

State and Local Government Privatization

Testimony before the House Committees on State Affairs and Government Efficiency and Reform

by The Honorable Talmadge Heflin

Chairman Callegari and Chairman Cook, Members of the House Government Efficiency and Reform Committee and House State Affairs Committee, my name is Talmadge Heflin and I am the Director of the Center for Fiscal Policy at the Texas Public Policy Foundation, a non-profit, non-partisan free market think tank based here in Austin, TX. Thank you for the opportunity to testify today regarding the interim charge to *examine areas of potential privatization of state services in an effort to achieve a higher level of service and greater efficiency for Texas taxpayers. Specifically, we will be speaking to when privatization works and why and when it does not and why.*

To begin our discussion on the topic of privatization, it is important to define what it is and why it is done.

There are two basic types of privatization: the privatization of government enterprises and the privatization of government services or tasks that government performs, often called “contracting out.”

A good way to begin thinking of the first type of privatization is to apply the Yellow Pages test to the enterprise. In other words, if you can find the private sector providing the service, why are taxpayers subsidizing a government-run competitor?

Specific examples of these kinds of government entities at the federal level include:

- **Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)**, which use taxpayer dollars to compete with private sector mortgage providers, which distort the marketplace for home loans while incurring massive moral hazard.
- **General Motors**, which leverages taxpayer subsidized capital to compete against Ford and other auto companies, offering products, such as the electric Volt, that are having a hard time gaining public acceptance.
- **The National Railroad Passenger Corporation (Amtrak)**, a federally-subsidized passenger rail service with revenue of \$2.4 billion and 19,000 employees that has benefitted from about \$40 billion in federal subsidies since its inception in 1970. It has never earned a profit.*
- **Tennessee Valley Authority (TVA)**, founded in 1933, the TVA generates electricity and provides river navigation, flood control and other services with revenue of more than \$11 billion.

The United Kingdom moved away from this sort of government ownership of the means of production during the Thatcher era beginning in 1979 when it sold off many government-owned industries, such as:[†]

- **Public Housing**, with 1 million units sold for about \$18 billion.
- **British Petroleum (BP)** a 5 percent stake in 1979-80 for \$415 million, followed by 7 percent stake in 1983 for \$815 million, transferring a majority of ownership to the private sector which had owned a minority stake of some 40 percent of the venture before the government sold its majority position.
- **British Telecom**, a 50.2 percent share in 1984-85 for \$5.875 billion.
- **British Gas**, a 100 percent stake in 1986 for \$9 billion.

continued

* “Privatizing Amtrak,” by Tad DeHaven, CATO Institute (June 2010).

† “Privatization: Lessons from British Success Stories,” by Stuart Butler, Ph.D., Heritage Foundation (12 Feb. 1987).

Dozens of other government-owned entities were sold off in the U.K. by 1987, with a total of more than \$43 billion in revenue to the government via divestiture, equivalent to some \$90 billion in today's dollars.

By comparison, the federal government today owns \$9 billion of GM stock and is on track to own "assets" of Fannie Mae and Freddie Mac totaling \$389 billion

The value of publicly-owned assets sold by the U.K. was equal to almost 9 percent of their GDP in 1980. Today, the federal government's stake in GM and the two mortgage companies is worth about 3 percent of the U.S. economy. Add in Amtrak, TVA and state and locally-owned enterprises, such as redevelopment agencies and municipal utilities, and the U.S. would likely exceed the U.K.'s Labour-era share of government-ownership as a portion of the economy.

In contrast to divesting itself of functions that compete with the private sector, contracting out sits at the other end of the privatization spectrum. It runs anywhere from outsourcing the management and provisioning of information technology services (some of which is done by all government agencies) to outsourcing almost the entirety of government function. The latter is the case with contract cities in California, Colorado and Georgia where a half-dozen city employees manage a suite of service providers from the county sheriff who performs city police functions, to dozens of private sector firms who issue building permits or maintain parks.*

Since the Eisenhower Administration in the 1950s, the federal government has sought to rely on the private sector for the performance of what are considered commercial services. The Office of Management and Budget (OMB) first issued specific guidance as to how these services are to be identified and competed in 1966 under OMB Circular A-76. This circular has been repeatedly revised, the last time in 2003.† OMB Circular A-76 set federal policy for determining whether recurring commercial activities should be performed by the

private sector or federal employees.‡ Further, A-76 mandates that federal agencies yearly list the activities they perform as to whether they are inherently commercial in nature or governmental. Commercial activities are potentially competed but governmental activities are not. Competitions under A-76 compete activities, not positions. Only a small fraction of federal contracts are awarded under A-76 rules.

The OMB has reported that using A-76 to compete a government function has historically generated savings of from 10 percent to 40 percent—even if the existing government function wins the contract over the private sector competitor. It is the act of competition, or rethinking a task, that appears to generate the savings.§ Much of the evidence for the savings achieved by these competitions was gathered during the Clinton Administration years when Vice President Al Gore led the "Reinventing Government Initiative" which contributed to a reduction of the federal civilian workforce by more than 370,000 employees, many of them within the post-Cold War-era Defense Department.

A portion of the drive to reform government through the use of managed competitions can be seen in the systemic failures of government agencies such as the General Services Administration (GSA). Two decades ago, the GSA charged government agencies \$2.21 for a dozen BIC pens that could be provided by a private-sector firm for 89 cents. Now GSA employees simply go to Las Vegas on the taxpayers' dime (or the taxpayers' \$823,000, to be precise††). Had lawmakers acted to break up GSA into its functional parts and then divested these to private firms, millions upon millions of limited tax dollars could have been saved.

In contrast, the Obama Administration has sought to extend a recent ban on A-76 competitions, largely at the behest of federal labor unions.‡‡ This highlights the fact that A-76 competitions, in spite of being around for almost 60 years, are controversial, with government employees claiming the process is slanted in favor of private enterprise while the private sector views the

* The City of Chicago under Mayor Rahm Emanuel implemented competition for a city recycling program that is expected to save more than 50 percent. Chicago also outsourced the water bill call center. See "Privatization and Public-Private Partnership Trends in Local Government," Annual Privatization Report 2011, by Harris Kenny and Adam Summers (1 May 2012) Reason Foundation.

† Office of Management and Budget, text of the 2003 A-76 revision.

‡ "Competitions: Background and Issues for Congress," by Valerie Bailey Grasso, Specialist in Defense Acquisition (28 Nov. 2011) Congressional Research Service.

§ Ibid.

** "Privatizing The General Services Administration," by Ronald Utt, Ph.D. (29 June 1995) Heritage Foundation.

†† "GSA Scandal: So What Does \$823,000 Buy You in Las Vegas?," by Courtney Subramanian (18 Apr. 2012) *Time Magazine*, <http://newsfeed.time.com/2012/04/18/gsa-scandal-so-what-does-823000-buy-you-in-las-vegas/>.

‡‡ FY 2012 budget request to Congress, "SEC. 728. None of the funds appropriated or otherwise made available by this or any other Act may be used to begin or announce a study or public-private competition regarding the conversion to contractor performance of any function performed by Federal employees pursuant to Office of Management and Budget Circular A-76 or any other administrative regulation, directive, or policy."

large number of contracts won by federal employees as proof that the system is slanted towards them. Existing government employees also view the process as adversarial and inefficient.*

Other than the scale of the work involved and the rules peculiar to time and government, lessons learned from privatizing overseas or with the federal government are easily applied to the state level.

In 2010, the State of Texas maintained about 317,900 full-time equivalent positions with local government funding about 1.13 million positions. Some portion of the services these government employees provide might be more cost effectively accomplished by the private sector. Of these government positions, 65,510 are in positions broadly described as financial and administrative support—precisely the kind of positions that, if competitively bid out, might result in savings to the taxpayer. These positions at the state and local level include:

▪ Financial Administration	23,354
▪ Other Government Administration	16,641
▪ Social Insurance Administration	4,788
▪ Non-Sworn Police Employees	20,727

An additional 270,634 full-time equivalent positions are in occupations that are duplicated in the private sector. Many of the enterprises that employ these government workers do not pass the Yellow Pages test, though not as many as other states with traditionally larger governments, such as New York. These tasks might be better performed if the government divested itself of the assets, or contracted out a portion of the effort. The full-time equivalents at the state and local level include:

▪ Highways	37,293
▪ Air Transportation	5,419
▪ Water Transportation and Terminals	1,144
▪ Health	52,277
▪ Hospitals	83,981
▪ Solid Waste Management	6,725
▪ Sewerage	8,558
▪ Parks and Recreation	16,726
▪ Housing and Community Development	6,131
▪ Natural Resources	14,960
▪ Water Supply	16,178
▪ Electric Power	8,835
▪ Gas Supply	1,070
▪ Transit	11,337

Looking at the latter list, it is hard to understand why, in 2012, we believe that government is superior to the private sector in operating an airport or a power plant or a landfill or a bus line or a golf course.

Just because it is so today, does not mean it must remain so. For instance, some states operate liquor stores but Texas doesn't. Conversely, Texas has 26,000 local government employees who work to provide water, power and gas while other states have little if any employees in these areas.

Below we cite some specific examples for your consideration.

The City of San Antonio operates a Solid Waste Management Department funded by an Environmental Services Fee and a Brush Service Fee and employs 482 workers with a budget of over \$90 million.[†] The City of Houston also has a Solid Waste Management Department, but its scope is more limited, collecting some 35 percent of the total waste stream in the city, with the private sector collecting trash from “apartments, condominiums, commercial businesses and private industry in Houston.” Houston operates a fleet of 430 heavy and 100 light vehicles with a staff of 440 full time equivalents and a budget of \$65.5 million.[‡] As shown in the listing above, state and local government in Texas maintains 6,725 full-time equivalents in the area of solid waste management.

The competitive market for electricity in Texas went into effect on January 1, 2002. However, many Texans cannot participate in a free market for electricity as they are held captive to a local monopoly, some of which are owned by government. On the eve of deregulation there were at least 11 municipal power companies, four river authority companies and eight electric co-operatives that were granted monopoly status, free from competition. All of these entities operate with explicit permission in state law from the Legislature. Unlike investor-owned utilities, these operations often indulge in political policy decisions, such as the use of more expensive renewable energy, rather than simply stick to providing reliable and affordable power to their constituents. Further, to the extent that publicly-owned utilities make a profit, these profits may be used to subsidize local government. In addition, key maintenance or infrastructure investments that an investor-owned utility would routinely make, might be deferred for other, political reasons when a utility is operated by a government. Divesting these assets, perhaps with a timeline for ending monopoly protection, would increase the free market for electricity in

* “Competitions: Background and Issues for Congress,” by Valerie Bailey Grasso, Specialist in Defense Acquisition (28 Nov. 2011) Congressional Research Service.

[†] Solid Waste Management Department website, San Antonio, Texas.

[‡] City of Houston website, Houston, Texas.

Texas while at the same time paring government down to its basic functions. As the above list illustrated, Texas state and local government has some 8,835 employees laboring to generate and deliver electricity.

In Texas, the testing for banned substances in race horses is performed by Texas Veterinary Medical Diagnostic Laboratory at Texas A&M in College Station. This facility is one of 18 laboratories around the nation that handle race horse drug testing. Of the 18, five are private sector labs serving 19 states through competitive bid contracts, while 13 are state or state university-run labs serving 16 states, 13 of which are captive to a state monopoly on testing. Texas is one of these latter states where state law grants Texas A&M the exclusive right to perform race horse drug testing.* Of note, six of the 18 labs across the nation are accredited—the Texas Veterinary Medical Diagnostic Laboratory is not one of them. In California in 2005, the lab associated with the University of California, Davis conducted one-third of the testing for two-thirds of the cost. This lab was run by the veterinarian who also served on the staff of the race horse commission. He recommended to the commission that his taxpayer supported lab take all the work in-house. The legislature's approval of the move was easy as the University of California system had far greater clout, with several full-time paid lobbyists, some of them on the government payroll, than did the private sector firm with 300 employees which had competitively won the work for several years. Taxpayers now pay millions of dollars more to support a state-sanctioned monopoly staffed by state employees with very generous pensions and health insurance benefits.

Texas has long experience with prison system privatization with eight firms operating more than 70 prisons, jails or other criminal justice facilities. These privately-run facilities have saved millions of taxpayer dollars. Critics have contended that these savings are mainly the result of hiring fewer guards and support staff, paying them less, and accepting higher turnover rates. In some instances, this may be true. However, if policymakers view such outcomes as undesirable, they may certainly stipulate specific conditions for contracts for prison services. Further, some critics have maintained that prison privatization has been unduly influenced by political donations from the private sector. Such critics are silent, however, regarding the outsized influence of prison guard unions in states such as

California where the average per year cost to incarcerate an inmate in state prison was \$47,102 in 2009[†] compared to \$15,330 in Texas. The next step in prison privatization is evolving in Florida and the U.K. where contracts are incentivizing private companies to meet a range of program performance measures such as reducing the rate of recidivism.[‡]

The provision of health care to inmates in the Texas prison system is another area of reform that this body has rightly examined. In 2011, the State Auditor reported that the inmate health care system managed by the University of Texas Medical Branch at Galveston was significantly overcharging the state for services. Corizon, a private inmate health services firm, submitted a proposal to Texas that projected savings up to \$50 million per year via privatization.[§]

The State of Texas should continue to build on their successes in prison privatization and take note of what is happening in other states and countries to realize even more savings while reducing recidivism.

The State of Texas operates a myriad of programs and agencies, many of which could be eliminated or consolidated to save money as they are redundant, outmoded, or their functions could safely be done by the private sector without risk to the public. Assuming policymakers desired to continue these functions, some candidates for outsourcing or divestiture include:

- **Trusted Programs within the Office of the Governor**
 - Texas Music Office
 - Texas Film Commission
 - Economic Development and Tourism Division
 - Economic Development Bank
 - Texas Tourism program
- **Texas Workforce Commission**
 - Skills Development Program
- **Texas Windstorm Insurance Association**
- **Texas Education Agency**
 - Regional Education Service Centers
 - Steroid Testing

* Vernon's Civil Statutes, Title 6. Amusements—Public Houses of, Article 179e. Texas Racing Act, Article 3. Powers and Duties of Commission, Section 3.07 (d) states, "Medication or drug testing performed on a race animal under this Act shall be conducted by the Texas Veterinary Medical Diagnostic Laboratory or by a laboratory operated by or in conjunction with or by a private or public agency selected by the commission after consultation with the Texas Veterinary Medical Diagnostic Laboratory." In other words, there can only be competitive bidding for private testing of race animals if the lab at Texas A&M approves of it.

[†] Up \$19,500 from 8 years earlier, according to the California Legislative Analyst Office.

[‡] "Annual Privatization Report 2011: Corrections and Public Safety," by Leonard Gilroy and Harris Kenny, Reason Foundation (Apr. 2012) 9.

[§] *Ibid.*, 24.

- **Higher Education Coordinating Board**
 - Doctoral Incentive Program
 - Top Ten Percent Scholarship Program
- **Library and Archives Commission**
 - Resource Sharing and Local Aid
- **Office of Public Insurance Counsel**
- **Office of Public Utility Counsel**
- **Texas Commission on Environmental Quality**
 - Texas Clean School Bus Program
 - Recycling Market Development Implementation Program
- **Texas Department of Agriculture**
 - Seed Quality
 - Seed Certification
 - Feral Hog Abatement
 - Egg Inspection Program,
 - Agricultural Commodity
- **Texas Parks and Wildlife Department**
 - Promotion and Outreach Programs
- **Texas Railroad Commission**
 - Energy Resource Development and Alternative Energy Promotion
- **Board of Plumbing Examiners**
- **Texas Board of Professional Geoscientists**
- **Funeral Service Commission**
- **Texas Medical Board**
- **Board of Podiatric Medical Examiners**
- **Executive Council of Physical Therapy and Occupational Therapy Examiners**
- **Optometry Board**
- **Board of Examiners of Psychologists**
- **Board of Pharmacy**
- **Texas Board of Nursing**
- **Health Professions Council**
- **Texas State Board Dental Examiners**

- **Board of Chiropractic Examiners**
- **Texas Department of Housing and Community Development and Texas State Affordable Housing Corporation**
- **Department of Assistive and Rehabilitative Services**
- **Department of Aging and Disability Services**

While this is not an exhaustive list, it does provide some possibilities for lawmakers to consider. For instance, professional associations have policed members of their own professions for years prior to the time that government got involved in licensing. Given the great incentive for insurance providers to underwrite policies with low risk, what does government involvement and certification add to the public? There are still bad apples today with government oversight—but those bad apples come with the government’s stamp of approval until they are found out and sanctioned.

A final word about the effectiveness of contracting out. As with all human endeavors, there are instances of failure along with success.

Many of the more high-profile failures in contracting out can be found in the information technology space. In these instances, failure can be ascribed to the government employees in charge of the contract to properly define the requirements, and then manage the project. As the computer programming slogan goes, “Garbage in, garbage out.” As a way to reduce risk of failure the federal government often hires a Systems Engineering and Technical Assistance (SETA) contractor who works with the government to define system requirements and ensure that the contracted system is up and working properly. SETA contractors are prohibited from bidding on the main contracts—they are hired as the government’s trusted advisors. Breaking a contract in two, with one part for up front requirements, scoping, request for proposal development and the analysis of bids and the other half for the implementation of the project or services, can greatly reduce the likelihood of a costly and embarrassing failure. That said, for every high-profile example of an expensive contracting out failure, there are dozens of unpublished examples of the government quietly continuing to perform the inefficient, over-staffed functions that it has performed for decades, out of sight.

Thank you for time and interest in this important fiscal issue. I would be glad to take any questions you might have now. ★

* “The Pros and Cons of Privatizing Government Functions,” by Russell Nichols (Dec. 2010) *Governing* magazine, discussing how in 2010, Texas terminated “... its seven-year contract with IBM, an \$863 million deal that called for IBM to provide data center and disaster recovery services for 27 state agencies. When an audit criticized the state’s Department of Information Resources for lax oversight, inadequate staffing and sloppy service, the partnership fell apart.”

About the Author

The Honorable Talmadge Heflin is the director of the Texas Public Policy Foundation's Center for Fiscal Policy.

For 11 terms, Heflin served the people of Harris County as a state representative. Well regarded as a legislative leader on budget and tax issues by Democratic and Republican speakers alike, he for several terms was the only House member to serve on both the Ways and Means and Appropriations committees.

In the 78th Session, Heflin served as chairman of the House Committee on Appropriations. He navigated a \$10 billion state budget shortfall through targeted spending cuts that allowed Texans to avoid a tax increase.

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