Private Corrections Institute, Inc.

"Providing Information to Help Make Informed Decisions"

Cost-Saving or Cost-Shifting

The Fiscal Impact of Prison Privatization in Arizona

Kevin Pranis

The Private Corrections Institute, a non-profit advocacy group, is proud to publish Kevin Pranis' *Cost-Saving or Cost-Shifting: The Fiscal Impact of Prison Privatization in Arizona* in collaboration with American Friends Service Committee Tucson and the Arizona Leadership Institute.

Mr. Pranis, a criminal justice policy analyst with Justice Strategies, takes an in depth look at past research on Arizona private prison cost studies and reports that research used to justify the expansion of the private prison program is methodologically flawed, outdated and, in one case, discredited by the researcher's financial ties to the private prison industry. Mr. Pranis also reports that critical issues such as the implications of municipal bond financing of private expansion have never been addressed.

PCI hopes that the Arizona legislature, the public and media considers Mr. Pranis' recommendations when making decisions about whether to continue using private prisons as part of Arizona's criminal justice system.

1114 Brandt Drive - Tallahassee, FL 32308

850-656-7311 - www.CorrectionsInstitute.org

About this report

Cost-Saving or Cost-Shifting: The Fiscal Impact of Prison Privatization in Arizona was commissioned by American Friends Service Committee Tucson and the Arizona Leadership Institute. The research that forms the basis of the report was conducted independently by Justice Strategies, a non-profit criminal justice policy group that provides high-quality research to policymakers and advocates in the fields of criminal justice, juvenile justice and immigrant detention. Research methods included interviews with criminal justice professionals, review of relevant literature and media coverage and analysis of prison population data generously provided by the Arizona Department of Corrections (DOC). Justice Strategies did not receive compensation for work on the report from private prison operators, unions that represent corrections officers or any other party with a financial interest in state policy regarding prison privatization.

About the author

Mr. Pranis is a criminal justice policy analyst and campaign strategist. A past Soros Justice Fellow, he has produced educational materials, training manuals, reports and white papers on topics that include corporate accountability, municipal bond finance, political education, prison privatization and sentencing policy. Mr. Pranis' work has been covered in numerous publications, including *The New York Times* and *The Wall Street Journal*. In 2004, Mr. Pranis co-authored *Arizona Prison Crisis*, a major report on sentencing and correctional policy in Arizona released by Families Against Mandatory Minimums.

About the sponsoring organizations

The American Friends Service Committee (www.afsc.org) is an international non-profit social justice organization affiliated with the Quaker faith. Internationally, AFSC conducts relief, reconstruction, and conflict mediation programs in countries all over the world. In the US, the organization is engaged in a wide array of programs addressing violence, poverty, and discrimination. AFSC's Arizona office is located in Tucson. The Criminal Justice Program monitors prison conditions; advocates on behalf of prisoners, former prisoners, and their families; and works toward statewide policy change to reduce our reliance on incarceration as a solution to social problems. In addition to its Criminal Justice Program, the Arizona office engages in immigration/border policy issues and conducts conflict resolution programs.

The Arizona Leadership Institute (ALI) is a non-partisan, non-profit organization dedicated to improving the lives of working Arizonans. Through research, education, and advocacy, ALI works to secure and increase access to economic opportunity for all residents of Arizona

The Private Corrections Institute (PCI) is a non-profit advocacy group that provides information and assistance to citizens, policy makers, and journalists concerning the dangers and pitfalls of correctional privatization (**www.CorrectionsInstitute.org**).

Executive Summary

Arizona's corrections budget has doubled over the last fifteen years, placing a tremendous burden on taxpayers and on the families of state university students. Despite the growth in corrections spending, however, the state prison system remains under funded and dangerously overcrowded.

Arizona's corrections crisis has led many to call for an overhaul of the state's sentencing system, which packs state prisons with non-violent, substance addicted offenders who make up half of all prisoners. Others argue that privatization is the answer to the state's prison woes because private companies can operate prisons at lower cost and finance new prisons the state cannot afford.

Bolstered by reports that Arizona's private prisons have generated cost-savings for the state, supporters of privatization have won legislative approval for thousands of new permanent private beds, including a 1,400-bed DUI prison in Kingman; a 1,000-bed prison for sex offenders expected to be sited in Florence; and a proposal to build a 3,200-bed women's prison that has been withdrawn by the Department of Corrections (DOC). Even without the women's prison, the number of private beds will have nearly tripled between 2003 and 2005.

Unfortunately, our investigation shows that the research used to justify the expansion of the private prison program is methodologically flawed, outdated and, in one case, discredited by the researcher's financial ties to the private prison industry. Further, critical issues such as the implications of municipal bond financing of private expansion have never been addressed. Among our findings:

- **No rigorous, independent evaluation has ever been made of Arizona's private prison program, nor have the cost-comparison figures reported by DOC been independently audited.** Further, existing research fails to account for key factors such as population characteristics, facility design and proper allocation of costs.

- **Prisoners housed in private facilities were far less likely to be convicted of serious or violent offenses, or to have high medical and mental health needs, than prisoners housed in public facilities used to generate cost comparisons.** Public prisoners were seven times as likely to be serving time for violent offenses, three times as likely to be serving time for serious offenses and twice as likely to have high medical needs than those housed in private facilities.

- **Private prison costs appear to have risen rapidly since 2002 due to generous contracts approved by former DOC Director Terry Stewart.** The new rates, which are nine to 35 percent higher than the rates provided in the contracts that were effective in fiscal year 2002, are likely to push private prison costs **above** public costs even before accounting for differences in population characteristics.

- **The use of municipal bonds to finance construction of new private prisons and re-finance existing facilities carries significant risks for both the state and host counties that have assisted with financing.**

In sum, it is impossible using the available evidence whether privatization has delivered cost-savings or merely shifted costs from the private sector onto the public sector. Based on these findings, we recommend that the state of Arizona exercise great caution when considering further privatization until there is reliable evidence to support cost-savings claims.

Introduction

Arizona's rigid sentencing system has made the state the incarceration capital of the western United States, standing head and shoulders above its neighbors in terms of its overall incarceration rate as well as the rates for African Americans, Latinos and women. Yet Arizona's "get-tough" approach has done little to reduce crime: the state leads the nation in its overall crime rate and lags far behind the rest of the country in crime-rate reductions.

Instead, the major impact of Arizona's sentencing laws has been on the corrections budget, which doubled over the last fifteen years. The bulk of prison expansion costs have been borne by taxpayers, and also by middle and lower-income state university students and their families, who end up paying higher tuition to make up for a nearly dollar-for-dollar shift in state spending from higher education to corrections.

As corrections costs continue to grow, it is likely that more and more Arizonans will feel the resulting fiscal pinch. The annual cost of operating 3,400 new prison beds recently opened or in the pipeline could exceed $60 million, yet these beds are expected to cover just a quarter of the 13,584-bed deficit projected for fiscal year 2008. With the prison population growing at a rate of nearly 100 a month the state will need to add over 1,000 beds and increase spending $20 million each year to keep pace.

The rising cost of corrections has prompted calls for sentencing reforms designed to divert some non-violent offenders – who make up over half of the prison population – into drug treatment and other effective alternatives to incarceration. In more than half of states, lawmakers of both parties have enacted similar reforms, which enjoy widespread public support according to national opinion research.

Others say that privatization is the answer to Arizona's prison woes. By increasing the number of prisoners in private beds, some proponents of privatization suggest that the state can contain costs while continuing to grow its prison population – in effect, "have its cake and eat it too." Advocates of this approach base their argument on cost-comparisons between Arizona's public and private prisons that appear to show significant cost-savings as a result of privatization.

Unfortunately, a close analysis of evidence cited by proponents of privatization casts grave doubt on cost-savings claims. We found that research on the success of privatization in Arizona suffers from serious methodological flaws, is badly outdated, and, at least in one case, has been discredit by the investigator's financial ties to companies he purported to evaluate. Further, we found that comparisons between public and private prisons have been skewed by a system that disproportionately assigns serious and violent offenders, as well as prisoners with high needs, to public facilities.

This report does not attempt to determine whether private prisons are more or less costly than public prisons – such a determination would require an extensive, and truly independent, analysis. Instead, we sought to examine factors – assignment policies, allocation of costs, financing and changes in cost over time – that need to be considered as part of any serious comparison of public and private prison costs.

Prison Privatization in a National Context

Prison privatization has been the subject of passionate debate and controversy since its inception in the mid-1980s. The private prison industry grew rapidly in its first decade and a half, propelled by skyrocketing rates of incarceration and the trend toward privatization of government services. At the end of the 1990s, however, the industry fell on hard times as a result of falling crime rates, operational problems and financial mismanagement.

Several leading players in the industry reorganized between 2000 and 2002, bringing in new management in an attempt to improve finances and operations. The industry has experienced a small resurgence of growth as states seek relief from mounting budget deficits and the federal government continues to expand its use of private beds, especially for detained and incarcerated immigrants.

The record of prison privatization over the past twenty years has been mixed. Literature surveys conducted by proponents, such as the pro-privatization Reason Foundation, conclude that privatization has generated a fairly consistent cost-savings record. On the other hand, a literature survey commissioned by the Bureau of Justice Assistance concluded that there was little evidence that meaningful cost-savings had been achieved through privatization.

A similar debate has taken place over the quality of operations at private facilities. Opponents of privatization cite numerous examples of operational difficulties, including riots, escapes and deaths in custody, while those who favor privatization point out that such incidents also occur in public facilities. Publicity surrounding problems at poorly-run private facilities in Ohio (Youngstown), Louisiana (Jena) and New Mexico (Hobbs) hurt the industry's image and contributed to its slump in the late 1990s.

After a couple of relatively quiet years, operational problems have again put private prison companies in the headlines. For example:

- On May 14, 2004, more than 500 Arizona prisoners rioted for four hours at Corrections Corporation of America's (CCA) Diamondback Correctional Facility in Watonga, Oklahoma. Inmates pushed down fences, used shower rods as battering rams and smashed windows with boards and rubble found among construction materials left in a recreation yard, according to a DOC report.

- On July 20, 2004, more than over 500 Washington and Colorado prisoners rioted for over seven hours and set fires at a facility almost burning down portions of the prison in Crowley County, Colorado that is managed by CCA. CCA was fined over $380,000 by the state in recovery costs.

- On August 6, five men detained by the U.S. Marshal Service escaped from a Frio County, Texas detention center operated by Correctional Services Corporation (CSC). As of October, two of the five – who were alleged to have ties to the Mexican Mafia – had not been apprehended.

- On September 20, 2004, more than 100 Vermont inmates rioted at CCA's Lee Adjustment Center in Kentucky.

Prison Privatization in Arizona

Arizona's experience with private prisons has also been mixed. On one hand, the history of the CCA-run Florence Correctional Facility illustrates some of the problems cited by critics of privatization. Violence at the facility – including two deaths, six assaults and a riot within the first year of operation – led to investigations by the state of Arizona and the Hawaii Department of Corrections. Hawaii's investigators reported unacceptable level of violence, prison gang activity and drug dealing.

A report prepared by DOC on Arizona's first state-contracted private prison – a facility in Marana run by Management and Training Corporation (MTC) – concluded that in the first year of operations, "almost literally, everything that could have gone wrong has!" The report found that, in the first ten months of operation, the prison was run by four wardens, two assistant wardens, three business managers and two security chiefs.

Further, the state has repeatedly experienced problems with out-of-state private facilities contracted to house Arizona prisoners on a temporary basis. In addition to the recent riot mentioned above, a CSC facility in Newton, Texas has been a source of serious trouble, including an escape and a riot in which 82 Arizona prisoners were pepper-gassed.

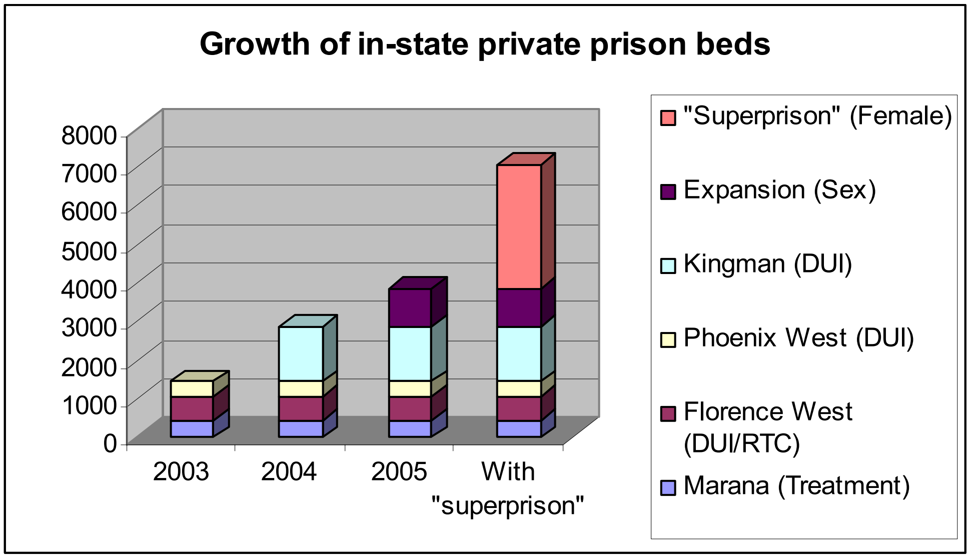
On the other hand, with the exception of the initial evaluation of Marana, DOC officials have reported relatively few problems at Marana and the two CSC-run in-state facilities under contract with DOC – Phoenix West and Florence West. Further, in the past, both DOC and the Auditor General's office have reported significant cost-savings when compared to operations at public minimum-security (Level 2) units.

In recent years, the apparent success of the privatization and mounting population pressures have, together, become the impetus for rapid expansion of Arizona's private prison program. In 2002, the state legislature authorized DOC to contract for construction and operation of a 1,400-bed prison for offenders convicted of Driving Under the Influence (DUI), nearly doubling the number of state-contracted private beds from 1,450 to 2,850. Later that year, legislators authorized DOC to contract for construction and operation of a 3,200-bed facility to accommodate the rapidly growing population of women prisoners, a decision that would have raised the number of private beds to 6,050.

By 2003, some legislators were suggesting that the state should privatize even further in order to alleviate budget and overcrowding crises. Representative Russell Pearce (R – Mesa) proposed that Arizona sell off state-owned prison and assigning all but 6,000 prisoners to the private sector, while Senator Bob Burns (R – Peoria) argued that the state should build a private facility in the Mexico to house Mexican nationals. Former DOC Commissioner Terry Stewart, now a private prison consultant, proposed this idea.

The move toward privatization slowed, but did not stop, when Democratic Governor Janet Napolitano took office in January 2003. Plans for the 3,200-bed private women's prison were shelved in the face of growing doubts about the project's viability, as well as mounting opposition from grassroots activists who called the project a "dangerous experiment." But during an October

2003 legislative special session, legislators authorized DOC to contract for an additional 1,000 in-state private prison beds.[1] Although proponents argued that the state would save money by contracting out, they exempted the new beds from a statutory requirement that private prisons provide cost-savings over public operations.



The addition of 2,400 permanent beds represents a significant expansion in the scope of Arizona's private prison experiment. If the state ever needed to have good data on the cost of operating public and private prisons, now would be the time. Yet closer examination shows that no rigorous, independent evaluation has ever been made of Arizona's private prison program, nor have the cost-comparison figures reported by DOC ever been independently audited. Further, the data used to compare costs are out of date and do not reflect significant changes in private prison per diems that occurred in late 2002.

Fortunately, according to published reports, DOC has engaged a firm to make an independent assessment of the cost-model and cost-comparison figures. DOC has also included in its 2004 re-organization the establishment of an office of contract beds, the equivalent to a third region to ensure that conditions of confinement are uniform across the department, and to rigorously and routinely audit its operations. Until these tasks are accomplished, however, the state will continue to lack adequate data to inform decision-making regarding prison privatization.

What the Research Shows, and What It Doesn't

Proponents of privatization cite three sources of information to bolster their claim that Arizona has achieved cost-savings through prison privatization: Charles Thomas' 1997 study of Marana commissioned by the Department of Corrections; DOC's 2000 Public-Private Comparison Report; and a 2001 audit of the program conducted by the state's Auditor General.

---

[1] The new private beds authorized in the special session were part of an agreement with the Governor that also included construction of 1,000 low-security public beds and issuance of temporary contracts to house 1,400 to 2,100 offenders outside the state.

Charles Thomas (1997)

Charles Thomas, then a University of Florida professor, collected data on the operating cost of private prisons and state-run minimum-security (Level 2) units between July 1, 1995 and June 30, 1996; as well as data pertaining to operational performance at the same facilities between January 1, 1996 and June 30, 1996. Thomas reported that Marana delivered cost savings of between 13.8 and 16.7 percent, and that the facility's performance across a range of indicators was equal or superior to that of state-operated Level 2 prisons. While Thomas rated Marana a success, he cautioned against extrapolating too much from his findings, noting that there was no state-operated prison equivalent to Marana.

Although Thomas' research was cited as evidence of the privatization program's success in DOC's fiscal year 2001 annual report, several experts have questioned his methodology. In a 1999 article published by the University of Minnesota Law School, researcher Steven Belenko observes that Thomas fails to explain significant variance in per diem costs among the public prisons studied, some of which had lower costs than Marana; or to account for the cost of medical care, which was capped at $10,000 per prisoner under MTC's contract with the state. A 2001 national survey of research on prison privatization by criminologists James Austin and Gary Coventry also questioned Thomas' conclusions, noting that no public prison in the state had a comparable facility design or inmate population.

Thomas was himself discredited when it emerged that both he and his Private Corrections Project had financial ties to several of the companies whose performance Thomas purported to evaluate. Not only did Thomas own stock in CCA, Wackenhut Corrections Corporation (now known as GEO Group) and CSC, but he also received a staggering $3 million consulting fee from CCA for his services. Thomas was eventually forced to shut down his research institute at the University of Florida and pay the largest fine levied by the Florida Commission on Ethics for having contractual relationships with private prison companies while serving as a consultant to the state's Correctional Privatization Commission. In its investigation, the Ethics Commission also uncovered evidence that Thomas took a week long, expense-paid trip to Hawaii to attend an MTC board meeting while in the middle of his research on Marana.

DOC (2000)

A September 12, 2000 DOC report, "Public-Private Prison Comparison", also found significant differences in cost between public and private facilities, although the DOC estimate of 12 percent savings is more modest than Thomas'. The report, issued in September 2000, compared the performance of public and state-contracted private prisons during fiscal years 1998 and 1999. Performance was measured in a number of areas, including security, inmate management, programming, administration, personnel practices and health services. The report concluded that private prisons met or exceeded DOC operating standards in most areas.

According the DOC report, average performance scores for public and private prisons were nearly identical, although there were differences in specific areas. For example, private prisons had more than twice as many disciplinary referrals than public prisons, which DOC attributed to the private prisoners' lack of familiarity with the rules of prison life. Security performance also fell sharply at private prisons between 1998 and 1999, from an aggregate score of 91 percent to 72 percent, although the report noted that corrective action had been taken.

While the report, which DOC describes as a "service comparison," contains extensive discussion of operations, little attention was devoted to cost comparison, which takes up just two of the document's 50 pages. In those pages, using a simple comparison of daily per capita cost figures for fiscal years 1998 and 1999, DOC estimated that private prisons produced savings of 12.23 percent when compared to Level 2 state facilities, but also noted that "a detailed cost comparison is not within the scope of this report."

The DOC report made no attempt to determine whether the lower cost of private prisons was due to private management or other factors such as inmate population characteristics and facility design. Nor did the report examine differences in per capita costs among public and private facilities. Finally, the report did not address the question of whether the formula used to allocate costs properly accounted for all costs, such as the cost of medical care, which has been capped under private prison contracts at $10,000.

The report explained that such detailed cost data were not provided because DOC was required by statute to produce a rigorous cost-comparison of public and private prisons every five years, and such an analysis was planned for fiscal year 2002. Unfortunately, the promised comparison did not materialize, and the DOC continued to report the very rough numbers contained in the 2000 report to the public and other agencies, including the Auditor General.

Auditor General (2001)

In 2001, the state Auditor General released an audit of the private prison program in which the office concluded that DOC's approach privatization appeared to be effective, and that the cost of using and monitoring private prisons remained below that of state facilities. The audit contained very helpful information on the management of Arizona's private prison program in comparison to other states and the federal government.

The audit's discussion of cost, however, replicated the weaknesses of the 2000 DOC report, which was cited as a basis for the cost-saving finding along with Thomas' 1997 evaluation of Marana. According to staff at the Auditor General's Office, the office did not conduct an independent analysis of costs at public and private facilities, but instead reported the figures provided by DOC. As a consequence, the figures from the 2000 DOC report were reported to the public as verified facts even though they were originally designed to provide "[s]ome generalizations concerning cost."

As mentioned previously, a comprehensive cost-comparison between Arizona's public and private prisons is also outside the scope of our report, although we are encouraged by reports that DOC has commissioned such a study. Instead, this report seeks to identify key factors and how they might affect the outcome of a truly valid cost-comparison. In doing so, the report will attempt to address the following questions about the apparent differences in cost between public and private prisons:

- Are the differences attributable to prisoner characteristics?
- Are the differences attributable to facility age and design?
- Are differences attributable to misallocation of costs?
- How have public and private prison costs changed over time?

- What other factors should be considered when evaluating the cost-effectiveness of privatization?

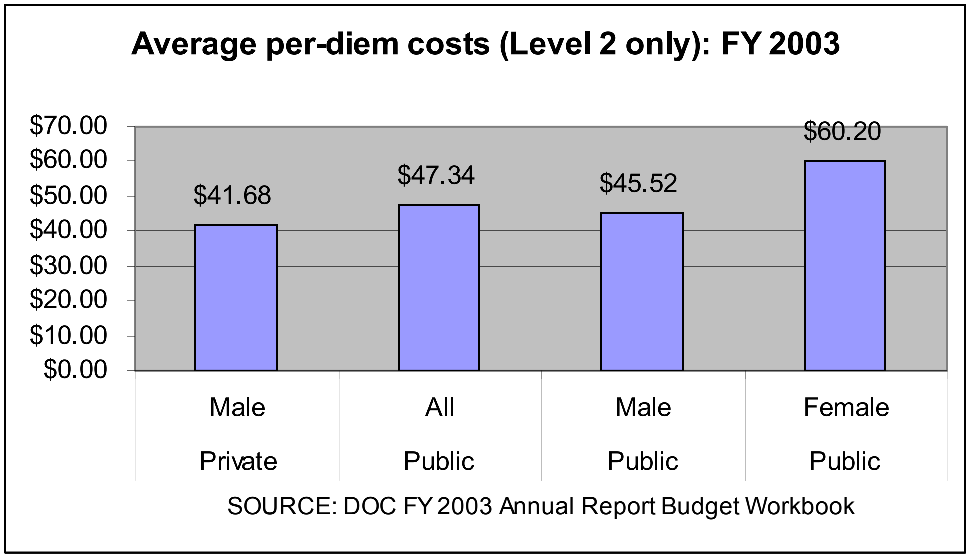
The most recent figures comparing the cost of operating Arizona's public and state-contracted private prisons are contained in DOC's Fiscal Year 2002 Budget Workbook. The workbook reports that the average per-diem cost for private prisons was $41.68, including $1.59 for program administration and oversight. That figure is 12 percent lower than the average per diem for all public Level 2 facilities ($47.34) and seems to confirm claims of 12 percent savings through privatization.

These aggregate figures, however, conceal considerable variance in the cost of specific pubic and private facilities. For example, the workbook shows that the publicly operated Graham Unit had lower per-diem costs than any private prison ($33.91 compared to $34.96 in the Return To Custody unit of Florence West). The workbook also shows that the per-diem costs at Marana ($46.71 including oversight) are actually **higher** than most of the publicly operated units. Further, it quickly becomes clear the figures fail to account for factors that skew the comparison in favor of private operators.

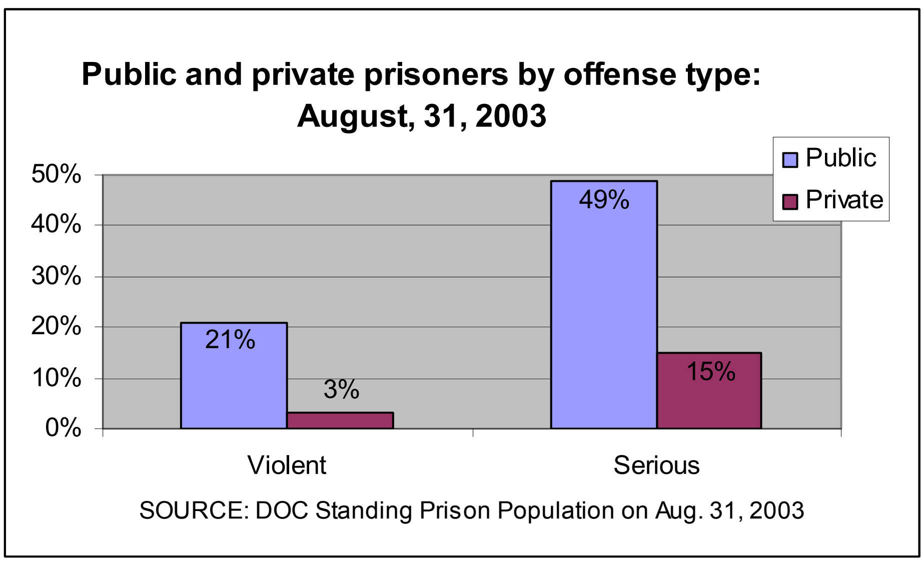
Public vs. Private: A Tale of Two Populations

How well a prison runs, and how much it costs to run, depend not only on the quality of operations, but also on the needs and characteristics of prisoners—from medical and mental health issues to length of sentence to propensity toward violence. Because Arizona's state-contracted private prisons house only low-security prisoners, DOC has historically compared them with public Level 2 facilities. But such a comparison only makes sense if the facilities house similar populations. An analysis of DOC data on prisoners incarcerated in private facilities and Level 2 public facilities on August 31, 2003, shows that the populations are in reality very different.

First, private prisons that currently house only men are being compared to a group of public facilities that house male and female inmates. Since women have greater medical needs and are more expensive to house – an average of $60.20 per day for Level 2 women compared to $45.52 for men – inclusion of women artificially inflates the cost of public beds. **Correcting for this error by comparing private prisons to male Level 2 facilities brings the per-diem cost of public beds down to $45.52 and reduces apparent savings by a full third, from $5.66 to $3.84.**

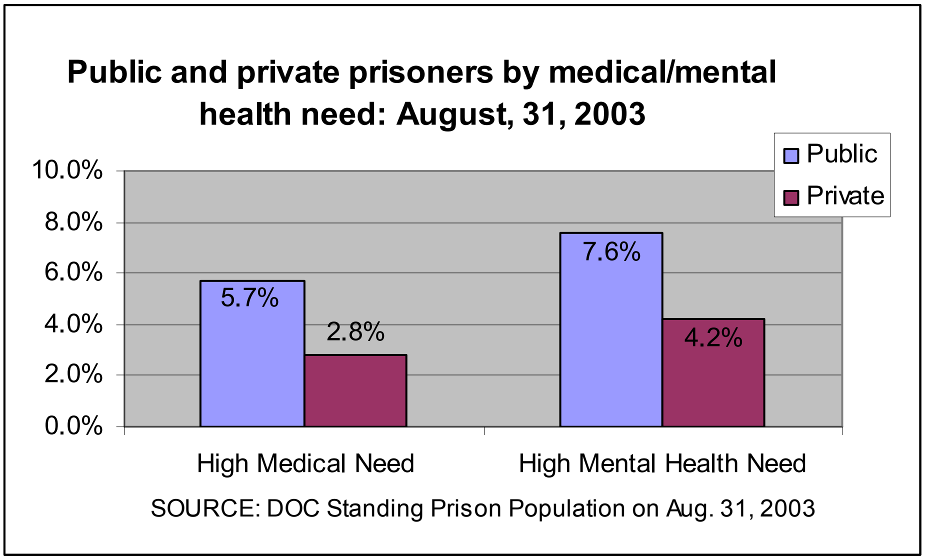


Second, private prisons are being compared to public facilities that house a far greater proportion of serious and violent offenders. Although the overwhelming majority of prisoners housed in both private and public (male, Level 2) prisons were non-violent offenders, **public facilities were seven times as likely to house violent offenders** – 21 percent of the population compared to just three percent in private prisons. Public facilities were also **three times as likely to house offenders convicted of serious offenses** (Class 1, 2 or 3 felonies). Serious offenders made up nearly half of the public prison population (48.5 percent) but just 15.1 percent of private prisoners.



Third, Level 2 public prisoners were more likely to have major medical and mental health needs. **Public prisoners were more than twice as likely than private prisoners to have high medical needs** (a score of three or higher). While the proportion of high-need prisoners was small – 5.7 percent of public prisoners and 2.8 percent of private prisoners – they account for a disproportionate share of medical expenditures. Public prisoners were also significantly more likely to have high mental health needs (a score of three or higher) than private prisoners – 7.6 percent and 4.2 percent respectively.

The significant differences between public and private prison populations are not a matter of chance, but instead the product of a system that assigns low-risk and low-need prisoners to private facilities. For example, according to a DOC classification chart issued on December 15, 2000, two public Level 2 units (Gila and Papago units at Douglas) accepted prisoners with a public risk score up to three, whereas private facilities accepted only prisoners who score two or less. Similarly, two of three private prisons and almost all of the public Level 2 units accepted prisoners with an "institutional risk" score of three, but Marana accepted only institutional risk scores of two or below.



A review of the administrative exclusions and placement criteria that govern which prisoners can be housed at state-contracted private prisons provides further evidence that low-risk, low-need prisoners have been steered into private prisons. For example, prisoners were excluded from Marana if they had:

- A conviction for any felony involving violence or the threat of violence;
- A conviction for a Class 2 or Class 3 property felony (except a narrow list of offense such as fraud or trafficking in stolen property);
- An arrest or conviction for sex offenses or child-related offenses;
- Medical and health care needs scores higher than "M-2";
- More than 12 or fewer than four months remaining to their earliest possible date of release; or
- Pending disciplinary actions or a history of Security Threat Group involvement. [2]

While Marana has the longest list of exclusions, the other state-contracted private prisons also have restrictions on which prisoners they can receive. The DUI units at Florence West and Phoenix West will not accept prisoners with medical needs scores or mental health needs scores above three. The Return To Custody unit at Florence West will not accept any prisoners returned with new convictions or active warrants (i.e. only technical violators), nor will the facility accept prisoners with chronic medical conditions.

[2] "Administrative Exclusions: Marana Community Correctional Treatment Facility (CCTF)." ADC Clas-Op-Man, Appendix A, Ch 24. 12-15-00.

It is clear from this preliminary analysis that, even among minimum-security facilities, Arizona's public and private prisons handle very different populations. It is also clear that public facilities disproportionately bear the burden of higher-risk, higher-need prisoners who are presumably more costly to house, no matter where they are assigned. Without further research, it is impossible to know whether the state is achieving cost-savings through privatization or simply shifting costs between facilities.

In at least one case, the system is designed to directly shift costs onto the public sector. Prisoners housed in state-contracted private prisons are not only less likely to have major medical needs, but also to create fewer medical liabilities because their medical costs have been capped at $10,000 per prisoner. This means that, whenever a prisoner's medical bill exceeds $10,000, the companies were permitted to charge the state for the extra costs or have the prisoner transferred to a public facility.

Although some of the caps have recently been changed or eliminated, it is another factor that has tended to skew cost-comparisons in favor of private operators. According to DOC budget analysts, the department has not yet quantified the extra medical costs incurred as a result of these caps in order to make appropriate adjustments to per-diem costs. The state of Florida reported over $1.8 million in cost shift to DOC in FY 2003 -2004 because of a similar medical cap for its five private prisons.

Private Prison Inflation?

The preceding analysis casts doubt over whether private prisons **ever** achieved real cost-savings. Even if real cost-savings were being realized in the past, however, there is further doubt about whether the program will show savings when DOC issues daily per capita figures for fiscal years 2003 and 2004, as a result of elevated per diem rates guaranteed in contracts signed with CSC in 2002.

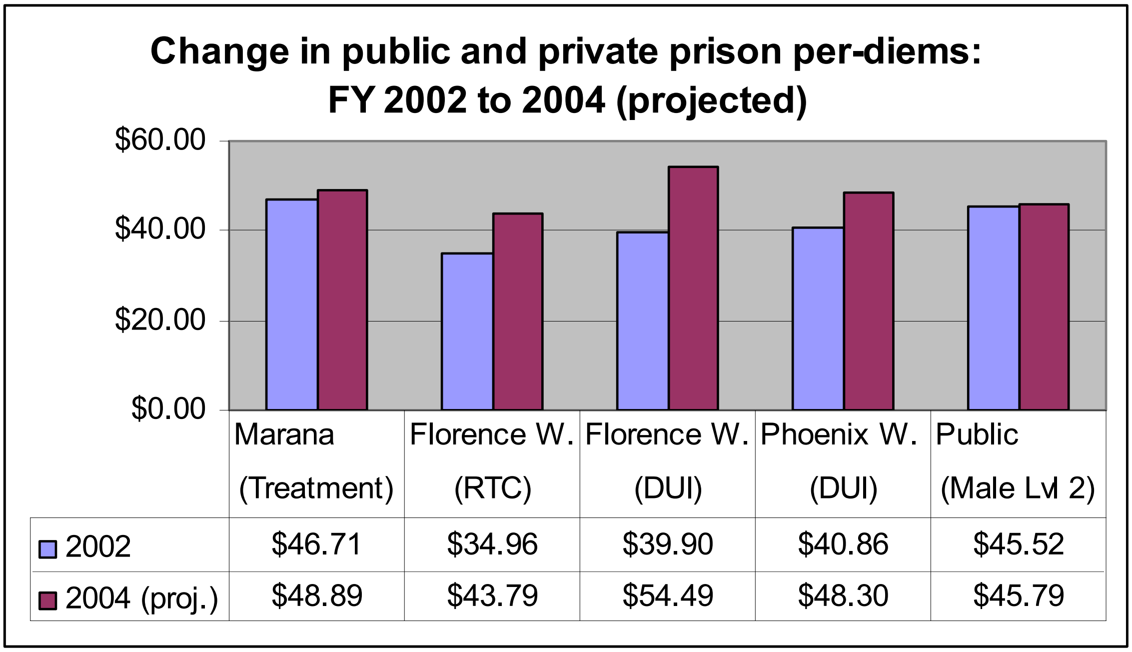
The period between fiscal years 1998 and 2002 saw little change in the gap between the reported average cost of incarceration in public and private prisons. The average daily per capita cost for public Level 2 beds, including male and female units, rose by 1.3 percent from $46.72 to $47.34, while the average for private beds fell by 0.3 percent from $41.81 to $41.68.

If public prison costs continued to grow at the same 0.3 percent annual pace, we would expect the average daily per capita cost of all public Level 2 beds to rise from $47.34 in fiscal year 2002 to $47.65 in 2004. We would also expect the average for male Level 2 beds to rise from $45.52 to $45.79.

On the other hand, average private prison costs are likely to shoot up, thanks to new long-term contracts signed by DOC Director Terry Stewart before he left his post to consult for the private prison industry. The Phoenix West and Florence West contracts guarantee CSC per diems from 9 percent to 34.6 percent higher than were provided in FY 2002 under the old contracts.

On average, the current contract rates for Phoenix West, Florence West and Marana are 15 percent higher than the 2002 contract rates. Even if other costs associated with the privatization program stayed constant, we would expect to see the average per diem for private prisons rise 13.3 percent to $49.63. This is a conservative estimate, since it assumes that the real contract costs will equal in the contract rates. In the past, per diem contract costs have exceeded contract rates because, among other factors, existing contracts guarantee payment for 90 percent occupancy whether or not the beds are occupied.

Further, requests for rate increases submitted to DOC by both CSC and MTC between 2002 and 2005 claim cost increases of as much as 8.5 percent (CSC) and unrecaptured expenses of up to $900,000, suggesting that private prison companies may not be able to control costs as effectively as has been assumed.



	Marana (Treatment)	Florence W. (RTC)	Florence W. (DUI)	Phoenix W. (DUI)	Public (Male Lvl 2)
2002	$46.71	$34.96	$39.90	$40.86	$45.52
2004 (proj.)	$48.89	$43.79	$54.49	$48.30	$45.79

Of course, it is impossible to know exactly how contract increases and other factors will affect daily per capita figures when they are reported for fiscal years 2003 and 2004. Because the new rates began to take effect in fiscal year 2003, the full impact will not be seen until fiscal year 2004. But given the size of the per diem hikes, it seems likely that they will bring the reported cost of private beds **above** the cost of public beds.

Private Finance, Public Risk

Aside from cost-savings, proponents of privatization argue that prison operators can leverage private capital to build facilities that the state could not afford to build itself. At best, private prison finance is a double-edged sword, since private companies only invest in prisons if they are certain that the state will provide enough consistent revenue to cover the cost of operations and financing, and also generate a profit for investors.

Further, the willingness of private prison operators to assume the risks involved in building new facilities has diminished over time. Today, private prison companies are increasingly dependent on borrowing, and their lenders have actively discouraged them from tying up capital in costly new facilities. As a result, private prison companies have increasingly sought public financing for "private" prisons, primarily through local government entities.

At a January 11, 2000 hearing of the House Committee on Public Institutions and Universities, CSC President and CEO James Slattery argued that "the role of the private sector is to help the elected officials maximize taxpayers' dollars by focusing resources on a particular population need and by transferring the risk involved with financing that sort of operations to the private sector by making sure that there is no lack of focus on safety and security."

When Phoenix West and Florence West were built, CSC did indeed take on the risk associated with the projects by financing them on its own credit line. Renting the use of CSC-owned prisons carried some risk for the state, such as the possibility of having to find hundreds of new beds quickly in the event of bankruptcy or operational crisis. But CSC's ownership of the facilities also gave the state leverage: if the state pulled out, CSC could end up paying debt service on an empty facility.

On July 1, 2002, however, shortly after receiving a new contract with DOC, CSC sold its Phoenix West facility to the Maricopa County Industrial Development Authority, which issued $11 million in municipal bonds to finance the purchase. Five months later, on December 1, CSC sold its Florence West facility to the Pinal County Industrial Development Authority, which issued $15.4 million in bonds for the acquisition. In a company press release on the Florence West sale, Slattery announced that the sale "completes our plan to sell the company's major real estate assets and use the proceeds to eliminate our bank debt."[3]

CSC no longer has any financial responsibility for the debt attached to Phoenix West and Florence West. Although the state of Arizona now has the "option to purchase" the facilities at any time, the state is not on the hook either, at least in theory. Arizona can legally walk away from the contracts and the debt at any time, since the failure of the Legislature to appropriate funds renders the contracts null and void.

The problem is that responsibility for debt repayment rests with corporations that were set up solely to hold title to the facilities; and with the industrial development authorities that issued the bonds. Since neither the development authorities nor the shell corporations have independent means to pay the debt, however, bondholders are clearly staking their investment on the DOC contracts, as is made clear in the Phoenix West bond documents.

> The Borrower has no operating history, no historical earnings [and] no significant assets other than the Project… The Borrower is wholly dependent upon payments from the Department [of Corrections] under the Contract or from funds made available under the Indenture to meet its obligations under the Loan Agreement and Note.[4]

Thus, while the state of Arizona has the legal right to walk away from the facilities, a decision to do so could prove disastrous. Not only could a default on the bonds damage the images and credit

---

[3] "Correctional Services Corporation Announces Sale of Florence Arizona Facility: Company Receives $10.0 Million in Proceeds" *Business Wire*, December 24, 2002.
[4] Official Statement for Correctional Facilities Contract Revenue Bonds (Phoenix West Prison L.L.C. Project) Series 2002A and 2002B, dated July 1, 2002.

ratings of the counties and industrial development authorities that facilitated the deals, but rating agencies could also decide to hold the state of Arizona responsible and reduce the state's credit rating.

The state of Louisiana recently found itself in just such a predicament. In the mid-1990s, Louisiana contracted with businessmen affiliated with then Governor Edwin Edwards to build and operate a for-profit juvenile facility in Tallulah, LA. Within a few years, Tallulah became known as perhaps the worst juvenile facility in the nation, a place where children went hungry, wore filthy clothing and were frequently beaten by guards. At the end of the decade, scandals and court intervention persuaded the state to take over operation of the facility, which the state continued to rent from the owners, who had already paid themselves millions in "dividends" by refinancing it. By spring of 2003, legislators had concluded that the abuse and problems, while lowered, continued to persist; and that the state had built too many secure juvenile beds.

However, just as the legislature was about to exercise its legal right to stop appropriations for Tallulah, the state received letters from rating agency Standard & Poor's and bond insurer Ambac warning that failure to appropriate funds would lead S & P to downgrade the state's debt.

> When trying to pull the financial plug in the spring on a juvenile prison they viewed as a boondoggle, Louisiana legislators got some shocking news: to quit financing the prison, which was privately owned but paid for with state-backed bonds, would put Louisiana's bond rating at risk… Now some of the state's highest-ranking public officials are trying to determine whether Louisiana has more unpleasant surprises like Tallulah waiting in the wings.[5]

The case of Tallulah could have tremendous implications for Arizona. Not only could the state be held responsible by the bond markets for debt associated with Phoenix West and Florence West (a total of about $26 million), but the state could also be on the hook for tens of millions of dollars in debt associated with new prisons that have been, and will be, financed through the same mechanism. The DUI prison in Kingman, for example, was financed with bonds issued by the Mohave County Industrial Development Authority (IDA), which authorized $60 million in borrowing for the project.

Even if the rating agencies did allow Arizona to walk away from tens of millions of dollars in revenue bond debt for state-contracted prisons, the impact of such a decision—which would likely lead to a massive default—would be devastating to the business climate in the host counties, not to mention the state's ability to finance other projects with lease-revenue agreements.

Further, aside from the financial risks created for the state and county, private finance significantly increases the cost of borrowing. Because neither the borrower nor the issuer has assets or revenues that can be pledged to bond repayment, investors demand high interest rates and/or bond insurance; and because such deals are more complicated, underwriters demand larger fees to sell the bonds. For example, when the Industrial Development of Authority of Maricopa County borrowed $11 million to acquire Phoenix West, the authority had to set aside $1.2 million to cover costs related to issuing the bonds, including a $464,500 "discount" (fee) for the firm that sold the bonds and a $351,185 premium payment for bond insurance.

---

[5] "Bond backlash; Lawmakers worry partnerships could hurt state's rating." Yerton, Stewart. *Times-Picayune*, September 18, 2002.

By contrast, when a state (or other large, stable institution) issues bonds, the costs are generally far lower. For example, when Arizona State University issued $106 million in revenue bonds, total costs of issuance (including the underwriter's discount and bond insurance premium) were just over $1 million—about 1% of the total issue, compared to the 10% built into the Phoenix West deal. Since the state is footing the bill for debt repayment, by way of operating contracts with private prison companies, all of the excess borrowing costs are being passed on to taxpayers.

Conclusion

Arizona's corrections budget has doubled over the last fifteen years, placing a tremendous burden on taxpayers and on the families of state university students. Despite the growth in corrections spending, however, the state prison system remains under funded and dangerously overcrowded. Proponents argue that privatization is the answer to the state's prison woes because private companies can operate prisons at lower cost and finance new prisons the state cannot afford.

Unfortunately, our examination found that evidence to back up these claims is virtually non-existent. Aside from a report produced by a consultant to the private prison industry who has subsequently been discredited, the only documentation of savings through prison privatization in Arizona comes from a single DOC report that failed to consider a wide range of factors that might account for apparent differences in cost.

Further, until today, no report has attempted to examine the impact of generous new private prison contracts, approved by Terry Stewart before he left the DOC to consult for the private prison industry, on the relative cost of operating public and private prisons. These agreements, which drove up the direct contract costs of housing prisoners at CSC's Phoenix West and Florence West facilities by an estimated 23 percent, are expected to cost the state an additional $3 million a year.

Until a full audit of the private prison program is completed, it will be impossible to determine whether costs have been avoided, shifted or even increased as a result of privatization. What is clear is that policymakers can no longer rely on flawed or outdated information as they make decisions that will critically impact taxpayers and residents.