

TAB D

1. "The Politics of Privatization" by Robert Poole

THE POLITICS OF PRIVATIZATION

by
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Privatization is far more extensive than is generally realized. While much international attention has been focused on the transfer of major national enterprises such as British Telecom and the Japanese National Railways from the public to the private sector, tens of thousands of less-dramatic, smaller-scale cases of privatization exist at the state and local level in the United States, Great Britain, West Germany, and Japan. By examining this extensive data base, we can draw many useful lessons about the politics of privatization, and see how to overcome many apparent obstacles and barriers.

State and local governments in the United States perform hundreds of different public services, ranging from emergency ambulance operations to operating museums to enforcing zoning codes. A nationwide survey in 1982, conducted by the International City Management Association, categorized these services into seven groups, comprising a total of 59 different services, and asked participating local governments how each one was provided. For 12 of the 59, a majority of the cities and counties relied on some form of privatization.

There are many different forms by which public services can be provided. For simplicity's sake, it is useful to focus on two dimensions of the problem: who provides the funding and who delivers the service. If the state does both, that is the

traditional model of public service delivery, in which the service is paid for via taxes and produced by a public-sector work-force. (Police protection is a very common example of this method of public service provision.) A second method is for users to pay directly for the service, while the public sector continues to provide it. This user-fee model is commonly used for services such as transit, water supply, and golf courses (though there is often tax money involved as an additional source of funding). A third general model is to have the state finance the service, via taxes, but hire one or more private firms to provide it, under contract. This model is generally called contracting out. Finally, if we transition to a situation where users pay directly and private firms provide the service, we have total privatization (which is sometimes called divestiture, denationalization, or load-shedding).

Both contracting out and divestiture are generally included in U.S. and British discussions of privatization. Both rely heavily on private enterprise to produce and deliver the public service, usually involving some form of competition--either competition to win the contract for a limited period of time, or side-by-side competition for customers on an ongoing basis. Numerous studies have demonstrated that both forms of competition provide strong incentives for private-sector firms to develop better ways of organizing people, equipment, and systems so as to get the greatest output for the smallest total expenditure. Thus, it is increasingly acknowledged that privatization tends to produce more efficient, cost-effective public services.

Nevertheless, there remain numerous obstacles and barriers

to the spread of privatization in the United States, Britain and elsewhere in the developed world. Some of these result from simple misconceptions while others represent significant obstacles that must be dealt with by appropriate public-sector and/or private-sector action. Many of these same misconceptions and barriers appear to exist in the developing world, as well. It is very much in the interest of those who favor maintaining the status quo to promote the following misconceptions as if they were truths.

MISCONCEPTIONS ABOUT PRIVATIZATION

1. "There won't be enough suppliers to permit competition."

The implication of this claim is that only one or a handful of firms will actually be qualified or willing to enter the field, leading to a monopolistic or oligopolistic situation which will harm consumers. Hence, the status-quo of state provision should be maintained.

The first problem with this view is the assumption that a permanent public monopoly is better than a temporary private monopoly. Numerous studies of how bureaucracies actually perform should dispell the naive notion that civil servants, in fact, are any more altruistic or enlightened, on average, than entrepreneurs. And because a public monopoly is generally permanent, if its service is costly or of low quality, consumers have no hope of an alternative. Turning the service over to one or a few private firms under conditions that permit competition at least offers consumers the chance of improvements, as new suppliers are ultimately attracted by the monopoly profits being earned by the initial entrants.

But the reality is likely to be better than that. In virtually every field of public service, many possible suppliers exist:

- o The employees of a public-service agency can form a company and bid for the contract to provide the service (e.g. Fort Wayne, Indiana, paramedic staff).
- o Administrators frustrated by bureaucratic constraints will often be motivated to form companies to do the

same work more efficiently (e.g. Corrections Corporation of America)

- o Firms in related fields may be attracted by the chance to diversify into a new area (e.g. a private security firm such as Wackenhut going into the fire protection business).
- o Many labor-intensive public services are ideal start-up businesses for lone entrepreneurs, of whom there will always be a good supply if the opportunity to make money is present (e.g. garbage collection, jitneys, landscape maintenance, janitorial service).

2. "Many public services are natural monopolies, so they should be operated by the public sector."

There are two relevant questions to ask about this assertion. First, are the services in question really natural monopolies? And second, even if they are, is public ownership the best response?

All too often, existing providers of a service claim that their field is naturally monopolistic or oligopolistic in order to prevent the introduction of competition. For decades this type of claim supported public-utility-type regulation of airlines, railroads, bus lines, trucking, and taxicab service in the United States. But within the past decade, significant deregulation has occurred in all of these areas, leading to expanded service and lower average prices for the great majority of consumers. Even such traditional public utilities as telecommunications are being opened up to competition, and studies of very limited amounts of competition between electricity firms and between cable TV firms show lower costs and greater responsiveness to consumers. So

we should be very suspicious of claims that a given service represents a natural monopoly--and should certainly not protect any such provider against entry by other would-be providers.

Even where a political consensus exists that a utility service should be provided on a monopoly basis, it is not at all clear that state ownership is the preferred form. American telephone service has generally been acknowledged to be among the best (and lowest-cost) in the world. Yet it has always been provided by private enterprise (albeit on the basis of price-regulated, franchised monopolies). Most US electricity and most French water supply is also provided by private enterprise. So claims of natural monopoly offer no compelling reason for state provision of the service in question.

3. "The service must be provided by the state to ensure that the poor will have access to it."

This widely believed proposition is a major reason why so many public services are produced by the state and made available without charge or at heavily subsidized prices. Ironically, such policies can actually be harmful to the poor. A heavily subsidized transit system, for example, does manage to keep its prices low. But there are numerous other consequences of subsidization: a lack of cost-consciousness by management and employees, continuation of little-used routes, toleration of above-market pay scales and inefficient work rules, etc. The result is often a very costly transit system that is not responsive to changing demands for service. The poor are especially the victims, because it is they who depend the most on public transit. Moreover, although the

poor receive the greatest benefit from subsidized prices, they themselves pay many of the taxes used to provide the subsidies: sales or Value Added Taxes, property taxes (as part of their rent), and corporate taxes (as part of product prices). There is also the huge waste involved in subsidizing the majority of riders who are not poor, and who could readily afford to pay market rates.

A far more efficient alternative is to make use of what the U.S. Department of Transportation calls "user-side subsidies"-- i.e. subsidize only those users too poor to pay market-level prices, letting everyone else pay the full rate. The transit system is then run as a business--presumably by private entrepreneurs interested in getting the job done in the most efficient way.

The general term for this mechanism for enabling the poor to pay market prices is "vouchers." The state can issue transit vouchers, health-care vouchers, housing vouchers, or school vouchers, each redeemable only for the designated service, and cashable by the service provider for reimbursement by the state. The provision of vouchers solves the problem of access by the poor and facilitates opening up entire areas to more-efficient private enterprise provision of services.

4. "Public services should be organized for service, not profit."

This objection is purely emotional or ideological, with little real application to reality. Even the most sensitive of services--whether it be the skill of a surgeon or the compassion of a clergyman--are rewarded with a regular income, enabling the

service provider to enjoy the comforts of this world. Other than those who take a vow of poverty and live as ascetics, everyone engages in a trade or profession in order to "profit." What separates productive economies from stagnating ones is whether or not people are motivated to devote their talents most effectively toward identifying and meeting the real needs of others. It is precisely this that entrepreneurship is designed to do. By ruling some areas of life off-limits to entrepreneurship, a society denies itself a vital source of innovation and creativity, as applied to those areas. The desire for profit is what motivates entrepreneurs to seek out and fill the vast diversity of human needs. So there is no dichotomy between profit and public service.

Each of the foregoing misconceptions can easily be made to service the interests of those opposed to privatization, whether it be a bureaucracy unwilling to shift its role from service-provider to that of contract-administrator or the franchised monopolist desperately fighting to prevent the introduction of competing firms. In each case, however, both theory and evidence can be utilized to discredit these propositions, when they are used to defend inefficient vested interests.

REAL BARRIERS TO PRIVATIZATION

While dispelling misconceptions such as those discussed above is important, it is also necessary to recognize that there are a number of very real barriers to privatization, all of which may restrict or prevent shifting services from public to private-- unless dealt with. Five of the barriers discussed below are frequently encountered at the state and local level in the United States, and are likely to arise elsewhere, as well. The sixth is more likely to be a problem unique to developing countries.

1. Misleading Cost Accounting

Claims that private enterprise can deliver a service at less cost are often met with counter-claims from current state providers. Unfortunately, the alleged costs of state service provision are all too commonly seriously understated, by any of the following means:

- o Stating price as if it were cost. Some city officials have compared the proposed price to be charged by a would-be private supplier with the price charged by the government agency, ignoring the fact that the firm must price to cover all of its costs while the government agency is generally subsidized.
- o Ignoring overhead costs. If a city government got out of, say, the garbage collection business, a portion of the city's general overhead costs would no longer be needed. So it is necessary to include in the cost comparison the garbage-collection department's proportionate share of city overhead, in order to make a fair comparison. But this is often not done.

- o Ignoring retirement costs. Many U.S. cities operate a retirement system for all city departments. Generally, these costs do not show up in each department's own budget. Yet they are very real (and large) costs of having that department.
- o Ignoring capital costs. Most governments also do not include the costs of buying major pieces of equipment (e.g. vehicles or heavy machinery) in departmental operating budgets. Hence, unlike commercial firms, no annual depreciation charges are made, to account for the eventual replacement of these assets.

Properly accounting for all of these factors will give a realistic picture of the true comparative costs of public and private provision of the service in question. One must never rely on the department whose continued existence is in question to produce such a cost comparison. It is essential that a knowledgeable but disinterested external party (e.g. a public accounting firm) be tasked to perform these important cost comparisons. To ensure that the external party is truly objective, it might be necessary to accept bids only from firms which would not stand to lose future business with the government in question by coming to the "wrong" conclusion about the relative costs. For example, if it is a city government that is considering privatizing one of its services, it might be wise to invite bids only from firms located in other cities (or in the case of a small country, only from foreign firms or international organizations).

2. Fear of job losses and unemployment.

One reason privatization frequently means lower costs is that public sector enterprises tend to be overstaffed. All too often, rather than seeing their function as delivering the particular service in the most cost-effective manner, agency or department heads see their task, in part, as providing employment. This naturally leads to "protective" work rules (e.g. restrictions on the use of part-time labor, arbitrary division of work among crafts, etc.) as well as simply hiring more people than are needed to do the job.

In fact, this policy rests on a mistaken notion of work in society. It does no service to a country's economy to waste resources in this way. If 10 people are employed for a task that can be done by six, the other four are unavailable for productive work elsewhere, and the funds absorbed in paying them are unavailable to pay them for productive work. So employment should not be substituted for efficiency as a principal management objective.

Nevertheless, when the transition from public to private is proposed, the fear of creating at least short-term unemployment (by eliminating the unnecessary jobs) can pose a significant political barrier. Hence, it is important to develop techniques for dealing with this problem. Among the methods used in American cities and counties are the following:

- o Contractor preference requirements. When a service is first being privatized, the state can require that the company or companies taking over give first preference in hiring to the displaced government workers.

- o Phased-in privatization. Another option is to implement privatization gradually, usually on a geographical district basis. Public employees displaced by the first privatization can be transferred to other (not-yet-privatized) districts, to fill any vacancies arising from normal attrition due to resignations, retirements, firings, etc. (Turnover in state and local public services can range from as little as 5% to as much as 20% per year.)
- o Worker enterprises. Government employees in an enterprise slated for privatization ought always to be allowed to form a company and bid for the contract, in competition with other companies. A variant of this idea is to require a department to bid against outside firms without having to convert to corporate status. If the department wins the bidding, it continues in existence, performing the function in accordance with the terms of its bid (which may mean significantly revised work rules and fewer total employees). If it loses, the work goes to the winning outside firm, which might or might not offer to hire the now-displaced workers.

Wherever possible, it is wise to give affected parties a stake in privatization. The compensation of agency administrators can be changed so that instead of getting paid more the larger their agency grows (as measured in money and numbers of employees), their compensation is instead based on obtaining the maximum level of performance per unit of money spent. This gives the administrator

a tangible incentive to seek out more cost-effective ways to operate--such as contracting out. Similarly, when a state agency is denationalized, the natural fear and opposition of the work force may be overcome if they are given (or allowed to purchase cheaply) shares of stock in the newly private company. This method has been used with great success in British denationalizations.

3. Fear of corruption

One ever-present danger with the contracting-out form of privatization is that one bidder will make an under-the-table deal with the contracting agency whereby it is awarded the contract in exchange for illegal considerations. Such instances have occurred in American cities and counties--though they appear to be the exception, rather than the rule. Opponents of privatization, however, take great pains to publicize such events, hoping to discredit the entire phenomenon based on a small number of anecdotes.

Since the temptation to give in to bribery and corruption will always be there, in both public and private-sector participants, there is a great need to develop procedures to guard against it. The answer is to have clear-cut, open bidding procedures and written, objective selection criteria--and to make sure they are adhered to. This can be done by requiring that all such rules, procedures, and criteria be matters of public record, and by holding bid openings and other important decision-making sessions in public. Several detailed handbooks on methods to be used in contracting out have been published during the past several

years, compiling what has been learned from the experience of thousands of local governments in the United States.

The problem of corruption is much less serious in the event that privatization takes the form of "load-shedding"--i.e. where the state simply decides to cease providing a particular service in favor of the marketplace. When individuals are left free to select their own providers (as is the case with bus service in Buenos Aires, for example), then it is the granting or withholding of their patronage that determines whether a particular firm grows, shrinks, or remains in business at all. The only way a firm in a competitive marketplace can use "bribery" to increase its share of the business is to "bribe" potential customers with lower prices and/or better service.

4. Legal prohibitions

Another significant barrier can be explicit legal restrictions stating that government itself must perform a particular service. In other cases the administrative law may be ambiguous or unclear, leading cautious interpreters to conclude that government may not delegate the service to the private sector, while other interpreters conclude the opposite. In order for privatization to be possible in these cases, reform legislation must be researched, drafted, and enacted.

In the U.S. experience, it is frequently the private sector--firms wishing to enter a particular field--that takes on the task of developing legislative or administrative provisions to remove barriers to privatization. This process is taking place

today in a number of states, in order to permit private firms to build and/or operate prisons. Most state laws do not permit the state to delegate its correctional power to commercial enterprises. But in the states where such provisions have been modified, companies headed by experienced correctional people have begun to operate. In some cases they have bid on and been awarded contracts to operate existing jails or prisons. A more recent development is the "turnkey" contract, under which the firm raises the money, designs and builds the correctional facility, and then operates it under long-term contract.

Other legal barriers may involve the tax laws. Under U.S. tax law, tax payments by individuals to state and local governments are deductible on federal income-tax returns. Thus, when a person pays taxes to support a service such as garbage collection, the real cost is reduced by the extent of the deduction. If that same public service is privatized and paid for by direct user fees, that cost is not allowable as a deduction to individuals. Thus, the tax law itself contains a form of discrimination against private provision of services.

Although the impetus for removing legal barriers often comes from private-sector entities, enlightened public-sector officials in both England and the United States have sometimes made the removal of legal barriers a priority objective, in the interest of greater efficiency in government. They have come to see that making possible lower-cost, more-responsive public services via privatization and/or deregulation can be politically popular.

Although risking loss of favor with status-quo interests (public employees, franchised private firms), they stand to gain popularity with taxpayers and would-be private-enterprise service providers. Deregulation of airlines and trucking was a popular pro-consumer issue for liberal Democratic Senator Edward Kennedy in the United States. Privatization has become a popular pro-taxpayer issue for Margaret Thatcher in Britain.

5. Regulatory problems

Another obstacle to privatization can be an adverse climate of government regulation. Municipal bus systems in the United States were once almost entirely private enterprises. But most local governments, operating on the mistaken notion that bus service is a natural-monopoly-type public utility, imposed stringent price controls and service requirements on the bus companies. When Americans moved to the suburbs in massive numbers following World War II, the bus companies were severely restricted by these regulations in being able to adapt to the changed patterns of settlement and transportation. It became far more costly to serve a dispersed, low-density population--but political pressures from riders prevented adequate fare increases. Numerous routes become unprofitable, but similar political pressures caused them to be maintained anyway. One after another, the bus companies went bankrupt and were taken over by the local governments.

Today, transit economists are advocating a competitive model for urban transit, rather than the old public utility

monopoly model. In this case, the developed world can learn many lessons from the cities of the developing world, where competition with state-owned transit is commonly permitted (e.g. in Calcutta, Caracas, Dakar, Manila, Singapore, etc.). In some cases, private enterprise provides virtually the entire bus and taxi system, as in Buenos Aires and Hong Kong. But if private transit entrepreneurs are encouraged to enter the business, it would be a profound mistake to resurrect price controls and service requirements, since that might lead to yet another wave of bankruptcies. Public officials need to understand that competition is an alternative to state-imposed regulation, to control prices and motivate responsive behavior by the providers.

Likewise, in denationalizing large-scale state-owned enterprise which have functioned as statutory monopolies, it is important that public policymakers open the way for competition at the same time. The Thatcher administration has been criticized for allowing only a single competitor to newly privatized British Telecom (and only in a limited segment of BT's business--commercial long-distance service). Consumers would have been better served by complete legalization of entry into all aspects of the telephone business, as is occurring in the United States.

6. Inadequate legal structures.

Privatization depends upon the willingness of entrepreneurs to risk their own funds developing an enterprise, in the hope that it will meet the needs of enough customers that the entrepreneur will more than cover his costs. But the willingness of

entrepreneurs--and of those who lend them money--to take those risks depends very much on the legal environment in which they seek to operate. If the law does not contain strong protection for private ownership of property and for the sanctity of contracts, backed up by an impartial, smoothly working judicial system, then entrepreneurship is unlikely to develop and flourish. What entrepreneurial energies remain will likely be channeled into the "underground" or informal economy, instead. In many countries, both developed (e.g., Italy) and less-developed (e.g. Peru), the thriving informal sectors testify to the gross inadequacy of one or more key elements of the necessary legal system. Hence, an important prerequisite for extensive privatization may well be the strengthening of legal protection of the right to private property ownership and the enforceability of contracts, and reform of the judicial system so that it provides for the prompt and fair resolution of disputes.

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Privatization and deregulation are still the exception rather than the rule, despite a growing body of international evidence that competition and entrepreneurship can generally provide public services more responsively and less expensively than monopoly and bureaucracy. What stands in the way is the politics of contending interests. Defenders of the status quo can often maintain their positions by relying on misconceptions about public services and privatization as well as on some very real barriers. Overcoming these obstacles requires a new kind

of leadership--the public official or political candidate who can change the calculus of interests, so that citizens (as both taxpayers and service users) learn to understand the connection between privatization/deregulation and lower costs and better service. Those who might appear to lose out from privatization--public employees, bureaucrats, the poor--must be taken into account and, wherever possible, given a stake in the outcome. In that way, the calculus of interests can be altered to make privatization a politically feasible proposition.

TAB E

2. "Legal and Tax Considerations in Privatization" by
Peter Thomas