MINNPOST

The costs of privatization: It may not save the state money

By David Schultz | 01/06/11

Gov. Mark Dayton and the Republican Legislature face a $6.2 billion deficit and a legal mandate to produce a balanced budget. They differ on how to address this task. One thing is certain: Some will argue that a solution is the privatization of state functions or services. For those who think privatization yields immediate savings, that is not necessarily correct. Privatization also forces critical tradeoffs in equity, service delivery to the poor, and perhaps in public safety, quality and accountability.

Privatization has multiple meanings. One definition is the selling off of state-owned enterprises that can make money as private businesses. This is what privatization generally has meant outside the United States, especially in former communist countries, where government enterprises such as utilities are sold to investors. Minnesota does not have these types of enterprises to sell.

Perhaps Minnesota could sell its prisons to be run privately, or maybe some transportation functions. Selling off prisons means a loss of control over them and the possibility of worker strikes. Privatizing snow plowing might save some money, but coordinating a massive fleet of private vendors to plow the roads is a costly logistical issue.

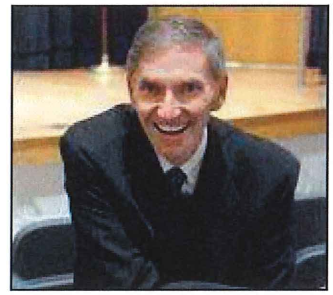
Second, privatization means contracting with private or nonprofit vendors to provide goods or services. Already Minnesota contracts out several billion dollars with vendors to provide many health and other services. There is little evidence here and in the research on privatization that this type of contracting saves money. Often the reason to do this type of contracting is to give more flexibility in service delivery, or to use vendors who have technical expertise the state lacks. But this flexibility and expertise is often costly.

Transaction costs

Also, contracting out often incurs significant transaction costs. Shifting state functions to third parties means expenses in phasing out and reorganizing the government and doing the bidding process to find vendors. When contracts are let, monitoring and compliance costs are incurred. Taxpayers should not foot the bill for contracts if there is no oversight to ensure that money is being spent properly.

These costs are often ignored when privatizing. A 2007 Legislative Auditor report noted that in 2005 more than $4.7 billion was contracted out to nonprofits for health services. It found little accountability and oversight for the money. It echoed a 1992 report that found little oversight given to technical contracts awarded by the state. Thus, taxpayers often do not know if they are getting quality services for their money.

There is also the assumption that letting contracts saves money because of vendor competition. Yet the Legislative Auditor and others have found that competitive bidding environments rarely exist. Often only one vendor is available, because of technical skill or capacity, or because the contract needs to be for such a time period that it all but renders competition nil. Private monopolies replace public ones, but with less accountability.



Courtesy of Hamline University

David Schultz

Finally, with contracting out there is the potential for government actually to expand and not contract its reach. With government contracts comes increased supervision and control over private and non-profit entities. Those ideologically opposed to big government who see contracting out as a solution may find in fact Big Brother's reach gets even larger.

The shedding or unloading of state functions

Third, privatization means the shedding or unloading of state functions. This means that there are some functions the government will no longer perform or fund. Private vendors and citizens are on their own to decide how to distribute and receive these services. This type of privatization asks a normative question regarding what we want government to do.

Load shedding implicates tough choices with clear losers. Government workers lose jobs, as is true with other types of privatization. But as with any type of privatization, research suggests that load shedding means many people, especially the poor, will not receive some services. Equity is lost; the more affluent make do, the poor do without.

Approximately 76 percent of the budget goes to education and health and human services. Throw in public safety and local government aid and that totals more than 90 percent of the budget. No matter which privatization option is considered, the question becomes what do we not want the state to do that we feel the private sector can and will provide in a way that will not hurt the poor, affect quality of services, and which can save the taxpayers money?

Privatization forces tradeoffs. It may make sense in some situations, but thinking cost savings is the only issue is naive. Instead, a host of issues, including quality, equity, control and fairness must also be addressed.

David Schultz is a professor at Hamline University School of Business, where he teaches classes on privatization and public, private, and non-profit partnerships. He is the editor of the Journal of Public Affairs Education (JPAE).

COMMENTS (10)

SUBMITTED BY DAN BUECHLER ON JANUARY 6, 2011 - 5:50PM.

Retirement cost are often not figured into the bid. Low wage employees can't even afford 401K's. If you read Elizabeth Warren you would know that such 401K's benefit upper level managemnt and were never intended to fully replace pensions but unfortunately they have and we continue to kick the can down the road.
On a seperate matter at least the Obama administration is willing to implement end of life planning such as the Gunderson Clinics do in Wisconsin.

SUBMITTED BY RON GOTZMAN ON JANUARY 6, 2011 - 8:49AM.

David,

In Mpls and MN, are private, non-union companies treated equally with Union contractors in the bidding process?

SUBMITTED BY MYLES SPICER ON JANUARY 6, 2011 - 9:55AM.

One quick but interesting measure of public vs private is the administrative costs of health insurance. Private insurers (i.e United Healthcar for example) typically have 20%+ in administrative costs (including some outrageous executive salaries and the nowe infamous golden parachute). Medicare administrative costs are estimated at 4-6% depending on adding in certain collateral expenses. And Medicare is well run (the fraud issues are outside the adminitrative costs, and fraud is prevelant in both the private and public sectors). In many ways, government can be more efficient, cost effective, and should not be dismissed by unproven "slogans" to the contrary. Many nations which have effective health, educational, and similar social programs run very well with government operations and/or well thought out public/private cooperation.

SUBMITTED BY DENNIS TESTER ON JANUARY 6, 2011 - 10:54AM.

Farming out services to private companies saves the taxpayers the cost of retirement plans. Unfunded public retirement plans is a HUGE problem.

SUBMITTED BY GREG KAPPHAHN ON JANUARY 6, 2011 - 12:13PM.

Considering how reliable the private pension system (401k's 403b's,etc.) have been over the past few years, and the fact that Wall Street and the commodities markets, in which a lot of those funds are invested no longer have any basis in the real actual value of anything, but are nothing but a gambling scheme in which speculators hope to make a killing at the expense of everyone else, the idea that privatizing "saves" pensions costs translates into something else entirely.

"Privatizing" simply wipes out the likelihood that employees will have a pension of any kind (save social security, which many of the same people so enamored with "privatization" would like to drive into speculative investment programs as well).

As to overall cost savings, the simple fact is, that a privatized government service simply can't compete with the cost of a government bureaucracy because of the necessity of paying private executives outrageous levels of compensation and paying dividends to private investors.

What privatization REALLY is, is a scheme by which the already fabulously wealthy enable themselves to further enrich themselves and their friends by extracting massive compensation directly out of taxpayer's pockets.

Contracts awarded based on initial lowball bidding (which may SEEM to promise reduced costs) rapidly balloon as soon as the government is completely dependent on the private entity to perform the services required. The private servicers know that they have the government over a barrel because the costs of re-establishing a government bureaucracy to perform those "privatized" services usually stands in the way of switching things back.

Finally, the current round of attacks on public employees is nothing more nor less than a thinly-veiled attempt to lay the groundwork for our state and nation's wealthiest citizens to convince the general population to support their efforts to greedily pad their already-overstuffed pockets with money lifted directly out of our own wallets by "privatizing" as much of the government as possible.

SUBMITTED BY DAN BUECHLER ON JANUARY 6, 2011 - 12:19PM.

David, I tend to agree with you, where do the profits go? Certainly not to the employees and probably often back to other states and countries. I know this for a fact.

SUBMITTED BY JACKSON CAGE ON JANUARY 6, 2011 - 5:07PM.

Retirement Plan costs are built in to the costs of the bid....you don't save anything. I've seen plenty of work farmed out to independent contractors and have NEVER been convinced it's less expensive.

SUBMITTED BY BERNICE VETSCH ON JANUARY 7, 2011 - 1:58AM.

Thanks for this article, Mr. Schultz. I fear that, at the state or local levels, privatization ends up costing more while providing less. When the goal of a prison is to make a profit, for instance, the temptation must always be there for the private company to reduce the quality of food or living conditions to save money.

On the national level, the US military's use of highly-paid private contractors to perform work in war zones that Army privates used to do (cooking, laundry, vehicle maintenance, driving) for their normal government salary is an egregious example of privatization. How many billions of extra dollars have we spent? And how many untracked dollars wasted? And how much wealth has Dick Cheney gained since taking office in 2001?

And the State Department's use of these private contractors instead of US Marines to guard embassies is another. When we "leave" Iraq, for instance, State will hire about 5,000 Halliburton et al. contractors to guard the Largest Embassy In the World. And if African countries ever allow the US to fully implement AFRICOM (military bases from top to bottom of that continent, to keep America safe from terror, I guess) they are to be staffed with contractors paid out of money put into State's budget for that purpose.

SUBMITTED BY DAVID SCHULTZ ON JANUARY 7, 2011 - 8:18AM.

Thanks for the comments.

As far as I know, union and non-union companies are not treated differently when privatizing but I could be wrong. But Ron and Dan raise good questions. Often the motive to privatize is to bust public sector unions, with the biggest savings in money coming from the paychecks of workers. We thus substitute non-union low wage jobs for union scale and pay jobs. In terms of where does the savings go? Chuck Davis who used to teach labor economics at the UMN, argues that privatization is simply another way for taxpayers to subsidize private businesses.

SUBMITTED BY DAN BUECHLER ON JANUARY 7, 2011 - 8:43AM.

Another arguement I have heard of in the past is that private companies cherry pick. Take the best deals and let the unmanageable ones left for the state to do.