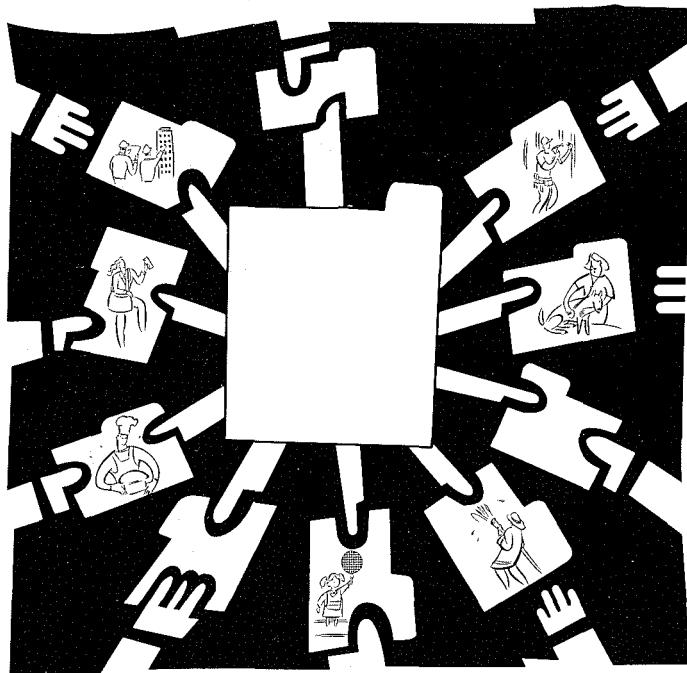


LOCAL OFFICIALS GUIDE

Municipal Service Delivery: **THINKING THROUGH THE PRIVATIZATION OPTION**

A Guide for Local Elected Officials



National League of Cities



Center for the Study of Ethics in the Professions
Illinois Institute of Technology

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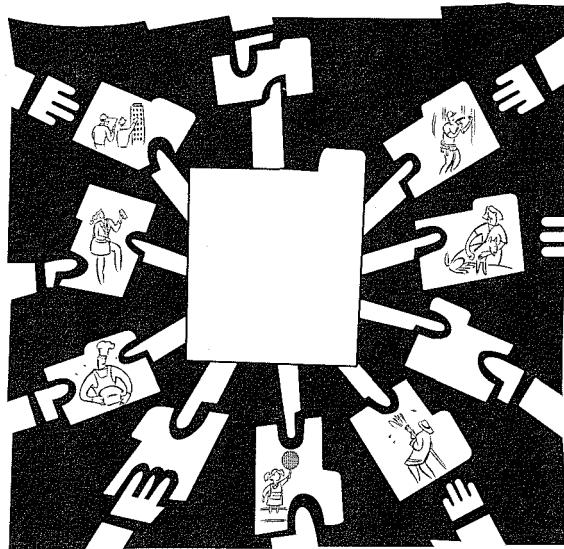
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by

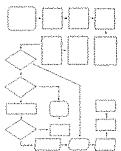
Inge Fryklund, Vivian Weil & Harriet McCullough



National League of Cities



Center for the Study of Ethics in the Professions
Illinois Institute of Technology



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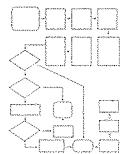
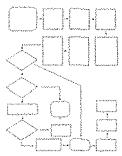


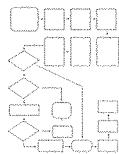
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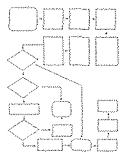
Foreword

The National League of Cities (NLC), in cooperation with the Center for the Study of Ethics in the Professions of Illinois Institute of Technology (CSEP-IIT), is pleased to publish this guide to the process of municipal decision making about the option of privatizing (contracting out) a city service or function. The topic of privatization is current, the interest in competition and "reinventing government" is widespread, and we offer this guide as a helpful tool for cities to use in the decision-making process. This publication is the product of a cooperative project on privatization between the CSEP-IIT and NLC, conducted during 1996 and 1997.

The National League of Cities seeks to provide municipalities with timely information on important issues of municipal concern, and this guide is part of that tradition. City officials daily confront the challenge of providing services to their communities as effectively and efficiently as possible. Since the late 1970s, the impetus of competition and the need to deliver services effectively with sometimes shrinking municipal resources have led local officials to employ a number of options. Creativity and pragmatism have been the watchwords as cities developed alternative service delivery models. Alternatives or options have included reorganizing city administration and redesigning city departments to increase efficiency and effectiveness; privatizing services by contracting with non-profits and the private sector; contracting with other governments for some services; managed competition in which city employees compete with private vendors to bid on providing a particular service; and public/private partnerships. These processes have shown the richness and variety of the local government experience.

This guide provides to municipal officials a context for decisions about delivering services and offers a systematic process encompassing practical steps and ethical considerations for making decisions about the option of privatization — contracting out or outsourcing, as it is commonly called. The guide was written by Inge Fryklund, a principal in the consulting firm of Tactics, Inc., Chicago, Adjunct Professor at the J.L. Kellogg Graduate School of Management at Northwestern University, and former City of Chicago Parking Administrator; Vivian Weil, Director of IIT's Center for the Study of Ethics in the Professions; and Harriet McCullough, Ethics Consultant and former Director of the Chicago Board of Ethics. Margaret M. Swanton, CPA, CFE, a principal in Tactics, Inc., prepared the sections on activity-based costing.

We also are grateful to Mayor Ingrid Sheldon of Ann Arbor, Michigan, who served on the project committee as a representative of NLC's local elected officials. Mayor Sheldon's



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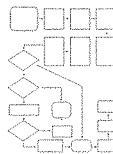
experience with this issue added greatly to the process of producing this Guide. In addition, thanks also are due to Mary Stone, Program Development Manager at NLC, who reviewed and edited the draft and coordinated the process with the authors; and to James Brandon Poole, an intern at NLC in 1997, who assisted with editing as well as researching and providing examples of city programs. We very much appreciate helpful comments on one portion of the manuscript by the Association of Metropolitan Sewerage Agencies. Thanks also are due to Jeff Fletcher, NLC's Director of Public Affairs, for thoughtful comments as well as his oversight of the production process, and to Carol Kochisen for comments on a portion of the draft.

Clint Page has provided excellent final editing. Special thanks are due to the Public Affairs team for preparation of the manuscript and production: Camille Kellogg, Manager, Marketing Communications; Susan Teetz, Graphic Artist; and Mae Davis, Marketing Assistant.

We gratefully acknowledge the grant from the Joyce Foundation which provided the support for this project.

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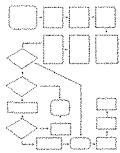


Preface

The Center for the Study of Ethics in the Professions (CSEP) at Illinois Institute of Technology, in Chicago, Illinois, has been engaged for twenty years in assisting professionals to develop the skills they need to identify, articulate, and resolve the ethical issues facing them in the everyday conduct of their professions. The Center has focused on decision making in professions such as engineering, architecture, and science to incorporate ethical considerations in a process that can be applied amid the pressures and constraints of the real world. Through this project on privatization of city services, conducted in partnership with the National League of Cities (NLC), the Center has now had the opportunity to work with local elected officials. The research to prepare this guide has included consulting with municipal officials, studying responses to NLC surveys of city governments and city officials, and searching data bases, articles in periodicals, books, and other sources. In a roundtable discussion at the 1996 Congress of Cities, representatives of approximately 15 municipalities helpfully presented some of their experiences with privatization of city services. This roundtable was chaired by Mayor Ingrid Sheldon, of Ann Arbor, Michigan.

The project on privatization that produced this guide was carried out by Vivian Weil, Director of CSEP; Inge Fryklund, a principal in Tactics, Inc., Chicago; Harriet McCullough, Ethics Consultant, Chicago; and Mary N. Stone, Program Development Manager at NLC, Washington, D.C., assisted by NLC intern James Brandon Poole.

The project group received comments and advice at critical junctures from an Advisory Board representing major interests affected by privatization. The members of the Advisory Board are Joel Asprooth, former City Manager of Evanston, Illinois; David Beam, Director of the Graduate Program in Public Administration of the Illinois Institute of Technology; Michael Davis, Senior Fellow of CSEP; William Grimshaw, Professor of Political Science at the Illinois Institute of Technology; Roberta Lynch, Deputy Director of the American Federation of State, County and Municipal Employees (AFSCME), Chicago, Illinois; John Crotts, Senior Sales Executive, ServiceMaster in Downers Grove, Illinois; Ben Reyes, Executive Director of the Chicago Public Building Commission, Chicago, Illinois; and Mayor Ingrid B. Sheldon of Ann Arbor, Michigan. Two meetings of the Advisory Board were held,

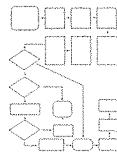


the first to help define the conception and scope of the guide, and the second to provide a critique of the first draft.

The organization of the guide reflects feedback from students in the privatization course that Inge Fryklund has taught for the past five years at the Kellogg School at Northwestern University. David Beam and Michael Davis made contributions as reviewers of an earlier draft, as did Donald Borut, Jeff Fletcher, William Barnes, Mary Stone, and Brandon Poole of the NLC staff. Any errors of omission or commission are, of course, the responsibility of the authors.

The authors are grateful to the Joyce Foundation of Chicago, which made this project possible.

Vivian Weil
Inge Fryklund
Harriet McCullough
Chicago, September 1997



Introduction

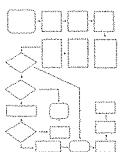
Among their many duties, local elected officials have the responsibility for effective and efficient delivery of services to the communities they serve. Since the late 1970s and 1980s, municipal governments have developed a number of creative and effective options or alternatives for service delivery. While these alternatives may have been initially driven by scarce municipal resources, cities have applied pragmatic and innovative approaches, with results that maintained or improved service delivery standards at reduced costs. Some cities have used the option of "privatization" of certain services by contracting with private or nonprofit service providers. Others have entered into contracts with adjacent municipalities. Others have embraced competition, allowing a city department to bid with private vendors for the award of a service-delivery agreement — a practice called, variously, competitive contracting or managed competition. Still others have followed the lead of the private sector and found ways to become more businesslike and entrepreneurial, streamlining their administrative and management procedures. Many cities have pursued all these strategies.

This guide is intended to help local elected officials in making ethical decisions about how best to deliver municipal services — whether on contract or in-house. Because the choice is often popularly posed in terms of whether or not to "privatize" or "outsource," the guide will focus on the issues involved in the privatization option. The guide neither advocates nor opposes privatization. Rather, it lays out an orderly process for thinking through choices and options. By carefully evaluating assumptions and alternatives, local elected officials can be sure that they will consider a wide range of alternatives and need not be restricted to a dichotomous choice between privatizing and continuing current practices.

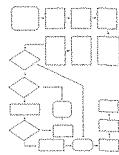
The decision process has to encompass accountability to the public for ensuring efficient services at appropriate cost, for fair allocation of services, for attending to the service needs of vulnerable populations, for impacts of decisions on public employees, and for guarding against conflicts of interest. Important considerations are openness, explicitness, and providing reasons for the choices made. Such ethical aspects are interwoven with all areas of public responsibility.

The process described ensures that relevant questions are asked and answered, affected groups are consulted, costs are accurately assessed, the opportunity to compete for public contracts is open to appropriate potential contractors, and the public's interest in quality of service and cost-effectiveness is safeguarded.

Part of fair and effective decision making is the insistence by local elected officials that cities undertake the difficult task of comparing costs, and evaluating alternatives and consequences. Although the elected official personally is unlikely to compute costs or draft procurement documents, elected officials need to explain the rationale, stress to city staff the importance of comparing costs and evaluating alternatives, and direct that the process be undertaken.



MUNICIPAL SERVICE DELIVERY



1. The Object: Better Decision Making

In the reform era of government early in the twentieth century, most cities made changes in how municipal government functioned, in order to increase professionalism and accountability. Among the changes enacted were procedures to ensure that services and functions generally were carried out by city employees subject to civil service or other neutral employment processes, not by private businesses. These changes were put in place to avoid the favoritism and lack of clear administrative accountability that historically had characterized many of the dealings between government and business. Other reforms were instituted to achieve increased effectiveness, fairness, efficiency, and consistency in government practices.

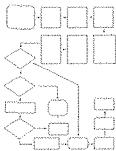
Now, late in the twentieth century, the pendulum has swung. In the course of reinventing government, municipalities are again making use of contractual relationships — with the private sector, with nonprofits, and with other units of government — in the delivery of municipal services. To avoid repeating the problems of the early part of the century, local officials are now taking care to ensure that the decision-making and contracting processes are open and transparent, and relationships between the public and private sectors are carefully managed.

A Structured Decision Approach

A structured decision process can help local officials achieve savings and service goals, while avoiding some of the pitfalls that could occur with privatization: cost overruns, violation of collective bargaining agreements, service deterioration, or contract fraud.

The decision tree in Figure 1 presents a structured approach for making decisions about competition and privatization options. The first choice point is the decision about whether or not government is to be responsible for a given function. Next come a series of decisions about who can or should deliver the service. It is important to keep these choice points separate, and answer them in sequence, in order to be clear which are decisions about responsibilities and which are decisions about means.

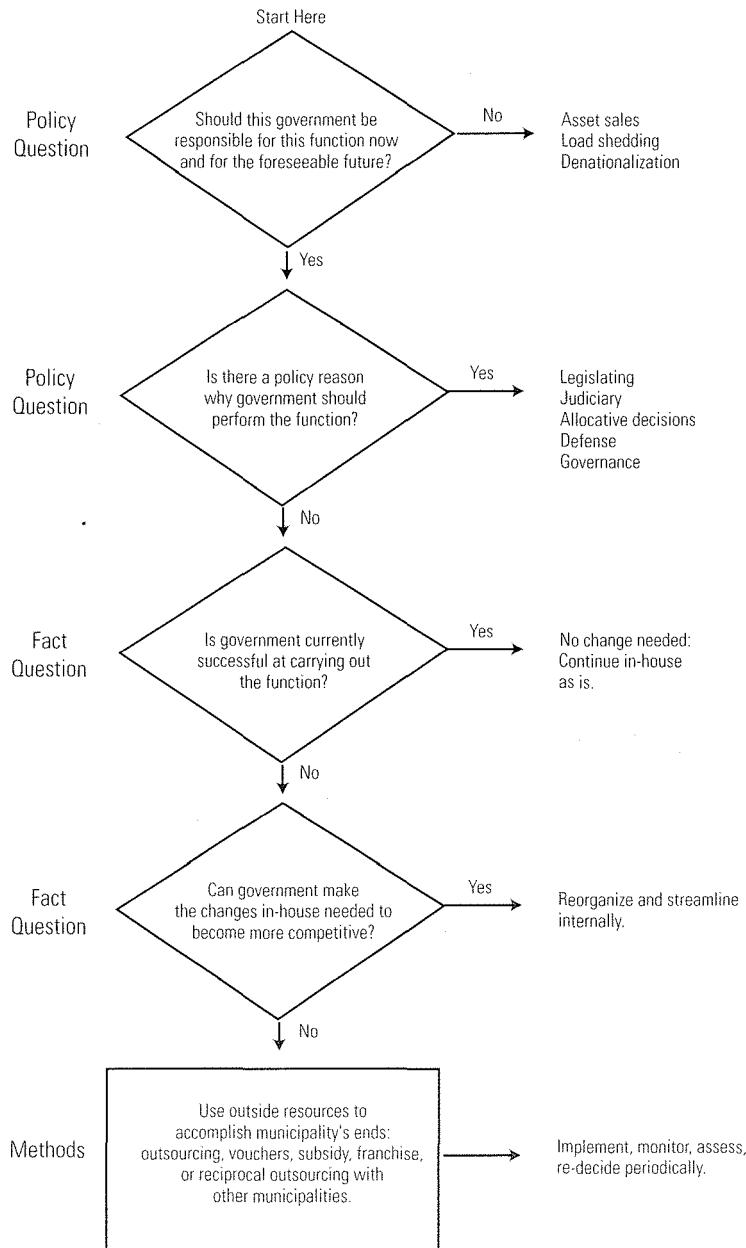
In practice, local officials often find themselves in situations in which the municipal question as it is raised (for example, should the city contract out for home energy audits) is far down the decision tree. In these cases, it is useful to identify the point on the tree where the issue falls. Officials can then either join the discussion where it is or insist that decision makers go back to the logically prior questions and be sure either that they are satisfied on those points or that they are where they want to be in the decision process.

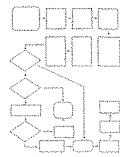


MUNICIPAL SERVICE DELIVERY

Choice Points

Actions





Should a municipal government be responsible for a given function?

The first decision a municipal government faces is whether it should be responsible for a given function. The *responsibility* decision for each local official is one to be made about his or her particular city government, taking into account local circumstances and conditions. To be responsible means that the city: is accountable for how the function is performed, has a duty to monitor the performance of the function, needs to provide general guidance, and, ultimately, has to answer for success or failure. Who will *perform* the function is a subsequent question.

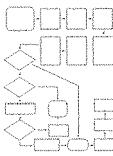
At a high level, the U.S. Constitution and state constitutions make some of these choices about governmental responsibilities. Federal and state legislative mandates have affected local government's choices about services. For the most part, however, questions about the scope of government are addressed through the political process in the federal, state, and municipal arenas. At the level of particular services, decisions about services are the decisions that elected officials make every day. Local government can assume responsibility for parks or day care programs or business incubators — or not. Different societies at different times have come to very different conclusions about the proper functions of government. During the colonial period in this country, many of the early highways were privately constructed toll roads. Today, every state has a highway department, and we have the federal interstate highway system — as well as renewed interest in privately constructed toll roads.

In the logical decision process described in this guide, if the answer to the responsibility question is "No," then the government transfers the function or property to private hands, and government has no further role — beyond generally applicable regulation. The terms *asset sale* and *load shedding* are generally used for this variety of privatization. The reference is usually to property, rather than to services. (This is the usual meaning of "privatization" outside the United States and a synonym is *denationalization*. In many cases, the government-owned asset was originally owned privately but was seized and nationalized. Because the United States never nationalized private property, this meaning of privatization is largely irrelevant here.)

If the answer to the responsibility question is "Yes," then the decision process moves on to consider how that governmental responsibility should be discharged.

Is there a policy reason why government should perform the function?

Some functions, such as legislating, are inherently governmental, and we choose to keep these functions in government hands, even if the private sector could perform them. Values other than efficiency are critical. The inherent deliberative quality of the legislative



process and the system of checks and balances ensure that competing interests are weighed and action is not taken precipitously. The democratic process — with hearings, votes, and elected officials accountable to voters — is well equipped to thresh out the interests at stake in policy and allocative decisions. How should the right-of-way down a public street be used? Should a parcel of land be taken for public use?

Governmental performance may also serve an important symbolic function. Not only is the power to define what is criminal uniquely governmental, the public nature of entities such as courts and prosecutors symbolizes the community's consent and consensus behind particular court decisions.

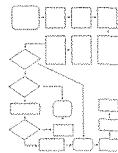
Other governmental functions advance governmental purposes and the general well-being of the community. Local government examples include, among other functions, zoning, parking meter revenue collection, parks and recreation, or solid waste collection and management. For some of these operations, the local government may face practical decisions about whether actually to conduct the service itself or contract it out.

Government officials should be thoughtful about policy considerations in the decision process about outsourcing. It is important to distinguish policy choices from the methods used to achieve policy goals. For example, some have argued that cities should run buses all night, despite low ridership, so that those working night shifts might have transportation. This "policy" argument intermixes questions about responsibility and means. Government could well decide to accept responsibility for nighttime transportation, but discharge that responsibility by means of taxicab vouchers. The municipality could decide it wants clean city offices, but decide either to employ janitors on the city staff or to contract out janitorial services.

Is government currently successful at performing the function?

In contrast to the policy questions, whether or not government is currently successful at performing some function is not merely a matter of opinion or democratic consensus; facts are important. It is possible to review the evidence and draw some conclusions about whether government is effective or efficient at performing a function — in terms of cost, speed, or quality of service. Implicitly, there is always some frame of reference for evaluating current performance. It could be the experience of private sector or nonprofit providers, or of other governmental entities. Any comparison involves carefully computing costs and measuring performance.

If it appears that government is currently successful, then the function can continue in-house without alteration. However, given that debates about privatization usually arise in the context of asking whether performance and/or cost could be improved, the answer at this choice point is probably "No." The next practical choice point is how to address this problem.



Can government become more effective?

If the answer is "Yes," local government can improve its operation and keep the function in-house. Given all the search and monitoring costs entailed in the use of an outside vendor, this may well turn out to be the most cost-effective alternative. The decision process described in this guide ensures that this option will always be evaluated.

If the answer is "No," then the city needs to turn to other sources for assistance in discharging the responsibilities that it — as a matter of policy choice — has accepted. There are several distinct mechanisms by which government might enlist the services of the private or nonprofit sector: *vouchers* (for example, for transit services or food stamps); a *franchise* (for example, to allow a private company to operate bus service in some geographic area); an *outsourcing contract* (for example, to have a private company handle payroll or maintenance services); a *subsidy* (for example, to compensate a private hospital for treating indigent patients). While these options may look very different, they are all simply variations on a theme: finding a practical means, using outside resources, to supply a service that government wants to provide but cannot itself deliver effectively or efficiently.

Why Should the Questions in the Decision Tree be Asked in Sequence?

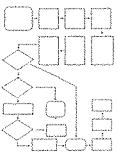
Answering these questions distinctly and in sequence means that issues of responsibility and of means will not be confused with one another. For example, a state senator once commented that his legislature was considering "privatizing" health clinics, and he feared that privatization would mean less health care for the poor. He asked whether this was a likely result of "privatization." His question did not distinguish responsibility (a public policy choice) and means (the practicality of providing a service).

Without stopping to resolve the responsibility question, the legislator had jumped directly to "privatization" (variety unspecified). Depending on the type of privatization selected (for example, an asset sale), the state could inadvertently end up with no control at all over health care for the poor.

By asking the policy question first, the governmental decision-making body can make an explicit choice about government's responsibility for health care. If the policy decision is "No," then closing the clinics, or selling them to a private medical group is an appropriate choice.

If the legislature instead votes first to accept responsibility for health care for the poor, it shifts its operational choices to a different set of options: continuing to run clinics in-house, or obtaining services from private providers on behalf of the poor by means of subsidies, vouchers, or clinics run on contract.

A decision to make use of a private provider for a governmental responsibility is only the beginning of another process: fairly choosing an appropriate contractor and structuring a



deal that will give maximum protection and flexibility to the government and citizens while enabling the government to monitor performance under the contract. With the contract in place, government has the long term task of managing the public-private relationship and monitoring and assessing the achievement of the government's goal.

The Meanings of “Privatization”

Vouchers, asset sales, outsourcing contracts, load shedding, franchises: all have been referred to as examples of “privatization.” However, as the decision tree suggests, different varieties of “privatization” are not interchangeable. Asset sales and load shedding are the result of a policy decision that government *should not be responsible* for the function in question. The other mechanisms are the result of two policy decisions — government should be *responsible* for the service but need not *perform* it — and one practical conclusion: other parties are better able to carry out the governmental responsibility.

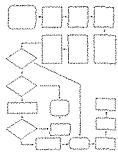
Given the imprecise manner in which the term “privatization” is sometimes used, it is helpful to be clear which type is contemplated and what consequences are entailed. For example, an asset sale involves a legal transfer of ownership and a cessation of government responsibility. For outsourcing or contracting out, government retains long-term contractual, policy-making, and oversight authority — and can never contract away blame or responsibility. Even though government has signed a contract for an outsourcing relationship, it still retains responsibility and needs to pay attention to the service and its provider. Remembering this will help in developing appropriate monitoring and oversight mechanisms. And, in fact, most cities that privatize services use multiple methods of oversight.¹

2. The Decision Process

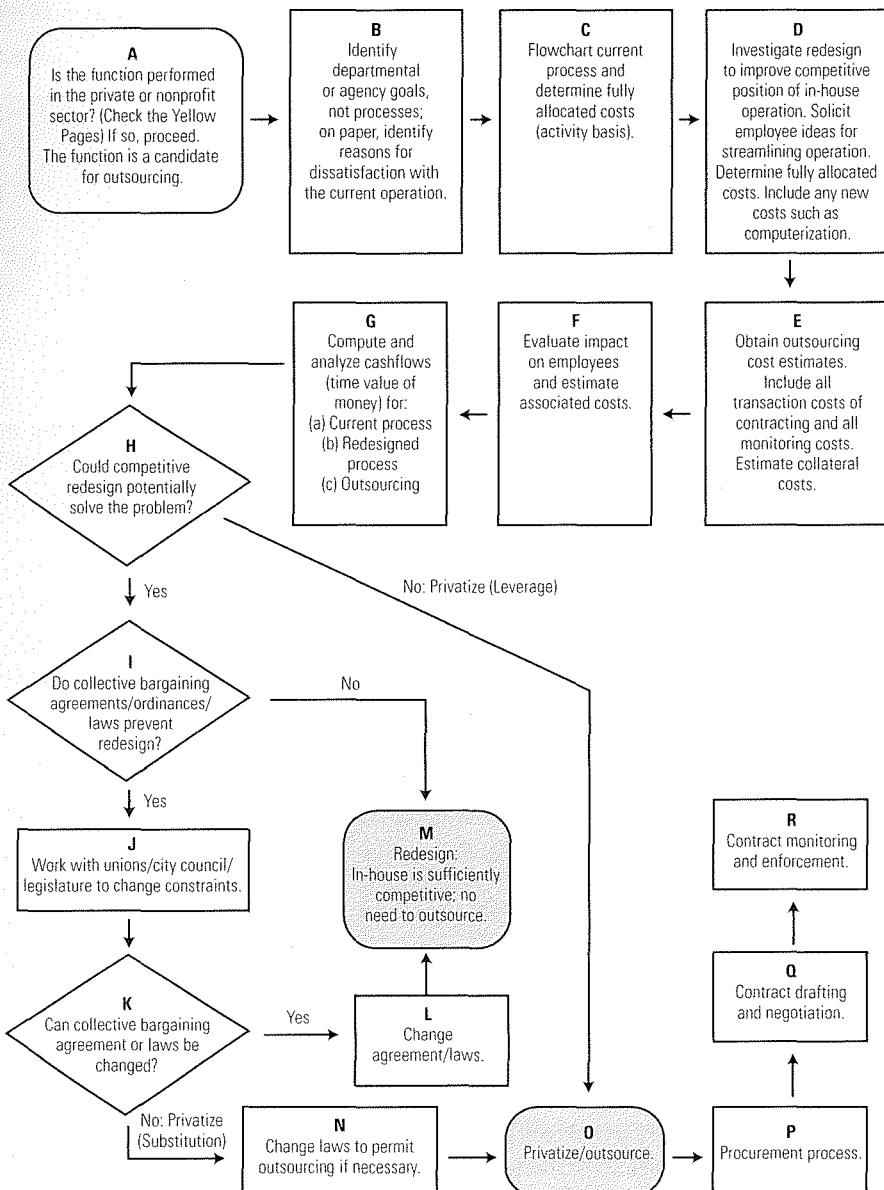
This guide — focused on outsourcing, or contracting out — presumes that government has already made the policy choices discussed above about responsibility and has concluded that, while it will be responsible for the function, it need not necessarily perform it. Now, officials move on to decide whether to

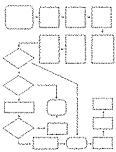
- **Continue the current process,**
- **Redesign the in-house process, or**
- **Outsource.**

The following flow chart represents a systematic step-by-step process for evaluating these alternatives. By following a structured decision process, the municipality can be sure that alternatives have been honestly considered, costs have been identified and determined, and the interests of employees, citizens, and other affected parties have been weighed. By ensuring the completeness and explicitness of its decision making, the municipality can also help ensure that its decision about whether to outsource or not will be clearly understood by all affected parties.



Thinking Through the Outsourcing Decision





One point about the flowchart should jump out at the reader: the box labeled "Privatize/Outsource" comes near the end of the decision process. It is an answer to a structured set of questions and data analyses, and choices about options, rather than the starting point.

Example: The city of Thornton, Colorado, has developed a systematic approach to their contracting activities. The following table outlines the specific steps in the privatization process after the decision to contract out has been made. For more information, contact: Mayor Margaret Carpenter, City of Thornton, 9500 Civic Center Dr., Thornton, CO 80229; 303/538-7200.

3. Understanding Consequences

The flowchart presents a set of alternatives to investigate and figures to compute. There are also some general perspectives that lie behind the specifics. These might be referred to as (a) the short term, (b) the longer term, and (c) the very long term consequences of privatization.

The Short Term: Will Privatization “Work”?

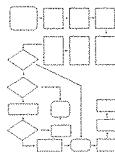
What are the mechanics of the privatization or outsourcing option? Will it save money? How should a vendor be selected? These are practical matters of computing costs and following procurement rules. These issues are addressed over a short time span, usually when the eyes of both city officials and the public are focused on a problem.

The Longer Term: Will Privatization “Work Out”?

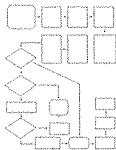
Whenever government is using an outside entity to carry out governmental responsibilities, it is embarking on a long-term relationship that must be managed over a period of years, long after public attention has turned to newer problems. Can the contract be managed for the duration? Will there be slippage in performance? Will the city lose expertise that may be needed later? Will sufficient bidders remain in the business and vicinity to keep the incumbent vendor on his or her toes? Could the contract realistically be re-bid? Are there incentives in place to prevent corruption in contract management?

The Very Long Term: What Are the Long Term Effects?

Outsourcing has some long-term implications for the relationship between the public sector and the private/nonprofit contractor. While there used to be a fairly clear separation



	City of Thornton, CO, Privatization Steps
Step One	Identify the service which the City has an interest in improving.
Step Two	Clearly identify the costs of the operation and document - not as easy as it sounds. This step often requires the assistance of outside consultants.
Step Three	Provide employees the opportunity to identify and implement cost saving measures. Leap Technologies' "Work Out" program is a useful and quick process to use to identify opportunities for improvement.
Step Four	Benchmark service with other public and private organizations. Benchmark studies typically take 3 to 6 months to complete.
Step Five	Determine the competitiveness of the service based on the benchmark study.
Step Six	Implement additional cost saving measures identified in the benchmark study.
Step Seven	Recalculate the cost of the operation.
Step Eight	Compare internal cost to costs identified in the benchmark study.
Step Nine	Decide whether or not to contract or keep the service in-house.
Step Ten	Issue requests for proposal from the private sector.
Step Eleven	Plan for possible employee transition. This step takes a considerable amount of time - don't underestimate.
Step Twelve	Compare the bids of the private sector to internal costs; evaluate proposed level of service; evaluate all costs and benefits.
Step Thirteen	Implementation.
Step Fourteen	Assign responsibility for contract monitoring and contract compliance.
Step Fifteen	Annually assess the contract, the assumptions of the contract and the contract language to ensure continued savings.
Step Sixteen	Annual contract negotiation (use findings from step 15 during this process.)
Step Seventeen	New contract signed.



between government and nongovernment, the relationship is becoming intertwined under various service delivery options, including privatization.

On the one hand, government is often urged to become more cost-conscious and entrepreneurial — more like business. On the other hand, government policy choices are being extended via contract to private entities. For example, a city may refuse to do business with a company that does not provide domestic partnership benefits to its employees. While municipal government could not directly impose this choice upon businesses, it can obtain that result indirectly through the promise of contract awards.

Small nonprofits performing contractual services for a city government may need to be especially watchful, lest they cease to be independent policy voices. These changes happen gradually, and, often, without being noticed; yet, over time, alter the landscape of public-private-nonprofit relationships.

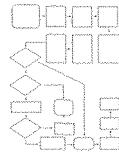
Further, the ways that the city departments operate may be forever changed through any successful competition with the private sector over contracts - managed competition. City officials will benefit by being alert to all the long-term implications of choices made under competitive options.

4. Identifying Candidates for Improving In-House Operations or Outsourcing

At this point in the process, the municipality has already made several decisions. First, it has made the political decision that it should be responsible for, but not necessarily perform, a given function - whether cleaning streets, or providing clean drinking water. Second, after taking an honest look at the empirical evidence, it has concluded that it really is not very successful at handling that function. The question, then, is how to obtain those services on behalf of constituents in a practical and ethical manner. Government can either improve the in-house operation or contract with an outside service provider.

The Yellow Pages Test

Many commentators have recommended the “Yellow Pages Test” as a good rule of thumb for deciding whether a particular function is a potential candidate for outsourcing. If there are a number of entries in the Yellow Pages — for janitorial services, or electrical contractors, or payroll services — then government managers know that there is nothing uniquely governmental about the function in question and that a competitive private market exists. The city could potentially contract with one of these companies.



The Yellow Pages test is meant figuratively, in the sense of local availability. The real question is who is willing to do business in the city, not simply which firms are headquartered locally. For example, there are several national or regional engineering firms that operate water filtration or waste water treatment plants on contract to municipalities. A firm that already does business in other parts of the state or in adjoining states may well be prepared to bid on business in other cities — without necessarily having an entry in every telephone directory. The city's purchasing or procurement departments are resources for determining the availability and qualifications of vendors. The Internet is an increasingly useful source of information about national providers.

If there are few competitors for some service, outsourcing should be approached with caution. A private sector monopoly is unlikely to be an improvement over a public operation. Successful outsourcing requires competition. The greater the number of competitors, the greater the likelihood that profit-driven vendors will compete with one another to drive prices down and service up.

In a large metropolitan area, there may be sufficient competitors for most services. In a small town in a rural area, there might be three private vendors capable of maintaining snow removal or asphalt equipment, but no pharmacist. This town could realistically outsource equipment maintenance, but not prescriptions for welfare recipients. A town 30 miles away might have a competitive market for pharmacists, but no one to service equipment. While learning about the experiences of other cities is useful, officials are always aware that their community has its unique context. A decision that is right for one locality may be a big mistake for another.

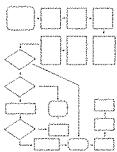
Remember:

- **Outsourcing decisions are local.**
- **A decision that is good for one city is not necessarily good for another.**

Understanding the Competitive Market

In searching for potential vendors, it is also necessary to think carefully about (a) how the municipality is defining the problem, and (b) how the industry is customarily organized. "Plumbing" may be obvious, with buyer and supplier picturing the scope of services in roughly the same way. But how might parks maintenance services be located? Under "Landscape gardening?" "Trees and shrubs?" "Nurseries?" "Garden supplies?" "Tree trimming?" "Pool cleaning?"

Even though the city has traditionally included playground design and tree trimming as part of a general "parks" function, private businesses do not necessarily aggregate functions in the same way. Successful outsourcing requires understanding the local vendor markets



and tailoring any procurement to fit that market. Identify the functional components, and consider separate procurements for different pieces. There may be one or no firms to bid on “Park Maintenance,” but several competitors each interested in pool maintenance, tree trimming, and sidewalk paving. Without disaggregating a large function into its market components, the city might design a procurement that attracts very few bidders.

Remember:

- **Successful outsourcing requires defining the scope of the problem in a way that matches business practice.**
- **Disaggregate functions in order to optimize the number of potential competitors for each service.**

The difficulties encountered in attempts in Baltimore and Hartford to outsource schools to a single educational contractor may be due, in part, to aggregating most schools-related functions and seeking to outsource to a single bidder. There are few, if any, competitors for this scope of service. In contrast, there are many competitors for maintenance, food service, payroll, and tutoring.

5. Specifying Goals

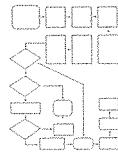
After identifying the service that needs to be improved or outsourced, the next step is to define and articulate desired results.

Focus on Goals

How goals are defined can determine the success of the project. Keep the focus on the *end results* that the city or department wants to achieve. For example, “Have diseased trees removed within one week of a request” is a goal defined in terms of the result that matters to the city resident. “Speeding up data entry” or “faster handling of customer complaints” refer to particular internal *procedures*. A procedural focus may lead to *efficiency* improvements, but at the risk of missing ways to be more *effective*. Maybe machine-readable forms will remove any need for data entry. The real goal is solving the underlying problem so that constituents will have fewer complaints that require handling. A danger in privatizing procedures without explicitly maintaining a focus on results is that current inefficiencies will simply be outsourced.

Remember:

- **Focus on end results, not on process.**
- **Think effectiveness, not just efficiency.**
- **Address problems; don’t just outsource them.**



Be Explicit About Current Problems

It is very helpful in the initial stages to summarize on paper the city's dissatisfactions with the current operation. Are current expenses too high? Does accountability for monies collected need to be improved? Is the permit processing cycle time too long? Among those involved in making the decision about outsourcing or reorganizing, reaching a consensus about the assumptions and goals that will guide the decision process is important in order to prevent working at cross purposes. For example, one city was considering outsourcing management of a nursing home; the home was failing to attract residents. It turned out that one group of managers thought the problem was an unattractive facility and that more money should be spent. Another group thought the per bed cost was already too high and assumed that the object of privatization was cutting costs.

Listing current problems and issues can help keep a clear focus and guide the process the municipality is using. The list of issues that need addressing should go into a file to be used later, as a basis for guiding a departmental reorganization or preparing for a procurement process. If dirty floors are a problem under current city auditorium maintenance, that item needs to be specified in any bid document, negotiated in a contract, and tracked during contract monitoring.

Remember:

- Be honest and explicit about listing problems with the current operation.
- Use the list to guide any eventual reorganization or procurement process.

6. Analyzing the Current Process

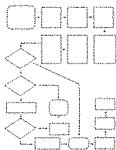
If the city will maintain responsibility for some function (for example, garbage collection, building permits, water billing) that is currently inefficiently managed, analyzing the operation in detail will help in understanding why the function is not being performed well.

Without this effort, it is impossible to tell whether matters can best be improved by redesigning the process, outsourcing it entirely, or by some combination of public and private resources.

Flowchart the Current Process

Identify all the inputs to the department: service requests, phone calls, complaints, etc., and trace out all steps in, for example, filling potholes or conducting an inspection.

Especially for a department that has been in existence for a long time, flowcharting may involve some real detective work. Tasks may have been computerized piecemeal over the years, or jobs rearranged to work around space or employee constraints.



Interview employees to find out what really happens in each step: Where does each employee get work? What does that employee do? Where does completed work go? Are there steps or employees that do not add value? Are employees bypassing a convoluted official process? What does the resident do to obtain a service or pay a bill? How many times must the same information be provided to different city employees? How do documents move physically: from one floor of city hall to another? Across town? Back again? How much time is spent in transit? Specify not only the flow, but how long each step takes to complete and how long work sits in a queue before the next step begins. Also, determine whether citizens are treated equally and predictably by the process.

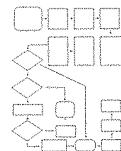
Flowcharting can be a real eye opener, revealing inefficiencies, duplication of effort, or delay. This flowchart provides the baseline and specific details for improvement through redesign or outsourcing. It is also important not to short circuit this analysis by making assumptions about what is wrong. Sometimes the real inefficiency is elsewhere, and the apparent problem is only a ripple effect. Identifying all components involved is also a prerequisite to determining the costs of the current operation (see section below on Activity-Based Costing).

Flowcharting and task analysis are, in general, a good way for city officials to learn what is going on in a department. For example, while analyzing responsibilities and costs in its Department of Transportation, Indianapolis discovered that DOT employees were also picking up trash and cutting grass — responsibilities supposedly assigned to other departments.

Determine Current Costs: Why It Matters

Saving money is a commonly offered reason for privatization.² Indeed, a 1997 National League of Cities research report indicated that 78 percent of cities responding to the NLC survey reported "dollar savings to the city" as a very important factor in the decision to contract out municipal services.³ However, cities may lack a clear picture of the current costs of a function such as tree trimming or street sweeping. It is impossible to determine whether outsourcing will reduce costs without knowing those costs. Further, displaced employees, unions, constituents, and unsuccessful contractors will want the assurance that privatization was driven by an honest desire to conserve city funds. Similarly, a decision to take back into city services a formerly outsourced function may be open to question if costs are not identified.

Both accuracy and efficiency are increased for the city in the negotiating and outsourcing process if current costs are understood. An experienced contractor can easily estimate costs for cleaning a building or programming computers, for example, or can estimate how much revenue a certain parking garage should produce. If the city does not understand its



costs and potential revenues, it is at a distinct disadvantage when negotiating a contract. The city can drive a better bargain if it, too, can compute revenue and expenses realistically.

Activity-Based Costing (ABC)

It can be very difficult to identify all the current costs of an activity or the extent of cost savings with outsourcing. The problem is that traditional financial reports (for businesses as well as municipalities) break down costs not by activity, but by accounting category — such as wages, benefits, and supplies. For example:

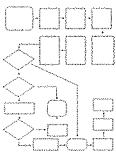
City of _____	
Public Works Department	
Financial Report — Traditional	
Salaries & Benefits	500,000
Equipment	150,000
Supplies	50,000
Use & Occupancy	30,000
Total	\$730,000

When the department conducts several individual activities — such as repairing potholes, maintaining street lamps, and plowing snow — it is impossible to identify the cost of each activity from the traditional financial statement.

Activity-based costing (ABC) is a technique for allocating costs to individual activities. ABC can be used to report financial information by service provided:

City of _____	
Public Works Department	
Financial Report - Activity Basis	
Fill Potholes	120,000
Replace Sidewalks	130,000
Replace Lights and Signs	270,000
Remove Snow	120,000
Replace Light Bulbs	90,000
Total	\$730,000

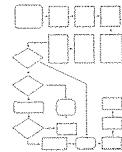
The goals of ABC are (1) to allocate costs accurately to the activities which caused them and (2) to do so cost-effectively.



The process of developing an ABC reporting system can be complex. It is necessary to identify the cause or *driver* of each cost and determine how the cost should be allocated to each activity which caused that cost. When it is expensive to track the actual cost driver, ABC seeks simple and inexpensive approximators. For example, the cost of many tasks is determined by time spent. For those employees who plow streets or fix potholes (called Direct Labor), time records are generally available. However, time records are probably *not* available for support functions (called Indirect Labor), such as dispatching or inventory control. In order to allocate costs accurately but inexpensively, the ABC process seeks an approximator of time, so that costs can be allocated to activities without requiring detailed time records for all employees. It is essential to chose an indicator which approximates the cost driver as closely as possible to avoid misstating costs.

There may be additional complications. First, although the examples above show a simple reallocation of total departmental costs, many cities report direct costs of an activity across several departments or funds. The costs of public works vehicles may be reported by fleet management, or the cost of repairing potholes in a park may be reported in a separate fund because the costs are paid by a different funding source. Second, indirect costs, such as personnel, legal and purchasing costs, are generally reported outside of the public works department. It is important to capture all related costs — direct and indirect — regardless of how and where they have been reported.

While the techniques for activity-based costing are beyond the scope of this guide, the rationale should be clear. With ABC reports, management can identify those *activities* that are most costly and where a more cost-effective operation (whether outsourced or streamlined) would yield the greatest savings. Per-unit costs, such as the cost per pothole, can be developed and compared with private sector proposals or — assuming continuing ABC reporting — prior periods. ABC reports provide the information management needs, whether or not it is considering outsourcing. In the outsourcing decision, however, ABC reports are an essential beginning step in identifying activities in need of improvement. The privatization decision will be both technically easier and less politically contentious if the decision is based on accurate information at each step in the decision process, and the city can show that it is making sound management decisions. Because ABC techniques are relatively new, it is necessary to take some care in explaining these reports to interested groups.



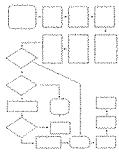
In one city, office supplies had been purchased centrally. Departments were charged only the direct costs of the items ordered and were unaware of the (high) in-house costs of warehousing and distribution. The city accurately computed these costs, and the decision was appropriately made to privatize. Each department would order directly from a vendor. However, the full costs were allocated to, and charged to, the user departments. As a result, when the new system was implemented, total costs were reduced, but the users' costs increased. The user departments reported their costs to the news media which, in spite of management's explanations, reported that privatization increased costs. Explaining the cost allocation in advance could have reduced the risk of misunderstanding.

Many cities use more traditional budgeting and accounting methods. Nevertheless, when the city is considering outsourcing an *activity*, it needs to understand the costs of that activity. Part of effective decision making is a willingness to undertake the sometimes difficult task of accurately determining costs. In implementing an ABC system, budget department involvement is key because responsibility for relevant costs crosses departmental lines. Centralization allows access to *all* financial data needed and ensures a consistent methodology across departments. However, implementing ABC requires an accountant with specialized training. If the city does not have an individual with the requisite skills and education, the city can outsource the ABC analysis. Indianapolis Mayor Stephen Goldsmith writes that when he took office in 1992, the City of Indianapolis used outside accountants to assist the city in moving to activity-based costing analyses in order to improve service delivery.⁴

The City of Charlotte, North Carolina, reorganized 26 city departments into 13 "Key Businesses." The city implemented activity-based costing in order to develop the cost information needed for make-buy decisions. Contact: Ed Sizer, Contracts Administrator, City of Charlotte, 704/336-3862.

7. Investigating the Redesign Option

If the current city service or function seems an attractive one for competition, including outsourcing, it is worth investigating the in-house redesign option. Given that any savings attributable to outsourcing must be offset by the costs associated with procurement and contract monitoring, redesign may be an attractive alternative.



Zero-Based Approach

While contemplating redesign, think “outside the box” of current job descriptions or a collective bargaining agreement. Think only about how people with sufficient skills and equipment might theoretically do the job. Only this zero-based approach will enable the city to assess the costs of restrictive work rules, outdated management practices, or statutory constraints. Eventually, the city will want to compare (a) the cost of the current way of doing business, (b) an improved in-house alternative, and (c) an outsourcing alternative. If work rules are shown to be driving up the in-house costs, making outsourcing relatively more attractive, making those costs explicit may provide the political will for change.

Get Employee Input

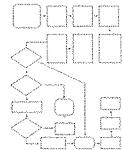
Front-line employees who deal with disgruntled residents and service recipients have a great deal of insight into current problems. They are also the people who face the possibility of job loss if the service is outsourced. For these reasons, employees may be quite prepared to assist in rethinking the operation. City officials will want to assure front-line employees that they will not be put at risk because of their offering ideas and comments on how operations could be improved.

Employees can be a valuable source of innovation when redesigning current processes. If certain procedures or policies are preventing employees from efficiently completing their jobs, their frustration will often provide the impetus for the creation of solutions. Given the ability to express their own ideas and suggestions freely, these employees, from the lessons of their own experiences, can often provide insightful tools for effective redesign. Furthermore, letting employees take part in the redesign of their own departments can foster teamwork and build morale.

Note: In a unionized jurisdiction, take care to obtain guidance from the city labor relations department or city attorney before initiating discussions with a unionized workforce. There is a risk that any conversations might be construed as a violation of the existing collective bargaining agreement, and legal advice on these points is essential before any discussions take place.

Design and Project the Costs of a New Process

If there are major inefficiencies in a city operation, privatization may be cheaper than the current operation, even after all transaction costs of contracting are factored in. However, if the flowcharts reveal duplication of effort, lack of accountability, or information falling through the cracks, consider redesigning the in-house process. Estimate the total cost of



a redesigned operation. Some investment in technology may be necessary — particularly if the current process is very paper intensive. Managers should take a hard look at their own costs and practices as well as front-line operations.

In the course of putting pothole filling out to bid, Indianapolis discovered that the Transportation Department had 32 persons supervising 94 employees. After reducing the supervisor-to-employee ratio, which resulted in eliminating 18 supervisory positions, the city concluded that it was cost-effective to keep street repairs in-house.

Source: City of Indianapolis, *The Indianapolis Experience*, December 1996.

Because redesign does not carry all the transaction costs of privatization, it may well be the best way to exercise good stewardship of the taxpayers' money. Thus, redesign is an important option to consider in comparing both the current process and contracting out. For example, a transit agency estimated that it cost a dollar in-house to process every transit check issued. An outsourcing possibility would apparently cost only fifty-six cents. Privatization looked to be the only viable alternative — until the agency stopped to consider the redesign alternative: twenty-eight cents.

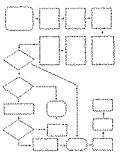
Even if it appears clear that outsourcing will be the best alternative, it is worth at least a rough computation of the cost of an improved in-house operation. When government better understands the source and costs of current inefficiencies, it is in a better position to negotiate an outsourcing contract.

8. Investigating Outsourcing Alternatives

If outsourcing appears to be an option for the service considered, the decision process then moves to determining whether there are firms in the local market willing and able to participate.

Is There Adequate Competition Among Contractors?

Competition should be evaluated along two dimensions: numbers and independence. How many competitors are there in the service or function that the city is considering privatizing? Is there reason to suspect collusion among vendors? Since competition is needed to keep prices down and provide alternatives, city officials will need to take care not to tie a city function to a monopoly provider. If there is a competitive market in the business to be privatized, the city may yet obtain a good contract price even when it does not have a good handle on its current revenues or expenses.



Good contracting practice also means that the contractors be independent of one another — and of city officials. Cities should be very cautious about outsourcing to any vendor with family, business or political ties to elected officials or appointed administrators. Many cities have ethics ordinances that apply in such circumstances, requiring disclosure of business ties (or recusal from decision making) and the disclosure of campaign contributions. Also, it is not advisable, and may even be illegal, to permit individuals who have assisted the city in drafting procurement documents to bid.

Example: The importance of making sure that there are adequate numbers of competitors for a service is underscored by the experience of Portland, Oregon. According to the Office of the City Auditor, in 1990, Portland hired a private firm to repair and maintain four new street sweeping machines under a three-year contract. Although street sweepers had been previously maintained by the city fleet maintenance staff, maintenance managers hoped to lower costs by using a private contractor.

After the first year when the machines were under warranty, the contractor continually claimed that repairs were necessary because of operator negligence and not covered by the contract. After the second year, the company went bankrupt and walked away from the contract. City attempts to sue were fruitless because the company had few assets.

Subsequent request for bids produced no bidders and the city once again maintains the sweepers.

Source: "Competitive Contracting: Opportunities to Improve Service Delivery and Save Money", May 1995, City of Portland, Office of the City Auditor

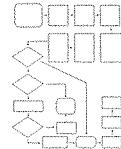
Outsourcing to Nonprofits

Many cities outsource to nonprofits, particularly for human services such as job training, counseling, and addiction treatment.⁵

When outsourcing to the private sector, cities look for economies of scale, specialized expertise, costs driven down by the competitive marketplace, and business management expertise (including project management, accounting, and financial record-keeping).

When the contractor is a nonprofit, the city may obtain specialized skills and lower overhead, but also may find less sophisticated project management or accounting skills.

Wages and benefits are very often lower in the nonprofit sector, so outsourcing reduces



city costs accordingly. For many human services, there may not be a fully competitive market. Further, some nonprofits are longstanding and customary contractors of city government. Attention to these issues and careful monitoring of contract performance are essential for city oversight of nonprofit contracts.

City officials should think through the rationale for outsourcing to a nonprofit, be prepared to deal with potential problems (as they would be with for-profit companies), and be fair and open about the contractor selection and monitoring mechanisms involved.

The City of Ann Arbor, Michigan, has developed a useful approach in working with nonprofit contractors. Ann Arbor privatizes human services through some 50 nonprofit agencies. The city offers technical assistance in developing contracts through the city's publication of "Guidelines for Nonprofit Organizations under Contract with the City of Ann Arbor," which assists nonprofits in developing fiscal and administrative capability and meeting funding requirements.

Contact: City of Ann Arbor, Community Development Department, (313) 294-2912.

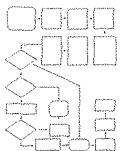
Estimate Potential Contract Costs

Estimate direct costs of the contract. Without bids, the city may not be able to nail down precise costs, but it should be possible to obtain ballpark estimates based on surveys of vendors or other cities. (Being fair to private or nonprofit bidders means not putting a project out to bid simply as a means of obtaining price data, since preparing a bid response is costly and time-consuming for potential contractors.)

Estimate costs of contracting and monitoring — the hidden costs of privatization

The city needs to estimate the transaction costs of contracting: these reflect the time spent by the user department in defining requirements and by the legal, purchasing and user departments to draft, advertise for, and evaluate bids, and negotiate the contract.⁶

The city's accountability responsibilities are present throughout the entire term of the contract. Thus, there are transaction costs to getting the answers to such questions as: Is the job being performed adequately? Are performance standards met? Is billing accurate? Are revenues remitted on time? Are expenses and/or revenues audited? Is the contractor complying with minority participation requirements? The expertise to handle such considerations may be present on the city staff, or this contract management responsibility may require skills not possessed by current employees. If so, some new city hiring may be needed.



The costs of obtaining and monitoring a contract are some of the hidden costs of privatization and do not appear in any one department's budget. A department proposing privatization should work with the city budget office to obtain estimates of all these costs. The city cannot make an informed decision about the cost-effectiveness of privatization unless these costs are identified.

The most basic rule of outsourcing is "Don't contract out unless the benefits of contracting exceed the costs of contracting."

9. Jobs

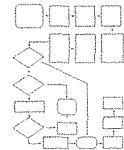
When comparing various in-house and outsourced alternatives, elected officials need to consider the question of who will perform the work — current city employees or employees of the vendor. These are complex issues, often involving trade-offs. Setting the overall policy will require carefully thinking through the implications of various options.

Job Loss

Potential loss of jobs by current municipal employees is an important concern when a city is considering outsourcing. Officials face many issues on this front, especially impacts on employees. Less skilled employees at the lower end of the wage scale may face greater risks from downsizing. The impact on all employees needs to be considered carefully. Cities engaging in privatization have developed a number of ways to minimize harmful effects, as described later in this chapter.

Elected officials need to look carefully at indirect costs as well as direct costs. Loss of family income for displaced city employees may show up in other places — such as welfare, social services, or costs attributable to family instability. It is important to consider whether the city is trading costs in one place — wages — for costs in other places — social services or other family services. These possibilities should be assessed and the costs estimated along with other more direct costs of contracting. It is also important to note that some of these indirect costs may be borne by different levels of government. For example, unemployment compensation is a state rather than a municipal expense. Welfare may involve county, state or federal monies.

For city employees who obtain work in the private sector, wages may be lower. Benefits — such as the number of paid vacation days and the availability of family dental care — may also be lower.



Choices made can also affect the morale of employees remaining on the city payroll. According to a report from the Illinois Comptroller's office, "Not addressing employees' concerns about privatization can lead to a demoralized and unproductive workforce."⁷ The City of Charlotte, North Carolina, adopted a no-layoff policy in its privatization and restructuring efforts, which made employees more willing to engage in re-design thinking and assessments of current efforts. The result was 272 positions eliminated with no layoffs.⁸

The Illinois Comptroller's report notes that there are a number of strategies to deal with employee concerns about job loss: reducing the public workforce through attrition, requiring private contractors to hire public employees affected by privatization or giving them at least hiring preference, transferring city employees to jobs in other departments, providing job training and placement services for displaced employees, and initiating early retirement programs for older employees. This guide discusses some of these options in the section below entitled "Employee Protections."

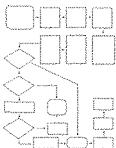
Local officials will want to consider seriously the effect of outsourcing on women and minorities. Often, these workers are among the most recently hired and may be especially vulnerable if there is a change resulting in job loss. Outsourcing may involve loss of mid-level employment positions that may be held by women or minorities. Many regard the public sector as historically more advanced than the private sector in achieving employment gains for women and minorities. Many municipalities have been models of good employer practices on these issues and privatization decisions will need to be made in that context. Ensuring that such employment gains are not overlooked is an important policy consideration.

Job Creation

Unless a job really does not need doing (in which case it is hard to justify using city dollars to continue doing it), work does not disappear when it is outsourced. Streets still need paving. Sewage still must be treated. Garbage still must be collected. Privatization can, therefore, result in job *creation* in the private sector.

Legitimate concerns can be voiced about substituting lower-wage private sector jobs for better-paying public sector jobs, in terms of tax base and of impact on individual workers. One study by the Chicago Institute on Urban Poverty concluded that wage and benefit levels of workers whose jobs were contracted out by the City of Chicago fell 25 to 49 percent after privatization during the period 1989-1995, with many falling to or below the poverty level.⁹

Others point out that an increase in the number of *private sector* jobs in a locality may have advantages for the local economy. A private contractor who cleans the public



school may also gain contracts with a local bank or office building. This can increase the tax base, particularly if wage levels are promising. Outsourcing of service jobs — which do not require large capital investments — may be a particular boon to small and minority-owned firms.

Example: Indianapolis has outsourced courier services to a minority-owned firm, Pillow Express. Besides saving the city approximately \$60,000 a year, Pillow Express has attracted new private sector clients, and now has 20 percent more full time employees.

Source: City of Indianapolis, *The Indianapolis Experience*, p. 12.

While some argue that workers have a greater opportunity for advancement in the private sector, others point to outstanding training and advancement opportunities in city government, such as that operated, for example, by the City of Phoenix. Whether workers benefit from outsourcing must be weighed considering each city's individual circumstances and opportunities.

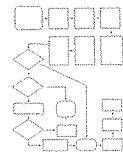
Depending on whether vendor firms are local or out-of-state, the local job market may be enhanced — or jobs might be exported. A requirement that contractors be local does keep jobs in the area but may reduce the number of potential bidders.

Employee Protections

Cities have used a variety of employee protections in the transition to privatized services, as described below. Whatever methods are used, the costs of these transition protection options need to be included in the city's cost calculations.

Attrition

Reducing public employment through attrition is a common practice. Disadvantages are that it can be a passive management strategy and the pace of reduction may be unpredictable. Advantages are that current employees do not face job loss when a city privatizes. Relying on attrition is particularly effective when the scope of outsourcing can be increased gradually. For example, the city might hire no new janitors but progressively contract out janitorial work for additional facilities.



Transfers to current or future city jobs

Transferring displaced employees to other open city positions is effective — assuming employees meet the requirements of other departments. This strategy is easily used for job categories that are not specific to one department, such as clerical, data processing, or laborer categories; a sanitary engineer may be hard to place outside the water department. When outsourcing is on the horizon, it is a good idea to allow other city vacancies to remain open and coordinate the downsizing plan across city departments. Transfers may also involve a cascade of employee moves if employees have bumping rights under a collective bargaining agreement. Displaced city workers may also have recall priority when other city positions become open in the future.

Early retirement

Special early retirement options may be offered as an inducement when there is a need for a rapid workforce reduction. In these cases, city officials have to consider whether this would cause an unacceptable loss in expertise. Some cities have found that they needed to hire retired workers back on contract in order to maintain operations. It is also important to consider the condition of the pension fund. Any increased costs should be factored into the cost of privatization.

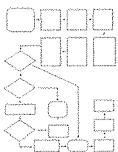
Right of interview with contractor, or right of first refusal

It is quite common for outsourcing contracts to require that the contractor interview displaced city workers. Workers have the opportunity to place their qualifications before the contractor, and often to be hired before others if they meet the requirements for employment.

Requirement to hire

Some cities have stipulated that the contractor is required to hire displaced municipal workers. As long as employees become subject to the vendor's wage, benefit, and work rule conditions, this can benefit employees in that they do not lose employment (although they may see a lower set of wages and benefits). This option leaves the city with all the benefits of outsourcing.

When the city seeks to require the contractor to maintain employees at the same wages, benefits, and work rules, impediments can occur. Given the internal transaction costs of outsourcing, this requirement can make it more expensive for the city to outsource than to carry on with current operations. Requirements to maintain the municipal level of wages, benefits, and work rules are also likely to limit the pool of interested vendors, who may find such requirements commercially unappealing. Nevertheless, check that state law does not require such a provision.¹⁰



Successor Organization: If the public employee group was unionized, and if a significant portion of these employees are employed by a vendor performing substantially the same work, that vendor might, under federal labor laws, be treated as a “successor organization” and be required to recognize the union as the bargaining agent for the employees. Consulting the city’s labor attorney will help identify any constraints or trigger points.

10. Side by Side Comparison of All Alternatives

The above steps give city decision-makers the information they need for a side-by-side comparison of the three basic alternatives:

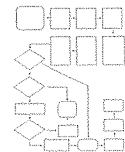
- the current process,
- the redesigned alternative, and
- the outsourced alternative.

It is advisable to compute costs, assess feasibility, and weigh consequences for all affected groups. Make sure the analysis is complete since all subsequent decisions depend upon good information.

Reverse Privatization: While this guide focuses on evaluating the **public-to-private transition** the same cost comparison logic applies when the service is already outsourced and government is considering taking it back in-house. Is the change appropriate when service levels and all costs — including termination and start-up costs — are considered? Again, the decision process and rationale should be open and explicit.

What Will Change? (Or, Computing Marginal Costs)

Activity-based costing (ABC), while vital for determining the current cost of a service, is not the end of the story. It is based on computations of *average cost*. Deciding whether to reorganize or outsource, however, requires answering an additional question: what costs will change as a result of any decision? These are the *marginal costs*. Consider the dispatcher who handles street cleaning and snowplowing crews and also handles police and fire dispatch. If the dispatcher’s hours and, therefore, wages cannot be reduced, there is no savings in the dispatcher budget if snowplowing is outsourced. ABC allocated a portion of the cost of the dispatcher to snow plowing, but the cost of the dispatcher will continue whether or not snowplowing is outsourced.



Consider public works employees who clean streets during the summer and plow snow during the winter. What costs could be reduced if the city decided to outsource snow plowing — but not street cleaning? If it is not possible to reduce employee positions and thus wage costs, savings may be limited to the cost of overtime expense specifically related to snow plowing. Marginal costs will be less than ABC costs and total costs may increase as the cost of the snowplowing contract is now in addition to the yearly employee cost, reduced only by winter-time overtime. Managers can consider the options. Could the employees be switched to seasonal (summer) work only? If yes, could the yearly payroll be reduced, and by how much? Would employees seek full time employment elsewhere? What are the potential savings of outsourcing both street cleaning and snowplowing?

Or consider the human resources costs that were allocated to snowplowing under activity-based costing. Unless the city can proportionately reduce space and personnel in the Payroll Department, these costs will not disappear if snowplowing is outsourced.

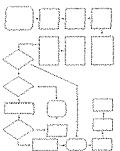
But marginal costs need *not* necessarily be less than the average costs allocated under ABC. With a creative look at all options, savings may be significantly greater than the allocated costs. For example, if a city is currently renting outside (and relatively expensive) office space for Department A, and is considering outsourcing many of the services provided by Department B which is currently located in less expensive quarters at city hall, it may be possible to relocate Department A to Department B's old quarters and sublease the outside offices. This savings, although reduced by the cost of the move, may be substantially greater than the costs allocated under ABC.

It is important to review each cost, to identify all options and to determine how the change — whether outsourcing or redesign — could affect it.

Determine Net Present Value of the Alternatives

Different ways of performing a function may require different outlays of money at different times in the future. One vendor may propose \$200,000 in capital investment in year one of a five year contract, while another proposes \$100,000 each in years 2 and 4. In nominal dollars, these are the same, but they are not equally valuable. One hundred dollars in hand today could be invested and is, therefore, more valuable than \$100 payable a year from now. In order to compare vendors, the city needs to convert these bids into equivalent terms.

By converting to *net present value*, all future expenditures are discounted (using the applicable interest rate and inflation assumption) to today's dollars. While elected officials need not know the formulas for computing net present value, they do need to consider the time value of money. The budget department can handle the present value computations so that user departments are free to deal with the technical and substan-



tive aspects of the process.

Cost Comparisons

Without discounting to net present value, the comparison of costs will be invalid.

The Chicago Park District was trying to choose between two vendors. They selected the bidder that was higher in nominal dollars by about \$1.05 million.

However, because of the timing of proposed capital improvements, the costs were comparable over the life of the five-year contract when discounted to net present value, and the choice was made on the basis of expected service quality. Because the computation was not successfully communicated to watchdog groups, the Park District was unjustly criticized for spending an extra million dollars.

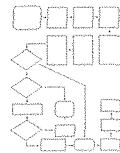
Source: Ari Ferziger, Eric Logan, and Joel Turner, "Chicago Park District Golf Course Privatization," March 14, 1994. Research paper written for the Kellogg Graduate School of Management privatization course.

This example in the box illustrates two points: First, determine net present value before making a comparison. Second, it is important to explain the net present value calculation — including assumptions about the discount rate — to constituent groups.

11. Competitive Contracting

"Competitive contracting" refers to the practice of allowing or encouraging employees to bid against private vendors for the performance of a city service or function. The term "managed competition" is also used.

Competitive contracting may involve training the employees to compute costs and to interpret and respond to procurement documents. For example, in the instance of contracting for street repair, the City of Indianapolis chose to assist city employees, who wanted to bid for the contract, by providing an outside consultant to assist in developing in-house entrepreneurial bids.¹¹ The costs of such technical assistance should be made explicit. It is also important to note that a private bid must also cover the cost of owning or renting facilities and the costs of property and sales taxes, while a city department is not subject to taxes and may not have to cover space rental costs. These imputed costs and estimated foregone revenue should be made explicit when comparing city and private vendor bids.



Several cities have encouraged city employees to bid against private sector vendors for the delivery of a particular service.

Examples:

- The City of Charlotte, North Carolina, held a managed competition for the operation and maintenance of one wastewater treatment facility and one water plant. The city's utility department submitted a competitive bid along with those of private firms. After review by the Charlotte City Council, the city utility department won the contract, bidding 20 percent lower than the closest private firm.

By initiating cost-savings techniques within its operations, the city utility bid proposed to reduce maintenance and operating costs by more than \$4 million over the five-year contract period. The department's director, Doug Bean, stated "This [competition] process has led to an entirely new way of thinking within city government. Our success proves that when municipal employees are given time, resources and freedom from typical bureaucracies, they can successfully compete with the best private companies in the world. . . .

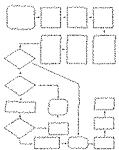
Competition is good for government and it's good for our customers. . . . For municipal departments to provide the best service at the lowest cost, they must re-engineer their operations and start thinking competitively."

Contact Charlotte-Mecklenburg Utilities at 704/399-2221.

- Under its competitive approach, the City of Indianapolis has had several examples of city departments and employees bidding successfully against private vendors for city contracts. One example is that of fleet maintenance. In 1994, the Fleet Services department won a bid for maintaining and repairing the city's 2,800 vehicles, including snow plows, garbage trucks, road graders, police cars, and fire engines.

The Fleet Services department, when first told that competition would determine what entity would conduct fleet maintenance services, requested that the city delay the competition so that the department could prepare. The successful bid was the result of several months of re-thinking and streamlining by the department in order to be able to compete. The contract includes incentive awards to employees if savings are greater beyond those proposed. Such savings are shared between employees and the city.

Source: *The Indianapolis Experience*, 1996.



Competitive contracting is often cited as a source of creative ideas for reducing costs. For example, it was Indianapolis Department of Transportation employees engaged in preparing a bid for street repairs who determined that the Department had 32 supervisors for 94 employees. However, if the city's objective is simply to determine whether the efficiency of the in-house process can be improved, it may be much more cost effective for managers simply to work closely with employees to flowchart and analyze the process (as described in steps D and E of the flowchart). This is an ongoing managerial responsibility — whether or not employees are interested in bidding. This approach also eliminates the possibility of unfairness to vendors.

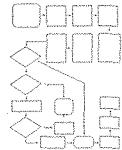
Tackling this responsibility prior to undertaking a bidding process eliminates such city expenses as departmental, legal, and purchasing department costs associated with preparing bid documents for private vendors. It also avoids the costs of training or assisting city employees to learn how to interpret bid documents, compute costs, and prepare a bid response.

By carefully proposing and evaluating the three alternatives described above — the current process, a redesigned alternative, and an outsourced alternative — and working closely with employees to define these options, managers can make decisions within the framework outlined here that will incorporate both employee and management input and will clearly lay out the direct and indirect costs of all alternatives. The end result can tap employee knowledge and creativity and achieve the efficiency and participation aims of competitive contracting without unrecognized costs, or without unfairness to potential bidders in the private sector.

12. First Choice Point: Will In-House Redesign Suffice?

The city now has data on three alternatives and their estimated associated costs: the current operation, a redesigned in-house alternative, and one (or more) outsourcing possibilities. It is time for the first decision point: will redesign — making the function more efficient and cost-effective and continuing to perform it with city employees — solve the problem at hand? (It is highly unlikely that “business as usual” will turn out to be the preferred alternative!)

Yes: The flowcharts of the current process show that there is duplication, delay, or inadequate internal controls. By reorganizing the flow of work and decision-making, it is at least *theoretically* possible to reduce costs and provide more effective service. Section 13 outlines a systematic process for exploring the feasibility of in-house redesign. If necessary



changes prove to be impossible, then the cost-effective option is outsourcing. This is termed **Substitution Privatization** — performing the task roughly as before, but substituting outside workers on contract for public sector employees.

No: Flow charting instead may show that the in-house process is as efficient as possible, and that re-design and reorganization will not suffice to improve service. The function requires greater economies of scale, or an investment in equipment, computers or expertise that the city cannot afford. Or, the function (for example, staffing a clinic) requires work force flexibility that cannot be achieved in-house due to constraints on hiring and firing. In such situations, the city needs access to new ways of doing business, and must look outside for assistance. This is termed **Leveraging Privatization** because it allows a city to leverage outside resources to accomplish tasks that it could not perform in-house, and may allow the city to make major gains in service. Because these varieties of outsourcing usually involve new functions, rather than simple substitution of private for city workers, employee issues are less likely to arise. Leveraging strategies include a variety of contractual arrangements involving deals with outside providers or with other cities or units of government. These approaches are explored in Section 14.

13. Privatization (Substitution)

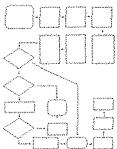
If the answer at choice point H in the flowchart is yes, then redesigning the in-house process appears to be a viable option. The steps described below are used to determine whether the potential alternative is a realistic one.

Identify Any Obstacles to Redesign

The next choice point (I) asks whether there are any obstacles to effective in-house redesign.

No: Either there is no problem with statutory constraints, current work rules, or job titles or shifts in job responsibilities are within management's discretion under any collective bargaining agreement the city may have. Consult with the city's labor relations attorneys, notify the union as appropriate (with the attorney's advice), and proceed with reorganization. The process terminates at the end point labeled M — no need to outsource.

Yes: The process cannot be cost-effectively continued in-house without statutory changes or changes negotiated with one or more unions. For example, suppose that a street work crew of two people could *theoretically* fill potholes, but the union contract requires that two members of the laborers union take care of the potholes while a third person, a member of the operating engineers' union, is present solely to turn the air compressor on and



off. The pothole-filling function can be cost-effectively continued with city workers only if the laborers are permitted to start the compressor as well as use the jackhammer. If this change cannot be negotiated, it may be cost-effective to turn the function over to a private contractor who can do the job with a two-person crew.

For a Unionized City, Work With the Union to Change Constraints

After obstacles have been identified, the city that has employee unions has reached another choice point: Will the union(s) work cooperatively with the city? Consult the city's labor relations attorneys. Explain the proposal for redesign and the work rule obstacles. They will advise which union representatives to contact and will have suggestions about how to conduct discussions. If employees were involved in the initial redesign process, it may be easy to gain support for the elimination of work rules that are demonstrated to be cost-prohibitive. An open decision process helps to show the union that management has done its job in analyzing and confronting problems and is not trying to privatize its way out of its own mistakes.

Yes: Implement legal changes. Jobs will be preserved, yet the city can still save money and deliver services more effectively. Proceed with reorganization. Again, the process terminates at M on the flowchart.

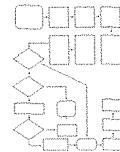
No: Substitution privatization is the only remaining option. When the outsourcing choice is made at this stage, it is clear that management has gone the distance in proposing changes to the city-run operation. Proceed with privatizing.

Identify Statutory Obstacles to Outsourcing

Sometimes, outsourcing requires a change to state law. For example, in California, outsourcing of jail food service is prohibited by state law. In Illinois, public school maintenance outsourcing was possible only after the legislature changed the Illinois Education Labor Relations Act to remove outsourcing as a topic of collective bargaining. At this point, the municipality is ready to outsource (O on the flowchart).

14. Privatization (Leveraging)

When the answer at choice point H in the flowchart is no, then the city has concluded that the in-house redesign will not suffice. In this case, the city must look to leverage outside resources and capabilities. A decision to outsource has been reached (O on the flowchart).



Technology Procurement

Outsourcing is likely to be the answer when information technology is involved. With rapid technological change, the government procurement cycle can lag behind, and the municipality may lack the expertise to match that found in the competitive private sector.

Westchester County, New York, entered into a seven-year, fixed price agreement with a private company to provide information technology infrastructure services. The contract, valued at over \$100 million, includes data center operations, desktop application development and support, and phone installation. The county retains responsibility for strategic planning, capital development, and program control.

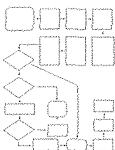
The county government anticipates savings of \$26 million over 10 years, assuming the three one-year extension options are exercised. The county will review performance and prices on a yearly basis and can solicit separate bids on any contract components if desired.

For more information, contact the Westchester County Department of General Services, 914/593-2700. (Source: *civic.com*, March 1997.)

Private Sector Market Power and Expertise

Even though cities purchase some goods in bulk, they are very small consumers of other items. For example, Chicago (a very large buyer for some purposes) had only one application citywide that required optical disk storage — for the ticket images for its parking ticket system. As a one-time purchaser of this technology, the city had no experience in evaluating and selecting such equipment and could well have received little attention from manufacturers. Fortunately, implementation of the parking program has been outsourced to a large systems integrator company which purchased and owned all equipment. The company is a very large purchaser of optical storage equipment world wide and has corresponding market experience and purchasing power. By procuring its equipment via the large contractor, Chicago was able to leverage the contractor's experience and supplier relationships to its own benefit.

The use of such pre-existing supplier relationships not only provides access to quantity pricing, expedited shipping, and priority service, it can also reduce information and search costs. A regular purchaser in the market has already evaluated equipment and suppliers, and knows whom to call for specialized repairs.



The contract to operate the two waste water treatment plants owned by Indianapolis was won by a partnership that included a French-owned firm. Besides saving an estimated 44 percent, the partnership gave the city access to technology and expertise previously beyond its grasp. As the city's Director of Public Works put it, "It's just a different league. [The French] firms have resources our guys only dream of."

Contact: Matthew Lamkin, Office of the Mayor, 317/327-2868. (Source: City of Indianapolis, *The Indianapolis Experience*, p. 8.)

Economies of Scale

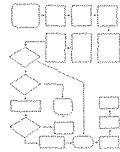
Economies of scale may be particularly important for cities too small either to have sufficient expertise on staff or command market power in purchasing.

The City of Mustang, Oklahoma (pop. 11,000), outsourced its entire public works department to a Houston-based firm that specializes in water and wastewater treatment. Services include maintenance of the water and wastewater plant, water distribution and wastewater collection systems, meter reading, garbage collection, animal control, and street, park, and grounds maintenance. According to the city manager, outsourcing saves \$200,000 per year and allows city staff to concentrate on long-range issues. One city employee acts as liaison between city and contractor.

For more information, contact the City of Mustang at 405/376-4521. (Source: *American City & County*, September 1993)

Workforce Flexibility

Outsourcing can give the city the flexibility to hire particular skills if and when needed. This flexibility is most obvious for seasonal workers (such as parks or snow removal employees) but is equally important for highly skilled positions. A water department may need civil engineering expertise one year and environmental engineering expertise the next. If there are too few year-round needs and duties for a given position, it may not be economical to keep that position on the payroll all the time. However, stripping the city of particular technical skills that it will need is not a good idea either.



The "when" of hiring is another aspect of flexibility. Public sector hiring can be slow. A contractor can move quickly when it is necessary to bring on additional staff. Public sector procedures for firing individuals or downsizing departments when skills are no longer needed also can be slow. A contractor can be hired for a set contract term, or be terminated earlier (per the contract terms) if the need disappears.

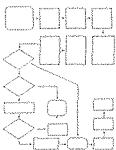
Reciprocal Outsourcing

Instead of outsourcing to a private vendor, cities within a region may outsource to one another, with, for example, one city handling snow removal for both and the other handling garbage collection or sewer billing. Joint purchasing or other interlocal agreements are not uncommon among cities in a region, allowing economies of scale. The 1994 *Municipal Yearbook* reports that provision of service delivery by "another government or authority" is increasing, with the largest gains from 1982 to 1992 occurring in child welfare programs, mental health programs, and public health programs, with other noticeable increases occurring in cultural and arts programs.¹²

15. Hybrid Arrangements

Pure substitution privatization (performing the same tasks but with contract workers) and pure leveraging (obtaining by contract new services that the city could not itself supply) are really two ends of a continuum. In between are a variety of business arrangements. Depending on the relative skills of city personnel and available contractors, cities might outsource different sets of services. For example, a department that lacks management capability might outsource the management of departmental employees.

Management of the Downingtown, Pennsylvania, Regional Water Pollution Control Center was contracted out to a national firm. Municipal employees initially feared a decrease in pay or benefits, or even job loss. Those fears were not realized. The company also increased training and safety programs for the workers, and the operation won the Eastern Pennsylvania Water Pollution Control Safety Award. (Source: *American City & County*, September 1993)



16. Procurement Strategy

Whether the municipality has reached the decision to outsource (O on the flowchart) via the substitution or the leveraging branch of the flowchart, it is important to focus on procurement. This section provides a discussion of procurement strategy. Elected officials will want to be familiar with the strategy and the process in order to make necessary policy decisions related to the process.

The practical process of contracting with a private or nonprofit provider or negotiating a deal with other municipalities is similar, whatever the variety of outsourcing. Information about conducting requests for bids or qualifications and requests for proposals is in the appendix to this guide. This section concentrates on the various steps in preparing procurement documents and monitoring contracts.

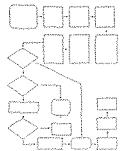
With the flowcharts and requirements analyses prepared earlier (C and D on the flowchart), it is a short step (working with the city's legal and purchasing departments) to turn these materials into a request for bids, qualifications, or proposals. The purchasing department should be able to evaluate the merits of the possible contractual arrangements — for example, lease agreement vs. management contract, or performance standards-based contract vs. contract for specified services.

Budget for the costs of monitoring. Add monitoring costs to the direct costs of each vendor's bid to determine the total cost to the city of that bid. Add the transaction costs of the procurement process to identify the total cost to the city of privatization. Decide how decision-making authority and risks should be allocated between vendor and city. In drafting the procurement documents, maintain a focus on the goals and problems listed early in the process (C on the flowchart): what exactly is the user department trying to accomplish? After bidding, vendors' responses are evaluated in light of the requirements analysis and are checked against the list of current problems.

Competition

Competition is vital to successful procurement. To get the best deal for the city, the process must be designed to avoid impropriety and the appearance of impropriety as well as to maximize the number of competitive and independent bidders.

It should go without saying that accurate information about anticipated requirements should be equally available to all potential contractors. In one instance, a city issued a procurement for 10,000 forms. Certain vendors were made aware that the real need was for 100,000 forms, and priced the 10,000 assuming that their costs could ultimately be spread over the larger volume. Vendors whose per item price was based on 10,000 bid a higher price, and consequently lost the bid.



Should Some Capability Remain In-House?

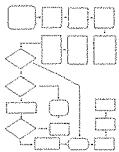
Again, the key to keeping a vendor in a market-conscious mode is competition. If there are many other competitors ready and willing to take over the contract, the fear of losing the business will keep the vendor's bid competitive, and there is no need to retain in-house operational capability. If the city is small or there are few private vendors, it may make sense to keep a department in-house to provide competition and to be able to take over performance in the event of a contract default. This is especially significant if expertise is important and if start up costs are high; the city would have a hard time starting from scratch if it suddenly had to resume responsibility. The city would be vulnerable if the contractor knows that the city has no alternative and must settle for substandard performance. The city must always maintain the expertise to be able to monitor the contract and conduct a new procurement whenever the contract term expires, or sooner, if necessary.

Michael Perry, a Chicago labor official, noted that "contracting out can lead to the slow dismantling of departments, which in turn leads to an over-reliance on contractors. With this dependence comes a loss of knowledge and ability to monitor the contractor, prepare for emergencies and insure against the contractor's failure to provide service."¹³

When there are insufficient contractors to maintain a competitive environment, one strategy that can ensure independence from contractors is to maintain at least partial responsibility for service delivery in city government. In Indianapolis, managed competition used to accept both public and private bids for the city's trash collection. The city was divided into eleven service districts for collection and the Department of Public Works was guaranteed to remain in control of at least one district to ensure that the capacity to handle collection in the event of problems was maintained. The other ten districts were then opened to competition from private collectors and the Department of Public Works.

Contract Length

In order to attract bidders, the length of an outsourcing contract has to be commercially reasonable. If the contract will require the vendor to make investments in training, vehicles, or equipment that are not readily used elsewhere in the vendor's business, the contract price has to cover all these expenses. A multi-year contract allows these costs to be spread over several years. Each yearly payment will include components representing ongoing operating expenses and amortization of initial investment. Up to the useful life of the equipment, a longer contract should mean a lower yearly cost to the city. If the city insists on a short term contract, the vendor's price will have to recoup the investment within that term. If the city replaces contractors frequently or rebids every year, the total cost to the city will be much higher than with a long term contract. Sometimes applicable law pro-



hibits multi-year contracts. As outsourcing is more often employed at both the state and local level, such provisions may be re-examined.

In cities where money cannot be obligated more than a year in advance, a longer term relationship depends on the vendor's faith that the city will renew year after year.

Depending on local political circumstances, a vendor may be satisfied with a five-year contract explicitly contingent upon reauthorization and funding for each year.

A contract which is longer than commercially needed in order to amortize costs raises red flags of another sort. For example, a 10-year contract to provide food concessions at a public park has no discernible economic rationale. Unless extensive facility construction is necessary, start-up costs are minimal. The public interest is not served by foreclosing the possibility of a change in vendor.

Please refer to the appendix for procurement procedure guidelines on RFPs, RFQs, and Bids.

Procurement Approach

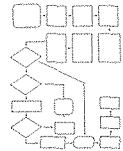
Different procurement approaches are typically used for different types of outsourcing.

Specifications-oriented

With this approach, precise specifications are drafted and put out to bid. An advantage of this strategy is that the city *can* specify precisely what is required. The disadvantage is that the city *must* specify precisely what is to be supplied and must have on staff the expertise to write those specs and inspect the work. This is a particularly common approach for public works type contracting where some *tangible object* (roadway, building) is to be procured. For a construction job, monitoring takes place during construction and involves acceptance before delivery and final payment. If the city does not have sufficient expertise to draft or monitor such contracts, it may be effective to engage an engineering firm to act as the city's agent (i.e., outsource this management function) and then have the agent firm conduct the procurement (outsourcing the construction component). Of course, the city must exercise general supervision over its agent to assure a fair procurement process.

Bidding is typically used when specifications can be drafted. Some state procurement rules require selection of the lowest bid or the lowest *responsible* bid. This refers to a bidder that can demonstrate financial stability and a track record of performance.

Tailoring specifications to only a single vendor is a clear signal that favoritism is at work, undercutting the procurement process. Elected officials must be watchful to ensure that



purchasing and user departments understand the importance of this point and specify only what truly must be specified.

Those who draft specifications must take departmental operations into consideration and apply a comprehensive vision to the procurement process. Such understanding of operations will ensure efficient procurement, even of such items as replacement bulbs for street lights. Even though a particular brand of bulb is cheapest on a procurement date, the process of procurement needs to ensure that the brand is compatible with all or most existing light fixtures. If several different types of bulbs have been purchased at different times, there are hidden costs in terms of slower customer service and increased warehousing and inventory record-keeping. Different items may also be handled differently at the time of disposal or recycling.

Remember:

- **Specifications must reflect the full life-cycle of the item as actually used.**
- **Lowest cost must be determined in light of these full life cycle operating costs.**

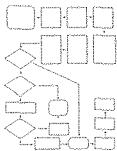
Results-oriented

This type of contracting is most useful for procuring *services*. The city does not need much operational expertise in-house but must only be able to describe clearly the result that is desired. An RFP or RFQ process is often employed (see the appendix). Monitoring goes on for the life of the contract. A competitive procurement process is not always required for service contracts, especially for professional services. Elected officials must take particular care to ensure that the contracting opportunity is equally available to all qualified proposers. By political contributions or other means, vendors may attempt to achieve an advantage in the absence of a competitive procurement requirement.

17. Contract Drafting and Negotiation

Local elected officials are rarely involved in actually drafting contracts or negotiating terms. Nevertheless, an understanding of the process ensures that local officials can ask the right questions and set appropriate expectations for the city's procedures.

Local officials will understand that a department that is experienced in operating a service is not necessarily equipped to draft a contract. The law and purchasing departments have expertise that can be tapped for developing a contract. By the same token, the legal and purchasing departments need to understand the operational requirements of the user department. By involving all three sources of expertise, the contractual arrangement cho-



sen will meet operational needs, expand the range of potential bidders, and minimize costs of contract monitoring. Many jurisdictions have purchasing acts and ethics ordinances that govern contracting, and the legal and purchasing departments will be familiar with these provisions.

Refer Back to List of Concerns

Earlier in the process explained in this guide, the user department itemized the problems and frustrations of the prior way of delivering the service (B). If these are the things that really matter to city staff and/or constituents, the contract must be drafted to cover these items explicitly.

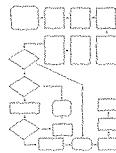
The Contractual Relationship

It is a fundamental principle of contract law that performance under a contract is governed by the terms of that contract. The vendor is obligated to meet the performance standards of the contract but is not obliged to go beyond — and the city should not expect it. The city, therefore, has to be very definite about specifying what it requires from the contractor.

Keeping this need in mind is important when embarking upon an outsourcing relationship. When a function is conducted in-house and extra effort is suddenly needed, it is often possible to get city employees to pitch in, skip lunch, or work late — perhaps in exchange for compensatory time later or overtime, perhaps not. Sometimes pizza or donuts will suffice to say thank you for the extra effort. Or long-time city employees will have a good general understanding of managers' and citizens' expectations and may be able to carry out vague directives.

Such a casual relationship cannot be expected with a contractor. The contract spells out the vendor's responsibilities and the price to be paid. The city cannot unilaterally change the terms of the contract to impose additional responsibilities and probably cannot make additional payments to the vendor without a formal contract amendment. Of course, a vendor who is eager to maintain the city's goodwill may help out in a pinch, but the city should not expect this on a regular basis. It is the city's responsibility to articulate in the contract what it needs.

This makes it critical for the city to understand its own operation and requirements before negotiating the contract. A school bus maintenance outsourcing contract in Fairfax County, Virginia, failed, in part, because of a lack of clarity — on the part of both vendor and county — about the state of repair of the buses at the time the contract began.



Not every future requirement can be anticipated and the contract should incorporate a plan for dealing with the unanticipated. For example, a contract that involves computer programming and software development (e.g., for managing parking ticket or tax payment collections) might include (and pay for) a certain number of hours of programmer or systems engineer time, to be used as the city requests.

A question often raised is whether there are some functions that cannot be contracted out because of the difficulty of specifying requirements and performance standards. This is a frequent question in human services areas (education, drug treatment, etc.). This does indeed pose problems not only for outsourcing but also for in-house management, if the function is performed by city employees.

Public Contracting Law

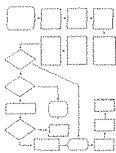
This is not the place for an extended discussion of procurement law, but city officials contemplating any variety of outsourcing understand that there are state and city laws that govern public contracting. Examples include rules governing: the dollar amount above which purchases must go out to bid, when telephone price quotes are permissible, low bidder requirements, newspaper of record for bid advertisements, procedures for authorizing change orders, and requirements for local vendor or minority or women-owned business participation. Other laws may limit the services that can be outsourced or make special provisions for the outsourcing of unionized jobs.

Contractors Respond to Whatever is Measured

As a general rule, people pay attention to whatever is counted. By specifying what will be counted (time to answer citizen inquiries, number of documents scanned/hour, time to plow the streets), the contract also serves as a device for signaling the city's wishes to the vendor. If the vendor's speed is measured, but accuracy of performance is not, it should be no surprise when the vendor sacrifices accuracy to improve speed. Where tradeoffs are likely (as between speed and accuracy), it is important for the city to determine the balance it wants and make that choice explicit in the contract. A poorly drafted contract can send the wrong signals.

Spell Out Consequences and Liquidated Damages

The contract should specify not only what the vendor must do but also what will happen when the contractor fails to meet contractual obligations. The city must be prepared to monitor and measure performance and act to enforce the contract.



Redesign: What if a City Department Wins the Bid or Otherwise Streamlines its Operation?

After working through the decision process, the city may decide to keep a particular service in-house. This might come about as a result of the redesign process described in flowchart step D. Or the department may have responded to an advertised procurement bid and have won — even allowing for adjustments for the costs of technical assistance to the employees, imputed rent, and foregone tax revenue.

In either case, the service remains in-house. If the decision to keep the service in-house was contingent on city employees' implementing change, local officials will want to make sure that projected efficiencies are indeed obtained and promised performance standards are met.

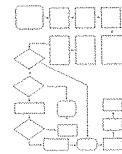
As a means of making contingencies and expectations explicit, some cities have made use of a "memorandum of understanding" between the chief executive's or mayor's office and the department continuing the service in question. The memorandum specifies the performance standards and cost savings to be achieved, as well as the obligations or level of support to be provided by other city departments. This device is useful for spelling out the monitoring plan and the circumstances under which elected officials would revisit the outsourcing decision.

Some cities do not use a formal memorandum of understanding but expect the affected department to meet the levels of performance and costs expressed in their bid or in their streamlined operation plan. Of course, even in the absence of a memorandum of understanding or other agreement, officials will want to make sure that the department functions efficiently and effectively.

In some cities, the terms of a collective bargaining agreement may have been modified (perhaps with concessions on work rules) in order to achieve the efficiencies that make it cost-effective to keep a function in-house (see steps J, K, and L of the flowchart). In this case, there is a formal contract — the collective bargaining agreement — affecting the redesign process. It should include procedures for measuring and monitoring performance. If agreed upon standards and service levels are met, then the city would be bound to keep the service in-house for the term specified in the contract.

18. Contract Monitoring and Enforcement

Although most contract and monitoring activities are performed by city staff, it is important for elected officials to have an overview of the monitoring and enforcement function, to be able to ensure appropriate safeguards for the city.



Plan and Budget for Expertise on Staff to Monitor

The needed expertise depends on what has to be monitored. Monitoring contract payment terms is a city responsibility. Some monitoring may be done by other parties. Over most functions, the public entity retains responsibility, even when services are contracted out. On technical issues such as environmental regulations, the city will want to proceed carefully.

Example:

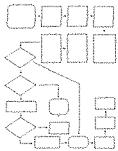
For wastewater quality, municipalities are responsible for meeting state and local monitoring and reporting requirements. Under private contract operations, in some instances, a private operator may offer to assume all regulatory risk of meeting federal and state permit conditions but may not actually become a permittee. In other instances, private operators may request that the public owner assume a portion of this risk, especially if the system is served by combined storm and sanitary sewers, or if the public sector retains responsibility for the industrial pretreatment program. Under these conditions, a private operator cannot control the quality or quantity of influent and is justifiably reluctant to assume all risk for meeting final effluent quality requirements. Depending on local circumstances, contracting for an environmental facility will not necessarily relieve a public owner of regulatory responsibilities.

Source: Association of Metropolitan Sewerage Agencies (AMSA).

Monitor Performance Continuously

The vendor's performance has to be tracked by the city, not just occasionally, but regularly. If the vendor sees that the city is serious, the vendor will be serious. If the city does not track performance and provide feedback to the vendor, the vendor will conclude that the service is apparently good enough, and will relax. (No home owner would expect top notch performance from a cleaning or yard maintenance service if the owner failed to notice or discuss service deficiencies with the vendor.) Close monitoring also ensures that small problems do not snowball into big ones.

Monitoring and auditing would have prevented the following problem from occurring: A large city hired a contractor to handle immediate towing of vehicles from bus stops and fire hydrants. In 1996, the vendor had to reimburse the city nearly \$970,000 for overpayments dating to 1991.



Formalize Rules for Interaction with Contractor

A long-term contract entails an ongoing relationship between the vendor and the contract managers. There are ethical minefields of two sorts here. The first is the traditional ethical problem of the quid pro quo. It is, therefore, important to formalize the rules up front for the conduct of this relationship. Policies and rationale should be explained and described — with examples — in a written document that is distributed to all municipal employees involved. This guidance is a responsibility of the elected official and his or her top staff. Front line employees should not have to extrapolate from the municipal ethics ordinance, or intuit what conduct is appropriate or where to draw the line.

For example, the policy might state that the vendor may not pay for meals or supply tickets to sporting events; employees can neither solicit nor accept such benefits. Unfortunately, this needs saying. Too many contractual relationships — and the credibility of the city's privatization — have foundered on the golf course.

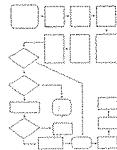
The second danger arises from the human element of the working relationship. While trust and civility are important, there is a risk of a gradual yet insidious relaxation of the independence and objectivity needed for monitoring and enforcing the contract.

The object should be to establish an open, above-board, businesslike relationship that does not leave employees, the vendor, or the general public with questions about the parties' motivations.

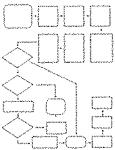
Contract Auditing

The primary responsibility for daily contract management should lie with someone in the user department who understands the operation. This continuous contract management should, however, be backed up by periodic (at least yearly) formal audits. The audit should track compliance with all contractual provisions and performance standards, and account for all funds expended and/or revenues collected.

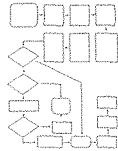
This audit should be done by someone outside the department charged with day-to-day management of the contract. There are two reasons for this recommendation: expertise and independence. Particularly where money is involved, an outside auditor (whether from a city budget department or an outside accounting firm) will have greater financial expertise than an operating department normally possesses. It also may be necessary to track records across city departments — for example, through a treasurer's or comptroller's department.



There is another independence issue to be considered as well. Even with the best will in the world, the very closeness of the ongoing relationship between contract manager and vendor — particularly when the contract manager was also involved in selecting the vendor—sometimes makes it hard to be independent. The manager wants to see the program succeed, sees the day-to-day problems that arise, and may not be quite as insistent upon contract enforcement as an outsider who looks only at the contract and at performance. Of course, there may be reasons for excusing poor performance, but good management means that those decisions are made explicitly.



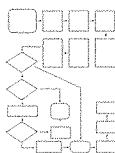
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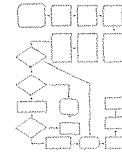
Conclusions

The guide has presented a decision-tree approach for deciding whether government should be responsible for a function and whether it must actually perform that function. It then has presented a framework that the city can use to analyze the current process and all its associated costs, and evaluate and cost out all the alternatives for re-design of functions or various types of "privatization." With an explicit framework for deciding which factors and costs to consider, and for involving constituent and employee groups, the process will be credible, and the end result — whatever it happens to be — will also be credible.

This type of management strategy is useful for assessing any city department or function — whether or not privatization is a possibility. By continually monitoring and improving operations, the city can be sure that it is always making the best possible use of resources and operating in the best interests of constituents. This framework can help maintain prudent and ethical decision making that guides effective and efficient government services and ensures responsible transactions with the private sector.



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Appendix

Procurement Procedure: RFP-RFQ-Bid

The choice among the three main types of procurement — bid, request for proposals (RFP), and request for qualifications (RFQ) — depends on the type of project. In all cases, the document should clearly specify the city's terms and requirements, and the criteria for selecting a winner.

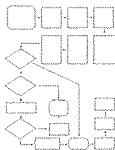
Bid

This type of procurement is used most often for commodities; the item to be purchased can be precisely described. The only variability is in price and delivery terms, and item quality can be objectively determined. Vendors must submit sealed bids, and it is typical for the lowest (responsible) bidder to be selected. A “responsible” bidder is one with the financial and organizational stability to be able to fulfill the terms of the contract and any warranty provisions. In some states, procurement laws require that the bids be opened in the presence of witnesses (to prevent any changing of the price bid).

The bid period is usually fairly short — perhaps allowing only a few weeks for advertising the bid and obtaining responses. In some jurisdictions, telephone bids are used for expedited procurement of low dollar items. Bidding is less often used for procuring services; there may be several different ways of producing the desired result. Quality and reliability can often be assessed only by consulting references.

Overly optimistic reliance on the formalities of compliance can sometimes result in poor contracting. In one municipality, a department head was praised for his careful compliance with the “rule of three” bids. Unfortunately, most of the documentation was fraudulent. Officials had been satisfied by the paperwork, without reviewing the underlying procedures.

Cities often complain about the restrictions of the “lowest responsible bidder” approach and the difficulties of obtaining satisfactory quality. The real problem may be imprecise specification drafting. If the bid documents simply ask for “copier paper” and require a choice based on price, the low bid may very well be an unsatisfactorily low grade of paper that jams the photocopier. Thus, the user department, with assistance from the purchas-



ing department, needs to specify requirements (for example, paper weight, finish, brightness, and moisture content) for the bid specifications. Both user and purchasing departments need to ensure that the specs are performance-based.

RFP (Request for proposals)

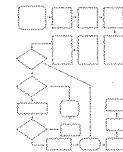
This mechanism is useful when the city has a clear picture of what it wants to achieve, and is looking to private sector expertise to devise a way of providing the service. The procurement documents describe the desired end result and invite vendors to submit proposals for providing it.

In contrast to the bid specs approach, the city can use the RFP approach to obtain ideas and alternative approaches from the private sector. The big advantage to the use of the private sector is the possibility of obtaining expertise, new approaches, and economies of scale that the city cannot supply. By minimally restricting the vendor's choice of methods, the city has the greatest chance of obtaining the best that the private sector can offer. Too detailed a specification of methods risks describing the solution to be proposed by a particular vendor.

In 1993, a city issued a very detailed RFP for a new parking ticket system, and the contract was tentatively awarded to a major national company. An investigation by a newspaper revealed that company employees had worked with parking violations bureau employees to draft the RFP—which described a company-specific-type solution.

The length of time proposers have depends on the scope of the procurement, but six weeks is usually adequate for a large procurement, assuming the city has clearly described what it wants. It is customary to hold a bidders' or proposers' conference two to three weeks into the procurement. This allows potential vendors to ask questions and clarify scope.

Given the variability in solutions that the RFP process is designed to attract and the importance of references and a track record for selecting a long term service provider, it is very risky to try to select on a "low bidder" basis. Unless state law requires this, it is better to specify "cost will be an important consideration," when describing selection criteria. This permits some subjectivity in evaluating proposals. It reminds vendor and city alike that it is important to conserve city resources, yet recognizes the reality that sometimes it is worth



paying more for certain services. For ethical and practical reasons, the rationale for selection should be articulated and defensible.

For similar reasons of flexibility in judgment, it is usually desirable (unless required by statute) to avoid a “point system” for evaluating proposals. This locks the city into evaluating proposals according to some predetermined categories and weighting. This assumes that the city knows in advance the weight to be assigned to different functions. A point system tends to be biased in favor of conventional solutions that describe a process similar to what the city is already doing in-house. Yet, the point of using the RFP rather than the bid approach is to obtain vendor ideas and expertise. A city using a point system may be dismayed to find that it has boxed itself into rejecting a creative and otherwise advantageous proposal. (Points for using a particular type of microfilm retrieval may eliminate imaging technology solutions.) Point systems also invite litigation: vendors can argue that the points were incorrectly awarded on some dimension.

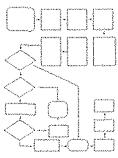
RFQ (Request for qualifications)

This approach is designed for the situation in which the city has only a rough idea of what it wants and needs vendor assistance in defining the problem as well as responding to it. The RFQ describes the problem in general terms and invites vendors to submit their qualifications for tackling the job. The city will then select two or three vendors (finalists) and negotiate with them or work with them to define the problem and the possible solutions.¹⁴ This approach was used by Chicago in procuring a new 911 system, a multi-million dollar undertaking.

This strategy is also responsive to the reality that no large company is going to put its resources into defining the problem as well as proposing a solution when it has only one chance — out of a large number of potential vendors — of being chosen. If it has been selected as one of a handful of qualified proposers, the odds on selection make participation worth while. In some RFQ procurements, qualified vendors are paid a fee for working with the city to define the problem and refine scope and requirements.

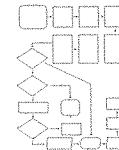
The RFQ strategy also reduces the number of proposals and the number of companies that the city has to evaluate (one of the transaction costs of outsourcing). For a large procurement, the proposal may encompass several volumes. Evaluating vendor expertise and references for a complex high tech procurement may be very time-consuming.

The RFQ process is often overused and can be a mechanism for restricting competition, rather than encouraging it. Except for very complex situations, the RFP process is preferable. As long as the city can describe with reasonable certainty what it wants, it should



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release the RFP and let the market respond. This open process allows any vendor who wishes to respond — without the city (which, after all, lacks expertise in this area) deciding in advance who is qualified. It is the vendor's risk to decide whether or not to bear the costs of responding, and it is usually not difficult to eliminate unresponsive proposals.



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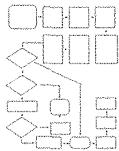
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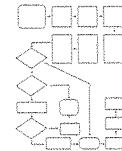
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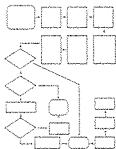
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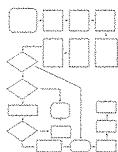


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MUNICIPAL SERVICE DELIVERY

About The National League of Cities

The National League of Cities was established in 1924 by and for reform-minded state municipal leagues. It now represents forty-nine leagues and more than 1,400 cities directly, and through the membership of the state municipal leagues, some 17,000 cities indirectly.

NLC serves as an advocate for its members in Washington in the legislative, administrative, and judicial processes that affect them; develops and pursues a national municipal policy that meets the present and future needs of our nation's cities and the people who live in them; offers training, technical assistance, and information to municipal officials to help them improve the quality of local government in our urban nation; and undertakes research and analysis on topics and issues of importance to the nation's cities and towns.

About the Center for the Study of Ethics in the Professions

The Center for the Study of Ethics in the Professions(CSEP) was established in 1976 to promote research and teaching on practical ethical problems. The first interdisciplinary center for ethics to focus on professions, CSEP continues to play a leading role among the nation's centers for practical and professional ethics. In both teaching and research, CSEP has collaborated with other institutions — universities, business organizations, professional associations, and agencies of local government. The Center is a unit in Armour College of the Illinois Institute of Technology and is located on the Main Campus at 10 W. 31st Street, Room 102, Stuart Building, Chicago, Illinois, 60616-3793.



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