

Privatization

The word "privatization" refers to a public, i.e., governmental body, turning a function it has traditionally provided over to a private company (nonprofit or for-profit). The private-is-better camp traces its recent roots to Peter Drucker's 1968 book, *The Age of Discontinuity*. Drucker argued that government should spend more time governing and less time producing services, that *shaping policy* is more the mission of government than actually *delivering services*. The buzzword hit the headlines in 1982 with E.S. Savas' book, *Privatizing the Public Sector: How to Shrink Government*. On the cover of Savas' book, a clenched fist squeezes a shrunken U.S. Capitol. Designers of AFSCME's book, *Passing the Bucks*, answered with this cover: what appears to be a businessman's hand opening the Capitol dome and two other hands pulling out the bucks.

While the public relations battle over "privatization" has called on clever images, substantive thinking has produced some odd bedfellows. In long essay-reviews of public-private books, Terry Hartle of the conservative American

Enterprise Institute appears to agree for the most part with Bob Kuttner, economics correspondent for *The New Republic*, a traditionally liberal magazine. Kuttner's viewpoint is obvious from the subtitle of his review, "The Dubious Case for Selling Off the State."²

Hartle develops his thesis slowly, first pointing out the limitations of comparing government to private enterprise: "In short, despite widespread and longstanding recognition that public and private management are different phenomena, we remain fascinated with the idea that the efficiency and effectiveness of government can be improved by adopting private-sector management techniques."³

Hartle seems most concerned with simplistic generalizations. "Those who see the private sector as a fertile source of ideas for running government should take care to ensure that the techniques they use come from IBM and Schlumberger rather than Chrysler, Braniff, or Lockheed," he concludes after reviewing books about these companies. "This is not to argue that the public sector can learn nothing from the

private sector. . . . But it is easy to confuse administrative improvements with changes in public policies.”

Public policies survive contrary to logical business principles because they “satisfy a public need or a constituency group,” explains Hartle. For example, in 1984, he notes, Congress extended the provision of the Hoover Dam’s electric power to several western states at far below market values. “Any policy analyst can identify a dozen programs or policies that continue to exist despite manifold evidence that they are ineffective or inefficient.”

Kuttner’s essay focuses more specifically on Savas’ book. “Like vouchers, contracting out is another Savas favorite,” writes Kuttner. “Contrary to Savas, purchase of services often combines the least desirable aspect of the public sector—bureaucracy—with the least desirable aspect of the private—greed.”

Persons advocating various degrees of “privatization” also cut across liberal and conservative lines. Savas stands firmly in the Reagan camp, favoring the least government that is possible. A wide range of other analysts have taken up the Drucker theme. Government should focus on policy decisions, not on providing services, argue Verne Johnson, formerly with General Mills and now head of Altcare in Minneapolis, and Ted Kolderie, a senior fellow at the Hubert H. Humphrey Institute of Public Affairs, also in Minneapolis.

“We need to understand that the essential function of government is a policy function: to *decide* what shall be provided publicly, and to *arrange* for it to be paid for,” contend Johnson and Kolderie. “It is not essential that the service

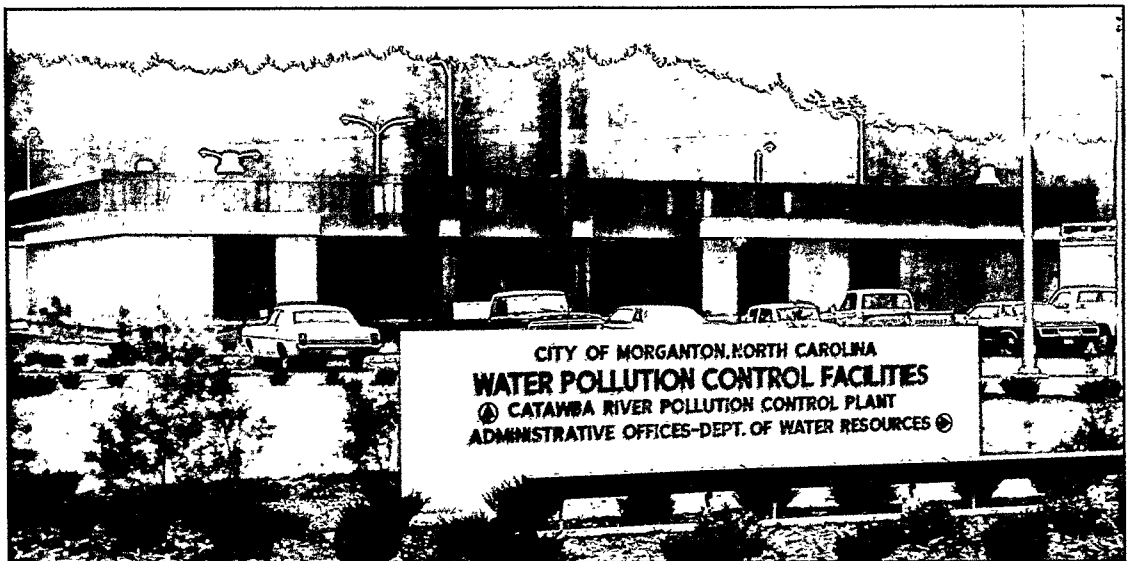
in question then be *produced* by the government itself.”⁴

“To arrange for it to be paid for” can mean one of three things: *contracting* with a private firm to provide a particular service (such as garbage collection); *giving vouchers* (i.e., cash or its equivalent) to particular groups of persons to purchase a service (such as vouchers to parents for educational services); and *turning over the entire operation* of a service to a private firm (such as a county selling its hospital).

Durward “Butch” Gunnells, executive director of the State Employees Association of North Carolina, is skeptical about “privatization.” “In areas like prisons, I’m not certain that it has been demonstrated that ‘privatization’ is the most economical or that it accomplishes what it ought to be accomplishing,” says Gunnells, speaking for himself, not for the 50,000-member association. “The association has taken no formal position on this subject.” Formed in 1984 in a merger of the two largest state employee groups, the association is the largest non-union state employee organization in the country.

(For a summary of pro and con arguments, see box on pages 8-9.)

In North Carolina, no estimates exist on the current amount of state and local money going to private companies to provide public services. Nationwide, the Council of State Governments reports that the amount of such spending has grown steadily, from \$27 billion in 1975 to \$81 billion in 1982.⁵ *State Government News*, the council’s monthly magazine, reported that “privatization” arrangements include everything from providing care for mentally retarded persons to running transit systems.



N.C. League of Municipalities

How does the situation in North Carolina stack up with the points raised by the analysts above? How have contracts, vouchers, and turning over a service entirely worked in this state? Here's a rundown of four types of services where private companies are taking an increased interest: refuse collection, water and sewer systems, hospitals, and prisons.

Refuse Collection. In North Carolina, one of the best traditional examples of "privatization" has been garbage collection (janitorial services is another). Sanford, for example, has contracted with American Refuse System for 12 years to collect its garbage. "It's a little bit cheaper," says City Manager P.B. Stokes. "Plus the city does not have to face major garbage truck purchases periodically." Similarly, the town of Clinton contracts for the hauling of limbs and leaves.

Raleigh has awarded a three-year contract to Browning-Ferris Industries to collect garbage in recently annexed areas of the city. At first glance, Raleigh appears to be saving money with its contract service. If the city has to take over the service at the end of three years, however, it will have to make capital purchases which will apply to future years' costs but won't show up during the three years of the private service.

In 1982, 50 of the 59 municipalities that contracted for garbage collection were towns with fewer than 5,000 people, according to a survey by the N.C. League of Municipalities. These 50 towns represented 25 percent of the 199 towns under 5,000 that responded to the survey. These findings indicate that capital purchases—most difficult for towns with the smallest tax base—are an important factor in deciding whether to contract with private companies for garbage collection.

Contracting with a private company goes beyond the convenience of delaying a capital purchase, however. In 1985, the General Assembly passed a law requiring municipalities either to contract for two years with the private refuse companies serving a newly annexed area or to reimburse the companies a year's revenues—if the annexation was involuntary.⁶ Initial capital costs, combined with the new law, will probably increase the short-term contracting of garbage collection to private companies. The impact on the long haul will be more difficult to determine.

The League is currently updating the 1982 survey. The results should indicate the extent to which two trends are developing. First, how many municipal officials agree with Hickory City Manager Wilfred A. Wells? The Hickory garbage collectors do much more than just collect garbage, says Wells. When it snows, they

clear away snow. They clear away trees pushed down in storms, and they clear storm drains and clean sidewalks.

Second, what happens when initial contracts come up for renewal? The Robeson County contract for garbage collection will expire on December 31, 1985. Officials are considering the possibility of Robeson County again collecting its own garbage. But no decision has yet been made.

Water and Sewer Systems. Mayodan and Morganton illustrate just two of the many approaches being used in North Carolina to build and operate water and sewer systems. "We have 3,000 public water suppliers in North Carolina," says David Moreau, director of the Water Resources Research Institute at North Carolina State University. "Only 50 serve more than 10,000 people. The larger cities have the experience. But there is a place for it ('privatization'), particularly with the small systems."

Private arrangements could be particularly valuable with regional systems, says Moreau. "They (private companies) would have to meet the same operating criteria as cities would have to."

Thus far, private companies have generally limited their involvement to building or operating water and sewer systems. Cities (and in some cases counties) still own and finance the construction of the systems. Leigh Wilson, executive director of the N.C. League of Municipalities, sees capital projects, like water and sewer systems, as an area where "privatization" could move beyond the traditional contracting for services. Local governments have had the authority for some time to contract with the private sector to operate water and sewer systems.⁷ In 1985, the General Assembly gave local governments a blanket authority to contract for any service they are allowed to provide themselves, including new water and sewer systems.⁸

Even so, municipalities are encountering barriers to contracting the entire water and sewer function to private companies. Planners envision a private company building a system and operating it, without the municipality (or county) having to pass a bond issue or invest major capital resources. After a 15-year depreciation period, the private-sector tax benefits would be exhausted, and the company would sell the facility to the governmental unit.

J.D. Foust, head of the state's Local Government Commission, says such private financing schemes haven't been pulled together yet, although negotiations are underway for facilities in Concord, Long Beach, and other North Carolina towns. "We can't use industrial revenue

Advantages of "Privatization"

1. Provides a timely answer to environmental and economic development needs.
2. Minimizes federal and state involvement in local affairs.
3. Avoids construction time delays and compliance with federal procurement regulations, which collectively may increase the capital cost of a facility by 20 percent to 40 percent.
4. Permits greater flexibility in key factors such as flow-matched sizing of the treatment works and billing users for services provided, and avoids indirect costs of grant administration and potential headaches of grant audits.
5. Privatization may provide 100 percent funding of sewage treatment plant construction costs, thereby preserving local debt capacity for other essential purposes. The grant program, in contrast, provides a percentage of funding for eligible costs only, and eligible costs are typically determined at the time a local project is placed on a state priority list, not when construction costs are actually incurred. Time delays may therefore significantly raise the local share.
6. Tax benefits which the private sector is capable of using should result in lower user fees than local debt financing would necessitate. Tax benefits available to the private sector include:
 - Investment tax credit—10 percent of eligible project cost.
 - Depreciation of machinery and equipment over five years.
 - Depreciation of structural components over 25 years.
 - Deductibility of interest expense.
7. Opportunity for community/private sector organizations to work together toward the

issuance of industrial development bonds would further lower the interest cost of financing by the private sector, and may, in fact, equate the interest rate borrowing cost of the private group with that of the local community.

8. For many communities, proper operation and management of sewage treatment facilities is best achieved through a private-sector contractor. Community difficulties include pay scales to attract and retain key technical talent and limited career growth opportunities.

9. The private sector should experience significant economies of scale in the operation of multiple facilities, thereby resulting in lower user fees for operation and management. Reasons include factors such as:

- Ability to share licensed operators among multiple plants.
- Ability to centralize/consolidate common services such as preventive maintenance, accounting and administration, laboratory services, spare parts, etc.
- Ability to bulk order chemical supplies and other essential common commodities.
- Profit incentive for cost-efficient operations and search for revenue-generating capability of treatment plant resources in addition to local user fees. □

Taken from a report on "privatization" of wastewater treatment facilities prepared by the Arthur Young Company for the New Jersey Department of Environmental Protection. "Advantages" and "Disadvantages" articles reprinted by permission from special "privatization" issue of American City & County magazine, January 1984.

bonds in this state except for manufacturing facilities," says Foust. "So there is no tax-exempt financing available to the companies. And the (federal) accelerated depreciation is not as good as it was three years ago." Foust has not given up on having private companies finance new water and sewer facilities as a way to help municipalities faced with declining federal dollars for such projects.⁹ "We hope that we can work out a way."

Is "privatization" better for water and sewer systems? Except for very small municipalities—which generally do not have sufficient in-house expertise—the decision does *not* depend upon efficiency in operating the system, says Moreau of the Water Institute. "You get the same people to work the systems," says Moreau. "Nation-wide, customers pay more for water from private

—continued page 10

Disadvantages of "Privatization"

The nation's largest public employee union has announced a national public education program designed to alert policymakers to the drawbacks and abuse associated with contracting out, or privatization, of state and local government services.

As part of its effort, the American Federation of State, County and Municipal Employees (AFSCME) released a 116-page book entitled, *Passing the Bucks: The Contracting Out of Public Services*. The book, which is the result of two years of study and research, details dozens of examples of mismanagement, abuse, fraud and corruption as a result of contracting out at the local level.

"The on-the-job experience of AFSCME's one million members clearly has shown that contracting out has serious shortcomings. Contractors providing government services are frequently more costly; contracting out often results in reducing the quality and efficiency of services; it is inevitably accompanied by a lessening of public control; and there are documented cases of crime and corruption associated with contracting out," declares Gerald W. McEntee, president of AFSCME.

"The Reagan administration's cuts in aid to state and local government have greatly increased the budget problems of those governments and contracting out is being promoted as a quick fix," McEntee continues. "But, our report shows that contracting out is no panacea. In fact, contracting out much more often operates against the best interests of the public it is supposed to benefit."

Among the findings of the report are:

- Rather than saving money, contracting out often results in higher costs. Hidden costs such as contract preparation, administration and contract monitoring usually increase the price of contracted services.

- Contracting out can result in a decline in the quality and efficiency of services. Contractors are tempted to cut corners by hiring inexperienced personnel, by ignoring contract requirements and by providing inadequate supervision.

- Corruption in contracting out has increased dramatically. Numerous cases of bribery, kickbacks and collusive bidding have

characterized contracting out over the past several years. In addition, organized crime appears to have assumed an even larger role in illegal activities associated with contracting out.

- Contracting out is still a tool of political patronage in many areas.

- Contractors bidding to provide public services have sometimes encountered financial problems which have left cities, counties, and states in difficulty.

- Contracting out has often been characterized by "lowballing" or "buying in" at unrealistically lower prices in order to obtain a contract.

- The drafting of job specifications and contracts often leads to contractor performance which is too rigid or narrow to maintain quality public services.

- Competition for contracts to provide public services is too often the exception rather than the rule.

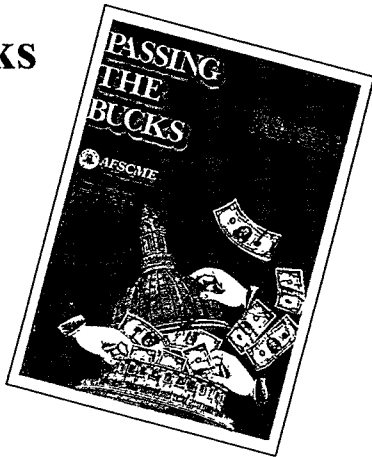
- Contracting out results in less accountability by government to the public.

- Contracting out is frequently used to mask the inadequacies of public officials who cannot manage their own operations properly.

"The lesson is clear for state and local government officials. They should proceed with extreme caution when tempted by the heady claims of contracting out," explains Linda Lampkin, AFSCME director of research. "At a minimum, public officials must be willing to explore the alternative. That's a basic management responsibility."

"The key to improving public services is good public management and efficient public services, not the selling off of government," says McEntee. "Public officials all too often have used contracting out as a crutch to prop up weak management. In every case of failure, in every case where the quality and efficiency of a public service has deteriorated and the cost increased, where control over public services has diminished, where corruption has come into play, the public is the chief victim. The public endures the consequences and the public pays the bill where the contracting out has not worked." □

Passing The Bucks



companies then from publicly owned systems because they are profit-making operations.”

The crux of the matter, then, is *financing the capital expense of a new system*, “or measuring the private sector opportunity with capital,” as Moreau puts it. “You weigh higher interest rates (since private companies have no tax-exempt bonds in North Carolina) versus the advantages in depreciation, plus the profit required.”

Hospitals. For many years, the state has run specialized hospitals for mentally ill and retarded persons, children with cerebral palsy, and North Carolina Memorial Hospital, part of the University of North Carolina system. For the most part, however, county governments have been in the business of providing general hospital health care only since about the 1940s. After some 45 years, hospital care is swinging back to the private sector.

Counties are turning to private hospital management corporations for general hospital services by: 1) contracting for the management of hospitals; 2) leasing hospitals to a private group; or 3) selling hospitals outright. Counties are using one of these three arrangements with both for-profit and nonprofit corporations.

Currently, of the 129 acute care hospitals in the state, the state owns and operates one (North Carolina Memorial); 53 are owned by local governmental bodies, and 75 are owned by private corporations. Of the 53, local governmental units operate 39 themselves and contract with private companies (both nonprofit and for-profit) to manage the other 14 hospitals. Of the 75 owned by private corporations, 65 are owned and operated by nonprofit groups and 10 by for-profit companies.¹⁰

In 1984, the legislature’s interim study committee on public health facilities held hearings on the trend towards “privatization” of county hospitals. C.B. Martin, chairman of the Edgecombe County Board of Commissioners and retired superintendent of the Tarboro City Schools, summarized the viewpoint of county officials who favor private-sector involvement. The Hospital Corporation of America had offered the county \$3.6 million for the hospital, which would cover the \$2 million the county had in obligations, leaving some \$1.6 million for other expenditures. “They had the money. They were willing to provide the services, and they were willing to take the indigent patients,” Martin told the legislative committee.

“After studying this thoroughly, we decided to sell the hospital,” explained Martin. “That’s a lot better off than we were before because if we had kept going, we would have had to close the place.”

Some county commissioners have had a different experience from Martin’s. Nolan O’Neal, a New Hanover County commissioner and board member of the county hospital, has objected to the county’s considering turning over its hospital. The proposal under consideration would transfer the assets and management of the hospital to a private, nonprofit corporation. “The public hospital has continued to make money,” says O’Neal. “It has a good medical and administrative staff. The hospital cost the taxpayers \$14 million and is worth \$80 to \$90 million now,” explains O’Neal. “Why mess with success?”

Confusion over the buzzword “privatization” shows up when discussing the transfer of county hospitals to the private sector. “Competition, and the use of private producers, does not mean ‘privatization,’” contend Johnson and Kolderie, the Minnesota-based analysts. “It is ‘privatization,’ for example, when the government says it will no longer pay for the care of the medically indigent, not when it arranges with some other organization to run the county hospital.”

When Edgecombe County sold its hospital to a private company, why shouldn’t that be called “privatization”? The point is this: The word “privatization” can mean different things to different people. What’s important is the impact of cost and quality of services and who is paying for the service, not the label given to the arrangement between the county and the private corporation.

Johnson and Kolderie call for a change of emphasis in judging the performance of public officials. For many years, they argue, “government came to be defined generally by *what it did rather than by what it decided*, with the unfortu-

nate consequence that elected officials who should be concentrating on the success of the policy have come instead to see themselves as involved primarily with the process of implementation" (emphasis added).

Such a perspective seems years away from the realities that county commissioners are now facing. Take the case of Eva Clayton, who chairs the Warren County Board of Commissioners. "All Things Considered," the nightly news program for National Public Radio, recently aired a feature-length report on how Clayton has struggled, but failed, to keep the Warren County hospital running in the black. The program quoted Clayton supporters who held her and other county commissioners responsible for the hospital's problems—and not the changing nature of the hospital industry.

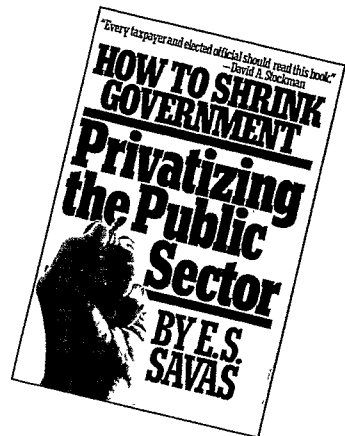
Prisons. One of the newest types of services now being offered by the private sector are detention centers, minimum-security prisons, county jails, and halfway houses. A leader in the field, the Nashville-based Corrections Corporation of America (CCA), tapped the same venture capital fund that launched the Hospital Corporation of America in the same city. Since January 1985, CCA has owned and operated a halfway house in Fayetteville under contract with the Federal Bureau of Prisons. The same corporation operates a county detention facility in Chattanooga, two federal detention centers in Texas, and has been hired to operate a county jail in Panama City, Florida.

In July, N.C. Secretary of Correction Aaron Johnson visited the Texas facilities run by CCA. He returned "extremely impressed" with CCA and has begun conversations with the company about building and operating a minimum-security state prison in North Carolina. Gov. James G. Martin has said that "he doesn't see a problem with it," although he has not yet given the go-ahead.

Like garbage, water and sewer, and hospitals, prisons sometimes go private because of cost considerations. Thomas Beasley, founder and president of CCA, and former chairman of the Tennessee Republican Party, contends that his company can build and operate a prison cheaper than can a governmental unit. Beasley points to cost savings through speed of construction (without the public bidding procedure) and the ability to negotiate with vendors quickly without slow-moving government contracts.

The *Winston-Salem Journal*, in an editorial on August 7, 1985, called the trend towards private-sector prisons a "free-lunch fantasy." If the state relies on private investments for new facilities, the editorial noted, the state becomes dependent upon that facility. This point is important in light of lawsuits filed on behalf of

How to Shrink Government



prisoners claiming overcrowded conditions.

Such a suit recently forced the state to commit \$12.4 million to improve conditions in 13 southern Piedmont prisons. "The settlement is a long overdue response to shameful overcrowding and inadequate programs in correctional facilities in this area, and should lead to a push for similar upgrading of prisons statewide," opined *The Charlotte Observer* in its lead editorial on August 6, 1985. What happens if a private company does not perform adequately? Where does the state turn for other facilities if it has come to depend upon a private company for a certain number of beds?

Other opponents question various legal and ethical issues. "Prison officials serve a quasi-judicial function," explained *The Fayetteville Observer* in a February 19, 1985, editorial, with duties ranging from advising parole boards to administering a sentence imposed by the courts. "It is not clear that the state has a right to delegate that responsibility to a private corporation." Legal aid lawyers and American Civil Liberties Union officials also worry about turning over an "unpopular function of government" to a private company, which is driven by the profit motive. Finally, what happens if there is a prison riot?

In addition to the minimum-security facility, Secretary Johnson is considering other forays into the "privatization" field. For example, Johnson considers the Central Prison hospital in Raleigh a "disgrace," and is interested in having a for-profit hospital chain take over that hospital. Possible cost savings and the hope of improving services may win the first round in North Carolina.