating the contract.

The one thing that should be emphasized is that contract negotiation involves highly specialized skills. This is particularly the case in subcontracting. The negotiators must be pessimists in the sense of trying to predict and provide for all potential errors, defaults, and misfeasances. These special skills are the sort that should lead the legislature to consider who best can perform this critical role. Although the public agency would have expertise in the nature of its work, it would not necessarily have expertise in negotiating and preparing contracts. In addition, it is likely to be seen as biased. Thus, while it certainly should be available for consultation on technical matters, care should be taken as to just what role it plays in the negotiation process. This, again, is a job that may better be carried on by a centralized body, but not necessarily the same people who made the decision to subcontract. Making the decision to subcontract and assessing the information are different skills than negotiation.

By the time this stage has been reached -- and especially if layoffs are contemplated -- the affected employees' union must become part of the process. Failure to do so is a breach of the duty to bargain and may result in the state's liability for back pay, benefits and reinstatement of the workers. (Brenner, 1997).

Exercising Oversight: A recent GAO study found oversight to be the weakest part of privatization. (Nadel, 1997) Joshua Wolf Shenk reports that the Department of Energy (DOE),

which relies more heavily on the private sector than any other agency, with 80 to 90 percent of its budget paid to private companies, it has only 20,000 civil servants and anywhere from 7 to 10 times that number of employees on private contract has a miserable record. At Rocky Flats plutonium plant Rockwell International poured toxic and radioactive waste into the ground, and stored more in leaky metal drums, leaving 108 separate waste dumps and toxic solvents in the earth at 1,000 times the acceptable concentration. DOE officials gave Rockwell \$27 million to clean up five "ponds" of radioactive and hazardous waste it had helped create. But Rockwell bungled the procedure and the General Accounting Office estimated cleaning the pond would take until 2009, at a cost exceeding \$170 million. Yet, it received a rating of 90 out of 100 -- and \$26.8 million in bonuses. The department's management is so thin and the burden of oversight so heavy that there is virtually no accountability. "[W]hen government contracts out, the lack of qualified managers -- or sheer incompetence -- often leads to a surrender of authority to the shadow government. With time, as contractors make the crucial decisions and develop expertise and authority, the government starts working for the contractor instead of the other way around. Decisions that should be the province of elected officials fall into the hands of hired guns." (Shenk, 1995).

One committed to the marketplace as a fully self-regulatory mechanism might argue that there need be no oversight of subcontracted work. However, the market conditions of competition with many small buyers and sellers and complete information, are unlikely to exist for most types of governmental functions. Therefore, some method of ensuring compliance with contract terms is necessary. Some entity must be charged with ensuring that subcontracted work meets the agreed-upon criteria during the term of the contract as well as assessing whether the express performance benchmarks are adequate or need improvement. (GAO, 1997:16-18) Oversight must take place on a regular and frequent basis to ensure actual performance and quality and early warning of problems in order to prevent a subcontractor's absconding or engaging in financial improprieties. If oversight is not frequent and regular, problems that could have been prevented may become serious and even irreparable.

The skills needed by such an oversight body include contract auditing and performance monitoring. Contract auditing ensures that payment is made only as provided in the contract, while performance monitoring ensures services meet quality standards. (GAO, 1997:17) The oversight body can take many forms, depending on the situation. It can, for example, be lodged within the department whose work was subcontracted, if that is appropriate and can best assure proper performance.^{xix} The department has the advantage of expertise and can thus more accurately assess whether the contract terms are being carried out and also make recommendations for improvement. Another oversight candidate would be the same body which decides whether or not to subcontract. Both will understand most fully the context in which the

^{xix} Arkansas requires that when state functions of the Division of Youth Services are privatized the contract must include a performance evaluation outlining a method for evaluating services provided and identifying the contracts goals and performance indicators and how the state agency intends to evaluate the services. In addition, the Department of Human Services must make an annual report to the legislature concerning the subcontractor's performance. (1999 Ark. Acts 525).

subcontracting is taking place. Certainly, in all but the simplest contracting out situations, the assessment criteria are many and complicated and often cannot be understood outside their context.

However, there are important reasons why neither should be the overseer and certainly not the sole overseer. (GAO, 1997:18). Most fundamentally, any but an overseer which can have no goal other than determining whether the contract terms have been met either cannot make a fair assessment or will be perceived as not capable of making a fair assessment. Agency capture, cronyism, and even conflicts of interest between an agency, the entity which decided to subcontract, and a subcontractor must play no part in the oversight process. Elliott Sclar describes the many ways in which Massachusetts' decision to subcontract road maintenance suffered from assessment by an interested party. Massachusetts wanted to prove the program was a success. As a result, it allowed costs to be deferred to later years and shifted to inappropriate accounts, public sector workers to be pressed into service to perform the subcontractor's work, public assets to be lent to the subcontractor, supervision costs to be understated, and important parts of maintenance left undone. In addition, many tasks did not meet the requirements of the contract, no benchmarks or baselines were created, and, worst of all, the oversight body set up by the executive branch was not motivated to find any fault with the subcontractor's performance – rather, the opposite. (Sclar, 2000:28-46, 119-21).

An oversight body should have distance from individual contractors so it is not tempted to slant its findings. The public has to rely on the probity of the oversight body, because, unfortunately, it is easy for it to slant its findings as to whether the complex criteria are met and to escape detection. It is important that both the oversight agency and the body deciding whether to subcontract not be ideologically motivated, be the captive of ideologues with rigid positions on privatization, or have other motives not to perform oversight solely in the public's interest. One example of this is hiring contractors to monitor each other's performance. While it may appear that their natural competitiveness and expertise would make them especially good critics of each other's performance, in fact they may extend "professional courtesy" to one another, hoping a kind eye will later examine their own operations. ACES President Geraldine Jensen testified:

Another expensive and worrisome practice is when states hire one vendor to monitor another vendor's performance. For example: Massachusetts paid Lockheed Martin IMS \$13.2 million for a computer system and paid Maximus \$1.9 million to monitor the Lockheed Martin IMS contract. Oklahoma paid PSI \$1 million for work on the computer and then paid Maximus \$102,000 to monitor PSI's contract. We are concerned that having one vendor monitoring contracts of another, gives both vendors an incentive not to complete the contract on budget and on time. Cost

overruns and not meeting deadlines has been a repetitive problem found with vendors on state automated child support enforcement systems.

(Jensen, 1997).

The oversight process must give the public easy access to lodge complaints, ask questions, and get responses. Geraldine Jensen, President of ACES testified:

ACES members in all of the states utilizing private companies for child support enforcement report problems identifying that a private company was responsible for action on their case. They also experienced the inability to find the government agency responsible to monitor the private company to voice a complaint of problems with the contractor. Attached to my testimony is a list of states who have contracts with PSI, Maximus and Lockheed Martin IMS. Families who report little or no action or incorrect action on their cases by private vendors cannot determine who to hold accountable. If the family is lucky enough to be able to determine which government agency hired the vendor, the state agency often tells them there is nothing they can do because the case has been turned over to a private company.”

(Jensen, 1997) If the public cannot find someone to whom problems can be reported, then no one can be held accountable and subcontracting may fail to provide a superior service or even the same level of service.

Terminating or Renewing Contracts: Contracts may terminate either when the contract’s end date is reached or when there is a breach. Some states mandate a term limit. Massachusetts, for example, limits the term of privatization contracts to five years. (Mass. Ann. Laws ch. 7, § 54(1) (1996)). There are both advantages and disadvantages to such a scheme. On the one hand, it may be disruptive to have a periodic reassessment of the initial decision to subcontract and change in provider. On the other, a fixed date means all parties know there is a chance of nonrenewal. Most affected would be the subcontractor who will be unable to feel it has gained a sinecure and will be impelled to perform at a level it feels is likely for it to be renewed. A specific terminate date requires the government to assess whether the subcontracting met the goals set for privatization. In addition, having a specific date, lets the government be ready for a

graceful transition to another contractor or to recapture the work.

Some privatization experiments do fail, and when they fail the government – preferably through well thought out contract processes – must be prepared to step in. Privatization failures when there has been no forethought as to how they should be handle can be disastrous. When Educational Alternatives Incorporated (EAI) failed to meet its contractual undertakings, the City of Baltimore was suddenly faced with the prospect of having to step in to ensure public education would still be provided. (Palast, 2000; Green, 1997); Thompson, 1995).

Having specific safeguards may help prevent such a problem by making it clear what the consequences are. Fallback arrangements can include financial protections such as requiring the contractor to put up a bond or buy insurance as well as contingency provisions to resume public services if the contractor is dismissed or leaves. The contract should determine the level of financial protections appropriate to the situation. Ideally, it should provide for liquidated damages to cut the likelihood of protracted litigation over damages.

Prosecuting Breaches and Other Misfeasance: Subcontracting contracts must include an enforcement mechanism. These must be part of the contract negotiations. They can use an array of litigation or para-litigation devices, including mediation. Failures to comply may also be dealt with through a combination of existing criminal or civil penalties and contract remedies built into the subcontracting arrangement. Deciding what to include in the contract and what remedies to seek in the case of a breach or misfeasance means assessing what range of existing statutory remedies are sufficient and whether additional ones specific to subcontracting this service are necessary.

Periodic Reporting: Oversight requires regular reporting to the legislature, executive and public. Reporting should be on at least an annual basis -- or more frequently if necessary. More frequent reporting is advisable where sensitive matters are handled, large sums of money were involved, or interruption or degradation of service would be especially serious. The Arizona welfare privatization program requires bimonthly reporting with a comprehensive report at the end of the first year which includes (1) whether the vendor has met the contract's requirements, the goals of the program, and the requirements of its performance bond; (2) the fiscal impact of Arizona works implementation; (3) the impact of Arizona works on placement of recipients in paid employment, reduction of caseloads, and development of community partnerships. (Ariz. Rev. Stat. § 46-344 (1999)). A more comprehensive report is required in the fourth year of the program. In addition to the sorts of information in the annual report, it includes a survey of client satisfaction. (Ariz. Rev. Stat. § 46-345 (1999)).

B. Conclusion

Must privatization take place with none of the guidance experience and common sense can provide? Must people be victimized by scams, failures, and cost overruns in the name of privatization? The answer is no. We can protect our assets and services, save taxpayers millions of dollars, and prevent graft and corruption if our leaders only have the wisdom and courage to learn from privatization mistakes and successes. This is a case in which being wise requires hard

work and the courage to stand up for what is right in the face of true believers who preach a simple and seductive message: the market will provide. Our political leaders need to remember that most of us taxpayers are not true believers. What we want is good quality, stable public services at reasonable cost -- not subcontracting to satisfy an ideology or to help a subcontractor make a profit.

Hardline ideology, simplistic theories and slogans make it easy to draw lines and make decisions, but not necessarily good ones. A politician may believe she can better advance her career by making an unsupported claim to have saved the taxpayers money by contracting out public services than by explaining the nuances of market theory -- and she would probably be right. News stories announcing subcontracting and projected savings are more likely to be trumpeted and to make front page news while reports of subsequent problems are more likely to be hushed up and buried. An agency which privatizes may be able to cut costs but only by quietly and less visibly shifting them to another agency or to the public. As tempting as it is to avoid the complex decisions necessary to decide whether a specific service is best provided by the public or private sector, legislators know they have a responsibility not to waste public money, and they certainly do not want to be accused of causing waste by making ill-advised, poorly thought through decisions.

If states continue to subcontract without taking precautions to safeguard the public, waste and poor service are likely at best. At worst, there may be disasters. It is not too late to learn from past mistakes and use common sense to make wiser decisions about how to provide public services.

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