UNCTAD CONFERENCE

2nd Session of the Working Group on Privatization

Techniques and Financing

April 1993

To File

From/Location W. Neil Murdoch

Date June 18, 1993

Re Brief Trip Report
UNCTAD Ad Hoc Working Group on Privatization
A.I.D. Privatization and Development Contract
Task Order No. 42

This memorandum presents a brief overview of the activities of this buy-in, the results and further actions that should be taken.

The purpose of the buy-in was to fund a U.S. privatization expert to accompany the U.S. delegation to the UNCTAD Ad Hoc Working Group on Privatization's second working session. The U.S. delegation was headed by Monica McKnight, Acting Director of PRE/EM; Penny Farley also was a member of the delegation. I was privatization expert on the panel that lead the discussions during the first two days of the session. The other members of the panel are listed on the attached page.

The work product prepared/and or presented under the buy-in trip included a case study of the U.S. experience in privatization (in both English and French), a written contribution on the techniques and financing of privatization (originally intended as the hard copy of a speech), two short presentations (10-15 minutes each) on the objectives of privatization and the techniques of privatization and a longer talk (40 minutes) on the financing of privatization. In addition there were numerous meetings with individual delegates to discuss particular issues and questions during the country presentation sessions.

The atmosphere during the working sessions was particularly conducive to a learning experience. The majority of the delegates were in Geneva to share experiences, address particular concerns and develop a better understanding of, and solutions to, the issues that they are facing on a day-to-day basis. There was very little of the polemics that UNCTAD had previously been known for. One drawback to the session was its location, Geneva. In certain instances the resident mission personnel attended the session rather than the hands-on implementors. If the session was held at a location where such an option is not available, then the "quality" of the attendees could be even higher.

During the working session there was broad agreement and recognition of the basic objectives of privatization e.g. economic efficiency. There were repeated statements of these objectives during

a

the country presentations. The delegate from the International Labor Organization asked some basic questions about the principles of the process but apparently he was considerably more "neutral" than at the first session. Similarly, the delegate from Pakistan asked two thought provoking questions concerning the perceived scarcity of capital and privatization's effect on this scarcity and whether privatization is a fad similar to nationalization in the 1960's. Yet later the same delegate was enthusiastically reporting on his government's privatization program.

There was a good review of the various techniques of privatization. Many different examples of schemes that have been successful were presented to the group. There was little, if any, discussion on methods that have not worked (with the exception of the panelist from Sri Lanka). During meetings with delegates between sessions there was a clear consensus that the presentations and discussions had been very helpful.

The session on the financing of privatization was somewhat less focused. I began the session by giving an overview of the different sources of financing, the advantages and disadvantages of each, and methods of obtaining them. Subsequently the discussion moved through a number of points, particularly regarding mass privatization and restructuring. Less time was spent discussing how to actually finance transactions, what potential problems are and what lessons had been learned.

A large number of countries presented aspects of their privatization experiences. Other countries provided written briefs on their privatization programs. In certain presentations, the country briefs were simply restated but some countries developed specific examples or updates for the second session. The sharing of experiences was invaluable and the presentations were able to generate good discussions.

The UNCTAD Secretariat (primarily in the form of Mr. K. Khaw, Chief of Privatization and Enterprise Development), prepared a summary of the main points made during the panel discussions. The panel members had a very brief opportunity to review the document and suggest some changes. The summary is intended to serve as the basis for the final report of the Ad Hoc Working Group. At this point it still needs considerable work; it does not have any flow but rather is a series of unconnected statements. The report does not present any conclusions or lessons learned.

b

The third session of the working group is scheduled for the week beginning November 29, 1993. The two main topics on the agenda are:

i) Competition and regulation of privatized monopolies (including the privatization of utilities); and
ii) Social impact and socially related support measures.

It was clear from the second working session that both of these topics generate considerable interest and the second topic could generate widely varying views.

Monica McKnight discussed with Mr. Khaw, the role that the U.S. delegation could play in the next session, including the possible provision of an expert on a panel. Mr. Khaw indicated he would take this offer into consideration but that he was concerned about the geographic diversity when constituting the panel. PW/IPG will have to continue to liaise with Monica and Penny Farley concerning the methods by which we can aid the U.S. delegation at the next working group session.

An immediate task will be to respond to certain requests that country delegates and the UNCTAD Secretariat have made concerning materials (primarily from the IPG library). i will take care of these matters this week.

PRIVATIZATION IN THE UNITED STATES

February 26, 1993

I. INTRODUCTION

The U.S. experience with privatization has been limited as a result of the dominant role of private enterprise in the national economy. In 1991, Federal, state, and local government output accounted for 11.1%[1] of GDP and government expenditures constituted 34.2%[2] of GDP. In addition, the public sector accounted for 17.0% of non-agricultural employment.[3] Following is a breakdown of the public role in the U.S. economy by level of government.

	Federal	State and Local
Output as % of GDP	3.4%	7.7%
Expenditures as % of GDP	23.5%	13.4%
Employment as % of non-agr. emp.	2.7%	14.2%

Because the public sector in the U.S. does not account for a substantial portion of production, the U.S. privatization experience has emphasized the private provision of public services and infrastructure facilities rather than the sale of state-owned enterprises.

An additional reason for the limited extent of privatization in the U.S. is the lack of a national government policy or program. U.S. privatization has occurred predominately at the state and local levels, rather than at the Federal level. Despite the lack of a national agenda, many of the local and state governments that have instituted privatization programs share common objectives and methodologies and have experienced similar results. This paper describes U.S. privatization efforts at the state and local levels, as well as the limited Federal experience.

II. OBJECTIVES OF PRIVATIZATION

In recent years, governments have increasingly turned to the private sector to provide public services and facilities due to extreme fiscal pressure at all levels of government. Taxpayers have strongly resisted general tax increases while demanding increased levels of health care, education, corrections, police, and other services. As a result:

- More than one in four cities faced a budget gap of 5% or more in 1991[4];
- More than half the states faced deficits of one percent or more in 1991[5];
- The Federal budget deficit was $269 billion in fiscal year 1991[6].

Governments have pursued privatization to achieve the following objectives:

- cost savings;
- additional sources of financing;
- higher quality services and facilities;
- greater flexibility in service provision;
- shorter implementation time.

An additional motivation for privatization has been an ideological preference for private-sector management and a belief in the inherent efficiency of the private sector relative to the public sector.

III. MACROECONOMIC CONSIDERATIONS

Macroeconomic considerations have not played a significant role in the privatization process due to the limited extent of privatization in the U.S. and the lack of Federal involvement in privatization decisions. Privatization may have had some effect on the macroeconomy as a result of its marginal role in reducing government fiscal deficits.

IV. SCOPE OF PRIVATIZATION AND ROLE OF THE STATE

A. Experience with Privatization

The U.S. experience with privatization has included contracting out of public services to private providers, public-private infrastructure development, and, on a very limited basis, sales of state-owned enterprises.

1. Contracting Out

Fiscal pressures have provoked state and local governments to seek more efficient means of providing public services. The primary way in which governments have done this is by contracting with private companies for the provision of needed services such as:

- Solid waste collection and disposal
- Prison management and construction
- Transit operations
- Health care

Contracting out is the most widespread form of privatization in the United States. Nearly every government entity in the U.S. contracts out for at least one service. Eighty percent of governments surveyed said they realized cost savings of 10 to 40% from contracting out.[7] Additional benefits of contracting out include: higher quality service, greater flexibility, and shorter implementation time for service provision.

The most often cited obstacle to public service privatization is the opposition of public employee unions concerned about employment reductions. Other obstacles include opposition from elected officials and citizens.

2. Infrastructure Development

The move to private development of infrastructure has also been driven by government fiscal pressures, as well as the following trends in the last quarter of the century:

- a nearly 50% decline in the percentage of the nation's GNP that is devoted to public works spending[8];

- a decline of more than 50% in real highway expenditures per unit of travel since 1960[9];

- increasing taxpayer preference for direct user charges over general tax increases and fuel tax increases.

Private sector involvement is growing in all areas of infrastructure, but particularly in transportation, an area extremely well suited to privatization. Many infrastructure facilities can generate enough revenues from user fees and neighboring commercial development to attract private financing. Facilities that are commonly targeted for privatization include:

- Toll roads and bridges
- Airports
- High speed inter-city rail systems
- Water treatment facilities

Private infrastructure development can provide the following benefits:

- New sources of capital to finance needed infrastructure
- Reduced time and cost to develop new infrastructure
- Improved operating efficiency and responsiveness to customers
- Efficient (market) pricing of infrastructure services
- New tax revenues

In spite of the interest and potential of private infrastructure, few projects have actually been financed and constructed. The inability to attract financing to private infrastructure projects has been a major obstacle to implementation. (This is discussed in more detail in Section V). The following projects are close to implementation:

- A $110 million, 2-mile toll bridge linking San Juan Puerto Rico with the international airport. The project has been financed but with substantial government financial guarantees.

- A $100 million, 10-mile toll road in the median of State Route 91 in Orange County, California. The project has completed design and permitting and is close to seeking financing.

- A $400 million, 14-mile toll road between Loudoun and Fairfax counties in Virginia. The project has completed design and permitting and is in the process of soliciting financing.

President Clinton's infrastructure proposals are unlikely to have a significant impact on privatization. The President has proposed an additional $4.1 billion in infrastructure spending over the next 4 years.[10] This increase in public spending may support certain private projects. For example, some of this money may be used to build highway-railway grade crossings for a high-speed rail project from Chicago to St. Louis. However, the President's plan is unlikely to stimulate broad new interest in infrastructure privatization.

3. Sale of State-Owned Enterprises

Sales of state-owned enterprises to the private sector have occurred infrequently in the United States due to the limited number of enterprises available for privatization and the public controversy surrounding most proposed sales.

a. Sale of State and Locally-Owned Enterprises

Until last year, one of the most important barriers to privatization was Federal policy requiring that Federal grants be repaid out of the sale price in the same proportion that they were used to fund the development of the enterprise. For example, if a facility had received 50% of its funding from Federal grants, the state or local government would be required to pay up to 50% of the sales price to the Federal government, even if this amount exceeded the original Federal contribution.

An April, 1992 Executive Order of the President reduced the repayment of Federal investment to no more than the amount of Federal grants received less the accumulated depreciation on the grants. In addition, the Executive Order instructed all federal agencies to undertake efforts to privatize and eliminated other barriers to the sale of enterprises with Federal interest. The Executive Order, however, has not yet resulted in increased sales of state-owned enterprises.

State and locally-owned enterprises that have been proposed for privatization include:

- Los Angeles Airport
- Philadelphia Airport
- Massachusetts Turnpike
- New York State Thruway

b. Sale of Federally-Owned Enterprises

Numerous Federally-owned enterprises have been proposed for sale and several have been successfully privatized. The sale of Conrail is an interesting case because the issues faced are similar to those faced in Eastern Europe and the developing world.

Summary of Conrail Privatization:

- Conrail begins operations in 1976 from a group of six bankrupt railroad companies with a mandate to revitalize freight rail service in the Northeast-Midwest.
- June, 1984: 14 formal offers are made to the US Government for the purchase of Conrail.
- February, 1985: USDOT recommends that Congress approve a sale to Norfolk Southern.
- October, 1986: President Reagan signs legislation to privatize Conrail by public offering. Congressional leaders site transparency as a major reason for selecting a public offering over a private sale.
- March, 1987: Conrail sold in a $1.6 billion public offering, the largest initial public stock offering in U.S. history.
- Conrail has generally been profitable since privatization.

Two other successfully privatized entities are the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC):

- FNMA and FHLMC are government sponsored enterprises that buy home mortgages and sell mortgage-backed securities in the secondary market.
- Both receive government guarantees and are regulated but are privately owned. (FNMA has been privately owned since 1968 and FHLMC has been privately owned since 1989).
- Both are publicly traded on the New York Stock Exchange
- Both are highly profitable

Other enterprises that have been proposed for privatization but continue to be publicly held include:

- United States Postal Service
- Amtrak (the National Railroad Passenger Corporation)
- Naval Petroleum Reserves (two Federally-owned oil fields)

- Alaska Power Marketing Administration
- Bonneville Power Administration
- Tennessee Valley Authority

The barrier to privatization in most of these cases is opposition by affected constituencies which are able to block Congressional approval. In the case of the Postal Service, for example, these constituencies include Postal Service employees (675,000), Postal Service management, and rural residents who fear that privatization will result in higher rural postal rates. In the case of Amtrak, opposition includes Amtrak employees, Amtrak management, and railroad passengers who fear that privatization will result in higher fares and reduced service.

B. Institutional Follow-up

Regulation is often an important issue in the privatization process because most of the services and facilities privatized in the U.S. do not operate in competitive markets. After a privatization transaction is complete, the sponsoring government agency or a government auditor often regulates the private service or facility provider.

Private providers of public services are monitored to ensure that quality, service, price, and safety standards are met. Contracted out services are infrequently regulated on price or profits as these issues are resolved in the service contract.

Infrastructure projects and state-owned enterprises that have undue market power, such as toll roads, must be price-regulated or profit-regulated in order to protect the public interest. Economic regulation is an added risk to private investors and can inhibit the financing of these projects. Some infrastructure projects, such as high speed rail systems, face strong competition and may not require price regulation.

V. TECHNICAL AND LEGAL ISSUES

A. Legal Issues

1. Implementing Legislation

Private entities are often unwilling to participate in privatization efforts without explicit legal authorization. Privatization programs generally require implementing legislation that accomplish many, if not all, of the following objectives:

- authorize a government agency to enter into agreements with private partners to provide services and facilities;

- authorize the collection of user fees on the facility;

- describe any regulatory requirements;

- prohibit the government from expropriating or otherwise impairing the financial viability of a project or enterprise without fair compensation;

2. Tort Liability

Tort liability is an increasingly important legal consideration for private owners and operators of public-use facilities. Public-use facilities are exposed to substantial law suits resulting from personal injuries. The potential for tort claims can seriously impair the ability of a project to attract financing.

3. Federal Grant Restrictions

Federal grant restrictions have been an important legal constraint to privatizing facilities that have been developed with Federal funds. Until last year, Federal regulations required state and local governments to share proceeds of enterprise sales on a prorated basis with the Federal government for facilities built with Federal funds. This and other Federal policies effectively blocked the sale of airports, roads, and other publicly-owned facilities to private investors. These restrictions were relaxed in an April, 1992 Executive Order, as described earlier.

4. Federal Tax Law

The tax treatment of public and private infrastructure projects has had an important impact on privatization. The Federal tax code exempts from Federal income tax the interest earnings on bonds issued to finance facilities used by governments. The interest on most bonds issued to finance private-use facilities, however, is generally subject to Federal income taxes. As a result of this discrepancy, the cost of financing for private projects can be substantially higher than that of publicly controlled projects. This tax bias against private projects has been a significant barrier to privatization.

B. Privatization Programs

As mentioned earlier, there is no national privatization policy or program. States and localities wishing to privatize have developed their own privatization programs on an ad hoc basis. These programs are frequently targeted at providing specific services or facilities, for example:

- Chicago's municipal contracting program has privatized management of city parking lots, towing of cars, janitorial functions, and other services;

- Pennsylvania recently privatized operation of three state hospitals that might otherwise have ceased operation;

- California Assembly Bill 680 authorized the California Department of Transportation to grant franchises for the development of four private transportation projects;

- The Florida High Speed Rail Act authorizes private development of high-speed rail service.

Many other state and local governments have implemented or are considering programs for private services or facilities. Although there is no nationally coordinated program, the state and local programs often share common objectives and methodologies.

C. Organization of Privatization Programs

Municipal contracting offices are generally responsible for contracting out for private service delivery, while state agencies are responsible for administering private infrastructure programs (e.g., the State Department of Transportation for transportation projects). Other institutions, such as Public Utility Commissions, may also be involved in the post-privatization monitoring process.

Privatization involves complex legal, financial, regulatory, and technical issues that are often beyond the expertise of government officials. Consequently, governments often employ lawyers, financial advisors, and technical experts to advise them during the privatization process.

D. Structure of the Privatization Process

Ninety-four percent of municipalities surveyed contracted out services by competitive bid[11] and ninety percent of municipal contracts are on a fixed price basis.[12] Although selection criteria vary by municipality and by service, the major criteria generally include:

- cost;
- quality level and consistency of services provided;
- past experience of the contractor.

Infrastructure facilities are privatized through a franchise agreement with a private partner to finance, develop, own, and/or operate a facility. The private partner is usually selected based on detailed proposals submitted through a competitive bidding process. The terms of the agreement are then developed through extensive negotiation between the public and private partners. The infrastructure privatization process generally involves the following steps:

i. Development of privatization program
ii. Issuance of Request for Proposals
iii. Evaluation and selection of private sector proposals

iv. Negotiation of franchise agreement between public and private sectors
v. Implementation of franchise agreement and development of facility

Public share offerings have often been used for sales of state-owned enterprises. Conrail, FNMA, and FHMLC were all privatized through public share offerings.

E. Conditions for Privatization

Performance requirements are frequently included as part of all types of privatization agreements. They are especially important to municipalities contracting out services because of the need to ensure that the service is acceptable in terms of quality (citizens may have no alternatives to the municipal contractor), that it is consistent, that it is available to the municipal constituents in need, and that it meets environmental and other requirements. Many of these performance requirements are monitored by the sponsoring government agency or by the municipal contracting office.

Private infrastructure projects are required to meet safety, construction, and environmental standards set by the Federal, state, and local governments. In addition, infrastructure projects may be price-regulated or profit-regulated, as discussed earlier.

F. Private Participants

The private contractors for municipal services vary tremendously by service sector and region. Many services, such as solid waste collection, are provided by large companies under contract to numerous municipalities across the U.S. However, smaller, regional contractors do provide some services, such as janitorial services.

The private participants in infrastructure development are often consortia of engineering, construction, management, and banking firms. These consortia have extensive experience in all aspects of the planning, construction, financing, and operation of infrastructure projects.

State-owned enterprises have often been sold to the general public through public share offerings.

G. Financing Privatization

Private municipal service delivery is generally not a capital intensive activity. Financing these services is usually the responsibility of the private contractor and has not been a major barrier to privatization. Private contractors are often large corporations with established financial records and access to capital.

Potential sources of financing for private infrastructure projects include international banks, institutional investors, bond issues, and private equity investors. However, the inability to attract financing to private infrastructure projects has been a major obstacle to implementation. Infrastructure developers have experienced substantial barriers to financing, including:

- Unavailability of tax-exempt debt
- High business, political, and tort risk associated with private infrastructure development
- Reluctance of financial markets to finance the first private projects with no government financial support
- Lack of sophistication on the part of public managers attracting private infrastructure providers
- Local opposition and environmental regulations (these affect both private and public projects)

Other countries have been more successful in implementing private infrastructure projects because they have been willing to extend extensive financial guarantees to project investors The Puerto toll bridge, one of the few public-private infrastructure projects financed in the U.S. to date, is heavily supported with government financial guarantees.

The Intermodal Surface Transportation Efficiency Act (ISTEA) of 1991 will provide an additional source of financing for private projects by allowing Federal highway funds to be used for the construction and rehabilitation of public and private toll facilities. ISTEA should greatly expand the opportunities for private development of toll highways, bridges, and tunnels.

Sales of state-owned enterprises have often been executed through public offerings which have not faced major barriers due to the depth of U.S. equity markets.

H. Environmental Aspects of Privatization

Environmental considerations have not been a major issue for contracting out of municipal services. Private service providers must follow the same environmental laws and regulations that are applied to public providers and are subject to fines and damaged reputations for violations of these rules.

Environmental regulations have been a barrier to private infrastructure development. Infrastructure facilities must undergo a rigorous environmental permitting process before beginning construction. The process often requires the private developer to undertake time consuming and expensive environmental assessments which increase project costs and risks, and can impair the ability to attract financing to a project.

VI. SOCIAL IMPACTS

The social impacts of privatization have been limited. Only the contracting out of services has been extensive enough to result in significant social impacts. The effects of contracting out on public employees have been studied by the Department of Labor. The findings of its 1989 study[13] include:

- Job displacement from privatization is limited. Only seven percent of affected workers were laid off. Fifty-eight percent found work with the private contractor, twenty-four percent were placed in other government jobs, and seven percent retired.

- Little public assistance is available to displaced workers. Seven of ten privatizations were not accompanied by the disbursement of unemployment benefits by the government.

- Privatized services both eliminate and create jobs. Privatization causes a reduction of the public-sector work force but an expansion of the private-sector work force. The Department of Labor study found that the reduction in public sector employment was greater than the expansion of private sector employment, leading to a moderate net job reduction.

- Pay, but not benefits, is similar under private and public management. In only four of twenty-eight cases were wages significantly lower after privatization. However, in nearly half of the cases, benefit packages were rated worse with the contractor than with the municipal government.

- Labor turnover rates are not unusually high with private service providers. Roughly sixty percent of workers remained with the private contractor for at least three to five years, indicating a level of job satisfaction commensurate with other private sector jobs.

The social impact of privatization has been mitigated, in part, by the private partners' willingness to abide by certain public-sector labor standards.

VII. CONCLUSIONS

A. Monitoring and Evaluation

There has been relatively little nationwide monitoring and evaluation of privatization. Even on the local level, comparisons of private and public provision of services are infrequent and methodologies differ widely.[14] Some private groups, including The Reason Foundation ("Privatization 1992"), Touche Ross ("Privatization in America"), and the Mercer Group

(1987 survey), have conducted surveys of privatization trends in the U.S.

B. Results

- The U.S. privatization experience has been limited because of the relatively small role of Federal, state, and local governments in the U.S. economy and because the U.S. does not have a coordinated national privatization policy.

- The most successful area of privatization in the U.S. has been contracting out for public services and this area is expected to continue to grow. Governments report substantial cost savings (up to 40%), higher quality, greater flexibility, and shorter implementation time as a result of privatization.

- There is a tremendous potential for private development of transportation infrastructure, however these projects have proved difficult to finance without government financial support. The high demand for infrastructure facilities, continued government fiscal stress, and the implementation of ISTEA should help private infrastructure projects move forward in the future.

- Some state and local enterprise sales may move forward under the April, 1992 Executive Order, however, enterprise sales are not expected to become widespread at the Federal, state, or local level.

Endnotes

1. The Economic Report of the President 1993, United States Government Printing Office, Washington, D.C., 1993, Table B-8.

2. The Economic Report of the President 1993, United States Government Printing Office, Washington, D.C., 1993, Table B-77.

   The difference between government spending and output represents government spending on privately provided goods and services. Disaggregated data on Federal and state and local expenditures as a percent of GNP do not total 34.2% because of Federal grants-in-aid to state and local governments.

3. The Economic Report of the President 1993, United States Government Printing Office, Washington, D.C., 1993, Table B-41.

4. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

5. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

6. Congressional Budget Office.

7. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

8. "Public Investment and Private Sector Growth," David Alan Aschauer, Economic Policy Institute, Washington, D.C.

9. "The 1991 Status of the Nation's Highways and Bridges," Federal Highway Administration.

10. The Washington Post, February 22, 1993, p. A22.

11. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

12. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

13. "Partnership Focus," National Council for Public-Private Partnerships, Washington D.C., June 1990.

14. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

PRIVATIZATION IN THE UNITED STATES

May 25, 1993

I. INTRODUCTION

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In addition, compared to other countries, state-owned enterprises in the U.S. do not account for a substantial portion of total production. The state-owned sector as a share of the value added in production in the mid-1980s is estimated as follows[4]:

Czechoslovakia	97%
East Germany	97
USSR	96
Yugoslavia	87
Hungary	86
Poland	82
France	17
Italy	14
West Germany	11
Britain	11
Denmark	6
U.S.	1

Thus, the U.S. privatization experience has emphasized the private provision of public services and infrastructure facilities rather than the sale of state-owned enterprises.

An additional reason for the limited extent of privatization in the U.S. is the lack of a national government policy or program. U.S. privatization has occurred predominately at the state and local levels, rather than at the Federal level. Despite the lack of a national agenda, many of the local and state governments that have instituted privatization programs share common objectives and methodologies and have experienced similar results. This paper describes U.S. privatization efforts at the state and local levels, as well as the limited Federal experience.

II. OBJECTIVES OF PRIVATIZATION

In recent years, various levels of government in the U.S. (i.e., state governments, local governments, and, in limited cases, the federal government) have increasingly turned to the private sector to provide public services and facilities due to extreme fiscal pressure at all levels of government. Taxpayers have strongly resisted general tax increases while demanding increased levels of health care, education, corrections, police, and other services. As a result:

- More than one in four cities faced a budget gap of 5% or more in 1991[5];
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In spite of the interest and potential of private infrastructure, few projects have actually been financed and constructed. The inability to attract financing to private infrastructure projects has been a major obstacle to implementation. (This is discussed in more detail in Section V). The following projects are close to implementation:

- A $110 million, 2-mile toll bridge linking San Juan, Puerto Rico with the international airport. The project has been financed but with substantial government financial guarantees.

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The Clinton Administration has proposed an additional $4.1 billion in infrastructure spending over the next four years. This increase in public spending, if approved by Congress, may support specific private projects. For example, some of this money may be used to construct highway-railway grade crossings and track improvements for a high-speed rail project from Chicago to St. Louis.

The Administration's plan is unlikely to stimulate broad new interest in infrastructure privatization, however. Congress' reluctance to pass new spending measures will make it difficult to enact even pressing spending initiatives. Moreover, even if Congress appropriates additional money for infrastructure development, the funds may not be used to promote privatization over traditional government procurement methods. Finally, even if the additional funds are used to support private infrastructure development, the value of the money available for privatization projects will be small compared to total infrastructure spending. A 1991 study by the Office of Technology Assessment estimates that Federal, state, and local governments spend approximately $140 billion annually on building, operating, and maintaining infrastructure facilities[11], compared to the Administration's proposed additional infrastructure spending of $4.1 billion over four years.

3. Sale of State-Owned Enterprises

Sales of state-owned enterprises to the private sector have occurred infrequently in the United States due to the limited number of enterprises available for privatization and the public controversy surrounding most proposed sales.

a. Sale of State and Locally-Owned Enterprises

Until last year, one of the most important barriers to privatization was Federal policy requiring that Federal grants be repaid out of the sale price in the same proportion that they were used to fund the development of the enterprise. For example, if a facility had received 50% of its funding from Federal grants, the state or local government would be required to pay up to 50% of the sales price to the Federal government, even if this amount exceeded the original Federal contribution.

An April, 1992 Executive Order of the President reduced the repayment of Federal investment to no more than the amount of Federal grants received less the accumulated depreciation on the grants. In addition, the Executive Order instructed all federal agencies to undertake efforts to privatize and eliminated other barriers to the sale of enterprises with Federal interest. The Executive Order, however, has not yet resulted in increased sales of state-owned enterprises.

State and locally-owned enterprises that have been proposed for privatization include:

- Los Angeles Airport
- Philadelphia Airport
- Massachusetts Turnpike
- New York State Thruway

b. Sale of Federally-Owned Enterprises

Numerous Federally-owned enterprises have been proposed for sale and several have been successfully privatized. The sale of Conrail is an interesting case because the issues faced are similar to those faced in other countries that are undertaking privatization programs.

A summary of the Conrail Privatization is as follows:

- Conrail begins operations in 1976 as a Federally-supported enterprise. Conrail was created from a group of six bankrupt railroad companies with a mandate to revitalize freight rail service in the Northeast-Midwest.
- June, 1984: 14 formal offers are made to the US Government for the purchase of Conrail.
- February, 1985: U.S. Department of Transportation recommends that

Congress approve a sale to Norfolk Southern.

- October, 1986: President Reagan signs legislation to privatize Conrail by public offering. Congressional leaders site transparency as a major reason for selecting a public offering over a private sale.
- March, 1987: Conrail sold in a $1.6 billion public offering, the largest initial public stock offering in U.S. history.
- Conrail has generally been profitable since privatization.

Two other successfully privatized entities are the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC):

- FNMA and FHLMC are government sponsored enterprises that buy home mortgages and sell mortgage-backed securities in the secondary market.
- Both receive government guarantees and are regulated but are privately owned. (FNMA has been privately owned since 1968 and FHLMC has been privately owned since 1989).
- Both are publicly traded on the New York Stock Exchange
- Both are highly profitable

Other enterprises that have been proposed for privatization but continue to be publicly held include:

- United States Postal Service
- Amtrak (the National Railroad Passenger Corporation)
- Naval Petroleum Reserves (two Federally-owned oil fields)
- Alaska Power Marketing Administration
- Bonneville Power Administration
- Tennessee Valley Authority

The barrier to privatization in most of these cases is opposition by affected constituencies which are able to block Congressional approval. In the case of the Postal Service, for example, these constituencies include Postal Service employees (675,000), Postal Service management, and rural residents who fear that privatization will result in higher rural postal rates. In the case of Amtrak, opposition includes Amtrak employees, Amtrak management, and railroad passengers who fear that privatization will result in higher fares and reduced service.

B. Institutional Follow-up

Regulation is often an important issue in the privatization process because most of the services and facilities privatized in the U.S. do not operate in competitive markets. After a privatization transaction is complete, the sponsoring government agency or a government auditor often regulates the private service or facility provider.

Private providers of public services are monitored to ensure that quality, service, price, and safety standards are met. Contracted out services are infrequently regulated on price or profits as these issues are generally resolved in the service contract.

Infrastructure projects and state-owned enterprises that have undue market power, such as toll roads, must be price-regulated or profit-regulated in order to protect the public interest.
Economic regulation is an added risk to private investors and can inhibit the financing of these projects. Some infrastructure projects, such as high speed rail systems, face strong competition and may not require price regulation.

V. TECHNICAL AND LEGAL ISSUES

A. Legal Issues

1. Implementing Legislation

Private entities are often unwilling to participate in privatization efforts without explicit legal authorization. Privatization programs generally require implementing legislation that accomplish many, if not all, of the following objectives:

- authorize a government agency to enter into agreements with private partners to provide services and facilities;
- authorize the collection of user fees on the facility;
- describe any regulatory requirements;
- prohibit the government from expropriating or otherwise impairing the financial viability of a project or enterprise without fair compensation;

2. Tort Liability

Tort liability[12] is an increasingly important legal consideration for private owners and operators of public-use facilities. Public-use facilities are exposed to substantial law suits resulting from personal injuries. The potential for tort claims can seriously impair the ability of a project to attract financing.

3. Federal Grant Restrictions

Federal grant restrictions have been an important legal constraint to privatizing facilities that have been developed with Federal funds. Until last year, Federal regulations required state and local governments to share proceeds of enterprise sales on a prorated basis with the Federal government for facilities built with Federal funds. This and other Federal policies effectively blocked the sale of airports, roads, and other publicly-owned facilities to private investors. These restrictions were relaxed in an April, 1992 Executive Order, as described earlier.

4. Federal Tax Law

The tax treatment of public and private infrastructure projects has had an important impact on privatization. The Federal tax code exempts from Federal income tax the interest earnings on bonds issued to finance facilities used by governments. The interest on most bonds issued to finance private facilities, however, is generally subject to Federal income taxes. As a result of this discrepancy, the cost of financing for private projects can be substantially higher than that of publicly controlled projects. This tax bias against private projects has been a significant barrier to privatization.

A coalition of privatization advocates (the Infrastructure Alliance) has proposed to eliminate the tax bias by broadening the use of tax-exempt debt to privately built or owned infrastructure projects. Such legislation, however, is not expected to be enacted in the near future because of its potential cost to the Federal treasury.

B. Privatization Programs

As mentioned earlier, there is no national privatization policy or program. States and localities wishing to privatize have developed their own privatization programs on an ad hoc basis. These programs are frequently targeted at providing specific services or facilities, for example:

- Chicago's municipal contracting program has privatized management of city parking lots, towing of cars, janitorial functions, and other services;

- Pennsylvania recently privatized operation of three state hospitals that might otherwise have ceased operation;

- California Assembly Bill 680 authorized the California Department of Transportation to grant franchises for the development of four private transportation projects;

- The Florida High Speed Rail Act authorizes private development of high-speed rail service.

Many other state and local governments have implemented or are considering programs for private services or facilities. Although there is no nationally coordinated program, the state and local programs often share common objectives and methodologies.

C. Organization of Privatization Programs

Municipal contracting offices are generally responsible for contracting out for private service delivery, while state agencies are responsible for administering private infrastructure programs (e.g., the State Department of Transportation for transportation projects). Other institutions, such as Public Utility Commissions, may also be involved in the post-privatization monitoring process.

Privatization involves complex legal, financial, regulatory, and technical issues that are often beyond the expertise of government officials. Consequently, governments often employ lawyers, financial advisors, and technical experts to advise them during the privatization process.

D. Structure of the Privatization Process

Ninety-four percent of municipalities surveyed contracted out services by competitive bid[13] and ninety percent of municipal contracts are on a fixed price basis.[14] Although selection criteria vary by municipality and by service, the major criteria generally include:

- cost;
- quality level and consistency of services provided;
- past experience of the contractor.

Infrastructure facilities are privatized through a franchise agreement with a private partner to finance, develop, own, and/or operate a facility. The private partner is usually selected based on detailed proposals submitted through a competitive bidding process. The terms of the agreement are then developed through extensive negotiation between the public and private partners. The infrastructure privatization process generally involves the following steps:

i. Development of privatization program
ii. Issuance of Request for Proposals
iii. Evaluation and selection of private sector proposals
iv. Negotiation of franchise agreement between public and private sectors
v. Implementation of franchise agreement and development of facility

Public share offerings have often been used for sales of state-owned enterprises. Conrail, FNMA, and FHMLC were all privatized through public share offerings.

E. Conditions for Privatization

Performance requirements are frequently included as part of all types of privatization agreements. They are especially important to municipalities contracting out services because of the need to ensure that the service is acceptable in terms of quality (citizens may have no alternatives to the municipal contractor), that it is consistent, that it is available to the municipal constituents in need, and that it meets environmental and other requirements. Many of these performance requirements are monitored by the sponsoring government agency or by the municipal contracting office.

Private infrastructure projects are required to meet safety, construction, and environmental standards set by the Federal, state, and local governments. In addition, infrastructure projects may be price-regulated or profit-regulated, as discussed earlier.

F. Opposition to Privatization

The most often cited obstacle to public service privatization is the opposition of public employee unions. Unions that oppose privatization often cite the following concerns:

- immediate job losses
- long-term job security
- loss or reduction in civil service benefits
- loss or reduction in pension benefits

The most immediate concern of civil servants is the loss of their jobs. If the form of privatization is contracting private companies to engage in formerly public services, the public service jobs may no longer be necessary. In addition, civil servants fear that the private concern will reduce the number of jobs in order to attain greater efficiencies regardless of the type of privatization. A reduction in employment is not automatic; if the new company is able to expand the business or services it provides, it may actually increase employment.

Often, however, employment reductions do follow privatizations. Thus, many unions and civil service employees oppose privatization efforts. It is imperative that governments work with local unions to structure the privatization in such a way as to minimize the negative effects on the employees.

There are many ways to mitigate employee opposition to privatization:

- If the government is contracting for services, it can require the private concern to hire the government employees.

- Governments can require the new company to establish a no-fire policy or minimum employment levels for a given period of time. Even under a no-fire policy, significant reductions in the work force can be made through attrition. Additionally, if service is expanding, revenues per employee can increase without a reduction in the work force.

- Companies may offer generous severance packages to employees. Severance packages can be used to significantly reduce the work force. Furthermore, since the acceptance of the packages are voluntary, worker opposition is low.

- The government or the new company can offer job retraining for displaced workers. The effectiveness of job retraining, however, is unclear.

- The government can promise to absorb all displaced workers. This option, however, is very costly and reduces much of the benefit created from privatization.

Similar methods can be used to mitigate concerns about losses or reductions in benefits. For example, a government can require that a company maintain a level of benefits commensurate with the public sector as a precondition to privatization.

G. Private Participants

The private contractors for municipal services vary tremendously by service sector and region. Many services, such as solid waste collection, are provided by large companies under contract to numerous municipalities across the U.S. However, smaller, regional contractors do provide some services, such as janitorial services.

The private participants in infrastructure development are often consortia of engineering, construction, management, and banking firms. These consortia have extensive experience in all aspects of the planning, construction, financing, and operation of infrastructure projects.

State-owned enterprises have often been sold to the general public through public share offerings.

H. Financing Privatization

Private municipal service delivery is generally not a capital intensive activity. Financing these services is usually the responsibility of the private contractor and has not been a major barrier to privatization. Private contractors are often large corporations with established financial records and access to capital.

Potential sources of financing for private infrastructure projects include international banks, institutional investors, bond issues, and private equity investors. However, the inability to attract financing to private infrastructure projects has been a major obstacle to implementation. Infrastructure developers have experienced substantial barriers to financing, including:

- Unavailability of tax-exempt debt
- High business, political, and tort risk associated with private infrastructure development
- Reluctance of financial markets to finance the first private projects with no government financial support
- Lack of sophistication on the part of public managers attracting private infrastructure providers
- Local opposition and environmental regulations (these affect both private and public projects)

Other countries have been more successful in implementing private infrastructure projects because they have been willing to extend extensive financial guarantees to project investors.

The Puerto Rico toll bridge, one of the few public-private infrastructure projects financed in the U.S. to date, is heavily supported with financial guarantees from the Puerto Rico Highway and Transportation Authority.

The Intermodal Surface Transportation Efficiency Act (ISTEA) of 1991 will provide an additional source of financing for private projects by allowing Federal highway funds to be used for the construction and rehabilitation of public <u>and</u> private toll facilities. ISTEA should greatly expand the opportunities for private development of toll highways, bridges, and tunnels.

Sales of state-owned enterprises have often been executed through public offerings which have not faced major barriers due to the depth of U.S. equity markets.

I. Environmental Aspects of Privatization

Environmental considerations have not been a major issue for contracting out of municipal services. Private service providers must follow the same environmental laws and regulations that are applied to public providers and are subject to fines and damaged reputations for violations of these rules.

Environmental regulations have been a barrier to private infrastructure development. Infrastructure facilities must undergo a rigorous environmental permitting process before beginning construction. The process often requires the private developer to undertake time consuming and expensive environmental assessments which increase project costs and risks, and can impair the ability to attract financing to a project.

VI. SOCIAL IMPACTS

The social impacts of privatization have been limited. Only the contracting out of services has been extensive enough to result in significant social impacts. The effects of contracting out on public employees have been studied by the Department of Labor. The findings of its 1989 study[15] include:

- Job displacement from privatization is limited. Only seven percent of affected workers were laid off. Fifty-eight percent found work with the private contractor, twenty-four percent were placed in other government jobs, and seven percent retired.

- Privatized services both eliminate and create jobs. Privatization causes a reduction of the public-sector work force but an expansion of the private-sector work force. The Department of Labor study found that the reduction in public sector employment was greater than the expansion of private sector employment, leading to a moderate net job reduction.

- Pay, but not benefits, is similar under private and public management. In only four of twenty-eight cases were wages significantly lower after privatization. However, in nearly half of the cases, benefit packages were rated worse with the contractor than with the municipal government.

- Labor turnover rates are not unusually high with private service providers. Roughly sixty percent of workers remained with the private contractor for at least three to five years, indicating a level of job satisfaction commensurate with other private sector jobs.

The social impact of privatization has been mitigated, in part, by the private partners' willingness to abide by certain public-sector labor standards.

VII. CONCLUSIONS

A. Monitoring and Evaluation

There has been relatively little nationwide monitoring and evaluation of privatization. Even on the local level, comparisons of private and public provision of services are infrequent and methodologies differ widely.[16] Some private groups, including The Reason Foundation ("Privatization 1992"), Touche Ross ("Privatization in America"), and the Mercer Group (1987 survey), have conducted surveys of privatization trends in the U.S.

B. Results

- The U.S. privatization experience has been limited because of the relatively small role of Federal, state, and local governments in the U.S. economy and because the U.S. does not have a coordinated national privatization policy.

- The most successful area of privatization in the U.S. has been contracting out for public services and this area is expected to continue to grow. Governments report substantial cost savings (up to 40%), higher quality, greater flexibility, and shorter implementation time as a result of privatization.

- There is a tremendous potential for private development of transportation infrastructure, however these projects have proved difficult to finance without government financial support. The high demand for infrastructure facilities, continued government fiscal stress, and the implementation of ISTEA should help private infrastructure projects move forward in the future.

- Some state and local enterprise sales may move forward under the April, 1992 Executive Order, however, enterprise sales are not expected to become widespread at the Federal, state, or local level.

Endnotes

1. The Economic Report of the President 1993, United States Government Printing Office, Washington, D.C., 1993, Table B-8.

2. The Economic Report of the President 1993, United States Government Printing Office, Washington, D.C., 1993, Table B-77.

   The difference between government spending and output represents government spending on privately provided goods and services. Disaggregated data on Federal and state and local expenditures as a percent of GNP do not total 34.2% because of Federal grants-in-aid to state and local governments.

3. The Economic Report of the President 1993, United States Government Printing Office, Washington, D.C., 1993, Table B-41.

4. "Business in Eastern Europe," The Economist, September 21, 1991, p. S10.

5. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

6. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

7. Congressional Budget Office.

8. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

9. "Public Investment and Private Sector Growth," David Alan Aschauer, Economic Policy Institute, Washington, D.C.

10. "The 1991 Status of the Nation's Highways and Bridges," Federal Highway Administration.

11. "Financing the Future," Report to the Commission to Promote Investment in America's Infrastructure, February 23, 1993, p. 11.

12. Tort liability is defined as a private or civil wrong, other than a breach of contract, for which the justice system can provide a remedy in the form of an action for damages. For example, a highway owner may be liable for damages if an accident occurs due to negligent construction and/or maintenance of the highway.

13. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

14. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.

15. "Partnership Focus," National Council for Public-Private Partnerships, Washington D.C., June 1990.

16. "Privatization 1992," The Reason Foundation, Los Angeles, CA, 1992.