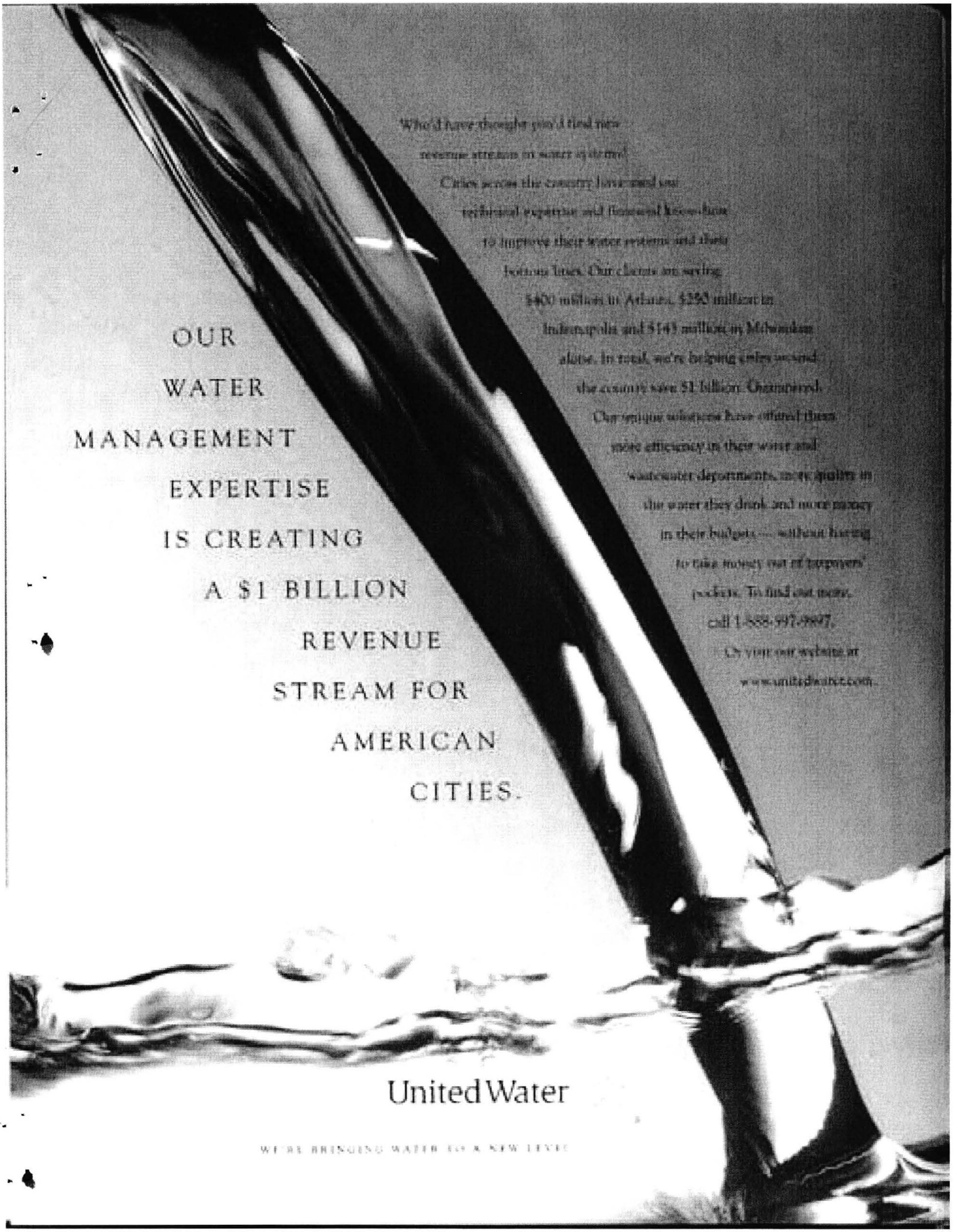
PRIVATIZATION 2002

Putting the pieces together

16th Annual Report on Privatization

Reason Public Policy Institute


OUR
WATER
MANAGEMENT
EXPERTISE
IS CREATING
A $1 BILLION
REVENUE
STREAM FOR
AMERICAN
CITIES.
United Water
WE'RE BRINGING WATER TO A NEW LEVEL

Welcome to Privatization 2002
Reason Public Policy Institute's 16th Annual Report on Privatization and Government Reform

September 11^{th} forever altered the world we live in. The effects of the terrorist attacks have rippled across all of our lives. The impact they will have on privatization remains to be seen. Immediately following the attacks, government was no longer the problem, but rather the solution. Citizens became more comfortable with government provision of services, providing the "push" away from privatization.

Nothing highlights this attitude better than the federalization of airport security. With little debate, the plan flew through the Senate. However, House deliberations produced a very different bill. The final bill signed into law allows for five airports to opt out of the federal takeover, and others two years later. While not the optimal result, things could be much worse.

The United States is now in a recession of unknown duration. A major reason that privatization has been a tough sell over the past few years has been that governments had plenty of money to spend. Fiscal constraints and budget shortfalls will "pull" government officials toward cost-effective privatization initiatives. This is especially true in nonpublic-safety related service areas.

In addition to the fiscal crunch, for the first time in eight years, the United States has a president who is serious about government performance and privatization. Federal privatization and outsourcing under the leadership of Pres. George W. Bush appears to be strong. The Presidential Management Agenda requires all federal agencies to compete 5 percent of all full-time federal positions in 2002, and be an additional 10 percent by the end of 2003. The Department of Justice, one of the first agencies to submit an annual inventory of jobs, classified over 7,000 prison guard positions as commercial.

Ironically, in one of the world's largest real-estate deals ever, the World Trade Center had been privatized less than two months before its destruction. In mid-July the Port Authority of New York and New Jersey and Westfield America agreed upon a $3.2 billion 99-year lease.

This year's *Annual Privatization Report* includes several articles on emerging privatization initiatives including Social Security, Medicare, and federal military housing. A new chapter on deregulation highlights the recent trends and partnerships developing in the electricity and telecommunications markets. Also, during his tenure in office, "America's Mayor," Rudolph Giuliani, embarked on a massive privatization and competition program in New York. Inside, renowned privatization expert E.S. Savas highlights the results of his bold and ambitious program. Included is a brief discussion of why Enron's collapse does not signal the end of government contracting for energy.

As in past years, the rest of *Annual Privatization Report 2002* examines some of the major trends and issues involving privatization during the past year across all levels of government and for specific services. Case studies, trends, and analysis are examined for all of the usual suspects—HOT lanes, schools, corrections, welfare, and water, to name a few.

We hope you will find our 16^{th} *Annual Privatization Report* useful as well as informative. Please take the time to fill out the survey at www.rppi.org/survey.html, and receive a free six-month subscription to *Privatization Watch*, our monthly newsletter on privatization and government reform news, trends, and policy.

—Geoffrey F. Segal, Editor

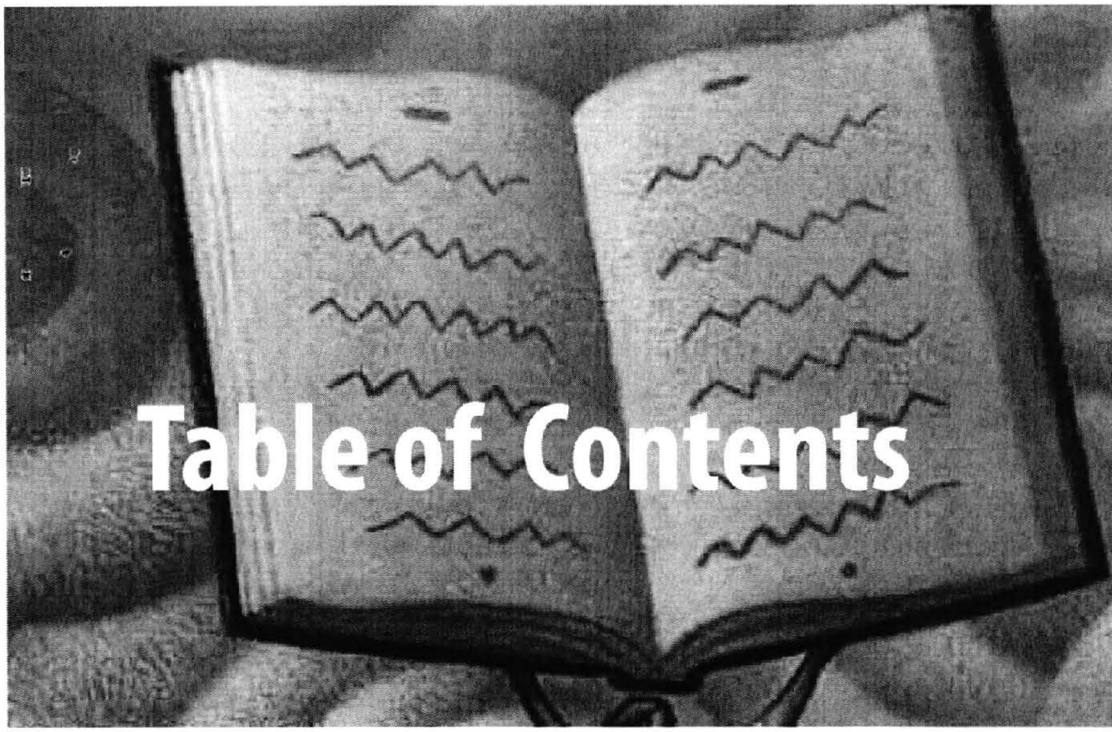


Table of Contents

Privatization 2002

Editor

Geoffrey F. Segal

Principal Authors

Robin Johnson
Lynne Kiesling
Adrian T. Moore
Robert W. Poole, Jr.
Lisa Snell

Contributing Authors

Charles Chieppo is the Director of the Center for Restructuring Government at the Pioneer Institute in Massachusetts.

Diallo Dphrepaulezz is a Policy Fellow in the Center for School Reform at the Pacific Research Institute for Public Policy.

Laura Dykes is a freelance writer in San Francisco specializing in privatization and welfare issues.

Peter Ferrara is the co-author with Michael Tanner of *A New Deal for Social Security* and was a former member of the Reagan White House Office of Policy Development.

Dr. John Hill is Director of Research at the Alabama Policy Institute.

Tom Miller is the Director of Health Policy Studies at the CATO Institute.

Eric Montague is a policy analyst at the Washington Policy Center.

Max Pappas is a freelance writer in Washington, D.C.

E.S. Savas is a professor at Baruch College, City University of New York.

Design/Production

Raymond Ng

Executive Director

Adrian T. Moore

Published by
Reason Public Policy Institute
3415 S. Sepulveda Blvd., Suite 400
Los Angeles, CA 90034
310/391-2245
310/391-4395 (fax)
http://www.rppi.org

Chapter 1

Federal Government Reform

Performance Management and Federal Redesign

In November 2000, Reason's Director of Government Redesign wrote in a transition report to the incoming President and his administration (www.rppi.org/transition2000.html):

> *Too often overlooked during this critical transition period are the less-glamorous, yet fundamentally important issues of how to improve the day-to-day management of government agencies. That is why our organizations—dedicated to improving government performance—collaborated on a unique initiative to develop non-policy specific recommendations on improving the management of the federal government.*
>
> *In the months leading up to the election, our organizations organized and hosted four management-specific discussion sessions under an initiative called **"The Transition Dialogue Series."** Over 140 individuals participated in these dialogues, with representation from current and former career and political officials from federal agencies, interest groups, academics, management experts, congressional staff, and current and former officials from the White House, Office of Management and Budget, General Accounting Office and the Congressional Budget Office.*
>
> *The dialogues were specifically designed to produce non-partisan, experience-tested observations and recommendations for the next Administration and Congress in the following four areas:*
>
> - *Management and Performance Improvement*
> - *Information Technology and E-government*
> - *Civil Service Reform and Human Resources*
> - *Procurement and Contracting*

In other words, Reason Public Policy Institute recommended that the President focus on results, operate efficiently, use technology, eliminate employee ineffectiveness, and privatize.

Nine months later, President Bush presented "The President's Management Agenda" (www.whitehouse.gov/omb/budgetfy2002/mgmt.pdf). It calls for government that is citizen-centered, results-oriented, and market-based. It calls for five government-wide changes. They are:

- Budget and Performance Integration;
- Improved Financial Performance;
- Expanded Electronic Government;
- Strategic Management of Human Capital; and
- Competitive Sourcing.

In other words, the President's goals are to focus on results, operate efficiently, use technology, eliminate employee ineffectiveness, and privatize.

Recognizing that some statutory changes must be made in order to remove obstacles to effective management in the federal government, the Administration is pursuing two legislative proposals. The Freedom to Manage Act of 2001 will permit agencies to identify statutory barriers to effective management and request expedited congressional consideration while the Managerial Flexibility Act of 2001 will make reforms to various personnel, budgeting, and property-management laws. The proposed reforms would enhance recruitment and retention through new personnel management flexibilities and incentives, improve full accounting and reporting of costs and performance in agency budgets, and improve allocation and use of federal property.

Federal Agency Implementation

Through the Office of Management and Budget (OMB), the Administration has established standards for success in five government-wide management areas:

- **Strategic Management of Human Capital**—changes civil service and personnel policies to make them more flexible and performance-based;
- **Competitive Sourcing**—requires agencies to conduct public-private competitions or privatize at least 5 percent of full-time positions in 2002, and be up to 10 percent by the end of 2003;
- **Improved Financial Management**—declares agencies' ability to manage their finances a key performance criteria;
- **Expanded Electronic Government**—requires agencies to move services online if they can be done more effectively and efficiently there; and
- **Budget and Performance Integration**—changes law and policy to start tying agency appropriations to agency performance.

Federal agencies are in the process of reviewing these standards and taking appropriate remedial action within their individual programs. Naturally, there is a lot of resistance, but President Bush has many political appointees in the agencies who are making this a central goal.

Performance is Embedded in the FY2003 Budget

With his new budget, President Bush has made the first move at embedding performance into the appropriations process.

First, to provide for oversight and accountability, OMB has created a Management Scorecard embedded in the President's new budget that score agencies red, yellow, or green based on how well each agency is doing in meeting the standards listed above. The scorecard is a sea of red, with every single agency evaluated getting a red light on competitive sourcing.

Second, the President is walking the walk of focusing not just on how much money programs get, but how they perform. As a result, some poor performers are lined up for budget cuts, while others with notable success received more investment of resources.

- Department of Energy's fossil energy research and development programs were judged ineffective and budgeted for $43 million less than the $ 101 million they were funded at this year;
- Department of Labor's Youth Opportunity Grants program paid for its failures with a $180 million cut, while the successful Job Corps program got a $73 million boost; and
- Department of Agriculture's nutrition program for Women, Infants and Children (WIC) successes led to an increased investment of $364 million.

Federal Privatization Trends

Going into 2001, federal government contracting and privatization was a growing business. A May report, "Government Contractor Industry Survey: The Pulse of a Vital Industry" found that 16 percent more companies were seeing increased revenue from federal contracts in 1999 compared to the previous survey in 1997.

Grant Thornton LLP conducted the survey of 109 federal contractors about federal contracts vs. private sector transactions. The contractors attribute the change to the increasing ease of firms doing business with government, some changes in attitudes about outsourcing, and legislation like the 1994 Federal Acquisition Streamlining Act and the 1998 Federal Activities Inventory Reform Act, which improved the process of federal outsourcing.

While legislation has removed some barriers to outsourcing, pressures on agencies to outsource have grown as they have confronted staffing and flexibility challenges in providing services. For example, a report by INPUT Inc. argues that spending by the federal government on private workers to improve communications and information technology services will climb 16 percent by 2006 to $13.2 billion. The Commerce Department has pointed out that over half of federal technology workers will retire in that period. Federal agencies will have difficulty competing with private sector salaries and flexibility to replace retiring workers while continuing to provide technology services in house. Privatization will likely be the only viable option.

But an even bigger opportunity for competition and privatization in the federal government came from President Bush. In August he released his President's Management Agenda in which he embeds goals for competitive sourcing by federal agencies in the context of performance-based management.

His goal is for agencies to compete 15 percent of positions by 2004, and 20 percent per year after that. This means competing 42,500 federal jobs with proposals from private firms by September 30, 2002 and another 85,000 by September 30, 2003. Under the Federal Activities Inventory Reform (FAIR) Act, federal agencies in 2001 identified roughly 850,000 federal positions as commercial in nature and subject to review for privatization (and Reason analysts consider that number to be well below the true one due to flawed inventories from many agencies). President Bush's ultimate goal is to have agencies put half those jobs to competition during his term. However, at the same time the federal government will likely add many new federal workers, starting with roughly 28,000 aviation security workers.

The federal government's process for public-private competitions under Office of Management and Budget (OMB) Circular A-76 and implementation of the FAIR Act have been controversial for years. In response to growing demand for reform, the 2001 Defense Authorization Act ordered the Government Accounting Office (GAO) to convene a panel to examine federal privatization policy and specifically the A-76 process and FAIR implementation. The Commercial Activities Panel convened in 2001, held a series of hearings with testimony from experts (including Reason's Carl DeMaio) and practitioners, and will provide recommendations to Congress in May 2002. (For details, visit www.gao.gov/a76panel/index.html.)

Meeting the President's competition goals will be challenging. Agencies have been slow to embrace the challenge and begin to work toward it (See Table 1-1). Indeed, the Department of Defense created a furor in January 2002 by announcing it would halt all competitions of its workforce. By January 31st, however, OMB announced that the Pentagon was back on board with the plan and would compete roughly 70,000 jobs over the next two years.

Other agencies and outside experts are unenthusiastic about the President's goals. Most federal agencies have very little experience with putting their work to competition with private firms, and in the past such competitions have often taken up to four years to complete and have been costly. Some may be waiting for the Commercial Activities Panel recommendations to see if the rules of the road are going to change, but the biggest resistance is cultural. Career personnel in federal agencies and their unions are fighting bitterly against the President's goals. Meanwhile, OMB insists that the long-term savings from competition more than offset the up-front costs and has not backed down from the goal to compete 450,000 federal jobs.

Competitive Sourcing and Privatization

The President's Management Agenda embeds goals for competitive sourcing in the context of performance-based management. His goal is for agencies to compete 15 percent of positions by 2004, and 20 percent per year after that. He has no specific goal for outsourcing. And that is good, whether agencies are doing things the private sector can do or not. This is because President Bush is after bigger fish. An outsourcing goal is an ephemeral thing, with nothing to sustain it over time. President Bush instead is looking to change the institutional structure in which decisions about what an agency should be doing are made.

A central challenge in government management is the limited signals agencies get about how programs are working and how customers are being served. Without a bottom line and without competitive forces, program structures and approaches often stagnate, success is not always visible and easy to copy, and problems grow. Worse, since budgets are not linked to performance in a positive way, too often poor performers get rewarded as budget increases follow failure.

Before fundamental change can occur in government, there has to be a bottom line and a competitive system. This is why for

Federal Fiscal Trends

In an address before the Conference Board's annual dinner in October 2001, Office of Management and Budget Director Mitch Daniels said that needs related to the attack of September 11th will be properly funded. He cautioned, however, that government needs discipline in its expenditures, and that government must avoid the "risk of runaway spending and the erection of a much larger permanent federal government." Indeed, with the availability of $40 billion in emergency spending, agencies submitted more than $120 billion in "helpful suggestions."

Daniels further suggested that any future stimulus package should be limited to between $60 and $75 billion. He suggested that the U.S. fiscal situation "has probably never been so strong," noting that despite all the events (impact of the recession and the extra spending), the United States will still run a surplus.

Table 1-1: OMB Evaluation of Agency Competitive Sourcing Plans	
Level	**Agencies**
TOP—commitment to goal and creating incentives	Commerce, General Services Administration, Interior, Justice, Office of Personnel Management
FIRST—pledge to meet goal	Agriculture, Defense, Education, Environmental Protection Agency, Health and Human Services, Housing and Urban Development, NASA, National Science Foundation, Smithsonian, Transportation, Treasury, Veterans Affairs
SECOND—no commitment to goal	Energy, State

Source: Govexec.com citing Office of Management and Budget

over 20 years Reason's work on privatization and outsourcing has emphasized these are not ends, but tools. Competition is the end. The five areas and goals of the President's Management Agenda are really aimed at creating the institutional change that creates a bottom line and a competitive system. In applying competition to decisions about doing activities in-house or moving them to the private sector, these institutional changes begin to solve the problem of inadequate cost information and no longer accept an agency's failure to use performance measurement to track and compare quality/value. Performance is the common thread. Where outsourcing has worked best, it has worked because the agency was motivated by a search for "better value" rather than "reduced cost."

Privatization and Outsourcing Processes Need to Evaluate Performance

The difference between outsourcing projects deemed failures versus those deemed successes is the presence of several critical success factors including:

Clear strategic logic. Successful outsourcing projects begin with the establishment of a clear strategic logic for the agency that is cascaded down clearly to performance expectations for every program and function within the agency.

Reliable financial information. Projects must have adequate and accurate cost information, usually provided by systems that use activity-based costing or other mature accounting practices.

Emphasis on redesign/re-engineering. Agency leadership should aggressively pursue a "redesign" option that allows agency operations to be re-engineered prior to the competition. As our research uncovered, in many cases the agency emerged better off as a result of its redesign efforts, regardless of which side won the competition.

Performance measurement. Successful projects define and monitor clear measures of performance both during the competition phase and after. These performance measures are vital tools for clarifying expectations, ensuring value-based comparisons, and improving accountability and daily management after final contracts are awarded.

Assuming these four principles are actively implemented by the agency, the only other ingredient needed is an open, fair, and transparent process through which the employee and contractor bids can be solicited and evaluated using these criteria.

Outsourcing Decisions Should Emphasize Performance

It is important to be clear on what should motivate an agency to consider outsourcing. Our research showed that cutting costs was often the primary motivator of failed projects and usually not the primary motivator of successful projects. The primary motivators of successful projects include:

- **Enhancing focus on core mission.** The agency turned to outsourcing to clear the deck of extraneous activities so that it

GAO Finds Competition Does Not Harm Employees

In May 2001 GAO released a report, *DoD Competitive Sourcing: Effects of A-76 Studies on Federal Employees' Employment, Pay, and Benefits Vary* (GAO-01-388) in which they examined what happened to employees after three completed public-private competitions (one won by federal workers, two won by private firms). GAO found that:

[A]bout half of the civilian government employees remained in federal service following the studies, either in the new or another government organization with similar pay and benefits. Most of the remaining employees received a cash incentive of up to $25,000 to retire or separate. There was a relatively small number of involuntary separations. Further, employees who left government service and applied for positions with the contractors who won the competitions were hired.

In addition:

- After shifting to working for contractors, some employees made less than what they did as government employees and others made more;
- In many instances, former government employees who accepted employment with the contractors received a cash incentive to leave government service and federal retirement benefits; and
- Contractor benefit packages appeared to be similar to what the government offers.

Study Finds Competitive Sourcing Yields Long-term Savings and Improved Performance

In February 2001 the Center for Naval Analyses (CNA) released *Long-run Cost and Performance Effects of Competitive Sourcing,* which examined outcomes of 16 Department of Defense (DoD) competitions from five to twelve years ago to allow evaluation of changes in savings and performance over time. CNA examined competitions won by federal workers and by private firms. The report documents that:

- Savings from competition are real and sustained over time, with average effective savings of 34 percent (see Table 1-2);
- Performance in the eyes of management and contract officers tends to fall the first year after competition and then rise to satisfactory levels, while customers tend to be uniformly more satisfied with performance after the competition;
- DoD does not do a good job of tracking and documenting outcomes of competitions, especially when federal workers win [of the competitions CNA originally examined, they had to drop for lack of data 83 percent (22 out of 24) of competitions won in-house and 44 percent (11 out of 25) of competitions won by private firms]; and
- DoD likely could have increased savings by being less proscriptive in what it asked for from competing service providers and allowing innovation and new ideas to be offered.

Table 1-2: Savings Rates from DoD Competitions

Function	Pre-competition annual Costs	Effective Savings
Supply/Logistics	$17,687,482	15%
Housing Manintenance	$11,410,072	19%
Visual Information Services	$3,572,072	61%
Base operations support	$11,807,125	46%
Grounds maintenance	$1,026,437	(25%)
Aircraft maintenance	$28,703,925	42%
Base operations support	$10,264,890	42%
Grounds maintenance	$903,059	11%
Housing maintenance	$2,234,118	17%
Grounds maintenance	$1,139,500	23%
Housing maintenance	$1,328,338	24%
Housing maintenance	$2,860,295	42%
Aircraft maintenance	$2,069,450	66%
Vehicle ops and maintenance	$3,382,846	48%
Supply/Logistics	$945,667	1%
Supply/Logistics	$668,533	38%
Weighted Average	$6,250,275	34%

could focus on a limited number of functions that were of the most strategic importance to the agency's mission.

- **Flexibility and speed.** The agency wanted "just-in-time" access to services and products through a vendor relationship.
- **Improved quality.** The agency determined that outsourcing would improve the performance and/or quality of the service.
- **Access to personnel or skills.** The agency found it could not recruit and retain the necessary human capital to continue providing the service internally—or discovered the service was seasonal in nature, making the maintenance of a full-time year-round staff inefficient.
- **Innovation.** The agency determined that internal controls or processes that stifled innovation and created inefficiencies could be avoided by removing the service from the public sector.

Studies into cost savings show that well-designed outsourcing usually results in cost savings. At the very minimum, outsourcing provides better performance at contained or in a few cases slightly higher costs. Governments that turn to outsourcing initiatives motivated merely by a desire to cut costs are taking a short-term perspective. Outsourcing should improve the quality and efficiency of the services that are provided. Cost reductions, when they do happen, should be seen as a welcome side benefit rather than the primary motivator.

The Road Ahead

Tying performance to budget allocations and improving agency accounting practices create the transparency and accountability that makes policy changes like the FAIR act and Services Acquisition Reform Act more relevant because they change the incentives that act on the agencies and drive more fundamental institutional change.

Similar evolutions of change have happened at the local level. In Phoenix, once the city started measuring the performance of its expenditures (how much does it spend per mile of street paved? how does that change over time? how does it compare to other cities? and how smooth are the roads in exchange?) and providing that information in clear and simple form to all residents, a cascade of institutional changes began. Unnecessary or poor performing programs cannot survive that kind of transparency and the scrutiny that follows it; they change or they go away.

Federal agencies are starting down that same path. It may be a long walk, but over the next couple of years the President's Management Agenda will be a great lever, an opportunity to move things along at a good pace. It looks to be an interesting ride.

Social Security Privatization

By Peter Ferrara

The year 2001 was when the formerly radical, free-market idea of Social Security privatization was established in the United States. Pres. George W. Bush had openly campaigned on the idea in 2000 as one of the central planks of his economic program. After the election, the President established a bipartisan Commission to develop Social Security reform proposals including a personal account option. The Commission included seven Democrats and seven Republicans and was co-chaired by former Democrat Senator Daniel Patrick Moynihan, as well as black business leader Richard Parsons. The Commission also included former Democrat Rep. Tim Penny of Minnesota and Democrat economists Estelle James of the World Bank and Olivia Mitchell of the Wharton school. Another key Commission member was black business leader Robert Johnson. The Commission was staffed by experts from the Social Security Administration, who produced all of its calculations and projections.

The Commission concluded that:

- Social Security will be strengthened if modernized to include a system of voluntary personal accounts.
- Personal accounts would permit individuals to seek a higher rate of return on their Social Security contributions, offering higher total expected benefits to individuals with accounts than those lacking them.
- Retirement security will be increased through personal accounts by creating wealth for individual participants.
- Social Security should be extended to include inheritable assets with a system of personal accounts. These inheritable assets would improve Social Security's treatment of demographic groups with lower incomes and shorter life expectancies and enhance the possibilities for asset accumulation and wealth building in underserved communities.
- Strengthening Social Security to include personal accounts can add valuable protections for the segments of American society at greatest risk of retirement in old-age including widows, divorced women, and demographic groups with shorter life expectancies, particularly African-Americans.
- The Commission believes that the establishment of personal accounts is likely to lead to an increase in national saving. This would lead to higher wages, more jobs, and increased economic growth.

The Commission then offered three alternate reform plans including personal accounts. Each one of them did the following:

- Produced higher overall retirement benefits for working people, counting the personal-account benefits and the benefits that would continue to be paid by Social Security; and
- Reduced the long-term financing gap faced by Social Security.

The personal-account options in each of the three plans would allow workers to shift from 2 to 4 percentage points of the Social Security payroll tax to the accounts, in return for a proportionate offset to their Social Security benefits. But what is important now is not the details of these proposals, for the Bush administration will finalize a specific plan over the next year.

What is most important is that a presidentially appointed Commission of bipartisan experts has now examined the idea of a personal-account option for Social Security and endorsed it. This included several serious Democrat figures, who all now have spoken out in favor of a personal-account option.

The Commission, moreover, was staffed by experts from the Social Security Administration itself. They evaluated various personal-account reform options. In each case, they concluded that the options would lead to higher benefits due to the higher returns of private investments, and at the same time would ultimately reduce the long-term financing gap of Social Security. That is an extremely important milestone on the long march to reform. The proposal for a personal-account option for Social Security has now effectively been established through the activities of this Commission.

A presidentially appointed Commission of bipartisan experts [including several serious Democrat figures] has now examined the idea of a personal-account option for Social Security and endorsed it.

So what's next? As suggested, the plan is for the Administration to develop a specific proposal to offer Congress in January 2003. It plans to use the next year to debate the issue and explain all of the positive features of a personal-account option for Social Security. These accounts will increase retirement benefits for working people, all working people, including those with the lowest incomes. Moreover, workers would personally own and control the personal accounts and the funds and would be able to leave accumulated funds to their children and other heirs. Over the long run, the personal accounts would reduce the burdens on Social Security and the unfunded liabilities and financing gaps of the program, without raising taxes or cutting benefits.

Moreover, personal accounts are highly progressive. Lower-income workers are most in need of the higher benefits that the personal accounts would produce, and can least afford the higher taxes or lower benefits that would otherwise result. The reform would give these lower-income workers their only real chance to participate in the capital markets as owners and accumulate substantial savings and wealth, like higher-income workers. The result would be more equal ownership of wealth and greatly enhanced social solidarity. The special discriminatory effects of the current system on blacks, women and other minorities would end.

Over the longer run, the reform would also mean lower taxes and much less real government debt. Increased saving and investment and reduced taxes can be expected to increase economic growth, with more jobs and higher wages. And all of this would be accomplished with no changes for seniors today, or for anyone near retirement. Indeed, these personal accounts would simply reform Social Security to be what the public always thought it was. The more workers rely on personal accounts, the more the program really is a system where workers each pay into an individual account devoted to them that will finance their own future benefits. That, of course, is not what Social Security is today.

Polls show that the personal-account option continues to be highly popular. A CNN/Gallup poll taken in November 2001 found the public supporting a personal account for Social Security by 64 to 31 percent. A Reuters-Zogby International poll taken in June 2000 found the public favoring the idea by 65 to 27 percent. In January 2000, a CNN-*USA Today* poll found the public favoring personal accounts 62 to 33 percent. A *USA Today* poll in January 2002 found the public favoring the President's approach on Social Security by 20 points over the approach of Congressional Democrats. The polls have consistently shown these same results for several years now. The prospects for eventually achieving a real personal account option for Social Security in the United States by 2005 are quite bright.

Competitive Alternatives to Medicare

By Tom Miller

In 2001, several efforts to rebuild momentum for further privatization of the federal Medicare program came up short. The existing Medicare+Choice (M+C) program was plagued by withdrawals and service reductions by private health plans. It failed to gain more than a handful of plan participants representing newly authorized types of options, such as preferred-provider organizations (PPOs). However, renewed efforts are underway to improve and expand private health-insurance options for seniors.

The 1997 Balanced Budget Act (BBA) originally aimed at addressing several chronic problems plaguing the Medicare program, including the fact that private-plan alternatives to traditional fee-for-service (FFS) Medicare were limited to health maintenance organizations (HMOs) that tended to be more available to seniors in larger metropolitan-area markets.

The BBA did manage to achieve significant cost reductions, primarily by simply reducing prospective payments to doctors and hospitals. It also launched a Medicare Plus Choice (M+C) program that was intended to make it easier for seniors to opt out of FFS Medicare and acquire health coverage in the private sector. Even though the M+C program aimed at offering consumers more choice, only about 14 percent of the 40 million current Medicare beneficiaries were enrolled in a private plan during 2001—a smaller percentage of beneficiaries than before the 1997 BBA.

As of August 2001, the number enrolled in M+C was 5.6 million, down 10.5 percent from the December 2000 total of 6.26 million enrollees. The decline in enrollment was accompanied by a sharp reduction in plans participating in M+C. In 2001, withdrawals and reductions affected an estimated 934,000 M+C enrollees. At the beginning of January 2002, another 536,000 enrollees were likely to be dropped from M+C plans curtailing their participation in Medicare.

The BBA had expanded the authority of the Health Care Finance Administration (since renamed the Centers for Medicare & Medicaid Services, or CMS) to fund a variety of private insurance policies as voluntary alternatives to the traditional Medicare FFS program. The private insurance options included health maintenance organizations (HMOs), preferred provider organizations (PPOs), provider sponsored organizations (PSOs), private fee-for-service (FFS) insurance plans, and medical savings account (MSA) plans. However, only a handful of insurers offering PPOs have applied for an M+C contract since the BBA passed (two M+C plans currently offer PPO products), and no insurance

Key Points

- **The Medicare+Choice program is in decline**
- **Politics stymie competitive pricing reforms**
- **The key reform needed is a shift from defined benefits to defined contributions based on competitive prices**

carrier has offered a Medicare MSA plan. Sterling Life Insurance began offering the first private FFS option in July 2000 and currently operates in about two-dozen states (primarily in rural areas where other M+C options are not widely available). The latter offers open provider choice, combines Medicare and supplemental benefits, and pays providers on a fee-for-service basis. As of August 2001, it served just 18,000 Medicare beneficiaries, but its enrollment was growing.

M+C represents a small step toward a different system of health-care financing, based on "defined contributions." It allocates government payments to private insurers on the basis of individual county rates that are then multiplied by risk factors for each beneficiary covered in a given private M+C plan. These risk factors are supposed to reflect the expected cost of serving each person.

It should be easier to control total Medicare expenditures if more beneficiaries receive M+C defined contribution payments instead of Medicare FFS reimbursements for a set of defined benefits. Paying a fixed-dollar amount per person is more predictable than paying after-the-fact for a set of promised services.

Before passage of the BBA, several studies suggested that Medicare's payment methodology for private plans failed to adjust for the fact that beneficiaries who enrolled in Medicare HMOs generally were healthier (and cost less to insure) than those who remained in the traditional Medicare FFS program. Inadequate risk adjustment added to the uneven pattern of enrollment in private plans and wide variation in their benefits packages.

The pre-BBA payment rules for Medicare managed care meant that the program paid too much in some markets (particularly for plans that enrolled healthier beneficiaries) and too little in other markets. Those payment policies limited the benefits from more efficiently managed care and discouraged beneficiaries from making cost-conscious choices. The BBA required HCFA to begin making payments to M+C plans on January 1, 2000 using a new risk-adjustment method that took into account health status differences among its beneficiaries, in order to reflect more closely the expected cost of serving each person.

The key impediments to competitive pricing are not conceptual or practical, but rather political.

But the Balanced Budget Refinement Act (BBRA) of 1999 first slowed down the phase-in rate for the prospective in-patient diagnostic cost group (PIP-DCG) risk adjusters. Then the Medicare, Medicaid and State Children's Health Insurance Program Benefits Improvement and Protection Act (included within the Consolidated Appropriations Act of 2001) further stretched out the transition to full-risk adjustment. There were so many objections to the new risk adjusters (particularly the use of data from ambulatory settings and other non-hospital in-patient encounters) that Congress largely set them aside until 2004. In September 2001, CMS Administrator Thomas Scully suspended collection of ambulatory encounter data for a year and put further implementation of risk adjustment on hold.

Payments based on diagnoses as well as demographic factors may eventually give insurers more of an incentive to hold onto patients who have potentially costly problems. Thus far, the limited application of the new risk-adjustment rules for payments have had little effect in this regard.

In response to the above trends and developments in the M+C program, the Bush administration on July 12, 2001, offered The President's Framework to Strengthen Medicare. The Bush plan included a voluntary drug discount plan for Medicare seniors, but its administrative implementation was delayed by a court challenge. The rest of the framework proposed principles rather than legislative details. It emphasized:

- Current seniors (and those near retirement age) must have the option of keeping their traditional Medicare benefits "exactly the way it is today;"
- A range of new, competing Medicare plan options all must offer subsidized prescription-drug benefits;
- Medicare should provide true stop-loss protection from high expenses; impose no cost sharing for preventive benefits, and charge lower copayments for hospitalizations; and
- Medicare should encourage high-quality care and provide better benefits.

The President underplayed several of the key ingredients needed to make such qualitative improvements affordable—allowing private plans to bid to provide required benefits, letting beneficiaries capture the savings from less costly options, and eventually requiring the government's share of Medicare funding to reflect the *average* costs of the mandatory benefits provided in private plans as well as traditional Medicare (a level playing-field payment system).

However, a once-promising vehicle for demonstrating the benefits of competitive alternatives to Medicare price controls—the Medicare competitive pricing demonstrations originally mandated by the BBA—was derailed by a congressional appropriations rider in November 1999. When the final report of the Competitive

Pricing Advisory Committee was issued on January 19, 2001, it concluded that "the key impediments to competitive pricing are not conceptual or practical, but rather political."

Relatively little congressional activity toward Medicare reform occurred during 2001. Sen. John Breaux (D-LA) and Sen. Bill Frist (R-TN) reintroduced their Medicare Preservation and Improvement Act, S. 357, which would create a competitive premium system in which both traditional Medicare and private plans would submit premium bids for the "standard" and "high option" plans they decided to offer. Beneficiaries would receive varying levels of "premium support" subsidies (no more than 85 percent of the national average premium), depending on the premiums charged for a particular plan's "core benefits." It set various regulatory limits on the range of private-plan competition, in such aspects as cost sharing, benefit design, and service area.

Sen. Bob Graham (D-FL) introduced a more limited measure, The Medicare Reform Act of 2001, S. 1135, which focused primarily on improving the FFS Medicare program and integrating a new prescription-drug benefit into the traditional program's structure. The bill would provide CMS with additional resources and authority to implement purchasing, contracting, and quality-improvement techniques (coordinated care, disease management, competitive pricing, preferred provider options) that have been used successfully in the private sector. Neither the Breaux-Frist bill nor the Graham proposal moved toward any formal markup at the committee level during 2001.

The long-term route to greater privatization of Medicare health service choices remains moving from the program's traditional defined benefit structure to a defined contribution/premium-supported model, under which seniors could choose among competing packages of health benefits with taxpayers' costs capped at preset levels. Healthy competition would encourage the FFS Medicare program to improve and fight for market share on a level playing field. Seniors seeking additional supplemental benefits would pay additional premiums reflecting their marginal costs, and their value.

However, defined contribution payments still would need to be determined by competitive market prices, instead of bureaucratically administered prices. Competitive bidding mechanisms and reasonable ground rules for periodic open enrollment choices would provide the best mechanism for this task, but recent political support for those tools has been fleeting at best. ❑

State Fiscal Trends

Like everything else, the budget pictures governors and state legislatures saw before and after September 11th were quite different. Although the current economic decline started before the tragic events, the attacks have exacerbated state budget problems. States have to address higher security costs, and many others like New York, California and Florida, where tourism is critical to revenue generation, face even more battles.

The National Governors Association and the National Association of State Budget Officers detail the economic realities states face in their biannual report, "The Fiscal Survey of States." The study, conducted in April and May of 2001, provides actual fiscal year 2000 data, estimated fiscal year 2001 data, and recommended fiscal year 2002 data.

According to the report, rising health care costs, a slowing national economy, and shrinking revenues are causing many states, especially those in the Southeast and Midwest, to deal with budget shortfalls.

Over the past five years, general-fund spending has increased an average of 6.4 percent. The report estimates spending to increase 3.6 percent in FY 2002, the smallest general fund spending increase since 1993. FY 2001 saw an increase of 8.2 percent

Table 2-1: State Nominal and Real Annual Budget Increases (FY 1993 – FY 2002)

Fiscal Year	Nominal Increases(%)	Real Increases (%)
2002	3.6	1.3
2001	8.2	3.0
2000	7.2	4.0
1999	7.7	5.2
1998	5.7	3.9
1997	5.0	2.3
1996	4.5	1.6
1995	6.3	3.2
1994	5.0	2.3
1993	3.3	0.6
1979-2002 Average	6.8	2.2

Source: National Governors Association and the National Association of State Budget Officers

over 2000 levels. Almost two-thirds of states experienced expenditure growth of more than 5 percent in both FY 2000 and 2001. However, in FY 2002, about two-thirds of the states are seeking to stabilize increases to less than 5 percent; seven states experienced reduction. A series of proposed tax and fee changes would decrease revenues by $677 million in FY 2002—the smallest tax decreases proposed since states began cutting taxes in 1994. The report notes that FY 2001 revenues dropped by $5.8 billion, while 17 states recorded higher than original projections of sales, personal income and corporate income tax collection. However, 17 others are lower, and 13 are right on target.

Year-end balances for FY 2002 are projected to total $29.1 billion, or 5.9 percent of expenditures, continuing a trend downward from a 20 year high in 2000 that had balances of 10.1 percent or $44.4 billion—representing a fall of nearly half. The number of states anticipating balances of less than 5 percent is also trending up to 23 in FY 2002 versus 16 in FY 2001 and 11 in FY 2000.

After the attacks, economic uncertainty and rising expenditures on security have dealt legislators tremendous fiscal challenges, unseen in at least a decade, upon their return to office. According to a December survey by the National Conference of State Legislatures, 43 states report revenues below forecasts. Furthermore, spending is already above budgeted levels in 19 states, and another seven expect cost overruns.

With their finances rapidly souring, several states are considering reversing course and raising taxes after a seven-year run of tax cuts. Most every state will face some sort of fiscal challenge. California has an estimated $12 billion gap—voters there could be asked to consider a quarter-cent sales tax increase. Michigan has cut spending and cancelled capital projects. Ohio plans on cutting spending and raising $465 million in targeted business taxes to help fund a $1.5 billion shortfall. Colorado has cancelled some $400 million in transportation and capital projects and Florida has cut $1 billion from a $20 billion budget, as well as suspending a scheduled tax cut. North Carolina raised taxes by $620 million in their new budget. The only saving grace for many states is the tremendous surpluses that built up from years past.

Finally, a study commissioned by the Institute for State Studies and prepared by the University of Tennessee suggests that as a result of remote sellers inability to collect sales and use tax, state and local revenue losses will total $439 billion between 2001 and 2011. In 2001, e-commerce caused an estimated total state and local government revenue loss of $13.3 billion. By 2006, the loss is expected to triple to $45.2 billion; and in 2011 to $54.8 billion.

Table 2-2: Total Year-End Balances, FY 1993 – FY 2002

Fiscal Year	Total Balance (Billions)	Total Balance (Balance of Expenditures)
2002	29.1	5.9
2001	34.3	7.2
2000	44.4	10.1
1999	39.3	8.4
1998	35.4	9.2
1997	30.7	7.9
1996	25.1	6.8
1995	20.6	5.8
1994	16.9	5.1
1993	13.0	4.2

Source: National Governors Association and the National Association of State Budget Officers

State Privatization Trends

According to the Government Contracting Institute, the value of state government contracts to private firms is up 65 percent since 1996, reaching a total of $400 billion in 2001. The Government Performance Project at Syracuse University reported that at the end of 2000, contracting consumed on average about 19 percent of state operating budgets. From past experience, we can expect the tight fiscal conditions of 2002 to increase privatization by state governments.

Pennsylvania Information Technology Outsourcing Recognized for Achievement

The Outsourcing Journal's 2002 Editor's Choice Award selected Pennsylvania's partnership with Unisys to manage the state's data centers. (http://www.outsourcing-journal.com/issues/feb2002/strategic.html).

When Tom Ridge took office as Pennsylvania's governor in 1995, only 5,000 of the state's 80,000 employees had computers, and technology added little to the management of state agencies. Now, according to the *Outsourcing Journal*, the American Electronics Association ranks the state as one of the nation's top 10 "Cyberstates" and it's in the top five for attracting IT and biotech companies.

The five-year partnership, worth $527 million, is on track to save the state's taxpayers more than $110 million. Benefits from the partnership are already being realized, including:

- **Speed and flexibility.** Unisys can implement a mainframe upgrade in two weeks, while the state's process requirements take 30 days to decide to proceed before even designing a solution.

- **State-of-the-art hardware and software**. Whereas before state agencies could rarely get the capital budget lines to upgrade hardware or pay for backup systems, or fund new software, now Unisys keeps all systems up-to-date, and manages backups and disaster recovery.
- **Funding flexibility**. Unisys has been able to backload or frontload costs in response to state funding status and budget changes, thus allowing the project to cope with unexpected hurdles and opportunities.
- **Agency focus.** With Unisys managing the data centers and the technology, the 180 state workers who used to do that are able to focus on core state technology planning, implementation, and management projects.

Florida Makes Privatization Core

In 2001 Gov. Jeb Bush continued to march on his plans to reduce the size of the state government. His plans would cut 3,023 state jobs, though many would shift to contractors. Some of the state privatization plans include:

- Turning over all toll collections on state turnpikes to private companies;
- Opening up nearly $13 billion in state-employee pension funds managed by the state for private investment companies to control;
- Expanding privatization of mental health counseling, foster-care placement and other child welfare services;
- Using private firms, under a pilot program to take over maintenance and concessions at six of the state's 153 parks; and
- Expanding the already privatized state welfare-to-work program by devolving job-training programs to regional councils who will then contract with private firms to deliver services.

But the granddaddy of Florida's privatization initiatives is a nearly completed deal with Convergys Corp. to take over the human-resources management for the state's 135,000 workers. The $40-million a year contract should save the state about $20 million a year over the next five to seven years and is likely the biggest government HR management privatization ever in the United States, though large-scale HR outsourcing is becoming commonplace in corporate America.

Convergys will manage the paperwork and data systems, while state agencies will still hire, fire, discipline and promote workers. The firm will hire some of the 1,200 current employees of the state HR system, and the rest will be offered other state jobs.

But privatization has not all been a bed of roses for Florida. A poorly managed privatization of the vocational rehabilitation and disabled services has caused the state considerable difficulties. The Occupational Access and Opportunity Commission was recommended for dismantling by the state's Office of Program Policy Analysis and Government Accountability after poor management led to Florida's second year in a row as the only state at "high risk" of losing federal vocational-rehabilitation funds.

Massachusetts and The Pacheco Law

By Charles Chieppo

In 2000, Follett Education group took over management of the University of Massachusetts bookstore. The five-year contract will save $1.3 million and increase revenues by $879,000, according to the State Auditor. Prior to privatization, the bookstore was losing $90,000 per year. The fact that this most recent state-level privatization in Massachusetts was such a cost-effective, small-scale effort and yet proved to be so controversial demonstrates the sorry state of privatization in the commonwealth.

There is nothing mysterious about the lack of privatization activity. Massachusetts is home to the most restrictive state anti-privatization legislation in the nation, the so-called Pacheco law, named after State Senator Marc Pacheco.

To contract out any service currently delivered by state employees, a state agency must compare the cost of using a private vendor not to the actual cost of using existing employees, but to the cost if the employees were to work "in the most cost-efficient manner." At no time are state employees actually held accountable for performing to this level.

Prior to this comparison, the private cost is "adjusted" in several ways. The proposed vendor must pay employees working on the state contract wages at least equal to the lesser of those paid to comparable state employees or the average private sector wage for the relevant industry. The law also limits the compensation of the private sector's officers and managers to the wage rates of comparable state managers.

Next, it requires the private contractor to pay at least the same percentage of its employees' health insurance premiums as the commonwealth does. The contractor must also provide the state attorney general with quarterly payroll records to prove it is complying with the wage and benefit requirements.

Finally, the state agency seeking to privatize must add lost tax revenues to the cost of the private bid if any part of the work is to be performed outside Massachusetts. No such addition is made to the public sector bid for the loss of tax revenues that would be realized if the work were to be performed by a private business subject to state taxes.

That's not all. The State Auditor can strike down the contract if it fails to satisfy any of five different tests, the most basic being that the work must remain in-house if the adjusted private cost is higher than the hypothetical public cost. This rigid requirement prevents an agency from paying more to improve service quality, increase the number of people served, or reduce an existing backlog.

The Auditor can also reject a contract he determines not to be "in the public interest," without providing a definition or reason. In short, the Auditor acts as both judge and jury, raising concerns and then deciding whether they rise to the level of threatening the public interest. His ruling may not be appealed.

Even under the best of circumstances, bidding on a contract is expensive and uncertain. Add to that uncertainty government-mandated wage rates for both labor and management positions, compulsory levels of employer-paid health insurance, burdensome reporting requirements, and the fact that after jumping through all these hoops the contract could be short-circuited for almost any reason, and it's no surprise that privatization is at a standstill in Massachusetts.

Unfortunately, a 2000 ruling by Massachusetts Supreme Judicial Court (SJC) has made the law all but bulletproof. The court found that the Massachusetts Bay Transportation Authority (MBTA) did not have standing to challenge the law's constitutionality after the Auditor rejected the MBTA's attempt to privatize the cleaning and maintenance of bus shelters. The decision means that the only entity with standing to challenge the Pacheco law would be an aggrieved contractor. After enduring the excruciating process described above, many companies are not likely to sink additional time and money into a legal challenge.

Instead of paying state employees to clean and maintain the shelters, the MBTA would get the services for free and receive a guaranteed minimum of $8.1 million in new revenue.

The bus shelters case is perhaps the best illustration of Pacheco's folly. A private contractor agreed to provide shelter cleaning and repair services worth $1.18 million at no charge, and promised the MBTA $2.1 million for the right to display electronic advertisements on the shelters. The company also offered to build 400-600 new shelters, with a guarantee of $6 million in additional revenue for the authority. Instead of paying state employees to clean and maintain the shelters, the MBTA would get the services for free and receive a guaranteed minimum of $8.1 million in new revenue.

Initially the State Auditor rejected the contract due to a discrepancy over how many shelters were maintained by MBTA employees. The numbers were then clarified and the contract resubmitted to the Auditor, who again struck it down. This time he claimed the MBTA had not submitted certifications from state and local tax authorities of the proposed contractor's good standing with the agencies—another Pacheco law requirement. The Auditor went on to rule that the entrepreneurial scope of the Request For Proposal (RFP) created a scenario in which public employees were unable to compete on a "level playing field," since the union could not attach a revenue source, like advertising, to their bid.

The State Auditor's decisions, buttressed by the SJC's ruling, reinforce the Pacheco law's original goal: to make the process so onerous that neither state agencies nor private contractors would ever attempt to privatize. It has worked like a charm. From 1991 to 1993, Massachusetts saved $273 million by opening the delivery of 36 state services to competition. Since the law was passed over a gubernatorial veto in December 1993, a total of six services have been privatized, most of them similar in scope to the University of Massachusetts bookstore.

Now, for the first time since passage of the Pacheco law, Massachusetts is facing a fiscal crisis. The chairman of the House Ways and Means Committee is forecasting a $2 billion dollar revenue shortfall—nearly 10 percent of the commonwealth's budget—for fiscal 2003. During eight years of paying monopoly prices for state services, Massachusetts's budget has grown by almost 44 percent, from $15.5 billion to $22.3 billion. The stage is set. As the budgetary noose tightens, Massachusetts policymakers have a choice: make deep cuts in popular programs, or reintroduce competition to the delivery of state services by repealing or amending the Pacheco law.

Signs of Hope for Privatization in Washington State

By Eric Montague

Washington state, although a hot bed of grass roots populism and fierce anti-tax independence, has yet to embrace competitive bidding for government services. State law mandates that jobs currently being performed by state workers cannot be contracted out to a private company.

In a recent interview, Governor Gary Locke blamed the state Supreme Court's 1979 decision in *Washington State Federation of State Employees vs. Spokane Community College* for the restriction on contracting out. Based on the Court's interpretation, current law requires that any work "historically and customarily" provided by the state workers may never be contracted to a private company.

The governor acts as if his hands are tied because state courts issued a ruling on a state law. He seems to confuse the limited scope of Washington's court with the overarching powers of the federal Supreme Court. However, a state court's ruling does nothing to bar the legislature and the governor from simply changing the law, something they do routinely several hundred times every year.

As it stands, the prohibition against contracting out presents a formidable legal barrier to privatization in Washington. Attempts to ease the crowded inmate population by contracting for private prisons have been blocked by a memo from the attorney general. A study by the independently-elected state auditor finds the state could save at least $25 million a year by opening the highway maintenance program to private competition. Yet stiff resistance on the part of the Department of Transportation has frustrated implementation of the study's recommendations.

Public sector unions are historically strong in Washington. In 1919, Seattle had the honor of suffering the nation's first General Strike, which closed down city life for almost a week. The tradition continues. In early 2001, state workers walked off the job, an act supposedly prohibited by law. The governor and attorney general refused to urge workers back to their jobs, saying the walkout was only a "job action"—a phrase used to call on public employees *not* to work. The pattern of pandering to entrenched public sector unions will likely continue through 2002. This year both houses of the legislature, the governorship and seven of nine statewide offices are controlled by anti-privatization elected officials.

Despite legal and political opposition at the state level, encouraging opportunities are emerging for privatizing some government services. One is Washington's work-release program. Building on the early success of local private work-release programs, some elected leaders would like to expand this type of contracting out at the state-level. While there remains stiff resistance to outright privatizing of state prisons, contracting out for the management and operation of work-release facilities would be a good first step. Privatization would reduce mounting pressure on the public corrections budget and help the state better handle a rising inmate population.

While support for privatization from state officials may be limited, at the local level there is greater reason for optimism. Local governments, stunned by the people's overwhelming support for two statewide initiatives that ended the hated car tax and reigned in soaring property tax rates, are now more open to reducing the cost of providing basic services. Local leaders are not bound by the same anti-privatization restrictions faced at the state level.

For example, the Pierce County Health Department tapped privatization as part of a plan to close a $1.6 billion budget shortfall. Health director Dr. Frederico Cruz-Uribe closed six public clinics and contracted their services to private doctors. In the first year these clinics nearly doubled the number of needy patients treated while trimming costs by $650,000. Dr. Cruz-Uribe's reforms also reduced the number of his agency's middle managers by 12 percent and trimmed public positions from 392 to 283.

Elected leaders from Bellevue, the fifth largest city in Washington, provide another example of how contracting out can successfully improve efficiency. Starting in 1986, Bellevue began hiring private contractors to handle the simple maintenance and landscaping requirements of 16 public parks. Today, while other local parks departments struggle to address mounting budget concerns (King County just closed 44 parks for the winter), the flexibility of contracting out allows Bellevue to maintain a thriving parks program year round.

Bellevue's responsive program stands in sharp contrast to the hardened attitude of the state park system, which struggles daily with a bloated government workforce and runaway maintenance backlogs. A study by the Washington Policy Center recommended contracting out and market-based fees as a viable way to break the fiscal logjam, similar to what many Canadian provinces have successfully implemented. Instead, leaders at the state agency threatened to close parks and summer campgrounds if they weren't given more tax money.

The economic slowdown is putting the squeeze on many state budgets, and Washington is no exception. Unemployment has jumped to over 7 percent and the state budget is facing a $1.2 billion shortfall. The fiscal pressure felt by state leaders provides a chance for them to think anew about how the government does its job. In good times, governments feel they can "afford" high wage employees and inefficient monopoly services. During downturns, when demands for service are at the highest level, opportunities to reform the system become more appealing. As the budget bite deepens, contracting out will look more attractive to elected leaders in Washington.

Table 2-3: America's Cities Fiscal Condition

	All Cities (%)	Cities over 100,000 pop. (%)
Strength of Local Economy		
Weakened Local Economy	41	59
Not Much Change	58	41
Stronger Local Economy	1	0
Municipal Revenues?		
Decreased Revenues	31	50
Not Much Change	69	50
Increased Revenues	0	0
Public Safety Spending?		
Decreased	0	0
No Change	69	46
Increased	31	54
Public Confidence?		
Weakened	28	36
No Changed	54	42
Strengthened	18	36

Source: National League of Cities, "State of America's Cities Survey," October 18, 2001

Local Government Fiscal Trends

Facing uncertain times, cities are trying to cope. According to a National League of Cities (NLC) survey, "City Fiscal Conditions in 2001," 44 percent of respondents reported concern about financial resources, up from 27 percent last year, representing the highest percentage since 1994. Fifty-four percent are concerned with finances in 2002, up from 37 percent, which also represents the highest percentage since 1994. Respondents in the nation's largest cities (population over 300,000) are especially pessimistic. Seventy-eight percent expect 2002 to be worse than last year.

On the positive side, many cities report high ending balances. Ending balances as a percentage of expenditures leveled off at 18.7 percent, the highest level since the NLC general-fund survey was initiated in 1986. These balances typically become revenues for "rainy day" funds. Furthermore, property tax receipts grew by 5.8 percent over 2001. Eight in 10 cities identified their "economic base" as critical to their ability to meet budgetary needs.

Post September 11th, many cities have become grimmer on their financial outlook, according to the NLC's "State of America's Cities Survey." One in three cities reports that its local economy, municipal resources, and public confidence has declined while public spending is up. Among larger cities, 59 percent report weaker economies. Nearly one-half of the cities surveyed suggested they intend to seek federal and state aid to defray additional security costs. Expenditures are up due to heightened public safety and security measures—51 percent of cities report additional spending. Expected revenues are down by 4 percent, representing an $11.4 billion decrease in municipal revenues nationwide (excluding New York City and Washington D.C.).

Local Government Privatization Trends

As is usually the case, a tighter economy and lower revenues for local governments are spurring increased discussion of privatization as an alternative to tax increases. In this environment, a new comprehensive survey of local government privatiza-

Competitive Cities

Overall Efficiency Rankings	
Rank	City
1	Phoenix
2	El Paso
3	Tulsa
4	Memphis
5	Nashville
6	San Diego
7	Dallas
8	Virginia Beach
9	Indianapolis
10	San Antonio

Consumers turn to objective third-party reports for information on many of the goods and services they purchase. Likewise, citizens often turn to guides and report cards that evaluate how their governments perform on readily understood measures. Money magazine rates the best cities in which to retire. Fortune magazine rates the best cities for business. Governing magazine grades cities on how well managed they are. The U.S. Conference of Mayors rates city livability.

Yet none of these reports examines how efficiently cities deliver services—what resources does it take to pick up the trash, fix the streets, or provide fire protection? Do some cities use more or fewer resources than others?

In 2001, Reason Public Policy Institute issued the first ever evaluation of how efficiently the largest cities in America deliver basic services. The Competitive Cities Report Card (http://www.rppi.org/compcity/) initially set out to evaluate the 50 largest U.S. cities while looking at 18 services. Due to missing, incomplete, or incompatible data RPPI was only able to rank 44 cities in 11 different service areas.

Phoenix ranked most efficient, and indeed held the position of most efficient each year in 1995-1998. Los Angeles ranked least efficient, holding that position each year 1994-1996, but improving quite a bit in 1997 and 1998.

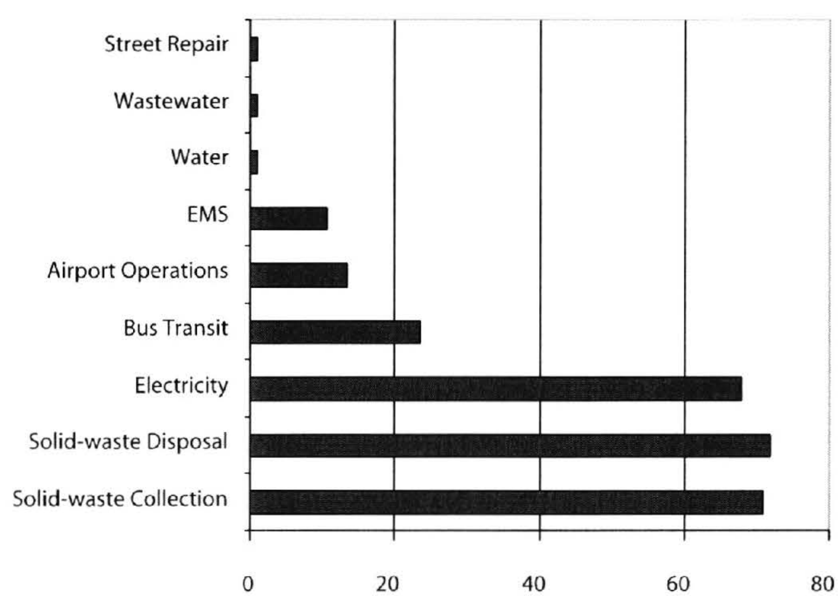
There were several interesting results from the analysis:

- Cities with strong city managers were 50 percent more likely to be efficient. Possibly because city managers, without the political pressure of running for office, can more readily focus on efficient operations of city services.
- There were no efficiency implications in density. More compact, dense cities were as likely to be efficient as were spread out or sprawling cities. In fact, Phoenix, often considered one of the most sprawling cities, was the most efficient according to our analysis.
- There were no strong scalable economies for basic municipal services. The report found that efficiency was not dependent on the amount of services provided.

Another way to view this report is as a critique of how well cities inform citizens of how their tax dollars are being spent. Despite a strenuous effort over several years, we struggled constantly to wrest data from city agencies and were left with many areas of only partial data. No city could provide data for all services for even part of the time period we examined.

One problem is that only a handful of cities have implemented meaningful performance measures, which focus not only on quantity but also service delivery, that is, quality, efficiency, timeliness, accuracy, accessibility, and professionalism.

Figure 2-1: Percent of WI Municipalites Privatizing Selected Services



tion in Wisconsin was released in 2001. And examples of privatization abound, from cities big and small to counties as well.

Municipal Privatization in Wisconsin

In June the University of Wisconsin-Madison made available results from a survey of municipal governments on privatization (see www.uwex.edulgcpro gram/pdf/privpaper.pdf). They used the same survey that Reason Senior Fellow Robin Johnson did in Illinois a few years ago, and the results in Wisconsin similarly provide a good snapshot of privatization practices in municipalities of all sizes.

Extent of Privatization: The survey asked about delivery of 82 service categories. Only parole programs were not privatized by at least one municipality in the state. Public works and public utilities were the services most often privatized. Other services, public safety, health and human safety, and parks and recreation, were less often privatized, with intergovernmental contracts being more common.

Reasons for Privatizing: The survey asked municipalities to list all the reasons they chose to privatize services. The most frequent reason was internal pressure to decrease costs (cited by 70 percent of municipalities), followed by successful use of privatization in other jurisdictions, external pressure on finances, including tax restrictions, concerns about municipal liabilities, and finally intergovernmental mandates. Asked why some services were not privatized, the most common reason cited was lack of evidence on effectiveness of privatization, followed by loss of control, insufficient supply of competent private deliverers, opposition from elected officials, restrictive labor contracts and agreements, and opposition from unions.

Methods for Winning Support for Privatization Proposals: Successful privatization often depends on getting buy-in from other elected officials, stakeholders and citizens. The survey asked about methods of promoting privatization to residents. The most frequently used method was analyzing the feasibility of privatization (cited by 64 percent of municipalities), followed by promoting the general features of privatization, identifying successful uses in other jurisdictions, using privatization only for new or growing services, and implementing privatization on a trial basis.

Success of Privatization: Asked how successful were their uses of privatization, 69 percent of municipalities said it was a success in most cases, 13 percent a success in a few cases, and one percent said a failure in most cases. Municipalities reported that the most important factor in privatization's success was financial considerations, followed by quality of work, responsiveness, and timeliness of services.

Effect of Privatization on Employees: Asked what happened to employees after privatization, municipalities most commonly cited transfers to other government jobs (42 percent of municipalities), followed by retirement, and taking jobs with the private contractors. In only 6 percent of cases were workers laid off. Roughly two-thirds of municipalities did not keep data on what happened to employee wages and benefits. Of these municipalities who could report on changes in wages and benefits, about one-third each reported that private firms paid wages that were higher, lower, or about the same as the municipality paid, and about one-third reported that private-firm employee benefits were lower, while about one-sixth each reported that the private firm offered either better benefits or about the same level as the city or town.

Key Findings on Municipal Privatization in Wisconsin

- **Most Privatized Services—Solid waste collection & disposal**
- **#1 Reason For Privatization—to decrease costs**
- **Success of Privatization—69 percent say privatization succeeds in most cases**
- **Effect on Employees—Most move to other jobs, only 6 percent get laid off**
- **Wages & Benefits—as likely to be higher after privatization as lower**

Privatizing Facility Services in Baltimore

Autumn 2001 saw the Baltimore city council approve privatizing security and custodial services for a number of city buildings. The city is facing a $21 million budget deficit in FY 2002, and Mayor Martin O'Malley has proposed privatizing some services to cut about $2.2 million from the budget.

The security contract will pay Abacus Corp. $1.7 million a year to provide security services, $700,000 less than the city was spending. The firm plans to hire 20 guards to perform the work, for which the city employed 33 guards, and will hire first from the guards that worked for the city. The custodial contract is with three different firms to care for various municipal buildings, for a total of $1.8 million per year, more than $2 million less than the city was spending. The private services will be replacing 138 city workers, many of whom will likely be hired by the contracting firms.

To help ease the transition for the displaced city worker, they will be kept on until March 2002 and receive job-placement counseling.

Privatization to Rescue Hamtramck, Michigan

In November 2000, Louis Schimmel swept away the government of Hamtramck, Michigan, population 23,000, and literally took over the city—lock, stock, and barrel. Appointed by the governor under a 1990 law that allows the state to assume temporary control of a dysfunctional municipality, Schimmel has transformed the finances and the infrastructure of Hamtramck.

The governor acted so drastically because the city government was in a shambles with services almost nonexistent. Garbage lay in the streets for as long as seven weeks, the city had 95 fire hydrants that were either broken or in need of repair, and the city had 40 bank accounts. According to Schimmel, "financially, nobody knew where anything was. Nobody even knew what the deficit was."

Schimmel moved quickly to reduce what he saw as a bloated workforce, and by the end of 2001 had cut 17 percent, from 162 employees down to 135. He privatized all public works services, with private firms taking over trash pickup, fire hydrant repair, tree trimming, snow plowing, street repairs, water and sewer line repairs, etc. Then he held a public auction to sell unnecessary city vehicles and equipment for $186,000.

Services have improved dramatically. At much lower cost, garbage actually gets picked up on time, trees get trimmed, snow gets plowed, and city finances are starting to come back into order.

Detroit-Wayne County, Michigan Privatizes Mental Health Services

Facing a $6.3 million deficit, the Detroit-Wayne County Mental Health Agency signed a contract with Magellan Behavioral Health to manage mental health and substance abuse benefits for its enrollees. The contract will pay Magellan $20 million over four years to manage a network of about 80 outside agencies that provide mostly outpatient treatment to county residents with mental health and substance abuse problems. Magellan will administer access and handle claims. The goal of the contract is to control costs, after the agency's spending rose more than 50 percent since 1998, from $356 million in 1998 to $543 million in 2001.

New York City Privatization Initiatives

By E.S. Savas

As the mid-1990s approached, management of New York City's public services was widely perceived to be in need of improvement. Inefficiencies abounded, effectiveness was spotty, taxes were wasted, and archaic work rules handcuffed managers and led to the tacit recognition that city agencies were not really manageable. The conventional public administration solutions—such as enhanced training and professional development, zero-based budgeting, automation, reorganization, incentive systems, management by objectives, productivity programs, joint labor-management committees, and total quality management—were not enough; an additional strategic approach was needed.

Privatization wasn't new to New York City. The city had been contracting out streetlight maintenance for years, for example, and had franchised private bus lines and municipal golf courses. Many of the most important social services administered by the city have always been provided under contract. What was new, however, was Mayor Giuliani's deliberate program to use privatization to improve the performance of city agencies. The Mayor made this an important element of his campaign in 1993, and delivered on his promise.

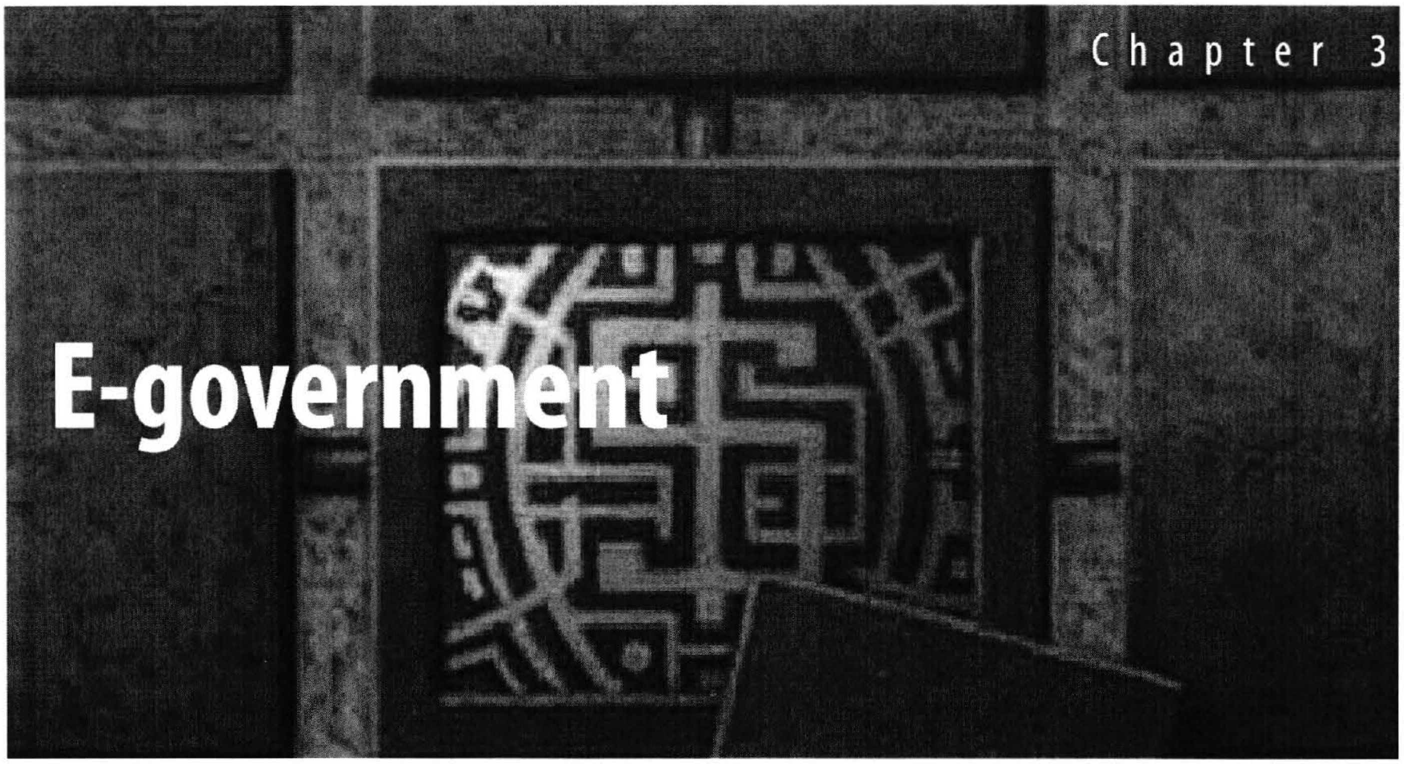
The Giuliani Administration implemented more than 60 different privatization actions, and others are still underway. These actions ranged from contracting out fleet management in the Parks & Recreation Department, to allowing dollar vans to expand services in underserved areas of the city, to franchising private ferries, to divesting the WNYC radio and television stations.

The city's privatization initiatives in the aggregate resulted in cost savings, cost avoidance, more revenue, better service quality, greater responsiveness to the public, and direct savings to the public. For example,

- Tax-levy spending for public assistance has been reduced by over $550 million a year;
- Readily identifiable savings from contracts amount to more than $42 million annually;
- Competitive contracting in the Parks Department reduced fleet maintenance by 30 percent while reducing the proportion of out-of-service vehicles from 18 percent to 5 percent;
- Selling city-owned apartment buildings resulted in cost avoidance of $43 million;
- Sale of tax liens on delinquent properties brought in more than a billion dollars;
- Other divestments during 1994-2000 brought in $657 million;
- Sale of the Off Track Betting Corporation will yield revenues up to $389 million; and
- Revenue from ambulance calls increased $10 million per year by using a contractor for billing and collection. ❑

Table 2-4: New York's Privatization Initiatives

Type	Number	Results
Managed Competition	1	Union agreed to greater productivity
Public-private Partnership	3	Cost avoidance of $95 million a year
Deregulation	3	Increased service and cost savings
Divestments	10	Generated over $2.5 billion
Contracts	30	Saved millions of dollars and improved service quality and speed of delivery.
Volunteerism	7	Matching funds from non-profits, to provide 85 percent of Central Park Budget
Voucher	1	Coverage increased 310 percent
Franchise	4	Raised over $80 million



Chapter 3

E-government

Federal and International E-government

Since the first federal government presence on the Internet (www.whitehouse.gov in 1993), many national governments have expanded their use of information technology in communicating with and providing services to their citizens. This trend continued in 2001, although the global economic downturn and ensuing decreases in tax revenues have slowed the implementation of e-government in some places. Still, many national governments continue to incorporate information technology and e-government strategies into their long-run plans, but implementation continues to lag behind rhetoric and vision statements.

In a recent comparative study of international e-government implementation, "Rhetoric vs. Reality—Closing the Gap," Accenture analyzed the state of e-government in 22 countries as of January 2001. Accenture's researchers distinguished between two dimensions of e-government—service maturity and delivery maturity. Researchers measured service maturity by analyzing service breadth and depth. Delivery maturity measured the integration and user-friendliness of the online interface between the government and the citizen-customer. Accenture's model is an integrated service portal that uses customer relationship management techniques.

Using these measures, Accenture ranked the 22 countries and grouped them into four categories depending on their overall maturity: innovative leaders, visionary followers, steady achievers, and platform builders. The three innovative leader countries are Canada, Singapore, and the United States. Close on their heels are the visionary followers: Norway, Australia, Finland, the Netherlands, and the United Kingdom. The distinction between these top two categories and the others is driven by achievement in the delivery maturity dimension—these countries have both breadth and depth of online service offerings, and are developing integrated delivery portals across agencies. Interestingly, Accenture found that even the innovative leaders had only achieved moderate maturity; in their ranking, Canada achieved the highest score, at 50 percent. These rankings indicate how complex the implementation of e-government strategies can be.

This study indicates a continuation of a trend seen in 2000 and expected to continue in 2002: the movement of e-government through different phases of its life cycle from passive information provision to active, coordinated service provision online. A recent Progressive Policy Institute study, "Breaking Down Bureaucratic Barriers: The Next Phase of Digital Government," (www.ppionline.org) categorizes the process of e-government into three phases:

- Using the internet to share information;
- Online transactions and service provision; and
- Integration.

The three countries that are innovative leaders in the Accenture study–Canada, Singapore and the United States–have generally progressed through the first two phases, and are now beginning to embark on the difficult process of integration of government services across agencies, across levels of government, and through an integrated online portal that is customer-focused and organized by customer service, not by agency silo. Most analysts consider this third phase to be more difficult than the first two, because integration requires a change in attitude and culture, particularly in breaking down agency-centered thinking or "silos" and thinking about the relationship between government and citizen as active and customer-focused.

Singapore's eCitizen Web site (www.ecitizen.gov.sg) provides an example of the focus on citizen problem-solving instead of on agencies. Called intentions-based design, this approach leads to portals like eCitizen, which has on its front page categories of activities that citizens are likely to undertake: upgrade my skills, get married, apply to camp in parks, apply for visa. The active, customer-based approach in this portal has led to more efficient service provision than a more passive approach would, such as a front page that lists the names of all government agencies and requires the citizen to search across various agencies to meet his or her needs.

Canada's integrated government Web site (www.canada.gc.ca) is the most developed of the three top innovative leader countries. Organized by whether the user is a Canadian citizen, a Canadian business, or a non-Canadian, the links are by service. For example, on the Canada citizen page is a link titled "life events: lost ID." This one page lists all of the possible official documents or certificates that a citizen might ever need to replace, with drop-down menus linking the user to information on how to replace them. At this point, Accenture's measure of service depth becomes important. Someone who lives in Ontario and needs to replace a driver's license still must go into a provincial office to have a photo taken, instead of, for example, the Ontario Ministry of Transportation having a digital photo on file and being able to process the entire transaction online. That transaction would show depth of service.

The U. S. government portal, www.firstgov.gov, also operates along service-oriented lines. The front page is designed along the Yahoo (www.yahoo.com) model, and allows for extensive cross agency searches. One interesting link on the front page is "cross agency by audience," (http://www.firstgov.gov/topics/interests.html) which indicates a move toward an integrated customer service model. The site is undergoing a redesign that is likely to introduce elements found in Canada's portal.

Implementation of e-government through integrated service portals will continue through 2002, but some of the issues and obstacles are complex and not necessarily solved through simple technological solutions. As these vision leaders described above indicate, they will continue striving to integrate their portals, and they will serve as role models to inspire other national governments to approach their citizens with a customer service orientation.

State E-government

The Center for Digital Government and the Progress and Freedom Foundation released their annual survey of state Chief Information Officers in early 2002. "Digital State 2001" is conducted to assess the progress made by state governments in the "adoption and utilization of digital technologies to improve the delivery of government services to their citizens." The survey found that:

- All but two states have downloadable permitting and licensing forms. Fourteen states have at least 76 percent of their forms online.
- More than 90 percent of states allow taxpayers to file online; more than 90 percent provide at least 75 percent of tax forms online.
- At least some benefits applications can be received online in 18 states.
- Thirty-nine states recognize digital signatures for some legal functions.
- Arizona held a legally binding primary over the Internet in 2000.
- More than 40 percent of states have implemented a statewide architecture to coordinate IT systems across agencies and functions of government.
- More than 80 percent of the states collect and make available performance data on K-12 students.
- Every state has Global Information Systems (GIS) data available online.

E-procurement Consolidation in Difficult Times

The economic downturn and woes in the technology sector influenced many of the e-procurement events of 2001. E-procurement software spending and investment increased faster than other information technology investments in 2001, largely due to their higher ability to generate cost savings. InternetWeek estimates that companies spent approximately $1.7 billion on e-procurement software in 2001, a 29 percent increase over 2000. Procurement software from vendors like Ariba, Clarus, SAP, Oracle, i2, iPlanet, and MRO, and more focused small providers like FreeMarkets, can help governments at different levels generate short-term and longer-run benefits. These benefits range from contract negotiation simplification and supplier data analysis to automatic invoice processing and agency spending data analysis. In a time of potential pressure on state tax revenue, such cost savings is a particularly important driver in investment decisions.

Table 3-1: Overall Rankings—Digital State 2001			
State	**Rank**	**State**	**Rank**
Illinois	1	Maine	5
Kansas	1	New Jersey	7
Washington	3	Utah	7
Maryland	4	Ohio	9
Arizona	5	Michigan	9

The Commonwealth of Virginia is a model e-procurement system. Virginia's system, eVA, was launched in February 2001. Between then and the end of the year, eVA handled 3,300 orders, valued at $22 million. Over 3,800 vendors have registered for either basic service ($25 fee) or premium service ($200 fee). Vendors also pay a 1 percent fee up to a maximum of $500 per order. All 167 state agencies use eVA, and the state has committed to ongoing staff training to ensure that agency personnel and vendors can use the system effectively and are comfortable with the technology.

Measuring the success of e-procurement systems like eVA often proves difficult, though. The savings from e-procurement usually arises from reductions in time and resources used in the procurement process, with some studies suggesting a 70 to 80 percent reduction. Additional savings can come from administrative cost reductions and lower prices from the more competitive nature of the bidding process under e-procurement. In Virginia, for example, contracts that used to average 12 to 15 bids now average 40 to 80 bids.

Federal and state governments have been able to use the large volumes of their purchases and contracts to reduce both costs and the prices that vendors offer them, but city and county governments often have a harder time achieving such outcomes. A process called demand aggregation or bid aggregation can change that. With bid aggregation, several purchasers can pool their orders, which makes them more attractive customers to suppliers that can offer lower prices for volume purchases. One such system is called MunicipalNet (www.municpalnet.com). Government buyers register and have access to a pool of potential bidders through an online interface. This process enables local governments to maintain their existing arrangements for sealed bid proposals, requests for proposals, and requests for quotations, yet increase the pool of possible bidders for these orders and projects. MunicipalNet essentially acts as an information mechanism, enabling local governments to exploit the similarities of their demands for goods and services. Bid aggregation can deliver substantial cost reduction without having to revise procurement procedures drastically, thus delivering significant value in a time of pressure on government revenues. ❑

Local E-government

Government Technology magazine and the Center for Digital Government awarded the seventh annual "Best of the Web" award to New York City. Nyc.gov is one of the few sites that allow citizens to personalize content. The site includes more than 30,000 pages of content and more than 100 transactional services. Unique offerings include online traffic hearings and a one-stop epayment center.

Table 3-2: "Best of the Web"		
1	New York City	www.nyc.gov
2	Montgomery County, MD.	www.emontgomery.org
3	Conyers, GA.	www.conyersga.com
4	Miami-Dade County, FL.	www.miamidade.gov
5	Chicago	www.cityofchicago.org

Welfare

By Laura Dykes

Today, self-destructive behavior is considered to be the result of insufficient resources rather than a behavioral disorder. A lack of resources is thought to be the barrier to a healthy work ethic. As a consequence, welfare agencies have vastly contributed to the entitlement philosophy by making the provision of material assistance their major task.

Recent efforts to reform welfare, including the privatization of government welfare services, have reversed this destructive trend, harking back to fundamental self-reliance. Privatization of welfare services has created competition and lowered costs to taxpayers, increased efficiency, enhanced performance, and increased flexibility.

Wisconsin's Story of Privatization and Competitive Bidding

Wisconsin was the first state to completely privatize its welfare system, and has become the leader in reducing welfare dependence. In 1987, Wisconsin enacted "Learnfare" which required welfare recipients to ensure that their children attended class regularly or their welfare payments were reduced. Also enacted was "Children First" to threaten incarceration for noncompliance with compulsory child-support payments.

In January 1995, two Wisconsin counties began the pilot program Work Not Welfare (WNW) which placed a 24 month time limit on individuals receiving Aid to Families with Dependent Children (AFDC) and required recipients to work. WNW is now Wisconsin Works (W-2) and requires immediate work or community-service from beneficiaries. The same year, Wisconsin contracted out services to private firms to decrease AFDC caseloads.

In December 1995, Wisconsin competitively bid the management of each county's welfare system, requiring each county to reduce its caseload. Wisconsin counties contracted for completing eligibility determinations, case management, employment, and other welfare services. Contractors were awarded a flat fee for services. In Milwaukee County where the majority of welfare cases are located, private firms screen and determine eligibility, train, and place welfare applicants. For-profit and non-profit private firms supervise most of the W-2 cases.

In April 1996, Work First required recipients to search for employment and work. A "self-sufficiency planning interview" also diverted potential recipients to other resource specialists. Robert Rector, a Senior Research Fellow at the Heritage Foundation, describes the consequence of work requirements as the "dissuasion effect" because the requirements actually deter individuals from entering the system.

Another program, Job Access Loan, lent money to recipients so they could secure transportation to work. The loan had to be repaid either in cash or through the performance of community-service. Work First also established a pay-for-performance system where recipients would not receive welfare benefits until after they had performed work. If they failed to show up, welfare benefits were reduced or denied. Work First was renamed Self-Sufficiency First and Pay for Performance (PFP).

W-2 has now replaced AFDC and the program is based on the principle of work. The program requires supervised job searches and immediate work or community service, from all recipients in exchange for benefits. Rather than receiving welfare benefits, beneficiaries receive benefits from private or community-service employers. During the first two years of the W-2 program, Wisconsin taxpayers saved $10.25 million. Wisconsin has cut its AFDC/Temporary Assistance to Needy Families (TANF) caseload by 90 percent. The success of Wisconsin's work-based program aptly demonstrates that while well-intended, handouts actually harm those they are intended to help by creating a disincentive to work.

The Passage of National Reform

In 1996, Congress enacted the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA). Modeled after Wisconsin's achievements, states are now required to reduce caseloads, set up pay-for-performance systems, and make recipients work. PRWORA also replaced AFDC with TANF. The national reform ended entitlement-basis funding, eliminating the perverse financial incentives for state governments. Previously, states were fiscally penalized for reducing caseloads. Now states receive a flat fee and are permitted to keep the surplus from caseload reduction. However, if caseloads grow, states bear the additional cost. A five-year time limit was also established, while providing states greater flexibility.

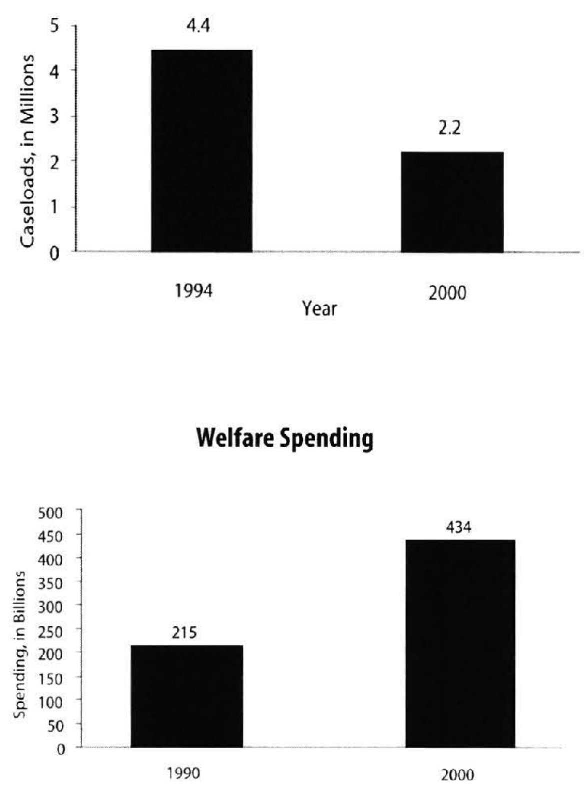
PRWORA also paved the way for privatization. Prior to PRWORA, state employees were the only people who made AFDC eligibility determinations. The new legislation removed the restrictions from awarding contracts to private for-profit and non-profit organizations to deliver welfare services. Firms such as America Works, Curtis & Associates, Maximus Inc., Lockheed Martin, Electronic Data Systems, and Anderson Consulting bid for contracts to distribute welfare benefits.

The Triumph of Privatization

Since the adoption of the federal reform legislation, AFDC/TANF caseloads have dropped 60 percent from March 1994. The number of recipients has considerably declined from 4.4 million to 2.2 million in June 2000, indicating that work is far superior to welfare. Unfortunately, despite dramatic caseload reductions, federal and state welfare spending rose from $215 billion in 1990 to $434 billion in 2000. Reducing caseloads would help to control the rising costs of welfare.

The decline in caseloads is closely tied to welfare reform. Studies show that states with immediate work requirements have an average caseload reduction of 50 percent. Requiring a supervised job search, work, or performing community-service in exchange for benefits unmistakably increases employment, reduces dependence, and promotes self-sufficiency.

Figure 4-1: U.S. Families on AFDC/TANF



Source: U.S. Department of Health and Human Services; and Office of Management and Budget, *Budget of the United States Government, 2000,* appendix.

The flourishing welfare law expires September 30, 2002 and new legislation will be needed to extend the accomplishments of welfare reform. In order to keep the caseloads down, Congress will need to reauthorize the work requirement at the current levels or increase them. Intensifying federal work requirements to ensure that states require all recipients to engage in a supervised job search and/or community service work, as a condition of receiving aid could continue to reduce caseloads.

How Privatizing Child Welfare Services Protects Children

By Laura Dykes

President Bush has proposed increasing the child welfare budget by $200 million to strengthen states' ability to promote child safety. But without fundamental reform, more money will not protect the children that are abused, neglected, and sometimes even killed in the foster-care system.

Foster-care payments, as uncapped entitlements, create a perverse financial incentive for states to retain children in foster care. Indeed, the foster-care population has skyrocketed in the past decade.

The number of children in foster care has doubled from 270,000 in the mid-1980s to 547,000 children in March 1999. These statistics don't reveal the countless children who would have remained in the system but who turned 18, referred to as "graduates." Previous federal reforms have done little to keep foster care from becoming a permanent situation for many children.

States such as Kansas, Michigan, and Florida have successfully reversed this dangerous trend. Kansas's child-welfare privatization shows optimal signs of success.

In 1996, more than one out of ten foster care children typically remained in foster care for three to four years, and almost that same number had been there for five years or longer before reunification or adoption. By 1999, almost one in seven had been in foster care three to four years and almost one in five had been in foster care for five years or longer.

Children are much more likely to be maltreated in foster care than in their own homes. In 1998, six children per 100,000 were killed in foster care compared to one per 100,000 in the general population according to the National Center on Child Abuse and Neglect. The same system mandated to protect children is abusing them as they continue to languish in foster care.

Foster care has other harmful and lasting effects on children. Foster children are far more likely to end up on welfare, homeless, or in prison than adopted children. A Westat, Inc. study concluded that 40 percent of graduated foster children had been on public assistance, incarcerated, or were a cost to the community in some other way.

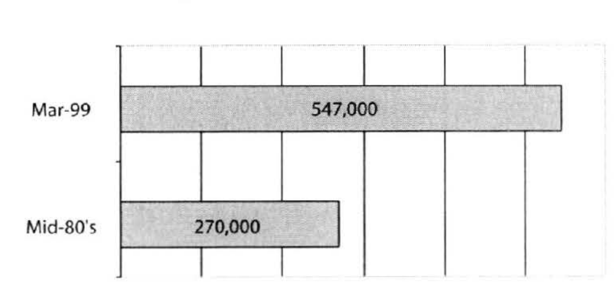
States such as Kansas, Michigan, and Florida have successfully reversed this dangerous trend. Kansas's child-welfare privatization shows optimal signs of success.

By contracting with private agencies to provide family preservation, foster care, and adoption services, Kansas utilizes competition, incentives, and innovation. Removing the perverse financial incentives that keep children in foster care is the primary cause for Kansas's success.

By giving contractors a lump sum, rather than paying them on a per-day, per-child basis, the perverse incentives are removed. Contractors are free to use the fee toward reunification or adoption. Overwhelmingly positive results confirm the accomplishments of Kansas's child-welfare privatization. Adoptions have increased 78 percent since privatization, and the dissolution rate (adoptions that fail) is only 2.4 percent, compared to 12 percent nationally. Additionally, there have been 30 percent more child-protective services workers investigating cases of suspected abuse and neglect.

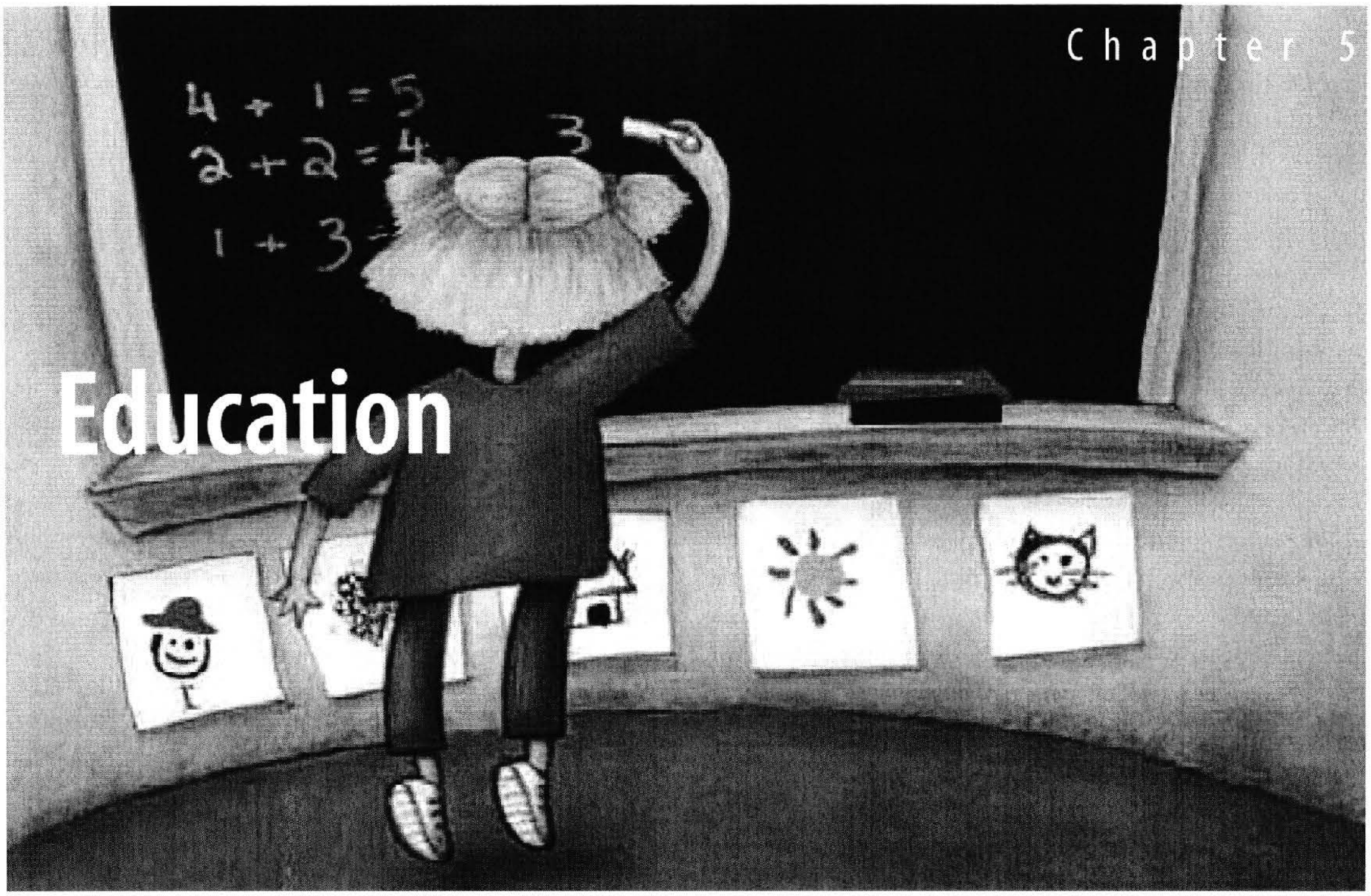
In Florida, the legislature ordered the state to privatize the child-welfare system by 2003. Hillsborough County will become the third county to privatize. A coalition of the Tampa Metropolitan YMCA and Children's Home Society of Florida will soon take over an assortment of child-welfare services, including foster care, adoption, and crisis response. ❑

Figure 4-2: Children in Foster Care



Chapter 5

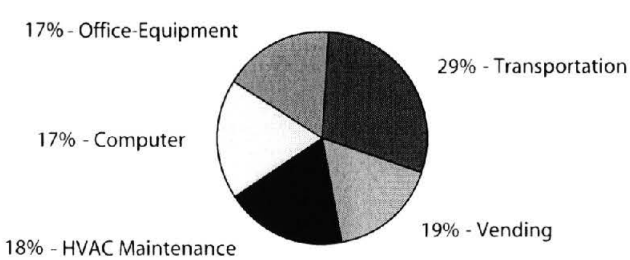
Education



A popular source of information on school service privatization is American School & University's (AS&U)annual Privatization/Contract Services Survey. Unfortunately, the AS&U survey's methodology does not support making claims about trends in school privatization over time.

For example the 2001 survey was mailed to 1000 school business officials and the survey response rate was 29 percent.This is compared with 750 surveys mailed in 1999,with an 8 percent response rate, and 500 surveys in 1997 with an 11 percent response rate. Aside from the fact that the low response rates make generalizations about privatization to the survey pool questionable and generalizations to all public schools even more questionable, the AS&U survey is not capturing increases or decreases in school privatization at the same schools over time. Instead, it is making privatization generalizations from different groups of public school respondents. So while the number of people responding in 2001 may have reported less privatization, it is unclear if the 1999 and 1997 respondents are experiencing more or less privatization. Nonetheless, the survey does provide a useful snapshot of privatization each year.

Figure 5-1: Most Common Contracted Services in 2001



Source: American Schools & University's 7th Annual Privatization/Contract Services

Illinois Schools Successful in Outsourcing Support Services

While the recent focus on education in the United States has centered on vouchers, testing, and accountability, other issues have important implications for the proper management of public schools. Schools provide a host of services internally that bear no relation to their fundamental purpose of educating our youth. Functions, such as transportation, food services, and cleaning and maintenance, can be outsourced to private firms and allow school officials to focus on their core mission. Schools that contract support services can save tax dollars, improve the quality of services, and use the savings to hold the line on local property taxes or plow back into instructional purposes.

Reason Public Policy Institute produced a report exploring the extent of contracting support services in Illinois schools and several key issues involved in the privatization process. Information is based on a survey of Illinois school districts that generated nearly 500 responses.

Some of the key findings are:

Contracting is more widespread than previous surveys indicated. Virtually every school district responding to the survey in Illinois contracts at least one of the services listed. The average number of contracted services in school districts is 7.6. Nearly one-fourth of the school districts contract at least 10 services, with a high of 18.

For some schools, contracting is the only way to provide services. Two hundred school districts (41 percent of the total) said that contracting was the only way they could provide a certain service. A lack of technical expertise or financial capacity prevented the school districts from providing certain services. Nearly all of these districts (135) reported that they provide more than one service only through contracting.

Privatization is increasing, especially in large districts. Trends indicate that many school districts are increasing the number of contracts with private firms. Roughly one in four school districts increased privatization in the past five years, and one in four plans to increase contracting in the next five years. The rate of increase is higher for school districts with larger enrollments.

Most contracts are short term and competitively bid. More than half (56.2 percent) of contracts are for less than three years and 83 percent are for five years or less. When initial contracts expire, most are rebid although one-third of school districts renew with the existing contractor.

Few layoffs occur because of privatization. Confirming other surveys of governments, a small number of school districts (34 or 6.9 percent) reported any layoffs due to privatization. Most districts have policies in place to minimize the impact of privatization on employees. In fact, a successful privatization is strongly linked to efforts to soften the effects on employees.

Cost savings are important, but quality drives success. Most school officials consider privatization because of financial pressures and rising personnel costs. Most school districts also report cost savings from privatization. However, when asked what factor was most important in making privatization a success, a majority of officials cited improved quality of work performed, about twice the number that said cost savings.

Success creates success. Two-thirds of school officials rated privatization a success. Only four school districts statewide said it failed, with one in five saying it was a mixed bag. As school officials successfully privatize a service, they are more likely to look for further opportunities. They also heavily rely on experiences in neighboring school districts for guidance. In fact, networking among school officials is an important, if understated, part of the decision-making process, playing a role in information gathering and contract monitoring.

Table 5-1: Number of Companies, Schools, and States Profiled by Year

School Year	Number of Companies Profiled	Number of Schools Managed by Profiled Companies	Number of States in which Profiled Companies Operate
1998-99	13	135	15
1999-00	20	230	21
2000-01	21	285	22
2000-02	36	368	24

Source: Alex Molnar et al., *2001-2002 Profiles of For-Profit Education Management Companies*, Education Policy Study Laboratory, Arizona State University, January 17, 2002. http://www.asu.edu/educ/epsl/news.htm

Education Management Organizations Expand in 2001

Charter schools are public schools financed by the same per-pupil funds that traditional public schools receive. Unlike traditional public schools, however, they are held accountable for achieving educational results. In return, they receive waivers that exempt them from many of the restrictions and rules that shape traditional public schools.

The number of for-profit companies managing public schools in the United States soared 70 percent in the past year, according to data compiled by the Education Policy Studies Laboratory at Arizona State University. The fourth annual *Profiles of For-Profit Education Management Companies* found that 36 companies now operate 368 schools in 24 states and the District of Columbia. An overwhelming majority of those schools are public charter schools. Arizona and Michigan, two states with strong charter school laws also have the most schools managed by for-profit companies. Seeing the similarities with health maintenance organizations (HMOs) that manage the health care process, Wall Street has started to use the term "EMO" to describe for-profit companies involved in the management and administration of public schools. While nationally about 10 percent of all charter schools are managed by for-profit Education Management Organizations (EMO), an estimated 25 percent of Arizona's charter schools are operated by EMOs. Arizona and Michigan account for nearly half of all schools managed or operated by EMOs.

For-profit management of public schools generally takes two forms: local school districts contract with EMOs to manage existing traditional K-12 public schools (termed "contract schools") or the EMOs manage public charter schools either as the charter holder or under the terms of a contract with the charter holder. In the early 1990s, EMOs tended to pursue the contract school approach, but in recent years, many EMOs have taken the opportunity afforded by charter school legislation and focused on the management of charter schools. It now appears that the increase in the number of charter schools is the main source of EMO growth.

In 2001, several of the major EMOs were involved in merger and acquisition activities. Edison Schools, Inc. announced on June 4, 2001 that it would acquire LearnNow, Inc. and on July 2, 2001 Mosaica Education, Inc. announced that it would acquire Advantage Schools, Inc. On January 8, 2002, Chancellor Academies Inc. and Beacon Education Management said that they would merge to form Chancellor Beacon Academies, making it the second largest EMO in the country after Edison Schools, Inc.

Philadelphia Hosts Privatization Battle

Philadelphia hosted 2001's most contentious school privatization battle. The Philadelphia public school system was taken over by the state, which plans turning over 60 schools to private management. Edison is the favorite to be the "lead provider" which, under the state plan, will give them 45 schools. It remains unclear what role Edison will play in the forthcoming school privatization. The School Reform Commission, appointed by Pennsylvania's Governor Schweiker, is considering all the available privatization options. Edison faces some tough competition. Chancellor Beacon Academies is vying for the full contract, and 31 companies, nonprofit organizations, and universities responded to the School Reform Commission's "request for qualifications" for 22 different school consulting services.

In January 2002, Edison also pitched to the Austin, Texas school board the running of 15 of the district's lowest performing schools. The school board is expected to vote on the proposal sometime in Spring 2002.

School Construction Privatization

A new federal public-private partnership program designed to spur school construction took effect January 1, 2002. The program, which was part of the $1.35 trillion tax package signed into law last June by President Bush, allows private for-profit companies to use tax-exempt bonds to build and repair schools and lease back the facilities to a school district. The locality would take over ownership of the facilities upon maturity of the lease and the debt. Each state is authorized to issue the greater of $10 per capita or $5 million in private-activity debt annually for this purpose without having to gain voter approval. That adds up to an annual bond capacity of about $2.8 billion nationwide.

According to *The Bond Buyer* at least one local school district is seriously considering the new public-private partnership program. Fairfax County, Virginia, with 165,000 students and 234 schools, is taking a hard look at whether the new program makes financial sense. The county has about $1.7 billion in school construction and renovation needs, while its available funding reaches only about a third of that.

"In our case, we are very much desperate for additional sources of revenues," said county school superintendent Daniel Domenech, who has established a committee to look at alternate funding sources for the county's schools. "This public-private partnership concept fell right into that category." "The bottom line here is, is it financially attractive to us?" he said about the program. "The point is, from a cash-flow perspective, is the annual lease payment going to bring about any kind of relief for us as opposed to an annual debt payment on bonds? In essence you're just trading a payment of a lease for a payment on debt service on a bond."

One of the most attractive features of the program is that the private company pays the up-front capital costs and completes the construction quicker than the county could. A developer might build a school in two years, while it typically may take a school district seven to ten years, he said. Part of the reason it takes school districts longer to build, is that bonds first have to be approved by voters. Approval at the ballot box would not be required under the new program.

In a variation on the tax-exempt bond financing approach, in 2001 LCOR Incorporated and the D.C. Public Schools (DCPS) partnered to build the James F. Oyster Bilingual Elementary School in Washington, D.C. The school was constructed and financed at no cost to taxpayers through an innovative, community-initiated public/private development partnership between LCOR, a national real estate company, and the school system. The Oyster School public/private partnership was initiated and facilitated by the 21st Century School Fund, a Washington, D.C. based nonprofit working to improve urban public school facilities with support from the Ford Foundation.

Under the terms of the development partnership, school construction costs—financed by an $11-million, 35-year tax-exempt bond package issued by the District of Columbia—will be repaid entirely from new revenue generated by a 211-unit apartment building being developed by LCOR on land adjacent to the school. The apartment building site was previously part of the school's 1.67-acre property but traded to LCOR under the partnership agreement. The net effect is that D.C. taxpayers incurred no costs

The War on For-profit School Management

By Diallo Dphrepaulezz

The parent-led fight to save the Edison Charter Academy in San Francisco marked a new chapter in the school-choice revolution. Parents' efforts sent a message that not only do they refuse to continue to send their children to substandard government schools, they also refuse to allow the school district to destroy market-driven alternatives like for-profit education management organizations (EMO).

As a result, in June 1998, under the state's charter school law, the board granted a charter to New York-based Edison Schools, Inc. (Edison), effectively turning over management of then-Edison Elementary School (coincidentally of the same name). When Edison took over, the school was renamed Edison Charter Academy (ECA). Though privately managed, ECA is a public school.

Before the San Francisco school board granted the charter, Edison Elementary School was one of the most notable failures in the district. The school went through two "reconstitutions," a process by which all personnel are vacated and must reapply for their positions. Student test scores were among the worst in the state. Former principal Ken Romines recalls that "violence was so commonplace, students expected to get hurt or hurt others, and they said so."

Ironically, ECA's successes grew to threaten the core of the public system that created the failure in the first place. Within two years, Edison's black and Latino students, who make up 80 percent of the student body, were posting impressive gains on the state's Academic Performance Index (API). Despite this, board members maintained a clear ideological opposition to the for-profit management of public schools. As declared by board member Mark Sanchez, "I am philosophically against a [for-profit] corporation running a school."

The Charges

In February 2001, the board passed a resolution stating that it had received complaints "that Edison might have materially violated its charter." Through the Office of the Superintendent, the board commenced a 90-day investigation into Edison and ECA. The board specifically alleged violations in the following areas: teacher turnover, charter governance, bilingual education, student performance, discrimination against low-income, special education, and black students.

Former principal Ken Romines described pre-charter teacher turnover as "excessive—50 to 70 percent" left every year of his two-year tenure. Teacher turnover at ECA was an admitted internal issue, but at the time of the charges all but one teacher signed the petition to renew the ECA charter. ECA replaced its bilingual program with an English immersion model, a method now endorsed by Superintendent Arlene Ackerman. With respect to charter governance, the district received minutes from required meetings of the ECA governing board and never investigated further. Comparing Academic Performance Index (API) results for the 1998–1999 and 1999–2000 school years, ECA's API scores improved at a greater rate than all but two of the district's 73 elementary schools. While ECA API scores dropped significantly in 2001, they still remained higher than pre-charter scores.

ECA's disappointing 2001 API scores are the culmination of three primary factors. The site administration and teaching staff had all been under the intense scrutiny of the district administration since coming in to manage the public school. Of 33 teachers, 23 were first year (70 percent) and all hiring occurred in July and August. The constant press tours and attention to outside inquiry as a result of the school board's charges against ECA were a major disruption at the school site.

Racial and low-income concentrations at ECA were no different than schools in the area and remain in excess of 80 percent. There were no names, no complaints, and no evidence to support the board's charges. The district also failed to bring any evidence of financial mismanagement against ECA, following a lengthy probe of its records.

In July 2001 the San Francisco school board made a deal with Edison permitting it to apply for a state charter or face definite revocation at the local level. The board's willingness to strike a deal after charging racism and fraud exposes the board's meritless charges as nothing more than a ploy to deliver a political victory for anti-charter forces in San Francisco. The state board unanimously granted Edison a five-year renewal charter.

Parents Unite and Fight to Save ECA

What began as a couple of loosely-organized meetings quickly blossomed into an organized parent committee dedicated to saving ECA. Calling themselves "Parents to Save Edison Charter," these parents showed up en masse at board meetings and launched an English-Spanish Web site at www.edisonaction.org. Their collective voice and faces began appearing in local and national media recasting the controversial issue as a grassroots movement against an oppressive school board that put ideology before the needs of children. Nothing better captured the spirit of their resolve than the motto printed on t-shirts and banners at a parent-organized march, reading "Nuestros hijos. Nuestra decisión." (Our children. Our decision.)

Across the country, school boards, teacher unions, and activists have been fueling a culture of resistance to the for-profit EMOs. In many cities for-profit EMOs face union pressure on teachers to leave EMO schools, followed by constant administrative hassles from school district headquarters, keeping school site administrators mired in menacing administrative communiqués. In San Francisco and New York tactics included meritless charges of racism, and frivolous litigation was pursued in Philadelphia. Variations of this pattern against Edison Schools, Inc. also appeared in Texas, Michigan, and North Carolina.

Ironically, the usual suspects that have for years decried the plight of underachieving minorities now find themselves at odds with those same groups. While these minority groups are demanding choice in education, particularly charter schools, the anti-parental choice advocates are fighting to keep minority children locked in failing public schools. They had better decide whose side they are on in the new era of school choice—it's either the parents and children or the unions.

to build the new school—the first D.C. public school to be built in 20 years.

LCOR's senior vice-president John Stainback considers the Oyster School development and financing approach to be a prototype for many other schools across the country. "The Oyster approach is innovative, but it's also highly replicable," he said. "Government entities, including school districts across the country, own trillions of dollars of land, a significant part of which is underutilized. Projects such as this one offer a way for governments to unlock the value of their underutilized land."

Alabama School Outsourcing Survey

By Dr. John Hill

In 2001, the Alabama Policy Institute contacted 123 of the state's 128 school districts to identify what inroads outsourcing has made in three support services: maintenance, student transportation and food services. Last fiscal year, Alabama's elementary and secondary schools faced a budget shortfall of approximately $200 million. Moreover, the threat of additional budget cuts is looming should revenues continue to fall short of state budgets.

Of the more than $4.04 billion projected for Alabama's education budget for FY 2001—2002, about 20 percent—$807.8 million—was spent on non-education support services. If significant savings in these services were realized via outsourcing, potential shortfalls in revenue could be averted, and more funds could be directed toward instructionally focused programs.

Some of the findings

Maintenance Services

Approximately 27.6 percent of all districts contract out at least one type of maintenance service. Districts outsourced 12 different maintenance services, including HVAC maintenance, groundskeeping and janitorial services.

Several school districts saved money by outsourcing grounds keeping. On average, districts that fully outsourced their groundskeeping saved 25 percent. An across-the-board saving of only half of this amount through outsourcing would result in savings of approximately $2.7 million per year.

Transportation

According to the Alabama State Department of Education, approximately 390,131 students rode some form of public transportation to school, at a cost to the state of $180.9 million.

On average, school districts in Alabama that earmark money to transport students during spent about $602 per rider. Ten districts in Alabama contract out some or all of their transportation services. While districts that outsource transportation comprise only about 8 percent of all districts, they represent three of the state's 10 districts with the lowest per-student rider costs.

A study by economists at Ball State University estimated that the costs for public ownership of school bus services can be as much as 12 percent more costly than contracting. If Alabama's $180.9 million school transportation service could realize only half that savings, an additional $10.8 million could be redirected to the classroom.

Food Services

Of the three support services examined in this report, food services were the least commonly outsourced in Alabama. Only two of the state's school districts—Alexander City and Brewton—outsourced their food service, far below the national average of about 17.5 percent. Although only these districts outsource any portion of their food service, they enjoy the lowest costs per student for food service in the state. Brewton's savings are particularly interesting, as the district only contracts out its high school food service, yet it keeps its cost per student extremely low.

Alexander City saved about 27.8 percent annually by outsourcing its food service. If other districts of at least the same size could obtain similar savings, a total of $17.7 million could be saved.

Conclusion

At present, less than 5 percent of spending on support services in Alabama goes to outsourced services. Properly designed and monitored, increasing the number of contracts with private providers could save Alabama's public education system tens of millions of dollars annually. ❑

The number of for-profit companies managing public schools in the United States soared 70 percent in the past year., according to data compiled by the Education Policy Studies Laboratory at Arizona State University.

Chapter 6

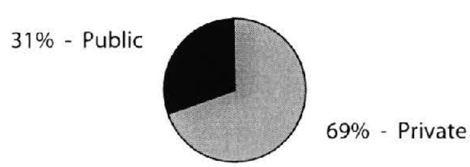
Environmental Services

Solid Waste

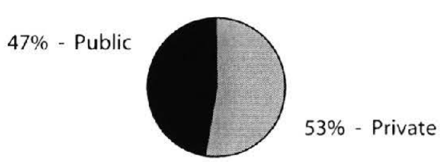
The U.S. solid-waste industry generated more than $43 billion in revenue in 1999, according to a comprehensive study by the Environmental Research and Education Foundation. The private sector generated approximately 76 percent of the industry's total revenues.

The study, conducted by R.W. Beck and Chartwell Information Publishers, found that of the estimated 27,000 operating solid-waste organizations, 55 percent are in the public sector and 45 percent are private companies.

Figure 6-1: Share of Municipal Solid Waste Managed (tons)



Ownership of Solid Waste Facilities



Source: RW Beck and Chartwell Information Publishers

Of the 15,740 solid-waste facilities in the United States, private companies own 53 percent of them. Private companies also manage nearly 70 percent of the tons of waste generated in the United States.

Flow-control/Carbone Update

Seven years ago, the U.S. Supreme Court ruled in the *Carbone* case that flow control, as practiced in the town of Clarkstown, NY, violated the Commerce Clause of the U.S. Constitution. Various congressional attempts to overturn the Court ruling have failed in years past. However, some lower courts have begun to whittle away the Court's ruling.

The latest occurs in *United Haulers Association v. Oneida-Herkimer Solid Waste Management Authority.* Oneida-Herkimer, a public solid-waste authority, operates a municipal solid-waste landfill and had initiated a flow-control ordinance, until challenged by the haulers. The Second Circuit Court of Appeals determined that the *Carbone* decision only applied to privately owned facilities, overturning a District Court ruling that the ordinance violated the Commerce Clause.

In January, the Supreme Court declined to hear the case. One day after, Madison County, NY, reinstated their flow-control ordinance, based on the decision. The new law will require haulers to take all solid waste generated in the county to the Madison County landfill. The law took effect on February 1.

The county predicts upwards of $500,000 a year in additional revenues. Before the ordinance, many haulers were transporting waste out of the county for $30 a ton. Tipping fees at the Madison County landfill is near $62 a ton, doubling costs to haulers, which will eventually be passed onto consumers.

Water/Wastewater

Privatizing water and wastewater facilities continues to boom internationally as well as in the United States. At the same time, opponents of privatization have stepped up their efforts and rolled out new tactics in the public debate.

A few examples give the flavor of expanding U.S. privatization in this sector. In Pawtucket, New Jersey a nearly year-long privatization process left the city council with a pair of options that will save the average city household $100 on its water bill. Pawtucket must have a new water treatment plant to meet federal safe drinking water standards that take effect over the next eight years, and if the city were to build and operate the new plant itself it would require a 40-percent rate hike that would increase the cost of water for the average household from $171 to $274 a year. Instead, the city decided to invite private firms to offer alternate solutions. Four companies bid, and the two finalists, USFilter and Earth Tech, gave the city a choice between two approaches, each of which would mean raising the average annual household water bill to $175.

Design-Build-Operate (DBO) contracts are an exploding part of U.S. water and wastewater privatization. In July, Houston approved a deal with Montgomery Watson Inc. to manage the financing, building and operating of a new 40-million gallons daily water treatment plant and trunk lines for $104 million over a ten-year contract with two five-year renewal options. U.S. Water will operate and manage the plant once it is completed in early 2004. The deal includes a $2-million concession fee up front and will cost the city 35 percent less than building and running the plant itself, according to *Public Works Financing*. In the smaller city of Richmond, California, a 20-year DBO partnership with USFilter to upgrade and operate the city's 16-mgd wastewater treatment concluded in December gives the city the guarantees and cost savings it wanted. Privatization will save city residents $25 million from the costs bid by the city wastewater staff and $21 million from the cost of a bid by the East Bay Municipal Utility District.

Report Calling for Increased Subsidies Generates Opposition

In February 2001, a coalition of groups led by the National League of Cities (NLC) proposed that Congress create a new $57 billion program to help local water systems meet their infrastructure needs. Citing an estimated $1 trillion for treatment plants, distribution systems, and wastewater collection systems over the next 20 years, the Water Infrastructure Now (WIN) proposal would provide grants, loans, loan subsidies, and credit assistance to help cover the expected $23 billion funding shortfall.

The final recommendations of the WIN Coalition were endorsed by several influential water organizations, such as the Association of Metropolitan Water Agencies (AMWA), the Association of Metropolitan Sewerage Agencies (AMSA), and the American Water Works Association (AWWA). However, not all groups have jumped on board. The National Council for Public Private Partnerships (NCPPP) declined to endorse the recommendations, on the grounds that the proposal does not go far enough in the area of promoting partnerships and outsourcing as solutions to the infrastructure problems. NCPPP Executive Director Rick Norment said the report failed to recognize some of the innovative solutions that already exist to help meet the nation's water infrastructure needs, such as privatization and public-private partnerships (P3s). "The enormous creativity and flexibility [of] P3s needs to be brought to the forefront so that new solutions can germinate, take root, and flourish," Norment commented.

A number of other groups that participated in the WIN report process have either declined to endorse the recommendations or have listed serious hesitations that echo many of NCPPP's concerns. These groups include the Association of State Drinking Water Agencies, Clean Water Action, the National Governors Association, the National Association of Water Companies, and the Water Wastewater Equipment Manufacturers Association.

In response to a request from the General Accounting Office (GAO), Reason Public Policy Institute replied to a series of questions prompted by the Senate Environment and Public Works Committee's request for a study of water/wastewater infrastructure needs. This study, released in February, is a direct reaction to the WIN recommendations, and calls for substantial grants for utilities to address infrastructure needs over the next five years.

The outlook for adoption of the WIN proposal is uncertain. Economic conditions are cooling, and pressures to hold the line on federal spending are increasing, so it may be difficult for such a federal grant program to pass Congress. ❑

Nader's Campaign Against Water Privatization

A new force in the public debate over privatization of water utilities emerged in 2001 as Public Citizen, a group founded by Ralph Nader, launched well-planned media campaigns against specific water privatization projects and issued white papers critical of water privatization in general.

Their public attack on water privatization began in September 2001 when they weighed in on the proposed privatization of New Orleans's water system, and followed up in October with a media blitz on the proposed privatization of Stockton, California's water system, and the release of their main white paper—*Water Privatization: A Broken Promise*. You can view their reports and press releases at www.citizen.org/cmep/water/.

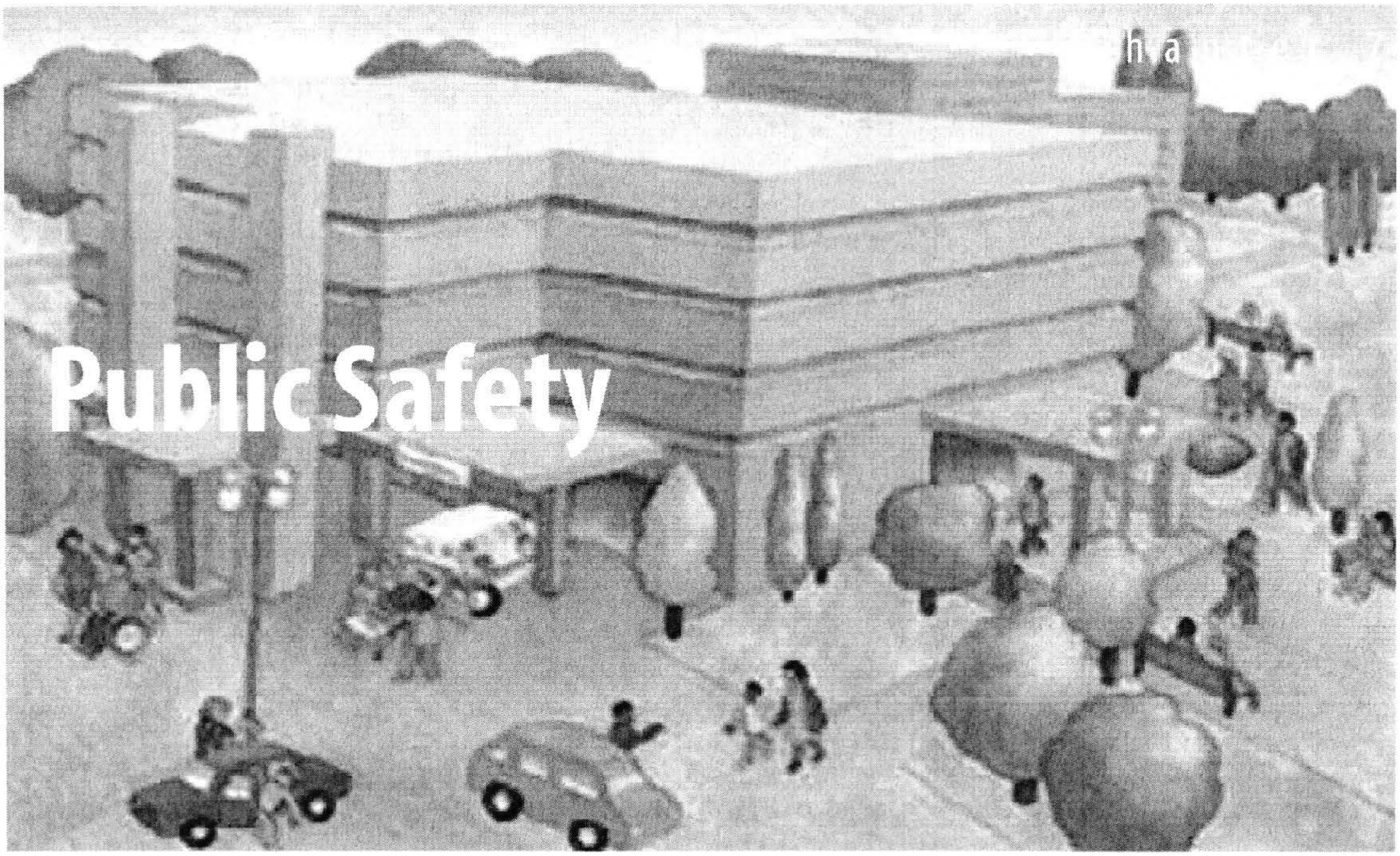
Public Citizen has taken two main approaches in its attacks:

- *"Background Checks"* on the corporations competing for water privatization contracts, which basically catalogue every press report critical of any of these companies ranging from alleged financial misdealings to worker complaints. Very few of the stories reported are substantiated in any way beyond the initial press reports.
- *Water Privatization: A Broken Promise*, in which Public Citizen examines 13 case studies of water privatization where something went wrong, or in some cases allegedly went wrong, and build its arguments that privatization is risky, it can backfire, and therefore public officials ought to think twice before they privatize.

Their case is surprisingly weak, even to a long-time researcher in water privatization. Their anecdotes of water privatization failures include such non-controversial events as government officials granting rate increases. Their inability to find a set of anecdotes of true failures of privatization is actually encouraging for privatization.

The Public Citizen report also suffers from lack of context—it does not discuss how many water privatizations occur and thus at what rate the "failures" it discusses occur. In fact, roughly 15 percent of the U.S. population is served by privately owned water utilities, and over 1,000 government-owned water systems have been privatized in some fashion to bring about private management and operations. In that context, Public Citizen's "exposé" is in fact a ringing endorsement of the success of water privatization.

Public Citizen's arguments do highlight one important lesson, though, by reminding us that privatization is just a tool, not magic. It works if it is done right; it may not work if it is not done right. Reading Public Citizen's case studies of "failures" does expose some poorly written contract language and reinforces that the government represents the consumers in privatization, and they have to be diligent in crafting arrangements that serve the customers. And the track record on the whole of success of water privatization indicates that most water privatizations do serve the customers well.



Public Safety

Emergency Medical Services

The 1990s were a tumultuous decade for public and private officials seeking to privatize ambulance services. Public officials had hoped that local battles among providers early in the decade would bring greater competition and better services. However, consolidation and changes in reimbursements in the mid-1990s altered the landscape. Now, a new decade brings new models that offer viable alternatives for achieving market-based solutions, although continuing reductions in reimbursements present financial challenges for private EMS.

The 2000 *Journal of Emergency Medical Services* (*JEMS*) survey of the 200 largest municipalities in the nation found that 188 have fire departments that provide first response for medical emergencies. For medical transportation provided by organization type, the results were:

- 34.5 percent private for-profit;
- 34.0 percent fire departments using multi-role personnel;
- 12 percent third-service agencies;
- 5 percent private nonprofit agencies;
- 5 percent fire departments using single-role personnel;
- 5 percent public utility model;
- 3 percent hospital-based services; and
- 1 percent volunteer.

Industry Trends

Changing conditions in the marketplace also have influenced the way emergency medical services (EMS) are provided. For one thing, many ambulance firms consolidated in the past decade. Previously, the market was fragmented and decentralized with a large number of "mom-and-pop" operations. Small ambulance firms still exist in some markets, but a large number have been bought out by larger firms. The current trend began in 1992, when four ambulance companies merged into American Medical Response (AMR). Then, in 1997, AMR and another major provider, Laidlaw, merged, narrowing the market down to two national firms: AMR and Rural/Metro.

Also, in the mid-1990s, the federal government began to tighten reimbursements for Medicare, a large source of funds for ambulance providers. In July 1998, Medicare rules for reimbursement changed, so that ambulance firms must now seek reimbursement from the relevant skilled nursing facility and not from Medicare directly. The frequent delays in federal reimbursements disrupted the cash flow to private providers, and made it difficult for them to operate. With Medicaid one of the state expenditures increasing most rapidly, many states are also cutting reimbursements to local health care providers. According to industry observers, further reductions in reimbursement levels from Medicare and Medicaid represent a threat to the continued viability of private sector delivery.

The Rise of EMS Privatization

According to a 1997 survey by the International City/County Managers Association (ICMA), approximately 16.3 percent of cities nationwide have privatized ambulance services. In a similar 1988 ICMA survey, ambulance services were not privatized by any responding cities. Such dramatic growth may not be consistently sustainable over the long term, but the results from the ICMA surveys indicate the potential for growth in the future.

Performance

According to the *JEMS* survey, several performance-related issues suggest that private EMS offers better quality and efficiency. For example, private for-profit agencies have the greatest number—66 percent—of providers subject to external reviews. Seventy percent of private agencies have defibrillation devices (used for heart attacks), compared to 40 percent of fire departments. More private agencies (48 percent) are using advanced technology than fire departments (20 percent).

Several performance-related issues suggest that private EMS offers better quality and efficiency.

Private EMS providers also can provide services less expensively than fire departments. Competitive paramedic wages and benefits are typically 25 less than for firefighters.

In addition, private agencies are moving to performance-based systems faster than fire departments. Finally, they also are making better use of technology and accessing advanced equipment more quickly than public agencies—and enhanced technology promises to increase efficiency and save lives.

For example, American Medical Response (AMR) announced in June, 2001, that it is providing to all ambulances in two California counties a communications system that promises to shorten response times, therefore potentially saving more lives. The communications system, called an Automatic Vehicle Locator (AVL), uses low-frequency radio waves that bounce off atmospheric dust particles to pinpoint the locations of both accident sites and ambulances in the area. Dispatchers can thus quickly identify and contact the closest emergency response vehicle and send that crew to the accident site.

Outlook

While the competition between private ambulance firms and fire departments abated somewhat during the mid-1990s, things are heating up again, as private firms and fire departments do battle for ambulance services in large cities such as New York City.

A hybrid approach is being used in some cities, with evidence of success. Chicago and Los Angeles, for example, use private providers who work in conjunction with fire departments to assure more rapid response times and lower per capita EMS costs.

Hybrid Public-private

In 1997, San Mateo County in California and AMR formed San Mateo County Hospital Advanced Life Support Services. Under this public-private partnership, public fire agencies provide the first-response paramedics, and AMR provides a second medic via ambulance as well as all the medical supplies, equipment, training, and clinical oversight for both the public and private medics. Both the fire departments and AMR are subject to fines for non-performance under the terms of the performance-based contract, and AMR shares revenue with the fire departments for first response. Since the program's inception, San Mateo County has increased its number of licensed and certified paramedics from approximately 60 to more than 220. Fire department paramedics are responding on time in nearly 98 percent of emergencies; private paramedics are responding on time in 95 percent of emergencies.

Managed Competition

Last year, Pinellas County officials in Florida conducted a managed competition for EMS services, which was won by a private bidder over a variety of public and private competitors. Among the benefits that this private provider brings to the county are:

- Emergency response times that have been reduced by 30 seconds, with 90 percent reliability;
- Non-emergency response compliance that has been increased from 90 percent to 95 percent;
- Only paramedics providing pre-arrival lifesaving instructions over the phone to 911 callers with medical emergencies;
- Upgraded equipment and software in the dispatch/communications center;
- An Accredited Center of Excellence Award for the provider's (Sunstar's) communications center (only the 34th issued in the world);
- Ambulance vehicles that are replaced every five years; and
- Savings for Pinellas County between $13 million and $21 million over the next 11 years.

Conclusion

Private ambulance firms that survived the 1990s face new challenges and opportunities in the 2000s. Data show that private firms perform better, have faster access to technology, and are more cost-effective than public agencies. However, the financial viability of private sector EMS is threatened by continued reductions in Medicaid and Medicare reimbursements. As shown above, new strategies are emerging that ensure a role for private firms in cooperation with public agencies. Such partnerships may be the trend for the future.

Corrections

The total capacity of private prisons in the world increased slightly in 2001 to a total of 142,521 beds, according to the Private Adult Correctional Facility Census at the University of Florida. The increase represents a less than 1 percent increase in capacity over last year. This reverses a one-year setback in overall private prison growth. However, capacity in the United States declined from 119,453 in 2000 to 119,023 in 2001, a difference of 430 beds or just .3 percent.

Department of Justice Classifies Jobs as Commercial

The Justice Department classified 7,256 federal prison guard positions as commercial jobs in their annual inventory of jobs. Commercial jobs are federal jobs that could be done by contractors. It's the first time the department included its force of security guards for low- and medium-security federal prisons.

Despite the classification, the Justice Department said that it has no immediate plans to subject its prison guard jobs to contractor competition. Under the 1998 Federal Activities Inventory Reform Act (FAIR), federal agencies are required to publish an annual inventory of jobs.

Supreme Court Rules on Prison Liability

On November 27th the U.S. Supreme Court, in a 5-4 vote, refused to hold corporations under contract with the federal government liable for constitutional violations in *Correctional Service Corporation v. Malesko* 122 S.Ct. 515 (2001). The case involved a federal inmate and a private contractor with the U.S. Bureau of Prisons (BOP).

Malesko, the inmate, was housed on the fifth floor of the Le Marquis Community Correctional Center, a halfway house operated by Correctional Service Corporation (CSC). A CSC policy required inmates that lived below the sixth floor to use the stairs to reach their rooms. Malesko was exempted from this policy because he suffered from a heart condition limiting his ability to climb stairs. But when a CSC employee forbade him to use the elevator, he was forced to use the stairs, had a heart attack, and fell.

The District Court treated the complaint as raising a "cruel and unusual punishment" (Eight Amendment) claim under *Bivens v. Six Unknown Federal Narcotics Agents*, 403 U.S. 388 (1971), in which the Court recognized "an implied private action for damages against federal officers alleged to have violated a citizen's constitutional rights." In dismissing the suit, the district court relied on the Supreme Court's decision in *FDIC v. Meyer*, 510 U.S. 471 (1996)—"a *Bivens* action may only be maintained against an individual" and thus cannot be brought against a corporation.

The U.S. Court of Appeals for the Second Circuit reversed this decision in part citing that while *Bivens* applied to federal agents and not to federal agencies (via *Meyer*), it should be extended to private entities to "accomplish the important *Bivens* goal of providing a remedy for constitutional violations."

The main issue the court had to determine is whether *Bivens* "should be extended to allow recovery against a private corporation operating a halfway house under contract with the Bureau of Prisons."

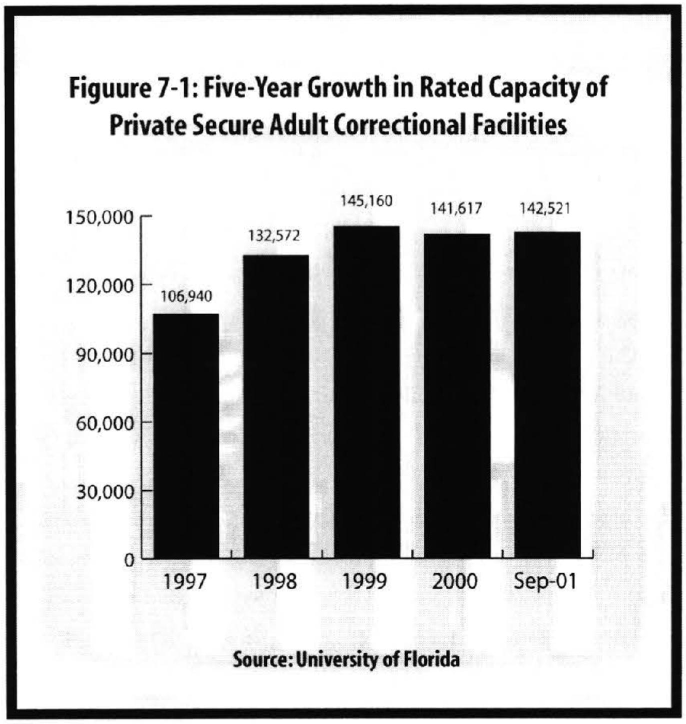
In the opinion of the Court, Chief Justice Rehnquist argued that Malesko's claim is fundamentally different from any other application of *Bivens,* and that the purpose of *Bivens* is to deter individual federal officers from committing constitutional violations. In *Meyer*, the court noted that threats against agencies did not carry the same type of deterrence. "If we were to imply a damages action directly against federal agencies...there would be no reason for aggrieved parties to bring damages actions against individual officers. The deterrent effects of the *Bivens* remedy would be lost."

Rehnquist further states that there is no reason to extend *Bivens* to include this remedy. *No federal prisoners* enjoy this remedy—if a prisoner in a BOP facility alleges a constitutional deprivation, his only course of action is against the offending individual officer (subject to the defense of qualified immunity). The prisoner cannot bring a *Bivens* claim against the officers' employer—the United States or the BOP. "Whether it makes sense to impose asymmetrical liability costs on private prison facilities alone is a question for Congress, not us, to decide."

In sum, Malesko sought an extension of *Bivens*. The Court concluded that the extension would not advance *Bivens'* core purpose of deterring individual officers from violating prisoners' constitutional rights. Therefore, the judgment of the Court of Appeals was reversed.

2001 Brings Canada's First Correctional Privatization

The Ontario Ministry of Correctional Services awarded the first private prison contract in Canada to Management and Training Company (MTC), to operate the 1,184-bed Central North Correctional Centre (CCNC) in Penetanguishene, Ontario. CCNC is a multi-purpose facility, consisting of six units of 192 beds for male accommodation, and a separate 32-bed unit for females. The C$85 million maximum-security facility began accepting inmates in a phased-in approach on November 10.



The estimated total value of the five-year contract is C$170.8 million. MTC will be paid C$90 a day for each inmate—C$40 less than a public institution costs taxpayers in Canada—a savings of 69 percent. In accordance with new legislation (the Corrections Accountability Act, which became law in June), the Ministry created a Board of Monitors, consisting of six local residents, to watch over the "super jail." The Board will act in an advisory capacity to the Minster to help ensure accountability.

MTC will also operate a new inmate programming initiative at CNCC. Under the prison industries program, which is a requirement of the contract, inmates will learn skills such as carpentry, power-tool use, blueprint reading and computer-aided design. Grant Forest Products is the first private-sector partner to join MTC's new training initiative. They donated panel products for flooring, roofing, and siding as well as seeking out other partners for the program on behalf of MTC.

Airport Security

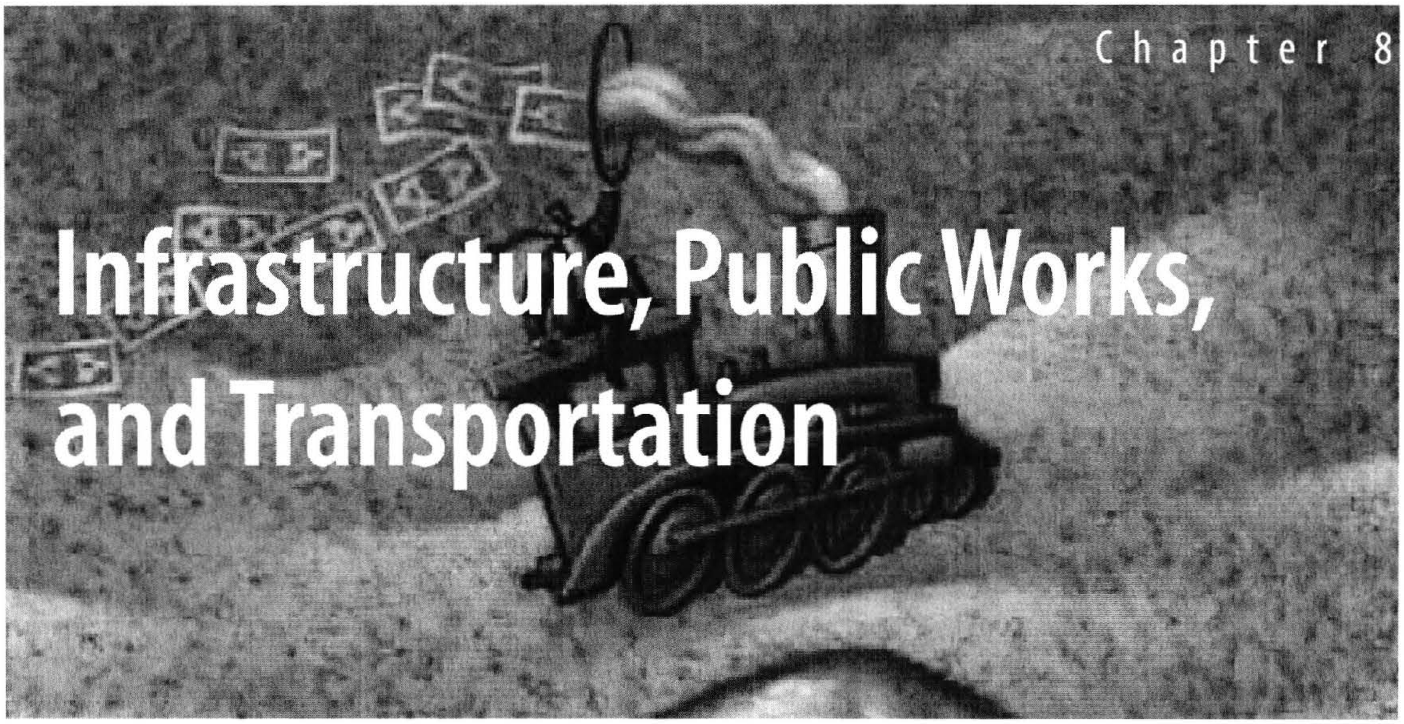
For the past two decades, passenger screening at commercial airports has been the responsibility of whichever airline had the largest role at each concourse. Since airlines compete fiercely, they sought to minimize the cost of screening, as they did all of their operating costs. Hence, they outsourced this function to private security companies. But since the Federal Aviation Administration set virtually no standards for screening, the result was low bidders paying minimum wage and suffering very high turnover. Though far from perfect, that system worked reasonably well in preventing hijackings—until September 11. Even then, passenger-screening companies did not fail; the terrorists' box-cutters were legal to bring aboard, under then-current FAA guidelines.

Most European airports have been corporatized or privatized over the past decade or two. Most of these airports have decided to outsource significant portions of security, especially passenger screening.

Europe has evolved a different approach. Most European airports have been corporatized or privatized over the past decade or two. Airlines do not have substantive roles in operating terminals or portions of terminals. Hence, all airport security is the responsibility of the airport companies, under oversight from their respective national transport agency. This provides for a far more integrated security approach. In carrying out their security responsibilities, most of these airports have decided to oursource significant portions of security, especially passenger screening. But with high standards and tough oversight, the results have been high-quality workforces and greater use of advanced technology for things such as baggage inspection.

In the wake of the 9/11 terrorist attacks, the American Federation of Government Employees put forth a plan to have the federal government take over passenger screening and some other airport-security functions. With little debate, that plan passed the Senate by 100 to 0. Subsequent House debate brought to light the fact that at 32 of the 34 largest airports in Europe and Israel, passenger screening is outsourced, with excellent results. The House bill embraced this high-standards outsourcing approach, and was passed by a two to one margin. The final Senate-House compromise provides for a federal takeover of passenger screening in 2002. But it permits five airports to opt out initially, and all others after two years of federalized screening.

As of early 2002, there is discussion within aviation circles of asking Congress to revisit this issue prior to full implementation of federalization. It appears that far more than five airport directors would prefer to opt out, and it is noted that an experiment involving only five out of 429 airports involves too small a sample size to be meaningful. ❑



Chapter 8

Infrastructure, Public Works, and Transportation

Airport Privatization

Global Trends

The decade-long global trend of airport privatization continued apace for most of 2001, but was interrupted by the events of 9/11, which put a number of pending privatizations on hold.

The largest airport sale in 2001 was the initial public offering of shares in Fraport, the company that owns Germany's Frankfurt Airport. The Initial Public Offering (IPO) of 29 percent of the company, in June, valued it at $2.68 billion. Fraport planned to use the proceeds primarily for adding a third terminal and fourth runway at Frankfurt, as well as for expansion overseas. Fraport has a joint venture with Amsterdam's Schiphol Airport (called Pantares) for global airport operations; it also announced a joint venture with shopping center firm ECE called Airport Retail Solutions.

Elsewhere in Germany, the two former competing consortia (headed by Fraport and Hochtief, respectively) for a 50-year concession to rebuild and operate the former Schonefeld Airport as the consolidated airport for Berlin received government permission to merge and negotiate the final terms for the nearly $2 billion investor-funded project. Late March saw the opening of the new $2 billion Athens airport in Greece, developed and operated by Hochtief, which provided 45 percent of the capital (with the balance by the Greek government).

Several other planned privatizations in Europe were delayed by airline woes following the 9/11 terror attacks. Zurich Airport, in which the Swiss government reduced its ownership from 78 percent to 50 percent at the end of 2000, did not have a planned further share offering in 2001, as its business plan was devastated by the collapse of its major carrier, Swissair. And planned IPOs of Amsterdam Schiphol and Milan's SEA (of which 30 percent was to have been offered) were postponed following 9/11.

Also hit by the airline slowdown were several other planned privatizations. The share offering for Mexico's Pacific Group of airports was deferred into 2002. And even in far-off Australia, the planned sale of Sydney's Kingsford Smith Airport was put on hold. Three consortia had been shortlisted by August, and the sale had been expected to yield a bit over $2 billion. On the other hand, at year-end the financing of Manila's $440 million Terminal 3 project was approved. Fraport owns 30 percent of the company that won the 25-year build-operate-transfer (BOT) concession.

A number of other transactions moved forward successfully during the year. In Europe, Cyprus shortlisted five consortia in December for a 20-year, $300 million concession to extend runways and expand terminals at its two main airports. On September 10, BAA, a private airport operator, was selected by Oman's government for a 25-year concession to expand and operate that country's two main airports. In this hemisphere, the Vancouver Airport consortium won the 30-year concession to expand Jamaica's Montego Bay Airport. And in Peru, a Fraport/Bechtel consortium won a 30-year concession to expand and operate the Jorge Chavez International Airport in Lima. At year-end, they announced the possibility of adding a new runway.

U.S. Developments

The largest airport privatization news of 2001 was the opening, in May, of Terminal 4 at JFK International Airport in New

York. The $1.4 billion project was developed and will be operated by a private consortium composed of LCOR, Schiphol USA, and Lehman Brothers. It was built over and around the former International Arrivals Building, now demolished. With 1.5 million square feet and 16 gates, Terminal 4 serves 37 airlines, mostly international but including U.S. carriers ATA, Continental, and Northwest. A possible $1.6 billion expansion for Delta Airlines is being negotiated. The consortium holds a 25-year BOT concession from the Port Authority of New York and New Jersey. Terminal 4 is the first use of this privatization method in U.S. airports.

Another privatization success story is Orlando's Sanford International Airport. This former Navy base northeast of Orlando has captured a major share of the U.S./U.K. charter market by offering low landing fees and no-hassle passenger processing, in competition with the giant Orlando International Airport. Sanford is operated under long-term contract by TBI Airport Management, a global airport firm based in the United Kingdom. TBI built and owns the international terminal, and operates both it and the domestic terminal. The airport's passenger traffic increased by 21 percent in 2001, to a new high of 1.3 million.

Elsewhere, however, the airport privatization news was not so positive. The second (of a potential five airports) applicant in the federal airport privatization pilot program was rejected by the Federal Aviation Administration in November. Niagara Falls, New York had submitted its final lease agreement with Cintra late in 2000, and expected routine approval (as had occurred for New York's Stewart Airport in April 2000). But local political opposition delayed the FAA's decision until after September 11th, and in light of the depressed state of the airline industry at that point, the agency rejected the privatization plan as unlikely to succeed in attracting airline service to the former military base. Earlier in the year, Puerto Rico had terminated its second attempt to privatize Rafael Hernandez, after a change of administration. And in October the San Diego city council failed to renew its development agreement with Diversified Asset Management Group (DAMG), under which the cargo-facilities firm was to have leased Brown Field and developed it into a major cargo airport. Opposition from private pilots and nearby residential areas turned out to be politically effective, after several years.

That left the fledgling federal pilot program, at year-end, with one completed privatization (Stewart) and one final application about to be submitted. The latter was the plan of the New Orleans Levee District to lease New Orleans Lakefront Airport. The District selected its winning bidder, American Airports Corporation, in September, and at year-end was close to completing negotiation of the 50-year lease agreement. It will then be submitted to the FAA, which is expected to act on it by summer 2002.

Air Traffic Control

Internationally, the momentum for converting air traffic control agencies into user-funded corporate entities continued in 2001. Several more countries took the initial step of separating ATC operations from other transport ministry functions such as safety regulation; among those taking this step were Denmark and Hungary. And local media in Singapore reported that investment banking firms had been asked to submit proposals to handle the corporatization of the Civil Aviation Authority of Singapore.

Perhaps the most dramatic news of the year was the "public-private partnership" for the U.K. National Air Traffic Services (NATS). Already a government corporation fully supported by user fees, NATS had limited ability (under U.K. rules for government entities) to raise capital for modernization. The Labor government put forth a controversial plan to sell 46 percent of NATS to private investors and give 5 percent to employees, retaining just 49 percent in state ownership. The plan finally took effect in July, with the 46 percent stake sold to the winning bidder, a consortium of the U.K.'s principal airlines. But shortly thereafter, the combined effects of recession and 9/11 led to a 20 percent decrease in North Atlantic traffic, and a 144 percent increase in military traffic (which does not pay user fees), putting NATS in financial difficulty. It announced significant spending cuts, and a several year delay in construction of the long-planned ATC center in Scotland.

Nav Canada celebrated five years of operation as of November 1st, but has also had to cut spending in the wake of 9/11. It drew on its rate-stabilization fund to partially offset the decline in user fee revenues, but also announced that it would rescind the temporary rate reduction that had been in effect since September 1999, as of January 1, 2002.

Here at home, the incoming Bush administration included a study of the overseas experience with ATC corporations in its 2002 budget proposal. And a detailed ATC corporation proposal from Reason Public Policy Institute was released in February with the endorsement of a dozen former top FAA officials, including four previous Administrators. The plan was discussed at length in aviation media and at sessions of key trade groups, including the Air Transport Association, the Air Carrier Association of America, and the National Air Transportation Association. But the driving force for serious ATC reform—the airspace capacity crunch and the inability of the FAA to resolve it—disappeared at least temporarily with the shrinkage of air travel in the wake of 9/11.

Meanwhile, internal reform of ATC moved slowly forward within the FAA. The Clinton administration's plan to reorganize the ATC portions of FAA as a "performance-based organization" is being carried out on two tracks. The agency itself has created a working group to set up the Air Traffic Organization (ATO) within FAA, and at year-end claimed to be close to hiring a chief operating officer to run the renamed entity. In parallel, the Air Traffic Services Subcommittee appointed by President Clinton as a quasi-board for the ATO finally received a modest congressional appropriation for staffing late in the year, and was expected to begin serious work early in 2002.

Highways and Toll Roads

There was no let-up in the global momentum of toll-funded BOT projects in 2001. Europe continued to see a new blossoming of the concept, which had first been used in the 1960s to develop the original toll motorway networks in France, Italy, and Spain. The largest single project currently under way is the $2 billion A86 tunnel project near Paris. Under a 70-year concession agreement, Cofiroute is developing twin tunnels, one 6.3 miles long for cars and another 4.6 miles long for trucks, to complete the missing link in this Paris ring-road. Two other concession agreements were finalized in 2001, a 78-year deal for the $275 million 2.5 km. Millau Viaduct on A75, and the $800 million, 125 km. A28 motorway.

BOT is getting off the ground in Germany's highway sector, as well. As of year-end, three BOT bridge projects were moving forward, with two already financed and under construction (in Rostock and Lübeck) under 30-year concessions, and a Baltic Sea bridge to connect Straslund with Rugen Island about to enter the bidding process. Other ambitious BOT toll-road efforts are under way in Greece where the government in 2001 launched a major effort to add or upgrade 630 km. of tolled motorway via BOT concessions, worth close to $1.7 billion.

In addition, both Spain and Portugal are making use of the "shadow toll" concept, for routes where there is insufficient demand to make charging actual tolls feasible. Under this approach, the state enters into a BOT concession agreement, under which the private firm finances, builds, and operates the highway, but the state provides an annual revenue stream based on the number of vehicle miles traveled. The shadow toll approach depends on the government having the funds to invest, but spread over the life of the project. It enables large projects to be done all at once, as long as government is willing and able to commit to paying for them over their lifetime. Shadow toll projects are also under way in Brazil, the Czech Republic, Ireland, and the United Kingdom.

In Asia, the biggest news of 2001 was the possible privatization of Japan Highway Public Corporation. Reformist Prime Minister Junichiro Koizumi has declared war on a whole raft of bureaucratic state-owned enterprises, including the four that develop and operate most of the country's toll roads and bridges—many of which are huge money-losers. A report by the Japan Initiative puts JHPC's debts at $86 billion, and projects them to grow to $380 billion by 2047. It says that JHPC has over-estimated traffic and been lackadaisical about costs, entering into sweetheart deals with favored contractors, etc. In November, Reuters reported that Koizumi had won agreement from all parties in the ruling coalition on his plan to privatize the first seven state corporations, including JHPC. As of April 2003, it will no longer receive government subsidies of more than $2 billion a year. Whether it and the other seven will actually be privatized remains to be seen. (In 1999, state toll-road corporations in Italy and Portugal were successfully privatized via public share offerings.)

The largest BOT tollway project in Africa was financed in August—the 381 km Bakwena Platinum Toll Highway. The $450 million project will build the N1 and N4 toll roads, ultimately linking South Africa's Pretoria with Maputo on the Indian Ocean and with Walvis Bay on the Atlantic coast. The actual N1 and N4 will extend only to the South African border in each case, connecting to other highways in Mozambique and Namibia. The principal overseas investors are Dragados and Macquarie Bank.

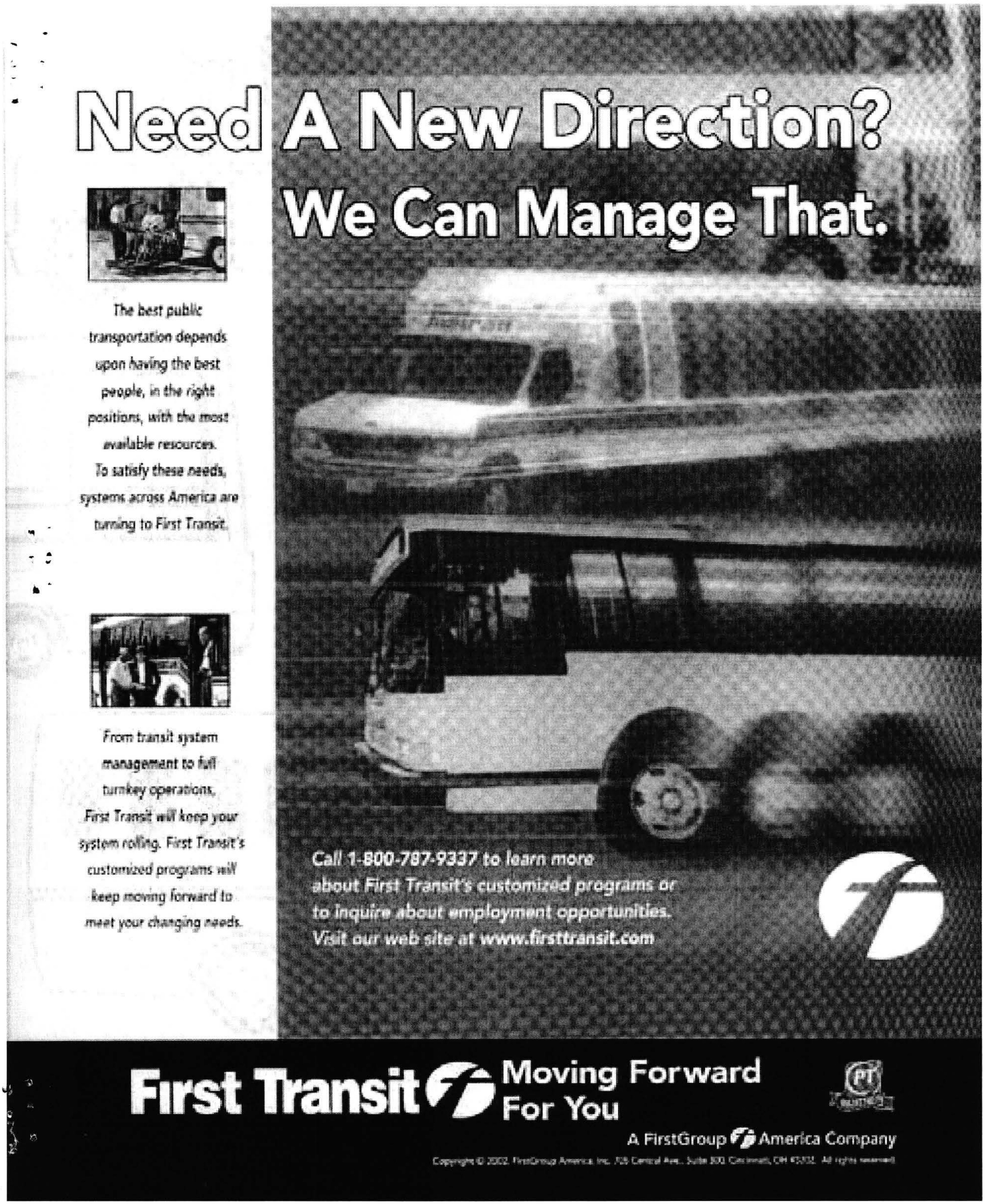
U.S. Toll Roads and HOT Lanes

Public-private Toll Road Partnerships

North and South Carolina joined Texas and Virginia as hotbeds of public/private toll road activity in 2001, with some activity and interest evident in several other states as well. February saw the opening of the 16-mile Southern Connector in Greenville, SC. The $190 million project forms part of a beltway around Greenville. The tax-exempt toll revenue bonds were issued by the Connector 2000 Association, a nonprofit corporation created specifically for this purpose under IRS ruling 63-20. The nonprofit contracted with developer Interwest, which also has a four-year contract for initial operation of the toll road.

Neighboring North Carolina enacted a privatization law in 2000 calling for a Pilot Private Toll Road program to test the private sector's interest. NCDOT suggested a dozen possible projects, and in mid-2000 it received two proposals, one for a Raleigh ring road and the other for a Catawba River toll bridge. It selected the latter, and at year-end was working to negotiate the franchise agreement. Meanwhile, the North Carolina legislature passed a bill to create a traditional state turnpike authority, with the power to issue toll revenue bonds and to enter into public-private partnerships. The legislation was inspired by a consultant study on the potential of toll roads to help cover a $1 billion/year shortfall between highway spending needs and available funding sources. Assuming the state senate approves the bill in 2002, NCDOT hopes its first project will be the 27-mile Gastonia Garden Parkway, a ring road around Gastonia, west of Charlotte's international airport.

Texas continues to have the largest volume of new toll-road projects. The Texas Turnpike Authority (a division of TXDOT) is developing the $3.2 billion Central Texas Turnpike Project, a set of four new toll roads in the vicinity of fast-growing Austin. The largest is SH 130, a 91-mile toll road largely parallel to congested I-35, a major north-south truck route, being developed as a public-private partnership. Harris County Toll Road Authority broke ground on the $260 million Westpark Tollway in June, the third major toll road in the Houston area. And the North Texas Tollway Authority is seeking to develop a 10-mile high-speed toll road along the Trinity River in Dallas.



Need A New Direction?
We Can Manage That.
The best public transportation depends upon having the best people, in the right positions, with the most available resources. To satisfy these needs, systems across America are turning to First Transit.
From transit system management to full turnkey operations, First Transit will keep your system rolling. First Transit's customized programs will keep moving forward to meet your changing needs.
Call 1-800-787-9337 to learn more about First Transit's customized programs or to inquire about employment opportunities. Visit our web site at www.firsttransit.com
First Transit
Moving Forward For You
A FirstGroup America Company
Copyright © 2002, FirstGroup America, Inc.

Virginia continues attracting private-sector proposals for new toll projects, under its Public-Private Transportation Act of 1995. Under construction in Richmond is the 895 Connector (Pocahontas Parkway), being developed under a 63-20 IRS ruling nonprofit corporation. An ambitious $4 billion project to develop the Hampton Roads Third Crossing in the Norfolk area—also via a 63-20 vehicle. And just after year-end, a consortium headed by Koch Performance Roads submitted an unsolicited proposal to VDOT to add two truck toll lanes in each direction to all 325 miles of I-81, a major truck route.

HOT Lanes and other Value-pricing Projects

High-occupancy toll (HOT) lanes continued to be a hot topic in urban transportation in 2001. The well-received I-15 Express Lanes in San Diego are to be expanded significantly, in a joint project by Caltrans and SANDAG; the 2-lane, 8-mile project will be expanded into a 4-lane, 20-mile project over the next decade, with strong popular support. HOT lanes are planned for inclusion in the expansion of the LBJ Freeway in Dallas and are being considered for a similar expansion of the Katy Freeway in Houston. CDOT planners are considering three HOT lane proposals: converting HOV lanes on I-25, adding new HOT lanes to C-470, and adding new HOT lanes to I-70. Maricopa County (Phoenix) is completing a comprehensive study of HOT lanes on the region's emerging freeway system. And FDOT is looking into a possible HOT lane project on congested I-95 in Miami. On the other hand, Maryland Gov. Paris Glendening vetoed several proposed HOT lanes in the suburbs of Washington/Baltimore, on egalitarian grounds.

Several major toll agencies shifted from flat-rate to variable tolls in 2001, aiming to use pricing to better manage traffic flow. Making this change were the Port Authority of New York and New Jersey (for its Hudson River crossings), the New Jersey Turnpike, and the Orange County (California) Transportation Corridors Agencies. Lee County (Fort Myers), Florida is considering an expansion of its variable-pricing program on local toll bridges. And the Florida Turnpike Authority is studying the addition of value-priced express lanes on the Homestead Extension of Florida's Turnpike.

Railroads and Transit Systems

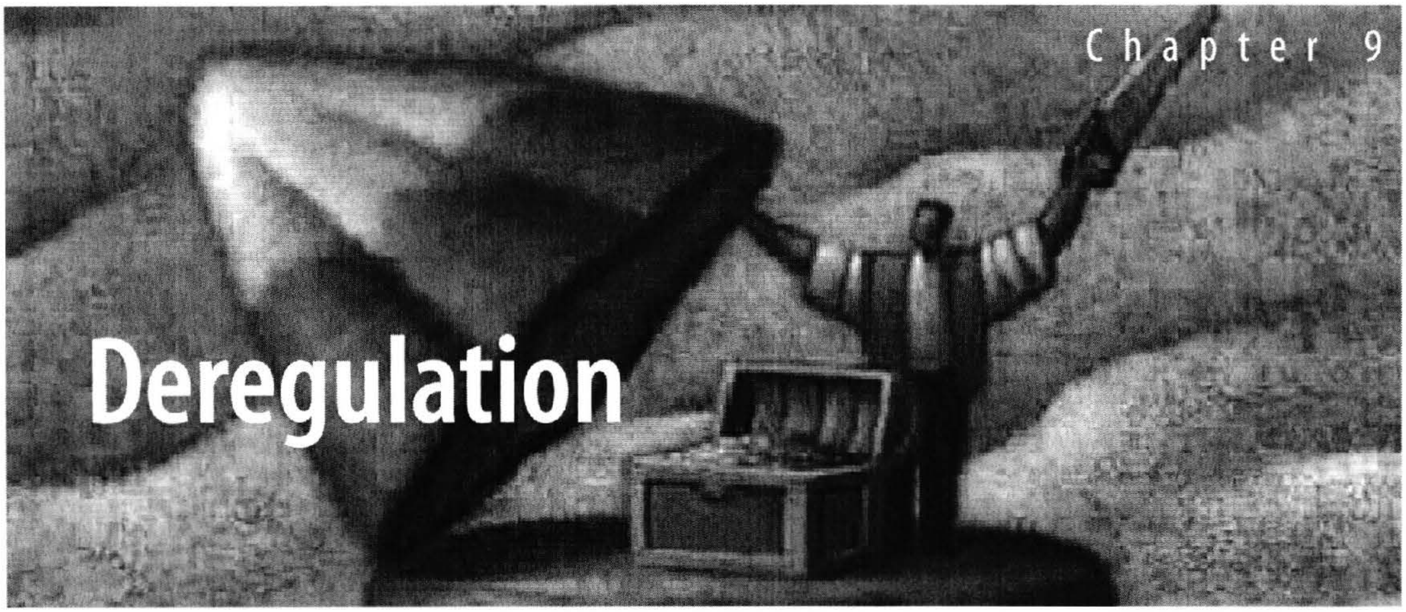
Global Rail Privatization

Railroad privatization got a black eye in 2001 with the involuntary bankruptcy of Railtrack, the privatized owner of British railroad infrastructure (track and stations). The much touted privatization of British Rail, in the final days of the last Conservative government in 1996, involved the separation of infrastructure from train operating companies, over two dozen of which were created and also privatized. So successful were they in increasing what had been declining passenger and freight numbers (up 26 percent and 34 percent respectively in four years), that traffic overwhelmed the infrastructure. But the infrastructure had suffered decades of deferred maintenance and under-investment. And with 90 percent of Railtrack's revenue coming from fixed charges, it had little incentive or ability to invest to the degree necessary. A pair of deadly train crashes in 1999 and 2000 led to speed restrictions, chronic lateness, and huge customer-relations and political problems. The Labor government in October, finding Railtrack insolvent and unwilling to bail it out, forced it into receivership.

Some analysts put the underlying flaw in the separation of track from operations. Most other countries that have privatized rail—Argentina, Australia, Japan, New Zealand—have maintained vertical integration, privatizing regional systems as complete business entities. Indeed, Australia at year-end was selling two more such units. The Japanese government announced plans to sell off its remaining stakes in three privatized railroad firms: JR East (in which it still owns 12.5 percent), JR West (31.5 percent), and JR Tokai (39.7 percent). And German officials in October announced that they are dropping plans to separate the track from train operations as they prepare to privatize Deutsche Bahn by 2005. But they continue to gradually allow private firms such as Connex and NOB to bid to take over money-losing commuter services.

Amtrak Reform

The many global examples of rail privatization and public-private partnerships helped lead to the creation of the Amtrak Reform Council by Congress in 1997. Its charge was to assess whether Amtrak could breakeven on operations (i.e., fares covering operating costs) by the end of 2002. In December the ARC issued its official finding that Amtrak could not meet this target, and under the law, the railroad company was supposed to then prepare a liquidation plan while ARC developed plans for alternate rail service. Congress slipped through a measure exempting Amtrak from having to prepare its plan, but the ARC proceeded to develop a plan that would end Amtrak's monopoly on passenger service, spin off its Northeast Corridor infrastructure, and permit states and/or private entities to bid for Amtrak routes. The plan was due to be released in early February 2002—though rail unions filed suit in January calling the plan illegal. ❑



Energy Restructuring in Limbo

The Year 2001 started with one of the early movers in restructuring its electricity regulation, California, facing rolling blackouts because utilities were unable to pay the higher fuel costs to generate the electricity demanded at regulated prices. The year 2002 brings a dramatically different policy environment, both at the state and federal levels, for a variety of reasons that include skittishness in the wake of California and the rapid decline in fuel costs that we experienced in 2001.

California's electricity crisis was not a failure of deregulation, but was instead a policy, political and financial failure. Since January 2001, one incumbent electric utility (Pacific Gas & Electric) has declared bankruptcy because of its inability to purchase electricity on the wholesale market and pay for it under fixed, regulated retail rates. The California Public Utilities Commission approved a series of rate increases, but the delays and inertia in the bureaucratic regulatory process ensured that the rate increases were insufficient to generate the revenues to enable the utilities to repay generators, which meant that many smaller generators (including those offering renewable "green" power to California customers) left the market with uncollected debt.

The state government has also taken over the responsibility for purchasing electricity in the wholesale market on behalf of the electric utilities, with the Department of Water Resources performing the real-time energy trading. As part of this process the state entered into long-term contracts with many suppliers; these contracts removed enough demand from the wholesale market that wholesale prices began to fall as early as March. However, these contracts also lock in prices that look exceedingly high given the low natural gas prices (and consequent wholesale electricity price) that have prevailed in energy markets since May. The gap between these high prices and the low cost of electricity generation with low natural gas prices will create a profit margin for the companies that signed contracts with the state, although they still run the risk that the state legislature will invalidate the contracts.

Either way, California taxpayers will pay for this policy failure for years to come, both through high electricity prices to pay for these contracts and because in October the Public Utilities Commission finally eliminated the retail component of restructuring—consumer direct access. California's consumers can no longer choose their own supplier, but instead are obligated to purchase electricity through the utilities from the California Department of Water Resources. The Public Utilities Commission unabashedly claims that it eliminated consumer direct access to ensure that the Department of Water Resources makes enough electricity sales to pay for the expensive long-term contracts into which the state entered in January and February. Finally, amid accusations of "greedy, price-gouging, out-of-state generators," wholesale price data indicate that public municipal utilities such as the Los Angeles Department of Water and Power charged the highest hourly prices of all generators selling in the California "market."

Pennsylvania has pursued electricity restructuring in stark contrast to California's. Governor Tom Ridge signed electricity deregulation legislation in Pennsylvania in December 1996. Under this legislation consumers could choose an electricity generator to provide them with power, but transmission and distribution would still occur through regulated utility companies. Importantly, the legislation did not mandate that incumbent, vertically integrated electric utilities divest their generating capacity. Pennsylvania also used market models and forecasts to set the standard offer price, instead of setting a low standard offer price that would benefit incumbents. Pennsylvania rolled out deregulation in January 1999; by January 2000 all consumers in Pennsylvania could choose their electricity generator. This two-phase process brought all of the state's consumers competitive choices more quickly than in other states.

A good indicator of how well Pennsylvania has done in providing for electricity customer choice is the number of companies offering to serve state residents. Pennsylvania's deregulation plan was aggressive in allowing all state residents and businesses to choose electricity providers, and by February 2001, 130 power suppliers competed for customers in the state. Similarly, in Ohio (which started its generation competition in January 2001), 40 energy suppliers have been active in the state. In California, few power suppliers entered the market, and most of them soon left after failing to win many customers. Pennsylvania did not have the stringent retail price caps and competitive transition charge that protected incumbents and discouraged entry in California.

In 2001 many suppliers left the Pennsylvania market, which some claim shows the failure of deregulation. In May and June 2001, many Pennsylvania electricity customers left the service of new suppliers and returned to their incumbent electric utilities. As wholesale electricity prices increased from April to July, these new suppliers had to raise their rates to make doing business in Pennsylvania worthwhile for them. When the competing suppliers raise rates, though, they run into the retail rate cap and the "standard offer price." As part of the consumer-protection provisions of electricity deregulation, consumers' rates are capped, and the cap phases out over ten years. When fuel input prices are declining, as they did for most of the 1990s, this cap is unlikely to have a strong negative effect on supplier entry and customer choice. What Pennsylvania experienced in the spring, though, is a short-term increase in fuel costs. The incumbent utilities have a "standard offer price" at which they are obligated to serve customers who return to them from a competing supplier, and as fuel costs increased, customers left the competing suppliers and went back to buying generation directly from the utility. This essential price cap drastically decreases competition in wholesale electricity markets when fuel costs are rising.

Texas also appears poised to succeed in realizing the benefits of electricity deregulation. While its legislation only went into effect in June 1999 and its generation markets program went live in January 2002, many already view Texas as a blueprint for deregulation success. It has incorporated the negative lessons from California with the successes of Pennsylvania, the United Kingdom, Australia, and elsewhere to craft a process that gives new providers real incentives to enter and provide competitive services at lower prices to Texas consumers. Texas is pursuing simultaneous wholesale and retail competition, which is more likely to succeed than the isolated wholesale competition that occurred in California. The Texas legislation stipulates a "price to beat," or default price, that is 6 percent below the January 1999 average price; this price is low enough to generate price decreases for consumers but high enough for market entrants to see profit potential (although any such price raises the risk of what has happened in Pennsylvania in the past year). The "price to beat" then becomes a retail cap that is effective for only five years, as opposed to ten years in Pennsylvania. Also, Texas has not mandated full generation divestiture, but has followed the Pennsylvania model of restructuring studies, with the incumbent utility retaining no more than 20 percent of the generation capacity in its service area. Finally, but perhaps most importantly, Texas has not established a centralized electricity market like California's Power Exchange, but will instead allow buyers and sellers to transact how they see fit through for-profit financial markets. This flexibility will enable all market participants to limit their risk (and their consumers' risks) of energy price volatility, and to be creative in devising financial instruments to manage that risk.

California's experience is in no way representative of the consequences of deregulation; in fact, when done well, these success stories of other states show just how much benefit both consumers and innovative sellers can gain from electricity deregulation. Electricity deregulation can deliver consumer choice, consumer savings, and a business climate that encourages entrepreneurship.

Enron's Demise, Government Contracting, and Regulation

Enron, the pioneering energy trading and services company, declared bankruptcy after its accounting irregularities and debt load quashed a merger deal. Enron's demise does not, though, endanger government energy contracting with private suppliers.

Since Enron's accounting problems became public in September, customers have been worried that they might be left high and dry if Enron ceased operations. These concerns are unfounded. First, Enron's bankruptcy does not mean that they have ceased operations, although they have dramatically curtailed their operations. Second, and most importantly, several companies, including American Electric Power and Duke Energy have already stepped up to fill any breaches. In fact the initial uncertainty caused Enron customers to begin to negotiate backup arrangements. Enron's fall does not signal the end of private energy contracting and risk management.

However, when one of the highest profile companies in the country goes belly-up, it's natural for people to call for more government regulation. Senate majority leader Tom Daschle (D-SD) called for a congressional investigation of the industry, and Rep. Billy Tauzin (R-LA), chairman of the House Energy and Commerce Committee, hinted that the energy services and trading industry might need more government regulation to increase transparency. Even the *New York Times*, called Enron the "poster child for the need for strong regulation on Wall Street."

The calls for more regulation are largely based on emotion; the natural reaction for many is to want the government to do something about it. But the Securities Exchange Commission already has the authority and means to investigate and punish Enron executives for lack of disclosure and for fraud. Criminal investigations are already underway, and markets have already punished Enron for its lack of transparency and poor disclosure. Investors large and small will now demand that the "gatekeeper" institutions of our financial markets—accounting firms, bond-rating companies, company boards of directors, and regulators like the SEC—do what they can to promote and reward transparency and disclosure. Companies failing to meet the transparency standards that the gatekeepers and the markets require will have trouble raising capital and will shrink, while companies that provide accurate information will thrive.

Telecom and Broadband Public-private Partnerships

As wireless and broadband technologies grow, change, and become more important in our everyday lives, local governments are investigating new means of investing in wireless and broadband infrastructure. In many localities these means include public-private partnerships.

Whether for a rural community or a city, the primary objective is increased commercialization of broadband wireless access systems, leading to more widespread broadband access in communities. Many industry observers believe that wireless broadband, using fixed units in customer homes and offices to connect to either a ground-based station or a satellite, can compete economically with wired fiber-optic broadband. Wireless broadband could also complement wired broadband, offering a way to connect in the "last mile" to the customer without having to dig and lay new fiber-optic cable from substations to customer buildings.

Many state and local governments are making broadband access a high-priority issue, acting on the belief that broadband access would benefit students, businesses, employees who could telecommute to facilitate child care, police and public safety, and the court system, among others. Public-private technology partnerships are attractive because large government investments in infrastructure are not likely.

The city of Chicago has initiated an innovative public-private partnership approach to extending information technology infrastructure, both wired and wireless, throughout the city. Called CivicNet, this initiative is intended to circumvent the difficult potential catch-22 of expanding technology infrastructure into underserved neighborhoods: many private firms would hesitate to build such a network until they perceive enough demand to make it profitable, but many businesses avoid moving into such neighborhoods and creating that demand because of the lack of infrastructure.

CivicNet (www.chicagocivicnet.net) is designed to break this chicken-and-egg cycle by aggregating the communications requirement of many large government agencies, and will work in partnership with private-sector communications and technology companies to build information technology infrastructure throughout the city.

The various government agencies own and operate facilities and other forms of infrastructure throughout the city's neighborhoods, and will serve as "anchor tenants" much the same way as large department stores anchor a shopping mall and create beneficial economic activity for other, smaller tenants. By working with private networking, telecommunications, and applications providers through CivicNet, these anchor tenants will bring information infrastructure to neighborhoods that might not otherwise have access to high-speed internet and data transmission. The anchor tenants will also give "right-of-way" access to vendors for laying fiber-optic cable and other construction activities, which will decrease the costs and hassle of completing the infrastructure projects.

These private sector partners will market, operate, and manage the infrastructure network. In addition to providing unprecedented e-government connections, the private vendors will also be expected to build in sufficient capacity to market in parallel to private sector customers. This market-oriented approach will make Chicago a thought leader in public-private partnerships, as the first large U.S. city to have high-speed and high-bandwidth capacity throughout the city.

Pennsylvania is also using public-private partnerships to increase broadband access, in this case in a rural community. As part of Adelphia Business Solution's (ABS) winning bid to provide information technology for the state government, ABS offered to wire underserved rural areas of the state if the state and local governments matched their investment. ABS is performing this work with a consortium of 16 technology companies. Their initial effort is to lay fiber-optic cable along the Interstate 99 corridor through the middle of the state; they will then proceed to other communities and focus on libraries and school buildings.

Another exploration of technology through public-private partnerships has been improving traffic congestion information. In Virginia, Pennsylvania, and Oklahoma, for example, governments and private technology firms have established consortia to make intelligent transportation systems (ITS) more feasible and more customer-oriented. Instead of just providing information passively to motorists through electronic road signs, using wireless sensor technology to monitor congestion and transmit that information to motorists in their cars could provide them with valuable information. Implementing such systems will require governments, technology firms and automobile manufacturers to work together to determine the uses of technology that motorists want.

In a variety of jurisdictions and projects, public-private partnerships have the potential to create real value for consumers by exploring and implementing innovative ways of harnessing information technology. ❑

Chapter 10

Emerging Issues

Privatization of Military Housing

By Max Pappas

In the mid-1990s the U. S. military services identified about 177,000 of the Department of Defense's (DoD) 290,000 family housing units as being inadequate. According to the DoD estimates it would have taken over 30 years and $20 billion to fix this problem using traditional military construction and financing techniques. In an innovative move, Congress passed new laws enabling the DoD to use private sector financing and expertise to improve the situation. With the help of private enterprise, the DoD believes it will have all military personnel and their families adequately housed by 2008—two years ahead of the original 2010 goal and more than a decade and a half sooner than would have been possible using standard methods.

The DoD has traditionally used a combination of two methods to provide housing for military families. The first is the longstanding policy of relying on private sector housing in the communities near military bases, where costs to military personnel are defrayed by the Basic Allowance for Housing (BAH). Current BAH rates only cover 81.2 percent of the average rental cost. The rest is paid for out of basic pay, which creates the excess demand for on-base housing despite its poor condition. There are proposals to increase BAH to cover 100 percent of off-base housing costs in an effort to maximize the use of this completely private option. Secretary Rumsfeld has observed that housing is not a core military competency and "can be performed more efficiently in the private sector."

Costs of Military Housing Upgrades Using Traditional Military Construction Funding

- **Fort Carson, CO—23 times the cost of privatization**
- **Naval Station Everett, WA—3 times the cost of privatization**
- **Camp Pendleton, CA—4.5 times the cost of privatization**
- **Elmendorf Air Force Base, AK—5.5 times the cost of privatization**

But the demand for military housing is qualitatively different from demand for civilian housing. Service men and women have to move when and to where their service orders them. Base closures relocate entire populations and the moving of a single aircraft carrier can suddenly shift 2,000 families to a new location. This can put service members in places where housing is unavailable or too expensive. To deal with this, the military has built housing on its own land with appropriated funds. This second option, military construction projects, or MILCON, is costly and slow-moving.

The DoD sees housing as an integral part of the quality of life for its service members and believes this directly effects the quantity and quality of those who decide to remain for a full 20-plus years of active duty. This, they argue, affects the level of competence and ability of those participating in military operations.

The National Defense Authorization Act for Fiscal Year 1996, containing the Military Housing Privatization Initiative (MHPI), provides new options for solving the military housing problem. Passed on February 11, 1996, this law grants the Department of Defense (DoD) twelve powerful authorities, for a five-year trial period, allowing it to work with the private sector to build and renovate military housing (see side bar). The DoD can obtain private capital to leverage government dollars in order to enter into limited partnerships with private developers to construct, renovate, operate and maintain housing. These new authorities are designed to give the DoD the flexibility necessary to take advantage of local real-estate market conditions.

Initial progress in creating new and refurbished housing was slow. By the end of August 1998, over three years into the original five-year program, only three projects had been awarded contracts. Working with private businesses was very different from anything that had been done in a long time. This new approach introduced DoD personnel to unfamiliar kinds of negotiations, and new legal, financial, and budget issues.

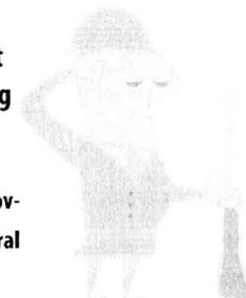
The Secretary of Defense, in October of 1998, decided a more decentralized approach would expedite the process and devolved operational responsibility for MHPI to the individual services (the Army, Navy, Marine Corps, and Air Force), with final approval authority given to the Office of the Secretary of Defense, Office of Competitive Sourcing and Privatization.

Table 10-1: Federal Military Housing Privatization Initiative Status

13 Projects Awarded	16,817 Units	$1.248 Billion
15 Projects in Solicitation	18,931 Units	
43 Planned Projects	51,528 Units	

Source: www.defenselink.mil/acq/installation/hrso/docs/report.htm. Note: this is as of November 2001.

Twelve "alternative authorizations" granted to the Department of Defense by the Military Housing Privatization Initiative.



1. **Conveyance of real property: The Government may transfer title of Federal property to private ownership.**
2. **Relaxation of Federal specifications for housing construction: Builders are allowed to construct housing in accordance with local building codes.**
3. **Inclusion of ancillary support facilities: Bids for contracts may incorporate additional amenities, such as child care centers and dining facilities, to enhance the attractiveness of the basic housing.**
4. **Payment of rent by allotment: Landlords may receive payment of rents through automatic electronic fund transfer from the appropriate Federal disbursing facility, guaranteeing cash flow.**
5. **Loan guarantee: The Government may guarantee up to 80% of the private sector loans arranged by the property developer.**
6. **Direct loan: The Government may make a loan directly to a contractor.**
7. **Differential Lease Payment (DLP): The Government may agree to pay a differential between the BAH paid to service members and local market rents.**
8. **Investment (Joint Venture): The Government may take an equity stake in a housing construction enterprise.**
9. **Interim leases: The Government may lease private housing units while awaiting the completion of a project.**
10. **Assignment of service members: Service personnel may be assigned to housing in a particular project that they may otherwise not choose to occupy (tenant guarantee).**
11. **Build to lease: The Government may contract for the private construction of a housing project, then lease its units (similar to Section 801 programs).**
12. **Rental guarantee: The Government may guarantee a minimal occupancy rate or rental income for a housing project (similar to Section 802 program).**

Source: *Military Housing Privatization Initiative: Background and Issues,* **CRS Report for Congress, Daniel H. Else, July 2, 2001.**

The General Accounting Office issued a report in March 2000 (GAO/NSAID-00-71) concluding that there was not enough data by which to assess the effectiveness of MHPI versus traditional construction practices. Between the issuance of this report and December of 2000 five more projects totaling 2,200 housing units were added.

Nine projects totaling 5,900 units had been approved by the end of the program, but little construction had taken place. Still, Congress expressed confidence in the program and extended the life of the MHPI through December 31, 2004. Along with this extension came an order to the four services to submit to Congress a Family Housing Master Plan to demonstrate how they intended to meet the DoD 2010 housing goal. The plans have been submitted and the goal is expected to be met early—by 2008. The estimated completion date using traditional techniques was 2025. The process has accelerated considerably, and at this writing 68 projects totaling 90,773 units are in various stages of execution, solicitation, and planning.

A formal Program Evaluation Plan (PEP) has been set up to evaluate projects awarded under the Military Housing Privatization Initiative. Uses for the PEP data, which will be collected semiannually, include the identification of best business practices and gauging service member satisfaction with privatized housing. The first set was collected in March 2001.

Case Study—Fort Carson, Colorado

Fort Carson is the DoD's largest in-construction privatization efforts and is the first installation to privatize the entire inventory of on-post housing. In November 1999, Fort Carson Family Housing LLC, a subsidiary of J.A. Jones Inc., assumed operation and maintenance responsibility for the existing 1,823 family housing units. They agreed to renovate these units by September 2005, while building 840 new units by September 2004. The company will own, operate, and maintain all housing on Fort Carson for 50 years with an option for an additional 25 years.

The early returns on Fort Carson indicate that it is both a big success and a considerable learning opportunity. At a briefing held in August 2001, six months after groundbreaking, a list of lessons learned was compiled. This list includes comments ranging from the complexity of closing such a large contract to the importance of transparency in the process. The briefing concludes with a note stating, "Privatization [is the] only solution to quickly and permanently fix[ing] a serious housing problem."

Concrete data on the success of the privatization initiative at Fort Carlson is currently being compiled. The initial survey data, collected last year, has been used to set the benchmark. The second data set is currently being put together and will be used to perform a dynamic analysis in the months to come.

However, the anecdotal responses are positive. While the privatization initiative was initially met with resistance, there is widespread support now. As one would expect, moving a couple thousand families out of military housing and into privately owned housing caused some turmoil. As the project got under way this resistance has been replaced by support from the tenants. Simple changes in procedures such as the way maintenance is handled, has pleased on-base residents. Under the old system each individual repair required a separate order. This slow-paced and inefficient process has been replaced by one where it is in the best interest of the company to get things fixed as efficiently as possible. Service members have responded positively to being able to ask the maintenance person for help as he walked by—and getting it.

In a recent congressional hearing, Paul Johnson, Deputy Assistant Secretary of the Army for Installations and Housing said, "At Fort Carson, we're well on our way. Right now we're constructing 20 new houses and renovating 40 new houses a month . . . it was a very successful program." Congressman David L. Hobson, Chairman of Military Construction Subcommittee praised the developer at Fort Carson saying, " I thought what was really smart was he went in there and he started managing the property and responding to families right away . . . that created a wonderful atmosphere."

Conclusion

The Military Housing Privatization Initiative lets the Department of Defense provide housing for service members in a new, market-based, way. The slow start and the recent acceleration of project approval show that this new process requires a lot of learning—and that such learning is taking place. As the process enters the next phase, where the private companies and the DoD figure out how to manage housing built under a joint public-private venture, more challenges lay ahead.

Although the data are still being sorted through for the first dynamic assessment of this new technique, the initial anecdotal responses are consistent with what one would expect. As the private companies have moved in and the old bureaucratic methods have stepped aside, houses are getting built and fixed more quickly at a lower cost. ❑

Reason Public Policy Institute
3415 S. Sepulveda Blvd., Suite 400
Los Angeles, CA 90034