

7. "Strategies employed in successful privatization efforts: Rx for privatization" by Steve H. Hanke

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PRIVATIZATION EFFORTS: Rx FOR PRIVATIZATION

by

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A paper presented at the International Conference
on Privatization, sponsored by the U.S. Agency for
International Development

Washington, D.C.
February 17-19, 1986

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Introduction

Changes in the thinking and evaluations of at least some government officials are a precondition of any successful privatization effort. Either the learning experience of incumbents or their replacement by other individuals effect these changes. Therefore, it is essential to the success of any privatization strategy that relevant theory and evidence be marshaled in such a way that it becomes part of the knowledge and understanding of present and future government officials. This strategic component has been fulfilled to some degree wherever privatization efforts have been successful.

This essay presents the theory and evidence about the comparative costs (production efficiency) of private versus public supply (independent from finance) of goods and services. In doing so, it provides information deemed most likely to effect the changes in government officials which must occur in order for any privatization strategy to succeed.

Much of this essay, then, does not concern itself with the myriad variations which exist among privatization strategies. Though variations among privatization strategies are assuredly important for differentiating between those with successful outcomes and those which fail, it stands to reason that the most important thing we can learn about successful privatization strategies is what they most frequently have in common.

The first step in ascertaining the common elements among strategies employed in successful privatization efforts, is to determine the conceptions which individuals (especially government officials) must hold in order for them to perceive privatization opportunities. The opportunities for privatization must be seen in order for efforts, and any privatization strategy, to ensue.

The greatest privatization failures are also the most ubiquitous. They consist of the myriad opportunities for privatization which go unperceived. These millions of instances are characterized by no privatization effort and strategy whatsoever. And they point up the critical importance of the theory and evidence which imbue individuals' conceptions of the world about them.

It is the task of this essay to delineate the theory and evidence most essential to cultivating privatization strategies and, then, ensuring their success. In launching this task, it is appropriate that we dispense with a misconception which prevents, more frequently than any other, the perception of privatization opportunities.

The Separability of Supply and Finance

It is frequently contended that various goods and services must be supplied by government because the poor would not be able to afford the prices which private suppliers would have to charge in order to recover their costs. By this view, any goods and services whose costs to consumers a government has decided to subsidize (finance, in whole or in part) must be supplied by the

government. This view is patently false. A government which provides food stamps to consumers (financing by voucher), for example, need not send bureaucrats into the fields to become food suppliers.

Goods and services can be supplied by privately or publicly owned enterprises. These enterprises can be financed, in part or in full, by revenues from private or public sources. In principle, the issues about private versus public supply are separable and independent from those about private versus public finance.

Upon attaining a conception of the supply of goods and services which is not contaminated by issues of finance, an individual will recognize opportunities for privatization that would have been otherwise impossible. Freed of this basic misconception, the individual can appreciate the importance of the theory and evidence about the comparative costs (production efficiency) of private versus public supply which appear on the following pages, and why the issues surrounding the merits of private versus public finance are not considered in this essay.

Theory

Property-rights arrangements provide the key to understanding the behavior of private and public employees and the performance of private and public enterprises. Private enterprises (assets) are owned by individuals who are free to use and transfer, within the confines of the law, their private property (assets). Consequently, those who own private property have residual claims on private enterprises' assets.

When private enterprises produce goods and services that

consumers demand, at costs that are lower than market prices, profits are generated. As a result, property owners' wealth is increased. Alternatively, if the costs of privately supplied goods and services exceed their market prices, losses are incurred. In consequence, the value of private enterprises' assets declines and their owners' wealth is diminished. Hence, the owners of private firms not only appropriate the gains but also bear the costs that result from the way in which private property is used. In short, private property owners must ultimately face the "bottom line."

The incentives created by private property rights -- by the linkage between the consequences of the use of private assets and their owners' wealth -- have profound consequences. Private owners face significant incentives that make it desirable to monitor the behavior of private enterprise managers and employees, so that they will tend to supply what consumers demand and do so in a cost-effective way. Consequently, private managers and employees find it difficult to engage in shirking behavior or behavior that is inconsistent with maximizing the present value of the private enterprise (the owners' wealth). Hence, private property puts in place incentives that tend to generate efficient performances by private firms.

By way of contrast, public enterprises are not "owned" by individuals who have a residual claim on the assets of these organizations. The nominal owners of public enterprises, the "taxpayer-owners," cannot buy and sell public enterprise assets. Consequently, "taxpayer-owners" do not have strong incentives to

monitor the behavior of public managers and employees. "Taxpayer-owners" could capture some benefits from increased efficiency of public enterprises through tax reductions. However, if realized, incremental benefits from improved efficiency would be spread over many taxpayers, so that individuals' benefits would be rather small. In addition, individuals' cost of obtaining these benefits -- acquiring information, monitoring bureaucrats, and organizing an effective political force to modify the behavior of public managers and employees -- would be very high.

The consequences of public ownership are predictable. Public managers and employees allocate resources (assets) that do not belong to them. They do not bear the costs of their decisions, nor do they appropriate the gains from efficient behavior. Since the nominal owners of public enterprises (the taxpayers) have little incentive to monitor public managers and employees, the cost of shirking to a public bureaucrat is low. Consequently, public managers and employees tend to engage in shirking activity and the acquisition of various perquisites that increase production costs. After all, the costs of shirking and perquisites are borne by taxpayers who have little incentive to police these activities, while the gains from them (more leisure and an easy life) all accrue to the public bureaucrats.

Private enterprises make plans based on what they expect consumers to demand and what they anticipate costs to be. Private owners bear the costs and capture the benefits associated with implementing their plans. While public enterprises also plan, their plans are fundamentally different from private plans, because they are developed by bureaucrats who neither bear the

costs of their mistakes nor legally capture the benefits generated by foresight. Hence, from a theoretical point of view, private and public managers and employees can be expected to behave in different ways. In consequence, private firms will tend to be more efficient than public firms.¹

Empirical Evidence

Although economic theory, as well as common sense, strongly supports the notion that private enterprises should be more efficient and productive than public enterprises, one question remains: Does the evidence support the theory?

Administrative Functions

Studies in the United States show that administrative functions are performed at lower costs by private than by public enterprises. For example, the costs of maintaining and pursuing comparable accounts receivable are 60 percent less for private firms than for the federal government. In addition, the federal government requires one year or more to obtain a judgment against a bad debtor, whereas private firms require only five months. In consequence, the federal government writes off bad debts when they reach about \$600. The comparable figure for private firms is \$25.²

The costs of processing payroll checks represents another administrative function. Each issued check by the U.S. Army costs \$4.20. The same function is performed by large private enterprises at a cost of \$1.00 per check.³

The cost of processing a public Medicare claim averages about 26.5 percent more than that of a comparable private health

insurance claim. Moreover, private claims are processed more rapidly and at a lower error rate.⁴

Airlines

Evidence from Australia shows that private airlines are more efficient than public ones. Australia's public and private airlines operate with the same equipment, tariffs, routes and departure times. However, data from 1958 through 1974 show that the private airline carried 99 percent more tons of freight and mail and 14 percent more passengers per employee than did the public airline. In addition, private revenues earned per employee were 12 percent higher than for the public⁵ airline.

Banking

Data from a large government-owned bank in Australia, one large private bank, and five smaller private banks show that, during 1962-1972: The public bank had lower ratios of profits to assets, of profits to deposits, of profits to capital, and of profits to expenses than did the private banks.⁶ Again, data from Australia support the hypothesis that private are more efficient than those of public enterprises.

Custodial Services and Building Maintenance

When custodial services are transferred from the U.S. Department of Defense to private firms, the savings range from five to 25 percent.⁷ Some public schools in New York City have also transferred their custodial services to private firms,⁸ and the savings have averaged 13.5 percent

Data about the cost of custodial services in West Germany

also show that private are more efficient than public enterprises. Private custodial services for government offices in Hamburg are between 30 and 80 percent less costly than public custodial services. For the federal post office system, private custodial services are 30 to 40 percent less costly than public custodial services.⁹

Electricity

A comparison of 95 publicly owned hydroelectric plants with 47 privately owned plants in the United States shows that the cost per kilowatt-hour was 21 percent higher, on average, in the public than in the comparable private plants.¹⁰

Fire Protection Service

There are 17 private fire companies that operate in 14 different states in the United States. The private companies operate at about a 50 percent lower cost and with a higher quality of service (measured by better fire insurance ratings) than do public companies in comparable cities.¹¹

Forestry

Commercial forest lands owned by the United States government generate annual negative cash flows of about \$11 per acre, while private timberlands, on average, generate positive cashflows. The high costs of preparing timber for sale on public lands (\$80-\$100 per 1,000 board feet), compared to costs on private lands (\$10 per 1,000 board feet), explain, in large part, the differences in cash flows on public and private lands.¹²

Data from West Germany are similar to those from the United States. Public forest lands in West Germany generate annual negative cash flows (30DM per hectare), while private timberlands

generate positive cash flows (15DM per hectare).

Hospitals and Health Care

The U.S. federal government, through the Veterans' Administration (V.A.), operates the largest health care system in the United States. When compared to private nonprofit and profit systems, the V.A. system is much more costly. For example, the construction cost per bed for V.A. hospitals is 50 percent higher than private, nonprofit hospitals. And the construction cost per bed for V.A. nursing homes is almost 290 percent higher than comparable private nursing homes.¹⁴ These cost differentials are explained, in large part, by the fact that the V.A. construction programs are over-administered and wrapped up in bureaucratic red tape. For example, the V.A.'s construction administration staff, on a per-bed basis, is about 16 times larger than comparable private sector staffs, and the length of time from construction project initiation to completion is 3.5 times longer for V.A. projects than for private ones.¹⁵

The V.A.'s operating costs are also much higher than those of private hospitals. The average cost at V.A. hospitals, compared to private ones, is 70 percent higher per episode for acute in-patient care, 48 percent higher for surgical care, and 140 percent higher for nursing home care.¹⁶

Military Support and Maintenance

For a wide range of military support and maintenance activities, private firms in the United States provide the same quality and quantity of services at cost savings that, depending on the service, range from 0.1 to 35 percent. When all

military installation support services are contracted out to
private firms the savings are about 15 percent.¹⁷

Nationalized Industries

Evidence from Western Europe reveals that nationalized industries produce a wide variety of goods and services. When compared to their private counterparts, sales per employee are lower for nationalized firms. Adjusted profits per employee are lower. Physical production per employee is lower. Taxes paid per employee are lower. Per dollar of sales, operating expenses plus wages are higher. Sales per dollar investment are lower. Profits per dollar of total assets are lower. Sales per employee grow at a slower rate. And, with the exception of nationalized oil companies, nationalized enterprises typically generate accounting losses.¹⁸

Postal Services

Parcels are delivered in the United States by the U.S. Postal Service and private carriers. The largest private carrier handles twice as many parcels as the U.S. Postal Service, has lower tariffs, makes faster deliveries and has a damage rate that is less than the U.S. Postal service. Moreover, the private firm generates accounting profits, whereas the U.S. Postal Service typically generates losses.¹⁹

Property Assessment

The State of Ohio requires that state and local property assessments be conducted by private appraisers, while the bulk of the property assessments in most other jurisdictions are conducted by public appraisers. The average cost per assessment

in Ohio is 50 percent lower than the national average. In addition, the quality of the assessments in Ohio -- measured by the relationship between appraised values and actual property sales prices -- is the highest in the nation.²⁰

Railroads

Labor employed by America's public passenger rail line, Amtrak, is much less productive than that employed by four comparable private lines. For example, the average member of an Amtrak work crew repairs 2,652 rail ties annually, while his private counterpart repairs 26,321 rail ties. An Amtrak crew member removes about 0.56 miles of rail annually, and a private crew member removes 4.47 miles of rail annually. A private crew member resurfaces 48 miles of roadbed annually, compared to only 8.84 miles of resurfacing by an Amtrak crew member.²¹

Refuse Collection

A nationwide study of 1,400 communities in the United States found that, after controlling for factors that determine costs, private refuse collectors are about 30 percent less costly than public collectors.²² Similar results have been reported for Canada and Switzerland.²³

Ship Maintenance

Even though private commercial ships are at sea 128 more days per year than comparable U.S. Naval support ships, the annual maintenance costs for the Naval support ships is 427 percent higher than for private ships.²⁴

Streets and Highways

Street and highway maintenance is one of the few functions

in which comparative cost analyses are available for private versus public supply in less developed countries. For example, a detailed evaluation of the costs of 19 types of road maintenance functions in Brazil showed that private contracted-out road maintenance was less costly than that performed in-house by the Brazilian National Highway Department. On a weighted average basis, the cost for these 19 functions was 37 percent less, when they were all supplied by private contractors.²⁵

Urban Transportation

Considerable data about the comparative efficiency of private versus public transport exist. They support the proposition that private suppliers are more efficient than public providers. For example, in Australia, private urban bus systems cost almost 42 percent less, per kilometer, than do public systems.²⁶ In West Germany, the nationwide average cost for public urban buses is 150 percent higher per kilometer than that of private buses.²⁷ In Abidjan, Ivory Coast, private minibuses produce three times as many vehicle miles per employee as do public buses.²⁸ In Puerto Rico, private minibuses' operating costs are 59 percent lower than public buses.²⁹ In New York City, the cost per vehicle hour is 10 percent lower for the private than public buses.³⁰ In Istanbul, the cost per seat, per kilometer, is about 50 percent lower for private minibuses than for public buses.³¹ In Calcutta, the capacity cost per kilometer is 35 percent less for the private than public buses.³²

Water Supply

Data from a sample of 24 private and 88 public water enterprises in the United States were used to construct a water cost model. From this model, it can be concluded that average operating costs per thousand gallons of water produced is 25 percent lower (other determinants of costs held constant), when water is produced privately rather than publicly.³³

Weather Forecasting

Weather forecasting at National Airport in Washington, D.C. was performed by a public entity. Now a private firm performs this task. As a consequence of the switch from public to private supply, costs have been reduced by 37 percent and the quality of the forecasts has improved.³⁴

Implementation

The evidence from the expost cost studies presented is representative of the more extensive literature which strongly supports the notion that private supply is more efficient than public supply. The evidence should surprise no one who understands both the separability of issues regarding the supply of goods and services from those regarding their financing and the theory which both explains and anticipates the positive results of privatization.

For the individual whose understanding has reached the advanced stage described in the preceding paragraph, a critical question still remains: how can we best implement this desirable policy called privatization?

This question is difficult even for public officials who

have acquired sufficient understanding and receive strong support from government leadership. For example, President Raul Alfonsin appointed Manuel Tanoira to find ways of selling some 350 of the enterprises owned by Argentina's government. Looking to turn the building of high-volume grain ports over to private developers, Mr. Tanoira provided indication of his advanced understanding by explaining that "You can't have the state running a grain port...It's like flying an airplane by decree."³⁵ Months later, however, Mr. Tanoira reports that the Public Works Ministry is resisting efforts to allow outside bidders to remodel a vital grain port, and charges that two of his efforts to organize privately built phone systems have been thwarted by the state telephone company's launching parallel programs of its own. "The bureaucrats are interested in one thing, holding on to their power," Mr. Tanoira says angrily. "That a project might be better handled by someone else is of no importance to them."³⁶

So, even when government leadership strongly supports the desirable policy called privatization, the critical question still remains: How can it best be implemented? Two generic approaches can be employed: The technocratic approach and the political one.

Although these approaches are not necessarily mutually exclusive, they will be treated here as if they were. The technocratic approach requires public bureaucrats to apply techniques that are used in the private sector to promote efficiency. For example, in choosing whether to privatize the production of goods and services produced in-house within the Federal government of the United States, bureaucrats use, or are

supposed to use, the Office of Management and Budget's Circular A-76. This document defines policies and procedures for comparing the costs of public versus private provision. In principle, if the results of an A-76 evaluation reveal that public costs are greater than private costs, then the activity in question should be privatized. By employing this technocratic procedure, goods and services used by the government should be supplied in the least-costly way.

Another technocratic approach has recently been suggested for determining whether real assets held by public entities should be retained or privatized. To employ the suggested procedure, the rates of return on real assets should be calculated, and if the rates fall below a predetermined target rate of return, then the assets should be privatized.³⁷

A-76, which was first introduced in 1955, has been infrequently used. Moreover, when it has been employed, it has been highly biased toward retaining the production of goods and services within the federal government. Although the technique described for determining whether real assets should be retained or privatized represents only a proposal, there is little hope that, if implemented, it would be more successful than A-76. Manuel Tanoira, at least, would not be surprised.

The reason why the technocratic approach is bound to fail and why the public sector cannot mimic the private sector centers on the differing incentives created by public and private property. In the private sector, the owners of private property can augment their wealth only by continually applying techniques that will

ensure that the least-costly production techniques for supply are employed. In addition, private owners must determine the rates of return on assets that they hold in their portfolios, so that they can determine which ones to retain or sell. The public bureaucrats do not benefit from these incentives, when they attempt to apply private-sector techniques for improving efficiency. This does not imply that the public bureaucrats are neutral with respect to the application of private-sector efficiency techniques and to the retention versus privatization options. Public bureaucrats are biased toward retention, because their job security and personal incomes are tied to retaining public assets and public production of goods and services. In short, it is in bureaucrats' personal interests not to apply the private-sector efficiency techniques in an even-handed way.

Given the bureaucratic biases and past failures of the technocratic approaches to public-sector efficiency, the most promising method for implementing privatization is the political approach. The political solution amounts to nothing less than passing legislation that mandates privatization. For example, a bill currently being debated in the U.S. Senate (S. 1746) would do just that. It would simply prohibit the federal government from engaging in most of the 11,000 commercial activities that it is now engaged in. Although this type of political solution might be initially more difficult to gain support for than a technocratic solution, the results from adopting a political solution appear to be much more assured than the application of the technocratic approach.

In gaining political support for privatization policies,

advocates should be clear as to what the real issues are, and they should also avoid false arguments. For example, those who oppose privatization often argue that private supply of public goods and services is unacceptable because the poor cannot afford to purchase from private suppliers. This argument about the poor should have nothing to do with the choice between private and public supply. The issue about the poor concerns the choice between private and public finance. The point here is simply that decisions about supply and finance are separable issues and should not be aggregated. If private supply is most cost-effective, it should be advocated. To the extent that the poor require assistance in purchasing privately supplied goods and services, public finance, through vouchers, can be employed to deal with this issue.

Before concluding this discussion of privatization implementation, it is important to mention that the propensity of politicians to impose price controls on goods and services, once they are supplied by private enterprise, can create serious problems and dramatically hinder the ability of private firms to perform. In the United States, for example, price controls are one of the major reasons why so many activities that were originally supplied by private firms are now supplied by public entities. The problems occur in the following way: private firms raise nominal prices, either because service improvements are mandated or because of inflation; this brings forth demands for politicians to control prices; after price controls, the private firms find that the only way they can maintain profit

margins is to reduce the quality of services; as service declines, the public becomes anxious and demands that the private firms be taken over by a public entity because the private firms are not capable of providing reliable service. ³⁸

Deregulation, therefore, is an important element that must accompany any privatization projects. Market demand and supply should be allowed to control prices for successful private provision of public goods and services. If, for political reasons, it is determined that market-determined prices are too high and certain groups of individuals within the service area cannot afford to pay for privately supplied services, price controls should be avoided. In these cases, public finance, through the use of vouchers given to needy individuals, should be considered as a mechanism to assist individuals in their purchase of "necessary" goods and services whose prices are determined in deregulated, open markets.

For those who wish to advocate privatization, the rules for success should be rather clear: (1) present the theoretical arguments and empirical evidence that demonstrate the superiority of private supply; (2) keep all debate concerning the choice between public and private finance separate from the choice between public and private supply; (3) keep all decisions concerning private versus public supply out of the hands of public bureaucrats (minimizing, also, the role of "private" business representatives whose principal income is derived from government); and (4) make certain that deregulation accompanies privatization. Only strategies that adhere to these rules should be expected to yield successful privatization efforts. ³⁹

Footnotes

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