

THE LIMITS TO CONTRACTING: WHEN TO MAKE INSTEAD OF BUY

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In our recent work we have identified network management as an essential tool of the effective public manager (Cohen and Eimicke, 2002). Learning when and how to buy goods and services to help achieve your organization's mission is a key to success in an increasing competitive public market place. Without contracting, you will hire too many people, use those people inefficiently, spend too much and not be able to produce the highest quality goods and services. Contract poorly or inappropriately and you will spend too much, not be able to produce the highest quality goods and services and possibly fuel corruption.

Contracting is a complicated process. Managers must learn how to write contract requirements and elicit bids that obtain important services and products at the best possible price and quality. They must learn to work with, manage and measure the performance of these outside private and nonprofit organizations. This two-way sharing of information is essential to decision making in a networked organizational environment. Managers must also learn how to participate in teams that include both public and private sector partners.

This paper begins by acknowledging these realities, but then explores the critical strategic managerial issue of when to do it yourself. Under what conditions is the task best performed directly by your own organization? When should you

develop the capacity in-house instead of purchasing it from another organization?

The most striking recent example of this issue took place in the early days of the war in Iraq. This war involves an extraordinarily large number of private contractors in the war zone, probably more than at any time in recorded history. Yet, at certain times during the war, private vendors refused to deliver services that might place their employees directly in harm's way. More problematic has been the presence of contractors in combat situations. There have also been allegations of systematic overcharging for products such as gasoline and abuse of prisoners by employees of these contractors.

One of the reasons for the high level of contracting by the Defense Department (DOD) was a desire to keep the number of U.S. government troops as low as possible. Contracting allowed DOD to provide services privately, instead of using military personnel in some traditional support functions. The military deployment could then appear to be smaller than it was; an image that was sought for political benefit.

There are, of course, many other examples of contracted efforts that do not succeed and are replaced by development of in-house capacity. This paper will review a number of cases of failed contracting with the aim of developing a deeper understanding of the factors that cause such failure. Our objective is not

to argue against contracting, but to enhance our understanding of the factors that limit it.

We strongly believe that contracting is a tool that managers must learn how to use effectively and is an important method for improving organizational performance. As Peter Drucker (1999) notes, a substantial and growing minority of the people who do the work of most organizations work for an outsourcing contractor. The most scarce commodities in organizational life are the time and brainpower of the organization's management. It is important for top management to take great care in allocating that time and choosing areas of focus.

What are the political, strategic, organizational, financial, cultural and other factors that make it difficult to contract out a function? Are there any patterns to contract failure that can be identified and known in advance? Our goal is to give managers faced with "make or buy" decisions a more sophisticated tool for making this key strategic decision.

The Make or Buy Decision and the Development of Distinctive Competence

In a private organization the make or buy decision is mainly a matter of organizational strategy: What type of organization do we want to be? Chester Barnard (1958) wrote that the development and maintenance of distinctive competence was the core definitional decision that management must make in

any organization. This involves addressing the question: What do we do around here? But also: How should we do what we do around here? What skills and competencies should we develop in-house, and what should we rely on vendors to produce?

An example of this is the decision of our university to mercifully get out of the business of cooking food. Management decided that we were about achieving world class performance in the classroom and the research laboratory, but in the kitchen, we needed help. Private outside vendors were brought in, and food service improved almost immediately. In making this decision, the university is deciding not to allocate scarce management time to managing food operations. It is making a decision about the areas of distinctive competencies they choose to develop and those they choose to purchase in the market place.

Making or buying is not the only way an organization makes decisions on distinctive competence. AT&T recently announced they were getting out of the business of selling phone service to individuals (AT&T, 2004). This is not an issue related to contracting, but a strategic decision on who are our customers. By no longer selling to individuals, AT &T is making a conscious decision to eliminate this capacity from their organization.

This paper focuses on the relationship of the make or buy decision to the development of distinctive competence. Organizations can also make broad

strategic decisions to develop new capacities due to emerging trends and opportunities. These issues are important in defining organizations, but outside the scope of this essay.

The decision to not contract, to make rather than buy, is, at its heart, a decision to retain and emphasize an area of distinctive competence. An organization must ask itself the question: What work is so central to who we are and what we do that we must maintain the ability to do it ourselves?

One issue in contracting is to retain enough expertise in the functional area to properly manage the work that is contracted out. In this sense, the organization maintains enough competence to manage, if not perform, the function. This introduces the notion that we may not be talking about an “on-off” switch, but a continuum. The competence needed to manage a contractor may or may not differ from what is needed to directly manage the work. Municipalities around the world have attempted to accomplish this by contracting out certain services by district, but keeping at least one district directly served by public employees, such as solid waste disposal in Bogota, Colombia and Phoenix, Arizona (Osborne and Plastrik, 1997; Eimicke, Cohen & Perez-Salazar, 2000). Or, as Steel and Long (1998) concluded from their study of road maintenance and construction by Oregon counties, “it is important for counties to maintain an independent capacity to provide maintenance, improvement, and construction of roads to insure both least cost and quality service” (p. 250).

The decision to contract a piece of work rather than perform it in-house affects the organization and also the capacity it retains. So, in deciding to contract, it is essential to project its impact on the organization. One reason an organization develops distinctive competence is to compete for and obtain resources. An organization gains market share in the private sector or missions and turf in the public sector because they do something better than anyone else and can convince customers or elected officials to “purchase” the outputs of their organization. A danger with over-contracting is that an organization can lose its capacity to deliver outputs by becoming too reliant on the work of other organizations. These other organizations can develop quasi-monopolies and raise their prices and/or lower their quality and reliability. They can also become competitors. Over time they may be able to obtain their own resources without relying on the funds provided by your organization, or offering to take over the policy making and coordination functions that you perform.

Therefore, the issue of contracting must be viewed in the light of the issue of organizational capacity. It may very well be that an organization seeks to get out of the direct business of delivering service and simply wants to set policy and manage contracts. In the 1980's, nearly all the homeless shelters in New York City were run directly by government. In 2004, the reverse was true-- most of the homeless population lived in shelters run by non-profit city contractors. The direct management of these facilities is no longer a core function of the city's

government. The nonprofit contractors deal with the problems related to day-to-day shelter operations while the city agency addresses overall policy issues.

Why did the City choose to get out of the direct service business? As in many other circumstances where government opts for non-profit service providers, the decision is often “guided by both ideological and utilitarian considerations” (Schmid, 2003, p. 308). The advocates and media generally view non-profits as mission-driven and thereby more likely to do a better job of delivering social services than civil servants. The contracting mechanism can also enable the public manager to “bypass bureaucratic constraints that would apply if they delivered the service directly”. (Sharkansky, 1989; Kramer, 1994; Schmid, 2003, p. 308) In fact, many observers view the trend to contract with non-profits as a means to increase accountability by using public funds more efficiently and moving services and decision-making closer to the consumer, and through the use of community-based organizations. (Bingman, 1997; Else, et. al., 1992; Hanly, 1995; Ryan 1999) Overall, the City’s shift in emphasis in assisting the homeless did not impair service delivery, and the changed capacity of the city agency was seen by practitioners as a positive development.

In sum, contracting out services changes the nature of the organization’s own work, and it may have a positive or a negative impact (or a little of both). Before deciding to contract, an organization must determine if it is willing to accept this

change in capacity. **A negative impact on a capacity that the organization wished to retain and develop is the first reason not to contract.**

Contracting and Accountability

The fact that the New York City Department of Homeless Services does not directly run its own shelters may make it more difficult for them to control what goes on in the shelters, but it does not shield them from responsibility for actions that take place there. Making a service available through the private market place is not the same as providing a government service. Government administrators must be authorized by law before they can act. An elected legislature and executive must provide authority and resources before a government agency can perform a task. Those that authorize this work are responsible to the electorate for its effective performance. Those that perform this work are responsible to the elected officials who authorize it.

The chain of accountability stretches from authorization to actualization. The “chain of command” typically will include people in many different locations. The degree of administrative discretion can vary widely as can the very definition of the work being performed. When government uses a nongovernmental contractor to perform a task, the chain of accountability may be broken. On the other hand, if accountability is the degree to which a worker can be held responsible for the performance of a task, the issue of accountability may not be so clear-cut. If a government worker is a life-time permanent employee of the

government, it may be difficult to punish them for failure or reward them for success. A contractor on the other hand could be subject to both termination and bonus clauses.

Therefore, the issue of accountability in many functional and program areas may be ambiguous. Still, sometimes the issue may be quite clear, and there very well may be program or functional areas where the issues of accountability are so profound that the work truly must be performed by government officials in a direct and meaningful chain of command. Issues of intelligence, national security and law enforcement are prime areas that require further exploration.

Issues of chain of command and accountability are less important when we are trying to find out why a park bench was not painted than when we are trying to find out who allowed a terrorist into the country. Speed and a clear chain of command may be a matter of life and death. The ethical and moral authority to place an employee in harm's way is another example of a management function that does not belong in the private sector. While some tasks may involve risk, such as working in a location where weather or other conditions may pose danger, this is different from a war situation in which a worker might be shot at. In all cases of private work, workers can and must be given the opportunity to remove themselves from risk. In the case of work that is performed by government, such as fire and police protection, or military service, the situation is

reversed; those on these front lines can be punished for desertion or dereliction of duty if they refuse to face danger.

A more complicated situation arises when government contracts with non-profit organizations to provide critical human services such as home health care and foster care for children. Here, government officials are challenged to “hold non-profits accountable without micromanaging them” (Buchanan and Snyder, 2001, p.13). As a general rule, **a reduced ability to ensure accountability, in an area where accountability is critical, is a second reason not to contract.**

Contractors Without Capacity

When an organization finds itself without the capacity to perform a task, it often makes the assumption that this capacity exists elsewhere and can be purchased. In the case of some military equipment contracts, the agency knows that capacity does not exist and pays a contractor to develop this capacity. For example, to develop new weapons systems, the capacity purchased is the Research and Development infrastructure needed to build that new system. The military has decided that private firms are better suited to develop and maintain that capacity. The government then attempts, with a history of mixed success, to prevent the contractor from selling the capacity to foreign governments.

We are not arguing that one should not contract with the goal of developing new capacity. The way that the military explicitly contracts to develop new weapons systems may very well be the best option available to develop such cutting edge technology. Our concern is when the contract is let out of desperation in the hope that the contractor can fix something the government has failed at. Or even worse, when the agency thinks the contractor knows how to do something and the capacity has not even been developed. The classic case of this type of contracting was the New York City Parking Violations Bureau under then Mayor Ed Koch. The City let a contract for a hand-held computer device that would permit parking enforcement agents to write and print tickets on the spot, as well as download such records to a mainframe computer. The “prototype” that was delivered to the City was a plastic box with nothing inside. As a result of the scandal that followed, the Queens Borough President killed himself, and a number of other people went to jail.

A less dramatic, but more significant example of this phenomenon has been the contracting of the management of a public school system. In some cases, this is a positive affirmation of a desire to improve quality. In other cases, the elected leaders of a jurisdiction have given up the direct management of this critical function in the hope that a private firm could do a better job. The resources to do the job may not be available, and or the community itself is in such a state of disarray that educators are asked to perform tasks that should be performed by families, religious institutions or other parts of the community. Contracting under

these circumstances may create unrealistic expectations and may simply not work.

The decision to buy a capacity or product that has yet to be produced is inherently risky. The capacity may never develop, or might develop in an unexpected fashion. The organization that develops the new capacity might then have a monopoly and may decide to charge an exorbitant price for the service or product. The strategic issue for the organization relates to the options available to the organization. What alternatives does the organization have to access the capacity it requires? How critical is development of this new capacity? Is there any way to develop this capacity in-house?

If the organization must contract to develop new capacity it should also develop a contract instrument that allows it to own what it has paid to develop. It should also ensure that an effective method is developed to assess contractor performance. Otherwise, they could end up with the portable computer bought by New York City's Parking Violations Bureau—the empty plastic case.

The next section of this paper provides examples of four failed or poorly functioning contract situations. These are intended to provide more in-depth detail of situations where contracting probably should be avoided. We will look at: (1.) Contracting in the Iraq war; (2.) Contracting the operations of prisons in

Florida, (3.) Contracting school management in Philadelphia and; (4.) Contracting waste disposal in New York City.

Contracts That Haven't Worked Well

Case 1: Contracting for the War in Iraq

Background:

The modern American military has a set of huge contracts to provide private sector support services for all manner of operational logistics. Food services, communications, transportation, supplies and even “security” are provided under contract to private firms. The size and scope of these contracts were indicated in testimony before Congress in June 2004, by William Reed, Director of the Defense Contract Audit Agency. As Reed (2004) reported at that time: “DCAA currently is responsible for providing Iraq-related contract audit services to both DoD and other Government organizations at 56 contractors holding more than 80 prime contracts with contract ceiling amounts of \$34.6 billion and funding to date under those contracts of about \$12.4 billion.” The largest of those contracts was issued to Halliburton subsidiary Kellogg Brown & Root (KBR). Reed (2004) noted that: “KBR has been awarded Iraq Reconstruction contracts with ceilings totaling more than \$18 billion under two major programs: Logistics Civil Augmentation Program (LOGCAP III) for \$10 billion; and Restore Iraqi Oil (RIO) for \$8.2 billion.” The scope of this work was so large that the Defense Department had established an extensive audit organization, exclusively for Iraq. As Reed testified:

To carry out the extensive and time-sensitive audit requirements, DCAA has implemented new planning and coordination procedures to effectively integrate audit work between the new Iraq Branch Office, opened in May 2003, and more than 50 DCAA CONUS Audit Offices with cognizance of companies performing contracts in Iraq. The Iraq Branch Office itself now has 22 auditors, and will increase to 28 auditors by the end of June.

During the first 8 months of FY 2004, DCAA has issued 285 audit reports related to Iraq reconstruction contracts (ibid.).

Most of the contracted functions identified in these audits were standard and fairly prosaic support services, but some were not. Reed (2004) testified about the activities of one contractor, CACI, and observed that:

DCAA is expanding its audit coverage at CACI based on recent disclosure of additional contracts awarded to the Company. Since August of 2003, the Army has awarded 11 task orders under a GSA Supply Contract for Information Technology services for interrogation and intelligence gathering effort in Iraq. At least three of those tasks related to interrogation of Iraqi prisoners. Billed costs as of March 2004 under these task orders is \$12.7 million, with a total funded contract value in excess of \$60 million. DCAA is reviewing the potential misuse by CACI of the GSA schedule contract on this Department of Interior contract that is funded by the Army, since "interrogator" type effort is not a function provided by CACI in their GSA schedule (ibid.).

The abuses of prisoners in the Abu Grhaib prison by contractor personnel was one of the issues that alerted the media to the unprecedented contracted effort underway in Iraq.

Peter Singer of the Brookings Institution has written the definitive work on this new method of performing military tasks in his book, Corporate Warriors:

The Rise of the Privatized Military Industry. In it, Singer details the firms and services provided by this industry, and he discusses the management and political implications of outsourcing. More recently, Singer (2004b) focused his attention on the specific issue of contracting in Iraq. In "Warriors for Hire in Iraq," he discusses the use of this new form of military contractor in Iraq:

Known as "private military firms" (PMFs), they range from small companies that provide teams of commandos for hire to large corporations that run military supply chains. This new military industry encompasses hundreds of companies, thousands of employees, and billions of revenue dollars. In Iraq, they're also accounting for a growing share of the force and the casualties. There are 15,000 private personnel carrying out mission-critical military roles, and they have suffered at least 30 to 50 killed in action...The Bush administration was unwilling to enlist serious assistance from the United Nations or from most of our NATO allies, but thanks to the PMFs that employ private soldiers of more than 30 nationalities, it has been able to assemble an international coalition of sorts in Iraq. But it is more a "coalition of the billing" than of the "willing." Indeed, there are more private military contractors on the ground in Iraq than troops from any one ally, including Britain. One single company, Global Risks, has a reported 1,100 employees in Iraq, including 500 Nepalese Gurkha troops and 500 Fijian soldiers, ranking it sixth among troop donors (Singer 2004b).

Singer discusses the increased use of contractors in combat but also notes that elected officials, and even senior Pentagon officials, are either ignorant of the nature of the contractor role or in "denial" about it.

To summarize, we see two types of contracting related to the war in Iraq. The first is the traditional military support and logistics that seems to be part of the “head-count”- driven trend of contracting throughout the federal government. The amount of this contracted support is quite high, but not without precedent. The second type of contracting - and what is new, or at least newly discovered-is the use of contractors in combat roles. While a certain amount of contracting is clearly needed in any military situation, the extent of contracting and the use of contractors in combat, strike us as examples of practices that should be avoided.

Analysis:

The type of decision made to contract logistics and even military actions was a highly constrained make-or-buy decision. Political factors made it necessary to present the smallest possible military force for public consumption. This is not a new phenomenon to government, although it did come later to the military than to the civilian agencies. After the expansion of the federal government in the 1960’s to fight the War on Poverty and the war in Vietnam, government staff growth was halted. At the same time government contract funding continued to expand along with the nation’s population and federal budget. Elected officials felt that if the number of full time employees did not grow, than government did not grow.

Paul Light has written the definitive work on this phenomenon in *The True Size of Government*, and Cohen experienced this directly in two of his experiences in the federal government in the 1980s. In the Superfund program, as a relatively junior GS-13, he had access to hundreds of thousands of contractor dollars and what

was essentially a staff about 6 or 7 people in a D.C.-based consulting firm. Later, as a consultant to the Department of Energy's nuclear waste program, he was part of a 150 person contractor team that reported to a Department of Energy office of fewer than ten people.

The work done by these contractors could have easily been done by government employees, but the political pressure to keep the headcount down made it necessary to use contractors. This seems to be the case here as well. In Vietnam, there were approximately four to five support troops for every soldier on the front engaged in combat. Of the 500,000 soldiers in Vietnam at the war's peak, no more than 150,000 were engaged in combat. That indicates that the scale of the U.S. commitment in Iraq is similar to the level of commitment in Vietnam. This is a comparison that the Bush Administration did not want to invite, and with an official force deployment (or head count) of about 150,000, they could avoid such comparisons.

The issues raised by contracting practices in Iraq included issues related to billing, contractor oversight by the military, and what the GAO termed issuing task orders for work that was "outside the contracts' scope of work" (Walker 2004). U.S. Comptroller General David Walker's 2004 congressional testimony dealt directly with the issue of maintaining sufficient distinctive competence to manage contractor work. He observed that:

Effective oversight of the diverse functions performed under the [Iraq] contracts requires government personnel with knowledge and expertise in

these specific areas. DCMA [Defense Contract Management Agency] contract administrators are contracting professionals, but many have limited knowledge of field operations.

These contracting officials rely on the military field units to provide them with the knowledge of operations needed to manage contractors. However, this expertise was frequently lacking in Iraq, and contractors had very little real oversight.

The use of contractors in combat raises a variety of issues related to democratic accountability. First, if their conduct does not adhere to military rules and priorities, they are not subject to military discipline. The need for strict adherence to orders from a chain of command is obviously more important for military and police officials who are authorized to remove a person from freedom, or even life. In a democratic system, the need for such strict accountability is profound and an absolute necessity if the values of liberty, free speech and self determination are to be preserved while security is maintained.

In the case of dining services and transportation, the issue is one of placing civilians in harm's way—a duty that perhaps should be reserved for military personnel who have been recruited or drafted to take those risks, and trained to minimize risk. While an argument can be made for contracting support services, the argument grows weaker in combat situations, and weaker still when the contractor is expected to bear arms and participate in combat. While this is a relatively new issue in need of further research and analysis, Peter Singer, the

scholar who has focused the most attention on this issue, concludes his analysis of military contracting in Iraq by stating:

We should also take a step back and examine the overall trend, rather than continue to breathlessly outsource. Just because we can turn something over to the private market does not always mean we should. Two basic questions must always be asked before handing over any public function, most particularly to private military firms: Is the function being privatized in symmetry with national security and the public interest? If so, how will this privatization save money and promote efficiency (2004b)?

For purposes of this analysis, even ignoring issues of cost and efficiency, the larger issue of accountability leads us to suggest that combat should probably not be contracted out. The issue of maintenance of distinctive competence is also raised, as GAO indicated in its audit of these contracts. Moreover, the loss of military personnel to contractors that pay higher salaries for similar work can also impair organizational capacity in the military.

Case 2: Contracting out the Operation of Prisons in Florida

Background:

Turning over the operation of state and local prisons to private operators is hardly a new phenomenon. Over the past twenty years, prison privatization has become big business, with more than twenty private operators in the United States; however, two such operators—Corrections Corporation of America (CCA) and Wackenhut—control nearly 90% of the market (Kyle, 1998). Privatization of prisons has also been highly controversial. Critics question whether it is appropriate and prudent to turn over the restraint of our fellow citizens to a for-profit corporation.

In addition, the primary argument in favor of privatization—saving tax dollars—has frequently not come true in practice. A 1996 report of the United States General Accounting Office, *Private and Public Prisons: Studies Comparing Operational Costs and/or Quality of Service*, concluded that there was not sufficient evidence to determine that privatization of prisons saved money or improved the quality of service. In Florida, privatization of prisons did not produce the expected savings and has brought charges of corruption and mismanagement as well (St. Petersburg Times, May 2004, p. 14A).

In 1996, two private companies, CCA and the GEO Group of Boca Raton, Florida were awarded contracts to run five state prisons for a total annual cost of \$90 million. Six years later, the state regulatory body charged with oversight of the experiment, the Correctional Privatization Commission, began an evaluation that would indirectly lead to the commission being disbanded and a scandal that led Governor Bush to admit that the state often lacks the capacity to oversee multimillion dollar contracts (James, 2004).

State law requires that the private operation of prisons must save taxpayers at least seven percent annually. The commission's review found that both companies had failed to meet the seven percent standard at two prisons. With the contracts of both companies expiring, the commission decided to put the contracts out for bid.

The commission's executive director hired Michael Moore, who had recently resigned as the Governor's correction secretary, to write the bid documents and oversee the process. Moore, who had no experience in writing bid documents, was awarded the job without a search process, and he subcontracted the work to two former employees still on the state payroll. The involvement of state corrections personnel in the bid process angered vendors as the state bureaucrats had opposed privatization of prisons in the early 1990's (James, 2004).

The State Legislature then complicated the process by funding the construction of 1,086 new beds at the two "failing" prisons at Lake City and South Bay. These two private prisons failed to meet the seven percent savings threshold. Nevertheless, the legislature wanted private operators to manage these prisons. The commission decided to go ahead with the bid process despite the problems with privatization. CCA, operator of the Lake City prison and potential beneficiary of the new construction contract, filed a legal challenge to the commission's bid process, arguing that it violated legislative intent.

During the very public controversy, the commission's executive director acknowledged that he had shared drinks and dinner with lobbyists or representatives from at least three companies interested in bidding on the prison contracts. But he contended business was never discussed and that he never

accepted more than the \$25 limit on gifts to state employees. The Governor's office then stepped in.

The commission extended the contracts of the two companies then under contract until 2006 and included the construction of the new beds in the contract. Several days later, the Governor announced that the commission would be disbanded, and he asked his inspector general to investigate whether state law was violated when his former corrections secretary was hired as a consultant (James, 2004b).

Analysis:

The authority to use force to restrain members of society is perhaps the most important and dangerous of the powers of the state. Turning that power over to private, for-profit corporations should only be done when the state is unable to do so, or when the benefits of privatization are overwhelming and accountability can be assured. None of these conditions exist in the Florida prison situation.

Florida decided to contract out the operation of prisons to save money. Eight years later, the results from a savings perspective are, at best, mixed. Two of the five prisons did not meet the seven percent savings threshold, and there were no negative consequences. Instead, the two contractors received contract extensions and additional work to construct new prison beds.

In this case, the oversight commission sought to open the prison contracts to new bidders after six years. In response to the failures to meet the required 7% savings threshold, an existing contractor took legal action against the oversight commission and the Legislature acted to thwart the process. In the end, the Governor ultimately disbanded the commission. An editorial in the St. Petersburg Times summed it up this way: “The commission created to oversee private contracts is being disbanded after questioning the cost of doing business with two big campaign contributors. Since 1996, CCA has handed out \$70,000 in political campaign contributions and GEO has delivered \$492,600.” (p. 14A)

A reduced ability to ensure accountability, in an area where accountability is critical, is our second reason not to contract. On this basis alone, the state of Florida should consider ending its experiment with private management of state prisons.

Case 3: School District of Philadelphia and the Edison Project

Background:

The City of Philadelphia has a long tradition, dating back to 1818, of quality public schools. However, since the 1970’s, the district has been under siege, plagued by budget deficits, a decaying physical plant, high dropout rates, low test scores, union problems, unhappy parents and political controversy. In 1998, the Superintendent of Schools threatened to shut down the schools, as funding was about to run out (Murray, 2003). The Commonwealth of Pennsylvania responded

with the passage of Act 46, authorizing a state takeover of the local school district.

Governance of the school district had been a controversial subject for decades. In 1965, after years of corruption and political interference, the school board, which was once an elected-body, became an appointed body (Committee of Seventy, 1997, p.2). Although appointed by the Mayor, the members had to be recommended by an independent nominating panel. Appointments were made for six year, staggered terms. So, in practice, mayors had limited influence over policy and appointments. The board was required to submit a lump sum budget to the Mayor and City Council for funding. As a result, the board blamed the Mayor and City Council for not providing sufficient funds, while the elected officials blamed the district for mismanagement of the funds it was given.

Layered on top of these local-level tensions are the partisan conflicts between the generally republican state government of Pennsylvania and the primarily democratic City of Philadelphia. As Pennsylvania's largest and most diverse city, Philadelphia is often viewed as a drain on state resources. Act 46 was one of several measures taken by the state, in recent years, to dilute the city's home rule powers, including the possible takeover of the city's Parking Authority and Convention Center Authority. Relations between the state and the city have even further deteriorated under current Mayor John Street, an independent leader with a combative style.

The story of school reform in Philadelphia would not be complete without taking into account the power of teachers' unions. By 2001, 176 of the 264 city schools were rated as failing, half of the students were dropping out, and yet, teachers were opposing reform through litigation and political action (Murray, pp. 10-11).

In 1997, despite strong opposition from the teachers' unions, the state of Pennsylvania authorized unlimited numbers of charter schools, subject to local school approval. According to studies by the Pennsylvania Department of Education and Western Michigan University, charter schools are improving test scores and serving more at-risk students and minority students than traditional public schools (Miron & Nelson, 2000).

It was in this context that, in December 2001, Pennsylvania Education Secretary Charles Zogby signed the Declaration of Distress for the school district of Philadelphia. As a result, the operation of the district was turned over to an independent School Reform Commission chaired by James Nevels, an appointee of the Governor. Philadelphia Mayor Street supported the Governor's action, given the high dropout rates and low test scores of most of the City's schools. For his support, Street received two of the five appointments to the Commission and \$75 million in additional state aid for the City's schools.

The Commission immediately set to the task of determining which schools would be turned over to private companies and negotiating contracts with those companies. In May 2002, four months after its formation, the Commission voted to privatize up to 75 schools, turning over the operation to a wide range of private organizations - organizations including the University of Pennsylvania, Temple University, Chancellor-Beacon schools and Edison Schools. The Commission also hired Paul Vallas, former head of the Chicago schools with a national reputation for effective leadership, as its CEO.

Despite the rapid pace of reforms, the media was reporting that the Governor and state legislative leaders were upset that the reforms were proceeding too slowly and that they were considering the addition of new members to the Board to help accelerate the process (Mensah, 2002). The Governor was also upset that the commission did not hire Edison Schools to manage all the troubled schools and to serve as consultant to the central administration (Ibid.).

Why did the Governor want Edison? That is unclear, although it may be simply that Edison is the dominant player in the privatization of schools, twice the size of its main competitor, Chancellor Beacon, and is a for-profit, publicly traded company and a reputation for doing more than improving test scores. Edison schools include foreign language, art, music, drama, and character building courses, as well as run a longer school day than the average public school. Each

year, the number of schools under their management grows (PBS Frontline, 2003).

So, have things gotten any better since the privatization began? To comply with the federal *No Child Left Behind* legislation, Pennsylvania adopted an accountability system for all schools beginning with the 2002-2003 school year. The goal of both the federal and state systems is to ensure that all children test proficiently in reading and math by 2014.

Progress has been uneven to date. In August 2003, the Pennsylvania Department of Education reported that half of the Philadelphia schools were not making enough progress toward federal goals for student achievement. The Philadelphia Schools' Chief responded that there was, to the contrary, substantial progress, which was demonstrated by the improvement in overall performance for the system, a reduction in the number of schools falling under the most troubled category, and general progress made by troubled schools. (Mezzacopa, Langland & Patrick, 2003).

While convinced that the system was making progress, CEO Vallas substantially scaled back the role of private operators in the system. For the 2003-2004 school year, only 32 of the 264 schools in the city were run by private contractors - a far cry from Governor Schweiker's vision of 100 schools managed by private companies (CNN.com/Education, 2003). Vallas fired the Chancellor of the

Beacon Academies, after only eight months in this role, for failure to perform and he has been a frequent critic of Edison.

Vallas has reduced the planned workload for Edison, reduced their fees and has downplayed their role in reforming the system. Additionally, Vallas has reinforced the role of universities in helping run the system, and he has enlisted the involvement of local hospitals, a local museum, a health insurance company and Microsoft. Commission member Sandra Dungee-Glenn summed up the current approach as a mixed management model: "Ultimately it is going to come down to having a qualified teacher in every classroom, no matter who is running the school" (Ibid.).

From the beginning of its presence in Philadelphia, Edison has accepted compromises in its model, agreeing to honor existing collective bargaining agreements covering the hiring and firing of teachers, and revising the structure of the "standard" workday (PBS Frontline, 2003).

Still, as a result of the strong role of the state in the Philadelphia schools, Edison receives nearly \$900 more per pupil than do city operated schools. Vallas has tried to cut the subsidy and has even threatened to fire Edison. However, after the saber-rattling, he has agreed to keep Edison through at least 2006 (although he has the authority to terminate them at any time).

For the 2003-2004 school year, Edison's 20 Philadelphia schools achieved 10-point gains in reading and math scores, substantially exceeding the statewide averages of 5 points in reading and 6 points in math, but holding steady with citywide averages: Philadelphia schools averaged 10-point gains in both reading and math. It is important to note, however, that Edison was assigned to manage 20 of the City's most challenged schools. Vallas is quoted extensively in the Edison press release on the achievement, noting past controversies but also saying, "Our partners at Edison have been a critical part of our success" (Edison Schools, 2004).

Analysis:

The debate over the wisdom of privatizing elementary and secondary education has been raging for two decades, and the controversy is not likely to end soon. Decades of failing public schools, particularly in urban areas, has led many parents, politicians, school administrators and even some teachers to embrace private operation as the best hope for improved school performance. Many believe that the profit motive and the force of competition will enable private managers to make tough decisions about teacher quality, student behavior, overhead cost containment and the decentralization of decision-making - decisions that their public counterparts are either unable or unwilling to make.

Opponents argue that the already under-funded public schools will ultimately become worse than the current situation because profit will now come first and

those profits will come from funds that could otherwise be spent educating children. They also worry that savings will come from creaming, where the private operators choose only the best students and refuse to take the high cost special needs children. And critics see fewer jobs at lower pay under private management; in essence, the profits will come at the expense of the already underpaid teachers and support staff. Finally, the critics raise concern over what will happen to children in the event that private operators suddenly become unwilling or unable to continue running a school, or worse, a large number of schools.

As for Philadelphia, the results to date are mixed. Reading and math scores have improved under private operation, although rather slowly and modestly. And, performance of publicly-run schools has also improved.

In Philadelphia, as noted earlier, because of state subsidies, Edison actually costs \$900 more per pupil than the city-run schools. It is therefore impossible to argue that the private operation has produced measurably better services at a cheaper cost. But even more worrisome would be the loss of the city's capacity to reclaim management of its schools, if it wanted or needed to. The collapse of a public school system due to failed privatization efforts has already happened.

In August, 2004, the California Charter Academy, operator of 60 schools with approximately 6,000 students across California, collapsed. A number of the

systems affected by the collapse are simply not open for the fall of 2004, leaving parents to try to find alternative schools with space remaining. (Dillon, 2004)

A negative impact on the capacity that the organization wishes to retain and develop is the first reason not to contract. Moreover, school privatization may very well be a case of entering into a contract where the capacity to perform needed tasks has not been developed. Public systems have difficulty managing the complex tasks required of inner city schools, and as we see in Philadelphia, private organizations also lack the capacity to do this work. Handing the task over to a private firm does not guarantee the work will get done. It may very well be that inner-city education should not be contracted until we learn more about how to deliver this service. In our view, this is a case of contracting in advance of demonstrated capacity. Neither public nor private school systems have demonstrated the organizational capacity needed to build and manage excellent inner-city schools. While there are individual examples of such schools, we have not developed a deep understanding of how to replicate these schools.

Moreover, public education is also a government service where issues of accountability may come to dominate. When a parent sends a child to a school, they trust that school system to educate and assure the safety of their child. Elected officials who delegate that trust to a private firm had better be certain that the private firm is capable and that the contract mechanism enables the elected official to maintain the authority and communication needed to assure the well

being of the children in the community. Clearly, this make-or-buy decision should be approached with great caution.

Case 4: Contracting Disposal of New York City's Waste

Background:

New York City's 8 million residents and millions of businesses, construction projects and non-resident employees generate as much as 36,200 tons of solid waste per day. The City's Department of Sanitation (DOS) collects nearly 13,000 tons per day of waste generated by residents, public agencies and non-profit corporations; private carting companies handle the remainder (DOS, 2001A&B). During the twentieth century, the DOS relied on a number of publicly owned landfills for garbage disposal. Then, in December 2001, the City's last municipal garbage dump, Fresh Kills Landfill in Staten Island, closed. In response, the City Council adopted a twenty-year plan for the exportation of DOS-managed waste as the exclusive method for waste disposal. The City has shifted from owning their own waste treatment and disposal facilities to contracting with private firms for this service.

New York City has a long and difficult history in solid waste management. In 1894, four years before the incorporation of the City of Greater New York, Streets Cleaning Commissioner Colonel George Waring stopped the dumping of the city's garbage into the ocean. Instead, he implemented a radical new program that included recycling and composting. Soon, however, a new administration

took office, and ocean dumping resumed. A federal lawsuit, brought by a coalition of New Jersey coastal cities, forced New York City to end ocean dumping in 1935 (McCrary, 1998). With plans for new incinerators slowed, first by the Great Depression, and then by World War II, the City found itself struggling to meet its waste disposal needs. In 1947, the Fresh Kills Landfill opened. Initially, the Staten Island dump was said to be a “clean fill,” and the City’s new mayor promised that “raw” garbage would only be landfilled at Fresh Kills for the following three years - the time it would take to build a large incinerator in every borough. However, by the 1960s, one-third of the City’s trash was burned in over 17,000 apartment building incinerators and 22 municipal incinerators. The remaining residential refuse continued to be sent to Fresh Kills, as well as the city’s other landfills (Miller, 2000).

As environmental awareness grew, public pressure began to mount against incineration and landfilling. Old landfills and incinerators were gradually shut down, with the last municipal incinerator closed in 1992. By the late 1990s, Fresh Kills remained as the sole waste disposal option for the residential and public waste managed by the DOS.

In May of 1996, Mayor Giuliani and Governor Pataki announced that Fresh Kills would receive its last ton of garbage no later than January 1, 2002. With the exception of the remains of the World Trade Center, that landfill has been closed since the last day of 2001. In an effort to determine how the City should go about

disposing nearly 13,000 tons of daily waste previously sent to the site, a Fresh Kills Closure Task Force was established. The principal goal of the task force was to develop a short-term plan for diverting the waste from Fresh Kills up to its full closure in 2001. The next goal was to develop a longer-term solution.

In order to divert the waste prior to closure, the City entered into a number of three-year interim contracts with private haulers. The City's annual bill for collecting and disposing residential trash jumped by nearly 50 percent to about \$658 million in 2000, and to nearly \$1 billion in 2001. While NYC was paying under \$50 per ton for disposal at Fresh Kills, some of the interim contracts cost more than \$100 per ton when increased transportation costs are taken into account (Earth Institute, 2001).

In addition to the interim plan, the City developed a long-term plan to manage its waste. Under the long-term plan, approved by both the New York City Council and the New York State Department of Environmental Conservation, the City entered into six 20-year contracts with private waste companies. The contracts featured fixed cost increases and, according to Department of Sanitation, no minimum tonnage requirements. Although the plan was ostensibly long-term, it remains vulnerable to cost escalation and increased regulation from host states, and it doesn't include careful planning for waste transfer processes within the City. As of 2004, waste from garbage collection trucks was regularly dumped

onto the floor of waste transfer stations, where it would wait to be loaded onto large trucks for shipment out of New York City.

In the summer of 2002, the City began to take some steps to develop elements of a true long-term, sustainable plan for managing waste. While the overall strategy of waste export was still being pursued, Mayor Michael Bloomberg announced a plan to develop garbage transfer stations to compact refuse and ship it by barge for disposal. These stations would be placed in waterfront locations in each borough of New York City, thus replacing a system of land-based waste transfer that uses thousands of diesel-fueled trucks daily to haul garbage through city streets to disposal sites in other states. In late 2003, the projected expense of building these transfer stations grew, putting the plan on hold.

Analysis:

The waste export system currently in place in 2004 will leave the City vulnerable over the long run, as both restrictions on waste disposal and costs are likely to escalate. As landfill space continues to diminish in the Eastern United States, and as political pressure from communities opposed to waste importation builds, it is possible that Congress and the courts will allow states to impose restrictions on the interstate flow of municipal waste. Bills that would authorize local governments, state governments, and governors to restrict or prohibit the receipt

of out-of-state municipal solid waste are regularly brought before Congress. And although the passage of these bills is far from certain, the possibility of such a bill being passed over the next twenty years is large enough to warrant concern. Similarly, stricter regulations on new landfills by federal and state Environmental Protection Agencies could increase the cost of new landfills and limit future landfill capacity. Finally, landfill operators will certainly raise prices over time, and state and municipal governments will likely enact taxes on waste disposal.

Aside from the issue of price, there is also the issue of control. The proper daily disposal of the City's waste is critical for the City's public health and well-being. One week of uncollected garbage would lead the City to become a breeding ground for vermin and disease - making the City's functioning difficult if not impossible. As compared to the issues introduced in the first section of this paper, the key issue at present is not one of contractor capacity or the need for the Sanitation Department to maintain the distinctive competence to dispose waste, but rather the extreme need for accountability for an essential city service.

The City needs to control its own waste facilities. In contrast to its waste system, one finds New York City in complete control of its system of water supply. Since the construction of the Croton Reservoir in 1842, New York City has been a world leader in long-term planning of its environmental infrastructure. Today's construction of the City's third water tunnel, at a cost of over \$6 billion, continues that tradition. New York's public water system provides drinking water that is

considered among the best in the world. The City owns the reservoirs, the aqueducts, the pipes, the pumps and thousands of acres of land in the recharge zones of two watersheds.

In the case of waste, the City owns the means of transporting garbage - collection trucks, barges and waste transfer stations - but no facilities or places to place to put the garbage. New York City's is vulnerable to a biological meltdown if waste disposal services are halted. In part, this has to do with the City's high level of population density- particularly in the sections of the city that do not have many single family homes. Other cities produce less total waste and have development patterns that permit longer periods of on-site waste storage. While most of New York City's land sits beneath single family homes, most of New York City's people live in apartments, and its millions of office workers work in multi-story towers. New York City's unique (for the U.S.) vulnerability makes waste disposal a poor candidate for contracting. Waste management requires a high level of attention and accountability, as the risk of failure would have a profound and immediate impact. This creates a need for a high level of immediate accountability and while contracting for waste disposal is not impossible- in fact it is being pursued currently - it is a risky way to proceed.

CONCLUSION

We begin by reminding the reader that we consider contracting to be an essential tool of contemporary public management. We are not "against" contracting. We

think in many cases it is a good way to deliver public services. It is, however, a tool—a means and not an end. Just because we have a hammer, doesn't mean we need to find a nail. There are situations when contracting should be avoided.

In Iraq, the issue of accountability is the primary reason to avoid using contractors in combat. The use of contractors for battlefield logistics raises issues of public ethics and the maintenance of organizational capacity. The issue of prison privatization also raises issues of accountability and the potential for corruption. Prison services are often invisible to the general public. Prisoner families tend to be disenfranchised, and their input is often unjustly ignored. This provides an environment that is custom-made for abuse and corruption, and we certainly saw evidence of that in Florida. Philadelphia's effort to contract a failing urban school system to a contractor who really does not know how to succeed in this environment represents a third case in which contracting is unadvisable. Contracting in this case is a form of an escape fantasy: We can't manage this [school] and perhaps someone else can do better. Unfortunately, no one really knows how to do this work best, and thus, contracting it out only moves the problem to another venue. The assumption that the contractor – in this case, Edison - had capacity that the government did not was a political, rather than managerial, judgment.

Finally, some functions, such as garbage disposal in New York City, are too vital to outsource. The risk posed by an interruption of service is so great that the

service must be controlled by the government. While elements of the service can be contracted out, the system must have enough redundancy to assure that it will not break down.

Fundamentally, we are arguing that any decision to contract should be based on an analysis of the issues of public management presented by the particular situation at hand. Many times contracting is a good idea, but sometimes it is a very bad idea.

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