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PRIVATIZATION PRIMER

How Government Can
Deliver Better Services
While Cutting Costs

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Introduction

In the years since the end of World War II, spending at all levels of government has risen faster than the rates of inflation and population growth combined. Part of the explanation for this dramatic increase in public sector outlays is that government is attempting to do more than ever before. Whether government should be attempting so much is an important issue, but one beyond the scope of this paper.

Coping with the financial stress of trying to do more can be difficult. In Arizona, forecasts for the state budget project deficits of \$70 to \$140 million for fiscal 1989. Governments at all levels in the state have accumulated debts in excess of \$1 billion. The need to deal with these financial issues has encouraged many people to consider the option of privatization.

One of the attractions of the concept of privatization is its independence from the issue of whether there is or isn't a real need for a particular public service. This allows for an alternative between an "all or nothing" choice for existing or proposed services. Whether one believes a government should or shouldn't provide a specific service, it is possible for both advocates and opponents to agree that reducing the cost of the service is a good idea. The savings generated through cost reductions could be used either to provide more of the service or to lower the tax burden. Since the primary focus of privatization is reducing the cost of providing services, it is

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an idea that has appeal for both liberal and conservative agendas.

What Is Privatization?

Privatization is a general term for a public sector policy of making more intensive use of the private sector in the provision of services for the public benefit. The privatization process can be as simple as contracting for a private firm to perform some service, say trash pick-up, that might otherwise necessitate the hiring of additional government employees and the acquisition of required tools and equipment to perform. Or privatization might be more comprehensive--involving the divestiture of assets and complete withdrawal from a previously provided service by the government. The federal government's sale of Conrail is an example of a more comprehensive type of privatization.

In all cases, the objective of privatization is to reduce the cost of supplying the service. In some cases, an ancillary objective is to raise funds for other government uses. The sale of Conrail netted almost \$2 billion for the federal government. Raising funds in this manner can be used to support other public programs or to reduce budgetary deficits. In periods of anticipated revenue shortfalls, privatization becomes an attractive alternative to having to discontinue services. Reductions in cost may enable service levels to be maintained at lower revenue levels. Funds obtained from the divestiture of some assets may enable the continuation of other services that might have been cut from the budget.

In short, privatization is a means of achieving the same level of service at lower cost, or a higher level of service at the same cost. Either way, the cost for each unit of service rendered will be lowered through the privatization process. The end result is greater efficiency in how tax dollars are spent.

Why Privatization?

On a theoretical basis, it should be possible to achieve efficiencies without privatization. After all, the private sector firms providing services of the sort that would be candidates for privatization rarely owe their superior efficiency to patented technologies or secret processes. So, it is not technically infeasible for the public sector to emulate highly efficient private firms. However, experience has shown that from an institutional perspective, there are significant impediments to public sector efficiency.

The institutional inefficiencies of the public sector fall into two broad classifications. On the one hand, there are difficulties imposed by politics. These include the special interest effect, electioneering abuses, and jurisdictional

disputes. On the other hand, there are problems arising from the nature of public sector bureaucracies. These include monopoly, access to tax financing, and the accumulation of redundant personnel. Ironically, the public sector offers politics as the remedy to the evils of bureaucracy and bureaucracy as the remedy to the evils of politics. The civil service tenure system prevalent in government bureaucracies was devised to counter the excesses of the political spoils system (i.e.: the placement of political supporters in public service jobs). At the same time, politics offers the only hope for the people, through voting, to have any control over the bureaucracy, as the elected politicians control the appropriations process.

While the political process may present the opportunity to control bureaucracy, its extensive authority over the legislative power creates its own incentives for inefficiencies. Getting elected may require substantial resources. Obtaining these resources may be easier if the urgent demands of generous special interests are met. Likewise, special interests having an important political agenda may find it advantageous to fund or otherwise support compliant candidates. In either instance, the broader interests of the community, state, or nation could be shunted aside in order to cater to these special interests.

The dynamics of the political process also create an incentive for electioneering abuses like pandering to voters by making expensive promises, the costs of which are intended to be passed on to someone else. The most likely victims are taxpayers in other states or future generations. It is politically advantageous to propose to deliver new stadiums, rail lines, hospitals, etc., that will provide immediate benefits for local voters, even though there are larger total costs, because these costs will be borne by non-voters (i.e.: persons residing in other political jurisdictions or persons currently too young to vote or as yet unborn). Projects that return only pennies on the dollar make political sense because the few pennies of benefits are concentrated locally, while the dollars of cost are dispersed or deferred. Yet, such projects are the epitome of inefficiency.

Finally, politics is prone to jurisdictional disputes that impede cooperation for mutual benefit. The boundaries of a jurisdiction may be inappropriate for the scale of operations most conducive to efficiency. A community may be too small to enjoy the possible economies of scale optimal for the provision of a particular service, but unable to cooperate with nearby communities having different political priorities. Conversely, a particular service might be effectively and efficiently feasible for only a part of a community. However, political pressure to extend the service to the rest of the jurisdiction may push beyond reasonable limits of effective service.

Municipal transit operations frequently provide examples of inappropriate scale on both ends. Jurisdictional jealousies or regulatory constraints often prevent the passage of transit vehicles beyond city limits. Since many passengers may have

origins and destinations on opposite sides of such boundaries, considerable inconvenience and inefficiency can be generated. At the other end of the spectrum, the successful operation of transit in a high travel density corridor frequently engenders political pressure to extend routes into low density areas in order to be geographically "fair" or "balanced." The result is underutilized and excessively costly service.

While politics make a contribution to the inefficiencies of government operated services, so too does bureaucracy. Perhaps the most prominent feature of government operations is their monopoly character. Community residents are faced with one provider of the service: the city, county, state or federal government. There are no competing vendors to patronize--or if there are, their customers must pay twice: once for the unconsumed government service and then again for the service supplied by the private vendor. The prototypical public sector monopoly is the public school system. All taxpayers are required to pay for it, whether they use it or not. Competing private schools are hampered by the diminished financial resources of their potential customers. For many people of modest means there is no choice. Public school is their only affordable option.

Monopolies have a tendency to take their customers for granted. The responsiveness to consumer desires for improved or different services is muted when competition is lacking. The substitution of voter sovereignty as a means of monitoring the quality and efficiency of a public monopoly is inferior to the consumer sovereignty enjoyed when competition is robust. Voters can organize and campaign for better public schools, or changes in municipal transit, or more sanitary waste collection. If enough people care, they may, by majority rule, institute the desired modifications. In contrast, consumers do not have to organize and campaign, nor convince a majority to endorse a specific change in policy. Each consumer is sovereign unto himself. Each consumer is free to pursue his desired mix of quality and price, without regard to whether the majority agrees with him or not. The diluted potency of voter sovereignty may be significant factor in the long term trend of declining quality of public education at increasingly higher costs.

The access to tax financing enjoyed by public sector monopolies acts as a further insulation from consumer feedback. The ever present threat of bankruptcy disciplines private sector firms. They must pay attention to customer wishes or lose sales. They must operate efficiently or see rising expenses wipe out their profits and replace them with losses. Public sector access to taxes provides protection against bankruptcy and removes it as a disciplinary force. Consequently, the public sector tends to be less attentive to customers and efficiency. In the private sector we have the watchwords "the customer is always right" to remind the businessman who ultimately controls the fate of the firm. The absence of any comparable mention of the taxpayer in the public sector helps to illustrate the lesser role played by the taxpayer in influencing public sector services.

In a bid to overcome some of the worst abuses of the political spoils system, the civil service concept was developed. The idea was that a permanent, professional staff of public servants would be able to resist the worst aspects of politics. The bureaucracy was made independent of politics by the creation of a so-called merit system of employment. That is, once an employee clears a short initial period on probation he cannot be fired except for "cause." The procedures for establishing "cause" are quasi-judicial in nature. The elaborate rules of evidence, the calling of witnesses, and the availability of appeals do provide the public employee protection against overt political abuses and accompanying pressures. Unfortunately, the lengthy and costly procedures also protect incompetence and mediocrity from expeditious remedy.

Because it takes so much effort to dismiss non-performing employees, it is easier to merely hire additional people to do their work. It also may work to the benefit of public sector managers to accumulate large staffs filled with redundant personnel, since the salary for managers is frequently tied to the number of persons supervised. The proliferation of personnel will tend to proceed at a pace faster than the demand for the activity being undertaken. In fact, the tendency toward proliferation of staff has been observed even in cases where the demand for the underlying service is declining. This phenomenon has earned the label "Parkinson's Law."/1/ An example of this tendency has been demonstrated by the relentless growth of the bureaucracy in the U.S. Department of Agriculture, despite the decline in the number of farms and farmers in this country.

All of the problems plaguing public sector attempts to provide services have bolstered government's reputation for inefficiency. The same people who would be outraged if their local hardware store tried to charge them \$600 for a hammer, are resigned to the prospect of the Pentagon paying as much, or more, for the same thing. An economist researching the phenomenon has come up with the "bureaucratic rule of two."/2/ What this means is that, on average, the same service will cost twice as much when provided by the public sector, than it would have if provided by the private sector. The almost universal perception that the public sector is frequently inefficient has spurred persons of varying political agendas to consider privatization as a means for pursuing diverse ends.

How Do We Privatize?

There are numerous variations in the ways any particular service can be privatized. The degree of control retained by the government can be nearly total, minimal, or somewhere in between. A brief outline of some of the more prevalent privatization forms follows below.

Contracting-Out: Perhaps the most common form of privatization is "contracting-out." This is a rather simple method for incorporating some of the benefits of the private sector into the provision of public services. When contracting-out, the government retains full authority over what service is to be performed. Often, the government agency will write detailed specifications for what is to be done by the private firm. Contracting-out has been used for decades in road construction. It is also currently used by Phoenix for week-end dial-a-ride transit services.

The retention of a high degree of government control allows the public sector a greater hand in determining the features of the contracted service. This has the advantage of reassuring political decisionmakers that they will get what they want. Thus, political support for this version of privatization is apt to be easier to obtain. Some efficiencies can be attained when private firms must engage in competitive bidding to secure the contract. Holding down costs will lead to more winning bids and profits for the private firm. To the extent, then, that the bidding is really competitive, some significant savings may be achieved.

The procedure for contracting-out is likely already established for most public sector agencies, since some products or services are currently acquired from private sources. Opposition to contracting-out may come from representatives of public employees unions. Resistance will be greater if contracting-out is advanced as a replacement for existing in-house staff. Resistance may be diminished if contracting-out is used for increments of growth in public services. For most Arizona communities, growth alone will provide opportunities to experiment with privatization.

Joint Funding: A second approach to privatization involves the solicitation of private participation in public projects. The public sector's cost to construct highways, parks, transit stations, etc. has been reduced in some instances by securing private sector participation. The lure for the private sector is the award of some benefit in exchange for financial support of the public project. The benefit might involve an expedited priority for a road segment of particular interest to a firm, the grant of a business franchise within the public facility, a zoning variance, or any other item of value that it is within the authority of the government agency to supply.

If the public sector has a clear idea of what it wants to achieve, joint funding can enable more to be accomplished at less cost to the taxpayer. On the other hand, lack of a clear idea of goals in the public sector could invite the manipulation of public expenditures for projects of questionable public value. Attaining genuinely public purposes at less cost to the taxpayer by forming joint ventures with private firms improves government efficiency. However, joint ventures that lead to activities with little public benefit pervert the process of privatization. An

example of a perversion of the process is frequently exhibited in private pressures to build municipal stadiums that produce substantial benefits for selected businesses, but continuing deficits for the taxpayers.

Vouchers: In this form of privatization, the government refrains or withdraws from supplying the desired service itself. Instead, government provides the means for targeted beneficiaries to obtain services from the marketplace. This type of approach is especially appropriate when the public sector objective is to aid some designated disadvantaged group. Groups inspiring government attention in this regard typically include the poor, elderly, handicapped, and children. Concerned that these targeted groups may not be able to secure adequate nutrition, education, transportation, or other service without aid, government often seeks to intervene. For example, it is repeatedly argued that government must provide transit in order to aid the mobility of the poor. However, subsidizing trains or buses for all passengers is a relatively inefficient way of attempting to achieve this objective. A large portion of the resources that could have been used to more effectively assist the target group are dissipated in aid to those whose needs could easily be met from their own means.

A voucher system would permit more effective channeling of assistance to those most in need. The cost of achieving the desired objective would be lower. In addition, since the recipients of the vouchers would be free to choose among vendors, a better match of convenience and value received for each dollar is more likely. The consumer sovereignty exercised by the voucher recipients would encourage competition and efficiency among the firms seeking their business. The federal food stamp program uses a voucher approach. Rather than having the government supply or subsidize all food so that the poor could more easily afford it, stamps redeemable for food are issued to targeted individuals. Critics have pointed to the widespread abuse in the food stamp program in order to discredit the voucher approach. Nevertheless, it is obvious that a generalized food subsidy program--like most public transit, for instance--would certainly cost much more.

Divestiture: Perhaps the most radical version of privatization is divestiture. Divestiture entails the sale of government operations to private sector owners. The British Government under Margaret Thatcher has divested itself of billions of dollars worth of assets. Not only has the British Government saved money from avoiding operating losses on these businesses, but it has also taken in substantial sums of money on the sales. In the U.S., sale of assets is often brought up as a possible deficit reduction tool. Local governments have frequently sold-off unneeded property. One example has been Phoenix's sale of unneeded school buildings.

Divestiture can take place with the expectation that the assets will be converted to other uses (old schools being

converted into commercial office space, for example). On the other hand, assets can be sold as on-going businesses with operations expected to continue under private ownership (Conrail, for example). The former case is a more routine type of privatization. Still, it should not be overlooked as a means of improving government efficiency. Public sector retention of unused assets does impose an opportunity cost both on the government and the broader community. Idle resources have social costs that impinge upon the general welfare. Assets that sit idle instead of being sold or rented-out force the community to incur the expense of duplicating the unused facilities.

Selling assets in the anticipation that operations will be continued is a more interesting and challenging proposition. Often the fear is that because these operations have been unprofitable in government hands they cannot be privatized. Fortunately, the insolvency of a particular undertaking does not mean that another owner cannot manage the assets profitably. Of course, the new owner will not be able to continue existing operating procedures unchanged. The temptation may be for the public sector to attach such conditions to the sale of an operation that it will result in no buyers coming forward. A potential resolution may lie in a combined divestiture and voucher program. In this way, the massive losses of operating an entire enterprise can be avoided, while the social goals can be pursued at a more modest cost.

Volunteerism: A frequently ignored option for privatization is the use of volunteers. Rather than put more people on the public payrolls, some services may be obtained from volunteers. People get psychic rewards from participating in what they view as important or useful public service activities. The problem is that many communities underestimate the potential from employing more volunteers. Active recruitment efforts may turn up significant numbers of persons willing and able to serve as firemen, auxiliary police, hospital aides, librarians, recreation leaders, etc. Aggressive solicitation of volunteers could save the public sector money, while simultaneously producing a greater sense of satisfaction in the community.

What Kinds of Services Can Be Privatized?

Almost any government service is amenable to some degree of privatization. Sometimes a combination of options can or should be applied, either simultaneously or in sequence, for best results. Below is a listing of some major activities of the public sector that could be privatized. The list is not comprehensive, either as to function or method of privatization.

Airports: Many can be divested and operated profitably. Others could be contracted-out. Capacity expansion could be pursued as a joint venture between public and private sectors.

Courts: Even this prototypical "public good" could see both an improvement in service and a reduction in cost if some civil cases could be contracted-out to private sector arbitration. Perhaps retired judges could be employed on a part time or volunteer basis. The "People's Court" television program is a flashy example of private sector resolution of disputes.

Entertainment and Sports: These are both potentially moneymaking industries. Divestiture should present no insuperable financial problems.

Prisons: There are firms that contract with governments to operate prisons and jails. Corrections Corporation of America operates a 250 inmate prison in Tennessee. Southwest Detention Facilities owns and runs jails in Texas.

Fire Protection: Some cities (Scottsdale, for example) have private fire fighting services. Since there is also a long waiting list in many cities for persons wishing to become firemen, the potential for volunteers would seem favorable.

Public Housing: A voucher approach would seem most suitable for taking advantage of the existing economies of the private housing marketplace.

Libraries: Subsidized public libraries are already going into unfair competition with video rental stores. Divestiture would appear feasible. Volunteers could be sought. Vouchers could be provided to assure access for the poor or for students.

Parks and Recreation: Greater use of volunteers could be pursued. Since firms do operate gyms for a profit, some divestiture may be feasible. Vouchers could be provided for the economically disadvantaged.

Schools: Vouchers have considerable appeal. More volunteers could be used in classrooms and extracurricular activities. Divestiture of underutilized facilities could follow.

Transit: Contracting-out is already employed in some cities for some aspects of transit services. Divestiture and vouchers would appear an attractive combination for reducing operating costs while assuring mobility for the economically disadvantaged.

Streets: Joint funding has already been exercised by some highway agencies. Privately owned streets exist in shopping malls and residential neighborhoods. Selective divestiture has good longer term potential.

Who Gains from Privatization?

The popular exaggeration on behalf of almost any policy proposal is that everyone will benefit. In reality, no proposal

can benefit everyone, all the time. If the objective of privatization is to reduce the cost of government services, the current recipients of government payments are not apt to perceive a benefit from the program. These recipients include government employees, as well as firms who supply existing public sector agencies. Even if the same quantity of services is provided after privatization, the dynamics of change are sure to alter the distribution of payments. Some firms will gain new business, others will lose business. The potential gainers are unknown and unorganized. The potential losers know who they are. Consequently, opposition to privatization can be strongly motivated and persistent.

The beneficiaries of privatization are more numerous, but dispersed. The incremental gains to any one person may be small or undetermined, especially when compared to the more concentrated losses for the minority that benefits from the less efficient status quo. In order to achieve the benefits of privatization, the benefitting majority will need to be more aware of the gains to be had. A brief summary of who stands to gain what may help to bolster support for privatization.

Politicians: Elected officials may have the most to gain from privatization. Few policy alternatives offer the opportunity to eat one's cake and to have it, too. Yet, privatization has such a potential. The efficiency gains from privatization will enable elected officials to deliver on more promises at a lower cost to the taxpayers. Politicians of liberal persuasion would gain the opportunity to expand programs to reach a wider array of deserving individuals and/or to provide a higher quality of service to an equal or greater number of people. Politicians of a more conservative nature will have the chance to trim expenditures and grant relief to the taxpayers. Compromise between liberals and conservatives would become more viable, since in most cases, privatization would enable a larger supply of services (a liberal goal) at a lower cost (a conservative goal).

Consumers: Consumers of government services would stand to gain from either the expansion of alternatives, the reduction in cost, or both. As more services are obtained from the competitive marketplace, the firms' attentions to consumer preferences will increase. The drive for profit will encourage innovation and improvement, as firms are compelled to offer better deals in order to attract and keep customers.

Businesses: While some businesses that currently deal with government will experience decreased revenues, others will have an opportunity to increase sales. Greater use of contracting-out and divestitures will create more business opportunities. The savings engendered by privatization could lower the tax burden and, thereby, attract more businesses to locate in the jurisdiction of the government doing the privatizing.

Taxpayers: The efficiencies achieved in the public sector should lessen the pressure for higher taxes. Some tax relief may even be possible. This could either increase disposable income for consumers or decrease expenses for business taxpayers. Either way, purchasing power would be improved.

Conclusion

Privatization is an idea that is growing in popularity. The prospect of saving money while continuing to provide necessary services has appeal for a wide spectrum of political opinion. Governments, at whatever level, facing budgetary constraints could turn increasingly toward privatization as a means of coping with financial stress. The amounts that could be saved will vary. The "bureaucratic rule of two" implies that savings of up to 50%, or more, are possible.

Perhaps even more important, privatization is a remedy that is available now to all levels of government. This allows for the autonomy to affect one's own destiny without having to seek or wait for federal aid or permission.

Notes

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