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PRIVATIZATION OPPORTUNITIES FOR STATES

by

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EXECUTIVE SUMMARY

The state fiscal crisis combined with the growing revolt against new taxes is forcing policymakers to search for ways to substantially cut the costs of delivering state services. Governors and state legislatures are seeking innovative approaches to fundamentally restructure, downsize, and "rightsize" state government in order to avoid continuing budget problems.

Privatization allows policymakers to avoid tax increases without eliminating essential services. Privatization is an increasingly important component of programs to restructure state government, as it serves policymakers’ short-term goals of cutting state deficits, while also furthering the long-term goals of rightsizing government and incorporating competitive incentives into state services.

Privatization is already a common practice in state governments. For instance, a 1992 Apogee Research survey found that of state agencies, 90 percent indicated they utilize privatization.’ Nevertheless, most privatization to date in state government has been sporadic, thus limiting the potential gains from privatization.

However, this is changing. To realize the full potential of privatization, states are beginning to explore the possibilities of applying various privatization techniques across the full range of state services, assets, infrastructure, and real estate. Over 20 percent of the states responding to the 1992 Apogee survey reported that they were preparing statewide or agency-wide privatization strategies, compared to none in 1989.

Privatization opportunities range from services such as road maintenance and child-support enforcement, to sales or leases of state assets such as turnpikes and parks. Privatization can also be used to assist states in rebuilding infrastructure such as bridges, roads, and tunnels. Another privatization option is providing vouchers to poor and handicapped people to purchase social services on the open market, rather than relying exclusively on government agencies.

Applying privatization techniques to state services, assets, facilities, and other functions will yield privatization opportunities in every state. Privatization offers state policymakers a powerful kit of tools to begin getting their fiscal house in order.

* Part one of a two part series on State Privatization. See also Reason Foundation Privatization How-To Guide #1, "Designing a Comprehensive State-Level Privatization Program," January 1993.

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I. INTRODUCTION

States are suffering from their worst budget problems since the Great Depression. Thirty-one states accumulated a $31 billion deficit in 1991 alone. This follows on the heels of several years of budget distress in state capitals across the country. In 1990, spending exceeded revenues in two-thirds of the states, while, in the Northeast, the first signs of fiscal trouble appeared back in 1988.

According to a number of state budget analysts, states will have to grapple with structural budget deficits throughout the l990s. For instance, Steven Gold, director of the Center for the Study of the States, forecasts that in the l990s, "Its virtually inevitable...The states will face continuing fiscal stress."2

Analysts cite several causes for the states' fiscal problems. These include: 1) the recession; 2) skyrocketing costs in federally mandated programs such as medicaid and welfare; and 3) courtimposed spending requirements for areas such as education and corrections.

The most important impetus for the budget problems of the l990s, however, is that states can no longer afford to fund the rapid growth of state spending that occurred in the 1980s. Between 1980 and 1989, state spending grew by 104 percent. In most of the states now facing the worst budget problems, spending grew even faster: by 119 percent in California; 174 percent in Connecticut; 169 percent in Florida; and 134 percent in Massachusetts.3 Numerous programs were created during the state spending increases of the 1980s. These programs, in turn, have generated strong constituencies that now resist attempts to terminate, cut, or slow the growth of these programs.

The main reason for the large growth in state government was that tax receipts were growing very rapidly in the 1980s, so there were few fiscal or political considerations restraining spending.4 As demonstrated by Table 1, per capita tax receipts increased from $658 to $1,147 between 1980 and 1988. Describing the Northeast's fiscal problems in 1989, Steve Moore of the Washington, D.C.-based Cato Institute wrote, "The plight of the Northeast is a classic case of the ratcheting effect of government. Higher revenues trigger new spending, which quickly becomes a politically indispensable fixture of the government."5

States are now finding it increasingly difficult, if not impossible, to pay for the growth of state government that occurred in the 1980s. Reason: slow personal income growth and sluggish Persona1 consumption caused by the recession has resulted in diminishing tax revenues.

Many states have chosen to solve this budget problem by increasing taxes, rather than by reducing spending. In fact, states have enacted record tax increases in the last three years: $17 billion in fiscal year 1992; $10.3 billion in fiscal year 1991; and $5.5 billion for fiscal year 1993. These tax increases are cumulatively larger than the total state tax increases in the entire decade of the 1980s.6

STATE TAX INCREASES SLOW ECONOMIC

GROWTH. A number of factors, however, are now working to slow the cycle of ever-increasing

state spending and taxes. For one thing, , turning to higher taxes to solve budget shortfalls can have adverse economic effects. Numerous studies in the 1980s indicated that high taxes reduced state growth rates.7 Among other findings, the studies revealed that tax increases can have devastating impacts on a state's economy by: 1) slowing long-term growth and employment; 2) causing businesses to relocate to lower-tax states; 3) deterring businesses from moving into a state; 4) deterring the growth in the stock of capital; 5) reducing small business starts; and 6) inducing consumers to cross state borders to purchase goods.

During the 1980s, states with fast-rising taxes experienced slower economic growth than states that kept taxes down. A 1981 study by the Joint Economic Committee (JEC), for example, found income growth in states to be inversely related to the level of state and local tax burdens and to the amount and progressivity of income taxes in the state.8 The inverse relationship between states' relative tax burdens and economic growth rates was confirmed in a 1988 study by A.B. Laffer Associates that examined the 1980 - 1986 period, and by a 1991 study by University of Dallas economist Gerald Skully.9

Some proponents of tax increases acknowledge the adverse economic effects of income and business tax increases, but contend that excise tax increases, on the other hand, do not damage a state's economy. Recent evidence, however, contradicts this notion. Increases in taxes on goods such as gasoline, alcoholic beverages, or cigarettes, may cause residents to cross the border into lower-tax states to buy certain goods, according to a 1992 Price Waterhouse study done for the American Legislative Exchange Council (ALEC).10 As a result, these higher-tax states experience reductions in potential tax revenue and business growth, while lower-tax states experience increases in both.

State legislators and governors often contend that the tax increases are necessary to eliminate government red ink. The evidence, however, suggests that rather than solving long-term fiscal problems, these tax increases typically lead to increases in government spending. In a study of state budget data between 1952 and 1982, former U.S. Treasury Department economists Michael L. Marlow and Neela Manage found that "tax receipts cause expenditures at the state level of government."11 In other words, revenue increases lead to spending increases, rather than smaller deficits.

TAXPAYER REBELLION. Citizen disillusionment with government and grassroots resistance to higher taxes is growing. In Connecticut, Governor Lowell Weicker had to escape via a tunnel when confronted with 65,000 angry voters who stormed the state capitol in 1991 protesting a new 4.5 percent income tax.12 A grassroots revolt against tax increases in New Jersey led to a Republican takeover of the state senate and house in 1991. Taxpayers also turned nine taxraising governors out of office in 1988 and 1990.13

In addition, through taxpayer-sponsored-state initiatives and referenda, citizens are making it increasingly difficult for politicians to continue the record level of state tax increases. In Oklahoma, voters approved on Super Tuesday in 1992 a ballot initiative requiring a three-fourths vote of the legislature to enact any future tax increase. A similar measure, this requiring a twothirds vote, was passed overwhelmingly in Arizona in the November 1992 general election. In Colorado, the general election voters approved by 54 percent to 46 percent a citizen initiative requiring voter approval of all state and local tax increases as well as spending increases above inflation.

Also in the 1992 general election, measures calling for tax increases were defeated in Missouri, North Dakota, Oregon, Oklahoma, and California.14 Spending-control proposals were approved in Connecticut and Rhode Island, while large public-works bond issues were defeated in California and New York.

Increasing citizen resistance to new and higher taxes, together with the documented negative economic consequences of state tax increases, is compelling politicians of both parties to seek alternatives to business-as-usual. Thus privatization, a proven alternative to higher taxes and/or deep cuts to essential services, is gaining attention as one of the most promising approaches for addressing state and local fiscal pressures.

PRIVATIZATION TRENDS. A 1992 survey of state agencies conducted by Apogee Research and sponsored by the National Association of Comptrollers revealed that interest in privatization is gaining rapidly in the states.15 Fully 85 percent of the 158 state agencies that responded to the survey said that they believed privatization will be a major tool to provide state services and facilities in the next decade.16 This represents an increase of 35 percentage points in just three years.

Over 90 percent of survey respondents employ privatization techniques. All of these contract out services; 30 percent have or plan to privatize facilities; and over 15 percent have or plan to sell assets.

With regard to specific service areas, over 70 percent of states responding now contract out services in corrections, health, higher education and mental health.

Over 20 percent of states responding have, or will be, preparing statewide or agency-wide privatization strategies. Three years earlier, no state reported working on such a strategy.

II. ADVANTAGES OF PRIVATIZATION

Many reasons explain the movement by cities and states toward privatization to restructure and "rightsize" government. Much of the impetus is the desire to inject competition into the delivery of state services in order to provide services to citizens in a more-efficient and cost-effective manner. If structured appropriately and sufficiently monitored, privatization can:

1. SAVE TAXPAYERS' MONEY

2. INCREASE FLEXIBILITY

3. IMPROVE SERVICE QUALITY

4. INCREASE EFFICIENCY AND INNOVATION

5. ALLOW POLICYMAKERS TO STEER, RATHER THAN ROW

6. STREAMLINE AND DOWNSIZE GOVERNMENT

7. IMPROVE MAINTENANCE

SAVE TAXPAYERS' MONEY. By applying a variety of privatization techniques to state services, infrastructure, facilities, enterprises, and land, comprehensive state privatization programs can reduce program costs.

Over 100 studies have documented cost savings from contracting out services to the private sector.17 Cost savings vary but average between 20 to 40 percent, depending on the service. For some services, such as prison construction and operation, savings are generally less, while for others, such as asphalt resurfacing, savings are often greater. Competitive bidding whenever possible and careful government oversight are crucial to sustained cost savings.

States can also realize large one-time windfalls from the sale or lease of state infrastructure and facilities. Moreover, privatization can put an end to subsidies to previously government-run operations.

Privatization also creates a steady stream of new tax revenues from private contractors and corporations who pay taxes and license fees, while state units do not.

INCREASE FLEXIBILITY. Privatization gives state officials greater flexibility to meet program needs. Officials can replace the private firm if it isn't meeting contract standards, cut back on service, add to service during peak periods, or downsize as needed.

IMPROVE SERVICE QUALITY. A number of surveys have indicated that public officials believed service quality was better after privatization. In a survey of 89 municipalities conducted in 1980, for example, 63 percent of public officials responding reported better services as a result of contracting out.18

If competitive bidding is instituted for a service, service quality can improve even if the service is retained in-house. The reason is simple: competition induces in-house and private service providers to provide quality services in order to keep complaints down and keep the contract.

Service quality is not assured, however, by privatization. Contracts must be well-designed with performance standards that create incentives for high quality service. Furthermore, diligent monitoring of the contractor’s performance through customer surveys and on-site inspections must also be performed by government in its oversight role.

INCREASE EFFICIENCY AND INNOVATION. Private management can significantly lower operating costs through the use of more flexible personnel practices, job categories, streamlined operating procedures, and simplified procurement.19

Private ownership can stimulate innovation. Competition forces private firms to develop innovative, efficient methods for providing goods and services in order to keep costs down and keep contracts. These incentives, for the most part, do not exist in the public sector.

ALLOW POLICYMAKERS TO STEER, RATHER THAN ROW. Privatization allows state officials to spend less time managing personnel and maintaining equipment, thus allowing more time to see that essential services are efficiently delivered.

STREAMLINE AND DOWNSIZE GOVERNMENT. Privatization is one tool to make bureaucracies smaller and more manageable. Large private corporations often sell off assets that are underperforming or proving too difficult to manage efficiently. Under new owners and leaner management, such divisions often receive a new lease on life. Entrepreneurial governments can replicate this experience.

IMPROVED MAINTENANCE. Private owners are strongly motivated to keep up maintenance in order to preserve the asset value of the investment in the facility. Public owners often defer maintenance due to political considerations, increasing overall long-term costs.

III. PRIVATIZATION TECHNIQUES

The term "privatization" refers to a wide range of activities. Those include

CONTRACTING. The state contracts with a private organization, for-profit or nonprofit, to provide a service or part of a service.

FRANCHISE. A private firm is given the exclusive right to provide a service within a certain geographical area.

VOUCHERS. Government pays for the service, however, individuals are given redeemable certificates to purchase the service on the open market. These subsidize the consumer of the service, but services are provided by the private sector.

SUBSIDY. The producer of the service is subsidized by the government contributing financially or in-kind to a private organization to reduce the cost of private provision to consumers.

SERVICE OR "LOAD" SHEDDING. Government stops providing a service and lets the private sector assume the function.

ASSET SALE OR LEASE. Government sells assets such as airports, gas utilities, or real estate to private firms, thus turning physical capital into financial capital.

VOLUNTEERS. Volunteers are used to provide all or part of a government service.

SELF-HELP. Community groups and neighborhood organizations take over a service or government asset such as a local park. The new providers of the service are also directly benefiting from the service.

PRIVATE INFRASTRUCTURE DEVELOPMENT AND OPERATION. The private sector builds, finances and operates public infrastructure such as roads and airports, recovering costs through user charges.

DEREGULATION. State regulations are eliminated from a government monopolized service to allow private providers of the service to compete.

PRIVATIZATION OPPORTUNITIES

In most states, there are numerous opportunities for privatizing state services, assets, infrastructure, and facilities.

IV. ADMINISTRATION AND GENERAL SUPPORT SERVICES

The greatest amount of contracting by state governments to date is of support and administrative services that serve government departments and agencies. The possibilities range from accounting to the removal of trash from state office buildings and facilities. Support services for state agencies may be the easiest functions to contract out because monitoring a contractor’s performance is simplified because the customer is provided directly to a public agency. (see Table 2)

Among the best opportunities for privatization of general services are contracting out computer maintenance, and the design and operations of information systems. The information technology of many state governments is antiquated, and personnel in these divisions are often not as highly skilled as those performing similar functions in the private sector. Contracting out these functions to the private sector allows state governments to provide enhanced services to government agencies and to make use of state-of-the-art computer equipment and systems without raising taxes.

Another option is privatizing state printing operations. Private printers capable of satisfying state printing needs exist in every state. Competition for state business from private providers can lower printing costs. A 1985 study, for instance, found that private printing costs were, on average, 33 percent lower than for state printing.20 States would also receive one-time windfalls from the sale of printing capital equipment and facilities. Numerous states already contract out for printing, including Colorado, Idaho, and Tennessee.

SALE OF SURPLUS PROPERTY. In most states, the general services or administration departments also manage the majority of state property. Many of these holdings earn no or little revenue and are greatly underutilized by state governments. Surplus and underutilized holdings of assets, land, buildings, and former state institutions could be sold or leased to the private sector, thereby generating significant revenues and providing a steady stream of property and business tax revenue. Options for sale, lease, or sale-leaseback include: maintenance facilities; parking garages; office facilities; undeveloped land; and recreational facilities.

In order to facilitate the sale or lease of selected state land and facilities, states can set up proactive asset management councils. The asset management councils would be charged with maintaining a detailed inventory of all state assets. California has created pro-active asset management programs in both the state general services and transportation departments.

Moreover, an executive order by Governor Wilson in 1991 created a state Asset Management Council charged with better integrating the capital expansion and asset management programs of various state agencies. Massachusetts also created an Asset Management Board in 1991 to promote the identification of underutilized state-owned assets.

Based on asset appraisals done of cities and universities by several consulting firms, states could realize hundreds of millions or even billions of dollars by disposing of as little as 5 percent to 10 percent of state properties and assets, excluding state parks.21

V. CORRECTIONS

Budget expenditures for prisons have been rising in many states at a rate even greater than the growth of the prison rolls. State corrections costs, between 1976 and 1990 soared from 19 cents per $100 of personal income to 40 cents per $100—a growth rate twice as fast as the economy.22

Growth in privatizing corrections has been dramatic in recent years. (see Table 3) There are now 52 privately run adult jails in the United States, England, and Australia, an 18 percent increase since November 1991.23 Half of all U.S. private corrections facilities were designed for medium- or maximum-security prisoners and onethird have received full accreditation by the American Correctional Association, compared to under 10 percent for public facilities.24

Ten states have engaged the private sector to either operate or build corrections facilities. Others contract with the private sector to provide inmate services ranging from health care to religious programs.

Most prevalent in the South, contracting out the full management and operation of corrections facilities can lead to cost savings due to increased management efficiency. (see Table 4) According to the Government of Texas's Sunset Advisory Committee, four private prisons in Texas operate at 14 percent lower costs than state-prison operation. Kentucky saved 21 percent by contracting with U.S. Corrections to operate a minimum-security prison.25 Such savings,

if applied to all state prisons, can add up. According to a 1990 Reason Foundation study, California could save at least $212 million by contracting out prison operations and management to private firms.26

FINANCIAL TECHNIQUES. The private sector is also engaged to construct and operate new prisons through the use of lease-financing techniques. For instance, in a lease-back arrangement, the state rents the corrections facility from the private builder, thereby avoiding up-front expenditures on new corrections facilities.27

Prisons can also be constructed through the use of straight leases and lease/purchase arrangements.28 Example: Southeast Missouri Correctional Facility Inc., a private firm, financed a prison by issuing in 1986 $55 million in tax-exempt bonds. The privately built, operated, and financed prison was then leased to the state for payments of $4.5 million a year for 30 years. After 30 years, the state of Missouri acquires ownership of the prison.29

There are other privatization possibilities for corrections. Inmate services such as food, medical, mental health, rehabilitation, transportation, and education have all been successfully contracted out to the private sector. (see Table 5)

The Weld Administration in Massachusetts estimates that it is saving $8 million annually by contracting with Emergency Medical Systems Associates of Florida to provide medical and mental-health services for 9,600 inmates in Massachusetts. Another $600,000 of estimated savings will result from contracting out prison food services at four institutions.

Contracting out educational instruction in prisons can result not only in cost savings but also higher-quality service. States can be more flexible in modifying vocational course subject matter and materials to parallel the changing job market. The state of Washington contracts out all its educational services in prisons to nonprofit institutions.30

VI. EDUCATION K-12

Education is one state budget area with tremendous potential for privatization. Possibilities include: contracting out educational instruction and support services; public-private education partnerships in which the private sector donates infrastructure or services to public schools; and vouchers to allow children to attend private schools.31

In cities, counties, and states throughout America, these privatization options are increasingly being considered and implemented. The interest in privatization comes in response to rising costs of public education and an increasing dissatisfaction with current public school operations.

CONTRACTING OUT IN EDUCATION. There are considerable opportunities for increased private-sector involvement in nearly every facet of education. For instance, numerous educational services can be contracted out. Cost savings, efficiency gains, increased flexibility, and, in some cases, more specialized educational instruction are among the benefits that can be expected by such contracting out efforts. The best contracting opportunities are:

School bus transportation. Private contractors bus 35 percent of American public school students.

Management of schools and school districts. A number of cities and counties are experimenting with turning over the management of schools or even entire school districts to private schools. Example: Baltimore Public Schools has contracted with the consortium Of Education Alternatives Inc. (EAI), KPMG Peat Marwick, and Johnson Controls World Service, to administer eight of the city’s elementary schools and one middle school.32 EAI previously had temporarily managed the public school district in Duluth County, Minnesota.

Custodial services.

Instruction. Public schools in Wade County, North Carolina and Upper Saddle River, New York contract with private firms for foreign language instruction. The Milwaukee public school district has contracted with the Wisconsin Institute of Science and Technology (WIST), the nonprofit arm of MacDonald Research, to formulate a program to provide science education for eight Milwaukee public schools.33

Drop-out education. A for-profit firm called Ombudsmen Educational Services contracts with over 70 school districts to provide educational instruction for dropout students.34

The company educates 2,000 drop-out students in Illinois, Minnesota, and Arizona. Contracting for alternative education rather than running a district program can yield notable cost savings. Ombudsmen Education

Services, for instance, educates drop-out students for 50 percent less per student than school district programs.35

PUBLIC-PRIVATE PARTNERSHIPS. The private sector can also help alleviate the infrastructure needs of public schools. Classroom space, land, equipment, furniture, and buildings can be provided to schools by the private sector in the form of public/private partnerships.36 The Mall of America in Minnesota, a new 4.2 million square foot shopping complex, is providing classroom space at modest rates for public school districts, and maintenance and utilities costs are being paid for by a group of businesses, private individuals, and foundations.

In Dade County, Florida, approximately 275 public school children are enrolled in worksite schools or "satellite learning centers." These worksite schools serve the children of employees, or the children of college students, for the Miami-Dade Community College, the Miami International Airport, and Mt. Sinai Hospital. By assuming the financial burden of providing the school facilities, these businesses saved the school district $1.9 million in construction costs alone in 1990, according to the school district.37

EDUCATION VOUCHERS. The most well-known means of turning over more responsibility in education to the private sector is by establishing a statewide voucher plan that empowers parents to send their children to a public or private school of their choice. State education money would follow the children to their schools of choice rather than going straight into local school boards.

Vermont has had a limited voucher system since 1869, and recently Milwaukee, Wisconsin adopted a pilot choice program. Overseas, Holland and Denmark have long had systems of school choice, while Sweden and a number of the newly free nations of Eastern Europe are planning to adopt school choice. California voters will have the opportunity to vote on such a system in 1994.

COST SAVINGS FROM EDUCATION VOUCHERS. By injecting competition and market forces into the public school system, educational choice could both improve education and likely result in substantial cost savings. A report by the New York State Senate Advisory Commission on Privatization found that implementation of a statewide voucher program could result in savings of $4.7 billion to the taxpayers.38 An August 1992 Reason Foundation study estimates that California could save $3 billion by adopting a statewide voucher program.39 This is equal to a savings of approximately 17 percent from the state’s current general fund expenditures on K-12 education. The savings estimate was based on a survey of Los Angeles residents that showed that 52 percent of those surveyed would use a $2600 voucher to send their children to private school.

VII. HIGHER EDUCATION

Many state universities are the size of small cities and offer numerous services for students and faculty. Like most cities, state universities and colleges can reduce operation costs and enhance the operation of existing facilities by turning to privatization. A 1992 study, for example, by the Privatization for America consulting firm, identified 182 privatization opportunities at the University of Maryland.40

In the February 1992 Apogee survey of state governments, 95 percent of higher education agency respondents said they had or plan to privatize some services and facilities.41 All positive respondents already contract out services, and 15 percent intended to sell university assets and/or facilities to the private sector. Services frequently contracted out by state universities include custodial services, food service, health care, and maintenance. (see Table 6) Despite the high percentage of higher education agencies that contract for services, the dollar amount of contracting is fairly low: $10 million or less for over 80 percent of respondents to the Apogee survey.

Other uses of privatization in higher education identified in the Apogee survey included: 1) management of restaurants, stadiums, and theaters; 2) build/operate arrangements for facilities; and 3) private funding for dormitories.

VIII. TRANSPORTATION

Major privatization breakthroughs will likely occur in transportation in the 1990s. Already, state transportation officials are exploring privatization’s potential for modernizing and developing airports, roads, high-speed rail, and other infrastructure. A number of innovative uses of privatization are being implemented under the direction of state transportation departments. These include: contracting out, asset sales, and build-operate-transfer (or build-transfer-operate) arrangements for new infrastructure.

Because the privatization opportunities in transportation are so substantial, states may want to consider setting up special privatization task forces or units within the transportation departments themselves. In Massachusetts, for example, an executive-branch transportation task force identified dozens of privatization opportunities in a report released in December 1991, some of which have since been implemented.42

The role of the transportation privatization task force would be to: 1) draw up an inventory of all infrastructure assets managed by the department; 2) identify possibilities for asset sales, leases, and contracting out; 3) determine whether savings or revenues from different privatizations accrue to the general fund or directly to the transportation department; 4) identify legal restrictions to privatization; and 5) explore opportunities and obstacles to public/private partnerships in developing new infrastructure.

ROAD AND REST AREA MAINTENANCE. In a number of the largest states, most highway maintenance and construction is contracted out. Hawaii, Florida, Pennsylvania and Texas all contract out the majority of their road maintenance work. (see Table 7)

Cost savings for highway maintenance can range anywhere from 10 to 106 percent, depending on the service.43 A Reason Foundation study, for instance, found that asphalt resurfacing performed by in-house units from the City of Los Angeles cost 106 percent more per mile than the same work done by contractors for the County of Los Angeles. Another study, by Robert Deacon of the University of California, found that contracting out street maintenance services resulted in a 30 percent cost savings for cities.44

States can also reduce costs by turning over some highway rest areas to private businesses to operate and maintain in exchange for letting the businesses (usually fast food chains) locate on part of the land. Another option is simply contracting with a private firm to maintain and operate the rest areas.

PUBLIC TRANSIT. Over 300 public agencies at the local level contract for transit service in the United States.45 Direct cost savings have averaged 30 percent.46 Some states also contract with the private sector for bus service. These include: California, Illinois, Texas, Virginia, and Washington.

Colorado provides a useful model for a state looking to contract out public transit. A 1988 Colorado law passed by the state legislature requiring the Denver Regional Transportation District to contract out 20 percent of bus operations has resulted in cost savings totalling $29 million, with no decline in service quality.47 According to a November 1991 report by KPMG Peat Marwick, the performance of the private contractors was as good or better than that of the Rapid Transit Department.

MOTOR VEHICLE REGISTRY. More prompt, convenient, and cost-effective service can be obtained by contracting out a multitude of driver’s and vehicle-license services. Driver’s license and vehicle-license renewal and inspection, for example, could be turned over to private firms through a competitive-bidding process.

In order to encourage the private firm to provide prompt service to customers, the firm could be paid according to how many clients they sewed per hour.48 The state could also make greater use of customer questionnaires in order to carefully monitor the performance of the contractor.

Some states also contract out centralized vehicle emissions checking facilities. Another approach is to license service stations to undertake vehicle emissions. Such a system, which is more flexible and decentralized, is more likely to spur innovations in customer service.

FLEET OPERATIONS AND MAINTENANCE. Most states and counties still maintain and repair vehicle fleets in-house. This, however, is likely to change in the 1990s.

According to a 1990 Mercer Group survey, fleet maintenance is one of the most frequently cited targets for privatization by counties.49

States seeking to privatize fleet maintenance can employ several privatization techniques, including: contracting out; selling the state's fleet, and then leasing vehicles and maintenance from a private company; or giving state employees vouchers in exchange for using their own vehicles for state business.50

Most common is to contract with private firms to repair and maintain government fleets. Prior to contracting out fleet maintenance, a thorough review of the costs and quality of the present government service should be undertaken so that the private contractor and state officials know in advance precisely what the job entails. Los Angeles County's initial experience with fleet maintenance, for example, provides a good example of how not to privatize this function.

Los Angeles County had not kept accurate records of its previous in-house fleet maintenance service and of the condition of the fleet. The actual work required of the private contractor, Holmes and Narver, was underestimated in the request for proposal and contract. Holmes and Narver faced a backlog of 850 vehicles when it began its contract—two times what was expected. Holmes and Narver eventually brought the backlog down and 88 percent of users Mted their service excellent, but the mistakes the County made earlier created a contract dispute and the contract was terminated.

AIRPORTS. Most U.S. airports are owned by cities and counties. However, a few states—Hawaii and Maryland, for instance—do own and operate airports. For such states, a number of privatization options are available. The operation of the airport can be contracted out to a private company. Private firms manage major airports in the United States and worldwide. By introducing private business practices into airport operations, they typically are able to increase airport revenues, attract greater private investment into airport-related facilities, and cut the costs of airport operation.

Airports can also be sold outright or leased to private firms. Many countries around the world are now in the process of privatizing airports or are studying the concept including Austria, Australia, Belgium, Denmark, Malaysia, and New Zealand.51 In addition to producing one-time revenue windfalls, privatization generates a steady stream of new property and business tax revenues from the private owner.

The May 1992 Executive Order on Infrastructure Privatization issued by President Bush greatly enhances the prospects for airport privatization.52 The order officially directs the Federal Aviation Administration and other government agencies to approve requests from state and local governments to sell or lease infrastructure enterprises such as airports. Furthermore, states that choose to sell their airports may now realize the lion's share of the proceeds from the sale. (see Table 8)

HIGHWAYS AND BRIDGES. The federal government's Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA) gives states the right to grant long-term franchises to private companies to rebuild and manage existing highways, tunnels, and bridges or to build and operate new ones. A bridge in need of repair, for example, could be sold to a private firm that would rebuild and modernize it. The private firm's original investment, as well as subsequent capital investment, would be returned through the collection of tolls. States and the private sector can both gain from this arrangement. The bridge is refurbished entirely with private financing and states receive revenue from the sale of the bridge, which can then be used to invest in new infrastructure.

Under ISTEA, federal highway funds may be used to draw private investment, on a matching basis. The maximum federal share for highways is 50 percent; for bridges, it is 80 percent. The lower the share of federal funds that is used, the greater amount of private investment is possible.53 A hypothetical state, for instance, could increase its total highway investment by 50 percent using a 49 percent federal/51 percent private formula. If all states took advantage of ISTEA's privatization conditions, it could mean $19 billion per year of new private investment in highways and bridges.

Selling infrastructure assets is beginning to catch on in the United States. In August, the Michigan Department of Management and Budget proposed that the state evaluate the feasibility of selling the state's Bluewater Bridge.

States can also realize revenue from leasing or selling surplus real estate holdings of state highway agencies.

Engaging the private sector to actually build and operate new infrastructure such as roads, tunnels, and bridges is another concept which is quickly taking hold.54 Five states have enacted private tollway laws: Arizona, California, Florida, Texas, and Virginia. Four private tollway projects were approved in 1990 in California.

TURNPIKES. Most of the major turnpikes in the eastern region of the United States were financed primarily by states via tax-exempt bonds. Little or no federal money was involved.55 Most of these bonds are now paid off, thus making turnpikes prime candidates for sale to the private sector. These eight eastern turnpikes have been conservatively valued at $7.4 billion.56 (see Table 9)

The private sector has shown interest in purchasing turnpikes. In the winter of 1992, the American Trucking Associations, Inc. and two other investors made offers to purchase the Massachusetts Turnpike in response to press reports that Governor Weld was considering selling it.

PORTS. Privatizing shipping ports offer another privatization opportunity. Thirty-six governments around the world are privatizing ports or considering doing so. Britain has already sold three ports and is in the process of selling its remaining fifteen.

A recent Reason Foundation study estimated that the 45 largest ports in the United States have a net value of between $9.6 and $13.2 billion. Most of these ports have been turned into quasiindependent authorities that are supposed to operate like private entities. Nevertheless, many of these ports fail to meet the ultimate test of a successful private enterprise—to operate at a profit.57

Selling ports could bring in substantial one-time revenues to state governments in addition to creating a new source of steady tax revenues. For unprofitable ports, states could consider selling them to private entities and allowing private investors to redevelop parts of the ports into more profitable uses.

IX. AGRICULTURE AND ENVIRONMENT

Privatization opportunities in environment and agricultural programs vary widely from state-tostate, largely reflecting the extent of state involvement in these sectors.

Many state environmental and agricultural functions can be shed or contracted out to the private sector. State agricultural export programs, for example, which typically benefit mainly agricultural businesses, are often partly funded by taxpayers. These could be funded privately by the agricultural interests that these programs support.

Fish hatcheries are another area that could be shed to private firms. While most fish hatcheries in America already are privately owned, a number of states own and operate them. These can be sold off to private companies, and fish then can be purchased like other commodities from the private sector. This could result in lower costs for the state.

Other functions typically found under the jurisdiction of the agricultural or environment departments that could be privatized include: laboratory testing, management of laboratories, environmental inspections, toxic waste cleanup, and waste collection.

X. STATE PARKS AND RECREATION

In the face of severe budget problems, parks and- recreation are often the first state services to be hit by the budget ax. In order to cut costs, state parks and recreation departments increasingly are looking to privatization options for parks and recreation such as load shedding, contracting out, making greater use of volunteers, leases, and outright sales.

Contracting out park functions potentially allows states to lower costs and have a greater degree of flexibility in service levels during peak and down tourist seasons. It also makes it easier to load shed" or eliminate state provision of the service altogether at a future date, if necessary. A number of park services can be contracted out, including:

Maintenance (for example of roads, grounds, and cabins); Management and operation of an entire park or park system; and Food and recreational operations.

Substantially increasing the use of volunteers can also cut costs without sacrificing services. States can save money by making greater use of volunteers for park maintenance, tours, and recreational services.58 Examples of statewide park volunteers groups include: Outdoor Washington, Volunteers for Outdoor Colorado, and the Tahoe Rim TMi1 Club in Nevada.

Some state parks and recreational services could also be considered candidates for leases or asset sales. At least eleven states lease historic landmarks to nonprofits and individuals.59 Parks can also be sold or given free of charge to conservation foundations, thereby removing an operating expense from the state balance sheet and, at the same time, ensuring the park's preservation.

Many recreational services provided by states directly compete against private firms. State provision of these services could be discontinued. If necessary, some of these services, if they cannot be operated by private firms at a profit, can be subsidized with taxpayer or voluntary contributions.

XI. LIQUOR SALES AND DISTRIBUTION

Eighteen states are involved in wholesale or retail liquor sales. Insulated from the competitive marketplace, state monopolies over alcohol distribution tend to be inefficient since they have few incentives to contain costs.60 In some of the states now controlling liquor distribution, income from the operation of liquor control systems has been declining. In Pennsylvania, for instance, from 1985—1990, the state liquor control board's net income after taxes declined by 2.3 percent per year.61 States furthermore have had little success in accomplishing what is presumably one of the main reasons for being involved in selling alcohol: lowering per-capita alcohol Consumption.62

Government officials in nearly all of these states are questioning whether their state should be in the business of selling alcoholic beverages. Bills calling for government divestiture are being considered in seven of the 18 states that operate liquor stores.63

The momentum for privatization seems to be gaining in recent years, especially for selling off the retail operations of liquor distribution. A 1992 survey of constituents by Pennsylvania state representative Greg Fajt found overwhelming support for liquor store privatization. Over 77 percent favored privatizing liquor stores. Moreover, several states recently have actually privatized some state liquor operations. West Virginia reaped $20 million in 1990 by selling its retail liquor stores. Iowa and Michigan also netted revenues from liquor store privatization in 1987 and 1989 respectively. Ohio began privatizing state liquor stores in September 1991. The 14-month plan to privatize 75 stores is expected to raise at least $10 million.

Privatization can also lead to lower prices for consumers. Competition from newly private retail outlets has driven prices down by 10 percent in West Virginia since privatization, according to Ron Moats, the deputy commissioner of the West Virginia Alcohol Beverage Administration.64

Liquor sale privatization also generates a steady stream of new revenues from business taxes paid by private liquor stores. A June 1991 study from the Commonwealth Foundation, a public policy organization in Pennsylvania, found that with appropriate licensing fees and business taxes, the state would generate the same revenues from private liquor stores after privatizing alcohol distribution as was being taken in under state control.65 In addition, according to the report, consumers would not pay higher prices.

XII. LABOR/INSURANCE

Around the country, state governments are searching for solutions to the difficulties plaguing workers' compensation systems. For states that run their own workers' compensation programs, privatization is emerging as one answer.

Numerous states operate workers' compensation insurance programs. State workers' compensation insurance monopolies exist in six states, while thirteen other states operate workers' compensation programs that compete against private firms in the state.66

State-run workers' compensation funds often experience substantial operating losses and are liable to political manipulation. The assets and surpluses of such funds are tempting targets in times of revenue shortfalls. In 1982, the Oregon legislature took $81 million from the state's insurance fund and transferred it to the general fund.67 Two years later, the insurance fund had to raise its rates by 50 percent, largely because of the legislature's action.

Michigan Governor John Engler has called for privatizing Michigan's state-run workers' compensation fund, the Accident Fund of Michigan. The Mackinac Center for Public Policy has suggested the fund could be privatized by either spinning it off into its own private company or selling it entirely to another private firm.68 Montana is also considering selling its workers' compensation program.

XIII. HEALTH SERVICES

Health services represent a growing segment of state budgets. A variety of privatization techniques can streamline operations in a number of health-related areas. (see Table 10)

MEDICAID. Medicaid costs to state governments are growing exponentially. In North Carolina, Medicaid spending grew by 20 percent a year in the 1980s. States' share of Medicaid, a joint state/federal program, is increasing at twice the rate of overall state spending. Medicaid now consumes 14 percent of the average state budget.

Privatization is one way to slow down the rise in medicaid costs. One privatization option is contracting out the administration of medicaid to a health insurance organization

(HIO). HIO’s do not actually provide medical care. They simply act as financial intermediaries between medicaid recipients and health care providers. Texas and Indiana, for example, contract out

Medicaid to private insurers.69 Blue Cross and Blue Shield provide comprehensive health services to medicaid recipients in Indiana, rather than the state operating the program itself. Blue Cross and Blue Shield have an incentive to keep costs down because their contract with Indiana establishes a fixed per-capita premium for each Medicaid recipient.

Another approach is to eliminate Medicaid as it is currently administered and, instead, provide Medicaid recipients with vouchers that could be used to purchase private health insurance.70 The vouchers would be equal to the average medical expenditure for a family of equal size as the Medicaid recipient’s family. These vouchers could be pooled by individuals and families to purchase group policies.7’ The voucher could also be used to join health care service organizations such as Health Maintenance Organizations (HMO’s).

MEDICAID PROCESSING. Fifteen states contract out medicaid processing to private contractors. California and Louisiana have performance-based contracts with private contractors allowing the contractor to keep a percentage of the money they save the state.72

HOSPITALS. For over a decade, states have looked to privatization as an alternative to closing state general hospitals in hard economic times. (see Table 11) Two state hospitals in Pennsylvania, for example, were rescued from imminent closure in 1991 when they were sold to private firms who took over their operation.73

Over 200 public hospitals have been turned over to private for-profit interests since the late 1970s and many more to nonprofit organizations. States receive a one-time windfall from the sale, a new source of tax revenues (if sold to a for-profit hospital), and divest themselves of a deficit-generating activity.

Opponents of hospital privatization often assert that for-profit hospitals will not treat poor patients.74 This claim seems to be refuted by the available evidence. A 1985 study found that for-profit chains provided the same amount of free care to the poor as voluntary, nonprofit hospitals.75

MENTAL HEALTH INSTITUTIONS. Another area ripe for privatization is state mental health facilities. By contracting with private firms and transferring patients to private, community-based settings, states can realize substantial cost savings. Furthermore, patients may benefit by being placed in more humane settings. Due to the nature of the service, however, great care must be taken in contract monitoring to assure that patients receive quality care.

Florida, Kentucky, and Massachusetts have all privatized at least one mental health institution. Kentucky saved 60 percent by contracting with ResCare for the management and operation of the Outwood Mental Retardation Facility.76

Massachusetts has recently closed four state mental health hospitals and plans to close five more. Patients have been transferred to private, community-based residential care settings. According to the Massachusetts Department of Health, closing the state hospitals and contracting out care to private contractors will result in annual cost savings to the state of $60 million.77

The privatization of mental health care in Massachusetts has not been without controversy. Critics have challenged the state's numbers on projected cost savings and questioned the competitiveness of the bidding process. Two lessons have emerged from the Massachusetts privatizations:

Accurate, presentable numbers on cost savings are crucial. The numbers should preferably be generated by an outside accountant and should stand up to close scrutiny.

A fair, open and transparent bidding process is critical to the longterm success of privatization. Any appearance of inside deals could doom privatization prospects.

XIV. SOCIAL SERVICES

Social services are among the functions of state government most frequently contracted out by states and counties. In the Apogee study, 38 percent of state agencies responsible for providing social services reported contracting with private firms. Contracting out can be used successfully in the delivery of social services; such opportunities include: child support enforcement, adoption services, disabilities rehabilitation, drug and alcohol treatment programs, vocational training, and employment retraining.

CHILD SUPPORT ENFORCEMENT. States and counties are under increasing pressure from the federal government to step up their activities in getting fathers to contribute to their children's upbringing. Wyoming, Tennessee, and Los Angeles County all contract with the private sector for child support enforcement.

In Tennessee, for example, Policy Studies Inc. (PSI), was awarded in 1991 a five-year contract to operate the state's child support enforcement program within a four-county area. The program is almost entirely administered by PSI. Tennessee pays no upfront fees for the service, instead paying PSI 13.5 percent of all collections. Collections went up 35 percent in the first four months of private operation.78

WELFARE ADMINISTRATION. The Wisconsin legislature in 1986 changed state statutes to require counties to handle all general relief. Brown County, in turn, privatized its entire general relief program. Costs went down from $411,000 to $190,000, because the private firm was able to operate the program more efficiently than the state.79

JOB TRAINING, RETRAINING, AND WELFARE PLACEMENT. Most job training and retraining programs target three types of individuals: workers from traditional industries that have been rayed off; high-school drop-outs, and welfare recipients. Many states contract with private firms to provide training to these individuals. California, Illinois, Massachusetts, and New York, for instance, contract out some job training and retraining.

Connecticut, Massachusetts, New York, Texas, and Wyoming have all contracted with private firms to assist Aid to Families with Dependent Children (AFDC) recipients. In most of these cases, the private firms are paid according to the number of welfare recipients they are able to place in jobs and how long these people stay employed. The contractors are usually paid little or no money for clients whom they can't place in jobs. New York and Connecticut contract with America Works, a welfare job-placement agency, to find jobs for over 700 hard-core unemployed, 68 percent of whom are permanently weaned from the welfare rolls.80 The firm saves New York and Connecticut taxpayers over $4.5 million annually.

Two-thirds of the welfare recipients taken on by America Works have previously been in government-sponsored training and education programs. According to private industry service

providers, one of the main reasons for the failure of the government programs to place more clients is government's training-heavy approach.81 The private firms, on the other hand, emphasize getting people in jobs quickly and letting them experience the rewards of regular employment.

Contracts for employment training should be competitively bid and should contain incentives for the provider to place the clients in jobs, performance being based on the number of people who are able to obtain and keep jobs.

PROBLEMS WITH SOCIAL SERVICE CONTRACTING. Not all social-service contracting is as successful as some of the cases outlined above. The reason: one of the key elements in successful contracting is that detailed contract specifications can be written about the service under consideration.82 Outputs for typical public works services such as garbage collection and street cleaning, for instance, are easy to specify in detail. Results are much harder to quantify, however, for most human services, thereby making effective contract monitoring far more difficult.

Due to this problem, contracts for human services are often judged according to meeting input measures—such as the number of "credentialed" employees—rather than on the basis of their effectiveness. Moreover, social-service contracting is also often laden with a morass of regulations.

The majority of social service contracts are with large nonprofit organizations and are negotiated rather than competitively bid. In fact, many states have laws that prohibit for-profit companies from competing with nonprofit agencies, and also exempt social services from the competitivebidding process applied to other government contractors.83

These problems have greatly reduced the potential for cost savings, efficiency gains, and service improvements by contracting for social services. Therefore, other forms of privatization may, in some cases, be preferable to contracting out in social services.

One option is to remove government involvement altogether from the service and rely instead on voluntary institutions such as community groups, families, and churches to provide the service. Nearly all the social programs now administered by government are also provided by voluntary institutions funded by private donations.

THE VOUCHER ALTERNATIVE. If the government decides to fund a social service, rather than rely on voluntary institutions, vouchers are often a better privatization technique than contracting out. Vouchers allow service recipients to choose their own service provider and empower individuals to make more decisions for themselves. They also bring consumer pressure to bear, thereby creating incentives for individuals to seek out low-cost, high-quality producers.84

In addition to education and health care, discussed earlier, other areas in which vouchers may possibly be used are employment training, day care, drug treatment and alcohol, assistance for the elderly, disabilities rehabilitation, housing, vocational education, and recreation services.

DAY CARE. Rather than running day-care centers, governments can assist low-income families with obtaining day care by providing day-care vouchers. New Jersey, Pennsylvania, Arkansas, and Maryland all have pilot programs for day-care vouchers. In New Jersey, parents were pleased with the voucher program, which costs 25 percent less than contracting out for day care and was also substantially less expensive than state-operated centers.85

REHABILITATION SERVICES. America’s public vocational rehabilitation system is funded 80 percent by the federal government, and 20 percent by states. States are free to design and operate the programs as long as they stay within broad parameters set by Washington, D.C. Over the years, the program has had little success returning handicapped people to the workforce. Less then one-half of one percent of the almost 3 million workers on the social security disability rolls in the rehabilitation program return to work each year.86

Switching to a voucher approach offers a promising option for improving this government program. Vouchers given to eligible handicapped people could be used to buy medical, vocational, or educational services from private companies or public agencies. By introducing competition among competing providers and giving the client freedom of choice among suppliers, vouchers create strong incentives for service providers to develop innovative rehabilitation programs at lower costs, thereby bringing down program costs. By giving them choices in the marketplace, voucher programs would also empower handicapped people to play a more active role in their own rehabilitation.

A private voucher program that could serve as a model for state agencies is the Denver Center for Independent Living in Colorado. The Center outfits handicapped people with vouchers for the purchase of equipment and services that enable them to continue to live independently. The vouchers have been used to purchase a wide variety of goods and services, including: orthopedic shoes; wheelchair repairs; home modifications; a wheelchair lift for a car; and daily specialty items that help the handicapped dress themselves. The year-old, fully private program has already assisted over 140 handicapped people.

To ease the transition for state social service employees as private provision of social services is introduced, these employees could be assisted with establishing their own private social service firms that would compete for vouchers with other providers.87

The chief drawback to vouchers is the danger that, due to political pressures, the voucher's initial value will later be increased and eligibility standards eased, thereby making more people eligible for the voucher. The result: costs could greatly increase.88

The pressures for inflating the value and eligibility of the voucher is especially pronounced when the vouchers are fully or partly funded by the federal government. In many of these cases, states would have little reason to control the cost of the program because the state only funds the administrative costs, and thus would not receive any of the savings from restraining the program's growth.89 One solution may be to provide block grants to the states based on total expenditures of the program and make the states responsible for a certain proportion of the expenditure. States would also be responsible for determining detailed eligibility rules. States would thereby have the ability to widen eligibility but would have to provide the additional money themselves.90

XV. CONCLUSION

One of the chief lessons for states in the 1980s and early 1990s was that short-term fixes such as tax increases do not necessarily lead to fiscal stability. Rather, tax increases typically have resulted in higher state spending and lower economic growth, thereby causing yearly fiscal crises.

More fundamental changes in state government need to be undertaken that will restrain spending growth and ensure that essential services are maintained.

Comprehensive state privatization programs can help achieve this end. By subjecting salaries and benefits to competition, states will be able to constrain rapidly escalating labor costs. By selling selected state assets to the private sector, states will be able to turn dormant physical capital into financial capital that can be used to invest in new infrastructure or for tax relief. Lastly, by systematically applying privatization techniques to a wide range of state services and assets, policymakers can realize the full potential of privatization.

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