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« Room for Debate Home

« Back to Discussion

Is Privatization a Bad Deal for Cities and States?

To save money, New York is turning the clock back on outsourcing by replacing private contractors with city workers.

The Pendulum Swings Again

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Steve Goldsmith has discovered what most city managers have known for a long time. “In-sourcing” services and functions that had previously been contracted out has been going on for as long as outsourcing has existed at the local government level.

I have been able to track the rates of new contracting out versus in-sourcing over time using the International City County Management Association surveys of local governments in the United States. Privatization peaked among local governments in 1997. From 1992 to 1997 new outsourcing contracts accounted for 18 percent of all service delivery, while in-sourcing was 11 percent. The ratios shifted in the 1997-2002 period with in-sourcing exceeding new contracts out by 50 percent. From 2002 to 2007 the rates were about equal (new contracts out were 11 percent, contracting back in was 12 percent). So the pendulum swings.

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Rational city managers recognize the need to manage markets for public services. Contracting out only saves money if there are technological innovations or economies of scale that come from moving functions out. Even if there is a technological gain, as in new information technology, government cannot afford to contract out its core information function and so governments use outside contractors to upgrade their systems, but then take control back in house. No organization, public or private, would want to have its central information (intelligence) outsourced. That would be irresponsible.

I.C.M.A. also tracks the reasons why local governments bring back in-house previously privatized work. The reasons are problems with service quality (61 percent), lack of cost savings (52 percent), improvements in public delivery (34 percent), problems with monitoring (17 percent) and political support to bring the work back in house (17 percent). It turns out citizens prefer local services to be locally controlled and publicly delivered.

Rigorous quantitative analysis of every published study from around the world of water delivery and garbage collection (the two most commonly privatized services at the local government level) finds no statistical support for cost savings under privatization. Economic theory would predict this result. Private firms have incentives to reduce quality to enhance profits. Hence careful monitoring is required. But monitoring is expensive and it requires continuing knowledge, within government, of how services are produced.

Many public services are natural monopolies. In these cases, monopoly provision is cheaper than competition. But monopolies require public control. Even in services which initially experience competition, a competitive market erodes after the initial contract. Fully 75 percent of contracts are given to the incumbent without rebidding. For most local government services the average number of alternative providers is less than two. Only one third of the 67 most common local government services have two or more alternative providers in the market. So in many cases, all privatization does is substitute a private monopoly for a public one. There is more potential for public control over a public monopoly.

If New Jersey really wants to save money, it should focus on internal process improvements within government. Agency staff have many ideas on how to improve service delivery. Ask them, and carry out their recommendations. That is how true, lasting cost savings are achieved.

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