

Private Competition for Public Services: *Unfinished Agenda in New York State*

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EXECUTIVE SUMMARY

The benefits of opening public services to private competition—in terms of cost savings and quality—are potentially enormous, as George Pataki recognized when he first took office as Governor nearly a decade ago. Despite Governor Pataki's early advocacy, however, competitive contracting has not taken root as the preferred approach to providing public services in New York. Given the dimensions of the state's current fiscal crisis, there's never been a better time for the Governor to pursue his original agenda by allowing private providers to challenge New York's entrenched public-sector monopolies.

For example, New York currently spends more than \$3 billion in state funds on highway maintenance, bus transit subsidies, mental health facilities, motor vehicles record-keeping, human resources management, prisons, and welfare and Medicaid administration. In just these areas, efficiency gains at the low end of the 5 to 50 percent range (gains typically attributed to competitive sourcing) could translate into annual savings totaling hundreds of millions of dollars. The savings potential is even larger when viewed in the context of the more than \$100 billion in total annual operating expenses by New York's state and local governments. By establishing an effective, permanent institutional framework for competitive sourcing, the state can provide much-needed practical guidance to counties, municipalities and public schools as well.

Impetus for competitive sourcing reforms should begin with the Governor issuing an executive order establishing a new oversight agency, the Empire Competition Council, as a vehicle for instituting competitive contracting as the standard way of doing business for every level of government in New York. The Council would include representatives from both the executive and legislative branches of state government, the state comptroller's office, and local governments. Public employee unions and the business community would be invited to designate observers on the panel.

The Council would conduct an annual inventory of all services and activities provided by New York State agencies and public authorities, as well as common activities of local governments. This would allow public authorities to distinguish between inherently governmental functions and potential commercial activities. The Council would also develop accounting models for determining the fully allocated and unit costs of commercial activities, since productive competition between suppliers depends on accurate and rigorous cost comparisons. Finally, the Council would establish priorities for competitive outsourcing of services and manage competitions between in-house workers and private firms to provide services. The Council would be staffed by the Governor's Division of the Budget (DOB), which is the executive agency with the greatest involvement in both the day-to-day operations and strategic direction of state government. Agency managers should be given the strongest possible incentives to participate fully in the competition process.

Competition is ultimately aimed at getting better results for the taxpayer's money. To bolster this initiative, New York should also create a permanent Sunset Review Commission to recommend ways the government can cut costs, reduce waste, and improve efficiency and service levels. Specifically, the Commission would review 20 percent of state programs each year, assess the importance of each agency functions and recommend the elimination or consolidation of unneeded or outdated programs.

Working together, the Empire Competition Council and Sunset Review Commission would help the Governor and legislature eliminate redundant or outdated programs and services through a transparent public process. This would allow New York state and local governments to take advantage of the competitive mechanisms and efficiencies that drive private sector success.

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PRIVATE COMPETITION FOR PUBLIC SERVICES: UNFINISHED AGENDA IN NEW YORK STATE

“Competitive bidding between the public and the private sector can lower costs and provide more efficient delivery of services.”

— Governor George E. Pataki, June 17, 1995

INTRODUCTION

The benefits of opening public services to private competition are potentially enormous, as George Pataki recognized when he first took office as Governor nearly a decade ago. Throughout the country, state and local governments have harnessed competitive forces to reduce costs and boost productivity.

Despite Governor Pataki’s early advocacy, however, competitive contracting has yet to take root as a preferred approach to providing public services in New York. Given the dimensions of the state’s current fiscal crisis, there’s never been a better time to pursue his original agenda by allowing private providers to challenge New York’s entrenched public-sector monopolies.

As shown in Figure 1, since 1995, New York State has increased its use of private firms to perform some relatively small-scale activities—but many larger opportunities remain to be pursued. For example, New York currently spends more than \$3 billion in state funds¹ on highway maintenance, bus transit subsidies, mental health facilities, motor vehicles record-keeping, human resources management, prisons, and welfare and Medicaid administration. In just these areas, efficiency gains at the low end of

the 5 to 50 percent range usually attributed to competitive sourcing could translate into annual savings totaling hundreds of millions of dollars. The upside savings potential looks even larger when viewed in the context of the more than \$100 billion in total annual operating expenses by New York’s state and local governments.

It won’t happen overnight, though. Effective, robust competition to provide government services requires something New York now lacks—a comprehensive contracting process that is open to public scrutiny and based on solid performance and outcome measures, coupled with accountability standards that measure all costs and benefits accurately.

This report will examine key issues and questions including:

- why competition deserves a central place in the delivery of government services;
- how widely it is practiced elsewhere;
- key principles of a good competitive process;
- what New York can learn from other governments’ competitive contracting models; and
- how a model competitive sourcing process would work in the Empire State.

Figure 1. New York’s Unfinished Competition Agenda

EXAMPLES OF NEW OR EXPANDED OUTSOURCED STATE CONTRACTS SINCE 1995

- Janitorial and custodial services
- Facility design
- Warehousing
- Courier services
- Bakeries and kitchens
- Park concessions

EXAMPLES OF PRIME POTENTIAL AREAS FOR COMPETITIVE SOURCING

- Highway maintenance
- Transit buses
- Correctional services
- Human resources
- Welfare and Medicaid Administration
- Mental health
- Motor vehicles

The scope of New York's competitive sourcing effort should not be limited to the state government. By establishing an institutional framework for competitive sourcing, the state can provide much-needed practical guidance to counties, municipalities and public schools as well.

Not long ago, New York State under Governor Pataki seemed poised to become a leader in government reforms designed to tap the benefits of private sector competition. It's time to get back to the front of the parade.

THE VALUES OF COMPETITION, TRANSPARENCY AND PERFORMANCE

Consumers in an efficient market economy are able to make informed purchasing decisions based on both price and quality of services offered by competing providers. But the traditional public-sector approach to providing services, which still predominates throughout New York's state and local governments, relies on in-house monopolies. In the absence of market forces, consumers of government services too often have no way of knowing whether they are actually getting a good value for their tax and fee dollars.

The solution to the public sector value equation is *competition*. Wherever it is feasible, private and public entities should be encouraged to compete for the right to provide government services. This is potentially the most effective tool government has for arriving at a true market price for public services.

Defenders of the governmental *status quo* like to claim that traditional bidding requirements create a "race to the bottom", where the lowest bid automatically wins and quality plummets as a result. In fact, under the right rules, competition creates a "race to the top" in almost any undertaking, as is proven in the private sector every day. Truly competitive environments foster innovation and continuous improvement, maximizing benefits while preventing price-gouging. Without routine and robust competition, public agency processes inevitably tend to become stale and inefficient.

The growth of competitive sourcing

Over the past decade, more and more governments have been inviting private firms to compete for contracts to provide services once restricted to public

sources. This practice, also known as competitive sourcing, has been embraced as an effective policy tool for driving change in organizations, improving performance and restraining costs. According to the Government Contracting Institute, the value of all federal, state and local government contracts with private firms—including service outsourcing agreements—is up 65 percent since 1996, reaching a total of over \$400 billion in 2001.²

Competitive sourcing doesn't establish an automatic preference for private sector providers. Nor does it assume that government workers are always less efficient and productive. Rather, it allows government managers to determine which provider—in-house public employees or private firms—will offer the best combination of price and value when given the opportunity to compete for service contracts.

This trend isn't confined to any particular region, or to governments dominated by either major political party. The reason for the widespread appeal of competitive sourcing is simple: it works. According to a vast array of studies by the federal government, academic researchers and others, outsourcing on a competitive basis historically has resulted in cost savings in the range of 5 to 50 percent.³

But cost savings aren't the only benefit. A review of state practices around the country found that a need for greater flexibility, access to skills not available in-house, and private sector innovation are all important factors in a state government's decision to outsource or institute competitive sourcing of services.⁴

Principles of an effective process

Once a commitment to competition has been established, the second key principle in building value is *transparency*. The entire process of sorting through competitive sourcing options—along with the true costs and outcomes of sourcing decisions—should be open to public scrutiny. A more open process in New York would clear up the sort of questions that have dogged contracting activities in the state.

A third key principle is *performance measurement*. Expectations should be crystal clear. The winner of a contracting competition, whether it is an in-house unit or a private firm, should be held accountable

for delivering on cost and performance expectations over the life of the contract.

These three key principles—competition, transparency and performance measurement—must be accompanied by a commitment to communicating goals and objectives to the public and to all stakeholders in the process, including current public employees.

Doing it the right way

At its most basic level, competitive sourcing involves looking at everything government agencies do and determining whether private firms could do the same things more efficiently.

Stephen Goldsmith, former mayor of Indianapolis and one of the most accomplished practitioners of competitive sourcing in American municipal government, described his approach as “the yellow pages test.”

If the phone book lists three companies that provide a certain service, the [government] should not be in that business, at least not exclusively. The best candidates for marketization are those for which a bustling competitive market already exists. Using the yellow pages test, [you] can take advantage of markets that have been operating for years.⁵

In practice, of course, it’s not that simple. Once opportunities for competition have been identified, there must be rules for conducting competitions, managing and measuring results, and folding competition into other management priorities.

Within those broad components are many elements of strategy and process that hard experience has shown are crucial to success.

Taking stock: The all-important “inventory”

At any level of government, the yellow-pages test must begin with a thorough inventory of public services, which can be divided into two general categories:

Inherently governmental services are those involving a core mission of an agency that cannot be shifted to a private entity. An example would be any activity that involves exercising judicial or police powers, or administrative discretion in the granting of licenses and permits.

Commercial activities are not inherently governmental and are widely available from providers in the private sector. This would include a wide range of non-core, secondary or administrative support services, operation of public facilities and the like.

Two promising models for such an approach can be found in the federal government and the Commonwealth of Virginia.

The Federal model

The Federal Activities Inventory Reform (FAIR) Act,⁶ passed in 1998, requires U.S. government agencies to conduct annual inventories to identify their commercial activities. Within this category, each activity is assigned a “reason code” to determine whether it is actually appropriate for competition—and, if not, why not. The President’s Office of Management and Budget (OMB) is principally responsible for managing this process.

FAIR is only part of the federal government’s process, however. The actual “sourcing” policy—which determines how the inventory is taken and how competitions for commercial activities are actually completed—is set forth in OMB Circular A-76.⁷

Under A-76 procedures, “streamlined” competitions, taking no more than 90 days and using a simple cost-based market analysis, are allowed when the responsibilities of fewer than 65 full-time equivalent (FTE) government employees are involved. “Standard” competitions, taking up to 12 months and requiring formal bids, are used for activities performed by larger government staffs. In both cases, agencies compare costs of private firms and the existing in-house staff. Proposals are weighed primarily on cost, although other performance-related issues can account for up to half the final decision.

Despite its identification with the “reinventing government” movement, the administration of President Bill Clinton made relatively limited and inconsistent use of the A-76 process to competitively contract for government services. For example, Clinton allowed 56 air traffic control towers to be contracted out to private firms, cutting costs on average by more than 50 percent, according to the Federal Aviation Administration. But in 2000, his last year in office, air traffic control was formally classified as inherently

governmental, effectively blocking further privatization.

President George W. Bush has strengthened the FAIR Act and A-76 by issuing the President's Management Agenda (PMA), which integrates competitive sourcing with his administration's goals for strategic human capital management, electronic government and performance budgeting. The President has made it clear that competition will be central to his agenda and the continued focus on improving performance at the federal level. (Thus, for example, the Bush administration has amended Clinton's classification of air traffic control towers and is renewing the FAA's bid to contract out more operations.)

The Virginia model

When it comes to developing a process that combines the objectives of competition, transparency and effective performance measurement, Virginia is head-and-shoulders ahead of other states, including New York.

The agency responsible for Virginia's process is the Commonwealth Competition Council (CCC), created in 1995 as an outgrowth of then-Governor George Allen's Commission on Government Reform.⁸ Charged with finding better and less costly ways to provide government services to Virginia's citizens, the Council focuses its efforts on reducing the size and scope of government activity, especially in areas where the services or products of government can best be provided by private sector organizations, through competitive sourcing.

Using a model similar to that of the federal government's FAIR and A-76 process, the Virginia council identified 205 commercial activities being performed by over 37,000 state employees. The council's recommendations currently are estimated to be saving at least \$40 million a year.⁹

Once the inventory has been established, the next step is to determine which commercial activities are the best candidates for competitive contracting. A comprehensive approach to this challenge, designed to make competition a routine feature of agency operations, would represent a significant step beyond the limited, low-priority, case-by-case approach now followed by state agencies. Both the federal government

and Virginia have developed analytical models for identifying competitive contracting priorities. These models are discussed in more detail in the Appendix.

COUNTING, MEASURING AND MONITORING

Since saving money is a key goal of competitive sourcing, reliable cost comparisons are a crucial starting point for the contracting process. This requires something rarely found in state and local budgets—an estimate of the "fully allocated" expense of providing services. This includes all direct full-time and part-time personnel costs; materials; supplies; equipment purchases; capital and equipment depreciation cost; rent; maintenance and repairs; utilities; insurance; travel; operations overhead; and general and administrative overhead.¹⁰

These features, in turn, all go into determining the "unit cost" of providing a service, such as the cost per hour of operating a transit bus, or the cost per beneficiary of administering a health insurance program.

To aid competitive sourcing decisions, for example, Virginia's CCC has developed a methodology for consistently calculating both fully allocated and unit costs. The method is incorporated in COMPETE, an automated personal computer-based program designed to help government managers determine whether a service or function should remain in-house or contracted out. Under a pending legislative proposal, all Virginia agencies will be required to establish the full costs of their activities using COMPETE, regardless of whether the services are competitively sourced.

The value equation

While cost is of paramount importance, it is not the *only* criteria for governments selecting the best-value provider of public service—any more than it is the sole criteria of people shopping for cars (if it was, American highways would be full of Korean-made subcompacts).

The other key criterion is quality, which can be assessed in different ways in different circumstances. For services heavily used by the public—such as transit buses, or park restrooms—quality can be readily measured against objective standards of performance and customer satisfaction. Other activities,

such as architectural and engineering design work, require more complex measures.

It's crucial, then, to develop a system for monitoring contract performance. How many people are needed to monitor contracts? What should they be doing? What kinds of internal structures are needed as governments shift from service provider to service facilitator and purchaser? When outsourcing fails to deliver promised savings, it is often because government managers have failed to even consider such questions. A lack of adequate monitoring has been cited by the state comptroller's office in connection with several outsourcing agreements in recent years.

The answers can be complex or simple, but they are always vital.

Public sector decision-makers have yet to learn from the private sector the significance of managing outsourcing. Efficient monitoring, though costly, pays for itself by preventing overcharges and poor quality performance in the first place by recouping inappropriate outlays, and by disallowing payment for inadequate performance.¹¹

Most government contract monitoring plans—such as those in place under New York State's existing procurement process—deal in great detail with the process for selecting the winning bidder. However, they fail to devote equal focus to measuring results.

Performance-based contracting

One powerful reform that can save government money and improve program results is implementing performance-based contracting for as many contracts as possible. Performance-based contracting is the soliciting of bids based on what results government wants accomplished, rather than what activities it wants conducted. In other words, the emphasis is on outcomes rather than inputs. This requires performance standards to be included in the contract and contractual payments tied to the achievement of results.

The better the performance standards for a given service or activity, the easier it will be to monitor the contract effectively. The design of the deal makes a lot of difference in the success of monitoring the contractor. Because these factors are so interdependent,

it is often best to write the performance standards and the monitoring plan simultaneously. Indeed, the federal OMB recommends simultaneous development of performance measures and monitoring plans as a best-practice.¹²

For many agencies, this would mark a significant change in the way of doing business. By compensating a contractor for results rather than effort or activity, the transaction becomes more efficient for both the vendor and government. The vendor has the freedom and flexibility to do what it does best (produce the service) without micromanagement by government.

The contract is structured under a fixed price for each service purchased, with no payment until performance is delivered. This reduces transaction costs for both government and the vendor as paperwork and auditing requirements are streamlined. The resulting focus on performance is likely to improve chances that government gets quality service.

This scenario stands in stark contrast to the preferred contracts used by New York State and other governments today: "cost-reimburse" and "fee-for-service" contracts. Under these contracting vehicles, government pays every time a contractor "works" on a project. Too often, this encourages a contractor to drag on the contract for as long as possible and take every opportunity to engage in an authorized activity under the contract.

Well-developed monitoring systems also take into account that sometimes contracts have to be terminated. Termination is the ultimate club in the hand of government officials, and the final stage of accountability. Some monitoring plans use an escalating scale of punishment measures, reserving termination as a last resort. At the same time it is crucial to create a paper trail that supports a decision to terminate the contract if it comes to that.

Outsourcing is a collaborative relationship that has to be worked on. The lawyers are very helpful in structuring a contract. Our job is to make sure we don't need them throughout the year. When the inevitable financial tensions arise, we have been able to have a 'closed door' meeting of several financial people from both sides and share our mutual objectives. Both sides feel a lot better when it is over.¹³

Splitting purchasers from providers

The contract administration functions of an agency that purchases a service on a competitive basis must be cleanly separated and isolated from service delivery functions. The goal is to free agency heads to advance policy options that are in the public's best interest but may be contrary to the self-interests of the department.

Splitting contract administration from service delivery creates incentives for governments to become more discriminating consumers, looking beyond government monopoly providers to a wide range of public and private providers. So, for example, it has been recommended that any contracts with private firms selected on a competitive basis to operate transit bus lines in New York City should be administered and monitored by a separate executive unit in the Metropolitan Transportation Authority, not by MTA's own competing bus operation.¹⁴

Trends in New York State

Before and immediately after his election as governor in 1994, George Pataki was a frequent advocate of opening more government services to private providers. However, he usually talked about it under the broader rubric of "privatization," a term that also describes the permanent transfer of government assets to the private sector.

"Countries like Canada and England and many states at home have shown it's possible to streamline government, improve services and cut costs by privatization," Pataki said in his 1995 inaugural address. "I will move aggressively on this front."

To spearhead the effort, Pataki formed a Privatization Commission, chaired by Ronald S. Lauder and staffed by a senior official of the Empire State Development Corporation (ESDC). The commission focused on complex divestiture deals involving high-profile government assets such as Stewart Airport, New York Coliseum, surplus mental health facilities and the World Trade Center.

By comparison, less progress was made in contracting out government services. Instead, the increased contracting-out of state services under the Pataki administration has unfolded incrementally and on

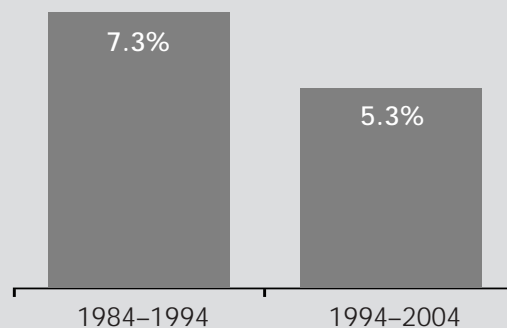
a relatively small scale, with no head-to-head competitions between private firms and in-house employees. Since 1995, the state has contracted out services in areas including janitorial and custodial work,¹⁵ facility design,¹⁶ warehousing, courier and package delivery, state bakeries and warehouses, and the management of park concession stands at state parks.

The single largest outsourcing by New York State actually dates back to the Cuomo administration. In 1994, just before Pataki took office, the state entered a 10-year contract with Fleet Bank¹⁷ to process income tax returns. An operation that once required the hiring of thousands of seasonal state employees was transformed by Fleet into an automated, state-of-the-art process employing many fewer workers.

The governor's office has not produced an authoritative compendium or status report on agency outsourcing projects. It seems clear, however, that this activity is a key reason why the executive branch of state government is now operating with about 20,000 fewer employees than it had on the payroll a decade ago. And while there is no single, consistent measure of savings from the contracting-out of services, this much is clear: As illustrated in Figure 2, total state operations spending over the past 10 years (a period that includes the end of the Cuomo administration) has risen at much slower rate than it did over the previous 10 years, after adjusting for inflation.

Figure 2. Impact of Increased Outsourcing

Real Growth in State Operations Disbursements
Fiscal years ending 1984-94 and 1994-2004



Source: Executive Budget and Comprehensive Annual Financial Report of the State Comptroller; figure for FY 2004 is preliminary

Beginning in 1996, New York's procurement statute (Article XI of the State Finance Law) underwent a sweeping revision culminating in the Procurement Stewardship Act, which includes a voluminously detailed list of contracting requirements and creates a 19-member State Procurement Council to "continuously strive to improve the state's procurement process." The Council's procurement guidelines stress the importance of competition and establish "best value"¹⁸ as a basis for awarding service contracts. However, neither the law nor the council guidelines have created a framework for expanding competitive bidding of public services to new areas, or for systematically evaluating the outcomes of outsourcing.

Disputed results

Public employee unions continue to claim that the state's outsourcing agreements are actually losing money. The unions' self-interest in preserving their remaining monopoly is patently obvious. Nonetheless, the state's contracting practices remain vulnerable to criticism because there is no open, comprehensive process for deciding which activities will be outsourced or how the costs and benefits will be measured.

For example, the Pataki administration has had disputes with public employee unions and the comptroller's office over the true extent of savings related to both the Fleet tax project¹⁹ and the use of consulting engineers by the state Department of Transportation.²⁰ In both cases, much of the disagreement can be traced to a lack of standard performance measures and documentation going into these projects.²¹

However, Governor Pataki has scored one major achievement that establishes an important precedent for proceeding with competition on a broader scale. In his first set of collective bargaining agreements with the state's major public employee unions, the Governor successfully negotiated a clause explicitly acknowledging the state's right to contract-out services and setting forth transitional requirements for state workers affected by outsourcing. Permanent state employees affected by a competitively bid contract must receive 60 days notice and must be offered a redeployment option of a choice of severance benefits, an education and training stipend, or a hiring preference with the winning bidder.

CREATING A COMPETITIVE PROCESS FOR NEW YORK

Building on the federal and Virginia examples, the Governor should issue an executive order establishing a new oversight agency, the Empire Competition Council, as a vehicle for pushing competitive contracting as the standard way of doing business for every level of government in New York.

The Council would include representatives from both the executive and legislative branches of state government, the state comptroller's office, and local governments. Public employee unions and the business community would be invited to designate observers on the panel.

The Council would be charged with the following responsibilities:

- 1) Conduct an annual inventory of all services and activities provided by New York State agencies and public authorities, as well as common activities of local governments, distinguishing between inherently governmental and commercial activities along the lines specified in the federal A-76 circular.
- 2) Establish priorities for competitive outsourcing of services and managed competitions between in-house workers and private firms to provide services.
- 3) Develop accounting models for determining the fully allocated and unit costs of commercial activities. (This is a pivotal concern, since competition will produce results only if subject to rigorous cost comparisons.)

Additional priorities:

- The Council should be staffed by the Governor's Division of the Budget (DOB), which is the executive agency with the greatest involvement in both the day-to-day operations and strategic direction of state government. This would correct the mistake of Pataki's initial foray into the more carefully circumscribed area of "privatization," which was based in a peripheral agency focused primarily on marketing real estate development and asset divestiture. It also would avoid replicating a weakness of Virginia's system, in which the CCC has broad responsibility but limited practical authority or operational oversight.

- Agency managers should be given the strongest possible incentives, including but not limited to performance bonuses, to participate fully in the competition process.
- Public employee transition arrangements, where necessary, should be consistent with collective bargaining language requiring severance pay or first preference in hiring for affected workers.
- The executive director of the Empire Competition Council should have a rank equal to that of a first deputy budget director, a senior position with recognized standing in the state's bureaucracy. Because DOB is a professional agency run by political appointees but staffed almost entirely by tenured civil servants, it also offers the best chance for institutionalizing a competition-based contracting policy in a way that will survive the current administration.

Running the Competitions

The existing State Procurement Council should serve as an advisory group to oversee the process for monitoring contract performance. The “best value” principles incorporated growing out of the Procurement Stewardship Act (Article XI, Section 162 of the State Finance Law) can be adopted for use in the competitive sourcing program. But in contrast to some of the existing procedures, the goal should not be to micromanage contracts but to focus on outcomes. This includes the not insignificant task of shifting the state's emphasis to performance-based contracting, which will entail a variety of complex issues and relationships such as employee transitions; asset transfers; developing outcomes, performance goals, and penalties; contract terminations; dispute resolution; and risk management.

Keep pruning the undergrowth

Competition is ultimately aimed at getting better results for the taxpayer's money. To bolster this initiative, New York should also create a permanent Sunset Review Commission to recommend ways the government can cut costs, reduce waste, and improve efficiency and service levels.²² Specifically, the Commission should review 20 percent of state programs each year, assess the importance of each agency's functions and recommend the elimination or consolidation of unneeded or outdated programs.

The challenge is to root out such government waste so that taxpayer dollars can be utilized most efficiently. To this end, the creation of a Sunset Review Commission would help the Governor and legislature to eliminate redundant or outdated programs and services. It's important that the commission focuses not only on program and service *efficiency*, but also *effectiveness*.

Outside assistance may be required to identify government waste and savings opportunities from restructuring, however. To this end, New York could benefit from the expertise and efficiency of a management-consulting firm to assist with its cost savings efforts. The costs of hiring such a firm would almost certainly be justified by the cost savings generated, and contracts can be structured such that compensation is a percentage of savings. Thus, there would be no payment up front and the consulting firm would be paid only out of realized savings. One study made such a recommendation for the State of California, and noted that even if the contract between the government and the consulting firm provided only a small “share-in-savings” bonus of 0.1 percent or so, for a state with a budget in the billions of dollars, this can mean serious money for the contractor *and* serious savings for the state.²³

Not only could the Sunset Review Commission identify duplicative services and programs that have outlived their purpose, it could also help the legislature to identify low-priority programs that the state may wish to fund during the luxury of good economic times, but are not imperative—and therefore not justified—in times of hardship. Thus, while New York is locked in a budget crunch, state legislators and the governor should reevaluate the government's core functions and responsibilities and question programs that fall outside this framework.

Contracting opportunities

Several areas stand out as prime candidates for consideration as commercial activities appropriate for possible contracting out to the private sector. These include:

Highway maintenance—The workforce assigned to “preventive maintenance” tasks in the state Department of Transportation totals 4,900 full-time equivalent employees, whose salaries and benefits cost at

least \$300 million a year. But much of their work could be put up for bid in a way that would require the public workforce to compete with private firms. States realizing significant gains from outsourcing highway maintenance include Florida, where the initiatives generated cost savings between 15 and 20 percent,²⁴ and Massachusetts, where the highway maintenance budget fell from \$40 million to \$25 million while the amount of maintenance performed grew between 1991 and 1999.²⁵

Transit Buses—New York City’s transit bus operations consume at least \$345 million a year in taxpayer operating subsidies, including the cost of privately franchised routes that the city wants to transfer to the state Metropolitan Transportation Authority. But a 2002 Manhattan Institute study showed the need for these subsidies could be eliminated if transit bus routes were contracted out to the private sector, based on experiences in major U.S. and European cities.²⁶

Prisons—Private companies in the U.S. now operate more than 119,000 prison beds, and three-fifths of all U.S. states have privately run prisons within their borders. A host of studies show private correctional firms generate operational savings in the range of 5 to 20 percent, and also result in quality improvements.²⁷ In New York, where the state correctional services budget totaled \$1.78 billion this year, the potential for savings was highlighted by a recent state comptroller’s audit showing the amount of workers’ compensation leave taken by corrections officers has risen 40 percent in recent years, despite decreases in inmate assaults and the prison population.²⁸ Governor Pataki’s repeated vetoes of a bill that would prohibit any prison privatization has preserved the option of opening corrections to competition.

Human Resources—The processing of the state payroll is handled by the state comptroller’s office at a cost of \$35 million a year, while the administration of health benefits is handled by the Department of Civil Service at a cost of \$23 million. Both areas constitute examples of human resources functions that many private corporations, as well as state governments, have outsourced.

Welfare and Medicaid administration—Not including federal grants, the state spends just over \$100 mil-

lion to administer Temporary Assistance to Needy Families (formerly known as Aid to Families with Dependent Children) and Medicaid programs. Shifting all or part of these responsibilities to private firms—which already have an extensive role in other parts of the system—would require a waiver of some federal regulations. Such a waiver seems likely to receive favorable consideration from the administration of President George W. Bush, who was rebuffed by the Clinton administration when he tried as governor of Texas to privatize welfare administration in his own state.

Mental Health—Even after four decades of steady shrinkage in the once-extensive network of institutions for the mentally ill, New York State runs 28 facilities, including 17 adult psychiatric centers and six children’s psychiatric centers, which employ a total of 17,300 workers at a state budget cost of about \$500 million a year. Yet there is no shortage of potential non-government operators for such facilities, including organizations already involved in running other types of private long-term care facilities and hospitals on both a for-profit and nonprofit basis.

Motor Vehicles—Several states have fully or partially outsourced various Department of Motor Vehicles (DMV) functions such as the administration of driver’s license and vehicle registrations, which in New York State are still handled almost exclusively by public employees. DMV “operations” (not including adjudication and other functions that might be classified as inherently governmental) will cost New York State \$68 million this year. One study of successful privatization initiatives in Arizona, Ohio, Florida, and North Dakota reported that through privatization DMV fees could be reduced by 14 to 17 percent; it also estimated cost savings between 55 and 67 percent.²⁹

How much can be saved?

Until the state actually embarks on such a comprehensive program, it’s difficult to establish a firm projection of how much might be saved. But the stakes are potentially enormous. For example, the state now spends \$3 billion on the areas listed above as prime potential candidates for outsourcing.

The operational expenditures³⁰ of state and local government throughout New York, including pub-

lic school districts, now exceed \$100 billion a year. Even if it is assumed that just one-tenth of this amount supports activities that would be suitable for managed competition or outsourcing, the likely annual savings from smarter sourcing would still amount to upwards of \$1 billion.³¹

This is why it is important for the Empire Competitiveness Council to develop an inventory of services provided by local governments as well as the state government, and to give local officials access to the cost-accounting methodologies developed to compare bids and measure results.

CONCLUSION

Pataki's outspoken philosophical commitment to privatization in his first year as governor, and his success in negotiating contract language that allows for transitioning affected state workers, have laid the groundwork for a truly comprehensive effort to bring the benefits of competition to government in New York.

The state's latest fiscal problems make this a perfect time to embark on such a program. This would certainly be consistent with the 2004-05 DOB budget-making directive urging state agencies to come up with "creative steps to maintain the delivery of core services."³²

It might be argued that the Pataki administration's incremental, go-slow approach to privatization of services was successful in avoiding pitched political battles that would result from pushing competitive sourcing on a broader front. However, the lack of an open, comprehensive sourcing process has unnecessarily undermined the credibility of savings estimates associated with services contracted to the private sector. Moreover, political battles over outsourcing have occurred anyway—and they now appear to be in danger of intensifying.

For example, by a vote of 148-0, the Assembly has passed a bill (S.198, A.1726-A) designed to make any outsourcing of personal services virtually impossible in practice. Supported by public employee unions (and deceptively described as a measure merely to require "cost-benefit analysis" of contracts) the bill was still in committee in the state Senate (as of the publication of this report).

It's not enough to just say "no" to such retrograde proposals. To preserve and build on the gains from existing outsourcing arrangements, the Governor needs to spearhead a new effort to create a permanent, institutional framework for competitive contracting. This way, the benefits of competition can be tapped not only to help solve the state's latest budget problems, but to pay dividends for future generations of taxpayers throughout New York.

APPENDIX: SETTING COMPETITION PRIORITIES

Once a government's "commercial activities" have been identified, how can a public agency decide which activities are the best candidates for competitive contracting? Both the federal government and Virginia have developed analytical models for answering this question.

The federal approach

To implement the Federal Activities Inventory Reform (FAIR) Act, federal agencies attach a "Reason Code" for each commercial activity to classify whether or not that activity is appropriate for competition. As shown in the table (below), six such codes are now in use.

REASON CODES FOR FEDERAL COMMERCIAL ACTIVITIES INVENTORY	
Reason Code	Definition
A	The Commercial Activity is not appropriate for private sector performance pursuant to a written determination.
B	The Commercial Activity is suitable for a Cost Comparison or a Direct Conversion.
C	The Commercial Activity is the subject of an in-progress Cost Comparison or Direct Conversion.
D	The Commercial Activity is performed by a Most Efficient Organization (MEO) resulting from a Cost Comparison decision made within the past five years.
E	The Commercial Activity is pending an agency approved restructuring decision (e.g., closure, realignment).
F	Performance of the commercial activity by government personnel is required due to a statutory prohibition against private sector performance.

The Office of Management and Budget (OMB) is largely responsible for managing this process. OMB sets the competition policy and reviews each agency's commercial activities inventory.

Upon completion of an inventory there is a limited administrative challenge and appeals process under which an interested party may challenge the omission or the inclusion of a particular activity on the inventory as a commercial activity.

Identifying opportunities in Virginia

Virginia's Commonwealth Competitiveness Council has a five-step process to determine what government services can be competitively contracted.

The initial step is largely an information gathering exercise. The council solicits information from citizens, business interests, and government employees. This information was used to develop the inventory of competition opportunities.

The second step requires agencies to conduct a performance analysis of public and private entities to determine whether services should be opened to competition. The analysis consists of five parts:

- Determine the potential for competition and the state's ability to measure performance.
- Establish fully allocated cost of operating current activity vs. estimated cost of contract or savings, using the COMPETE software program to make cost comparisons easier and more fair.
- Identify any issues related to public safety and welfare.
- Plan for all aspects of the competition itself—i.e., assignment of personnel, transition considerations, and contract administration.
- Consider implementation issues—i.e., procurement requirements, and quality assurance and evaluation procedures.

The third step is the request for proposal (RFP) phase. Both private sector firms and in most cases, state agencies are asked to tender proposals. Independent reviews of the in-house costs are also completed at this time to ensure that costs were complete, accurate, and reasonable.

Next, the agency receives sealed proposals. After review, a tentative decision to continue in-house operations or to award a contract to a bidder is announced. Contracts are awarded for a period not to exceed 5 years.

The last phase, which is essentially the monitoring phase, requires agencies to establish ongoing quality assurance programs to ensure that quality and cost standards established in the contract are met. In addition, agencies are required to conduct a post-performance review at the end of the contract period.

ENDNOTES

1. Including taxes and fees, plus bond revenues, but excluding federal grants.
2. Government Contracting Institute, 2002.
3. Over 100 studies of cost savings from privatization are reviewed in John Hilke, *Cost Savings from Privatization: A Compilation of Study Findings*, Reason Foundation How-to Guide No.6, (Los Angeles: Reason Foundation, 1993), <http://www.rppi.org/htg06.pdf>. For an overview of research on cost savings in federal privatization, see General Accounting Office, *DOD Competitive Sourcing: Savings Are Occurring, but Actions Are Needed to Improve Accuracy of Savings Estimates*, Washington, D.C.: GAO/NSIAD-00-107, Aug. 8, 2000; General Accounting Office *DOD Competitive Sourcing: Some Progress but Continuing Challenges Remain in Meeting Program Goals*, Washington, D.C.: GAO/NSIAD-00-106, Aug. 8, 2000; and Center for Naval Analysis, "Long-run Costs and Performance Effects of Competitive Sourcing," Washington, D.C., 2001 <http://www.cna.org/research/studies/comsourc.html>.
4. Keon Chi and Cindy Jasper, *Private Practices: A Review of Privatization in State Government* (Lexington, KY: Council of State Governments, 1998).
5. Stephen Goldsmith, *The Twenty-first Century City: Resurrecting Urban America*, (Washington, D.C.: Regnery, 1997), p.26.
6. See U.S. Office of Management and Budget, Office of Federal Procurement Policy for more information. <http://www.whitehouse.gov/omb/procurement/fair-index.html>.
7. The latest revised version of OMB circular A-76 can be downloaded from www.whitehouse.gov/omb/circulars/a076/a76_rev2003.pdf.
8. See <http://www.vipnet.org/ccs/commercial.htm>.
9. Author conversation with Phil Bomersheim, executive director of the Commonwealth Competition Council.
10. Lawrence Martin, *How to Compare Costs Between In house and Contracted Services*, Reason Foundation How-to Guide No.4, 1993, <http://www.rppi.org/htg04.pdf>
11. Jonas Prager, "Contracting Out Government Services: Lessons from the Private Sector," *Public Administration Review*, vol. 54, no. 2, 1994, p. 182.
12. Office of Management and Budget, *A Guide to Best Practices for Performance-Based Service Contracting*, (Washington, D.C.: Office of Federal Procurement Policy, Office of Management and Budget, 1996).
13. F. Warren McPharlan and Richard I. Nolan, "Outsourcing at Kodak," *Sloan Management Review*, January 1995.
14. E.S. Savas and E.J. McMahon, "Competitive Contracting of Bus Service: A Better deal for Riders and taxpayers," Manhattan Institute Center for Civic Innovation, Civic Report No. 30, November 2002.
15. Custodial services are contracted out in roughly 80 percent of the buildings managed by the state Office of General Services (OGS), according to OGS officials.
16. Prior to 1995, about 80 percent of OGS facility design work was done by in-house staff. By 2003, roughly 60 percent of the work was done by private consultants, according to agency officials.
17. Fleet's selection was an outright privatization resulting from a competitive request-for-proposal (RFP) process involving a number of private firms. The state workforce previously involved in processing tax returns consisted mainly of seasonal employees, and there was no in-house staff bid.
18. As defined in Article XI, Section 163.9(j) of State Finance Law: "'Best value' means the basis for awarding contracts for services to the offerer that optimizes quality, cost and efficiency, among responsive and responsible offerers. Such basis shall reflect, wherever possible, objective and quantifiable analysis."
19. Initially, the state estimated it would save \$76 million over the life of the Fleet contract. But a 1998 audit by then state Comptroller indicated the actual savings were less than half as large. Among other things, expenses were inflated by \$41 million by the Pataki administration's decision to move Fleet's operation from Albany to vacated space in Kingston.

20. The Public Employees Federation, the union representing engineers working for the state Department of Transportation (DOT), successfully sued to force the release in December 2000 of a KPMG study which found that engineering consultants were often more expensive than in-house DOT staff, a claim previously made by the comptroller's office as well.

21. In the case of DOT consultants, the greater expense may also be related to a provision in state procurement laws stipulating that architects and engineers are to be selected solely on a "most highly qualified" basis; their costs are thus a secondary concern and generally are negotiated only *after* a firm has been selected.

22. A good example of a Sunset Review Commission is Texas' Sunset Advisory Commission, <http://www.sunset.state.tx.us/>. "Since the first reviews, 44 agencies have been abolished and another 11 agencies have been consolidated. In addition, even as the scope of reviews has expanded, the Legislature has adopted a large majority of the recommendations of the Sunset Commission."

23. Carl DeMaio et.al., *Citizens' Budget 2003-5*, (Los Angeles and San Diego: Reason Foundation and Performance Institute, 2003), pp. 47-48, <http://www.rppi.org/citizensbudget.pdf>.

24. Bill Albaugh, Director of Highway Operations, Florida Department of Transportation, interview with authors, July 2002.

25. Ibid.

26. Op. Cit., Savas and McMahon.

27. Geoffrey F. Segal and Adrian Moore, *Weighing the Watchmen: Evaluating the Costs and Benefits of Outsourcing Correctional Services, Part 2: Reviewing the Literature on Cost and Quality Comparisons*, Reason Foundation Policy Study No.290, 2002, <http://www.rppi.org/ps290.pdf>.

28. See "Prison Officers Are Taking Longer Leaves" in *The New York Times*, Nov. 28, 2003. As the article noted: "Lax oversight by the department played a role in the expanded use of workers' compensation time, the audit concluded. But the main cause, the authors of the audit found, was a longtime provision in the correction officers' contract with the state that allows six months' leave with full pay."

29. Patrick A. Hazel, *Privatize the Oregon DMV*, (Portland: Cascade Policy Institute, 1997) <http://www.cascadepolicy.org/bgc/dmv.htm>.

30. At the state level, this figure consists of all spending on state operations and general state charges. Local figures are as reported in State Comptroller's 2001 Special Report on Municipal Affairs for New York State, adjusted for subsequent inflation.

31. For example, at least one-fifth of operational expenditures by local governments takes the form of federally subsidized income transfers to needy individuals, including welfare and Medicaid payments. Another 10 percent is spent on "public safety" functions that might be considered inherently governmental, such as courts and police.

32. Letter from Carol E. Stone budget director, to all state agency commissioners, September 29, 2003.

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