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2010 Highlights in State Government Privatization

By Leonard Gilroy

As Virginia's state government and many local governments throughout the Commonwealth look for ways to "reform" their operations, examples of what other governments are doing around the country will be helpful in those efforts.

Reason Foundation's recently released *Annual Privatization Report 2010* provides a comprehensive overview of state privatization activity, and it's clear that states' current fiscal malaise is prompting policymakers of all political stripes to either explore or implement privatization initiatives across a broad swath of services, large and small. Despite the fact that Virginia has historically been one of the more robust states for privatization, even Commonwealth policymakers well-versed in the subject may find inspiration and innovation in what other states are doing today.

Recent highlights in state privatization include:

Illinois Lottery: In September 2010, Illinois Gov. Pat Quinn announced the winning bidder for a first-of-its-kind contract to take over the management of the state lottery. According to state officials, the deal will generate $4.8 billion for the state over the next five years, a $1.1 billion increase over the revenues projected under state management. In fact, that's the most notable aspect of the deal—the private manager is *guaranteeing* increased revenues to the state over and above what officials estimate would be generated under in-house operation.

Under the terms of the 10-year contract, the winning bidder—Northstar Lottery Group, a partnership between vendors GTECH and Scientific Games—will take over responsibility for lottery operations, management and marketing functions in exchange for a portion of revenues. The state will continue to exercise control and oversight over all significant business decisions, including the state approval of annual business plans and ability to access all vendor information regarding lottery operations.

Vendors bid on the guaranteed revenues they would return to the state over the first five years of the contract, with Northstar pledging revenues to the state stepping up from $851 million in 2012 to over $1 billion in 2016. Through a combination of an annual management fee and incentives for enhanced revenues, Northstar could earn over $330 million over five years if it reaches its revenue targets. However, the contract includes a 5% total net income cap on the potential profits for the contractor, and in the event that the contractor fails to generate the required revenues in a given year, they're required to make a revenue shortfall payment to the state. Further, the contractor plans to retain all 170 current state lottery employees and hire an additional 100 workers.

Given the compelling features of this initiative, expect other states to explore similar moves soon. The Chairman of the Governor McDonnell's Commission on Government Reform and Restructuring, Fred Malek, has expressed interest in the idea of privatizing Virginia's lottery. Illinois' experience might be helpful.

Child Welfare Services: The privatization of child welfare services has been an area of quiet, but substantive, evolution at the state level in recent years. Reason colleague Lisa Snell prepared a comprehensive overview of privatization trends in child welfare for the 2010 report, which notes a shift away from simply contracting for a subset of specific services toward performance-based contracts that focus on purchasing for results and outcomes, a key driver of accountability. Further, the trend has also seen the scope of privatization expand from merely providing discrete services to the provision of large-scale services, with over a dozen states transferring some or all case management to the private providers, giving them primary decision-making authority over day-to-day case decisions.

Nebraska and Washington State are the most recent states to embrace privatized, performance-based child welfare case management, but Kansas and Florida are the two states that have privatized all statewide child welfare services (other than investigations), providing valuable case studies. An April 2010 Casey Family Foundation report examined both states' experiences, and it found that Kansas' child protection system has benefitted from privatization through increased data collection and accountability, a renewed focus on permanency and--most importantly--better outcomes, such as a 60% reduction in the number of children in residential placement, a doubling of adoptions and a 30% reduction in the average length of stay in care. Similarly, privatization has brought significant progress in Florida, and while tricky in the early years of transition, the child welfare system has dramatically improved overall since implementation, with significant reductions in foster care populations and the number of children in out-of-home care, among other factors.

Separately, the U.S. Department of Health and Human Services completed a demonstration project in 2010 evaluating three privatized child welfare programs (Florida, Missouri and Illinois) that employed a collaborative approach to planning and implementing performance-based contracts in foster care case management or residential youth services. The project found that performance increased over time in all sites from year one to year two, with Florida improving outcomes by 13.4%, Missouri by 18.1%, and Illinois by 29.1%. Such encouraging outcomes in these states should prompt others to explore how privatization could improve outcomes for children in public child-welfare systems.

Long Beach (CA) Courthouse: California has launched a privately financed courthouse project that may serve as a template for the private delivery of other social infrastructure assets in the U.S. In June 2010, the Administrative Office of Courts of the Judicial Council of California selected a private consortium to finance, design, build, operate and maintain a new, $492 million courthouse to replace an aging facility in Long Beach. Under the 35-year agreement, a concessionaire will finance and develop the project over the first three years and will be responsible for operations and maintenance of the facility over the remaining 32 years. In return, the consortium will recoup its upfront investment through an annual fee paid by the state over the life of the agreement. The state will maintain ownership of the building and land throughout, and the state’s annual payments to the concessionaire will be contingent upon achieving specified performance targets in operations and maintenance. In California alone, state officials estimate a need for over 100 courthouse projects totaling approximately $3 billion, and the Long Beach courthouse will be the first new courthouse built in California in 40 years, according to *Public Works Financing*.

State Parks: I've previously written on the opportunity to tap private sector management for cash-strapped state parks (here and here) in order to take some or all of their costs of the state's books and turn money-losing parks into revenue positive assets for the state. The U.S. Forest Service (USFS) has applied this approach throughout its massive system of recreation areas for over 25 years, and officials estimate that over half of the USFS's recreation sites nationwide are managed under such public-private agreements today.

States, by contrast, still largely rely on in-house parks management, though Arizona has taken some initial, but serious, steps towards exploring private parks management. In December 2010, Arizona State Parks issued a request for information (RFI) to private vendors to “solicit feedback and recommendations regarding the feasibility of transitioning or enhancing various operations at ASP with the private sector.” The RFI was open-ended in terms of scope—offering vendors the opportunity to present creative ideas and concepts for the agency to consider for further procurement—and can serve as a model for other states. The agency is currently evaluating responses from six vendors.

It's only a matter of time before states follow the feds lead on parks management. For USFS, the shift to private management came not from spontaneous innovation, but rather was necessitated by Reagan-era recreation budget cuts. Appropriated funds were not going to be available to keep these recreation areas open, so USFS had to pioneer a new model. With the massive budget cuts many states are facing, it seems obvious that state parks agencies are in the same boat the USFS was over two decades ago.

The beauty of our “laboratories of democracy” in the states is that innovations like those described above can filter up from one state and out to others. With the ongoing fiscal challenges states are facing, the more new ideas on how to creatively partner with the private sector to help drive down costs and streamline government, the better.

Governor McDonnell’s Reform Commission can hopefully find some actions to replicate in Virginia from what is happening around the country as governments strive to re-design their programs to be more relevant in today’s society.

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