



THE DECISION TO CONTRACT OUT:


UNDERSTANDING THE FULL ECONOMIC AND SOCIAL IMPACTS

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KEY FINDINGS

SOCIAL AND ECONOMIC IMPACTS CRITICAL TO COMPREHENSIVE, ACCURATE COST- BENEFIT ANALYSIS

Outsourcing to private corporations undermines principles fundamental to our democratic system by creating conditions such as:

- Reduced accountability, transparency, and clarity about who's in charge
- Frequent conflicts of interest and nepotism and fewer whistleblower protections
- Removing control of key public decisions from citizens and their elected officials

Contracting can involve substantially lower wages and benefits for local workers providing services, siphoning dollars away from local economies. Workers making less will spend less in their own communities. That leads to many direct and indirect economic and social impacts including:

- Declining retail sales and potential impacts on the housing market
- Higher wage gaps between men and women, and between blacks and whites
- More workers forced to rely on public assistance
- Fewer middle class jobs and wages for everyone
- Reduced ladders of opportunity for workers at the bottom
- Perpetuating low incomes for more female-headed households
- A larger share of "at risk" children in lower-income families
- Weakened viability of pension systems for remaining public workers

Private corporations' profit imperative does not always lead to efficiency or quality

- Cuts to workers' wages and benefits deliver short-term profits to shareholders but . . .
- Reduced staffing levels and lower pay often lead to higher turnover, lower quality of services, and potential health and safety issues
- Problems with the quality of services provided to citizens cited in 61% of contracts terminated

Outsourcing and contracting are not really "privatization"

- Responsibility for determining how public tax dollars are spent still lies with public officials
- Public services are funded by public dollars regardless of who provides them, but ..
- Local tax dollars now go to corporate profits, administrative costs and taxes in other jurisdictions

Cost savings of outsourcing vary widely and often diminish over time

- Average costs may be lower initially (studies show an average of 5-10%) but often shrink over time because of reduced competition and other factors
- Governments cited insufficient savings 52% of the time when ending private contracts
- Cost savings are often achieved at the expense of reduced wages and benefits for workers

UNLESS THERE IS REAL INNOVATION THAT LEADS TO GREATER EFFICIENCY OR HIGHER QUALITY, COMMUNITIES WILL SEE A NET NEGATIVE EFFECT ON THE WIDER SOCIAL AND ECONOMIC LEVEL

NOTE: Tools for estimating effects of outsourcing on local economic development are in Appendix A.

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I. INTRODUCTION

The delivery of public services has been changing for several decades. State and local governments -- traditionally the provider of many services -- are sometimes now only the funder of those services. Instead of directly providing services through their employees, they may contract with outside vendors.¹ While this is popularly called 'privatization', the term is misleading, since public tax dollars are still paying the bills.²

Since public officials continue to have ultimate responsibility to taxpayers, the more accurate terms 'outsourcing' or 'contracting' are used here. A trend related to outsourcing has been the lease or sale of publicly held assets to private companies in public-private partnerships, or 'P3s'.³ This arrangement is closer to true privatization than outsourcing -- since more control is delegated to the private company --but is still quasi-public.

While reducing costs is most often the motive for outsourcing, a growing body of research documents that savings are minimal, on average. It is also not unusual for total costs to be *greater* when performed by private contracting firms than they were in-house. In addition, problems with quality, control or accountability are common when services are outsourced. When contracting failed to deliver, quality was a major issue 61% of the

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¹ This report is focused on contracts with private companies. Contracts with non-profit organizations or other governmental units involve some, but not all, of the issues raised here.

² True privatization occurs when public assets are sold to a private company and future transactions regarding the use of those assets are between private citizens. An example is the sale of state owned liquor stores to various private companies where public involvement remains only in the regulation and taxation of liquor.

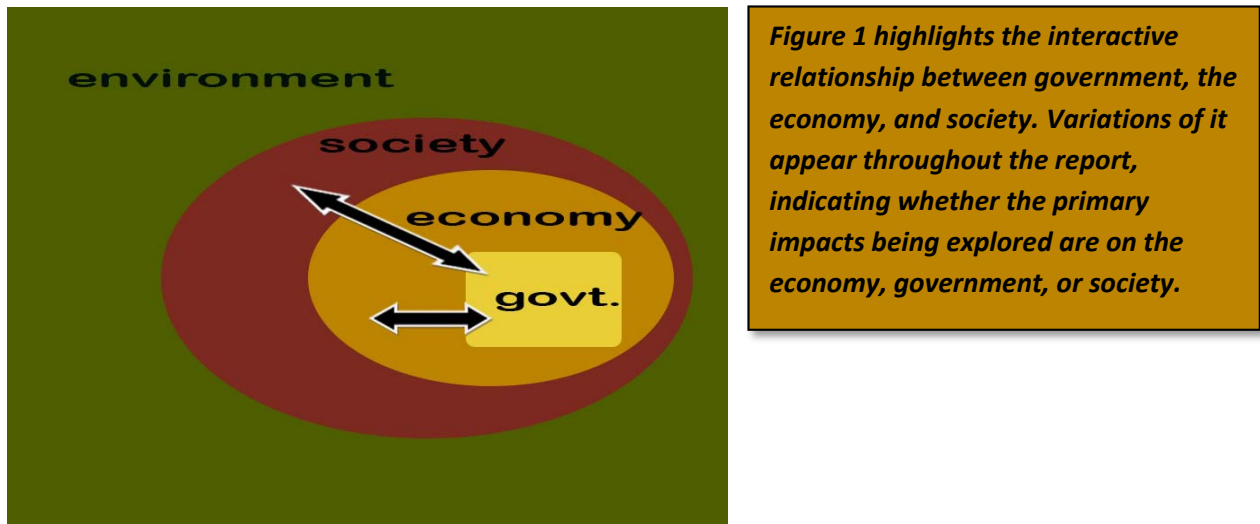
³ "A public-private partnership is a contractual agreement formed between public and private sector partners, which allows more private sector participation than is traditional. The agreements usually involve a government agency contracting with a private company to renovate, construct, operate, maintain, and/or manage a facility or system. While the public sector usually retains ownership in the facility or system, the private party will be given additional decision rights in determining how the project or task will be completed" (Report to Congress on Public-Private Partnerships, United States Department of Transportation, 2004, viii).

time, with insufficient savings in 52% of cases, according to surveys by the International City/County Management Association (ICMA).

Reflecting this mixed success, the survey also shows that while approximately half of all governments continue to explore new contracting,⁴ many continue to bring service delivery back in-house.⁵ While only 16% of municipal governments reported that political factors were a driving force behind outsourcing before the recession,⁶ public employees and contract alternatives became a focus in some state legislatures in the years following the Great Recession.⁷ The Reason Foundation began strongly advocating ‘privatization’ several decades ago⁸, and interest in it has been cyclical since then. There seems to be a resurgence of interest in exploring it now.

While many studies have examined the risks to government in contracting (such as uncertainties about costs or quality) there has been less attention to the broader social and economic effects of contracting. **To understand the impacts on local economies and communities, this report goes *beyond* the net fiscal impact on governments to the larger question of how changes affect citizen well-being.** Figure 1, below, shows the interrelationships between government, the economy, the society, and the physical environment within which they all operate.

Figure 1



The next section of the report examines the economic effects of outsourcing. First, there are direct and fairly immediate impacts on local businesses and other units of government. Some numerical examples

⁴ ICMA (2007, 6).

⁵ See Warner, Ballard and Hefetz (2003, 33) for discussion of the 2000 survey. It reported equal numbers brought back in and contracted out in the five years prior.

⁶ Warner, Ballard and Hefetz (2003, 36).

⁷ Kozlowski and Spirn (2014).

⁸ Savas (1987); Leech (2011).

are provided to show what happens to the local economy when a given public budget becomes a contract. In addition, there are indirect and longer term effects on job quality, the size of the middle class, economic mobility and pension viability – all of which affect economic well-being and economic development. Background on several of these is presented. A discussion of how state and local contracting decisions affect the availability of ‘middle class’ jobs, retirement security, and ladders of opportunity for historically disadvantaged groups follows.

Section III then looks at other social impacts such as health and safety, transparency, accountability, and citizen participation. It also considers the disproportionate effects of contracting on female and minority workers which run counter to commitments states and localities have made to equal opportunity. Appendix A outlines ways to measure some of these broader economic and social effects. Appendix B summarizes the existing evidence on costs, quality and control that most concern governments. Sources and more extensive discussion are provided in footnotes throughout. Let’s turn first to the question of economic development and how it is affected by public decisions about service provision.

II. ECONOMIC IMPACTS OF OUTSOURCING

Real economic development is the ongoing process of improvement in the standard of living across the community. That means not only higher average incomes, but improvement in many non-market aspects of quality of life. Good schools, transportation systems, and a healthy environment are just a few examples. In order for economic development to be sustainable it must reach most people – for economic, social, and political reasons. Most elected officials express a strong desire to boost jobs and the local economy to make that happen. Millions are spent each year on ‘economic development’ projects – many of which are misdirected – with the goal of improving opportunities and outcomes.

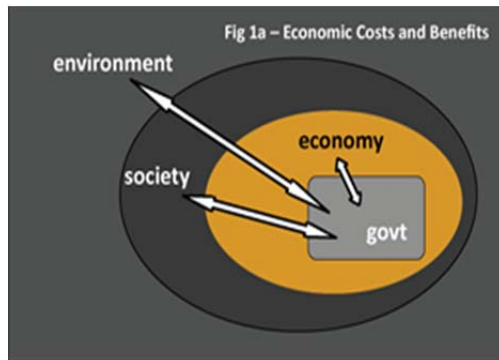
However, economic development is less about bringing in a particular business and more about how community elements interact to create jobs, improve opportunities, and increase quality of life. The elements of a community include its natural resources, individuals and families, non-profits and governments, as well as its private sector. Jobs and income come from the public sector as well as the private, and both sectors provide elements that contribute to quality of life.⁹ **Since local and state governments are major employers in many communities, their decisions about how to deliver services are important to economic development.** Let’s examine the impacts that outsourcing public jobs is likely to have on the local economy.

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⁹ For more on achieving real economic development see Greenwood and Holt’s *Local Economic Development in the 21st Century* (2010). Chapters 3 and 8 explore why economic growth and quality of life can diverge, and how communities across the nation track their progress through locally selected indicators.

A. DIRECT AND IMMEDIATE EFFECTS ON ECONOMIC DEVELOPMENT



In many communities with a military base, a state hospital, a prison or a college, the impacts of public employment are quite clear. But in all communities, there are public employees providing police and fire protection, teaching, and providing other services that the private market does not. It affects the local economy when these services are contracted out to private firms, for several reasons.

1. **First, there are several effects on local businesses.** Some businesses may have been suppliers to in-house provision.

They are less likely to continue to supply a contractor that is part of a large national or regional corporation. In addition, if workers earn less (as they usually do under contracting), they tend to spend less in local retail and dining establishments. As workers' income changes, the mix of sales at various businesses will change. At lower incomes, more workers may shop at 'big box' discount stores than did before, and fewer with local merchants.

The following tables present a simplified illustration of how changes in a public budget -- often invisible to the average voter-- will ripple through the economy. They are based on a typical medium-sized city in the United States today.¹⁰ Let's look at the effects one at a time so as to better understand the spending changes that influence economic activity. The first change (where public employees live) is shown in Table 1. The second (their levels of wages and benefits) will be shown in Table 2. Both tables are based on a very small (\$100,000) agency budget and show only the initial economic effects of changes. In Table 3, multiplier effects will show the annual economic impact of combining these two.

Table 1, below, keeps employment in the public sector, but contrasts the different economic effects based on where workers live. Pay is the same (\$90,000) in columns 2 and 4, but in column 3, all workers live in the community where they work. In column 5 all workers live elsewhere. Column 3 shows half of compensation, or \$45,000, spent at businesses in the community. The other \$45,000 'leaks out' of the local economy for spending on goods and services elsewhere -- even for locally based workers. But when workers live outside the community a much smaller share of their compensation (10% of \$90,000 =

¹⁰ In a smaller town, more tends to leak out. In a larger city more tends to stay. However, in each region there are other variations that must be addressed, depending on housing, retail, etc. in surrounding communities. The portion of compensation that is benefits rather than wages is also assumed to follow the 50/50 split, since social security and pension contributions immediately leave the community but most medical expenditures remain. This will also differ by community and for specific combinations of employer paid benefits.

\$9,000) is spent locally, as shown in column 4). Workers may buy gas for their car, go to lunch, and do some shopping or keep some medical appointments. But 90% of their compensation is spent elsewhere on housing, consumer items, and medical care even though wages and benefits remain the same.

Part of the cost of providing the service publicly is some portion of a manager’s salary (\$10,000 in this example). If the public administrator also lives in the community, \$4,000 (line 2, column 3) remains as local spending. This smaller share of income (40% vs. the 50% for lower paid workers) going to local spending is based on Bureau of Labor Statistics consumer surveys. Higher income groups spend a greater share of income on non-local goods and services, such as stocks and bonds, or travel. Local spending will fall considerably (\$4000 to \$500, from line2, columns 2 and 4) when they live elsewhere.

Table 1: Local Economic Effects of Where Workers Live

Spending Category	Compensation of resident employees	\$ Spent locally by workers	Compensation of non-resident employees	\$ Spent locally by workers
Worker Pay and Benefits	\$90,000	\$45,000	\$90,000	\$9,000
Public mgmt/ Admin	\$10,000	\$4,000	\$10,000	\$500
TOTAL	\$100,000	\$49,000	\$100,000	\$9,500
Note: Leakages from the local economy depend on both residence and the level of pay, as discussed in the three paragraphs above.				

In Table 1 dollars spent in the local economy annually fall from 49% of total payroll to 9.5%, simply because of where the workers live. In this example of a very small \$100,000 budget, \$49,000 used to remain in the community, but with workers living elsewhere only \$9,500 does. This is one reason why cities and school districts may require employees to live within the jurisdiction they serve!

If outsourcing to a private company results in major changes in the pay structure, as it often does, there are similar changes. Table 2, below, shows leakages resulting from a change in how the same budget of \$100,000 is divided. In addition to worker’s wages and administrators salaries, there are now profits and taxes with a private contractor. To keep it simple, let’s make three assumptions. First, any

costs for supplies are identical whether the service is provided in-house or with outsourcing.¹¹ Second, there is no difference in the total cost of \$100,000 whether in-house or outsourced.¹² Third, workers and managers continue to live where they work – at least for now. In a real-life situation, these complicating differences can be added in and the general principles identified here will stay the same.

Table 2: Local Economic Effects of How Workers are Paid

Spending Category	Compensation of public employees	\$ Spent locally by workers	Compensation of contracted employees	\$ Spent locally by workers
Worker Pay and Benefits	\$90,000	\$45,000	\$60,000	\$30,000
Public mgmt/ Administration	\$10,000	\$4,000	\$10,000	\$4,000
Private mgmt/Admin	0	0	\$20,000	\$8,000
Taxes to other jurisdictions	0	\$0	\$2,000	0
Shareholder profit (net)	0		\$8,000	\$0
TOTAL	\$100,000	\$49,000	\$100,000	\$42,000
Note: Leakages depend heavily on residence and to a smaller (but significant) degree on the level of worker pay, as discussed in the text.				

¹¹ Appendix B discusses how to make sure all costs (public and private) have been accounted for.

¹² The same principle holds if there are savings with a contractor, but the arithmetic will differ. If the contract price is \$95,000 vs. an in-house cost of \$100,000 the economic impact is still there, but will be partially offset.

In Table 2, above (and Figure 2 below) the total budget of \$100,000 is allocated quite differently with a private contractor than it was in-house. First, the contract is expected to make a profit for owners or shareholders (\$8000). Second, the contractor must pay income, sales and property taxes. Some of these taxes return as payments to the state or locality, helping its bottom line. But other payments (\$2000 in this example) will go to other localities, including corporate taxes to the federal government and (for a city or county) to the state.¹³ In this example, one-tenth of the \$100,000 expenditure immediately leaves the community. (Obviously, gross profits and taxes could be either higher or lower).

In addition, private management is usually paid considerably more than public sector managers. Table 2 includes \$200,000 for salaries vs. the earlier \$100,000 spent in-house.¹⁴ But to responsibly award and manage the contract, and to maintain oversight of the quality and billing, government must use its own upper middle management or hire outside consultants. It is not unusual for the public costs of oversight and administration to remain the same under contracting and they may actually increase.¹⁵ Without sufficient oversight, problems like the web launch for healthcare.gov in 2013 are more likely to occur.

High salaries for administrators are the norm among private contractors, while top public sector administrators earn less than they could in private jobs.

Since contracting generally means substantially lower wages and benefits for workers that equates to less spending, regardless of where workers live. In Table 2, a big chunk of the funds have been shifted to more highly paid private administrators, who also spend in the local economy. But just as with the

More money usually flows out of the local economy to pay shareholder profits and taxes. If contracting means lower wages for workers, there is less retail spending.

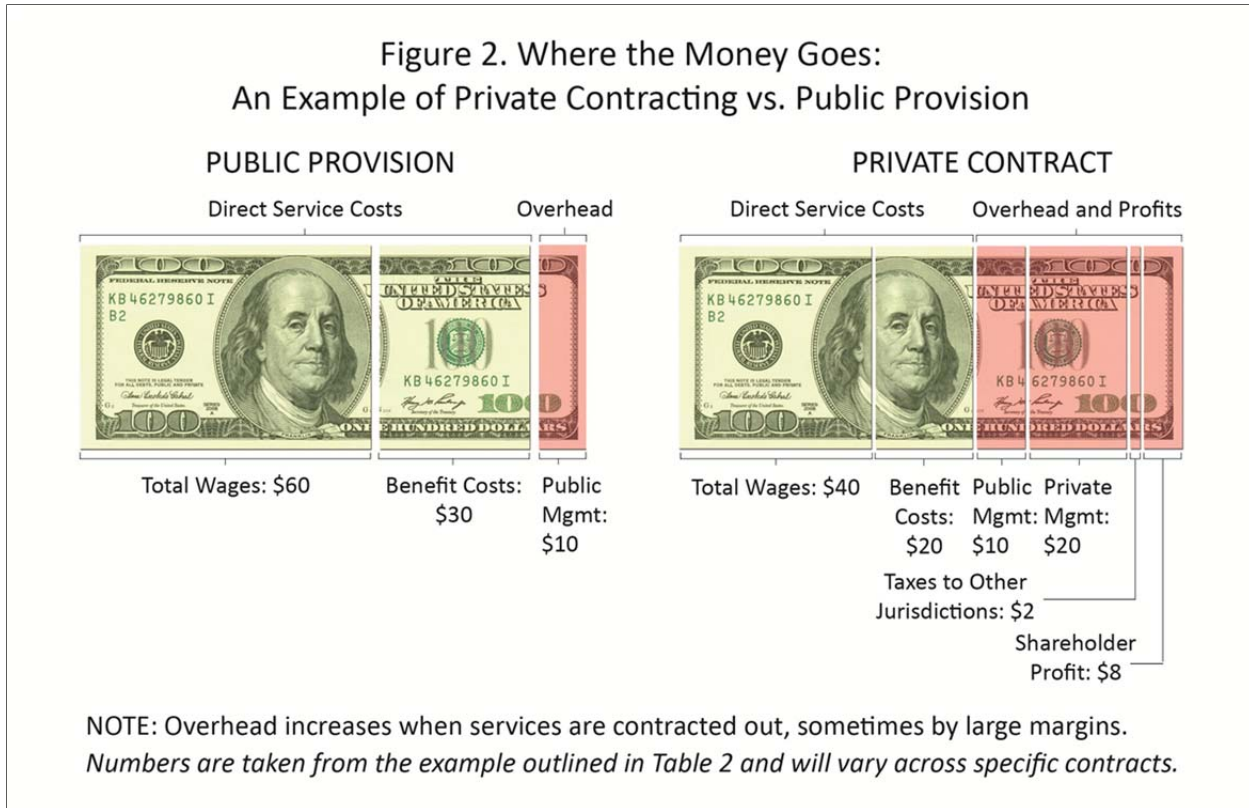
public manager in Table 1 who spent 60% of income outside the community, a smaller share of the higher management salaries will be spent on local goods and services. Combined with the outflow of profits and taxes, the change in where the money goes equates to 7% less of it staying in the local economy. In this example, the immediate decline in local spending is \$7000 (\$49,000 – \$42,000).

¹³ A locally owned contractor would have some, but not all, of these issues. But small, local firms are often not able to handle the legal paperwork, financial risks, and other administrative requirements to bid on major government contracts. Large national and multinational firms handle much of the contracting with state and local governments in corrections, food service, water system management and many other areas.

¹⁴ For management pay in prison corporations see Service Employees International Union (2012, 25).

¹⁵ This also is reflective of numerous analyses and case studies that show oversight and administrative costs within government increasing where compliance and quality are seriously monitored.

Figure 2, below, provides an illustration of how each \$100 in public spending is allocated among workers, managers, and profits in this example. Note that the share going to workers is much smaller because the share for ‘overhead’ to pay administrators, profit and taxes has increased.



A very important question for any community is what specific numbers should be used to look at that particular case. Each should be analyzed according to its own individual changes in wages, benefits, administrative and consulting costs. However, a one-third cut in labor costs for hourly workers is not uncommon.¹⁶ While at first blush that would seem to result in substantial savings, there is substantial data indicating that is often not the case. Savings from outsourcing average 5% in state government and 6-12% for local governments – much less than the cuts in wages and benefits that are usually seen.¹⁷ In many cases there are no savings, insufficient savings or quality problems. Governments then often seek another contractor or bring services back in-house.

If changes in pay lead workers to live in more affordable communities nearby, there will be added

¹⁶ Reductions of 30-50% in pay are documented in Pack (1989); Genter, Hooks, and Mosher (2013); Mason and Siegel (1997); and Wicks-Lim (2011).

¹⁷ Discussion and references of the evidence on cost savings is in Appendix B.

effects just as there were in Table 1. This depends on the variety of housing available locally in comparison to surrounding areas, as well as the extent of the pay change. Let's assume a change in where one-third of all workers live, since some may have already lived outside the area and some will remain. Table 3 shows the cumulative effect on the local economy of 1) the change in how the \$100,000 expense is allocated and 2) the resulting residency changes. The first line of Table 3 shows the effects on the local economy of paying workers 33% less. The second line shows the effect of having more workers (one-third in this example) live outside the district.

Table 3. An Illustration of Combined Effects on the Economy: Wage Cuts Plus Residency Changes

Source of change in spending and economic activity	Initial Effect on Local Economy	Annual Effect on Economic Activity (Multiplier of 1.4)
Workers are paid 33% less	\$7000 more of each \$100,000 of public dollars leaks out	A net decline of \$9,800 in economic activity for each \$100,000 shifted to contracts
1/3 of workers live in other, less expensive areas as a result of lower wages	Another \$13,030 more of each \$100,000 in public dollars leaks out based on residency	A net decline of \$18,242 in economic activity for each \$100,000 shifted to contracts
TOTAL CHANGE FROM THIS EXAMPLE	A total of \$20,030 more of each \$100,000 leaks out and is no longer spent locally	A net decline in economic activity: \$28,042 for each \$100,000 shifted to contracts in this example
<p>NOTE: It is important to realize that while these tendencies are present in every situation, the size of the effects depends on:</p> <ul style="list-style-type: none"> • the extent of change in wages and benefits • the size of the community and its economic multiplier • shopping and commuting options in the area • whether lower compensation is shifted to administration and profits or translated into lower costs. 		

These examples illustrate how contracting directly affects retail spending and local economic activity -- even if total costs to taxpayers are the same, whether the service is performed in or out of government.

More money usually flows out of the local economy. That means *less* spending, especially in retail and dining establishments.

2. The effects on the housing sector are more complex. Workers in lower paying jobs can't afford to pay as much in rent or mortgage payments. Depending on the state of the housing market, this increases the risk of mortgage foreclosures. But total spending *might* stay the same, with more demand for both very inexpensive housing and upper income properties, coupled with less demand for middle income housing. At any time, the difficulty of maintaining a stock of 'middle class housing' will increase as a few new high paying jobs are created and many mid-level jobs become low wage jobs. The property tax base will be more dependent on either commercial properties or the large homes of the wealthy.

Regional economic models can estimate the economic effects

with more accuracy and detail, as well as identifying local business sectors that will be affected and including the effects of employee residence change. Questions a state or local government should answer to establish whether negative economic effects are likely, as well as their size, are provided in Appendix A, along with information about a commonly used model, IMPLAN.

3. There are also fiscal feedbacks that affect local government. First, there is likely to be less tax revenue due to increased flows out of the economy. (States vary on what share of sales or property tax goes directly to local governments and how much the state apportions by legislative formula). If contracting saves money for local governments or taxpayers, that could recycle through the local economy in other ways that offset some of the decline in spending by lower paid workers. But there are new pressures on government.

Workers whose income falls substantially may use more public assistance for food, housing, or medical care.¹⁸ Since most 'safety net' benefits are paid for by the federal or state government, local

School cafeteria workers receive an average \$1743 in public benefits each year due to the low pay they get from contractors in California.

governments don't always recognize them as costs. But as more workers are eligible for the Earned Income Tax Credit (EITC) as well as medical care, housing, and food subsidies, this reduces what state and federal budgets spend on infrastructure, education, the environment and other high priority needs – directly affecting local government budgets.

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¹⁸ For example, school cafeteria workers on contract in California received an average \$1743 annually in public assistance (Jacobs and Graham-Squire 2010).

Just because the expense is borne by another level of government, it is not ‘manna from heaven.’

Over time there will be competing claims on federal or state appropriations that may lead to cuts in the benefits that keep low-paid workers afloat, or cuts in revenue sharing and grants for other activities. .

Public education, unlike food assistance or medical care, is primarily funded by local and state governments. More low income families means not only less tax revenue per family, but a larger share of children who are ‘at-risk’ and require higher levels of spending. And fewer will be able to attend even state or community colleges without substantial financial assistance.

A growing local population of the working poor or ‘near poor’ also puts pressure on non-profits.

When fewer workers are self-sufficient, local charities understandably target more to social needs. But

Loss of health insurance or sick leave means more uncompensated care at local hospitals and clinics. Risks of communicable disease transmission rise when more workers who are ill come to work.

these funds also have their limits - a dollar given in one area is often at the expense of another. States and communities have long relied on private contributions to the arts, historic preservation, recreation, or higher learning to enhance local quality of life. If workers who used to be self-sufficient need more and more help, this hurts economic development in many ways.

When it comes down to it, poverty is not cheap. That’s why real economic development is broadly based, increasing the number of families who are self-sufficient *and* contribute tax revenues to maintaining quality of life in their city or state. This means having more workers with pensions and medical insurance who earn enough to support a middle class lifestyle. **For those at the bottom, the ‘American Dream’ has always been that even if they cannot make it, their children will be able to have a better life.** There is mounting evidence that fewer can participate in that dream. Let’s turn next to that problem and how it is affected by outsourcing public services.

B. INDIRECT AND LONG-TERM ECONOMIC IMPACTS

Along with negative effects on the local economy there are also indirect – but very real – effects on government, the economy and private sector workers from outsourcing. Some of these are long-term rather than immediate, but a sustainable development policy requires considering how actions today will affect the future.

Government plays a dual role in labor markets. Along with setting formal standards for safety or pay that apply to the whole economy – such as the minimum wage, overtime rules, or workers compensation systems – the various units of government are direct players in the labor market. For any community, what constitutes a

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‘competitive’ wage, a reasonable benefit package¹⁹ and good working conditions is a product of both private and public sector decisions.

Most elected officials say they want a strong middle class and understand that means improving opportunities for working families. But they don’t always recognize how many of their decisions can hurt or help opportunity. Economic development policies must go beyond encouraging new business start-ups and supporting education, important as those two strategies are. Economic development involves leadership from the public sector as producer *and* employer. During the Great Depression of

State and local government shape market forces as well as responding to them. For example, the public sector led the way on the 40 hour work week, paid vacations, pensions and equal opportunities at work.

the 1930s and in to the 1950s and 1960s, the public sector led the way on many reforms. Private companies had to compete for workers by joining in higher standards. That helped to build a large and stable middle class in the United States. It is now

shrinking. Let’s look at changes in three areas of our economy and how public sector decisions can affect each of them. They are 1) the quality of jobs an economy produces, 2) how many ladders of opportunity there are to help workers join the middle clas²⁰s and 3) the effects of pensions on the well-being of seniors and their communities.

1. A smaller share of jobs available in the United States support a ‘middle class’ life than did thirty years ago. The Center for Economic and Policy Research tracked the number of jobs with employer paid pensions and health insurance that also pay at least what the average male worker got thirty years ago.²¹ Since a much larger share of workers today have a four year degree than in 1979, the share of workers with ‘good jobs’ should also be much higher.²² And the average worker today is seven years older than in 1979 and has more experience -- something the job market typically rewards.

Yet despite more experience and more education, the share of workers with ‘good jobs’ has trended down fairly steadily: from 27% of the workforce in 1979 to 24% today. That is almost five million workers behind where their experience and education would have put them thirty years

Almost five million workers today are behind where their experience and education would have put them thirty years ago.

¹⁹ See Keefe (2012) and Munnell, et al. (2011) for comparisons of public and private sector pay that include pensions and benefits and adjust for levels of experience and education. Only 2% of state and local workers lack a high school degree, compared to 6% in private jobs. 79% have at least some college, and 54% have at least a four year degree, compared to 67% and 35% in the private sector.

²⁰ See Kozlowski and Spirn (2014).

²¹ The 1979 median male wage adjusted for inflation to recent values is just under \$39,000 (Schmitt and Jones 2012, 2013). While many more female workers have entered the work force, their increased education and experience, along with equal pay laws, make this an inadequate explanation of a gap this size.

²² 33% of workers had at least a four year degree in 2010 compared to 20% of workers in 1979, according to Schmitt and Jones (2012, 2013).

ago. And it hasn't changed much since 2005, before the Great Recession hit. Growth in both labor productivity and GDP in the United States over this period should have made higher wages more prevalent--- not less.²³ But a larger share of workers lack either health insurance, a pension or pay that meets the modest criteria of being as well-off as workers in their parents' generation.

The decline in the average quality of jobs is not just a private sector phenomenon. Over 10% of the workforce is directly employed by a state or local government. Many more are serving the public sector through private contractors. While the public sector has remained steady at around 18% of the U. S. economy²⁴ over the past fifty years, job opportunities in the public sector have grown at a much slower pace than in the private sector. Mechanization explains much of the decline in manufacturing jobs. But public sector jobs are primarily service jobs, so many are difficult to mechanize. The much slower growth of job openings in the public sector must be coming, in large part, from shifting public sector work that taxpayers still pay for to private contractors.²⁵

The big increases in outsourcing began in the late 1970s and 1980s. There is no reliable and consistent information about the total number of public sector *jobs* now contracted out, although there is good data on the number of *services* outsourced by municipalities (about 35%).²⁶ At the federal level, taxpayer *dollars* spent on private contracts have more than doubled since 2000, with most of the increase spent on services.²⁷

Highly educated workers are paid much more in private sector jobs, but workers with less education do better in public sector jobs.

2. Economic development is based on a growing middle class, not a shrinking one. 'Middle class' means income of approximately \$45-90,000, a range that goes from 75% to 150% of median household income.²⁸ The Pew Center reports that just over one third of American families were middle class in 2007—right *before* the financial crisis and Great Recession. That compares

²³ Compensation of a typical worker grew at relatively the same pace as productivity from 1948–1973. Since then productivity has grown over 80% while median hourly compensation grew just 10.7 percent (Mishel 2012, 2-4).

²⁴ This includes the federal government, which employs another 5-6% of the workforce. The combined share of all governments in the economy is as low as 16.5% when the private economy is booming, and as high as 20% when the private economy is in recession. But it has exhibited no upward or downward long-term trend since the 1960s.

²⁵ Unfortunately, Census data collection does not differentiate between private sector workers employed on government contracts and those directly serving private customers. So while we know the total number of government employees, there is not adequate data on the number working under federal, state or local contracts but performing public sector work.

²⁶ For municipal services, see Warner and Hefetz (2012). Around 10% of all school district cafeteria workers work for private contractors rather than the district (Jacobs and Graham-Squire 2010).

²⁷ United States Senate report (2013, 1).

²⁸ The median income is income at the 50th percentile, or right in the middle of the distribution (in contrast to a simple average of all incomes that is skewed by a small number of very high incomes). The range of \$44,620 and \$89,241 is for 2007, but was little changed six years later, due to the effects of the Great Recession.

to 40% of Americans in the middle class in 1970.²⁹ So let's explore how state and local contracting decisions have contributed to that decline and then how they can help to reverse it.

While the pay gap based on education widened significantly in private jobs over the last thirty years it stayed steady in the public sector.³⁰ Highly educated workers are paid much more in private sector jobs (which meant higher administrative costs among contractors than in the public sector in Table 2).

Ladders of opportunity in the public-sector have helped bring many low-income workers and their families into the middle class.

In contrast, workers with less education do better on average in the public sector. Including benefits, workers with only a high school degree receive 6% more, on average, in public sector jobs than private. Workers with a few years of college but no degree receive 9% more than in the private sector.³¹ That contributes to the pressure to outsource their jobs to private contractors.

However, paying more has enabled the public sector to reduce turnover in lower wage positions and spend less on training by attracting the most able of these workers. This contrasts with the low wage, high turnover strategy practiced by the fast-food industry and many retail businesses. Ladders of opportunity in the public sector have helped many low-income workers bring their families into the middle class and their children to become leaders in business, education, the law and government.

Contracting often weakens that ladder of opportunity into the middle class. It disproportionately impacts women and minorities – particularly African-Americans – along with all workers with less education. In the public sector, white men with similar education and experience still make more than women or minorities. But the wage gap between men and women, or blacks and whites is much smaller than in the private sector.

Mobility – becoming better off than one's parents – used to be associated only with the word 'upward' in America. But for some time it has not been unusual for a worker – even if they earned a college degree – to do less well than their parents. These newer patterns of mobility go back as far as children born in 1971, who would now be in their early forties.³²

Even before the recession, fewer workers who grew up in low income families had experienced upward mobility than did for several decades after World War II. And while some sons and daughters

²⁹ Taylor, et al. (2008, 110).

³⁰ See Borjas (2002).

³¹ This difference is due in part to performing different jobs. But it also occurs because a larger share of compensation comes in benefits (versus wages) for ALL public workers relative to those in the private sector. This emphasis on benefits then creates more equal total compensation packages. See Keefe (2012).

³² The Pew mobility project uses the Panel Study of Income Dynamics (PSID) and begins with adults in the 1960s, continuing to the present. Other mobility research that find declines are based on the PSID or the National Longitudinal Youth Survey in Ferrie (2005); Mazumder (2005); Levine and Mazumder (2007); Harding, et al. (2005). The somewhat different conclusions of Chetty, et al. (2014b) are based on data starting with those born in 1971.

from middle class families *have* risen into higher income groups, a larger share have fallen *below 75%* of what the median family has. In the slow recovery from recession, median income actually *declined* annually through 2011.³³

Shifting jobs from the public sector to private contractors helps perpetuate low incomes for minorities and in female-headed households.

Providing education and re-training programs are not the only ways public policy can contribute to mobility and opportunity.

As a player in local labor markets, governments that consider all the effects of outsourcing can contribute to upward mobility for their citizens and avoid adding to downward mobility. Shifting jobs from the public sector to private contractors further

contributes to low incomes in female-headed households and for minorities. Reacting to pension issues by trying to get out from under them misses the long view of how they support a strong middle class. Let's turn next to how pensions affect the living standards of seniors.

3. Governments across the country are exploring more outsourcing based on long-term pension obligations. Getting out of pension obligations is the reason city officials in Colorado Springs give for contracting out many services this year.³⁴

Following a one year experiment in contracted snowplowing where audited costs were 489% higher than in areas the city plowed, the mayor's office plans to expand the experiment and make it longer term to get "enough data to analyze it."³⁵ All this, for some savings on pensions?

Pension costs are not a trivial matter when planning long-term.

But often, financial problems can be traced to poor stewardship. Some state or local governments have failed to contribute regularly. In addition, state legislatures have sometimes used pension funds as a kind of 'rainy day fund.' If the money borrowed in bad times is not paid back during good, the pensions fund becomes increasingly weak. Lastly, unsustainable (and even retroactive) benefit increases have been granted by some cities and states when stocks were at their peak.³⁶ Public entities are not required by federal law to follow the rules imposed on private pensions after many funds went bankrupt several decades ago. Reforming these practices would help in the long-run, but do little to reduce pension exposure now. Does that leave no choice but to go 'full speed ahead' with pension cuts?

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³³ Median family income reached \$51,371 in 2012, 8.7% less than it was before the recession (Noss 2013,1,5).

³⁴ A new \$35 million contract with Serco, based in the United Kingdom, eliminated sixty city workers in fleet maintenance but is expected to save the city \$1 million in pension costs, reports Zubeck (2014).

³⁵ The contractor "missed more than 120 streets that pass by schools or feed into main arteries.....destroyed one mailbox," used less de-icer than normal, and started work later, leading to numerous complaints (Zubeck 2014).

³⁶ Surowiecki (2013, 46).

State and local governments need to keep the big picture in mind. Terminating or sharply reducing worker pensions will have a whole series of negative effects on local economies, well-being and the sustainability of existing pension funds. The short-term effects of eliminating or reducing pensions may appear quite small, since many workers will not be immediately affected. But the movement away from

Almost four times as many older households without a defined benefit pension receive public assistance as seniors with a defined benefit pension.

traditional 'defined benefit' pensions has already put more senior citizens at risk. 16.4% of older households without a defined benefit pension received food stamps, rent subsidies, energy assistance or supplemental social security (SSI), averaging \$6,494 per household. This was over triple the rate (4.7%) of cash transfers for older households with a defined benefit pension.³⁷

As the percentage of workers with defined benefit pensions declines, there will be more poverty and more dependence on cash transfers. And it will mean less spending power for many other seniors.

This affects states and localities where seniors are an increasing share of the population. And as the baby boom ages, that will be quite a few more places! Local and state governments participate in many programs to help seniors with low incomes. So if fewer seniors are financially independent, more will depend on Medicaid for medical and long-term care. That hits state budgets. Hospitals and clinics that treat seniors unable to pay will also be impacted. And withdrawing more workers from public pension plans makes the plans more fragile – setting up additional problems that must be addressed in the future.

There is certainly room for better pension practices in many states and cities, such as requiring public entities to follow some of the same funding rules that private companies must follow. And sometimes changes to pension plans or outsourcing are appropriate. But wider costs and impacts such as pension fund viability and the value we place on the independence of seniors should be carefully considered, just as the effects of decisions on workers and families should be. That brings us to the importance of other social impacts that affect quality of life and sustainable development.

III. THE SOCIAL IMPACTS OF CONTRACTING

This section addresses important social impacts of contracting that are distinct from economic impacts or fiscal impacts to local or state government: health and safety at work and in the community, the openness and accountability of government to its citizens, and our commitment to equal opportunity.

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³⁷ The comparison of benefit use is from Porell and Oakley (2012).

A. Health and safety are always high on the list of what people value, but increasingly the public role in protecting them is being contracted out. There is no readily available source for how state and local contractors across the United States measure up on worker health and safety. But many problems have been documented among major federal contractors. A recent Senate inquiry found that almost 30 percent of the top violators of federal wage and safety laws are also current federal contractors. This led

Many top violators of federal wage and safety laws are also current federal contractors. Their violations resulted in the death of forty-two workers between 2007 and 2012.

Congress to require a database for monitoring contractor problems. But **many fatal incidents, like the washroom operator sucked into an industrial dryer and killed at a Cintas Corporation facility,** do not show up in the database.³⁸ A report from the U. S Governmental Accounting Office (GAO) found that top contractors had also been hiring undocumented workers and violating environmental protection laws.³⁹ If practices like these are responsible for ‘savings’, many Americans might prefer not to have them.

New work rules and higher work intensity can be part of the problem. Work ‘speed ups’ which follow staff reductions often have substantial human cost to worker health and mortality.⁴⁰ Responsible decisions would weigh these costs against the benefits of savings to government. A good economic development policy requires that kind of consideration, if public actions are directed at benefiting the entire community. Operating at standards outside the law damages worker health and safety, creates an economic disadvantage for companies that obey the law, and establishes a downward trend in accepted standards for health and safety laws that is likely to affect all workers. Lobbying to weaken health and safety does much of the same, and private contractors are in a position to do just that.

Providing adequate public safety is also a primary role for all levels of government, yet it is not unusual for safety to be pushed to a back burner when outsourcing. Corrections, public health and infrastructure provide some examples of how ‘irresponsible contracting’ puts the public at risk.

³⁸ A 46-year-old father of four, working as a washroom operator at a Cintas Corporation facility in Tulsa was killed after being swept into an industrial dryer. He had been attempting to dislodge a clothes jam. The dryer continued to spin with him inside for 20 minutes at over 300 degrees. Cintas received \$3.4 million in federal contracts in fiscal year 2012. Despite a 2008 law establishing a database to help agencies evaluate violations of federal laws, they continue to lack the needed access and tools to evaluate the severity or repeated nature of these violations, according to the U. S. Senate report (2013, 2).

³⁹ U. S. Government Accounting Office (2010). Many of the same contractors had also submitted fraudulent bills to Medicare or Medicaid.

⁴⁰ Landsbergis, et al. (2012).

Privately owned and contractor-managed prisons have a lengthy record of public safety problems, along with cost overruns and quality issues. To generate returns for their stockholders, private prisons have often scrimped on staff qualifications, staffing levels, and training. A meta-study that distilled results from a number of researchers concluded that publicly managed prisons tended to perform better on public safety issues.⁴¹ Three escapees from a medium security state prison in Kingman, Arizona went on to kill two innocent tourists at a rest stop. Only after that did an audit identify how many employees were inexperienced and how inadequate the monitoring systems were. Lights were often out and alarms were so often false that staff typically ignored them.⁴² But prisons are not the only places where public safety can be a risk.

Several innocent tourists were killed at an Arizona rest stop by escapees from a medium security state prison in Kingman. Only after that did an audit identify how many employees were inexperienced and how inadequate the monitoring systems were. Lights were often out and alarms were so often false that staff typically ignored them.

More than half of America’s county health departments have delegated at least one service to contractors or started one new service with a contractor.⁴³ These departments provide many essential services that private organizations lack the incentives to perform, including maternal and pediatric care for low-income families. They also monitor environmental health and communicable diseases (including influenza, HIV and tuberculosis). Public health departments can engage in prevention where private providers would not have the authority or capacity to act.

On services to individuals, the results have been mixed – some good, some bad. But when there is an outbreak of a communicable disease, private providers rarely have the infrastructure to deal with

A contractor leasing primary toll roads placed barrels filled with sand in emergency turn arounds, blocking access for emergency vehicles to reach accidents. Since legal control of the public road rested with the contractor, it took months of effort to get them removed.

that. The rapid and clear communication needed in a public health emergency becomes more difficult. “Privatization added another administrative layer which made it more difficult to obtain reliable, specific information quickly,” concluded the authors.⁴⁴

Communication with multiple layers of decision making and delegation of legal authority can also affect safety on roads and other infrastructure. In Indiana, a contractor leasing primary toll roads sought to prevent drivers from using

⁴¹ Lundahl (2009, 392).

⁴² Service Employees International Union (2012, 11).

⁴³ Survey responses from a random sample of several hundred departments were analyzed in Keane, et al. (2001) See additional examples in Dannin (2001, 2006, and 2011).

⁴⁴ Keane, Marx and Ricci (2001, 130).

emergency vehicle turnarounds to avoid tolls.⁴⁵ This blocked access for ambulances and endangered the lives of accident victims. But since the contractor had legal control of the public road, it took months to get the barrels opened and the access restored.

A city or state may take for granted its historical freedom to act without realizing that contractual terms have changed its authority to act. Many times, the public does not realize that a policy change is being considered --- or has already happened. This loss of citizen involvement is often another nonfinancial social cost of outsourcing or P3's. Let's turn now to how relying on private contractors can lessen transparency and accountability.

B. ACCOUNTABILITY, TRANSPARENCY AND CIVIC INVOLVEMENT

Democracy, it is often said, needs sunshine to survive. But

according to legal scholar Ellen Dannin, the laws requiring freedom of information, open meetings, and many administrative procedures do not apply to private companies even when they do public business.⁴⁶

Without a true market to provide competition, the traditional methods of public accountability are likely to be needed -- but are often missing. This is another of the effects on society that often come from the halfway land of outsourcing, which is neither truly public nor truly private.

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Privatization advocates sometimes argue that market forces assure accountability for contractors. But once awarded a contract, payments and profits come from public funds, not free market decisions.

Citizens – and even elected representatives – often lose access to critical information when services are outsourced to private contractors or P3's. Private companies have rights to privacy that public organizations do not and that have been upheld in numerous court cases. Even audits cannot touch this information. Secret contract negotiations are often rationalized as necessary to protect these rights to privacy. (Sometimes the need to “rush” a contract approval is also given). This contrasts with open forums on many other issues.

Chicago and Denver provide two recent examples of transparency problems. When parking meters were leased to a newly created private entity (Chicago Parking Meters LLC) there were only three days of discussion, with no opportunity for public comment before a decision that could cost the city \$2 billion or more over the next 75 years.⁴⁷ In Denver, the contract awarded to a private company for the Northwest Parkway allowed it to object to new roads, improved roads or mass transit alternatives for a

⁴⁵ See additional examples in Dannin (2001, 2006, and 2011).

⁴⁶ Dannin (2006, 133).

⁴⁷ Sclar (2013).

99 year period – even though streets average 45 years of useful life!⁴⁸ Although these terms were not released until *after* the deal was signed, taxpayers must pay compensation for future actions that interfere with the operator’s profitability. Unfortunately, these cases are not unusual.⁴⁹ And the problems they highlight extend beyond P3’s to other forms of contracting.

Financial secrecy is often a right for private firms even when they are contracting with public entities.

“On a recently approved Texas charter school application, blacked-out paragraphs appear on almost 100 of its 393 pages,” according to a New York Times review of the publicly available online document.⁵⁰

Employee salaries, marketing expenses, and other commonly public financial information were blacked-out on a recently approved Texas charter school application.

Although commercial entities cannot operate public schools in Texas, contracting out the management of a school has sidestepped this requirement. Establishing business relationships with online course providers has the same effect. As a result, employee salaries, marketing expenses, and other commonly public financial information are not subject to public open-records laws.

In addition to having rights to privacy that collide with traditional expectations of transparency and accountability, **private providers are generally not subject to conflict-of-interest laws, nepotism statutes or ordinances, ethics codes or whistleblower protection for their employees, or restrictions on political involvement.**⁵¹ This last omission makes it possible to use political influence to get contracts and to increase public demand for their services. A prime example of this has been the large corporations that build, own, or manage prisons.

The corrections industry spends a great deal on campaign contributions and direct lobbying of state legislatures and the U. S. Congress in support of laws that will result in larger prison populations.⁵² This has increased profitability for these companies, but at the cost of state budgets. California voters repealed ‘three strikes’ legislation in 2012, based on evidence that it had contributed little to public safety.⁵³

The push for mandatory minimum sentences is an example of creating a demand and profiting from it. ‘Three-strikes’ laws were endorsed by the prison industry that now houses the larger inmate population they provide.

⁴⁸ Dannin, (2011, 48-49) cites a U. S. Department of Commerce estimate.

⁴⁹ Sclar (2000); Dannin (2001, 2006, 2011).

⁵⁰ Smith (2013).

⁵¹ Wisniewski (1992).

⁵² Shen (2012).

⁵³ A 2003 analysis by the California legislature’s research staff found that counties where ‘three strikes’ was used frequently had only slightly greater reductions in crime compared to counties that did not use it much (Brown and Jolivet 2005). In 2012, over 2/3 of voters supported Proposition 36, ending the law (Sankin 2012).

Private contractors for other services are not as visible as the few behemoths that dominate the corrections industry. But the same potential problem exists. A private company has the legal right – and some would argue a responsibility to its shareholders – to influence public opinion in ways that increase its profits. This includes marketing its message directly to the public as well as lobbying public officials and their staffs. Public employees and public agencies are expressly prohibited from this conflict of interest. In the case of prisons, giving more voice to those who can profit by it has had a big impact on laws, lives, and budgets.

With citizens at the very foundation of our democracy, all of these effects need to be taken seriously. Sacrificing responsiveness, transparency and accountability in the name of cost reduction diminishes quality of life. It may also result in higher costs and diminished quality of service.

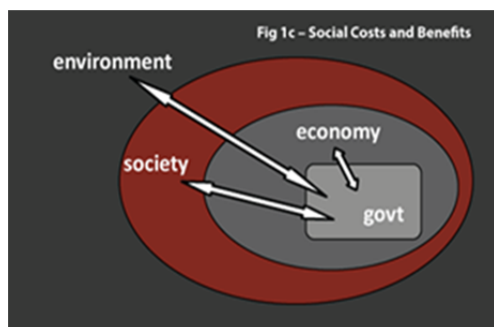


Figure 1c, at left, illustrates the effect that governmental actions have on society and therefore individual well-being. The end goal of economic development is to improve life for citizens. And that includes the society they live in as well as their economic circumstances. With that in mind, we turn next to how contracting affects opportunity for those who have been most disadvantaged historically.

C. Equality of opportunity is another principle at the foundation of our democracy. It has taken two centuries for serious efforts to be made to expanding it to all Americans. There are still much higher rates of poverty and lower average incomes for African-Americans, other minorities, and female-headed households, greatly affecting the opportunities of the next generation.

Many women and minorities have been attracted to public sector jobs by greater opportunities to rise through the ranks. The public sector is the largest employer of African-American men – ahead of both manufacturing and trade. For working women of all races the public sector is the third largest employer.⁵⁴ Workers have more opportunities to rise from entry level work (janitorial, for example) to other positions within a multifaceted government than with a contractor who specializes in cleaning services.

Long before the Civil Rights Act, an Executive Order from President Roosevelt required all federal contractors to include a non-discrimination clause on the basis of race, color, creed, and national origin. Later administrations built upon this, influencing the steps private businesses later took to address racial discrimination.

⁵⁴ In contrast, public employment is the 6th largest employer of Hispanic men (Appendix A, Pitts 2011). Note that this is based on data adjustments that move workers in health or education employed by the public sector into

Black workers are much more likely to hold jobs that pay in the top third in the public sector than when they work in manufacturing or trade. This also holds for female workers with less education.⁵⁵

Female and minority workers who become employees of private contractors are unlikely to have the same pay and opportunities. For example, a janitor in city government has more options to work their way up to other positions than one employed by a cleaning service. And an Urban Institute study finds that firms owned by women or minorities are less likely to be awarded government contracts than are firms owned by white males.⁵⁶

The public sector provides equal opportunity through a smaller wage gap between men and women, or blacks and whites than the private.

According to the Pew Center’s Mobility Reports, African-Americans

have been hit particularly hard by the declining mobility of the last few decades. They are much more likely (56%) to be downwardly mobile from the middle than are whites (32%) and much less likely to be upwardly mobile from the bottom.⁵⁷ The long history of ‘Jim Crow’ segregation laws only began to change shortly before patterns of mobility also changed.⁵⁸ Mobility continues to be lower in parts of the

United States where there is more segregation and more inequality of income.⁵⁹

Firms owned by women or minorities are also less likely to win government contracts than firms owned by white males.

Women of all races, along with African-American males, sought out public employment for more equal treatment than they often found in the private sector. **Outsourcing public jobs often lowers wages, takes away benefits, and reduces**

opportunities for advancement up the job ladder – and disproportionately affects the groups who have struggled most to get a foothold in the labor market and the middle class. Maintaining ladders of opportunity is an important part of the promise of America that public decisions can help to maintain.

V. CONCLUSIONS

This report has examined the broader social and economic effects of outsourcing to private contractors by state and local governments. These are often forgotten when considering the cost effectiveness of a contract. But preserving quality of life and sustaining real economic development

‘public jobs’ from ‘education and health.’ As a result, the education and health sector includes only those workers with private or non-profit employers.

⁵⁵ See Tables 7, 8 and 9 in Pitts (2011); Bernhardt and Dresser (2002).

⁵⁶ Compared to their share of eligible firms, they receive less than 60% of contract dollars (Enchautegui, et al. 1997).

⁵⁷ Taylor, et al. (2012, 18-20).

⁵⁸ For more discussion on mobility and opportunity, with particular attention to African-Americans, see Greenwood and Holt (2014).

⁵⁹ Chetty, et al. (2014a).

require that local and state officials consider these. As stakeholders, citizens expect their governments' influence on the economy and society to be consistent with deeply held social values.

As the tables in Section II showed, even when quality and total costs are identical, outsourcing public jobs to a private contractor is likely to have direct economic costs. It's important to weigh these costs, and those of social equity, public health and safety, and the civic environment, along with considering the direct impacts on government. The fact that many cities and states have established a minimum level of savings needed (usually 5-10%) probably reflects a realization of the risks involved, the difficulty of accurately measuring all costs, as well as an awareness of many 'intangible' costs to the community. **But a 5-10% margin is generally not going to be enough to account for all of those.**

It makes sense, instead, to conduct impact studies on the economic and social effects of outsourcing or asset sales, just as environmental impact statements have been required on major capital projects since the 1970s. Many states and cities rely on economic impact studies when making major financial

Montana Statute 2-8-303 requires calculation of "the estimated current and future economic impacts of the implementation of the plan on other state programs, including public assistance programs, unemployment insurance programs, retirement programs, and agency personal services budgets used to pay out accrued vacation and sick leave benefits [and]... the estimated changes in individual wages and benefits resulting from the proposed privatization."

decisions. Qualification for federal infrastructure funds often involve establishing economic impact. States can enact statutes or establish policies that require such an analysis before entering into contracts or P3's.⁶⁰

A full analysis should go beyond the direct costs to government to include 1) the impacts on public workers and their families, 2) direct effects on the local economy, 3) indirect effects on economy-wide wages, benefits, and mobility, and 4) the particular impacts on female and minority workers. In addition, since contracting or P3's can affect 5) health and safety, 6) governmental authority, 7) accountability and transparency, and 8) responsiveness to citizens, data on each of these should be collected and considered carefully .

Appendix A reviews the information needed to calculate economic and social impacts and provides examples of other statutes that go beyond cost and quality issues. **Appendix B** gives an overview of the evidence on cost savings, control and quality cited in this report. It also provides sources that can be helpful in ensuring that outsourcing or P3's will be done in ways that are fiscally responsible. Some economic and social effects are included.

⁶⁰ Dilanni's (2011) survey of state laws for the League of Women Voters includes both statutes mandating efforts to shift service provision from the public sector to private companies, as well as others requiring an informed and deliberate process that protects the public interest. State laws apply to counties and school districts and to all cities that are not designated 'home-rule'. Some of these cities have passed their own legislation.

APPENDIX A: How to Estimate the Effects of Outsourcing on Local Economic Development Where You Live

Step 1: Collect the following information related to the potential contract:

1. Expected changes in average hourly/weekly/monthly wages for employees in various classification groups (example: drivers/clerks/ maintenance/managers).
2. Expected changes in average hourly, weekly, or monthly monetary benefits (such as health insurance, pensions, disability insurance) for each of these classifications.
3. Changes in non-monetary benefits for affected workers: days of sick leave, personal or family leave, paid vacation and any other relevant areas.
4. Number of personnel at each of the different classification levels.
5. Average salary and benefits for different classifications of administrative staff and estimates of future changes in staffing levels, pay and benefits.
6. How much more (or less) will be spent on consultants during the exploratory phase? If outsourcing is decided upon? If a transition back in is needed?
7. The racial and gender mix of the public employees who will be affected and any expected changes after contracting.
8. Is there a requirement for public employees to live within the jurisdiction? Will this change with contracting, due to different requirements? Different pay scales that affect where housing is affordable?
9. The share of expenditures for soliciting, writing, funding and monitoring contracts that will go to entities, workers, or corporations outside the area.
10. If using a regional model like IMPLAN* to calculate the indirect effects, what is the relevant political unit or geographic area in which the economic impact will occur? (Note that since IMPLAN is based on zip code, some analysis can be done for a school district, a political subdivision, or portions of a large city).

Since each situation is unique, some questions will be more relevant than others. Others must be modified to fit local needs and preferences, and there are likely to be other questions that should be added. The goal is to collect information that can be presented to help estimate the direct *and indirect* economic effects on the community as part of a contracting or P3 decision.

Step 2: Much of this can be used in a formal economic analysis, but just collecting data to construct something like Tables 1-3 will help in understanding the initial economic effects.

***IMPLAN (IM** **impact analysis for PLANning)** is one model that can be used to analyze economic effects, including data-based estimates of how much spending will continue to circulate in the local economy and how much will leak out of the local economy. It can also identify which local business

sectors are likely to experience less demand due to contracting out or outsourcing. It is basically an input-output model – somewhat like a giant set of spreadsheets -- showing the linkages between different economic sectors and actors, but has added Social Accounting Matrices that include ‘non-market’ transactions like unemployment benefits. It uses multipliers tailored to the region in question, rather than the mid-range example used in the text.

IMPLAN was designed under the direction of the USDA Forest Service to work with the Rural Development Act of 1972. First housed at the University of Minnesota, it was spun off through a technology transfer agreement to become a private company. IMPLAN is most often used to analyze the effects that the opening/closure of a military base, new factory, or other business would have on related sectors, employment, household incomes, and tax revenues. It can also be used to study changes in tourism, land management, health and human services, water, and energy, and **how the economy is affected by the use of contracted workers to replace former public sector employment.** It can be purchased by a local or state government as a package that includes the model and the most recent data related to a particular county or state from the U. S. Department of Commerce’s Bureau of Economic Analysis (see www.implan.com for more information). For cities or specialized districts or neighborhoods, the data can be broken down by zip code and aggregated as appropriate. The model is used directly by the purchaser.

IMPLAN customers include:

- The Bureau of Reclamation, since 1995
- The Bureau of Land Management, since 1999
- The Federal Reserve Bank, since 2000
- Booz Allen Hamilton, since 2001
- The Cherokee Nation, since 2003

Specific studies using IMPLAN include:

- The Economic Impact of Marshall County Hospital on Marshall County, Kentucky, available at www2.ca.uky.edu/KRHW/pubs/04aug_marshall_impact.pdf
- The Economic Impact of Minnesota’s Weatherization Programs, available at www.waptac.org/data/files/Website.../eia-mn-wap-success-story.pdf
- An Illustration of the Impact on the Santa Clara County Economy of Repealing the Prevailing Wage Policy of the City of San Jose. 2011. Kevin Duncan, Ph.D. for *Working Partnerships, USA*, January, available at http://wpusa.org/5-13-11%20prevailing_wage_brief.pdf

IMPLAN was also approved for calculating probable economic impacts in applications for the American Recovery and Reinvestment Act (ARRA). Examples available online include: Iowa

Department of Transportation, Burlington Bridge Replacement; South Park Bridge in King County, Washington; and the Fort Worth, Texas rail connection of BNSF railway.

It is important to note that a regional model like IMPLAN *cannot* make estimates for

- 1. equity issues such as disparate effects by race and gender**
- 2. the dynamic long-term effects of current changes on opportunity and mobility**
- 3. accountability, transparency, responsiveness, or citizen participation**
- 4. public health and safety, including the effects on workers**

Each of the above also contributes to quality of life and therefore to economic development, but is difficult to quantify as precisely as short-term economic effects. However, the likely effects on each element of equity, opportunity and mobility, principles of good government, health and safety should be compared to the vision statements of a city, school district or other entity.

They can also be compared to statements of principles of agencies in states and other organizations that do not have an overarching principles statement. These generally include commitments to fair hiring and treatment of employees, to environmental protection, to public safety, and often to increasing quality of life and sustainability in the community.⁶¹

There should be mechanisms in place to guarantee that contracts are made only with those who have a record of following accepted public standards on equality of opportunity, worker health and safety, or public health. Standing policy should also require looking at the short and long term economic impacts where there is any reason to think they will be significant.

This will require legal or procedural changes in many states and cities. Others that already have policies simply need to track performance and terminate relationships with repeat offenders. For example, California code specifies many requirements for contracting with private entities. Along with many provisions directed to cost and quality concerns,

“(2) Proposals to contract out work shall not be approved solely on the basis that savings will result from lower contractor pay rates or benefits. Proposals to contract out work shall be eligible for approval if the contractor's wages are at the industry's level and do not significantly undercut state pay rates.

(3) The contract does not cause the displacement of civil service employees. The term "displacement" includes layoff, demotion, involuntary transfer to a new class, involuntary transfer to a new location requiring a change of residence, and time base reductions. Displacement does not include changes in shifts or days off, nor does it include reassignment to other positions within the same class and general location.

⁶¹ See Greenwood and Holt (2010), Ch. 8 on aligning public policy with indicators and statements of purpose.

(4) The contract does not adversely affect the state's affirmative action efforts.”⁶²

California also stipulates that contracting can occur only when “the potential economic advantage of contracting is not outweighed by the public’s interest in having a particular function performed directly by state government⁶³.” Maryland specifies that contracts must not “adversely affect the affirmative action efforts of this State.”⁶⁴ Massachusetts provides that “the amount of income tax revenue, if any, which will be lost to the commonwealth by the corresponding elimination of agency employees...” should be added back in as a cost.⁶⁵ It requires written certification to the state auditor that the contract is in compliance with all relevant statutes “concerning labor relations, occupational safety and health, nondiscrimination and affirmative action, environmental protection and conflicts of interest.”⁶⁶

Miami-Dade County (Florida) code of ordinances⁶⁷ requires information on the characteristics of the contractor work force, whether there is a collective bargaining agreement, and whether health insurance is provided. A San Diego council resolution states evaluations must “consider safety, public health, employee compensation, and economic benefit” along with traditional concerns about quality, cost, and liability. San Jose’s council resolution requires advance posting on the city’s website of informational memos (28 days in advance of a council meeting) and of the staff report (14 days in advance) for use of public funds of over \$1,000,000.⁶⁸

Examples from abroad are also useful models for how to include the public interest, as well as direct savings to government, in a contract consideration. In Australia, the state of New South Wales requires a formal evaluation of public interests for privately financed infrastructure projects. The state of Victoria specifies aspects of the public interest to consider. These go beyond effectiveness, accountability and transparency to include **public access (especially for disadvantaged groups), consumer rights (especially for affected individuals and communities, as well as vulnerable populations), public health and safety, and privacy.**⁶⁹

These are each pieces of the comprehensive look at social and economic impacts recommended here. Another source in constructing implementation language is the emerging literature on the need to consider the “public interest” in P3’s. References to these are in Appendix B, below, which addresses the more traditional concerns of how contracting directly affects governments.

⁶² Tit. 2, Div. 5, Pt. 2, Ch. 5, Art. 4 § 19130. Conditions for personal services contracting.

⁶³ California Gov. Code Sec. 19130 (11).

⁶⁴ Maryland State Personnel and Pensions Code Sec. 13-404(2)(ii).

⁶⁵ Massachusetts ALM G.L. Ch. 7, Sec. 54(6).

⁶⁶ Dannin (2001, n99).

⁶⁷ Part III, Chapter 2, Sec. 2-8.1.

⁶⁸ San Diego Resolution R-284169 passed June 1994, San Jose Resolution 76184 March 2012.

⁶⁹ U. S. Government Accountability Office (2008, 52-54).

Appendix B

Direct Effects on Governments: Cost, Quality, and Control

This report has repeatedly referenced the generally small cost savings and the great variability in success of outsourcing state and local public services. The evidence that follows comes from case studies, surveys and statistical research based on publicly available data.⁷⁰ Statistical studies cover a broader group of cases, but they do not provide some of the in-depth information that may be found in case studies or surveys. On the other hand, case studies may not be fully applicable to other cities or states with different laws and institutional arrangements. And the accuracy of any survey depends on lack of bias in the sample of respondents and how well they recall information. As a result, using all of these sources together gives the best picture of savings, quality and control issues when outsourcing public services. At the end of this appendix are sources to help in asking the right questions and collecting the right information for a fully informed decision.

Since reducing costs is the primary motive reported for outsourcing, it is important to realize that there is a wide variation in the amount of savings. That includes zero savings and cost overruns. Costs are, on average, reduced in the near term, but there are often quality issues or longer term problems with costs or control. A meta-study of prisons (which reviewed many individual studies comparing costs and quality at private and public prisons) found that savings from outsourcing average 2.2%, including many cases where there were no savings.⁷¹ A regression analysis based on the International City/County Management Association (ICMA) data found cities that contract ten percent or more of their services spend about 3% less per resident.⁷² But it lacked the available data to look at the effects on quality of services or to examine whether private contracts had saved money relative to in-house provision.

While some governments begin with a direct comparison of contractor estimates to in-house costs, many others omit this important step. Although direct comparisons are a regular procedure for infrastructure projects in the United Kingdom, Australia, and British Columbia, Canada they are only

⁷⁰ Some analysis is by university researchers, others come from advocacy groups, think tanks, and governmental organizations. Since each does a more thorough job of covering certain aspects, a wide range of studies and sources have been used to arrive at the conclusions outlined in this report.

⁷¹ Lundhahl, et al. (2009, 392).

⁷² Levin and Tadelis (2010, 535) used the ICMA data for a regression analysis relating per capita spending in cities to the number of services contracted. Each service that is privately contracted is associated with a 0.6% decrease in per capita spending for that city.

required by a few states. Oregon and Texas were leaders on this. A 2006 study in Harris County (Texas) compared public control of toll roads to a concession, then concluded it could do more aggressive tolling on its own and yield better results than with outsourcing.⁷³ This kind of rigorous comparison of in-house and contractor performance should be applied to services as well as to infrastructure projects.

Results also vary between different units of government in different parts of the country and over different types of contracted services. At the municipal level, changing from in-house to private contract on a municipal service was associated with an average savings of 6-12%.⁷⁴ A 2002 survey of state agencies showed only one-third report savings from outsourcing, with an average reduction of 5%.⁷⁵ In a 1998 survey, 62% of respondents reported savings of 5% or less, but another 20% showed 6-10% savings and 14.6% had savings greater than 15%. “For state managers, the important insight to glean is that cost savings tend to be highly service-specific, so it is important to look to the contracting experience of other state or local agencies with the particular service in question,” concludes Dr. Deborah Auger, a specialist in contracting at the University of Delaware.⁷⁶

When promised savings fail to occur, or to be sustained over time, it is most often due to the following three factors, according to an extensive literature on the subject. First, the RFP (Request for Proposal) and/or the contract may not have included all the duties necessary to perform. In that case either some work still must be done by public employees or there may be extra charges for ‘change orders.’ Second, costs may not have been initially compared in a rigorous and complete manner. Charges for central administration may have been included in the cost estimate on the public side, although they are not an ‘avoidable cost’, i.e. one that goes away when the service is outsourced.⁷⁷ Third, and most common, is the omission or underestimation of various ‘transactions costs’ in the initial consideration. These include the preparation of request for proposals (RFP’s) and contracts, the process of selecting a contractor, and the monitoring of contractor performance. Performance monitoring, or oversight, is an ongoing cost. Periodic audits have been found to be much less effective than regular exchange of information and an ongoing relationship between agency staff and contract staff.⁷⁸ But this can absorb personnel time and eliminate or reduce savings.

Not only have unanticipated transactions costs been found to be the most common reason for a net increase in costs, they often add as much as 20% to the contract price. “Costs may be explicit ... where outside auditors are hired to monitor contracts. But costs are incurred even if such monitoring is done internally with existing staff and resources. Cost calculations in the latter case are more complicated,

⁷³ U. S. Government Accountability Office (2008, 57-59).

⁷⁴ Jensen and Stonecash (2005); Hodge (1999); Keefe (2012, 793).

⁷⁵ Chi, Arnold and Perkins (2003, 12-21).

⁷⁶ Auger (1999, 441).

⁷⁷ Sclar (2000, 65-68, 160).

⁷⁸ Pack (1989).

because, for example, employee time must be allocated between monitoring and other tasks. But they cannot be ignored,” writes Jonas Prager, author of the leading source on monitoring costs. He distinguishes between financial monitoring (or auditing) and technical monitoring, which is concerned with physical specifications. “Financial monitoring is designed to make sure that contractors are paid only as mandated by the contract. Auditors sample the document trail ... not only to check on contractors, but also on the contractor's staff. Audits stand to uncover both error and fraud. [In addition]... the auditing function is needed to clarify the grey areas, and so reduce the contractor's incentive to charge for questionable items. Technical monitoring refers to comparing the quantity and quality of product or service delivered against contract specifications.”⁷⁹

There is not as much information on monitoring costs in the public sector as one would wish, but a study of several hundred county public health services found that additional administrative costs for oversight often cancelled out savings in other areas.⁸⁰ Another analysis of over one thousand school districts, found that increased staffing necessary to provide oversight cancelled out expected savings from outsourcing, on average.⁸¹ **With fewer than half of the local governments surveyed by ICMA monitoring their contracts, it is likely that savings in many other cases would fade with adequate monitoring.** Low monitoring is especially common when measurements are difficult, although they may be most needed then.⁸²

Looking at what has been learned, it is clear that there is no “one size fits all” answer to whether there will be savings, and how much they are likely to be. An average cost reduction of 5% may well include some contracts that reduced costs by as much as 15% and others that had no savings at all -- or even cost overruns. Identifying factors that predict likely savings is important to reducing the risk to local or state government. “Insufficient savings” was the second most likely reason for resuming in-house provision, according to the 2007 ICMA survey of local governments.⁸³ (Inadequate service quality was the first).

True fixed-price contracts place full responsibility on the contractor to complete the terms of the contract on budget and on time, and rarely lead to cost overruns. But this does not rule out contract failure. Sometimes contractors realize they cannot profitably fulfill the terms of the contract and back out – leaving the contracting agency to pick up the pieces and resume providing the service in-house. The contracting firm may stay within the negotiated price by cutting corners on service and quality (as addressed in a subsequent section, below).

⁷⁹ Prager (1994, 178-80) provides evidence about the costs of monitoring of contractors in the private sector that has been widely accepted among public sector experts, including Warner and Hebdon (2001, 371).

⁸⁰ Keane, Marx, and Ricci (2001).

⁸¹ Rho (2013).

⁸² Warner and Hefetz (2008, 160).

⁸³ ICMA (2007, 6).

The contracts most likely to show cost overruns are those open to ‘change orders’ – which request more funds in order to complete the project. This includes fixed-price contracts with special clauses, and all types of cost reimbursement contracts. Information technology has experienced more cost overruns to state and local governments than other areas.

Since contracting is supposed to introduce competition into the process, why does it often result in a virtual monopoly? While there may be competition initially between bidders, over time other businesses are often reluctant to put resources into bidding against an existing contractor. Reviews of numerous cases find it not unusual for a small number of contractors to informally collude, dividing up the market and agreeing on a small range of bid prices. Even more serious is the fact that **the contracting government may have lost the ability to restore in-house provision** -- most common if needed capital equipment has been sold or the entire workforce in this area has been terminated.

There may not be enough viable competitors even for the initial bid, particularly in rural areas. And small, local businesses often lack the expertise to adequately answer a RFP. They are often much less able than large corporations to meet the requirements for “performance bonds” or “bid bonds.” In many contracting industries, mergers and consolidations have eliminated many smaller firms and left only a handful of competitors.

For a variety of reasons, initial savings often erode over the long-term. The most common reasons are low initial bids and the evolution of a virtual monopoly over time. Not only may a firm have ‘low-balled’ the initial estimate to get the job, they may also have made an initial bid in good faith but without full information of the true costs. After performing the service for some period at the agreed upon price, a firm may decide it is no longer profitable to continue without renegotiating the price upward.

But even when there are genuine and lasting savings, they may be achieved through unacceptable declines in quality, accountability and control. Fiscal responsibility doesn’t mean abandoning all these other responsibilities of governments to public constituents. Efficiency in government is about delivering quality services at the best possible cost ... not cost reduction at any price. Let’s next briefly examine the record on quality.

MAINTAINING QUALITY OF SERVICE

An experienced contractor may *improve* quality over what can be done in-house, and some outsourcing is done with exactly that in mind. The hope is that improved management techniques and use of technology might lead not only to lower costs but perhaps to better quality. But problems with quality actually outnumber problems with costs, according to reports by local governments that have ended contracting and brought services back in-house. The 2007 ICMA survey of local governments found that **when governments brought contracted services back in-house, quality issues were a major reason 61% of the time.** This exceeds the 52% of cases where contracting was ended because of non-existent or inadequate cost savings.⁸⁴ Obviously, in some cases both costs and quality were a problem!

A look at several hundred counties that outsourced public health services found a mixture of successes and failures. Although primary care hours and access increased, the quality and quantity of well-baby care and home-care for the elderly fell. Costs of providing care did fall, but at the 'price' of less access and quality in some critical areas.⁸⁵ Such reductions in quality are particularly risky to vulnerable populations such as children, the elderly, and people with substance abuse or mental health problems. And all are vulnerable when it comes to some areas. "Water quality records were falsified by the private company operating [the] sewer system ... for three years running in Ellijay, Georgia."⁸⁶ **Costs are often reduced by cutting the number of workers, but reductions in staff often negatively affect the quality of services.**⁸⁷ For example, Shelby County Schools in Memphis, Tennessee sought to end its contract with GCA just months after signing onto a controversial multi-year deal that cost 750 district janitors their jobs. Principals said schools are not being cleaned properly and GCA workers tell community groups that they are not being paid what they were promised.⁸⁸

The meta-study of prisons cited earlier as finding minimal cost savings also concluded that "publicly managed prisons [were] delivering slightly better skills training" than private prisons.⁸⁹ The great variability in quality can affect public safety, as outlined earlier in this report.⁹⁰ Academic studies that rely on statistical data bases don't include countless 'horror stories' that don't lend themselves to quantification and regularized reporting. But these raise the issue of how much control public officials retain when they have made contracts with private companies. Let's turn next to that.

⁸⁴ ICMA (2007, 6).

⁸⁵ Keane, Marx, and Ricci (2001).

⁸⁶ Cited by Dannin (2001, 254).

⁸⁷ Jensen and Stonecash (2005).

⁸⁸ See "SCS considers clean break from cleaning contractor," November 25, 2013.

<http://www.myfoxmemphis.com/story/24067035/scs-considers-clean-break-from-cleaning-contractor#axzz2llxjUODt>

⁸⁹ Lundhahl, et al. (2009, 4).

⁹⁰ Service Employees International Union (2012).

OUTSOURCING AND P3's: CONTROL OF PUBLIC DECISIONS?

Relinquishing control of traditional governmental functions through outsourcing or public-private partnerships also increases the risk of financial misbehavior, security leaks, and reduced flexibility in how elected officials are able to respond to changing circumstances. **States and cities lose control over processes and decisions under many contracts.** Contractors may have a website that looks like a government website, but is solely under their control. Contractor decisions and actions are often perceived as those of government agencies and the actions of their workers are seen by the public as representative of government. This confusion can contribute to even less faith in government.⁹¹

The public sector's ability to repair infrastructure, accommodate citizens in disasters, and change transportation modes is often severely limited. When the state of California allowed a contractor to build express toll lanes in the median of its highway⁹¹, it also agreed to forego repairs and even upkeep in parallel lanes – so as not to risk competing with the profitability of the contractor. After severe flooding in Indiana led to waiving tolls for people evacuating, the state had to reimburse the private Indiana Toll Road operator almost half a million dollars. But Chicago is likely to spend that much every year when streets are closed for repairs, street festivals, or other public purposes. Deciding to include rapid bus lanes, dedicated bike lanes or docking stations for bike sharing could be very difficult because of the terms of the meter arrangement.⁹²

Legal scholar Ellen Dannin concludes that:

“The inclusion of noncompetition and reimbursement terms in privatization agreements alters governance in many ways. First, it created divided loyalties for public officials... [who] find themselves compelled to prevent or impede public access to attractive transportation alternatives.”

Although there is growing concern about the negative effects of pollution from the current transportation system, it may be difficult to create urban green space and walkable cities when there are public-private partnerships where the private partner has the upper hand. Citizens might find their tax dollars going to compensate the private partner for ‘lost revenues’ due to less driving, parking, etc.

Public-private partnerships have been used not only to manage toll roads, water, and water systems but even to make key governmental decisions. One example is choosing how to award “economic development” incentives to prospective businesses.⁹³ This has led not only to exaggerated job-creation claims but to conflicts of interest and other accountability abuses. For example, many private prisons

⁹¹ See Dannin (2011) for a more extensive discussion.

⁹² Dannin (2011, 65); Sclar (2013, 51).

⁹³ Leroy, et al. (2013).

that actually resulted in *declining* in economic well-being in their communities received large subsidies through ‘economic development’ programs like these.⁹⁴

Last but not least, there are numerous ethical issues that can arise in contracting.⁹⁵ Not only are public workers prohibited from engaging in political activity directly related to their jobs or agencies, they are subject to conflict of interest laws. These laws do not apply to most contractors. Neither do rules prohibiting nepotism and protecting civil servants who report malfeasance in government through ‘whistleblower laws.’

For issues directly impacting the contracting government, the following guides and resources are useful.

RESOURCES TO HELP IN CONTRACTING AND P3 DECISIONS:

Asking the right questions: A guide for municipalities considering P3s, John Loxley, Canadian Union of Public Employees, <http://cupe.ca/municipalities/questions-guide-municipal-officials>

Alternative Service Delivery: Shared Services (2007), http://www.gfoa.org/index.php?option=com_content&task=view&id=1547, Government Finance Officers Association.

Best Practices in Contracting for Services: a four page summary from In the Public Interest, a non-profit advocacy group.

“Contracting That Works: A Toolkit for State and Local Governments”, David Madland and Karla Walter of the Center for American Progress; Paul Sonn and Tsedeye Gebreselassie of the National Employment Law Project.

“Cost Analysis and Activity-Based Costing for Government”, R. Gregory Michel, Ch. 8, Vol. 6 in the GFOA Budgeting Series of the Government Finance Officers Association.

The National Alliance for Fair Contracting has sample ‘responsible bidding’ requirements available at www.faircontracting.org

⁹⁴ Genter, Mosher, and Hooks (2013); Mattera et al (2001).

⁹⁵ Dannin (2011, 75-78); also Dannin (2001, 2006); and Wisniewski (1992).

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