



The Case for Contracting Out:

A Vital Tool to Help Balance Washington's Budget
and Improve Public Services

A joint research series from the Washington Roundtable and Washington Research Council

THE THRIVE WASHINGTON PROJECT

The Great Recession dramatically changed fiscal conditions in Washington state, possibly forever. The impact of falling revenues and structural budget deficits has elicited a near universal call for a transformative shift in state government. This research series—developed by the Washington Roundtable and Washington Research Council—will provide actionable state policy recommendations that, if enacted, will preserve essential services, lay a foundation for sustainable economic growth and create an environment in which Washingtonians can thrive.

BUDGET SHORTFALLS IN WASHINGTON STATE AND ACROSS THE NATION

According to the National Association of State Budget Officers, states faced a collective budget shortfall of approximately \$250 billion between the fiscal years 2009 and 2011. Washington has not been spared. After addressing a \$9 billion shortfall in 2009, the state immediately found itself confronted by an additional \$2.7 billion shortfall in 2010. Looking forward, the state projects another \$5.7 billion shortfall for the coming biennium. Washington’s structural budget

shortfalls require the state to seek new solutions to contain spending while preserving the quality of public services.

Economic prosperity comes and goes, while the need for quality public services—such as education, health care, transportation and public safety—are constant. In times of economic contraction, states face difficult choices. The two most common approaches: increase taxes at a time of economic fragility or decrease public services when citizens need them the most.

There is a third option.

Starting in the 1980s, and accelerating through the 1990s, the federal government, several state governments, and hundreds of local governments began to experiment with the idea of “competitive sourcing” and “contracting out.” Increased use of competitive sourcing will enable Washington state not only to save money while delivering high quality services, but to increase its focus on critical, high priority services such as education.

WHAT ARE COMPETITIVE SOURCING AND CONTRACTING OUT?

Competitive sourcing is a broad term that encompasses all types of policies that facilitate competition in the provision of government projects and services. It includes franchising, use of vouchers, asset sales (privatization), private infrastructure

RECOMMENDATIONS

- Reform how the state negotiates labor contracts so contracting out authority is not subject to collective bargaining.
- Direct the state auditor to survey all state agencies that provide government services and identify those that could save money through contracting out.
- By the end of 2012, set a goal of identifying savings of 15 percent from the selected agencies.
- Implement a prototype contracting out process for at least five agencies by 2013.
- Create a commission focused on maintaining Washington’s commitment to contracting out.

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It is the “win-win” possibility of better services at lower costs that makes contracting out so attractive.

development, deregulation, volunteerism and contracting out.

The Council of State Governments describes contracting out as a process in which “the state enters into agreements with private sector firms, for profit or non-profit, to provide goods or manage services.” Simply put, contracting out occurs when governments hire private firms to do jobs that government has done traditionally. If your local city uses a private garbage company, you are already familiar with contracting out.

Examples of contracting out and competitive sourcing can be found at all levels of government. The federal government has contracted out services as simple as window washing and as complex as air traffic control. Local governments utilize contracting out to provide a wide array of services, including bus service, grounds maintenance, fire protection, health services, legal services and many more. State governments were late to the contracting out phenomenon, but are catching up quickly. Many now contract out prisons, human resource services and nursing homes.

There are many reasons for contracting out public goods and services. The two most often cited are cost savings and improved quality of service. It is the “win-win” possibility of better services at lower costs that makes contracting out so attractive. Other reasons to contract out include: access to

specialized services government cannot provide, avoiding large start-up capital outlays, avoiding the constant cost of technology upgrades, benefiting from economies of scale, and stimulating the growth and diversification of a state’s small business sector.

Although there is no clearinghouse to identify every service governments have contracted out, Table 1 includes a list based on peer-reviewed journal articles.

TRENDS IN CONTRACTING OUT

Contracting out is not a fad in government reform. Since the 1970s, contracting out has increased across all levels of government. A number of organizations have conducted surveys to measure the extent and growth of contracting out among the states. The American State Administrators Project, the most comprehensive of studies to date, found that more than 70 percent of agency heads reported using contracting out to deliver some services. Of those agency heads that contract out, about 80 percent do business with private firms, 71 percent work with non-profits and 61 percent contract out to other government entities.

Deborah Auger from the University of Delaware reports that 68 percent of state auditors, budget directors, and comptrollers expect contracting out to continue to increase during the next few years. Interviews with

TABLE 1: EXAMPLES OF CONTRACTED OUT/COMPETITIVELY SOURCED SERVICES

- | | | |
|--|------------------------------------|--|
| ■ Airline Operation and Maintenance | ■ Highway Maintenance/Snow Removal | ■ Prisons |
| ■ Property Tax Assessment | ■ Hospitals | ■ Waste Collection/Waste Treatment |
| ■ Bus Service | ■ Legal Services | ■ Educational Services |
| ■ Maintenance of Public Buildings
(grounds keep and janitorial) | ■ Liquor Sales | ■ E-Government Services |
| ■ Day Care | ■ Auto Maintenance (of state cars) | ■ Public Health Services |
| ■ Debt Collection | ■ Parking Services | ■ Social Welfare Services (foster care,
domestic violence, substance abuse) |
| ■ Utilities | ■ Parks and Recreation | ■ Job Training |
| ■ Fire Protection | ■ Payroll and Data Processing | ■ Website Hosting |
| ■ Nursing Homes | ■ Human Resources | ■ Janitorial Services |
| | ■ Printing | |

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More than 70 percent of state agency heads report using contracting out to deliver some services.

state agency heads indicated that 70 percent expect contracting out to expand. A study by the Council of State Governments (2002) showed that, between 1997 and 2002, a quarter of states increased their use of contracting out, more than half held contracting out practices constant and only 11 percent decreased contracting out (10 percent did not respond).

DOES CONTRACTING OUT SAVE STATES MONEY?

For many policy analysts and agency heads, the most important question is if contracting out saves states money. There is overwhelming evidence that it does.

The most comprehensive study by John Hilke (1992) examined more than 100 independent studies of privatization efforts and found private firms could save states 20 to 50 percent. E.S. Savas (2000) studied contracting out practices around the world and concluded it saves about 25 percent. Contracting out-skeptic Graeme Hodge (1999) conducted a meta-analysis of 129 contracting out studies between 1976 and 1994, concluding that it saved governments between 8 and 14 percent.

In an era when Washington state confronts an enduring structural deficit, contracting out is a cost savings tool the state must utilize. A survey of other states reveals numerous contracting out examples that have saved money and improved service quality.

- The administration of Florida Governor Jeb Bush used privatization and competitive sourcing more than 130 times during his eight-year tenure (1999 to 2007), saving more than \$500 million in current dollars and avoiding more than \$1 billion in estimated future costs. Governor Bush also created the state's Council on Efficient Government, which developed a centralized process for evaluating when and where privatization is appropriate,

as well as assessing competitions for contracts.

- Chicago Mayor Richard Daley has privatized more than 40 city services and, since 2005, generated more than \$3 billion in upfront payments from private sector leases of city assets, including the Chicago Skyway toll road and several parking assets.
- Former Indianapolis Mayor Stephen Goldsmith identified \$400 million in savings and opened more than 80 city services – including trash collection, pothole repair and water and wastewater services – to competitive bidding.
- While serving as mayor of Philadelphia, current Pennsylvania Governor Ed Rendell saved \$275 million by privatizing 49 city services.

Academic researchers have also compiled a series of case studies on contracting out success stories.

- In 2004, the Texas State Health and Human Services Commission contracted out all of its human resources management. The state auditor estimates a five-year savings of \$32.7 million over the projected cost of maintaining the services in-house.
- A 2001 study of 347 local health departments showed that 57 percent had contracted out at least some of their

CONTRACTING OUT SUCCESSES

Florida Governor Jeb Bush, a Republican, used contracting out to save more \$500 million and avoid another \$1 billion in future costs.

Chicago Mayor Richard Daley, a Democrat, leveraged contracting out to generate more than \$3 billion in upfront payments.

If Washington achieved savings similar to Texas by contracting out human resources services, the state would save \$20 million per biennium.

services. Of those local health departments that contracted out, 44 percent reported lower costs. Seventy-seven percent reported costs were lower or held even. Only 10 percent reported higher costs.

- In an extreme example, the City of Weston, Florida, with 60,000 residents, contracted out 100 percent of its services. The entire city now has a staff of three. As a result, Weston has one of the lowest property tax rates in Florida.

Another approach to measure the success of contracting out is simply to ask agency heads how much they saved after adopting the practice. Looking only at city governments, the International City/County Management Association found that city administrators reported cost reductions of 15 to 20 percent. When the Council on State Governments polled state agency heads about 15 percent reported savings greater than 15 percent, 20 percent reported savings of 10 percent and 60 percent reported savings in the 5 percent range.

The decision to contract out no longer has a partisan tilt. When the concept was first developed by Public Choice economists in the early 1970s, the idea was cast as “conservative.” Over time, ideology faded from the debate, and, as the examples demonstrate, leaders from across the political spectrum, in “red” and “blue” states alike, have successfully utilized private firms to deliver public services.

Contracting out can require initial transition costs; however, it is generally accepted that the practice saves states money over the long-term. The question of how much is saved depends on a host of variables, including the type of service, how diligent the state is in procuring good deals, and how competitive the bid process.

HOW MUCH MONEY CAN WASHINGTON STATE SAVE IF IT CONTRACTS OUT?

There are a number of ways Washington can save money contracting out. For example, consider if the state contracted out human

resources (HR) services in the Department of Social and Health Services (DSHS) the same way Texas does. Washington budgeted \$38 million for HR services for DSHS during the 2009-11 biennium. When Texas contracted out its HR services in 2004, the state’s costs decreased 28 percent. If Washington experienced a similar rate of savings, the state would save more than \$10 million every year. That is \$20 million per biennium, the equivalent of 2,800 slots at our community colleges, 1,150 enrollment slots at the University of Washington, or 218 K-12 teachers (at the average salary level).

Consider a second example. According to studies reported by the Council of State Governments, several states have contracted out prison services. Alabama and Mississippi report a 15 percent savings from their efforts. Other states report numbers closer to 5 percent. Now apply this action to Washington state.

The National Institute of Corrections reports it costs taxpayers \$37,303 each year to house a single prisoner in Washington and we currently have just over 17,000 prisoners. That equates to \$630 million annually. If Washington realized 15 percent savings, similar to the level achieved in Alabama and Mississippi, the state would save approximately \$95 million each year. If Washington saved only 5 percent, as reported by other states, it would still save \$31 million annually – or three times the savings garnered from the HR reform noted earlier.

Similarly, Washington could save money by contracting out the state motor pool. Washington spends just over \$17 million per biennium to maintain its fleet of cars. A recent study commissioned by the State of New Jersey noted that contracting out that state’s motor pool would save \$4 to \$9 million out of a \$44 million budget. If Washington realized a similar 9 to 20 percent savings, the state would save between \$1.5 and \$3.4 million annually.

Determining how much a state can save from contracting out services is a function

Contracting out public services is only attractive if the state can also maintain or improve the quality of services.

of three variables: the size of the state budget, the percentage of the budget that is contracted out, and how much is saved by contracting out.

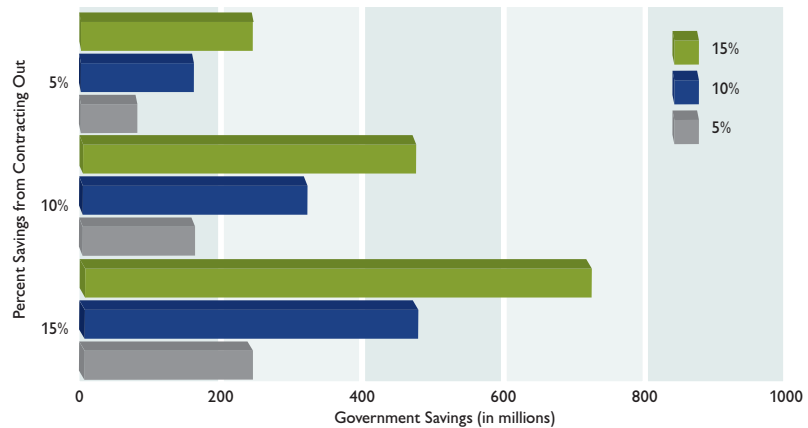
Washington’s Near General Fund State (NGFS) operating budget for the current biennium is approximately \$31 billion. Although NGFS funds do not make up the entire budget, it is the most discretionary portion and therefore the most amenable to contracting out. The unknown variable is what percentage of public services the legislature would be willing to contract out and, since the research varies, how much the state would save. We cannot pinpoint the exact savings; however, we can estimate based on a range of realistic scenarios.

Table 2 summarizes the potential biennial savings from contracting out based on two variables: what percentage of the NGFS operating budget the legislature would be willing to contract out (5, 10 or 15 percent) and how much savings contracting out would garner (5, 10 or 15 percent).

Table 2 illustrates the best and worst case scenarios along with possibilities in between.

- Worst case scenario: the state contracts out a minimal 5 percent of services and garners a 5 percent savings, which equates to \$80 million per biennium. That \$80 million would more than cover the biennial general fund appropriations for Central Washington University and the operating budget for the Higher Education Coordinating Board (HEC Board).
- Best case scenario: the state contracts out 15 percent of all public services and garners a 15 percent savings. This would save more than \$700 million per biennium. The savings garnered at those levels would almost pay for the state’s entire biennial appropriation for Children and Family Services.
- Middle ground: the state contracts out 10 percent of public services and garners a 10 percent savings, would result in biennial savings of \$320 million. That equates to a \$50 tax rebate for every man, woman and child in the state.

TABLE 2: POTENTIAL BIENNIAL SAVINGS FROM CONTRACTING OUT



Source: Fiscal.wa.gov, Historical Reports, Bond Retirement and Interest

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Contracting out could potentially save Washington state hundreds of millions of dollars over just a few biennia.

WHAT ABOUT QUALITY?

As the old adage goes, “cheaper is not always better.” Contracting out public services is only attractive if the state can also maintain or improve the quality of services. Two studies offer potential answers to the quality question.

In a 1999 analysis of extensive research, privatization authority Graeme Hodge found there was no difference between the quality of services offered by the government versus those offered by the private sector. Previously, in 1996, economist Paul Seidenstat concluded that services provided by the private sector were, at worst, the same quality of government services, but often better than government-provided services. Taking these two studies together, we can conclude that contracting out either saves taxpayer money without sacrificing quality, or saves money and actually improves quality.

IS WASHINGTON STATE THE RIGHT PLACE TO CONTRACT OUT?

Like all public policies, one size does not fit all. Contracting out is not a panacea that will work everywhere and with every public service. Considerable research demonstrates that contracting out works best when the market is large enough to supply multiple bidders and governments provide professional management of contracts and oversight of service delivery. The research also indicates that contracting out saves the most money in states with dense urban environments, large public employee unions, and high public employee costs.

Based on those criteria, Washington is an excellent place to pursue contracting out. Much of the western part of the state is urbanized and offers a multitude of competitive bidders. Washington also has a highly-unionized public sector. The state ranks 15th out of 50 states with 53 percent of its public employees unionized. As documented in the second paper of the

Thrive Washington series, “Nine Steps to Budget Sustainability in Washington State,” public sector employees generally earn comparable salaries to their private sector counterparts and tend to enjoy richer benefits. Washington’s high level of public unionization contributes to its higher public labor costs. Such labor market attributes make Washington an ideal state to realize significant gains from contracting out.

Contracting out does more than just lower labor costs. It provides access to specialized services the government cannot provide and allows the state to avoid large capital outlays, minimize the cost of technology upgrades and benefit from economies of scale.

Contracting out also promotes the development of small businesses. It provides opportunities for small businesses to compete for government projects, allowing them to grow and diversify. By shifting projects and services into the competitive marketplace, contracting out can promote small business growth and, in turn, increase private sector employment and tax revenue.

A few areas of state government that would be ripe for contracting out:

- Maintenance of public buildings and grounds
- Human Resources
- Bus services
- Parks, Recreation, and Campgrounds
- Prisons
- Roads Maintenance
- Public Health Services
- Tax Assessment
- Child Support Payment Collection Services
- Welfare to Work Programs
- Maintenance of State Motor Pool
- Information Technology Services

Contracting out lowers the cost of state-provided services and frees up money for essential services such as education, infrastructure and public safety.

Given the magnitude of the budgets for the above services, the potential for savings could run into the hundreds of millions over just a few biennia.

Washington voters support contracting out. In fact, a strong majority (56 percent) of those surveyed in the fall of 2010 believe the private sector would do a better job of providing the same service as the public sector. Only a third (32 percent) believed the state would do a better job.

FINDING INNOVATIVE WAYS TO FUND AND DELIVER SERVICES

As documented in the first paper in the Thrive Washington series, Charting a New Course, Washington's budget and system of service delivery must be realigned and transformed. Our budget shortfalls are structural and Washington needs to find ways to provide quality services to the public at lower cost. Contracting out offers a means by which to accomplish that two-pronged goal. It lowers the cost of state-provided services and frees up money for essential services such as education, infrastructure and public safety.

Many local governments in Washington contract out a variety of services. Our state government, however, does not. Despite 2002 legislation empowering Washington state agencies to contract out, only one agency (the Health Care Authority) had done so by 2009. The lack of action by agencies raises a question: why not?

In January 2007, the Joint legislative Audit and Review Commission (JLARC) published a "performance audit of the implementation of competitive contracting." JLARC staff found two main reasons why agencies were not competitively contracting:

- "Managers perceive the process, as established in statute, rule, and the Department of General Administration's Competitive Contracting Manual, to be

very complicated and confusing, providing a disincentive to competitively contract.

- Competitive contracting is subject to collective bargaining ... In addition, collective bargaining agreements can expressly exclude the option of competitive contracting. Thus, the competitive contracting process is intertwined with the complexities of collective bargaining and labor relations."

Perception issues notwithstanding, the conflation of collective bargaining and competitive contracting represents a serious impediment to administrators seeking marketplace efficiencies.

Washington can no longer afford not to take advantage of the benefits associated with contracting out. Lawmakers should:

- Reform how the state negotiates labor contracts so contracting out authority is not subject to collective bargaining.
- Direct the state auditor to survey all state agencies that provide government services and identify those that could save money through contracting out.
- By the end of 2012, set a goal of identifying savings of 15 percent from the selected agencies. This is an appropriate mid-range goal given the scale of

IF BOTH PUBLIC AND PRIVATE SECTORS COULD PROVIDE THE SAME SERVICE, WHO DO YOU THINK WOULD DO A BETTER JOB?



56% Private Sector
32% Public Sector
12% Don't know

Source: Thrive Washington, Sept. 2010

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contracting out and success already achieved by other state and local governments.

- Implement a prototype contracting out process for at least five agencies by 2013.
- Create a commission focused on maintaining Washington’s commitment to contracting out. Such a commission exists in every state where contracting out has been successful and sustained. The commission should be tasked with facilitating, promoting and overseeing contracting out activities. It must be representative of the labor and private sector communities. It should be a clearinghouse of information and procedures that would help interested agencies effectively contract out. It should also be entrepreneurial in nature—seeking out agencies that could benefit from contracting out, but have not taken the first steps on their own. Most importantly, the commission should have an established timeline for meeting clearly articulated savings goals.

As the old adage goes, necessity drives innovation—and nowhere is that more true than in the world of state budgets. Addressing continual budget shortfalls with tax increases, fund shifts and one-time monies solves problems only temporarily. Instead, structural change is required.

Washington’s current budget crisis serves as a reminder that the state needs to innovate and take specific steps to adjust the long-term cost curve in order to achieve budget sustainability. Contracting out is a step in that process.

The data clearly demonstrates Washington would get “more bang for its buck” with contracting out. Through better management of scarce tax resources, the state can maintain or improve the amount and quality of services citizens utilize and do so at a lower cost. This is a highly valuable tool that can accelerate the transformation of Washington’s budget and enable greater emphasis on public delivery of essential, high priority services. In an era in which every dollar counts, Washington must develop and implement a plan to increase contracting out across the state.

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