

The Pacheco Law: A Roadblock to Competitive Contracting



Massachusetts is the only state in the nation that virtually prohibits contracting out to the private sector any service currently provided by state employees—a practice that has produced millions of dollars in savings in other states.

Over the last nine years, only six state services—most of them very minor—have been opened to competition. There is nothing mysterious about this absence of competitive bidding. Massachusetts is home to the most restrictive state anti-privatization legislation in the nation, the so-called Pacheco law, enacted in 1993.

Background

To contract out any service currently delivered by state employees, a state agency must compare the cost of using a private vendor not to actual current costs but to the cost if employees were to work “in the most cost-efficient manner.” In response to competition from the private sector, public employee unions can make collective bargaining concessions or put together bids that decrease in-house costs. But once the contract has been awarded, there is no mechanism to enforce those concessions.

Prior to the cost comparison, the private cost is “adjusted” in several ways. The proposed vendor must pay employees working on the state contract wages at least equal to the lesser of those paid to comparable state employees or the average private sector wage for the relevant industry. The law also limits compensation for the private vendor’s officers and managers to the wage rates of comparable state managers.

The private contractor must pay at least the same percentage of its employees’ health insurance premiums as the Commonwealth does. The contractor must also provide the state attorney general with quarterly payroll records to prove it is complying with the wage and benefit requirements.

Finally, the state agency seeking to privatize must add lost tax revenues to the cost of the private bid if any part of the work is performed outside Massachusetts. No such addition is made to the public sector bid for the loss of tax revenues that would be realized if the work were to be performed by a private business subject to state taxes.

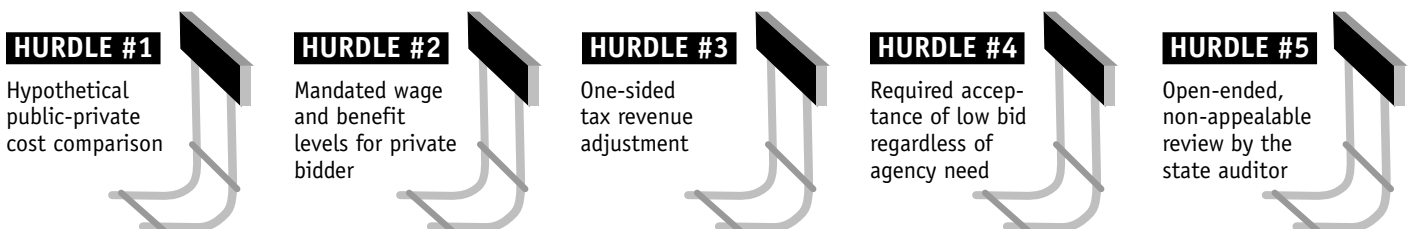
But the process doesn’t end with the cost adjustments. The state auditor can strike down a contract if it fails to satisfy any of five different tests, the most basic being that the adjusted private cost be lower than the hypothetical public cost. The auditor can also reject a contract he determines not to be “in the public interest,” without providing a definition or reason. The auditor acts as both judge and jury, raising concerns and then determining whether they threaten the public interest. His ruling may not be appealed.

Impact of the Pacheco law

Even under the best of circumstances, bidding is expensive and uncertain. Add to that the uncertainty of government-mandated wage rates for both labor and management positions, compulsory levels of employer-paid health insurance, burdensome reporting requirements, and the fact that after jumping over all these hurdles the contract could be short-circuited for almost any reason, and it’s no surprise that there is no competition for the right to deliver public services in Massachusetts.

While public contracting has become increasingly sophisticated in most other states in recent years, the Pacheco law’s low-bid requirement effectively freezes

Hurdles to competitive contracting under the 1993 Pacheco law



Massachusetts in 1993. The federal privatization guideline on which the Pacheco law was loosely based is currently under review, and a presidential panel has recommended switching to a “best value” standard that takes into account cost and quality rather than cost alone.

Data from the Council of State Governments indicate that cost is just one of the reasons that governments seek private vendors to compete for public contracts. Many seek additional flexibility to improve services, accommodate peak demand, or meet deadlines. Others are looking for access to private sector expertise. A growing number are looking to improve risk management through carefully tailored contracts that shift risks from government to the private contractor.

The Pacheco law also severely limits government’s flexibility by focusing on inputs like wages, benefits, and procedures. Forcing contractors to emulate government effectively eliminates many of the benefits they could otherwise provide. Performance-based contracts, under which government pays for specific outcomes and at least a portion of a contractor’s payment is based on achieving those outcomes, would be a better approach.

State auditor’s review

Government accounting systems are rarely able to determine in-house costs, making the cost comparison that is at the heart of the Pacheco law nearly impossible and making the state auditor’s power over privatization decisions virtually absolute. When comparing private and public costs, the auditor only counts expenses that are immediately avoidable as a result of privatization. This policy runs counter to the federal government’s approach and overlooks the fact that most administrative and overhead costs are avoidable over time.

For example, the Department of Revenue proposed to privatize mail opening during tax season. DOR had tradition-

Only six state services have been opened to competition since enactment of the Pacheco law.

ally used auditors and collectors to open the mail, resulting in \$986,000 in foregone revenue during the period they devoted to mail opening. Accordingly, DOR counted that sum as a benefit of privatization. The auditor removed the money from the cost analysis, arguing that since collections were not written off and audits not cancelled, no money was lost.

The auditor has also taken indefensible positions regarding the cost of transition from public to private management. When the MBTA attempted to contract out the operation of some of its bus routes, the contract included a provision that age-related repairs to a maintenance facility would be the T’s responsibility. The auditor counted the cost against the privatization savings, despite the fact that the repairs would need to be done regardless of who operated the buses. During the same review, the auditor objected to the contractor getting tax-free fuel for the buses from the MBTA, even though the T was not paying fuel taxes and the fuel would still be used for a public purpose.

Perhaps the best illustration of shortcomings in the auditor’s privatization review comes from an MBTA attempt to contract out the maintenance of bus shelters. A private contractor agreed to provide cleaning and repair services worth \$1.18 million at no charge and promised the T \$2.1 million for the right to display electronic advertisements on the shelters. The company also offered to build 400 to 600 new shelters, with a guarantee of \$6 million in additional revenue for the authority. Instead of paying public employees, the MBTA would get the services for free and receive a guaranteed minimum of \$8.1 million. The auditor struck down the contract, ruling that the entrepreneurial scope of the proposal created a scenario in which public employees were unable to compete on a “level playing field,” since the union could not attach a revenue source to its bid.

Recommendations

In view of the restrictions of the Pacheco law, a strong case can be made for its outright repeal. Facilitating greater private contracting of government service would reap benefits for Massachusetts taxpayers through the resulting cost-efficiencies. At a minimum, the law should be amended in the following ways:

- ▶ The cost of a private bid should be compared to actual rather than best-case public costs.
- ▶ The strict low-bid requirement should be eliminated.
- ▶ The auditor should use full-cost rather than avoidable cost accounting in his review.
- ▶ A mechanism that allows for appeal of the auditor’s determination should be adopted.

Watch for Pioneer’s *White Paper* “The Pacheco Law: Did We Miss the Boat? Can We Stay Afloat?” to be posted at http://www.pioneerinstitute.org/research/whitepapers/research_white.cfm.