Privatization Myths Debunked

Myth #1: Privatization saves money.

The Truth: Privatization often raises costs for the public and governments.

Proponents of privatization promise to fix budget woes by saving the government money. But numerous examples in a variety of sectors show that projected savings don't always materialize. Cost overruns combined with hidden and indirect costs, such as contract monitoring and administration, can make privatization more expensive than in-house services for governments. In fact, the Government Finance Officers Association estimates that hidden and indirect costs can add up to 25% to the contract price.[i]

The Government Accountability Office has found that methods by which agencies and privatization consultants conduct projections and report contract costs can make cost savings appear greater than they actually are.[ii] According to a 2007 survey by the International City/County Management Association, 52% of governments that brought services back in-house reported that the primary reason was insufficient cost savings.[iii]

- An audit report from the Wisconsin Legislative Audit Bureau revealed that the state's department of transportation wasted more than $1 million by outsourcing almost half its engineering work to private contractors over the past five years. The audit found that about 60% of these outsourced jobs could have been done at a lower cost by state workers, which would have saved the state $1.2 million.[iv]

- In February 2009, Chicago and Chicago Parking Meters LLC signed a 75-year concession agreement for the operation of Chicago's 36,000 parking meters. Along with many problems related to malfunctioning meters, rates have significantly increased, causing many residents to think twice before parking in the city. Many stores and merchants in the area complain that the rates have decreased business. In some parts of the city, rates increased in the first months to 28 quarters ($7) for 2 hours of parking time. The parking charges also have been extended to 7 days a week and for more hours during the day.[v]

Myth #2: Private companies do a better job than the public sector.

The Truth: Many examples show declines in service quality under private contractors.

Faith in the private sector to outperform government agencies is deeply ingrained in the American psyche. However, the facts disproving that belief are steadily mounting. In many cases, private contractors have failed to deliver, leaving communities without vital services and assets. Private companies naturally seek to maximize profits, which can incentivize cutting corners to reduce costs. This can greatly impair service quality and maintenance of vital assets. The most popular reason for in-sourcing, according to the International City/County Management Association survey mentioned above, was a decline in service quality. Over 60% of governments that brought functions back in-house reported this as their primary motivation.[vi]

- In 2009, Indiana cancelled its $1.34 billion contract with IBM to provide public benefit eligibility services. For two years, vulnerable families failed to receive benefits for which they qualified, including food stamps, health coverage, and cash assistance, due to the company's poor provision of these services. The privatized system led to high error rates and poor timeliness, among many other problems.[vii]

- In 2010, Gary, Indiana cancelled its 10 year contract with United Water. In May 2008, a state inspection found that the district, under United Water's management, had violated discharge limits 84 times between 2005 to 2007; had at least 25 pieces of broken equipment; filed inadequate monitoring reports; and failed to meet mandated deadlines.[viii] By cancelling the contract and bringing water service back in-house, the city expects costs to decrease from $16 million to $8 million a year.

Myth #3: Privatization allows governmental entities to better anticipate and control budgetary costs.

The Truth: Cost estimates are extremely unreliable and privatization can cause result in unforeseen budgetary consequences.

Some believe that privatization allows for more precise budgeting, since the inflow or outflow of money appears fixed once a contract with a private entity is signed. But hidden costs and cost overruns can significantly distort these figures, market circumstances can reverse the estimates, and ripple effects of privatization can increase unexpected areas of governmental budgets.

Governments cannot anticipate the cost of privatization failures, from the overtime expenses of sending city work crews to correct sloppy work by private road maintenance companies to the massive ordeal of rebuilding entire outsourced departments when a contractor's costs, delays or service breakdowns become unsustainable.

- In 2009, the Pew Center on the States analyzed Pennsylvania's failed attempt to sell the Pennsylvania Turnpike. The Governor predicted that the lease income would generate about $1 billion a year for the state's transportation budget. But this rosy figure assumed a 12% annual return on the state's investment. According to the Pew report, with the stock market decline the previous year, the state would have actually lost money on its investment.[ix]

- Sometimes perceived cost savings in one area can increase the cost in another area of the budget. According to the Economic Policy Institute, in 2006, nearly 20% of all federal contract workers earned less than the federal poverty level of $9.91 an hour, while 40% earned less than a living wage. Many of these workers do not receive employer-sponsored health benefits[x]. As a result, these workers must rely on public benefit programs, such as Medicaid and the Earned Income Tax Credit (EITC) program to make ends meet. Lower wages and benefits, while making contracts appear cost-efficient, lead to increases in other parts of the federal and state budgets.

Myth #4: Privatization allows governmental entities more administrative flexibility.

The Truth: Privatization requires substantial administrative resources for monitoring and oversight.

Substantial time and personnel are necessary to adequately monitor contracts, especially those involving essential governmental functions. If governments don't dedicate sufficient personnel and time to monitoring contracts, they run a high risk of poor contractor performance and wasting large amounts of money.

- In a *Cincinnati Enquirer* investigation, the newspaper concluded that the State of Ohio and many local governments engaged in "casually administered" contracts with "lax controls." From 2000-2003, 116 state audits found that contactors misspent $97.7 million tax dollars.[xi]

- Texas entered into a contract with Convergys to administer human resources functions for the Health and Human Services Commission. An audit in 2006 revealed numerous problems related to contract oversight. As a result of the minimal oversight, the state was unable to be fully involved in the development, testing, and validation of contractor's system. The agency relied on the contractor to both develop and perform the testing and then to assess the system and report the results of those tests.[xii] As a result, the agency did not have the working knowledge of the system to hold the contractor accountable for technical performance issues.

Myth #5: The public still maintains control over a privatized asset or service and the government retains the ultimate ability to make related public policy decisions.

The Truth: Privatization can bind the hands of policymakers for years, allowing private companies significant control of a privatized asset or service and the ability to dictate important policy decisions.

Non-compete and "make-whole" clauses are just a few of the ways that private companies control privatized assets and dictate important public policy decisions. Non-compete clauses forbid competition and prohibit the government from making policy and planning decisions that may affect the contractor's revenues. These contract terms have prevented numerous cities and states from improving public transportation or implementing other planning or environmental initiatives that may have threatened contractor revenues. Asset privatization contracts also frequently stipulate that the government must reimburse or "make whole" the contractor if an event, such as a parade or sudden natural disaster, occurs. Often the true ramifications of these types of provisions, which help reduce risk and guarantee profits for contractors, come as a surprise to policymakers.

- In September 2008, Indiana was required to reimburse the private Indiana Toll Road operator $447,000 for tolls that were waived for people being evacuated during a severe flood. This requirement in the contract forced the state to pay money to a private contractor in order to ensure the public's safety.[xiii]

- In 2008, the private contractors that operated the Northwest Parkway in Denver, Colorado, objected to improvements on W. 160th Avenue. The 99-year privatization contract allowed the private company to prevent improvements on city-owned and maintained roads, since the improvements "might hurt the parkway financially," by providing an alternative route for travelers, thus potentially reducing toll revenue.[xiv]

Myth #6: If anything goes wrong, the government can easily fire the contractor or adjust the contract.

The Truth: Reversing privatization involves huge costs and service interruptions.

When governments turn over core services to private contractors, it can be very expensive and time-consuming to alter contract terms or cancel a contract. Taxpayers can be stuck with legal expenses when companies file lawsuits seeking greater payment. Additionally, contract cancellation can lead to service interruptions or loss of access to public assets during the transition period.

- Virginia sought to end its contract with Northrop Grumman for statewide information technology services because of numerous instances of missed deadlines, cost overruns, and technical problems. The state's auditors calculated that cancelling the contract during fiscal 2010 would cost Virginia $400 million, which auditors said the state can't afford.[xv] As of 2010, the state may be forced to remain in the contractual relationship because it cannot afford the cancellation.

- In 2007, when Texas cancelled its contract with Accenture for public benefits eligibility services, it took 20 months for both parties to settle issues related to the contract cancellation. In the meantime, many families continued to have problems accessing food stamps, welfare, and health insurance because the state had fired a large portion of its case workers at the beginning of the privatization effort. Nearly three years later, Texas is still struggling to rebuild its public workforce.[xvi]

Myth #7: Companies are chosen for privatization contracts on the merits, not based on political or financial connections.

The Truth: Government for profit opens doors to unscrupulous behavior by politicians and businesses.

As many examples illustrate, the companies that receive lucrative contracts may not be the best company for the job, but instead may have the most insider connections.

- Two judges in Pennsylvania received $2.6 million over seven years from Pennsylvania Child Care LLC, a private company that operated a juvenile detention center. The judges helped secure the company a 20-year, $58 million contract with the county and aggressively sentenced children for minor infractions to ensure that the detention center remained at capacity. In early 2009, the two judges were charged with racketeering, extortion, bribery, money laundering, and fraud, among other crimes.[xvii]

- In 2009, the former president of the Jefferson County, Alabama county commission was convicted of taking bribes to steer government business to J.P. Morgan. The county commissioners followed advice of a J.P. Morgan consultant and set up an unorthodox financing scheme to refinance the debt on its sewer system. The county paid $120 million in fees -- six times the prevailing rate - to buy interest-rate swaps from J.P. Morgan and several other financial institutions. Within five years, the bad advice had increased the county's debt by $277 million. Low-income residents bore the consequences as the county raised sewer rates again and again to stave off bankruptcy.[xviii]

For more examples and updates on issues related to privatization, please visit the In the Public Interest privatization and responsible contracting resource center at www.InThePublicInterest.org. For questions, please email info@inthepublicinterest.org or call 202-739-1160.

In the Public Interest is a Resource Center on privatization and responsible contracting. It is committed to equipping citizens, public officials, and public interest groups with the information, ideas, and other resources they need to ensure that public contracts with private entities are transparent, fair, well-managed, and effectively monitored, and that those contracts meet the long-term needs of communities.

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[i] AFSCME, "Government for Sate: An Examination of the Contracting Out of State and Local Government Services," Eighth edition.

[ii] United States Government Accountability Office, "Department of Labor, Better Cost Assessments and Departmentwide Performance Tracking Are Needed to Effectively Manage Competitive Sourcing Program." November 2008. GAO-09-14.

[iii]International City/County Management Association. See: http://icma.org/en/results/surveying/survey_research/whats_new

[iv] Wisconsin Legislative Audit Bureau, "Construction Engineering in State Highway Projects." May 2009., See: http://www.legis.state.wi.us/LAB/reports/09-dotconstructionengineering_ltr.pdf

[v] In The Public Interest, Chicago Parking Meters case. See: http://inthepublicinterest.org/case/chicagos-parking-meters

[vi] International City/County Management Association. See: http://icma.org/en/results/surveying/survey_research/whats_new

[vii] In The Public Interest, Indiana Public Benefits Eligibility System case. See http://inthepublicinterest.org/case/indiana-public-benefits-eligibility-system

[viii] Food and Water Watch, "The High Cost of Privatizing Water and Wastewater Services." Summer 2010.

[ix] Marcia Carroll, "Privatization: Recent Development," March 2009.

[x] Economic Policy Institute, "Outsourcing Poverty: Federal contracting pushes down wages and benefits." EPI Issue Brief #250. February 11, 2009.

[xi] Cincinnati Enquirer, "Weak Contracts Waste Tax Money," May 19, 2003.

[xii] Texas State Auditor's Office, "The Health and Human Services Commission's Consolidation of Administrative Support Services." January 2006. SAO Report No. 06-018.

[xiii] Ellen Dannin, "Infrastructure Privatization Contracts and Their Effect on Governance." Pennsylvania Dickinson School of Law, Legal Studies Research Paper No. 19-2009. 2009.

[xiv] Ibid.

[xv] Washington Technology. "Trio of big contracts have problems." October 29, 2009. See: http://www.washingtontechnology.com/Articles/2009/11/02/Upfront-Contract...

[xvi] In the Public Interest, Texas Integrated Eligibility Redesign System Case. See: http://inthepublicinterest.org/case/texas-integrated-eligibility-redesign-system-tiers

[xvii] In the Public Interest, Pennsylvania Kids for Cash case. See: http://inthepublicinterest.org/case/pennsylvania-kids-cash-conspiracy

[xviii] In The Public Interest, JP Morgan Investment Consulting Fraud case. See: http://inthepublicinterest.org/case/jp-morgan-investment-consulting-fraud