

***STATE OF LOUISIANA
LEGISLATIVE AUDITOR***

**Competition and Privatization
Measures in State Government**

Staff Study
February 1995



Performance Audit Division

***Daniel G. Kyle, Ph.D., CPA, CFE
Legislative Auditor***

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February 24, 1995

Honorable Samuel B. Nunez, Jr.,
President of the Senate
Honorable John A. Alario, Jr.,
Speaker of the House of Representatives
and
Members of the Legislative Audit Advisory Council

Dear Legislators:

This is our staff study on Competition and Privatization Measures in State Government. This staff study was conducted as part of Phase Two of the Select Council on Revenues and Expenditures in Louisiana's Future (SECURE) project.

This staff study represents our findings and conclusions. We have also identified a matter for legislative consideration. Included as Appendix B is the response of the Division of Administration.

Sincerely,

A handwritten signature in black ink that reads "Daniel G. Kyle".

Daniel G. Kyle, CPA, CFE
Legislative Auditor

DGK/jl

(LEGLTR)



Office of Legislative Auditor

Executive Summary

Staff Study Competition and Privatization Measures in State Government

Globally, public administrators are seeking ways to introduce competition into government service provision. Historically, the motivating factor behind these moves has been financial necessity. As part of Phase Two of the SECURE effort, the Legislative Auditor compiled information gathered on efforts undertaken by other states implementing strategies to take advantage of the competitive marketplace. Our study found that:

- ◆ Privatization is only one of many strategies that states are using to promote efficiency and cost effectiveness.
- ◆ Nine states have developed an on-going function that reviews, analyzes, and evaluates competitive and privatization opportunities.
- ◆ Management systems should be developed to allow for accurate cost analyses and cost comparisons. Performance monitoring is also vital to assure quality of service.

Although Louisiana privatizes some functions on an ad hoc basis, no central entity exists to ensure cost savings and satisfactory contractor performance on an on-going basis.

Chapter One: Introduction

Study Initiation and Objectives

The Louisiana Legislature established the Select Council on Revenues and Expenditures in Louisiana's Future (SECURE) through Senate Concurrent Resolution (SCR) 192 in the 1993 Regular Legislative Session. This study was performed as a part of the Phase Two SECURE effort. See Appendix A for further details on SECURE. The objectives of this study, as defined in Phase One, were to:

- ♦ Consider and make recommendations for possible privatization opportunities;
- ♦ Consider the privatization efforts undertaken by other states; and
- ♦ Consider the expansion of on-going privatization efforts in Louisiana.

Report Conclusions

Privatization is only one of many management tools that states are using to promote more efficient and cost-effective services. It is a management technique that should be considered along with other options when determining how to deliver state services.

We surveyed 19 states that are recognized in current literature as leaders in the area of privatization. We found that:

- ♦ Nine states have established functions, either through the use of separate commissions or full-time staffs, dedicated solely to competitiveness and privatization issues.
- ♦ One of the states that has thus far used only dedicated staff will propose legislation in the 1995 session to establish a separate commission to deal with these issues.

- ♦ **Five states require agencies to continually review their operations looking for privatization or de-privatization opportunities as well as ways to use competition to deliver state services at a lower cost while improving quality.**
- ♦ **Five states have made efforts either by task force or statewide audit to identify areas where cost savings can be achieved, or have attempted to set up commissions to perform this function but have failed.**

In Louisiana, the Division of Administration looks for privatization opportunities on an ad hoc basis when performing routine budget analyses. The Office of Contractual Review ensures statutory and regulatory compliance, funds availability, and the reasonableness and advisability of services provided by the majority of state contracts. The Civil Service Commission makes sure that contract services cannot be performed by classified state employees. None of these entities check for cost savings or monitor contractor performance.

Cost comparison and analysis are necessary to determine if a government service should be kept in-house or privatized. However, most state governments do not have a system for easily assessing all of the costs of government service delivery. Monitoring contractor performance is the key to assuring continued cost savings and quality service.

Background

Privatization is the shifting of a function, either in whole or in part, from the public sector to the private sector. It is both a national and global trend. The Reason Foundation's Privatization Center, a national clearinghouse on state and local privatization, reported in *Privatization 1994*, that "around the world, over \$60 billion of state-owned enterprises were privatized in 1993, bringing the total over the past decade to more than \$388 billion." In the United States, it is being carried out at the federal, state, county, and local levels.

At the federal level, Office of Management and Budget (OMB) Circular A-76 is the oldest major instrument of privatization. It was first issued by the Bureau of Budget in 1966, and was most recently revised in August 1983. The circular "requires agencies, with some major exceptions, to use contractors for commercial services if such an approach is less expensive than public production of these services by more than 10%."

Common Forms of Privatization. Privatization has many forms. The most common forms of privatization are listed below.

- ♦ **Competitive contracting:** Private companies compete with government agencies for the opportunity to deliver public services. Some state agencies have begun to compete against each other to deliver public services.
- ♦ **Load shedding:** Government divests itself from both the funding and delivery of a service. The service is left to be provided by the private sector, if the service is to be provided at all.
- ♦ **Vouchers:** Government provides a voucher for a service, and consumers can obtain the service from competing private or sometimes public enterprises.
- ♦ **Privatization of facilities and sale of assets:** Government ceases to be the provider or controller of a function that is sold or shifted entirely out of government. This is the most complete form of privatization.

Louisiana's Privatization Initiatives. In Louisiana, efforts have been made in the past to find ways to reduce costs and improve services. In July 1988, the Governor's Task Force on Efficiency and Effectiveness was organized to identify opportunities and propose recommendations for expenditure reduction and service improvement in Louisiana state government. The study took approximately one year to complete, and the report was issued in July 1989.

The task force members were from both the public and private sector. To conduct the review of state government, the task force members were divided into five task force teams: Health, Corrections, Transportation, Education, and Compensation and Benefits.

One of the areas the Health Task Force concentrated on was the privatization of hospital services. The task force recommended that a comprehensive, non-partisan study be conducted to determine the feasibility of privatization of all services being performed by the Department of Health and Hospitals personnel. The task force specifically mentioned the areas of food, security, maintenance, and lab services. To date, no such study has been done.

Currently in Louisiana, the Division of Administration looks for privatization opportunities on an ad hoc basis when performing its routine budget analyses. Although the state has privatized several functions, no formal on-going analysis is being done to identify more opportunities for privatization.

Furthermore, some functions that have been privatized continue even though they have not been proven to be cost effective. Statutory requirements and other considerations cause this condition to exist. Areas in which Louisiana has begun to privatize include the following:

- ♦ Janitorial services (through Prison Enterprises)
- ♦ Guard services
- ♦ Community-based rehabilitation centers
- ♦ Medical care services
- ♦ Medium security prisons
- ♦ Highway maintenance
- ♦ Buildings and grounds maintenance

Areas in Louisiana that were privatized but, because of unfavorable results, have returned or are returning to the public sector are:

- ♦ Telecommunications
- ♦ Legal services
- ♦ Food service for a state-run prison

Office of Contractual Review. Each year the Office of Contractual Review, within the Division of Administration, reviews all professional, personal, consulting, and social services contracts for all state agencies, boards, and commissions of the executive branch of Louisiana government. The purpose of its review is to ensure compliance with all statutory and regulatory requirements, that funds are available, and that the services are

reasonable and advisable. In addition, the Office of Contractual Review is required, by executive order, to review and maintain records on all cooperative endeavor agreements entered into by all state entities within the executive branch where there is an expenditure of public funds.

The Office of Contractual Review reported that contracts approved for fiscal year 1993-94 total over \$950 million. However, the Office of Contractual Review is not able to identify the amount of interagency/intergovernmental contracts included in this total but will be able to capture this information in fiscal year 1994-95.

Furthermore, the Office of Contractual Review is neither able nor required to determine whether these contracts save or cost the state money. Also, this office is not required to review operational service contracts, such as pest control, janitorial, waste and guard services. Thus, total contracted services could easily exceed the approximately \$1 billion per year that is monitored by the Office of Contractual Review.

Civil Service Commission Rule. The director of the Civil Service Commission reviews and approves or disapproves contracts for personal services between the state or any of its instrumentalities, and any person. This review is performed to ensure that such agreements do not provide for the performance of state services that could be and should be performed by classified state employees.

In 1984, this rule was upheld in appellate court. In this case, a contractor had agreed to provide the state with professional, actuarial, and technical services required to organize and maintain the state group insurance program. The contractor brought breach of contract action against the state after the Civil Service Commission refused to approve its contract. Upon appeal, the court held that the contract was not enforceable.

Scope and Methodology

This report is a staff study and not a performance audit. Preliminary work began in August 1994 and work was completed in February 1995. This study focused on SECURE's recommendation in Phase One to consider and make recommendations on possible opportunities for privatization as part of SECURE's Phase Two analysis.

We did not make recommendations on possible opportunities for privatization. The process to determine if government services should be kept in-house or privatized involves detailed cost comparisons of government and private service delivery costs. This type of analysis is very time consuming and complicated and should be done on a case-by-case basis.

We reviewed relevant state and federal laws and regulations, pertinent articles found in current literature, and applicable studies conducted by other states. We interviewed legislative staff, state budget officials, and officials from the Division of Administration.

We performed an initial telephone survey of key personnel from 24 states that are recognized in current literature as innovative states in terms of competition and privatization. We then followed up with a written survey questionnaire. We excluded 5 of the 24 original states from the written questionnaire for various reasons. New Mexico and Washington were excluded because we were unable to reach a contact person to survey. We also excluded South Dakota, California, and Colorado because the interviewees reported that political influences had put a hold on continuing or furthering efforts in their states. Thus, the written questionnaire was ultimately sent to 19 states.

We requested copies of any legislation proposed and current reports issued on privatization from these 19 states. The information obtained from these surveys and interviews was summarized and appears throughout this report. It is not reproduced in full because of the bulk of information we obtained.

Report Organization

The remainder of this report is organized into two additional chapters and three appendixes:

- ♦ **Chapter Two** describes the characteristics of the 19 states included in our review.
- ♦ **Chapter Three** describes the conditions conducive to privatization, some states' cost analysis methodologies, and performance monitoring requirements.

- ♦ **Appendix A** contains an overview of the SECURE project.
- ♦ **Appendix B** contains the Division of Administration's response to this report.
- ♦ **Appendix C** contains the auditor's comment on agency response.

Chapter Two: Other State Reviews

Chapter Conclusions

In our detailed review of 19 states, we found that the different states' efforts have had varied results.

- ♦ Seven states have established commissions to deal with competitive and privatization issues.
- ♦ Two states have staff dedicated to competitive and privatization issues.
- ♦ Five states have left privatization to agency manager initiative.
- ♦ Five states have done one-time studies with results ranging from no recommendations to legislation pending that proposes a competitive council.

The majority of the states with an established commission have members from both the public and private sector. Even with demonstrated success, political and legal barriers can impact the success of competitive and privatization initiatives.

Fourteen States Have On-Going Review Functions

Fourteen of the 19 states in our study perform on-going reviews for competitiveness and privatization opportunities. Seven of these 14 states have commissions that address competitive and privatization issues. Those states are Arizona, Florida, Kentucky, Maryland, New Jersey, Texas, and Utah. Two states, Iowa and Michigan, have full-time staff dedicated to working only on competitiveness and privatization issues. The remaining five states, Georgia, Illinois, Massachusetts, New York, and Pennsylvania, have created an environment within state government that requires each state agency head to be aware of opportunities to privatize or de-privatize state functions.

Exhibit 2-1 on the following page lists the 14 states with on-going review functions, and what source, if any, authorizes the function. The remainder of this section gives specific information on each state's approach to competition and privatization. This information was provided to us by representatives in each state studied and has not been audited or otherwise confirmed by us.

Arizona. In Arizona, the Private Enterprise Interview Review Board was created in 1981 and reviews unfair competition violations. The Board can evaluate and review opportunities to contract with private enterprise that are deemed to be in the public interest. The Board plans to propose a bill to create a council on competitive government in the 1995 legislative session.

Also, the Arizona Joint Interim Committee on State Assets was created in 1993. The Committee may select certain state assets and direct joint legislative budget committee staff to prepare cost benefit analysis of the selected assets. This analysis shall include a cost estimate of retaining or disposing of the asset and the committee may direct the staff to make recommendations for alternative uses for this asset. The Committee is working on privatizing a coliseum, redesigning a state hospital, consolidating a motor pool, and eliminating state aircraft. No projects have been privatized as a result of either entity.

Florida. The Florida State Council on Competitive Government was created by the 1994 Legislature but has not yet met. However, the state already had an on-going process called Privatization, Adjustment, Retention or Elimination (PARE) performed through its Office of Planning and Budgeting.

The purpose of this process is to review state operations to develop recommendations to eliminate duplicative or unnecessary programs and to identify and achieve the most efficient means of accomplishing program goals. One component of the review is the identification and examination of programs for possible privatization. Privatization within the context of the PARE review includes the use of contracting, franchises, concessions, vouchers, and transfers of services to other units or levels of government. As a result of Florida's efforts, many state activities have been privatized. Some of the activities that have been privatized include toll booth operators, delinquency halfway houses, and medical consultants.

Exhibit 2-1 States That Perform On-Going Reviews for Privatization and Competitive Opportunities		
State	Authorization	Type of Review Function
Commission or Council Established		
Arizona*	Statute	Private Enterprise Interview Review Board
	Statute	Joint Interim Committee on State Assets
Florida	Statute	State Council on Competitive Government
Kentucky	Executive Order	Privatization Commission
Maryland	Executive Order	Governor's Advisory Council on Privatization in State Government
New Jersey	Executive Order	New Jersey Advisory Commission on Privatization
Texas	Statute	Council on Competitive Government
Utah	Statute	Privatization Policy Review Board
Staff Dedicated to Competitiveness and Privatization Issues		
Iowa	Designated by Governor	Department of Management
Michigan	Created Internally by Department of Management and Budget	Office of Contract Management, Privatization Division
Agency Initiative		
Georgia	N/A	Office of Planning and Budget drafted policies for agencies to use when considering privatization.
Illinois	Informally Mandated by Governor	Continuous review of new and existing programs by all state agencies
Massachusetts	Informally Requested by Governor and Lieutenant Governor	Agency heads asked to privatize wherever money could be saved or services improved.
New York	Informally Mandated by Governor	Individual agency head initiatives
Pennsylvania	N/A	Individual agency head initiatives
* Arizona has two entities that review competitiveness and privatization issues.		
Source: Prepared by Office of Legislative Auditor's staff using survey responses from each state.		

Florida has not quantified actual cost savings that resulted from the privatized activities. The official from Florida that we spoke to said that their state does not generally assume that it will receive great cost savings from privatization of activities. Instead, more realistic goals are as follows:

- ♦ Control of growth in state spending and number of state employees;
- ♦ Improved service delivery;
- ♦ Ability to expand service delivery to additional clients; and
- ♦ Maintenance of costs, despite growth due to increased technology available in the private sector.

Georgia. In 1992, a task force issued a report on the effectiveness of using privatization as an alternative way to provide state services. The task force recommended that a permanent privatization commission be established, but the Governor rejected this proposal because he felt the work could be performed by existing staff. The Office of Planning and Budget considers privatization during budget planning. It has also drafted policies for agencies to use as guidelines when considering privatization.

Illinois. The Private Enterprise Review and Advisory Board, which was established by executive order, identified more than 60 state government activities where efficiency might be increased through either privatization or de-privatization. The Board recommended that state agencies continually review new and existing programs to determine whether activities are candidates for privatization or de-privatization. The Board ceased to exist after it issued its report.

Iowa. Since 1991, the Iowa Department of Management has dedicated one staff person to assist agencies in identifying privatization opportunities. Using agency staff, this individual looks at areas of government that are labor or equipment intensive. Annual savings cited by Iowa include the following:

- ♦ Food service and housekeeping activities at the Iowa Veterans Home: \$1.1 million;
- ♦ A 48-bed women's correctional facility: \$100,000;
- ♦ Maintenance for the state's rest areas: \$250,000; and
- ♦ Alcohol receipt/alcohol beverage contract: \$800,000.

Please note that we have not audited or otherwise confirmed these figures.

Kentucky. At the end of its 1993 quality and efficiency study, the state of Kentucky established a privatization commission. This commission will develop guidelines to review state services. The executive order creating the commission requires the guidelines to consider quality, efficiency, and availability of vendors. The guidelines must also consider ability to measure performance and monitor accountability, as well as the impact of returning the service to the public sector, if necessary. The Commission has only met once so far.

Maryland. In Maryland, the Governor's Advisory Council on Privatization in State government was created in 1993. Its functions are to:

- ♦ Review and evaluate unsolicited privatization proposals;
- ♦ Provide information on privatization issues and offer procedural and implementation assistance;
- ♦ Provide oversight to ensure fair, comprehensive, and objective comparisons of privatization alternatives;
- ♦ Request status reports from state agencies on implementation efforts for privatization; and
- ♦ Request that state agencies conduct thorough evaluations of specific privatization opportunities.

The Department of Budget and Fiscal Planning provides staff to the Council and takes a leadership role in evaluating privatization alternatives. To date, 32 projects have been privatized, and approximately 40 projects are under review.

Massachusetts. In 1991, the Governor and Lieutenant Governor called on state managers to privatize functions wherever they would save money or improve services. The decision to privatize comes only after a rigorous review and cost comparison analysis. This review includes a privatization checklist that is standard for every agency and is the result of the lessons learned from early privatization efforts. According to officials in Massachusetts, estimated savings resulting from privatization are approximately \$273 million to date. The most significant savings estimates cited by Massachusetts are as follows:

- ♦ Hospital consolidation and community placements: \$50 million;
- ♦ Hospital consolidation and closure - capital avoidance: \$143 million;
- ♦ Managed mental health care and substance abuse services: \$33 million;
- ♦ Managed health partnership clinics: \$15 million;
- ♦ Revenue collection: \$8 million; and
- ♦ Prison health care: \$6 million.

Please note that these figures are estimates and that we have not audited or otherwise confirmed their accuracy.

Michigan. In 1993, the Privatization Division of Michigan's Office of Contract Management implemented the PERM process. PERM stands for privatize, eliminate, retain, or modify.

Under this process, each state agency conducts PERM analyses on its programs and activities. The Privatization Division then evaluates the analyses done by the agencies. More than 50 state programs or activities have been or are in the process of being evaluated using the PERM process. PERM analysis has led to privatization of some highway construction activities and disposal of some surplus land. At the time of our survey, Michigan had not developed comprehensive information on cost savings; however, a new statewide computer system is expected to be able to provide that information in the near future.

Michigan views privatization as only one option. The PERM process is designed to be a comprehensive approach and to be one of the tools used to ensure that the state provides the best services for its citizens in an efficient and cost-effective manner.

New Jersey. Privatization was one of several elements reviewed by the Governor's Management Review Commission in 1993. This Commission reviewed all 19 state agencies for possible areas of privatization, automation, reorganization, cost recovery, consolidation, and/or elimination of redundant programs. Many operations were privatized as a result of the Commission's study, including janitorial services, employee medical review, snow removal, and print operations. New Jersey recently established the Commission on Competitive Contracting and Privatization to identify asset sales as well as contracting

opportunities. To date, this commission has not privatized any state functions.

New York. The Governor of New York mandated that individual state agencies routinely and systematically consider what services are absolutely required and whether they can best be provided by the public sector, private sector or combination thereof. Although no statewide procedures have been developed to guide this assessment, state agencies work with the Division of Budget or the Office of Regulatory Management Assistance. In 1993, laundry services for six mental hygiene facilities were privatized with annual savings of \$600,000. This figure was taken directly from information we received from officials in New York. Please note that we have not audited nor otherwise confirmed its accuracy.

New York has dramatically reformed its Office of General Services, which manages the state's housekeeping activities. This office will develop a new model for cleaning and maintaining the state's buildings by increasing the number of front-line workers and flattening the supervisory structure. Also, new policies were developed enabling agencies to purchase items wherever they can find the best price consistent with competitive buying practices.

The Department of Taxation and Finance is privatizing the processing of the state's 10 million personal income tax returns. New York says that privatizing this function will reduce operating costs by 30 per cent, thus saving \$87 million over 10 years.

Pennsylvania. Although no formal review process or directives exist in Pennsylvania, agency managers have developed many privatization initiatives. Some of the initiatives include:

- ◆ Ownership and operating responsibility of all state general hospitals was transferred to local governments or other providers. Savings to the Commonwealth are estimated to be more than \$25 million per year.
- ◆ The Commonwealth's travel office is operated by a certified travel agent who is a private contractor and five state employees. As a result of this joint venture between public and private sectors, the Commonwealth says that it receives approximately \$150,000 in rebates and saves \$1 million in travel fares annually.

Please note that we have not audited or otherwise confirmed these figures.

Texas. Texas created the Council on Competitive Government in 1993 to inject competition, fairness, and efficiency into the process of providing state services. Privatization is not necessarily the Council's goal. The Council has wide discretion in determining what areas of state government would benefit the most from the introduction of competition and is authorized to require any state agency to engage in a competitive process with respect to a particular service. Thus, both public and private entities can bid to provide services.

Texas says that as of November 1994, consolidating print shops had saved \$3.1 million, renegotiating the state's long distance service had saved \$8.7 million, and privatizing mail pre-sorting and data centers saved \$1.2 million for a total savings of approximately \$13 million. As with the other cost savings figures cited in this report, we have not audited or otherwise confirmed their accuracy. Other functions under review include laundry services and fleet management, as well as several other functions.

Utah. In 1989, Utah state law created the Privatization Policy Review Board to review whether the privatization of certain state services would be feasible and would result in cost savings and elimination of any unfair competition. The Board can appoint advisory groups to conduct studies, research, and analyses but does not have the overt power to privatize. It recommends privatization to the agency head when privatization is demonstrated to provide a more cost efficient manner of providing existing services. The state has privatized printing and access to fuel but has not determined if any cost savings resulted.

**Five States
That
Performed
One-Time
Studies**

We identified five states that performed one-time studies on competitiveness and privatization efforts. Those five states are Maine, Mississippi, Oregon, Virginia, and West Virginia. The purpose of each study was to find ways to make state government more efficient and cost-effective. Exhibit 2-2 on the following page lists these five states, the types of proposals made in each state as a result of the study, and whether or not those

proposals were accepted or rejected. The remainder of this section gives specific information on each state's study.

Exhibit 2-2 States That Performed One-Time Studies on Competitiveness and Privatization Issues		
State	Proposal	Approved/ Rejected
Maine	No recommendations made.	N/A
Mississippi	Proposed Joint Legislative Privatization Commission (1992).	Rejected
	Proposed Executive Commission for Competitiveness (1994).	Rejected
Oregon	Recommended a statewide privatization methodology.	N/A
Virginia	Recommended formation of a Competitive Council.	Pending
West Virginia	No recommendation made to establish a privatization commission.	N/A
Source: Prepared by Office of Legislative Auditor's staff using survey responses from each state.		

Maine. In April 1992, Maine's Legislative Council authorized the Office of Policy and Legal Analysis to conduct research and to issue a report on privatization. The report focused on privatization issues in other states and in general. None of Maine's state functions were analyzed. Also, no recommendations were made.

Mississippi. Two efforts have been made in Mississippi to establish a government mechanism that would inspect government service delivery to determine the feasibility of private sector service delivery. In 1992, the legislature directed a study of state programs and services which specifically identified potential candidates for privatization, current state costs for these candidates, and a cost review process to help in the privatization decision-making process. The study also proposed a privatization program under the oversight of the Joint Legislative Privatization Commission. Later in 1994, the State Auditor proposed

legislation to create the Mississippi Executive Commission for Competitiveness. Neither of these efforts was successful.

Oregon. The Governor's Task Force on State Government provided an overview of privatization usage in Oregon state government and reviewed privatized activities in other states. The task force issued its report in January 1992. The task force found that Oregon had no clear statewide guidelines or standards for decision makers to use in determining if, when, or what to privatize nor is there any clear requirement that privatization must be considered as an option. Although the task force did not recommend any functions for privatization, it did recommend that current contracting procedures be merged and enhanced to produce a formal statewide privatization methodology. The methodology should include procedures for evaluating, implementing, recordkeeping, and monitoring of opportunities.

Virginia. A blue ribbon strike force, Governor's Commission on Government Reform, issued a report on November 15, 1994, that reviewed every aspect of state government and held public hearings to identify citizen and private sector concerns. One of the recommendations was to develop policies to introduce competition into state government through a competitive council. The General Assembly will formally address this issue during its next session. The assembly has already given its verbal approval.

West Virginia. In 1989, a select group of executives from the private sector formed a task force. This task force studied the boards, agencies, commissions, and departments of West Virginia state government and identified opportunities which might improve service, reduce cost, and eliminate unnecessary or redundant activities. The study recommended several ways to streamline government. Some of West Virginia's accomplishments include the following:

- ♦ Custodial services have been privatized. No savings figures were available.
- ♦ Maintenance functions of the State Motor Pool have been privatized for an estimated cost savings of over \$200,000 per year.
- ♦ The Department of Health and Human Resources closed a long-term care hospital, privatized two state hospitals, and downsized two other hospitals for estimated savings of \$7 million annually.

- ♦ The state privatized the Alcohol Beverage Control Commission's state operated retail liquor stores and is expected to save \$45,000 over three years.
- ♦ The state lottery closed its field offices for an estimated annual savings of \$400,000.

Commission Compositions

As mentioned previously, 7 out of 19 states have established separate commissions to review opportunities for providing services in a more cost efficient manner. Four of the 7 states have a mix of both public and private sector members on their commissions. Two of the 7 states have members from only the public sector on their commissions. One state has only private sector members on its commission. Exhibit 2-3 below shows how the composition of the commissions varies among these seven states.

Exhibit 2-3 Composition of Commissions in Other States			
State	Commission Composition		Total
	Public	Private	
Arizona	7	6	13(a)
	9	6	15(b)
Florida	7	0	7
Kentucky	5	5	10
Maryland	0	7	7
New Jersey	1	4	5
Texas	6	0	6
Utah	8	3	11

(a) Private Enterprise Interview Review Board
 (b) Joint Interim Committee on State Assets

Source: Prepared by Office of Legislative Auditor's staff using survey responses from each state.

Legal and Political Barriers Can Impede Privatization

Legal provisions and political influences have hindered privatization efforts in some states. In our survey, we asked other states what problems they encountered during their on-going reviews and after specific functions were privatized. Some of the barriers these states gave in their responses are as follows:

- ♦ The Mississippi PEER Committee's 1992 report pointed out that a critical precondition to privatization is for elected officials to be open to privatizing state programs and services and willing to remove legal barriers that impede privatization.
- ♦ Texas purposely designed its Council on Competitive Government to include members from both the legislative and executive branches to give the commission the flexibility needed to overcome many legal barriers. Also, the statute creating the council exempts all bids awarded by the council " . . . from all state laws regulating or limiting purchasing and purchasing decisions. This exemption applies to all decisions and actions of the council directly or indirectly relating to the competitive process." To preserve government ethics, the statute includes a conflict of interest clause that prohibits a person from participating in the competitive process, if the person has or may have a conflict of interest in the proposed or resulting contract.
- ♦ In Massachusetts, the Governor faced strong legislative opposition to privatization. The legislature passed a law mandating that the administration obtain legislative approval and a prior demonstration of 10 percent cost savings before embarking on any privatization. The bill was strongly backed by employee labor unions.
- ♦ In 1989, Colorado established the Governor's Commission on Privatization. The Commission consisted of legislators, private sector members, employee organization representatives, and other government officials. Also, Colorado's General Assembly passed bills to grant some state agencies the authority to privatize certain services. However, according to a 1993 report by the Colorado State Auditor, Colorado has had nine separate lawsuits filed against the state by the state employees' union. These

lawsuits were successful in halting efforts of the commission. In one lawsuit, the court held unconstitutional rules established by the Executive *Director of Personnel* regarding contract services. This court ruling took away state agencies' authority to continue or further privatization.

Chapter Three: Managing Privatization

Chapter Conclusions

Competition in the marketplace can be a catalyst to bringing down the cost of providing state services. Performing cost analyses and comparisons are vital before deciding whether to continue providing a service by a specific agency or to turn it over to another provider, be it another public entity or a private enterprise. Once a service is no longer provided by the government, monitoring is essential to ensure cost savings and high quality performance.

Privatization Can Encourage Competition

According to a study issued by the Massachusetts Executive Office for Administration and Finance in 1993, when privatization is being considered, certain conditions should exist for it to be successful. Exhibit 3-1 on the following page lists some of the ideal conditions conducive to privatization. This exhibit also lists suggestions on how to ease less than ideal conditions.

According to a publication from Texas, competition tends to weed out providers that offer services of poor quality or high cost. Relying on the forces of the market can be helpful in improving the quality and reducing the costs of providing services, as well as increasing efficiency. Without competition, the state may operate as a monopoly.

In their survey responses, some states referred to privatization as a tool for bringing competition into state government. The thrust of Texas' competitive council is that state agencies can compete against private enterprises as well as against each other to deliver services. In our literature review, we noted that one author said that the most important issue is not "public" versus "private," but "monopoly" versus "competition." Private monopolies can be just as inefficient as public monopolies. Examples given included public utilities and defense contractors.

Exhibit 3-1	
Factors to Consider When Evaluating Privatization Opportunities	
Ideal Conditions for Privatization	Suggestions for Mitigating Imperfect Conditions
Competitive marketplace	<p style="text-align: center;">To Preserve and Promote Competition</p> <ul style="list-style-type: none"> ◆ Write long-term contracts to ensure the contractor's recovery of capital in cases requiring substantial up-front investments. ◆ Contract with multiple vendors to ensure ongoing competition and avoid excessive dependence on a single contractor.
Potential for savings	<p style="text-align: center;">To Ensure Realization and Maximization of Savings</p> <ul style="list-style-type: none"> ◆ Build cost controls and cost containment incentives into contracts. ◆ Compare proposals with an eye toward innovative cost savings strategies.
Promise of enhanced quality or responsiveness	<p style="text-align: center;">To Ensure Quality and Responsiveness</p> <ul style="list-style-type: none"> ◆ Develop reliable measures of service quality where they do not already exist. ◆ Write contracts that require periodic performance reporting and provide for immediate termination in the event of unsatisfactory vendor performance.
Satisfactory assurance of government control and accountability	<p style="text-align: center;">To Ensure Accountability and Control</p> <ul style="list-style-type: none"> ◆ Write detailed contract specifications. ◆ Require contractors to maintain records and file reports that permit easy oversight.
Minimal risk	<p style="text-align: center;">To Reduce Risk</p> <ul style="list-style-type: none"> ◆ Require a performance bond. ◆ Maintain a list of alternate suppliers available on short notice. ◆ Require contractors to bear or share the risk of cost overruns.
No insurmountable legal, political, or practical barriers	<p style="text-align: center;">To Overcome Legal and Political Barriers</p> <ul style="list-style-type: none"> ◆ Target new services that are not currently provided by state employees. ◆ Involve affected interest groups in the decision-making process.
Minimal adverse employee impact	<p style="text-align: center;">To Soften Adverse Impact on Employees</p> <ul style="list-style-type: none"> ◆ Develop a personnel redeployment plan, including a requirement that private firms interview displaced employees. ◆ Offer employees an early retirement option. ◆ Provide job placement and retraining to affect employees.

Source: Prepared by Office of Legislative Auditor's staff using *Privatization in Massachusetts: Getting Results* (November 1993).

Cost Analyses and Comparisons are Critical

Before selecting privatization, thorough cost analyses and comparisons are necessary to determine if a service should be kept in-house or privatized. At the federal level, OMB Circular A-76 requires agencies to prepare cost comparisons to determine whether agencies should use contractors or government employees to perform commercial activities. The comparison required by OMB Circular A-76 involves comparing contract and in-house costs for the specific work to be performed.

State governments are often not equipped to easily assess all of the costs of delivering a state service. The total cost of any particular service is often located in two or more cost centers, thus increasing the complexity of assembling true costs. Omitting significant costs can lead to underreporting the cost of providing government services. The Reason Foundation, as well as Michigan's task force on privatization, suggest that an independent consultant or private accounting firm be used to calculate full government costs. Using outside assessments may ensure greater objectivity in the process.

Four states we surveyed have implemented procedures or developed cost analysis worksheets for agencies to use when making cost comparisons. These four states are Colorado, Georgia, Massachusetts, and Texas. In each case, the total cost of having the government provide the service is compared to the contractor's total costs. The primary types of costs that are considered for both providers are listed as follows.

- ♦ **Direct Costs:** These are easily identified and quantified costs, such as employee compensation.
- ♦ **Indirect or Hidden Costs:** These are costs that are not recorded in primary cost centers but are related to services being performed, such as supplies, rent, and pension costs.
- ♦ **Opportunity Costs:** Generally, these costs are not recorded but are directly related to the ownership decision and future service delivery. These costs can be avoided in the future through better use of resources. For example, funds generated from the sale of facilities and equipment to a contractor will provide funds for investment and may also increase the property tax base.

- ♦ **Conversion Costs:** These costs arise from the decision to privatize and will usually involve a one-time outlay of funds, such as paying employee severance, sick, and vacation pay and lease penalty clauses.

Louisiana government is in the process of implementing a programmatic budget system. This system is designed to clearly present and highlight the programs operated by the state and the financial requirements, including administrative costs, associated with those programs. The conversion to this system began in fiscal year 1989. To date, this system has not been fully implemented. Once implemented, this system could make determining the total cost of providing a state service easier.

Monitoring Performance

Privatization does not divest government of responsibility. Once privatization is selected, the government *still must monitor contract performance*. To do so, performance measurement systems must be developed. The cost of monitoring must be factored into the cost analyses discussed in the previous section.

The Illinois Private Enterprise Review and Advisory Board reported that its on-going success with privatization is closely linked with good performance monitoring. The Board also stated that continual and thorough performance monitoring is essential to ensure that services provided by the private sector are *cost-effective and meet high quality and performance standards*.

The Texas Council on Competitive Government is required by law to establish guidelines for monitoring the implementation and performance of contracts and for evaluating the success or failure of contracts. The statute also includes minimum provisions that must be included when developing these monitoring guidelines. One such provision is making on-site inspections where possible and reporting and comparing the findings with the contract provisions.

The state of Iowa uses quality control inspectors to monitor contract performance. In our survey work, an Iowa official stated to us that "You get what you inspect, not what you expect." To this end, he stated that their quality control inspectors inspect contractors' work on an almost daily basis.

Matter for Legislative Consideration

The legislature may wish to consider establishing an independent, centralized entity that introduces competition and innovative management practices into Louisiana state government. The duties of that entity should include the following:

- 1. Develop detailed cost analyses and comparison models.**
- 2. Analyze individual functions and services on a case-by-case basis to determine what method of delivery offers the best performance at the most reasonable price.**
- 3. Review the state's constitution, statutes, rules, and regulations to identify any legal barriers to implementing cost saving measures.**
- 4. Propose legislation to have legal barriers removed or eased.**
- 5. Include all affected parties in the decision-making process.**
- 6. Develop systems to measure contract performance.**

Appendix A

Overview of SECURE Project

Appendix A: Overview of SECURE Project

The SECURE Council was created to develop recommendations to improve the financial future of the state and the quality of life of its citizens. The resolution provided for the council to be composed of 27 members representing state and local government, private industry, education, labor, and special interest groups.

The SECURE effort has thus far consisted of two phases of study. In Phase One, SECURE contracted with the consulting firm of KPMG Peat Marwick (KPMG) to conduct a preliminary study of various facets of state government. In response to a directive in Senate Concurrent Resolution (SCR) 192, the Louisiana Legislative Auditor dedicated 35 members of his staff to work under the direction of KPMG.

During Phase One, staff from KPMG and the Office of Legislative Auditor conducted studies of Personnel and Benefits, Organization and Staffing, and State Cash Management Practices. The staff also conducted policy analyses on a variety of topics. These policy analyses identified areas with potential opportunities for immediate financial savings and issues with possible long term impacts that warranted further study. SECURE issued a report containing its recommendations to the legislature before the 1994 Regular Legislative Session. *After the Phase One report, the legislature passed several concurrent resolutions and a constitutional amendment designed to improve the efficiency of state government operations.*

The legislature reauthorized SECURE in the 1994 Third Extraordinary Legislative Session (SCR 17) to continue its efforts in developing recommendations to improve the financial future of the state and the quality of life of its citizens. The composition of the council was increased from 27 to 30 members. *This continuation of efforts became known as Phase Two of the SECURE project.*

In Phase Two of SECURE, the legislature again directed the Office of Legislative Auditor to provide services to the project and SECURE again contracted with KPMG. The scope of work in Phase Two was to continue some studies begun in Phase One and to conduct some new studies. The Phase Two agenda consists of two performance audits, a tax policy and fiscal model analysis, and follow-up of various issues identified in the Phase One work. SECURE divided the individual study items between the Office of Legislative Auditor and KPMG and assigned the following Phase Two projects to the Office of Legislative Auditor:

- ♦ Performance Audit of Planning, Budgeting, and Program Evaluation
- ♦ Performance Audit of State Procurement Practices
- ♦ Follow-up to Performance Audit of Personnel and Benefits
- ♦ Further study of Corrections and Justice
- ♦ *Further study of General Fiscal*
- ♦ Further study of General Government
- ♦ Further study of Infrastructure

Appendix B

Agency Response



EDWIN W. EDWARDS
GOVERNOR

State of Louisiana
DIVISION OF ADMINISTRATION
OFFICE OF THE COMMISSIONER

RAYMOND J. LABORDE
COMMISSIONER OF ADMINISTRATION

February 21, 1995

Mr. David Greer, CPA, CFI
Performance Audit Director
Office of Legislative Auditor
Post Office Box 94397
Baton Rouge, Louisiana 70804

Dear Mr. Greer:

RE; Competition and Privatization Measures in State Government

We offer the following comments on the aforementioned draft report provided to this office on February 15, 1995.

As we did not have access to information utilized from other state entities, we cannot offer comments on the findings and recommendations in that regard. For similar reasons we cannot offer comments regarding scope or methodology and scope of the report.

As to those items specifically addressed within the report which relate to the Division of Administration (DOA), we concur with all comments with one exception. On page 5, Chapter One, under the heading Office of Contractual Review (OCR), the report states that

"Each year, the Office of Contractual Review, within the Division of Administration, reviews all professional, personal, consulting, and social services contracts for *all* state agencies, boards, and commissions of the executive branch of Louisiana government." (Emphasis added).

Please be advised that there are specific exclusions provided in statute wherein such contracts do not require DOA-OCR approval or review.

We appreciate the opportunity to participate in this review and offer our comments.

Sincerely,

Raymond J. Laborde
Commissioner of Administration

RJL/WJK/sm

Appendix C

Auditor's Comment on
Agency Response

Appendix C: Auditor's Comment on Agency Response

In its response to this report (see Appendix B), the Division of Administration states that it does not concur with the following statement, which appears on page 4 in Chapter One of this report:

Each year the Office of Contractual Review, within the Division of Administration, reviews all professional, personal, consulting, and social services contracts for **all state agencies, boards, and commissions of the executive branch of Louisiana government.**
(Emphasis added)

The Division states that there are specific exclusions provided in statute wherein such contracts do not require DOA-OCR approval or review.

As a point of clarification, the auditors point out that the statement in question was taken directly from the 1993-94 Annual Report of the Office of Contractual Review within the Division of Administration.