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The Privatization Option

A Strategy to Shrink the Size of Government

Edited by Stuart M. Butler

The Heritage Foundation

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Foreword

The Conservative Agenda

To state that the United States is becoming increasingly conservative and is re-embracing traditional values today barely elicits a protest, even from the most dedicated leftist. Few can ignore the message of the 1984 election, which followed the impressive conservative gains of 1978 and the sweep of 1980. Public opinion polls, election results and volumes of anecdotal evidence demonstrate that Americans have turned to conservatives for answers to the most important problems facing the U.S.

In a number of areas, conservative answers are well known and well formulated. This surely is the case regarding government regulation of the economy, the disincentives created by high taxes and the need for a strong national defense. In other areas of pressing national concern, the conservative approach is not so well developed. Very often, to be sure, conservative analysts have mounted a powerful critique of the liberal approach to a problem. There are, for instance, strong and persuasive conservative cases made against liberal programs for the poor or civil rights or education. Less often, however, have conservatives described how they would replace discredited liberal concepts and programs with specific measures to help build an opportunity society. While the conservative critique, therefore, is well known, the conservative agenda is not.

It is to encourage the evolution of such agendas that The Heritage Foundation inaugurated a new series of publications. Inviting the participation of some of the conservative community's most creative and innovative thinkers, each study will examine a particular problem and attempt to go beyond critique to suggesting an agenda for action. The first of the series was *A New Agenda for Education.* It was followed by *Confronting Moscow: An Agenda for the Post-Détente Era*, *Banking and Monetary Reform: A Conservative Agenda*, and *U.S. Aid to the Developing World: A Free Market Agenda.* Upcoming publications will propose a conservative agenda for welfare and civil rights. With this volume, *The Privatization Option*, The Heritage Foundation is pleased to present five experts discussing a strategy to shrink the size of government.

Burton Yale Pines
Vice President

Introduction

Slowly but surely the word "privatization" is creeping into both the English language and the arsenal of political strategists. And though purists might wince at so grotesque a word, budget-cutters have greeted it with enthusiasm.

The reason that privatization—the shifting of government functions into the private sector—has aroused such interest recently is that it seems to offer a solution to the problem that confronts any politician seeking to reduce government spending: The anger of someone denied a government service is always greater than the gratitude of a taxpayer when savings are made. It is hard for a politician to avoid succumbing to the pressure of lobbyists for program beneficiaries. By providing the option of a similar—or even superior—service from the private sector, at less cost to the taxpayer, privatization allows the legislator the chance of satisfying both constituencies at once. The failure of even Ronald Reagan to make more than a small dent in the growth of federal spending demonstrates the urgent need for such a politically attractive strategy.

This series of Heritage Foundation lectures, held in 1984 and early 1985, explores the background and potential of this budget-cutting approach. Steve Hanke explains how the theory of privatization has developed from an examination of property rights, and how ownership is critical to the promotion of efficiency. E.S. Savas examines the various types of privatization that are available to the policymaker and the obstacles that are placed in the path of privatization. Robert Poole looks at ways in which privatization can be used to achieve substantial cost reductions in specific federal programs. And Madsen Pirie analyzes the dramatic success of privatization in Britain, citing 22 highly effective political techniques used by the Thatcher government. Finally, Peter Ferrara demonstrates how the privatization approach could be used to achieve politically feasible and fundamental reform in one of the most sensitive of all federal programs—Social Security.

The lectures make it clear that privatization warrants the growing interest it is arousing among policymakers in America. The budget war of attrition in Washington is yielding fewer and fewer results at a steadily mounting political toll. By recognizing that strategists wishing to cut spending should focus on ways to alter the demand for government services, rather than merely trying to stem the outflow of federal dollars, privatization can alter the underlying political dynamics of government spending, at last putting the initiative into the hands of the budget-cutter.

Stuart M. Butler
Director of Domestic Policy Studies
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The Theory of Privatization

Steve H. Hanke

February 26, 1985
The Louis Lehrman Auditorium
The Heritage Foundation

Over the past fifty years, governments have assumed a greater role in the economic affairs of most nations. There has been more emphasis on macroeconomic planning and management. In addition, public sector budgets have grown in absolute terms and also in relation to the size of private sector activity. This growth has been the result of rapid increases in welfare programs, military expenditures, and a vast increase in the range and scale of so-called public infrastructure and services. In addition, the less developed countries (LDCs) have increased the scope of the state by embracing the concept of an entrepreneurial state: one that is alleged to be the engine of growth and development, and one that attempts to achieve growth by either operating nationalized industries or intervening heavily in the operation of private firms and markets (state capitalism). Of course, some countries have voluntarily, but usually involuntarily, adopted socialist and communist economic systems for ideological reasons.

This trend toward more government involvement in the economy has begun to be seriously questioned. Indeed, there have been attempts to rely more heavily on deregulated free markets for the allocation of resources. In particular, there has been a significant move toward privatization and the private provision of so-called public infrastructure and services. Privatization has become fashionable in the United States and the United Kingdom. In the United States, privatization has been most visible at the state and local level. Faced with reduced transfers of funds from the federal government, voter disapproval for new bond issues, and growing hostility to increased taxes—state and local politicians have, in many cases, been forced to turn to the private sector to provide so-called public infrastructure and services. In other cases, politicians have privatized activities simply because they realize that private supply is cost-effective.

At the federal level, privatization is a policy of the current Administration. For example, President Reagan signed Executive Order 12348 on February 25, 1982, which established a Federal Property Review Board as part of the Executive Office of the President. The purpose of this board is to privatize surplus real assets owned by the federal government. To date, however, the Administration has moved slowly to implement its privatization policy.

The Administration's interest in privatization is also reflected by the President's Private Sector Survey on Cost Control (PPSS), known generally as the Grace Commission. It has produced a privatization report and made privatization recommendations that it estimates would save the federal government $28.4 billion over the next three years. Federal legislators have also played a part in the privatization movement. For example, the federal government currently is engaging in about 11,000 commercial activities that are also being performed in the private sector. Excluding postal workers, about one in every four federal employees is engaged in these activities. A bill introduced by Senator Warren Rudman is being debated in the Senate. This measure would outlaw most of these federal commercial activities. Senators and Congressmen are also debating the merits of federal privatization in the Joint Economic Committee, where Senator Steve Symms is holding a series of hearings on "Privatization of the Federal Government." In addition, proposals to privatize specific federal activities have been made. The Department of Transportation's recommendation to sell Conrail will shortly be debated in Congress. Also, Senator Steve Symms and Congressman Jack Kemp have introduced a bill to privatize public housing.

Much the same as state and local governments in the U.S., Prime Minister Margaret Thatcher has actively implemented a wide-ranging privatization program in the United Kingdom. Over the past five years she has privatized several hundred public enterprises by using 22 different methods.

At the international level, attitudes heretofore dominated by interventionists have begun to be influenced, to some extent, by those who advocate less state ownership and intervention. This has been reflected in works sponsored by the International Monetary Fund and the U.S. Agency for International Development (AID). In addition, the World Bank's *World Development Report 1984* includes free market analyses of the LDCs' economic development problems.

In addition to the changes in academic thinking about economic development and attitudes at international organizations, there have been a variety of factors that, from a practical point of view, have accelerated the implementation of privatization policies in the LDCs. For instance:

- IMF stabilization policies have acted, through conditionality requirements, to put pressure on many nations to reduce public expenditures and to also adopt policies that would foster the efficient use of resources and consequent growth. Although conditionality does not typically require privatization, this policy often becomes the most logical means of satisfying the IMF's constraints.
- Both World Bank and AID programs have become more open to the possibilities of partially, or, in some cases, completely privatizing some activities. This openness has, if nothing else, resulted in an environment in which major international organizations have not retarded moves to privatize, and in some cases international organizations have encouraged privatization.

- Changing views about the sectors that are vital to economic development have also acted to encourage thinking, if not acting, about the privatization option. For example, instead of focusing policies on conserving foreign exchange by protecting domestic industries from foreign competition, many LDCs have begun to focus on earning increased foreign exchange through export expansion and growth. This has resulted in efforts, including privatization, to make LDC economies competitive in international markets.
- Privatization often has resulted from a dramatic change in attitudes about the role of multinational firms. It is becoming clearer that multinational firms transfer more than investment capital to LDCs. Multinationals are also an efficient means of transferring technology, management skills, information, access to markets and entrepreneurial skills to LDCs.
- In some cases, privatization has resulted from nothing more than the implementation of on-going rolling privatization policies. Under these policies, the state originally invests in public enterprises, with the intention of privatizing them when they become viable. It should be mentioned, however, that this strategy, as does the infant industry justification for protection, often becomes difficult to implement because vested interests become entrenched and do not favor privatization.

The Economics of Privatization

Perfectly competitive markets and market socialism represent theoretical models that explain how static economic efficiency in the allocation of resources can be obtained under private and public ownership, respectively.

Perfectly competitive markets work in the following way: consumers maximize their benefits, subject to budget constraints that are determined by individuals' incomes and the prices of services and commodities. Income is determined by the quantities of resources offered and prices received for them by their owners. Prices are determined in competitive markets, so that individual purchasers of outputs or sellers of inputs have no control over market prices. Nature and technology constrain the stock of resources in the economy and the state-of-the-arts constrains technology. Competition and the desire for profit maximization ensure that procedures operate in a least-cost manner and derive the greatest value from the firm's assets.

The market socialist model of resource allocation is similar to the perfect competition market model, with the exception that resources are publicly owned and prices are determined centrally by technocrats, who set them equal to the production cost of the last, or marginal, unit of output.

Both of these models operate in a mechanistic way and in an institutional vacuum. For example, both assume that transaction costs are zero (that is, the costs of obtaining information and of negotiating, policing, and enforcing contracts are zero); adjustment costs are zero; all resources are fully employed; resources are allocated for purely pecuniary reasons; and shirking by "owners" and employees does not occur. In addition, it is assumed that the same quantity and quality of information can be generated by the centrally planned, market socialist system as by decentralized, perfectly competitive systems.

In the real world, the nature of rights to the use of resources, to the income the resources generate, and to the transferability of resources to others has an effect on the way resources are used. Property rights arrangements, in other words, are not neutral. The system of rights that accompany different organizational arrangements determines, through the price mechanism, how benefits and costs resulting from individual decisions will be allocated to decisionmakers and others.

When private property rights exist, it means that an individual has the exclusive right to use and derive the income from resources, and can voluntarily transfer resources to others. The more precisely these rights are defined, allocated and enforced, the closer the individual will be to obtaining the total benefits and being responsible for the costs which are generated by his rights. Hence the decisionmaker (the owner of the assets) has the greatest incentive to take all benefits and costs into account, since he will ultimately gain or bear them. With private ownership, zero information and transaction costs and, regardless of the initial distribution of property rights, individual owners will bear the full consequences of their decisions and resources will be used in an efficient way.

In practice, however, information and transaction costs are positive and property rights are often attenuated. This means that managers and decisionmakers in private firms will have opportunities to increase their own benefits, or avoid work that generates profits, at the expense of the owners of private firms' assets. Consequently, the private enterprise's behavior will deviate from that which would maximize the return on the firm's assets, and private enterprise behavior will deviate from the theoretical ideal. But there will still be a tendency to maximize the value derived from the firm's resources, even though this will be less than ideal.

At one extreme on the property rights attenuation spectrum is government ownership. What distinguishes public and private enterprises is the fact that public assets are not "owned," since they cannot be effectively transferred. The only way taxpayers can change "their" portfolio of public assets is to move to another political jurisdiction, convince politicians to change the composition of the public's asset portfolio, or change the way in which public enterprises are operated. These options are typically not attractive because they impose large costs on taxpayers. This lack of transferability means that decisions taken by public bureaucrats and employees do not readily translate into changes in the market price of the firm's assets, and the "owners" have little incentive to monitor public managers' and employees' behavior.

Consequently, public managers and employees have much weaker monitoring of their operations than do private ones. So public bureaucrats have a greater opportunity for discretionary behavior than is the case in the private sector. Bureaucrats have, for example, more opportunity to allocate staff and assets under their supervision to enhance their own benefits and careers, rather than to maximize the value of the public sector's assets. And since salaries of bureaucrats are subject to statutory limits, and there is nothing equivalent to a profit-related bonus, bureaucrats have incentives to allocate resources to enhance their job security and other nonpecuniary benefits. This suggests, in other words, that bureaucrats will tend to adopt policies that will ease their work load and make their jobs more pleasant. They will, for example, choose to ration output by nonprice means or by adopting pricing policies that are easy to administer, tailoring them less closely to demand and supply conditions and more closely to vocal special interest groups and powerful politicians; across-the-board wage increases will be more common than select wage changes based on merit; hiring practices will rely less on capability than on race, sex, education, congeniality, and other characteristics which may reduce organizational friction. As a result, public enterprises' behavior will be less responsive to demand and supply conditions, and will operate with higher costs for any given output level, than private enterprises.

Modern property rights theory, more then anything else, reflects themes contained in Adam Smith's *Wealth of Nations*. For Smith, "no characters seem more inconsistent than those of trader and sovereign." Smith observed that this was the case because people are more prodigal with the wealth of others than with their own. So public administration is negligent and wasteful, since public employees have no direct interest in the commercial outcome. Smith, for example, noted that the productivity of public lands was only 25 percent that of comparable private lands. Consequently, he recommended that the remaining public commons be privatized. If this occurred, he said, the owners would have the incentive to monitor activities, eliminate waste and maximize the value of their assets. As Smith put it: "The attention of the sovereign can be at best very general and vague consideration of what is likely to contribute to the better cultivation of the greater part of his dominions. The attention of the landlord is particular and minute consideration of what is likely to be the most advantageous application of every inch of ground upon his estate."

In the context of the privatization debate, the implications of property rights theory are rather profound. If our objective is to attain economic efficiency and reduce public sector waste, we should not rely on market socialist "reforms," such as replacing current bureaucrats with technocrats who will apply techniques such as benefit-cost analysis and marginal cost pricing. Without changing the underlying property rights arrangements—and thereby the incentives faced by public sector managers and employees—we cannot expect their behavior to conform with that needed to maximize the value of the public enterprise's assets. If we desire to improve efficiency and eliminate public sector waste, we must change property rights arrangements by adopting privatization policies.

The Public Goods-Externality Problem

Even though theory points to the superiority of private over public enterprises, many argue that there are factors, in addition to production costs, that must be considered when determining the choice between public and private ownership of enterprises. One of these considerations is externalities—that is, the costs or benefits to third parties arising out of transactions between buyers and sellers.

It is often argued that the existence of such externalities is a justification for public enterprise. For example, it is alleged that education generates large externalities in a democratic society, and that from a social efficiency point of view, private enterprise would undersupply education because external benefits would not be taken into account in the transaction between private schools and students. Hence, it is argued that there is a need for public schools.

The related concept of public goods is also used to justify certain types of public sector activity. A public good is a product or service which, once supplied, is available for all to use and enjoy simultaneously. A radio broadcast, for example, can be picked up free of charge by anyone with a receiver, without denying the signal to anyone else. The potential users of a public good are not competing with each other for access to the good. Hence there will be a tendency for all potential users to attempt to be "free riders" and not pay, or not pay enough, for the private provision of a public good. Consequently, it is argued that public goods will either not be supplied or undersupplied.

A classic example of public goods and the argument for public enterprises is spraying to eradicate disease-carrying insects. The spraying of an entire area is needed to do the job, and all the population benefits whether or not individuals choose to contribute to the cost. Thus it is argued that this activity should be under the purview of the public sector because it has public good characteristics.

To sort out the solutions to the alleged problems of externalities and public goods, we must realize that goods can be *supplied* by either public or private enterprises, and that this supply can be *financed* by public user fees and taxes, private charges of a mix of public and private finance. Once the distinction between private versus public *supply* and *finance* is made, it should be clear that, even if externalities and public goods exist and the polity decides that public intervention is appropriate, the supply of the products with either of these characteristics can be private, while their finance can be a public or a mixed public-private undertaking. For example, schools could be private, and insect abatement could be supplied by private firms at "appropriate" levels, by using public finance to compensate, in full or in part, private suppliers in each case. By combining public finance or mixed public-private finance and private supply, the problems of suboptimal private supply, due to externalities or to public goods, can be overcome. At the same time, the cost advantage of private supply can be attained.

Given our interest in the ownership of assets, we only address the issue of private versus public *supply*. Since the issues surrounding externalities and public goods are *finance* issues, we will not address them.

The Natural Monopoly Problem

Another alleged problem that gives rise to calls for public enterprise is the existence of natural monopoly conditions. It is argued that a firm will become a "natural monopoly" if the average cost of producing a product constantly declines as output is increased. In this case, if there is more than one firm supplying the total market, each firm must be producing at an average cost level that is above the average cost level that would exist if only one firm supplied the entire market. Faced with this situation, each firm will be inclined to cut its price in an attempt to increase its market share and reduce its average costs. Economic warfare will result and there will only be one survivor—a natural monopolist. Moreover, redundant facilities will exist.

As in any monopoly situation, it is argued that the natural monopolist will raise prices and restrict output once it has established itself and this will create economic waste. Many analysts conclude from this that when the conditions that spawn natural monopolies exist, government should step in and supply the market by employing a single public enterprise. It is argued that this will not only solve the problem of monopoly exploitation *per se*, but also that it will reduce the higher unit costs and eliminate wasteful duplicate facilities that would occur if unregulated competition prevailed.

The nineteenth century economist and philosopher John Stuart Mill was one of the first to argue that, under natural monopoly conditions, private firms would engage in wasteful competition. This would result in the duplication of highly specialized assets and ultimately private monopoly power. The solution, as he saw it, was to supply infrastructure and services in these cases by employing public enterprises. But Mill's analysis did not go unchallenged. Edwin Chadwick in 1859 argued that—although in natural monopoly situations competition for the right to serve individual customers would indeed be wasteful—this did not rule out competition and the desirable results that accompany it. The essential point made by Chadwick was that competition should focus on this right to serve an entire service area, rather than individual consumers. In short, Chadwick argued that an exclusive franchise or concession to supply an entire service area be established and that private firms compete for the right to serve the franchise.

Harold Demsetz rediscovered and extended Chadwick's notion that competitive results could be obtained, even in situations where natural monopoly conditions prevailed. A desirable outcome could be obtained, he noted, by simply establishing a franchise and then requiring competition for the right to serve the franchise rather than individual consumers. By doing this, Demsetz argued, public enterprise and its accompanying inefficiency could be avoided, and yet the wastes and inefficiency associated with a private natural monopoly could be avoided. Instead, the benefits of unregulated, competitive, private enterprise could be obtained.

The key to Demsetz's system is the bidding procedure. To obtain the desired result of free competition and the cost-effectiveness of private supply, the franchise must be awarded to the firm that agrees to serve the market with the lowest prices for the output specified in a contract. The public authority or private association establishing the franchise would act as a bargaining agent for customers in the franchise area. The public authority would seek to award the franchise to the private firm agreeing to supply a given quality and quantity of service over the franchise's life at the lowest price. The successful bidder would then have the contract for all consumers in the franchise area. Thus the natural monopoly problem would be solved without recourse to public enterprise. It should be noted that public utility regulation, an approach to the natural monopoly problem that is often used in the U.S., would not be required if the competitive franchise system was adopted.

As with any method for dealing with the natural monopoly problem four outcomes are desirable: (1) prices should be based on the managerial or incremental cost of supply; (2) the products supplied should be of the appropriate quality and quantity; (3) production should be accomplished so that costs are minimized; and (4) profits should be just sufficient to attract capital into the particular line of production under consideration. Demsetz claims that his private, competitive franchise arrangement would generate results that satisfy these desirable features. Moreover, he questions whether these features can be obtained either by public enterprises or by regulated private enterprises.

There are two phases in a franchising system, however, where some argue that problems can arise. They are the bidding phase and the operating phase. During the bidding phase, effective competition is alleged to be a problem. At the end of an existing franchise, for instance, the current franchisee, it is alleged, often has his franchise renegotiated, without visible competition from other bidders. Many have suggested that this indicates conduct that leads to the exercise of monopoly power and poor performance, since competitive forces are not at work to regulate the franchise.

The critics of franchising go on to speculate the reasons why firms that win original franchises tend to retain them, and why a visible competitive threat allegedly fails to appear. They suggest that an existing franchisee has an advantage over potential entrants, since an existing franchisee has more and better information about the demand and cost conditions associated with the franchise; has an established working relationship with the franchisor; and is possibly able to mislead potential bidders. And a potential bidder might shy away from bidding because of the transitional or start-up costs that it would have to incur, which an existing franchisee would not. It is argued that these factors eliminate potential competition from the franchise system.

In defense of the franchise system, we should mention the French water and wastewater industries, where franchising has been successfully used for over a century. In these industries, effective and vigorous competition exists as franchises are renewed. Similar strong competition has been reported in other sectors in France that use franchises. For example, Holcombe reported that 13 bids were received for the Paris gas system, when the franchise was put up for bid in 1905.

The effectiveness of the franchise system for water and wastewater in

France is attested to by the fact that the socialist government that came to power in 1981 did not nationalize these so-called public utilities—even though they did nationalize many firms engaged in commercial activity. The mayors, who act as agents for water and wastewater customers, regardless of their political party affiliation, argued against nationalizing water and wastewater firms. They claimed that nationalization would lead to increased costs for these services.

Even in cases where there are few visible bidders for a franchise, competitive results can be obtained if the market is periodically open to competitive bidding. Recent research in a new theoretical field called "contestable markets" indicates that competitive results can be obtained even when there are only two bidders. This research indicates that, if markets (in this case franchises) are contestable, potential entry or competition for the market disciplines behavior almost as effectively under "natural monopoly-franchise" conditions as if normal competitive markets had existed. So if a franchise can be contested, it will tend to perform in a competitive fashion.

It is alleged that pricing problems could also arise during the bidding phase. For example, if service to the franchise involved decreasing costs with volume, then it would be possible to have competitive bidding, where a winning bid generated accounting losses, and yet the bidder's price for the output was equal to the marginal cost of the output. Demsetz has responded to this concern noting that, by allowing either two-part tariffs or price discrimination in the bidding, both zero profits and prices set at marginal costs could be obtained. However, this complication would require more specialized knowledge on the part of the franchisor who was evaluating the bids.

In addition to alleged problems during the bidding phase of a franchise, several concerns have been expressed about problems that might be encountered during the operating phases of a franchise.

Franchises typically last for a considerable length of time. In France, where franchises are common and where the capital infrastructure is both owned and operated by the franchisee, the franchise can last for as long as 30 years. In situations where private firms have concessions only to operate and maintain capital that is owned by a public entity, the maximum length of the franchise in that country is 12 years. During this period, significant changes in demands, costs and technologies will probably occur, requiring complex pricing formulae. These will require considerable expertise on the part of the franchisor, so that the original bids can be properly evaluated and the franchise monitored during its life. In addition to complex price formulae, contracts usually contain clauses that allow for renegotiation, if pricing formulae "break down" due to unanticipated "shocks." If renegotiation takes place frequently, franchise bidding is said to be robbed of its most desirable characteristic, namely its reliance on price determination through competitive market processes.

The reason why pricing formulae complexity and contract renegotiations accompany long-term franchises is made clear with several examples. Early franchises were not bid on the basis of low price, but usually on the basis of the maximum price that could be charged over the life of the franchise. These terms worked against the consumers during deflationary periods and against the franchise during periods of inflation.

As a result of dissatisfaction with this simple type of pricing agreement, particularly during inflationary and deflationary periods, many franchises were simply abandoned or franchises were taken over by governmental entities. Although in some cases franchises were retained and made more complex to deal with changing general price levels. For example, the franchise to supply gas for Paris specified a maximum price and also fixed a minimum profit for the firm. This arrangement created considerable problems for the city, however, because the price of coal used to manufacture gas increased rapidly during World War I. Consequently, the average cost for gas was twice the maximum price allowed under the franchise. To maintain the franchise's minimum profit guarantees, the city had to subsidize the franchise from tax revenues.

To overcome the problems associated with early franchises, more and more complexity was built into pricing formulae, and renegotiation provisions were included so that the prices charged by the franchise could more closely reflect real cost and demand conditions. Although the complexity of franchise pricing formulae and evaluation and monitoring costs increase as the length of a franchise's life increases, the competitive price determination features of franchises are not lost if the franchise is contestable at the time of renegotiation.

A second potential problem associated with the operating phase of franchises occurs toward the end of a franchise's life. It is argued that incentives exist that make firms underinvest in fixed assets and reduce maintenance, when there is a chance that the franchise will not be renewed.

These investment and maintenance problems can be overcome, however, by allowing the firm to amortize its investments fully during the franchise and also by requiring the franchisee to be bonded for performance. This latter requirement reduces the monitoring required by the franchisee because the bonding firm will, in effect, take over responsibility in this area and guarantee that the bonded franchisee meets the terms of the contract. However, there will still be considerable monitoring responsibility placed on the franchisor who is acting as the customers' agent.

Conclusion

Considerable theoretical support exists for the effectiveness of private provision of so-called public infrastructure and services. Superior results are generated in cases where property rights are less attentuated, compared with those cases where rights are more attenuated or public. This leads to the conclusion that, from a theoretical point of view, private provision of public infrastructure and services would be more efficient.

Even though agreement might be reached as to the comparative cost advantages of private versus public enterprise, however, some argue that public enterprise is required because of the existence of externalities or public goods problems. But, as we have shown, these problems do not affect the decision as to whether a service should be supplied by a private or a public enterprise. Hence, we are still left with strong support for private over public supply.

Nevertheless, some point to natural monopoly problems as justification for favoring public supply. Natural monopoly problems, although not as common as most economists believe, certainly do exist in some cases, particularly when assets are highly specialized and require significant investments. But the natural monopoly problems can be overcome through competitive bidding and contestable markets for franchises. Hence, even in these special cases, we are left with the strong conclusion that private suppliers are, from a theoretical point of view, superior to public enterprises.

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The Efficiency of the Private Sector

E.S. Savas

April 3, 1984
The Louis Lehrman Auditorium
The Heritage Foundation

Privatization, is even older than government. Its origins are lost in antiquity. But on the state and local government level, a rather significant date was 1953, when something called the "Lakewood Plan" was created. Lakewood is a community in California with a population of about 60,000. It came into being and was incorporated as a city with a grand total of eight employees to provide the full scale of municipal services. How was that done? Everything was contracted out. Basically those eight people were contract officers, who purchased services from a variety of different suppliers. Most of the suppliers were other local government units—the county sheriff, the adjacent mosquito control district, a special fire district, and so on.

But Lakewood was the progenitor, and now there are some 75 cities in California that call themselves "contract cities." They have an association, the Contract Cities Association, and they buy and sell services from each other, from the private sector, and from other government entities in the area. A marketplace for municipal services has been created.

In 1971, there were some highly publicized studies of the New York City government. They showed that it was costing New York City about 2.6 times as much as it was costing the private sector to do things like pave streets and collect garbage. I directed those studies when I was in the Lindsay Administration. Because New York is a media capital, there was quite a bit of national and international attention to those rather dramatic findings, and the modern movement toward privatization was born.

The current interest in privatization derives from the growing concern about the growth of government, the taxpayer revolt in all its manifestations, and the general feeling that there must be a better way of doing all those things that the governments do not do too well.

Privatization is booming. When I was at HUD as Assistant Secretary, I initiated a study by the International City Management Association on the extent of privatization in the municipal sector. The findings showed that in just seven years, between 1975 and 1982, there was a 50 percent increase in the number of cities that had privatized one or more of their services.

By the way, the reason why I often talk about privatization in the context of cities is that 80 percent of all government employees work for state and local governments. So privatization of government services often will tend to focus on county, city, and state governments. But, of course, as this series here at The Heritage Foundation will show, there are many other areas besides narrowly defined government services. The sale or privatization of government assets, whether land or sewer systems or water supply systems, is another facet of privatization. Privatization of benefit programs such as Social Security, is another. In fact, the domain open to privatization is really quite broad.

I define privatization as relying more on private sector institutions and less on government to satisfy societal needs. That is a disarmingly simple definition—relying more on private sector institutions than on government to satisfy societal needs. By this definition, privatization refers not only to taking an existing government activity and transferring it into the private sector; it also refers to new activities that might have been handled by government—following recent practices—but instead the route taken has been more toward the private sector. Private day-care services and van pools are examples, as are urgent medical care clinics, which are rapidly replacing hospital emergency rooms for simple kinds of prompt medical care. A decade ago, these services would probably have emerged as government activities.

My book, *Privatizing the Public Sector*, provides an exhaustive typology and description of nine different methods of service delivery but I want to focus just on five important means of privatization that are found throughout the United States today.

1. *Contracting Out*

The most common method, and the one that people usually mean when they speak of privatization, is contracting out. Under this arrangement, governments purchase services from the private sector, either from for-profit or not-for-profit organizations. The services range from ship repair to meals-on-wheels for elderly citizens, to street paving, snow removal, and a thousand other kinds of services. In the municipal area alone I have identified 102 different services that cities purchase by contract from the private sector. One of the most recent examples to come to public attention is a new company called the Correction Corporation of America. It runs prisons under contract to governments. The particular prisons it currently operates are for illegal aliens; this is done under contract with the Immigration and Naturalization Service. Illegal aliens are detained prior to deportation in remodeled motels with fences around them. People have talked about privatizing corrections for a long time; here is a tangible manifestation.

2. *Franchising*

But contracting is just one approach to privatization. Another is franchising. Under a franchise, government awards an exclusive or nonexclusive right to a private firm to sell certain services to the public.

We are familiar with utility franchises for electricity, gas, and water. But there are also franchises for buses, taxis, and recreation facilities. Increasingly, there is private franchising of recreation facilities, such as golf courses, tennis courts, swimming pools, and skating rinks, which used to be awarded and operated by cities and counties.

In New York City, behind the public library on Fifth Avenue, is Bryant Park. The City recently announced that Bryant Park will be turned over to a private firm, which will operate a restaurant in the park, maintain the greenery, keep the drug pushers out, and provide for public safety and security, all under a franchise agreement.

In St. Paul, Minnesota, curb repair is franchised out. Certain firms have been authorized to sell street curb repairs, and private property owners can arrange for the service. While street curbs are really government property, homeowners who don't want to wait for slow municipal repairs can simply arrange with one of these franchise firms to repair the curbs in front of their homes and pay them directly.

3. *Vouchers*

A third major approach to privatization involves vouchers. Under a voucher system, someone who is issued a voucher can use it as a form of currency or script to purchase supplies, goods, or services in the open market. The person who sells the goods or services turns in the voucher to the issuing government and gets money for it.

The most visible example of vouchers is food stamps. Contrast the use of food stamps with the alternative in providing food for low-income households: government farms, government reapers, government food-storage silos, government food processing plants, government canneries, and government grocery stores. But instead of that clumsy and awkward approach, food stamps are simply handed out to low-income householders, who can use them to buy their groceries in the marketplace. The fact that there are abuses of that particular program, as there are of many programs, does not detract from the fact that it is a better method than others.

Education vouchers have been long recommended as the prescription for many big city education ills. Unfortunately the education bureaucracy has prevented use of tuition vouchers. It is known that they have worked very well, however, through the G.I. Bill, in higher education. But the political barriers to using them in high schools or elementary schools have been too strong. The tuition credit program that President Reagan has proposed is, in a sense, a step toward a voucher system in education.

Housing vouchers have been in the news recently. There are two diametrically different ways of providing housing assistance for low-income households. One is to give money to builders to subsidize the construction of housing, which is then operated by public housing authorities or by private corporations; such housing has an invisible sign over it that says, "This building is for poor people only."

The other way of doing it is to subsidize not the builder but the tenant. Government would issue housing vouchers to eligible low-income households, which the latter could use in the housing market to subsidize their rents. The voucher system proposed when I was Assistant Secretary of HUD, which has finally been accepted by the Congress on an experimental basis, involves precisely that kind of approach—subsidizing the tenant and not the builder.

And it makes a big difference. Under the conventional program for providing housing assistance (the so-called Section 8 New Construction Program), the average subsidy being provided by American taxpayers to low-income households was $415 per month. The subsidy under this program, of course, went to the builders, not to the tenants, but was $415 a month, to which the family added its own monthly rental. That is a great deal of money for a low-income household to be paying for rent. In California the figure was still worse: the subsidy there amounted to an average of $915 a month! Not many Americans can afford to spend $915 a month for their own housing, let alone housing for low-income families. With the voucher program that we designed, almost three times as many people can be housed for the same amount of money; obviously this is vastly superior to the preexisting program. In addition to being able to serve three times as many people for the same amount of money, the program also extends freedom of choice to the household. No longer would low-income households be restricted to living in buildings that are for poor people only. Instead families with a voucher can choose to live where they want and can supplement the voucher with their own money if they want to live in better housing or a better neighborhood. If they rent housing at less than the value of the voucher, they get the difference in cash. It gives greater freedom and flexibility to a low-income family to decide how and where to live.

Despite the fact that HUD spent $160 million studying this program extensively and exhaustively throughout most of the 1970s and the program is well-tested and well-proved, Congress saw fit to fund it merely on a demonstration basis. If I were a cynic, I might say that Congress prefers builder subsidies to vouchers because builders give larger campaign contributions than voucher recipients do.

4. *Voluntarism*

A fourth method of privatization is voluntarism. The most obvious example is volunteer fire departments. More than 90 percent of all the fire departments in the United States use volunteers. Voluntarism applies in a different way as well. In many ways, New York is considered the ultimate in large or unwieldy government, but right within New York City there is a homeowner community called Breezy Point in the borough of Queens. Breezy Point is a cooperative where the property owners in the area have deed restrictions that require their membership in the homeowner association. Through this homeowner association the members, who have long been dissatisfied with the conventional municipal services available to them, have arranged for their own services above and beyond whatever the city provides. So, for example, they have their own volunteer fire department, a private guard service, a volunteer ambulance service, and a health clinic. They buy water from a private water company and distribute it to the members through their own water supply system. They provide their own street maintenance, street cleaning, refuse collection, snow removal, and recreation programs. These are all paid for through the assessments the members pay to the cooperative. But, of course, besides paying this special assessment, they continue to pay the normal property taxes to the City so they are paying, in effect, twice for their services. And this is a middle-class community, not a wealthy one.

Kansas City and St. Louis have an effective approach whereby the city government in essence gives rebates of property taxes, in part, to homeowners who assume, in an organized, legal way, the responsibility for providing certain municipal services and taking care of certain so-called public facilities.

5. *The Free Market*

The fifth and most important means of privatization is the free market. Most people procure their food, clothing, and shelter through the free market, but in addition, many so-called public services are increasingly privatized through the free market. I need only point to what the privately owned United Parcel Service has done to the U.S. Postal Service over the decades when it comes to delivering packages. The U.S. Postal Service is all but out of business because UPS provides better service at lower cost.

The free market is creating innovations such as jitney transportation, corporate van pools for bringing employees to work, employer-sponsored day care centers, and innumerable other kinds of private services.

It must be recognized, however, that not all services can be provided by any one of the five different means of privatization—contracting, franchising, vouchers, voluntarism, and the free market. There are differences between what the economists call collective goods, private goods, common pool goods, and toll goods. The characteristics of each of these kinds of good limit the arrangements that can be used to provide them. It is not realistically possible, for example, for the free market to provide national defense or fire protection in an urban area where there are spillover effects that make this service a collective good. But even though the free market cannot always be used, there are alternatives to government provision of these services. Contracting and voluntarism can be used to supply collective goods, even though franchises, vouchers, and the free market cannot.

There appears to be a great deal of wasted rhetoric on this subject. It is not necessary to approach the issue ideologically and to attempt to prove theoretically that the free market can satisfy all of society's needs. Pragmatism has been the key to success in changing public policy. The practical success of privatization is sufficient reason to advocate it; it is not necessary to debate the virtues of capitalism or socialism to conclude that it is generally better and cheaper when private firms collect the garbage.

The Case for Privatization

The evidence in favor of privatization is becoming overwhelming. At the federal level, a study by the Congressional Budget Office released in 1982 showed that 81 percent of current federal in-house activities could be shifted to the private sector with annual savings of approximately one-third of a billion dollars in the first year, and could grow rapidly to almost a billion dollars a year in later years, with a corresponding reduction in the federal government workforce of about 165,000 employees.

Local government provides more and more evidence about contracting for services. Over the last ten years there have been many large-scale, cross-sectional studies comparing government services with equivalent private sector services. (Equivalent in this case means controlled for quality and for service level.) Of the 102 municipal services identified as being contracted out, only a handful have been studied in depth, but cost differences are found ranging up to 96 percent. The best studied municipal service with respect to privatization is solid waste collection. Large-scale scientific studies in the United States, Canada, and Switzerland demonstrate conclusively that it costs the public 30 to 40 percent more when government agencies perform the service directly than when governments contract with private firms.

One of the studies I initiated at HUD, carried out by a private independent research organization in 1983, showed that for janitorial services the government costs were 73 percent greater than equivalent private sector costs; for street cleaning 43 percent greater; street resurfacing and paving was 96 percent more costly, traffic signal maintenance was 56 percent more costly; street-tree maintenance was 37 percent more costly; and lawn mowing and park maintenance was 40 percent more costly. The American Public Works Association, which is a professional association of public works officials, released a study in 1984 showing that a number of those services were 39 percent more costly when performed by municipalities than they were when performed in the private sector.

In addition to such cross-sectional studies, there are many anecdotal bits of evidence. My favorite comes from Detroit where the city government discovered it cost $26 to process a $15 parking ticket. They promptly contracted out the work to a private clerical firm, whereupon the cost dropped to $1.80 per ticket. This is a particular instance, but the overall evidence is mounting up, becoming more obvious and widespread, so that more and more communities are beginning to change their thinking.

It is important to recognize that the difference between public and private service delivery is not that people who work in government are somehow inferior to those who work in the private sector. The real issue is not so much public versus private; it is monopoly versus competition. Far too many government services—federal, state, and local—are provided as monopolies when they need not be, and it is very difficult to tame monopolies and make them work in the public interest. So the introduction of competition is appropriate whether the competition comes about from the use of vouchers, competitive bidding for service contracts, franchising, or voluntary efforts. It is the introduction of competition that makes the difference.

I advocate prudent privatization, not willy-nilly privatization. I have worked with many cities and governments in designing systems that will reap the benefits of competition and not simply trade a government monopoly for a private one; I do not think the public will be served well under either monopoly.

Possible Barriers

Employee opposition is one barrier to contracting out; employees are understandably afraid of losing their jobs. In addition, many public officials like the patronage opportunities that are available when there is a large government workforce. And, of course, there is the ever present budgetary imperialism at work; William Niskanen and other have written about that particular phenomenon.

In my observation it is not savings alone that trigger a changing and a shifting toward privatization. Savings are a necessary reason but virtually never sufficient. Political factors often outweigh potential savings of 50 percent. It often requires a major scandal, an unpopular strike, or legal action before governments change their ways and decide to privatize by contracting out.

A particularly appalling argument is that government inefficiency is a way to provide more jobs. I remember talking with a mayor, who admitted to inefficient operations in various city departments, but explained in all sincerity that, if they became more efficient, then they would need fewer employees and therefore more people would apply for welfare assistance. In other words, a city job was a form of welfare. I pointed out, patiently, that inefficiency in government is not a satisfactory full employment program and that all government operations should be as efficient as possible. If, however, the government wanted to create jobs as a matter of public policy, it should do so by providing more services to the public, not by performing the current services inefficiently. This was a novel idea for this particular public official.

Another barrier to privatization is ignorance. Herewith is a composite of dialogues I have had with local officials who have pointed with pride to the virtues of a particular operation—let us say street surfacing.

Savas: You mean the service is only costing you 50¢ per capita per year? That is remarkable. Tell me, does that include the cost of the vehicles?

Mayor: No, the vehicles are in the capital budget; their cost does not show up in the operating budget.

Savas: Does it include the cost of vehicle maintenance and fuel?

Mayor: No, those costs are in the engineering budget; they don't show up in the street repair budget.

Savas: Well, how about the cost of overtime?

Mayor: No, overtime has a special budget.

Savas: What about fringe benefits for employees? I understand in your city they are running to 38 percent.

Mayor: No, fringe benefits are in another part of the budget.

Savas: How about the taxes foregone on the garages and on the property used?

Mayor: No, we never consider the taxes. They don't count.

Savas: How about insurance premiums?

Mayor: We pay insurance premiums, but they are in the overhead budget.

The moral here is that the true cost of a service may be sprinkled throughout a budget, thereby making the stated cost appear attractively low. Such faulty bookkeeping, or rather bookkeeping not aimed at cost accounting, permits government agencies—federal, state, and local—to bask in the belief that a service is very inexpensive and offers no opportunities for contracting out.

Yet another problem is ignorance of basic economic principles. Recently, a reporter from Raleigh, North Carolina, quoted a city official as saying, "Government can do it cheaper because it doesn't make a profit." It takes only three milliseconds to realize that the statement makes no sense at all. The city official obviously has the simplistic notion that there is a certain universal and fixed cost to provide a service—whoever does it—to which a private firm adds a profit so that it costs more. Many public officials do not understand that the profit motive causes people to operate more efficiently.

There are ways to overcome the barriers. Public officials and citizens must be made aware of the benefits of privatization and of how they can bring it about. Public officials need to become more entrepreneurial in their outlook. A government executive should look at his job not as running an agency that performs a certain service, but rather as running an agency that assures that the service is provided to the public efficiently, effectively, and equitably. This means that a government executive really should consider decisions in the following way: Is it better to buy the service or to produce the service? This is odd phraseology in the public sector, but it refers to the same decision facing an executive who manufacturers TV sets. Should he buy the cabinet from a supplier on the outside or should he make it in his own factory with his own workforce? The answer, of course, is that it all depends. The executive must look at the entire picture and determine the best way to obtain the cabinets. Perhaps the answer is to buy them from several different suppliers so as not to be at the mercy of any single supplier, not even his own workforce. Public executives and public officials must do the same thing and decide when to buy a service and when to produce it with their own employees.

A particularly effective approach in a federal, state, or local government, is to privatize part of it, maintain part of it in-house, and get a competition going. Many successful government executives have introduced systems of competitive bidding where their own agency bids for work against outsiders, and the work is divided among several different providers. Then the government executives are in the superior position of being able to judge if, at the end of the year or two, one provider is doing a better job than another. And then the official can expand the amount of work being done by the more efficient and effective organization and shrink the amount of work done by the less efficient, less effective organization. My own studies show remarkable results when that kind of competition is introduced; in a few cases the public sector has been able, finally, to match the private sector in cost and quality of service. Such institutionalized competition seems to be growing and should be encouraged, provided that government costs are properly calculated.

The Heritage Foundation has called for the creation of a Presidential Commission on Privatization. Along with that, there should be a White House Conference on Privatization, to focus greater attention to the issue and to point out that the public can be better served by prudent privatization.

There are many opportunities, but there is much education and proselytizing to be done. To repeat, I do not believe in blind privatization, but rather area by area, service by service, agency by agency, the alternative ways to privatize should be examined, the best one chosen on the behalf of the citizenry, and privatization then set in motion.

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Guest: Why should governments contract for garbage collection? Why not let each household make its own arrangement for service, in other words, use the free market?

Dr. Savas: There is a clear answer to that, and it demonstrates why each individual service must be examined on its own. In the particular case that you raise about garbage collection, there are certain economies in having one organization go up and down the block collecting from everybody on the same day, rather than having five different companies going five different days up and down that same block. It is much like the economies of scale in newspaper delivery. Having each homeowner's newspaper delivered by a different delivery boy is clearly inefficient; it is more efficient to have someone go down the block and deliver all the newspapers. Moreover, in this service the cost of billing is substantial when it is done on a private basis—as much as 15 or 20 percent of the total cost of service is spent to send out monthly bills to each individual household and to absorb bad debts. Thus, for this particular service, certain economies can best be reaped by having not continuous competition, in the way that you described, but rather by having a system of intermittent competition—it can also be called a temporary monopoly, where the temporary monopoly is awarded for a certain period by competitive bidding.

Guest: Why not simply require each family to arrange and pay for service privately?

Dr. Savas: The problem that arises in that situation is how well the law is enforced that requires every family to have such a contract. In parts of cities a common problem is that low-income families will not do that. They either try to stuff their trash into somebody else's garbage can, or toss it into the street, or do some surreptitious night dumping; then the problem becomes one of filthy streets. The system will work well in a homogeneous upper-middle-income suburb. In such communities, every household can get the service it wants. If you want service seven days a week from inside the kitchen and are willing to pay for it, then, by God, you can have it. I have seen such a system in Cairo, Egypt, and San Francisco has one not too different from that.

Guest: Where can one get information on contracting out?

Dr. Savas: There are several good places. The Local Government Center in Santa Barbara, California, is particularly good. They are putting together a data base for this. My own books contain useful information and so does a recent book by the Urban Institute.

Guest: What would a White House Conference on Privatization address?

Dr. Savas: The White House is "a bully pulpit," as Theodore Roosevelt said. White House conferences focus attention on particular problem areas, or particular opportunities. In this case I see this as an opportunity—for privatization that the American public has not yet fully availed itself of. A well-organized White House conference, addressing different kinds of approaches and bringing in various people, can be a valuable source of information and a great impetus. Bringing together the people who have actually done it—not the theoreticians or the ideologues—the people who have experienced it, who have run volunteer organizations and neighborhood organizations that provide different kinds of services, people with successful experiences in voucher systems and in contracting out. There are abundant experiences from people all over the country that more people ought to know about.

A decade ago it was fairly lonely talking about this subject, but the more successful experiences around the country, and the more officials (federal, state, and local) who take notice, the greater the mutual reinforcement of self-support. A particular public official may hesitate to be the first one on the block to privatize, but the more successful examples he sees around him, the more rapid will be the move toward privatization. Privatization works; the evidence is there, and if we share the experiences through a White House Conference on Privatization and a Presidential Commission on Privatization, I think it will help eliminate some of the concerns, shed more light on successful experiences, and let more people see what their neighbors are doing in different parts of the country.

Guest: Why don't we encourage privatization in our foreign aid programs?

Dr. Savas: Your question is a good one, and I share in the frustration that I detect in your voice. We have had Americans in international organizations go abroad and create agencies in developing nations that are mirror images of our own malfunctioning bureaucracies. Lo and behold we have thereby infected the developing world—not with Spanish disease or French disease—but with another kind of illness. Once people are empowered in bureaucratic agencies, particularly in the more dictatorial of the developing nations, it is very difficult to turn things around. The result is economic disaster and miserable public services. And yet the activities that seem to function best in developing countries are precisely those where individual entrepreneurs are ever alert in finding better ways to satisfy the people's needs. Transportation offers an example. Free market gypsy cabs are found not only in New York City and Hong Kong, but also in Belgrade and Moscow—I have ridden gypsy cabs in Moscow. Entrepreneurs in developing countries have created jitney systems and this is something we can import from them and utilize in our big cities. Making the transition to more cost-effective privatized services in developing nations is difficult, but I believe that it can be done by pointing to examples from successful developing nations, which rely more on the private sector.

Guest: Is it possible to privatize through employee stock ownership programs?

Dr. Savas: Yes. That can be an attractive route. A plan to "contract out" inevitably generates employee opposition, even though there are successful techniques used by governments to make the transition in a humane way without harm to current employees. Employee stock ownership plans can be particularly attractive because in one fell swoop they give employees an opportunity to get involved from the ground floor up in their own business. In England privatization has been proceeding effectively under Prime Minister Thatcher, and a particular technique that worked successfully was to sell the organization to its employees. The employees took to capitalism as ducks take to water. And now employees of one agency are trying to buy other public agencies that are in desperate need of privatization. There are many opportunities, and enlightened public officials can figure out the best approach, how to get over the very real barriers, and how to create the political coalitions that are needed to make privatization work.

One of my frustrations has been that minority communities have not latched on to this idea, particularly in cities. When I was first Deputy City Administrator of New York, I worked with the Bedford Stuyvesant Restoration Corporation and encouraged them to create a private corporation, comprised of indigenous people in this primarily black area, who would compete against the city government in providing city services. There was predictable opposition from city employees, but there was also a lack of leadership from the political representatives of those communities. There are extraordinary opportunities in American cities for local indigenous groups to get into the business of supplying municipal services, in competition with the existing government bureaucracies. This has not yet been sufficiently taken advantage of, in my opinion, and I think the political leadership from the minority community has passed up many opportunities.

Peter Ferrara: You mentioned the mayor in North Carolina who said that the public sector cost less because it does not make a profit. Another counterargument that is widely accepted among economists is that profit is merely the return to investors on the capital that they put into the company. If government does it, and borrows the funds to do it, it is going to have to pay interest anyway. If government does it and uses current tax receipts rather than borrowed funds, then the taxpayers incur an opportunity cost—foregoing the return that they could get on that capital investment in the private market—and in effect they are bearing the same cost as well.

Dr. Savas: You are absolutely right, and there are audiences and groups and public officials to whom that argument can be made. However, I despair of explaining opportunity costs to local officials.

Guest: Where can I get information on housing vouchers and their advantages over the conventional programs of public housing and construction grants to builders?

Dr. Savas: There are HUD reports available on this, and the testimony presented at Congress's hearings on the HUD budget contains some of this information as well.

It might be asked why Congress has not embraced housing vouchers wholeheartedly if they are so much better than subsidies to builders. A cynic would answer that builders make bigger campaign contributions than voucher recipients do. I would not dream of repeating that particular theory so close to the Capitol, but it is something to bear in mind. I understand that Heritage published a paper last November that has a voucher proposal. It recaps those statistics and can give you some references.

Some people say that contracting out still keeps government in the picture and is not true privatization. They believe that only the free market should be used. I disagree. Privatization means increased reliance on the private sector. There are several different approaches to privatization, including vouchers, franchises, and contracting out, all of which involve some role for government. If it is privatization by their definition, and more efficient and effective than a government monopoly, then I am all for it even if ideological rigidity is not the approach to gain pragmatic converts and to achieve the improvements that the American people want and need.

Guest: Isn't health care a private system and isn't it in trouble?

Dr. Savas: The issue of health care presents a real challenge. The current system cannot be called a private one, because even though there are private doctors, in one way or another they are paid at least in part through a variety of government program. The same is true of hospitals with their cost-reimbursement formulas. I think it would be unfortunate if the privatization movement were to consider hospital care as an example of privatization. It is not a good example. HMO's (health maintenance organizations) are a potential answer to that, but in no way should the current medical system be described as private.

Guest: Is it possible to reduce hospital costs through privatization?

Dr. Savas: Yes. One technique is by disaggregating the various hospital functions. It is not necessary to take an entire county hospital and privatize it, although in some cases that may make sense. Another approach would be for pieces to be privatized. For example, the pharmacy or the clinical testing laboratory can be privatized with competitive bidding for a franchise to operate on the premises. The one who bids the lowest prices would win. Custodial services and meal services can be contracted out or operated on a franchise basis respectively. The system can be looked at in pieces to find out, "Where in this system are the opportunities for doing this kind of privatization."

In hospitals there is beginning to be some interesting movement toward privatization. I heard a radio advertisement for a hospital with a new system whereby a relative of the person who is ill can move into the hospital and provide some of the routine, nonprofessional care that is needed. This is a form of privatization because it means having a family voluntarily perform functions that might otherwise be handled in a bureaucratic fashion by hospital employees in a public hospital or in a quasi-private hospital that is receiving public funds. This is a remarkable new development. The private sector has also introduced hospices and the birthing movement, where midwifery is back as a new phenomenon. In these instances, the private sector in a free market is introducing alternatives to the high cost of medical care. It is a different approach, not the same as contracting out specific hospital services, or selling hospitals to private corporations, but it also is a form of privatization.

Guest: Two questions. First, isn't there a lot of philosophical opposition to privatization? Second, what is the evidence about private power generation compared to public power, as in the Tennessee Valley Authority?

Dr. Savas: That is why I try to go to lengths to de-ideologize the subject. I find that there is more rapid progress if the issue is approached pragmatically, not ideologically. There is the appeal to the common sense notion that competition is generally better than a monopoly. Simple principles of this sort demystify the subject and facilitate an approach along pragmatic grounds. The evidence on privatization speaks eloquently for itself. If it is overpoliticized and overidealized, potential allies are lost.

One of the chapters in my book deals with the existing evidence on private and public hospitals, private and public airlines, private and public power. With respect to public and private power generation, there have been several conflicting studies, but they are not persuasive one way or the other. A definitive study is needed.

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The Politics of Privatization

Robert Poole

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Among advocates of the free market approach—conservatives and libertarians—it has already become something of a cliché to say that the federal deficit is not the problem; the problem is the size and scope of government. I think most Americans would agree that the federal government is too big, too costly. But that agreement by itself does not seem to have been effective over the last three years in producing any substantial cuts in the size, scope, or responsibilities of government.

Why hasn't it? I think a big part of the problem is a marketing problem. People see cutbacks in government as eliminating things that have some value to someone and for which they see no ready replacement, no alternative. And if you are marketing ideas, you cannot replace a "something" with a "nothing." If certain things are removed from government, they have to be replaced with a credible, workable alternative from somewhere else that will actually do the job and not leave people hanging. That's where privatization comes in and why privatization is so important as a way of making the case for cutting big government.

The fact today is that government—local, state, and federal—is involved in hundreds, if not thousands, of business activities in which it has no real comparative advantage and no basic reason for being involved. The classical argument for why government should provide certain things is "market failure." Certain things are alleged to be inherently public goods—things the market cannot or will not provide—rather than private goods. By the nature of a public good, if it is produced at all, then everyone will benefit from it; you cannot identify and charge specific customers. Supposedly it is impossible for private enterprise to get together and figure out a way to produce that particular good or service.

But a look at most of what government does shows that those conditions do not really apply. Government is involved in the insurance business; it's involved in transportation; it's involved in manufacturing; it's involved in all kinds of information service businesses, all of which are essentially private goods with specific customers or beneficiaries. The problem is that all sorts of political games are being played as to who pays what and who benefits. But it is not the case that these services cannot be supplied by the market.

I said a few minutes ago that government has no comparative advantage in producing many of these goods and services. Let me quote from last week's *Wall Street Journal* a front-page story on the New York subway. It is about the travails of this poor man who has taken over as chief and inherited "a 230 mile subway system that is synonymous in the public mind with dirt, danger, and delay," He faces "uncontrollable subordinates, multiplicity of bosses, angry groups of riders, and political pressures that even jaded New Yorkers find remarkable." Then it goes on to talk about the 42 state and local agencies that have some degree of control over the MTA, and mentions some examples of mismanagement: "Workers at the Coney Island Repair Shop recently had to bring their own rags and sponges because the transit authority was out of them. On the other hand, the agency has a 27-year supply of radiator assemblies and 144-year supply of snow chains for buses." This is not really a comparative advantage at producing transportation. When several MTA officials visited a bus garage in upper Manhatten recently, "they found a unionized foreman letting a mechanic work on his own car even though nearby buses with broken doors and smashed windows needed repair. The vice president decided it would be futile to discipline the foreman because of job protection provided by the transit unions."

That is really not the way an advanced, affluent society ought to be running transit in 1984. That is a business being ground into pieces by the most blatant kind of mismanagement. I do not think our society can afford to put up with this sort of costly boondoggle. That is why we need privatization.

The Experience of Local Government

We have a subsidiary at the Reason Foundation called the Local Government Center. It has been a lone voice over the last five or six years researching and publicizing the extent of privatization at the state and local levels. And there are hundreds of exciting success stories from all across the country, of services that most people assume government has to do that have been successfully privatized. For example, by now many people have heard of the private fire department in Arizona that provides service to Scottsdale and does as good or better job as nearby government fire departments—at 50 percent of the cost, as measured by independent studies. Few people realize that the publicity that we and others have given to that one example has helped spark a growth industry in private sector fire protection, to the point where private sector fire service exists in fourteen states, and there are seventeen or more companies in the business. In February, *International Fire Chief* magazine devoted an entire special issue to private fire service with four major articles and some other supplementary material. So there is a track record being established. But most of the national media are not aware of these success stories in turning over goods and services to the private sector to do a better and cheaper job.

Tax cutting referenda like Proposition 13 in California and Proposition

2½ in Massachusetts have helped because they have shaken up the status quo constraints to the point where they have gone past some of the bureaucracy and the resistance to change. The tax revolt provided some incentives for local elected officials to look at charging users for services that used to be free, such as emergency ambulance service. There has been a large-scale move in California in the last few years to shift from government provision to private provision and to shift from large subsidies to very minimal or no subsidies by putting in reasonable user fees for paramedic service. Paramedic service has been moving more and more into the private sector in California and at great savings in cost. Typically when a fire department runs a paramedic service, they hire and train people who for the most part do nothing but respond to emergency medical calls; the equipment sits idle a vast majority of the time. Private sector firms typically use the same people and equipment providing transport services to nonemergency patients. It makes for the kind of economic efficiency that goes along with private sector management, but not usually with government agencies.

There are dozens of success stories in just the last few years in local transit, where there has been deregulation and opening up the local market; breaking the monopoly of established, heavily subsidized transit agencies; allowing private entrepreneurs to come in; transforming moribund cab firms into diversified transportation providers that substitute for money-losing bus routes, and substitute for wheelchair-lift-equipped buses with specialized transport for the handicapped—at a half or one-third the cost of what it was costing in the typically centralized, bureaucratic, subsidized way.

What we have learned from these lessons at the state and local level is that it makes a great deal of difference how services are organized and provided. Competition works much better than monopoly. A profit incentive is a stronger incentive than any bureaucratic management incentive. Charging users, wherever possible, a market-type price, even if the service is still provided by a government agency (but preferably turned over entirely to the private sector), works a lot better than tax financing. What these privatization measures lead to in general is lower costs, innovations in how to organize people and equipment and procedures, and overall a better level of service for much less money.

Privatizing Federal Progams

I have prepared a list of federal goods and services that I think are candidates for privatization (see Table 1). It is a preliminary list and not

Table 1

PRIVATIZATION OPPORTUNITIES
A Preliminary Listing of Federal Programs

Program	Privatization Mode	Research Mode
Health and Welfare		
Social Security	Retirement IRA	Cato, Heritage
Medicare	Health Bank IRA	NCPA
Information and Communications		
Postal Service	Deregulate, sell off	IEA
Weather Service	Sell off	Reason
Census Data Products	Transfer	
Frequency Spectrum	Sell off	Cato
Geosynch. Orbit Slots	Sell off	RFF
Resources		
Hydropower Plants	Sell off	Grace
National Forests	Sell off	PERC, Reason
Wilderness Areas	Donate	Reason
BLM Grazing Lands	Sell off	Cato, Reason
Transportation		
Washington Airports	Sell off	Grace, Reason
Air Traffic Control	Sell off	Heritage, Reason
Amtrak	Sell off	Heritage
Interstate Highways	Toll/Sell off	Reason
Inland Waterways	Toll	Taxpayers Fndn., CBO
Shuttle	Sell off	Grace
Coast Guard SAR	Transfer	Grace
Military		
Commissaries	Sell off	Grace
VA Hospitals	Contract out	Grace, CBO
Military ATC	Contract out	Grace
Airbase Operations	Contract out	Grace
Intelligence Assess.	Contract out	Reason

Full names of research sources:
- Cato Institute (Washington, D.C.)
- Congressional Budget Office (Washington, D.C.)
- Grace Commission (President's Private Sector Survey on Cost Control)
- Heritage Foundation (Washington, D.C.)
- Institute for Economic Affairs (London)
- National Center for Economic Affairs (Dallas)
- Political Economy Research Center (Bozeman, Montana)
- Reason Foundation (Santa Barbara, California)
- Resources for the Future (Washington, D.C.)
- Taxpayers Foundation (Washington, D.C.)

meant to be exhaustive. It excludes, for example, many things that are done at the local level but subsidized by the federal government, such as public housing and mass transit. It includes only programs and assets that are strictly federal in the sense that the federal government owns, operates, and provides them. The characteristic that lets each one on the list is that one or more think tanks has done one or more studies that has looked into and established a case for privatization. So this is a list of things that already have been researched, at least to a preliminary extent, and for which a feasible case has been found.

Some notable aspects of this list include, first of all, two middle-class entitlements: Social Security and Medicare. I put those at the top deliberately because, if we want to talk about privatization as a strategy for reducing the size and scope of government, it is ridiculous to exempt the big-ticket items. And two of the biggest ticket items in terms of overall magnitude and rate of increase are Social Security and Medicare. But besides simply being large and having an impact on the budget, they are areas where a very profound case can be made, and has been made by organizations like The Heritage Foundation and the Cato Institute, that people deserve a better deal than the kind that they are going to get in the future from these programs. In particular, younger people deserve a better deal than what they are going to have. And the substitution of an IRA-type program that gives individuals control and choice over the type and form of retirement benefits they will have is a very marketable idea and gives people something solid and real. Presenting the case this way doesn't just take away something from people in the way that typical budget cut programs do. It offers a better deal to future retirees than they can get from government's badly managed so-called insurance program.

Obviously, these entitlement programs are areas where it is hardly feasible to make immediate, fundamental, top-to-bottom changes. The changes would have to be carefully phased in over many years. But the long-term dollar advantages would be tremendous, and the long-term benefits to the future recipients would be tremendous as well. There would actually be something there instead of nothing—which is a very big benefit.

Another notable aspect of the list is that the federal government owns some tremendously valuable assets, which ought to be seriously looked at as candidates for privatization. Again, there are potentially huge dollar savings, but there are also tangible benefits in terms of better use and management in private hands. Hydropower dams are one major asset. The Grace Commission has recommended privatizing those dams and estimates budgetary savings—or yield from the asset value receipts—at something like $20 billion from just the sale of these dams in the West. The Bureau of Land Management owns and mismanages vast amounts of acreage in this country; a couple of years ago a member of Senator Charles Percy's (former R-Ill.) staff made an estimate of the asset value of just the prime BLM lands and came up with a figure of $200 billion. Now I have not seen the details of that and I cannot vouch for it. But if it is anything like that magnitude, it is a tremendous asset. And yet the costs of managing that land, the annual operating costs, are far more than the federal government takes in in grazing fees. So here you have a net loss in an operational sense on a tremendously valuable asset. That's no way to run a business.

Steve Hanke, who was a senior fellow at The Heritage Foundation until recently, did a study of the asset value of national forestland as timberland and found it to be more than $100 billion. Here again, there is a net operating loss on that asset of more than $1 billion a year. It is mind boggling to think of how badly managed these assets are, and the insane kinds of things that are done, like spending $1,000 to recover $100 worth of timber by building roads in inaccessible places. And many of these activities have extremely destructive environmental consequences. They are the kinds of things that no private owner in his right mind would spend money on. Only a subsidized system where cost is really no object permits this sort of thing.

There are some other assets whose market value has not been estimated, as far as I know—for example, the frequency spectrum—frequencies that are used by radio stations, television stations, communications satellites, two-way radio services of all kinds, and mobile telephone service. Now these are used as if they were private property rights and in fact, when a radio station changes hands, a tremendous price is paid because of the access to a frequency that goes along with it. And yet the federal government maintains the fiction that these valuable frequencies are somehow publicly owned. No one ever tries to put an actual dollar value on them. People cannot legally buy and sell them and allocate them by the market. So we really do not know what they are worth. And yet if they were privatized, if they were sold into private hands, presumably to the existing users who are the *de facto* owners, they would yield a large one-time chunk of revenue. In addition, the use and allocation of the electromagnetic frequency spectrum would likely be much more rational, if the frequencies were private property and traded in a market rather than bureaucratically allocated by the Federal Communications Commission.

One last kind of asset is the information that is generated by many government agencies—for example, the Census Bureau. The Constitution authorizes enumeration of the population for the purpose of deciding the number of congressional representatives from each state. But nowhere does the Constitution authorize the government to be one of the largest information businesses in the country. And yet that is what it has become through the proliferation of questions on the Census and the huge amount of analysis of that data. But most of the data are sold at far below probable market value. So again, it is artificially priced, and there tend to be incentives to produce more and more of it without knowledge of what it is really worth. So there is the possibility of large amounts of data being produced that people might not really be willing to pay for. Then again they might, and if they are, then why aren't they having to pay for it instead of getting it free or way below cost?

A theme that has come up in several things I have said is that of benefits from privatization. I think it is a tremendous mistake to portray privatization primarily as a means for cutting budgets. It certainly is that. It is one means for reducing the size and scope of government, finally getting the whole business under control, and producing an affordable government. But I do not think that it is ever going to be saleable to large numbers of people for that reason alone. The exciting, marketable case that can be made is that we do not have to put up with bureaucratic boondoggles like the New York subway system, national forests, and the BLM lands losing $1 billion a year on incredible assets. We can get a lot more for our money through the incentives of the profit motive and the private sector. That is the case that needs to be made.

The Reason Foundation did a study on weather service about a year and a half ago that came out about the same time as the Administration's ill-fated proposal to privatize weather satellites. It was not limited to weather satellites, but looked at the entire business of gathering and marketing weather information, which is part of the information industry. It looked at who the users are and what they get for this service that is largely provided free. Of course, the common impression of what helped to torpedo and ridicule the idea of selling the weather satellites was that you and I are the customers for weather data. But the real customers are the people who buy it at wholesale and turn around and retail it the television networks, the local television stations, radio stations, and newspapers—well-off, prosperous businesses that can well afford to pay for the information that they use as a marketing asset for selling their papers or selling advertising on their stations. The other customers are agricultural organizations, who get the information largely secondhand from the wholesalers, and specialized customers like shipping lines, truck freight lines, and airlines that need much more specialized data than simply the general weather forecast.

The sad fact is that those people are being very badly served by the kind and quality of data that the weather bureau puts out. For example, a NASA researcher has looked into the specific weather service program that provides high-altitude wind data to airlines to that they can schedule their flights, take advantage of tailwinds, and avoid storms. It turns out that the data are collected only twice a day by sending up high-altitude balloons. And in a 12-hour period the winds at high altitudes can change dramatically. This NASA researcher has estimated that about $1 billion in fuel is wasted every year because those forecasts only come out every twelve hours. The weather service has no incentive whatever to produce better data because they cannot charge the airlines for it. They are struggling as hard as they can to make do with the budget that they can squeeze out of Congress. The National Advisory Commission on Oceans and Atmosphere estimates that the weather service needs $1 billion in new capital equipment over the next few years to keep up with technology and so forth, and they do not know how they are going to get it. But if they put a new fee on something, the money goes into the government's general fund. This is no way to run a business. And the point is that the weather service is a business; it is not a public good in the conventional sense.

There are some dangers inherent in privatization moves that do not go far enough. There are basically two major dangers: one occurs in the form of partial privatization that says "Let's keep the service provided by government (like weather data or highways, or whatever) but put a user tax on it so that the users pay." The problem is that government is very bad at doing rational pricing that would resemble what market institutions would do. So they usually end up enacting something like the gasoline tax that does not reflect fairly what damage heavy trucks are doing to the highways, because the rates are set by political mechanisms. Similarly, the aviation fuel tax charges people who do not benefit from air traffic control services and undercharges others who do. It undercharges the Lear Jet owner who takes up just as much space in a traffic pattern as a 747, but because he only uses a small amount of fuel, pays much much less for the service. But it overcharges the guy in the Piper Cub who never goes into an airport with a control tower or uses any air traffic control services. These are very crude kinds of instruments that government comes up with under political pressure and calls user fees. Most of them really are not user fees. They are usually just taxes. So there is none of the benefit from market pricing in figuring out what services are really valuable that would accrue when users pay directly. The lesson is that, if a service has identifiable users, and there is any sort of feasible way that they can be charged in proportion to what they use, the service might just as well be put into the private sector. That would insulate it from the political pressures that lead to charging taxes instead of prices.

The second danger comes from the form of partial privatization called "contracting out," where the government continues to collect taxes, but instead of producing the service itself, hires one or more private firms to deliver the service. Now in general, as a transition step, this is a very good idea. It helps to demystify the idea that only government can provide the service, gets people used to seeing private firms in the field, and helps to create the supply side of the equation. It is also useful in areas like national defense where the function itself is inherently governmental but needs more efficient provision of certain aspects of it, like repairing aircraft engines. For most of these business-type activities, the objective should be to put the service into the marketplace because the danger, the temptation, is always to play favorites—for example, to let people buy into contracts and then charge more later or to write the bid specifications so that a favored firm is the only one that really qualifies. As long as politics exist, that temptation is going to be there. So privatization can lead to some bad results if it is pursued only as far as contracting out and if that isn't handled under truly competitive conditions.

In sum, here are the lessons. Privatization properly implemented offers tremendous opportunities for getting rid of boondoggles, providing better services, and shrinking the size and scope of government. But two things must be done to make it happen: first, define what the benefits are so that people are not afraid that they will be left with nothing where they used to have something from government; second, build coalitions that can work to implement privatization, just as the coalitions in favor of continually expanding government have done over the years. Such a coalition would include the providers or the potential providers of the service, groups of beneficiaries (when you can identify who they are), and sympathetic people in the administration and legislative bodies who can be persuaded that the case is really there—that they can do something heroic by moving a service out of inefficient government-monopoly provision and into the competitive private sector.

An example of this has happened over the last year and a half with airport control towers at small airports. When the controllers' strike led to the closing of many small airports by the FAA (either temporarily or permanently), a market opportunity was created and several small firms that had already been providing control towers, at half the FAA's costs, moved in to start filling the gap. And finally the FAA got into the act with a program to contract out the operation of small control towers, as a way of reopening service at temporarily closed airports. That program has grown significantly over the last six months, primarily because of a lot of publicity that we helped give it, and partly because a major beneficiary group, the American Association of Airport Executives, got involved, took it on as an issue, and spread the word throughout the aviation community. Beneficiaries also got into the act—Chambers of Commerce in small cities and companies with manufacturing plants that wanted to have a control tower to serve their planes helped make the case for this issue. It even showed up on the "Today Show" several weeks ago. Control tower privatization was presented as a way of saving money for people and providing a higher level of safety because communities can afford to have more control towers at more airports. This is a good example of a successful coalition that is now proceeding to expand this promising idea, showing that the private sector can indeed do a job that people have taken for granted was a government function.

The bottom line is that there is real potential for major changes, but privatization has to be sold on the basis of doing a better job and offering benefits, not simply as a way of cutting things out and causing people pain by reducing government benefits. If we do it the right way, I think we can make major progress in shrinking the size of government.

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Guest: I don't read about transit deregulation in the *New York Times* or the *Washington Post*. Where is this sort of activity taking place?

Mr. Poole: What is happening is in cities other than New York or Washington where they are doing it step by step, piece by piece. The city of Phoenix, Arizona, for example, has eliminated all of the government provided bus service on Sundays. They found that the ridership was very, very low. Their losses on Sunday service were about five times what they were on regular daily service, so they eliminated the Sunday buses and contracted out the service to taxicab companies. The cost per passenger is something like one-fifth as much. And they are doing that now on an experimental basis with a number of what were their most money-losing bus routes. They have contracted them out to taxi and minivan firms. And these entrepreneurs are out there, usually with nonunion drivers and with vehicles that are less costly to buy and operate, providing the level of service that is needed, but without the incredible expense occasioned by featherbedding work rules, above market salary levels, and very costly vehicles.

In San Diego they opened up the local transit market and so they have now something like 35 or 40 privately operated jitneys in operation, providing service in some areas that never had public transit before. In other areas, the displaced bus service and competitive pressures from these jitneys and from deregulated taxicabs in San Diego have led to a historic wage agreement with the drivers in the transit union similar to what's been going on with airline deregulation. They have agreed to a 50 percent cut in the wage scale for newly hired people for any new service. This is just phenomenal. Nothing like this has ever happened before, but it shows the power of switching to a competitive marketplace even for bits and pieces of the service and the power that it has in promoting efficiency and better use of resources. So I think it is possible to do this in a bit-by-bit, nibble-away-at-the-edges fashion.

Guest: Should there be an office in the federal government to promote privatization? It seems to me that, at present, the federal government actually discourages saving money, for example, by making federal aid proportional to a community's tax effort. And just last week the Justice Department announced that it was supporting a bill in Congress to restore cities' immunity from the antitrust laws. That exposure has been a powerful force in breaking up municipal monopolies.

Mr. Poole: I would agree with you on all three points. I think there should be a focal point within the federal government to encourage and actively work for removing barriers to privatization and for figuring out initiatives to promote privatization within the federal government and in terms of aid programs to state and local government. And I think it is entirely backwards that federal aid programs now reward local governments for taxing their citizens harder, as opposed to rewarding them for easing up and allowing things to be privatized.

The last point about monopolies is especially important. Some of you may have heard that there was a U.S. Supreme Court decision in January 1982 in a case in Boulder, Colorado, involving whether a city could grant an exclusive franchise for cable TV. Their ordinance was challenged on antitrust grounds and went all the way to the Supreme Court, which ruled, "Well, this is interesting. We don't think that a city is automatically immune from the antitrust laws even though state governments are." And that decision (it's called the "Boulder Decision") has had a tremendous effect around the country. It has led to challenges to a number of other cable TV franchises. It has opened up the transportation and taxi market in a number of cities. It has led to new competition in garbage collection. In other words, it has been a lever to free up competition at the local government level and to foster entrepreneurship and break the grip of many long established anticompetitive arrangements. Unfortunately, a lot of conservatives have bought the arguments of the organized city lobbying organizations and have decided that this is a terrible thing that reduces the rightful power and control of local governments to set their own destiny. This instigated legislation in the House and the Senate that would essentially overturn the Boulder Decision. And just this past week, if I am not mistaken, the Justice Department endorsed that legislation. That is a terrible step backwards for what had been a very promising new development, which could have had good effects all around the country.

Guest: Wouldn't the prospects for privatization be even worse under a liberal administration?

Mr. Poole: I think it would probably differ from a liberal to a conservative administration, but I would like to remind you that, for example, the opting out feature in the Social Security retirement program that exists in England was introduced by a Labor government. Airline deregulation was sponsored and shepherded through the Senate by Teddy Kennedy, and trucking deregulation was promoted by Jimmy Carter. So I think we have a strong enough case with privatization—if we focus on benefits and make it appealing. We should not tolerate the kind of waste and inefficiency and anticompetitive, collusive kind of arrangements fostered by government control of markets, and we can make that a consumer issue with tremendous numbers of beneficiaries. It takes some work to do it and thinking in those terms is not something that conservatives have been used to doing. They have focused on being the penny pinchers and the bad guys. But if we get past that mind-set and really focus on benefits, I think it is possible to build coalitions that appeal to liberals, and we have some evidence of that already.

Guest: The short lives of the Administration's plans to privatize the weather satellites and public lands leave me pessimistic about the saleability of privatization proposals.

Mr. Poole: Those were marketing problems. The case has just not been effectively made that we have a serious problem with the way things are being done when these various services are provided in a socialized way. The evidence has not been marshalled together to show how beneficial it could be to shift from inefficient to efficient producers and from taxes to market pricing. The weather satellite issue was a classic case. It appears that no one had given any thought to the marketing of the idea that what was really involved was weather being part of the information industry, of looking at the examples of the existing private weather services and what they do. And it was probably poor strategy to pick that very visible piece of it, the weather satellites, and try to go first with that, rather than looking at more rational pricing and at the idea of who pays and who benefits and at identifying costs and problems of a socialized weather business. It was a solution where there wasn't a perceived problem. People must see that there is a problem first in order to solve something by privatization. The problem is an incredible misallocation of resources; weather data is largely not priced and therefore is produced in the wrong quantities and goes to the wrong places. Until that story is told and dramatized effectively, there is no reason for anybody to want to change things. Everyone who had some stake in the status quo got right out in front and made their case. So the proper case wasn't even heard.

Guest: Is there significant growth in the extent of privatization, at least at the state and local level?

Mr. Poole: I am trying to abstract quickly from a lot of specific examples, but I think in most cases, yes. Fire protection, for instance, is so unusual that it sounds fanciful until people see it really happen. There was one good entrepreneurial firm, the one in Arizona, that was the pioneer of the private fire business. *Reason* wrote up the story in 1976, which led to a "60 Minutes" television broadcast in 1978. That gave other entrepreneurs the idea that maybe this was a good way to make a buck, something that could be expanded. And that has sparked the growth of other entrepreneurial firms in just the last four or five years to the point where today a city of up to 150,000-200,000 can issue a request for proposals for fire service and actually have a realistic chance of getting two or three bids from national firms with a track record. That situation did not exist just five years ago because there was only one company out there that had any likelihood of being able to bid. There is even talk now about some major companies, like ARA Services, getting into the business.

There was an article in *Education Week* a couple of weeks ago saying that Bell & Howell, Encyclopedia Britannica, and I.T.&T., all of which operate postsecondary training schools, are looking seriously at the secondary school and elementary school market with an eye to setting up profit-making school divisions, because there is such dissatisfaction with the public schools.

The market opportunities are out there. The Corrections Corporation of America is going out actively bidding for contracts to operate prisons, not just halfway houses, but full-scale, lock 'em up, bars and gates prisons, and building them on a turnkey basis. And, of course, Hospital Corporation of America and all the private hospital chains have set a very good track record for ten or fifteen years. Sometimes an industry like the hospital chains is out there already doing a good job on a profit-making basis. And then the idea comes along: maybe they can take over some money-losing turkeys from the public sector. In other cases, the firms that are working there first, beat at the door trying to get government to turn over some things to them and then that leads to others. So there is probably not a single pattern.

Guest: You have said that privatization saves money, but how extensively has this been documented? Are you relying on anecdotes, or do you have hard data from studies?

Mr. Poole: The area that has the most privatization and that has been studied the most is garbage collection. Steve Savas directed the national study funded by the National Science Foundation that showed 30 to 50 percent cost savings from privatization. And just last year at the University of Victoria in Canada, a nationwide study found essentially the same thing to be true in Canada—a 30 to 50 percent cost savings from private sector garbage collection. I am not aware of any studies of a comparable scope on a nationwide basis in any other area. I know of specific case studies where people have come in and studied a private operation and compared it to government ones; the Scottsdale, Arizona, case has been subjected to that kind of analysis. And a number of other services have had small-scale case studies. I hope the Reason Foundation will eventually get around to doing some large-scale national studies. But it is costly—a massive kind of thing.

Guest: Would you favor a federal policy mandating contracting out?

Mr. Poole: Other things being equal, I would rather see a legislative measure, or better still, a constitutional amendment, that says "government shall not be in business," and so forth. But at the federal level, we have had Circular A76 from OMB that essentially says that. We have had that for 15 or 20 years. It says that services that are not inherently governmental, which presumably is shorthand for "a public good," shall not be performed by the federal government and shall be put in the private sector. But one major problem is enforcing such a policy, when there isn't the will to do so and there isn't a consensus to buck the vested interests. But the other difficulty is even getting such a rule passed in the first place. If you have to convince a legislature or Congress to adopt it, there is no reason why they should unless they are convinced there is a strong case for it and that it will make people better off. It seems to me that a very strong argument is being able to point to something real and show that it works. I am an academic in the sense that my business is words and studies and thinking and so forth, but it seems to me all the studies in the world are not as persuasive as the tangible facts of private firms out there controlling air traffic or picking up garbage or putting out fires and doing a bang-up job, costing less money, thinking up innovations—that is a very powerful persuader. So the more examples that are created and then followed up by publicizing, the easier it is to create a climate in which measures can be passed that encourage it. But I do not think the measures will come unless enough people see that is a beneficial thing.

Guest: Your "laundry list" mentions contracting out defense intelligence work. Where can I find out more about that proposal?

Mr. Poole: That is suggested in a chapter in the Reason Foundation's new book, *Defending a Free Society*, where some of the criticisms of major intelligence failures are reviewed. A lot of experienced analysts are very perplexed that you get a syndrome, especially with a centralized kind of structure, where a Director of Central Intelligence at the apex filters everything that comes in from the underlings and tells the higher-ups what they want to hear: "The Shah of Iran is in fine shape," "We're winning the war in Vietnam," that sort of thing. And so there is some support now in the intelligence community for the idea of competing assessments, but it is not taken very seriously. One of the things that we point out in the book is that there are people in the business of making objective assessments of what is likely to happen in foreign countries. They are political risk assessment firms, and they advise multinational corporations. Their pay and their future profits depend on not telling them what they want to hear but on telling them what is most likely to be true, because there are millions or billions of dollars of the client's money at stake if they make the wrong decision to invest in Iran when the Shah is going to be overthrown by a fanatic. So we suggest that some of the functions of getting competing assessments be contracted out to political risk assessment firms with the idea that it might improve the overall quality of intelligence assessments. I think there is something to be said for that.

Guest: Wouldn't it be a good idea to insist on funding contracted out services by user fees rather than taxes?

Mr. Poole: I think that is an excellent idea. One way of reducing the risks of creating monopolies in services that are contracted out is to make the users pay directly and let the costs be explicit; let them really bear the full cost and get past this morass of what passes for accounting systems in governments that conceals really more than it tells. I think that is an excellent approach.

Guest? But user fees aren't tax deductible, the way local property tax payments are.

Mr. Poole: That is correct, and I have urged for several years that there be federal legislation that would erase that artificial distinction. It would make payments for what are considered to be public services—namely the things that have traditionally been supplied by local governments—equally deductible as property tax payments are. That would remove that particular barrier. I don't know if that has any chance or not, but it would be a good idea.

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The British Experience

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In the United States, privatization is commonly thought of simply as "selling off the state," but in Britain, it is thought of as embracing a whole range of proposals, which bring the private sector into areas previously dominated by government. It is, in other words, a broad and general term. It includes the four major areas of government activity: the state industries, the big state utilities, the state services (such as health, education, Social Security), and finally the regulatory function of government. Privatization is taken in Britain to cover all of these four areas and to have a contribution to make in all of them. It is not true to say that Britain had large state industries and was therefore able to sell them off, and that what is happening in Britain has no relevance for the United States.

What has happened in Britain, of course, is that progress has been made in all of those four areas to various degrees. We have seen during the Thatcher administration the largest transfer of power and property in our country since the dissolution of the monasteries under King Henry VIII.

Why should this take place? The theory is well known. We compare the public sector with the private sector over ten major areas and we find that the public sector comes in second in all of them. First, it is more expensive. Empirically the figure is about 140 percent. Whenever a service is done publicly, it seems to cost roughly 40 percent more than when it is done privately. We find that it is less efficient, that it has a higher manpower level, and that there is no means of consumer input in the absence of competition and choice. We also find that the public sector is chronically undercapitalized because capitalization is decided on a political and not an economic basis. We see that the public sector is notoriously noninnovative and inflexible, that most of its decisions are made on electoral considerations rather than economic practice, and that its equipment is shoddy and poorly maintained. Moreover, its service is liable to interruption—most of the big service interruptions in Britain during the Thatcher years have been in the public sector (coal miners' strikes, steel workers' strikes, water workers' strikes, local government servants' strikes, health workers' strikes—all public sector operations, which government originally took over in order to guarantee the supply, but what is guaranteed is that the supply will be interrupted). Finally, we find that the big public operations are very slow to respond to changing times and needs.

Apart from all these points, the public sector is fine. Four traditional methods are employed in Britain in the attempt to control it. These four methods are very instructive. They are instructive because all of them fail.

First there is the efficiency drive. In Britain this represents the attempt to impose private sector expertise onto the public sector. Typically some "whiz kid" from a private business will be brought in as an advisor to the public sector in Britain, and he will recommend the introduction of all kinds of private sector activities such as bulk buying, better cash flow, and streamlined practices. The problem is that, while he can introduce all of these elements from the private sector, he cannot introduce the incentive to sustain them. This is why efficiency drives have a purely temporary effect. Streamlined practice ultimately grows out of a streamlined business. Since government business has no incentive or need to be streamlined, any streamlining is temporary and soon loses its shape. In Britain, this occurs in about three-year cycles. It is a kind of ritual purge to undergo, this bringing in city experts to do efficiency studies. When they have gone, the civil servants sigh with relief and say, "Now we can get back to normal."

The second method attempts an economy drive. Government, recognizing that public sector is so much more expensive, attempts to cut down on waste while maintaining the essential programs. The analysis is made this time by civil servants themselves of the public sector as a whole. The tendency, of course, is to concentrate on trivia instead of actually looking at the administrative establishment itself. A typical economy drive in Britain tends to result in recommendations that in the future bureaucrats be limited to five-star hotels when they are traveling instead of six-star or seven-star hotels. Typical practices suggest the re-use of envelopes; so if you work in the public sector you receive envelopes with half a dozen names on them, all in the name of another economy drive.

Another method of cutting excess expenses is to amalgamate inefficient departments, producing one new department responsible for several areas. The problem here is that, while this can achieve a very modest saving in the short term, there have been cases in Britain where the new department has actually been larger than the combined total of all those it replaced, because it needed a transition team in addition to oversee the change. Even when it is smaller, however, the problem is that a department has been created which is much more powerful than each of the others were. In that civil servants have the incentive to extend their operations to raise their own status and pay, a new department has emerged with the power to do that. This means that economy drives generally tend to have a very short-term and trivial effect.

The third method is the elimination of unnecessary programs, such as was tried in the United States. Very simply, government operations that are unnecessary are identified and cut out altogether. It can be done. It is said that in 1812 Britain appointed a gentleman to sit on the cliffs of Dover with a telescope watching for Napoleon's fleet. If he saw it, he was to light a beacon so that other beacons could be lit, thus conveying the message all the way to London. This office was abolished in 1948, by which time the danger had receded. If it is true, this story shows that occasionally unnecessary programs can be eliminated. The problem is that there are no unnecessary programs in the eyes of their recipients. Every program has its beneficiaries. These beneficiaries identify themselves as beneficiaries, they are self-conscious, they have media visibility, they form a coherent group who can parade through the streets and appear on television programs. And the losers, the people who finance the unnecessary programs, the ordinary taxpayers, have no such coherence and no such visibility.

The attempt to identify unnecessary programs thus finds that there are none. I witnessed this in the Edinburgh city government when the attempt was made to close the steam laundries that had been built in Victorian days to ensure that the citizens of Edinburgh had access to clean linen. Now that there was a coin-operated laundry machine on every street in Edinburgh, it was thought that these hugely subsidized Victorian steam laundries were no longer necessary. They were the size of a small railway station, marvelous to look at, but very costly to wash and dry clothes in. The attempt to abolish this service as unnecessary failed utterly. Through the doors of the council chamber came, first of all, the women themselves with tales of poverty. Then sociologists told us that, for these women, washday provided social interaction with their friends, and that they would be socially deprived and prone to mental illness without it. Penologists suggested that juvenile delinquency would rise if the women were not able to spend as much time with their children. It was even suggested that there would be a serious risk of epidemics. Of course the legislators gave in, realizing how foolish they had been to identify this as an unnecessary program.

The fourth method involves cash limits. The theory behind this is that, if an overall spending ceiling is imposed on an area of government, it deals with the problem of each department trying to expand its own operation. Government grows imperceptibly because each department extends itself little by little, fighting for an increased budget. If an overall cash limit is imposed, they have to fight against each other. A group wishing to expand must make a case that savings can be made elsewhere. The rule is: "set a bureaucrat to catch a bureaucrat."

The problem is that, when cash limits were applied, it was discovered that the direct delivery of the services suffered, instead of the establishment. The ability of the bureaucrats to manipulate the media was quite a discovery too. It might seem that imposing a 10 percent ceiling on the increase in costs allowed to a social welfare program would result in some administrative saving and streamlining. No so. It would result in the immediate closure of old people's homes and hospitals for crippled children. People would be thrown out on the streets with their furniture clutched around them as the first snows of winters came down and the arc lights of the TV camera illuminated the scene. And that would go out on the early evening news. The bureaucrats would be pleased to read in their newspapers the next morning that the legislators had decided to back-pedal on the desire to impose cash limits.

The effect of these four methods, all of which were tried and failed in Britain, is to create an impression that there is a failure of will on the part of government. The accusation is made that the government was not tough enough, that it should have done more earlier, while it was still popular. It ignores the above analysis, which suggests there are factors at work beyond the control of government. There are real forces within the public sector that produce these effects. The will of government is an intangible and fragile thing by comparison with these forces. The critics themselves are at fault in criticizing the government for not being tough enough. They perpetuate the myth of legislative omnipotence.

Thatcher's Tactics

It would be difficult to conceive of a British administration tougher than Margaret Thatcher's government. Scholars set about instead examining the forces that made the public sector work the way it did and finding out how to cope with them. Thus the concept of privatization was born, even though it barely appeared in the manifesto. It was discovered that, while government cannot be controlled either in growth or cost, it can be eliminated. Whole government operations can be moved into the private sector so that their costs are no longer the concern of government. Things that make a loss in the public sector can be transferred and become profit making in the private sector.

So far the government has employed 22 different methods of privatization. More are known in theory, but only 22 have been used so far. The aim has been to put private sector disciplines to work on services and goods and functions of government. It is recognized that trying to bring private sector disciplines into the public sector is tantamount to attempting to graft an alien growth. It is much easier to move the operation into the private sector where it will be exposed to those disciplines anyway.

In some cases government tries to sell the operation. If it is a publicly owned asset or something that is relatively profitable, then the whole operation can simply be sold off as a piece. This was done with Amersham International, a radionics company that was simply offered on the stock market. The sale was an enormous success, especially for those who bought it and made an immediate profit. The government had vastly underpriced it, but when a supermarket wishes to get its trade going, it often engages in loss leaders as a means of stimulating demand. Amersham was, after all, the first big case of a major company being privatized by sale.

There are very few public sector operations that can be sold in toto. More commonly, governments identify parts of a public operation that could be profitable. There are very few public concerns which make money. Because of this, they are hard to sell. Sometimes, however, parts of them could make money and those parts can be sold. The British government has sold 27 of its 29 railway hotels, even though it cannot yet sell the railway system itself. It has sold the English Channel ferry services. It has sold land from public concerns at five times the rate for which it sold in its first year. This is still increasing. The list mounts of discrete parts that are profitable enough to be broken up and sold. British Leyland, for example, which has not yet been put on the market, has already sold its tractor line and its forklift truck business. It sold Prescold refrigerators. The National Coal Board has sold land, vehicles, and buildings. British Airways, which is coming up next year for sale, has itself already sold International Aeradio Limited, a communications subsidiary. The freeway service areas, 39 of which were owned by the state, have all been sold. Oil stockpiles have been sold off. Regional water boards have disposed of large amounts of land, and various subsidiaries of British Steel have been sold. There is a list several pages long of complete parts which have been sold.

If neither the whole of it nor even any complete parts can be sold, it is still possible to sell part of the whole. A proportion can be offered for sale, provided that proportion is more than 50 percent. Then technically, the operation passes into private ownership. Once it passes into private ownership and is exposed to private disciplines, it can gradually become more profitable, allowing the state to unload its remaining share at a profit. This means that the state can afford to accept a reasonable price for the 51 percent it sells, knowing that it is going to get a very good price for the 49 percent later. This double act has been very successful. It was done with Britoil, the North Sea oil operation: 51 percent was sold. And it was done with with Cable and Wireless. Interestingly enough, the government has already gained a good yield by selling the second and the third tranche of shares in Cable and Wireless, following the successful privatization of 51 percent. It was done with the British ports; it was done with the British aerospace industry. All of these have now been privatized by this method, and in all of them the government is selling ever more shares, while its own holding is diminishing. It is a very useful source of funds.

There are operations, of course, which cannot be sold in whole or in parts, from which not even a proportion can be sold because they are so uneconomic. Occasionally, sales can be made to the workforce. The National Road Freight Corporation, which was suffering huge losses, was sold to its workforce at their initiative. The sale was extremely successful. It has done two years trading since then and has made enormous profits for its worker-shareholders, so much so that it has subsequently bought up three other state operations. A very huge state loss has been turned into a private gain, with an additional public gain. Instead of the state handing out subsidies, it is now taking in tax money both from the company and from the individuals.

The same has happened at Redhead's shipyard. It was closed as a state operation because it was losing so much money. Eighty employees pooled their layoff pay and bought the yard from the government. They opened a few months later with twenty of them at work; by January of this year it was 150, and all the order books are now full for the foreseeable future. This is obviously a private success. The reason is that, when people work for themselves, they are much less concerned about who does what. They are anxious to be more productive, to see their labor used more productively. And instead of seeking the best advantage from the point of view of wages alone, the worker also considers the company's profitability. For example, Redhead shipyard has just announced that it is training Britain's first shipbuilding apprentice. There has never been a shipbuilding apprenticeship before. There have been plate-layers', boilermakers', welders', and riveters' apprentices and apprentices in various craft unions. These jobs have all had different status, and only a specialist was allowed to do them. In Redhead shipyard, by training apprentices to build ships, they are employing a much more versatile use of labor.

Failing the sale of the whole of it or parts of it, or sale to the workforce, huge state losses can be given away. This was done with the cross-English Channel hovercraft company, Hoverspeed. In February of this year, the workers were called into a meeting, and the government handed them the deeds of the company and walked out. Now it is a private, worker-run and owned enterprise. The government just gave it away, wrote off a few debts and, incidentally, gave away the losses, which were being made annually on the operation.

The sixth method of privatization consists of cases that cannot be sold at all or even given away. In such cases it is often possible to privatize the financing of a public operation, leaving the production of it in the public sector. That is, instead of having it funded out of taxes, to have it increasingly funded out of user charges. This involves payment of more and more of the cost directly at the point of consumption, instead of through taxation. It adds some economic discipline. There are serious technical drawbacks to user charges. Once a user charge is established, attempts to increase it to keep up with inflation face political opposition. The public recipients object every year, creating a standing tendency for the user charge to become ever more nominal. User charges thus tend to become self-reversing. However, by dint of will and a Prime Minister called Margaret Thatcher, Britain has managed to raise the direct user charges for the National Health Service to four times what they were for such items as drugs, spectacles, and dentures. Of course, these are only paid by people who can afford them. The attraction is that the poor and the dependent receive them free, so that increasing the charges for those who can afford it provides a means of getting more money into the health service by the direct route.

Much more successful is the seventh method, which consists of privatizing the production. This has been of enormous importance in Britain. It retains finance with public money, but uses the private sector to obtain goods and services that were produced in the public sector. In other words, private contractors are used to provide public goods. This has spread like a brush fire throughout local government in Britain. It has taken over in streetsweeping, park maintenance, garbage collection and disposal, catering in schools, and the cleaning and security of public buildings and offices. All of these things are now being extensively privatized by contracting out. In the hospitals in Britain, ancillary services such as cleaning and catering are now beginning to use private contractors. Again, there is a list several pages long of such services as heavy goods vehicle testing, coin collection from public pay phones, the Property Services Agency, and road construction. In all of these, private contractors have stepped in to replace public supply. It means more economic discipline, competition, and efficiency, as private firms compete for the contract, and it introduces market pressure.

Sometimes diluting the public sector is possible. There are cases where it is so entrenched and impossible to deal with that no progress against the establishment can be made. But future expansion can be turned over to the private sector. Ultimately this will dilute the proportion of the public activity. For example, if in the building of roads in Britain, new roads are financed with private capital, allowing the investors a return on it, then as roads come to be repaired or replaced, the proportion of public roads diminishes over the years. Thus there are areas where the public sector can be diluted with private capital. This has been done in Britain with the state buses and the science parks, and it is just beginning with the roads.

One of the reasons it is so difficult to deal with the public sector is that its beneficiaries are self-conscious and will fight to retain their benefits. The ninth method handles this by buying out the existing groups, as the British government did with its policy on rent control. Had it simply attempted to abolish rent control, it would have failed. Its own legislators would not have voted for it ultimately. Cases of hardship would have been extensively featured by the media, and government would have retreated, as rent control presents special difficulties. What the government did instead was to introduce a new type of lease, which is called a "shorthold" lease. Existing tenants in rent controlled properties are secure. New properties may be put out on shorthold, which does not have the same security of tenure guarantees built into it. Basically a shorthold lease enables the landlord to secure repossession in three years and set new rent levels. Not surprisingly, many new properties in Britain are being put out as shorthold. As people die or move out of rent controlled properties, the landlords are putting the property on the market at shorthold. The existing interest group is not threatened and did not fight. Gradually, however, a procedure has been set in motion that will terminate rent control.

Sometimes it is possible to deal with an existing interest group only by setting up a countergroup that is larger and more effective. This is the tenth method. It was done in Britain with the publicly owned houses. Thirty-five percent of all people in Britain lived in publicly owned houses in 1979 when Mrs. Thatcher took office. Previous Tory governments had tried to increase the rents to economic levels and had failed. Given a choice between voting for a subsidized level and voting for an economic level, people in those houses had tended to vote for the subsidized level. The Thatcher government offered to them, instead, the right to buy their own house. If they had lived in the house two years, they qualify for a discount of 20 percent off the market price. If they lived in it 20 years, they receive 50 percent off market price, with a scale at all levels in between. In other words, an immediate profit is guaranteed to all who wish to buy their own house. Six hundred thousand have done so already. This is roughly one in eight, and the numbers are increasing. Furthermore when this happens, the house lasts longer because ex-renters maintain it better when it is their own property, their capital asset. In becoming property owners, they adopt a whole new set of social values, including the way they vote, as was seen in the last election.

Method eleven involves deregulation via voluntary association. Some of the regulatory function of government has been privatized by using voluntary associations. There were four separate government organizations regulating the protection of birdbaths in royal parks, birds on the sea coast, birds here, birds there. These organizations were all abolished by the Thatcher government, which now turns to the Royal Society for the Protection of Birds to do the same work. It is a totally voluntary organization, and it does the job infinitely better than the four government agencies did. The policy has been continued with some of the other so-called "Quangos"—the quasi-autonomous nongovernment organizations. These bodies do a job similar in some ways to that of the regulatory agencies in the United States. Of the 3,058 of them, the government has abolished 600 and is using a large number of voluntary organizations to perform the same kind of supervisory and monitoring work. The building trade is soon to be subjected to this approach. Under a new act going through Parliament now, part of the function of regulating and controlling building standards will be performed by the trade itself: by its Building Trades Federation.

The twelfth technique encourages alternatives to public supply. The government did this by giving a charter to the University of Buckingham. Britain's universities were all completely state dominated, a public sector activity. The little University of Buckingham, which had opened with 63 students, was adopted by the Thatcher government. It was given a royal charter and the rights to grant degrees and to call itself a university. It now has over 500 students and is flourishing.

Method thirteen calls for the use of small-scale trials. If deregulation cannot be pursued everywhere, selective deregulation can be introduced, gaining the support of the local areas which stand to gain from it. If there is to be selective deregulation in order to see how industry performs in such a climate, support will be attracted from the local politicians in the areas that stand to benefit. Politicians from the Labour party, for example, who would bitterly oppose the concept of deregulation will support it enthusiastically if it is targeted for the area they represent, because they recognize the prospect of jobs. The government designated 24 enterprise zones, and these are now in operation. The principle of deregulation has been established, and everyone is watching to see how they perform.

The case of free ports is similar. Six have now been designated, and exemption from various customs regulations and duties is to be tested as well. The small-scale trial is a very good way of illustrating a principle. When its success is proved, other areas clamor to join. The government originally designated six such enterprise zones; now there are 24. Soon it may be normal for British cities to contain enterprise zones. It will be because the principle has become so popular that the other areas feel left out otherwise.

Repealing the monopoly to allow competition to grow is yet another way. The National Bus Company, which dealt with long-distance bus transport, could not be sold because it had incurred horrendous losses. What was accomplished there was the repeal of its monopoly and the encouragement of private sector development. The private bus operators came in. They offered all kinds of new services. The put videos and vending machines and newspapers on the buses, and they reduced the fares to one-third. Not surprisingly, they gained a good deal of business. The National Bus Company responded by making its own services more efficient. It also reduced its prices and introduced some of the service innovations. It is now making money. And it can now be sold.

The same technique has been applied in the field of telephone equipment, the post office, electricity, and gas. The monopolies have been replaced in all of these cases, and private sector alternatives are developing. This action has made an enormous difference in gas. The National Gas Board had a monopoly on purchase of North Sea gas. Since that has been abolished, the volume of gas development in the North Sea and the sale of it has gone up beyond measure. Similarly, the development of business mail couriers in competition with the post office has mushroomed.

Method number fifteen encourages exit from the public sector, which is a form of privatization. If people locked into public supply can be encouraged to make an independent private provision, then private participation in that activity is increased. In Britain there is a National Health Service for which everyone has to pay. Some people take out private health insurance. The government gave a minor tax concession to those who did, making it slightly more attractive, and this has greatly increased the numbers who have taken out private health insurance. The result is that the private portion in Britain has gone up from 5 to 11½ percent in a very few years, and it is accelerating. What is most important is that, without ever touching the National Health Service, without threatening its supply at all, the private sector equivalent alternative is growing alongside it, and a new pressure group is being created with a vested interest in the new reality.

Vouchers can be used. Education vouchers in Britain, however, are not practical politics. They represent "macropolitics." By trying to change everything at once, they alienate the parents. The teachers fear they will lose their power. The principals do not want it, local government is determined not to have it, and the ministry regards it as mere theory. On the other hand, the use of transport tokens has been increasing enormously. The use of tokens means that the target recipients are identified and given tokens to buy in a private market. Instead of having to provide free transport so that old people in remote areas will be able to travel, the old people are given transport tokens to spend on private buses and cabs. They buy in a private market and the social objective is achieved, in that the old people are helped without having to withdraw a service from the public sector by using vouchers to reassure the dependent group that they will get better replacement services in the private sector.

The seventeenth method seeks to curb state powers. The regulatory function of government includes many thing that can simply be curbed. In Britain the entry powers of inspectors, the people who can enter home or business premises to inspect and harass, were reduced substantially by the Thatcher government. More than one-third of them have been abolished or curtailed. Regulation was a jungle, which included such bizarre life-forms as the inspector from the Ostrich and Fancy Feather and Artificial Flower Wages Council. The reason for the successful curbing of such powers was a deliberately public political campaign to show how absurd the system was, and that public campaign enabled the government to curb the entry powers. In curbing some of the silly ones, they curbed some of the ones that were seriously harassing small business—all the result of a carefully contrived public campaign.

Divestment is the eighteenth type of privatization. There are sectors that the state owns more or less accidentally. These are often subsidiaries which it picked up along the way. It can often sell them as little pieces to private buyers, not on the market but privately to related businesses. Again, there are several pages of case histories. In 1979 they sold two. In 1980 they sold eight, and sales have been accelerating at a great rate ever since. They add up—\$22 million here, \$2½ million there—to hundreds of millions of dollars in state operations and state-owned concerns, of which the government has simply divested itself.

The nineteenth method involves making a gift directly to the public. The Land Resettlement Commission used this device, whereby land owned by the state and used to promote food production has been transfered to the public tenants who were on it and a large part of the value simply given to them.

The twentieth way has seen the application of liquidation procedures. In some cases the government, especially in the case of hospitals and teacher training colleges, has applied the kind of break-up operation and close down that a liquidator would apply. Without actually withdrawing any services at all or causing unemployment, it has rationalized the operation in order that certain viable concerns can be identified and separated, and others closed down.

Method number twenty-one, withdrawal from the activity, is very rare for government. This would be simply to withdraw from an activity altogether as a means of privatizing a function, and it has happened with some of the Quangos. There is a short list of these state bodies for which the government simply announced that it no longer intends to engage in that activity. When government wants to do this, it must first win the argument that the activity will continue to be performed and performed better outside of the public sector. It has to point to examples of where this has been done. There are very few of them, but it does work. Undoubtedly, the Manpower Services Commission was influenced by the knowledge that private agencies are waiting to step up their own service.

The twenty-second road to privatization seeks to establish a right of private substitution. The housing bill going through Parliament establishes with public tenants the right to substitute a private service for a public one. If they do not feel that the state is repairing their houses satisfactorily, they now have the right to go to a private contractor, have the job done, and bill the state. There was an opinion given last year by the former Master of the Rolls, Lord Denning, that in the event of a national water strike, if the state failed to repair the pipes and maintain the water supply to any home, the residents in Britain already had the right in law to go to a private plumber, have the repairs carried out, and bill the state for the cost of it. The future looks quite promising for giving people the right to substitute private for public services. It means the public one faces real competition. It is an effective way of breaking a monopoly.

These 22 methods happen to be the ones that have been tried so far in Britain. There must be dozens more. The public sector is large. There is enough for everyone to privatize a piece of it. In Britain the state operations are being lined up like little piggies coming to market. They include Telecom (1984), Jaguar cars (1984), British Airways (1985), the airports (late spring 1985), the gas industry, further parts of the car industry, and the steel industry. All are scheduled to come to market before the end of the Thatcher administration. The work is already being done on the services and the regulatory function, to follow in the next administration. The process is only just beginning.

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Guest: Surely the unions in Britain have put up a lot of opposition to privatization?

Dr. Pirie: Union leaders, perhaps, but not necessarily the union members. In the local government operations, for example, new private suppliers often have outbid what the union offered and offered better basic wages and fringe conditions for working more, for using more productive machinery, for arguing less about who does what. In other words, the contractor is able to use labor more efficiently. The workers have been offered an alternative deal, and many of them have taken it. The leaders have found themselves unable to command their own following. The union leaders have objected and they have been defeated. They have no base of popular support, and their men reflect this. Every opinion poll shows in Britain that faith in the public sector is very low and still declining. People now assume that anything done in the private sector is done more efficiently and provides better, cheaper service for everyone. The intellectual argument is already won.

Guest: How much of the success of Mrs. Thatcher's privatization drive is owed to the different constitution you have in Britain?

Dr. Pirie: In Britain we have an automatic majority in the legislature for our executive. That is the basis for the executive; it derives from a majority in the legislature. This means that the government on the whole gets its own way.

The parliamentary system of government has its uses. It is possible to pursue an outside track, introducing the idea for privatization, having it talked about in the financial columns, putting it in the public domain so it can be discussed and people can feel comfortable with it. On the inside track, meanwhile, committees are being set up in administrative departments so that, when the pressure comes from questions in Parliament, the minister can report that indeed a working party is evaluating the proposal. It is like the jaws of a nutcracker, coming together from an outside track and an inside track in the parliamentary system. The United States would need a system appropriate to its own constitution.

Guest: Are any of the various techniques which you have outlined applicable here in the United States? Perhaps we would need to develop a completely different range to work successfully over here.

Dr. Pirie: Several of the methods which I have outlined would be appropriate here. Encouraging exit, for example, could work here. If you give people a tax concession of some kind if they make independent provision, you will gradually decrease the numbers of those wholly dependent on the public supply. If everyone has to pay the taxes that support the public system, only those who can afford to pay twice can make the extra cover for a private service as well. It is a question of allowing people to get back some of the tax in order to fund themselves in the private market. Then what starts as a prerogative of the rich eventually becomes the choice for all of society. Meanwhile, public resources can be concentrated on those who will never have the ability or competence or resources to provide for themselves. There are several methods here that should work specifically for entitlement programs.

Guest: Just how easy is it to calculate the costs of public sector operations? We find in the U.S. that it is by no means easy to get an accurate picture.

Dr. Pirie: We found a problem in Britain with costing in-house services, and that problem is creative accounting. When the department actually costs itself, its operation is nothing like that of a private business. It sometimes leaves out such items as buildings, maintenance, or even wages. It is very difficult, therefore, to get a realistic picture. If genuine comparison is to be official policy, then there is a need for a standard format. There must be a form to be filled in with headings under all of the items, and instructions as to how much to charge for a proportion of overheads. Even then the public sector costs, I guarantee, will be underestimated.

Guest: Did you say that the people who bought their own houses from the state actually changed the way they vote in elections, as well as other social values?

Dr. Pirie: There was a notable trend. I do not say that every single one changed; I did not look at the ballot papers. There was a notable difference in the vote of the council house estates. This was attributed to the fact that one in eight owned their houses. It might not seem very high, but 12½ percent is a landslide in electoral terms. Elections in Britain are won or lost on shifts of 1½ percent. There have been opinion polls among former council house tenants, who are now homeowners, and there was a dramatic tendency for them to change their voting pattern.

Guest: Did you allow your departments to gain any benefit from privatization? If all you did was to reduce their budgets whenever they made savings, it would not seem to offer them any encouragement.

Dr. Pirie: In Britain there is a saying "selling the family silver to pay the butler." It probably translates into American as disposing of capital assets in order to maintain a high level of current spending. Departments have been allowed to do that. If they are privatized, the savings could be deployed against current spending. There is always a tendency in the public sector to raid capital because the pressure all comes from the current side. The labor force and the administrators exert pressures, but capital does not show politically. If an old people's home is closed, it shows. If the building of another school is delayed for another year, it is less visible. By allowing them to pass on their savings to the current budget, they have been given an incentive to privatize. It is important to actually be prepared to privatize at a loss, in the knowledge that once it is in the private sector, it will no longer be a chronic drain. This is worth spending money on because it is like a capital expenditure.

Guest: Why do you think that so many different methods of approach are needed to deal with the public sector?

Dr. Pirie: The public sector is in some ways like a malignant growth. It is a unique genetic combination, and nowhere does it occur twice. The solution also needs to be unique. The government in Britain is not short of people saying, "You must sell off British Rail." It is like telling President Reagan, "You must get rid of food stamps." The problem is that he cannot any more than a British government can get rid of British Rail overnight. What is needed is for someone to come forward and demonstrate a technique by which privatization can eventually be introduced. How is it done? The answer is that each case is regarded as unique, and policy is tailor-made accordingly.

I employed the term "micropolitics" to describe the pressures and interests that actually work within the system. I invite you to picture a skier standing on top of a hill. The attitude striker will say, "Sell off the National Health Service. Get rid of food stamps. Down you go," and give him a push. Of course, he strikes the first rock and collapses into a pile of broken legs and skis.

Instead, he should stand at the top and identify an interest group here, a lobby group there. He should devise a slalom course, making the policy an intricate tactic designed to go around all the obstacles in order to reach the goal at the bottom. An approach like this will eventually succeed.

Guest: You referred to enterprise zones, Dr. Pirie. Did you not write somewhat skeptically about them as recently as 1981?

Dr. Pirie: Yes I did. I finished off that article saying, "Now we shall campaign for free ports. The revolution goes on." The Adam Smith Institute introduced in that same year the idea of free ports as a policy. We thought that the enterprise zones had become too bogged down in bureaucratic procedures, and they were basically operating as subsidy islands instead of genuine areas of deregulation. We came back at the apple from the other direction and had a bite at deregulation with free ports. When they eventually come through, the Treasury no doubt will blunt the deregulatory impact. Already we are coming back for a third bite, saying that the entire small business sector in Britain should be a deregulated sector of the economy. We now say that one problem with enterprise zones and free ports is that they are located in physical space, and therefore they give selective geographical advantages. What we want is an advantage located in an abstract sector of the economy. We need selective advantage given to small business, which is responsible for all of the new jobs and all of the economic growth. There are always new ways to keep biting at the regulatory apple until it is gone.

Guest: You very skillfully described how the resisting interest groups opposed to privatization were dealt with. Are interest groups on the private side now growing to the point where they could stop the next Labour government from reversing it all? Is there an infrastructure of private interest now that would enable them to do this?

Dr. Pirie: Exactly. It is an irreversible structural economic change. There is no way that a political party in Britain could take back the 600,000 houses that have gone into private ownership. Any party that tried to do so would not get elected. Faced with a choice of an economic rent or a cheap rent, they voted for cheap rent. Faced with a choice of keeping their own house or having the government take it away, they are going to make an equally rational choice. The same is true for those who own the state industries. The public at large will not allow an organization that has lost money over the years and cost them taxation, which is now profitable and paying taxes, to be taken back by the state. Any party that goes with that kind of program will not win.

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Social Security and Super IRAs

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As long as there is not a Social Security collapse pending in the next 90 days or so, many would prefer to ignore the program indefinitely for political reasons. But that would be like ignoring a sleeping elephant in your living room. For despite the very costly 1983 Social Security rescue legislation, the enormous program remains plagued by very serious problems.

Policy makers generally fail to appreciate adequately the large portion of federal spending accounted for by Social Security. The entire program, including Medicare, accounts for over 50 percent of federal domestic spending, and almost 30 percent of total federal spending. Adding national defense and debt interest in with Social Security accounts for about 70 percent of total federal spending. Those who ignore Social Security are consequently foreclosed from influencing policy for almost a third of the whole federal government. For conservatives, clearly the size and scope of the federal government will never be substantially reduced without addressing Social Security.

The huge amounts of federal spending through Social Security should be especially troubling because, of all federal programs, Social Security has the clearest, most widely utilized, private sector alternatives, including pensions, IRAs, and life insurance. As Milton Friedman has long argued, there is no reason why all the functions of Social Security must be performed through the public sector. It is indeed a truly radical departure from a private, free market economic system to require almost all Americans to rely on the government for the bulk of their income for a major portion of their lives—their retirement.

Market oriented policy makers also cannot ignore Social Security because the program just will not let them. One way or another, the program will be used repeatedly to undermine conservatives politically. Periodic financial crises will leave those favoring limited government in opposition to inexorable payroll tax increases with nothing to offer as an alternative but politically disastrous benefit cuts. This is playing the Social Security issue on the home field of the Liberal Welfare State. Imaginative leadership for the market must shift the issue to entirely different, more amenable ground, breaking out of the traditional tax increase/benefit cut dilemmas.

The Problems of Social Security

The overwhelming problems of Social Security create a compelling case for reform which should appeal broadly to the public at large. Indeed, while most of the public discussion has focused on the financing problems of the program, a new, even more destabilizing problem has been developing. The rate of return paid by Social Security has been falling steadily, and for those entering the work force today, even if all of Social Security's promised benefits are somehow paid, the program will still be a miserable deal. This is true even though today's retirees are still getting a good deal from the program.

The developing problem is a natural consequence of Social Security's "pay-as-you-go" method of operation, where the taxes paid into the program are not saved and invested to pay the future benefits of today's workers, but are instead immediately paid out to finance the benefits of current recipients. The taxes of the next generation of workers are to be used to finance the benefits of today's workers.

We can trace from the beginning of Social Security how this method of operation has led to an inevitable collapse of returns. Workers retiring in the early years of the program only had to pay Social Security taxes for part of their working careers. The tax burden in those years was also quite low. The maximum annual Social Security tax, including both the employer and employee shares, was $189 as late as 1958, and $348 as late as 1965. But because the program is run on a pay-as-you-go basis, the benefits paid to these early retirees were not limited to what could be paid based on their own past taxes. These retirees were instead paid full benefits out of the taxes of those still working. Their benefits consequently represented a high return on the taxes they did pay.

Over time, however, this return naturally began to fall as workers began paying higher taxes for more of their working careers. For today's retirees, as noted, the program's benefits still represent above market returns on the taxes they and their employers paid into the system. But those entering the work force today must pay taxes of several thousand dollars a year for their entire working careers. The maximum annual tax, including employer and employee payments, is today almost $5,600 and will be almost $8,000 by the end of the decade. For most of these young workers, the real rate of return promised by Social Security under current law is 1 percent or less. For two earner couples or maximum income workers—a large proportion of this rising generation—the promised real return is practically zero, or even negative in many cases.

If young workers entering the work force today could invest all their Social Security tax money, including the employer's share, in IRAs, and earn the returns historically received by broad based stock market investments, most would receive three to six times the retirement benefits promised under Social Security, while at least matching the other types of benefits provided by the program. Career minimum wage earners would receive about twice the retirement benefits, while two maximum income spouses would receive at least eight times the benefits.

Moreover, it is still quite doubtful whether the already inadequate Social Security returns currently promised to today's young workers will ever be paid, for the program still faces serious financing problems. Over the short run, the program remains vulnerable to weak economic performance. A recession causes Social Security revenues to fall off particularly sharply because the accompanying unemployment and weak wage growth cause an especially sharp decline in expected payroll tax revenues. If inflation is causing rapid increases in indexed benefits at the same time, the program is hit even harder. Without a major trust fund cushion to absorb these blows, the program's financial structure will collapse. It was just such a double whammy of inflation and recession that caused the program to collapse in the mid-1970s, requiring the 1977 legislative bailout, as well as the collapse in the early 1980s, necessitating the 1983 legislative rescue.

The latest Annual Report of the Social Security Board of Trustees reveals the program's continuing vulnerability to economic weakness. Projections under the so-called pessimistic Alternative III assumptions assume further recessions in the late 1980s, one mild and one significant, though neither as powerful as the 1982 recession or some of the experiences in the 1970s. Yet, under these projections, considering the whole program (OASDHI), and assuming any of the system's trust funds could borrow from each other as needed, Social Security would again collapse before the end of the next decade, just when the program is supposed to be accumulating large surpluses to finance benefits when the baby boom generation retires. These projections clearly indicate that another recession soon as strong as the 1982 downturn, or just renewed economic experience as throughout the 1970s, would lead to another Social Security collapse in the short term.

Indeed, recent studies indicate that the Social Security trust funds need assets equal to 85 percent to 145 percent of one year's expenditures to survive a serious recession, or close back-to-back recessions as were experienced from 1973 to 1982. Yet the Social Security Administration's (SSA) own most recent projections show that, even under intermediate Alternative IIB assumptions, the 85 percent level for the program as a whole would not be reached until 1992, and 145 percent would not be reached until the late 1990s. Under Alternative III assumptions, these levels would never be reached.

Over the long run, the SSA's own projections under Alternative IIB assumptions indicate that the entire, combined program, including HI, would be unable to pay promised benefits at about the time those entering the work force today retire. By 2035, Social Security expenditures under these projections are running almost 50 percent higher than revenues each year. Over the full 75-year projection period, the entire program runs a cumulative deficit under these assumptions 150 percent as large as the total amount raised in new revenue or cut in benefits over the same period by the 1983 Social Security rescue legislation.

Under Alternative III assumptions, the entire, combined, Social Security program will be unable to pay promised benefits before the end of the next decade. By 2035, Social Security expenditures under these projections would be running 2⅓ times as large as revenues each year. The cumulative deficit over the 75-year project period is incredibly more than 4.5 times as large as the financial gap addressed by the 1983 legislation.

In order to pay all the benefits promised to those entering the work force today, under these projections the combined employer/employee Social Security payroll tax rate would have to be raised to 37.5 percent, compared to 14.1 percent today. This would mean a total Social Security annual tax, including employer and employee shares, of $7,500 for a worker making $20,000. Now, the SSA itself in effect admits that this development is at least possible. Moreover, many outside observers believe that such projections are in fact the most realistic. They are certainly the most prudent.

Still another problem with the current system is that the program's benefit structure is grossly inequitable. Workers are not paid equal returns on past taxes paid into the program. Two workers who pay exactly the same taxes into Social Security over their working careers may receive widely different benefit amounts. Moreover, blacks and other minorities with below average life expectancies tend to receive lower returns through the program than the rest of the population because they on average live fewer years in retirement to receive benefits, though they are subject to the same taxes throughout their careers. A white male at birth today can expect to live 50 percent longer in retirement than a black male, and consequently receive 50 percent more in retirement benefits. In addition, blacks as a group are significantly younger than whites, and since the program offers a worse deal the younger one is, the program discriminates against blacks on this account as well.

Social Security also seriously damages the economy, destroying jobs and economic growth. A primary agent of this destruction is the Social Security payroll tax. To the extent the tax is borne by employers, it discourages them from hiring. To the extent the tax is borne by employees, it discourages them from working. Either way, the result is less employment, and consequently less output. The payroll tax is nothing more than a tax on employment, and here as elsewhere the result of taxing something is that there is less of it.

As noted, the maximum annual payroll tax is already almost $5,600, and scheduled to rise to almost $8,000 by the end of the decade. For at least half of all workers covered by Social Security, the total combined payroll tax is more than they pay in federal income tax. In 1984, payroll tax revenues, drawn primarily from low and moderate income workers, were over 80 percent greater than total federal corporate and business tax revenues. In a society deeply concerned about employment opportunities, this incredible tax burden on labor is ludicrous.

It should also be clear that Social Security reduces national savings sharply, despite the continued contention among academic economists over this issue. This occurs because to workers on an individual basis, paying into Social Security seems to be in effect the same as saving for retirement. Consequently, workers would tend to reduce the amounts they would otherwise save for retirement by roughly the amount of payroll taxes. Or, alternatively, workers recognize that they do not need to save for the portion of their retirement income that will be provided by Social Security. Consequently, they would tend to reduce their retirement savings by the present discounted value of their future Social Security benefits. Either way, since Social Security is run on a pay-as-you-go basis—with today's taxes not saved but immediately paid out to current beneficiaries—the program does not accumulate any offsetting savings to counterbalance the decline in private retirement savings which it causes. The result is a large loss of national savings on net.

Most workers today are providing for their retirement apart from Social Security through private savings vehicles such as pensions, IRAs, Keoghs and 401(K) plans. Yet, Social Security forces workers to provide for the bulk of their retirement through a system which creates no savings. In essence, Social Security is a form of *forced non-saving* for retirement. It would be truly remarkable if such an anti-savings constraint were not today substantially reducing private savings.

A Populist Proposal for Reform

The key to fundamental reform is to recognize that solving the above problems, and the many other serious difficulties of Social Security, does not in any way require imposing sacrifices on the elderly. Quite the contrary, appropriate reform would strengthen Social Security and assure today's elderly their benefits, while providing a more secure and prosperous retirement for today's young workers, and the opportunity to work in a more healthy and rapidly growing economy now.

In fact, the first step in any fundamental reform should be to provide each worker at the time he retires, relying for his future on promised

Social Security benefits, a U.S. government bond stating his contractual entitlement to those benefits. All those already retired at the time of the reform would receive such a bond as well. The bond would not change the amount of the retiree's promised benefits in any way. It would simply embody a contract with the government promising that the retiree would receive his monthly benefit amount each month for the rest of his life, plus COLA increases, calculated under the law in effect at the time he retired (or when he received the bond for those already retired when the reform is first adopted).

Congress would statutorily express its intent that the retiree would have the same legal status in regard to his Social Security benefits, as promised by his Social Security bond, as a U.S. Treasury bond holder has in regard to the payment of the interest and principal on his bond. The Constitution prohibits the federal government from refusing to repay the interest and/or principal on a U.S. government bond. Similarly, under the proposed Social Security bonds, it would be unconstitutional to cut the expected Social Security benefits of a worker once retired. Congress would retain authority to reduce benefits to apply to new beneficiaries in the future.

From a conservative, limited government, perspective, this proposed bond does not give up much, considering practical political realities. It is hard to imagine any but the most marginal benefit cuts for those already retired ever being attainable, with such minimal achievements still entailing great political costs. Far better to renounce such cuts altogether in favor of an alternative approach, described below, which holds the potential of eventually eliminating most federal spending for private retirement altogether, through the potentially quite popular means of offering workers a better deal in the private sector.

The second element of a fundamental reform package would be to allow workers an option to begin to rely on an expanded "Super IRA" in place of some of their Social Security benefits. To accomplish this, starting on, say, January 1, 1988, workers would be allowed to contribute to their IRAs each year, on top of any other amounts they may contribute under current law, an additional amount up to a maximum equal to 20 percent of their social security retirement taxes (OASI). Instead of the usual IRA income tax deduction for these contributions, however, workers would instead receive a dollar-for-dollar income tax credit equal to the amount of such contributions. Workers would also be allowed to direct their employers to contribute an amount up to 20 percent of the employer share of the tax to their IRAs, with each employer again receiving a full income tax credit for such amounts.

Workers who utilized this credit option would then have their future Social Security retirement benefits reduced to the extent they did so. A worker who opted for the full credit during his entire working career would have his retirement benefits reduced by 20 percent, which would be the maximum reduction. A worker who regularly took half the credit each year would have his future benefits reduced by 10 percent. Workers could take the credit in some years and not in others, and in differing degrees each year, with a proportional formula to calculate the resulting benefit reduction. In retirement, of course, the accumulated funds in the Super IRAs would pay benefits which would more than make up for the foregone Social Security benefits.

Workers already in the work force when the reform was adopted would receive full credit towards their Social Security benefits for past taxes paid into the program. These past years would be treated simply as if the workers chose not to utilize the Super IRA income tax credit option in those years. Moreover, workers would naturally always have the right to forego the Super IRAs altogether and rely entirely on Social Security as is, without penalty.

The Super IRA income tax credit is meant to be in effect a partial rebate of Social Security taxes to those who choose to substitute Super IRAs for Social Security. But it is crucial to recognize that the credit is taken against income taxes rather than payroll taxes. This means Social Security revenues would continue to flow into the program in full to finance benefits for today's elderly. The credit option would simply result in a loss of income tax revenues. If the credit option were in effect in the current fiscal year (FY 85) and workers utilized it twice as much as they currently use conventional IRAs, the income tax revenue loss for the year would be $14.5 billion.

This loss would eventually be offset completely by reduced Social Security expenditures, as more and more workers retired relying to a large extent on Super IRAs rather than Social Security. Long before this point, however, the revenue loss would be eliminated on net due to revenues generated from the increased investment through the Super IRAs. In the meantime, moreover, there would be increased savings through the Super IRAs at least equal to the amount of revenue lost, since the credit is only allowed for Super IRA savings. So even if the government had to borrow entirely to cover the revenue loss, there would be no net increase in the government borrowing drain on private savings.

A third element of the reform package would provide that starting on a later date, say January 1, 1992, workers would be allowed to contribute further amounts to their IRAs each year, up to a maximum of 10 percent of the employee's OASI taxes, for the purchase of private life insurance. Workers could also again direct their employers to contribute up to this amount to their IRAs for such purchases. Both employer and employee would again each receive an income tax credit equal to the amount of these contributions, instead of the usual IRA deduction.

An employee with no dependents who might not need such life insurance coverage would be allowed to devote these additional contributions to his retirement benefits instead. With only one dependent, the employee would be allowed to use half of these contributions for retirement.

Social Security currently pays survivors benefits on behalf of a deceased taxpayer who leaves a dependent spouse and young children, or an elderly spouse, as survivors. For workers under 65, private life insurance can entirely perform this function. Consequently, a worker who died before 65 would have his survivors benefits reduced to the extent he had used the tax credit option to purchase private life insurance in force when he died.

Once again, this credit is taken against income taxes rather than payroll taxes, and consequently Social Security revenues would continue to flow into the program in full. If this credit option were in effect in the current fiscal year and workers utilized it twice as much as they use IRAs now, the income tax revenue loss for the year would be $7 billion. This loss would be offset rapidly by reduced Social Security expenditures, as starting in the very first year all those who died while relying on insurance purchased through the Super IRA option would have their survivors immediately receiving private insurance benefits rather than Social Security benefits. The fully funded private life insurance system would also produce new investment, savings and tax revenues to offset the temporary income tax revenue loss in the meantime.

Later legislation could expand this Super IRA option further. The maximum income tax credit for Super IRA contributions could be increased to 40 percent of OASI taxes, for both employees and employers, in return for further Social Security benefit reductions. Eventually, this credit could be expanded to 100 percent of OASI taxes. Workers could then be allowed to purchase disability and retirement health insurance through their Super IRAs with further income tax credits allowed for these purchases in return for reduced reliance on Social Security. Ultimately, workers could have the complete freedom to choose how much to rely on Super IRAs or Social Security. But an initial reform package could begin with just the three elements described above.

The Benefits of Reform

As a result of the reform, the security of the elderly would be enhanced through the proposed Social Security bonds, creating a contractual entitlement to promised Social Security benefits and making it unconstitutional to cut the benefits of a worker once retired. Social Security itself would also be greatly strengthened by the reform, improving the ability of the program to pay promised benefits. This is because while the program's payroll tax revenues are maintained in full under the reform, the program's expenditures in the future would be reduced substantially as workers relied more and more on Super IRAs rather than Social Security. If the Super IRA option is expanded rapidly enough, the long-term financing problems of the program could be eliminated entirely, even under pessimistic assumptions. Indeed, with the Super IRA option eventually expanded to the maximum, Social Security expenditures would likely be reduced dramatically, allowing room for sharp reductions in payroll tax rates.

In addition, as we have noted, workers who desired would have the complete freedom to forego the Super IRA option and rely entirely on Social Security as is, without penalty. But those workers who did opt for the Super IRAs could expect much higher retirement benefits. The Super IRA benefits, moreover, would be financed on a fully funded basis, which would secure them against the financial instability inherent in Social Security's unfunded, pay-as-you-go system.

The reform would also allow workers much greater freedom of choice and control over their own incomes. While workers would still be required to provide for their retirement and insurance contingencies through some means, with the Super IRAs they would be able to choose and control the investments and insurance purchases to satisfy these requirements. Each worker consequently would be able to tailor his own individual packages of investments and insurance coverage to suit his personal needs and preferences. The Super IRAs would also allow workers complete freedom to choose their retirement age after the 59½ minimum age for IRA benefits under current law. Workers could also choose to leave some of their Super IRA funds to their heirs, which they cannot do with Social Security. With workers directly and personally owning and controlling their Super IRA funds as private property, their retirement prospects would not be subject to the same politicization and vagaries of public support as with Social Security.

Benefits paid through the Super IRAs would also be completely equitable, with each worker receiving back in benefits what he paid in contributions, plus interest, on an actuarial basis, unlike Social Security. One of the most blatant Social Security inequities is that many workers must pay for the program's survivors insurance even though they are not eligible for survivors benefits. This includes single workers without children and many childless two-earner couples. Married workers without children are not eligible for pre-retirement survivors benefits in any event. Through Super IRAs, these workers could substitute private life insurance for Social Security survivors insurance, and receive all the benefits they pay for. Workers with little or no dependent obligations who might not need or desire such insurance coverage could instead devote some or all of the funds for such insurance to their retirement.

In addition, minority workers with shorter life expectancies could retire earlier, receive higher benefits, and/or leave their accumulated Super IRA funds to their survivors instead of the quite limited survivors benefits offered by Social Security. The reform would also create special new opportunities for the poor, because it would give them control over some capital through their Super IRAs. If a career minimum wage earner entering the work force today could pay into a Super IRA, along with his employer, what they would otherwise be required to pay into Social Security, then at market returns he would accumulate almost $300,000 in today's dollars by retirement. This fund could pay him out of interest alone more than he is currently promised under Social Security, and the fund would serve as a solid foundation for the economic advancement of his children.

The Supplemental Security Income program (SSI) would continue to provide means-tested, general revenue financed, welfare benefits to the elderly poor, ensuring that retirement income would not in any event fall below a basic minimum. A substantial portion of benefits paid through Social Security today may be considered welfare benefits, not based on past tax payments into the program, but on certain criteria thought to indicate need. Because Social Security benefits are paid without a means test, this welfare assistance ends up going to too many who are not in need. The more workers rely on Super IRAs, however, the more welfare assistance will be paid only through the means-tested SSI program, channeling benefits only to those who are actually poor, and eliminating the current substantial waste of welfare benefits paid through Social Security.

The reform would also have important benefits for the economy. National savings could be sharply increased through the funds paid into Super IRAs, with a fully expanded Super IRA option potentially producing hundreds of billions in increased savings each year. Such a savings increase would in turn produce new jobs and increased economic growth. Eventual payroll tax reductions would also stimulate job creation and economic growth.

In addition, the more workers across the whole economy are allowed to accumulate assets in their Super IRAs in lieu of Social Security, the more equal the national distribution of wealth would become. If all workers paid into Super IRAs rather than Social Security, the national concentration of wealth would be reduced by one-third. Yet, this would be achieved not by redistributing existing wealth, but by providing an opportunity for the creation of new wealth equally distributed. Through the private IRA investments, each worker would be developing a substantial ownership stake in America's business and industry. This would revolutionize political attitudes. Instead of retirees developing a psychology of dependence on big government, as with Social Security, they would instead tend to support private enterprise and free markets, as would average workers watching their stake in the private economy grow.

Structurally, the reform would tend to "denationalize" the large portions of the pension and insurance industrry now represented by Social Security, shifting functions to the private sector which can be better performed there. It is particularly ridiculous that simple and easily available private life insurance coverage is today being displaced by Social Security survivors benefits. The proposed reform package would address this absurdity.

Finally, the reform would sharply reduce federal spending, as workers began relying more and more on Super IRAs rather than Social Security. With a complete option to rely on Super IRAs, federal spending could potentially be reduced by more than one-fourth. No other single reform offers the potential for such a massive reduction in federal spending, not only without hurting anyone, but indeed probably making virtually everyone better off at the same time.

Political Prospects

The proposed Super IRAs offer allies of the market precisely the opportunity to break out of all tax increase/benefit cut dilemmas, and shift the Social Security debate to entirely new ground. The reform does this by seeking to solve the problems of Social Security through offering workers a better deal in the private sector, without cutting the program's benefits or increasing the program's taxes. The cost of the reform is no more than a temporary net loss of income tax revenues, with new savings to offset any increase in government borrowing resulting from the revenue loss.

Structured in this way, the reform would not take anything from anybody. It would simply increase the freedom and options of workers. There is consequently no reason why it should be anything but wildly popular. Why shouldn't workers be able to choose a better deal in the private sector if they desire? With the elderly benefiting at the same time, and Social Security strengthened, such a question should become politically unanswerable.

The proposed reform should appeal especially to young workers, serving to enhance a somewhat surprising trend of increased support among the young for the market. And the strongest appeal of all would be to the politically conscious, young urban professionals. These individuals receive especially low returns from Social Security, because of their higher than average incomes, and the prevalence of single workers and two-earner couples among them. These professional workers should also most readily grasp the virtues of the private alternatives to Social Security.

The reform should appeal to the elderly as well, for while not hurting them, it offers great new opportunities for the young, and the elderly are in truth concerned about the legacy they will leave their children and grandchildren. Indeed, there is every reason for the reform to appeal not only to the young and the old, but also to liberals and conservatives, black and white, business and labor, the rich and the poor. For perhaps no other single reform concept could do so much to increase the liberty and prosperity of the American people.

Appendix

The Literature on Privatization

Steve H. Hanke

General

There is a growing body of published works on the theory and practice of privatization. Among the general works, Butler (1985) examines the underlying political dynamics of privatization as a method of cutting federal spending and provides several specific examples of how the approach might be applied. Madsen Pirie (1985) gives a detailed analysis of twenty-two privatization strategies used in Great Britain. Bennett and Johnson (1981) explain why bureaucracies are unable to deliver services as efficiently as private contractors, while Savas (1982) provides an anatomy of privatization techniques and a review of studies on the relative efficiencies of both private and public service delivery.

A number of studies have concentrated on the delivery of state and local services and several of these are effectively handbooks for the would-be privatizer. Among these are books by Armington and Ellis (1984), Hatry (1983) and Poole (1980).

Specific Areas of Privatization

Airlines

Although there are many nationalized and private airlines, there has only been one systematic series of studies which deals with the comparative efficiencies of private and public airlines, Davies (1971; 1977). Davies compared the performance of Australia's two interstate airlines, the public Trans Australian Airlines (TAA) and the private, but heavily regulated, Ansett Australian National Airway (Ansett). Davies found that, even with regulatory constraints, the private airline was more efficient. Using data from 1958-1974, he found that the ratio of tons of freight and mail carried per employee for Ansett to TAA averaged 2.03 to 1, for passengers carried per employee 1.17 to 1 and for revenue earned per employee 1.12 to 1.

Air Traffic Control

Poole (1982) concluded that the federally operated U.S. air traffic control system suffers from a troubled labor history, outdated technology, a lack of cost-effectiveness, a lack of responsiveness to users' needs, an absence of long-range planning, and political interference. Poole indicated that, for small and comparable towers, the FAA was spending about $1 million for installation, and about $275,000 per year to operate and maintain the towers, while private firms provide the services for about $120,000 per year, including amortization of their original capital investments. Poole also reported that, when a private provider took over the operation of the Farmington, New Mexico, tower in 1981, their contract was for $99,000 per year. The FAA had previously operated the tower for $287,000 annually.

Ambulance Services

Poole (1980) reported that a number of private ambulance services exist in the U.S. and that they typically provide better service at lower cost than public services. Typical of the cost savings is Newton, Massachusetts. It recently switched from a public operation to private provider, the savings is $500,000 per year (Hanke, March 29, 1984). It should also be noted that private ambulance service is extremely popular in Europe. Although comparative cost data are not available, both Stewart (1982) and Frazier (1981) report on the nature, scope and growth of these private services.

Custodial Services and Building Maintenance

Grace (May 1, 1984) found that the General Services Administration employs about 17 times as many people, and spends about 14 times as much, as private firms to deliver comparable building maintenance. Bennett and DiLorenzo (1983) reported that facilities maintenance at selected military facilities was reduced by 35 percent when these functions were transferred to private contractors. They also reported savings in custodial services, when supplied by private firms rather than the military. These savings ranged from 5 to 25 percent. Savas (1982) found that five New York City schools experimented with private custodians and saved 13.4 percent.

Day Care Centers

Public day care centers (federally funded nonprofit organizations) are more costly than those operated by user fee finance in the private sector. Bennett and DiLorenzo (1983) reported that the monthly public day care center costs per child were $188, compared with $102 for the private sector.

Debt Collection

Bennett and Johnson (1981) have summarized findings from a variety of General Accounting Office reports that document the relative inefficiency of the public sector debt collection operations, noting that government costs are often more than double those of the private sector.

Education

Orzechowski (1977) found that public colleges employed 40 percent more labor than comparable private colleges. Savas (1982) reported that in New York, the public City University's cost to produce a degree student was $103,061, while for comparable private institutions the cost was $18,570. Savas also reported that the public versus private per pupil cost differential in New York City's secondary schools was $4,785 versus $4,512, and in the City's schools for the handicapped the differential was $6,196 for the public versus $4,730 for the private.

These cost differentials might, in theory, be explained by lower quality in private schools. However, Bennett and Johnson (1981) reviewed evidence that suggests that increased expenditures per student have had no impact on the quality of graduates, and that large cost differentials between public and private schools exist, even after other factors that determine the quality of graduates are statistically controlled.

Electricity

Extensive U.S. studies support the notion that private electric utility firms are more productive than public firms. Typical of these is a comparison of federal and private hydroelectric plants, which was reported by Bennett and DiLorenzo (1983), and work by De Alessi (1974; May/June 1974; 1981; 1983), which tested various aspects of the property rights theory of the firm by using data from the electric utility industry.

Studies by Bellamy (1981) and Primeaux (1974; 1977) deal with the role that competition can play in so-called natural monopoly situations. Contrary to popular understanding, there are twenty-three cities in which two utilities compete directly with each other for customers. Using standard statistical techniques, Primeaux corrected for all the factors that cause electric prices to vary and found that, contrary to the conventional wisdom, marginal electric rates were 16 to 19 percent lower in the competitive environment than in the comparable cities served by only one utility. He also found that the average prices in the competitive cities were 33 percent lower. Bellamy found an average 20 percent saving in Lubbock, Texas, a city with two utilities, compared to the surrounding area.

Fire Protection Services

The private provision of fire protection in the United States is a growing industry. According to the Private Sector Fire Association, a private trade organization, 17 private companies now operate in 14 states.

Poole (1976) and Smith (1983) discovered that cost-savings from switching from public to private companies have typically been 20 to 50 percent. Ahlbrandt (1973; Fall 1973) conducted a careful econometric analysis of the private versus public cost issue, and calculated that the actual cost in Scottsdale, Arizona, which is served by a private firm, was 50 percent lower than it would have been with a public provider.

Forestry

There are over 90 million acres of publicly owned commercial forest lands in the U.S., managed by the U.S. Forest Service. These lands generate negative cash flows of about $1 billion per year (Hanke, Winter 1982). Private timber firms, on the other hand, typically generate positive cash flows.

Grazing Lands

The Bureau of Land Management manages and leases about 155 million acres of commercial public grazing land in the U.S. Excessive costs mean that this land generates negative cash flows of about $100 million annually, while comparable private range typically generates positive cash flows (Hanke, Winter 1982). In addition, the condition of public grazing land is worse than comparable private land.

Hospitals and Health Care

Despite the fact that a substantial amount of evidence has been accumulated to demonstrate the superior efficiency of private over public hospitals, there is still a considerable debate on the issue of comparative efficiency (Hanke, December 22, 1983).

Clarkson (1972) found that administrators of public hospitals spent a great deal more time following many more bureaucratic rules than did their private counterparts, whereas private hospital administrative staff spent much more time (including night duty) monitoring activities than did their private counterparts. Rushing (1974) found that public hospital administrators increased the proportion of administrators to "productive" personnel as hospital occupance increased, whereas the private hospitals did just the reverse.

The federal Veterans Administration (VA) operates the largest health care system in the U.S. The VA operates 172 hospitals, 93 nursing homes, 227 outpatient clinics, 16 domiciliary units, 73 extended care wards in hospitals and 50 satellite clinics. The VA system has been extensively studied (Lindsay, 1975; 1976; President's Private Sector Survey on Cost Control, 1983). Both the President's Private Sector Survey and Lindsay found that the VA system was highly inefficient when compared with either not-for-profit and for-profit private hospital systems.

Housing

Public housing projects are typically run-down, and are costly to construct and operate. Weicher (1980) found that the cost of new public housing units was about 25 percent higher than comparable private housing. The American Enterprise Institute's research also indicated that private management can lead to significant cost savings, when compared to public management. A switch to private management led to reduced administrative costs, reduced maintenance costs, and higher rental income through improved rent collection and reduced vacancy rates.

A privatization policy has been followed by the current Conservative government in Britain (Butler, 1984), with great success. During the past five years, over 700,000 public housing units have been sold to their former tenants at a discount from market clearing prices. This has allowed the Conservative government of Margaret Thatcher to sell unfunded liabilities (public properties that generate negative cash flows) at positive prices. Moreover, the former public housing units have been improved by their new private owners and neighborhoods have been stabilized.

Military Support and Maintenance

The U.S. Defense Department contracts with private providers for many base support and maintenance services. Bennett and DiLorenzo (1983) found that private providers performed the same quality and quantity of services at an average cost savings of 15.1 percent, with savings that ranged from 0.1 percent to 35 percent. Grace (1984) reported findings that are consistent with those of Bennett and DiLorenzo.

Parks and Recreation

Poole (1980) reported that contracting for the private operation and maintenance of public parks is a rapidly growing activity. His studies showed that private firms not only reduce maintenance costs by about 20 percent, but also improve service, when compared with public operation and maintenance.

Payroll

In testimony before the Joint Economic Committee, J. Peter Grace (May 1, 1984), Chairman of the President's Private Sector Survey on Cost Control, indicated that it cost the U.S. Army $4.20 to process a payroll check. He stated that the same function was performed by private firms for $1.00 per check.

Ports

Bennathan (undated) reported that evidence on private versus public ports and private versus public port services clearly shows the superiority of private provision. However, Bennathan cautioned that the data on private versus public ports have not been systematically analyzed and that most of the private ports are more specialized than public ones. He did note, however, that recent technological changes—such as containerization, better scheduling techniques and faster turn-around time—should all favor private over public ports.

Postal Service

The law prohibits private firms from competing with the U.S. Postal Service for first-class delivery, but many private firms compete for other classes of service, such as overnight delivery. These private providers have led the way in adopting innovative postal technology and have also been able to deliver a higher quality service at a lower cost than the U.S. Postal Service (Haldi, 1974 and Savas, 1982). United Parcel Service (UPS) handles twice as many parcels as the U.S. Postal Service, charges lower rates, makes faster deliveries and has a damage rate that is 80 percent less than the public post office. In addition, UPS makes a profit, whereas the U.S. Postal Service has typically generated losses. Further evidence of private enterprise's relative efficiency in the field of postal service has been provided by Grace (1984).

Prisons and Correctional Facilities

Faced with the need to expand capacity on the one hand and the taxpayers' reluctance to finance new prisons on the other, public officials have begun to turn to the private sector. Since 1979, the Federal Bureau of Prisons has contracted out all of its half-way house operations, and some states have done the same. The Immigration and Naturalization Service has begun to contract out for some of its lock-up facilities. In all, there are some 30,000 juvenile offenders housed in facilities owned or operated by private firms.

Poole (1980) found that private firms have been able to build and operate low security facilities at costs that were 10 to 25 percent less than public facilities. Moreover, private firms completed the design and construction of these facilities in six to twelve months as opposed to an average of five years for the private sector.

Refuse Collection

Savas (1977) reported results of a national study of about 1,400 communities, which undertook an extensive analysis of cost factors. The study revealed that, for cities over 50,000 population, private collectors were about 30 percent less costly than public ones.

Spann (1977) found that public collectors in Monmouth County, New Jersey were 70 percent more costly than private firms in the same county. Kemper and Quigley (1976) analyzed data from Connecticut, and found that municipal collection was 25 percent more expensive than contract collection. Bennett and Johnson (1979) found similar results in Fairfax County, Virginia.

Security Services

The private security industry in the U.S. has a long history. Private security forces now outnumber public forces in the U.S. at least 2 to 1 (Savas, 1982).

The efficiency of private over public security is attested to by a 1976 study of New York. New York was able to contract out security for a total cost of $4 to $7 per hour per guard. The equivalent public cost for a guard was $15, and that did not include any overhead or amortization costs (Savas, 1982). Gage (1982) reported similar results. For $90,000 annually, one-half the public cost, a private firm provided Reminderville and Twinsburg, Ohio, with twice as many patrol cars and an emergency response time that was over seven times faster than the public alternative.

Ship Maintenance

Bennett and Johnson (1981) and Bennett and DiLorenzo (1983) reviewed comparative performance and cost data about the public and private fleets. The average annual maintenance cost for a Navy support ship was $2 million, whereas for a private ship it was $400,000. Furthermore, data for eight specific equipment repair items revealed that the public cost for the identical job ranged from 3 to 52 times more than for private vessels. These cost data are also supported by data on days per year that are required for repair: naval support ships spent between 30 and 68 days per year in repair, whereas private vessels spent between 11 and 31 days in repair, even though on sea duty more than Navy ships.

Streets, Highways and Bridges

Harral, Henriod and Graziano (1982) reported that contracting out for periodic and routine highway maintenance was significantly more efficient than comparable public enterprise. Even though there are no private highway systems, there are some bridges that are privately owned and open to public access. The Ambassador Bridge, linking Detroit to Canada, is owned by a private company. There are some private bridges in Florida. The Progresso Bridge, which crosses the Rio Grande between Texas and Mexico, is also private. These, and other private bridges, not only generate a profit, but are better maintained than publicly owned bridges (McDermott, 1982).

Local private streets also exist in U.S. cities, such as St. Louis. The privatization of streets in St. Louis is effected by deed restrictions attached to each property on the street. These restrictions require that title to the street be vested in an incorporated street association to which all property owners must belong. Deeds also restrict property uses and require property owners to pay association fees which cover the cost of maintaining the street.

The private streets are better maintained, are much safer (public streets in the area had between 26 and 52 percent more crime in the period 1966-1973) and surrounding property values are much higher (Gage, 1981). By forming a street association, the shareholders (property owners) are able to transform what was a public common property resource into a private resource paying them to invest in maintenance and security.

Towing

Savas (1982) reported that towing of illegally parked cars was much less costly, when contracted out to private firms. New York's police department estimated that it cost the city $65 per car to make a tow. The costs dropped to $30 per tow with a private contractor.

Urban "Public" Transport

Until rather recently, the conventional wisdom in the U.S. was that urban "public" transport must be provided by public enterprise because private enterprise is unable to provide this service. These attitudes are slowly changing as public systems generate ever larger operating deficits and provide poorer service (Poole, 1980; Walters, 1979).

Public buses in New York generated $16,694 in annual revenues per employee, whereas the figure for comparable private lines in the metropolitan area was $26,279 (Ramsey, 1983). In Australia, private urban bus systems have been found to be 50 percent more cost effective than public ones (Roth, 1984). The pattern is similar in Germany, where the nationwide average cost for public buses was 160 percent more per kilometer than the contract price for comparable private bus service (Blankart, 1979).

The urban "public" transit sector is one of the few sectors in which systematic research has been conducted on the relative efficiency of public versus private modes in underdeveloped countries (Roth, 1982; 1984; Walters, 1979). Roth (1984) reported that in Abidjan, Ivory Coast, the private sector operated Gbakas (14 or 22 seat vehicles) on two routes that competed with public transport buses. The private sector carried about 200,000 passengers annually on these routes, whereas the public buses carried 160,000 passengers. The public buses operated with a large deficit, while the Gbakas operated with substantial profits.

Roth (1984) also reported on the evolution of urban "public" transit in Buenos Aires, Argentina. A private system has provided a wide variety of efficient and profitable services. Cairo is another city that is witnessing rapid growth in private "public" transit (Roth, 1984). The public system has realized an operating deficit of about $50 million per year, while private operators have typically generated profits. In Calcutta, private buses account for about two-thirds of all bus trips. They operate on routes comparable with those of the public buses and charge the same fares. Yet the private buses turn a profit, while the public buses generate operating losses of about $12 million annually (Roth, 1984).

The most sophisticated economic analysis of comparative efficiency of public versus private "public" transit was performed by Alan Walters (1979). In 1974-1975 Kuala Lumpur allowed 400 private mini-buses to enter the transit market. Although they only accounted for about 17 percent of the total bus capacity, they provided half the passenger miles. Walters carefully calculated the net benefits from this new private mode of transport, and included reduced passenger waiting time on the benefit side of his benefit-cost calculus. The net benefits of this new private mode of transport, which operated with average profits of about 37 percent on capital, were significant. Net benefits totaled about $10 million annually, or about one percent of per capita income.

Wastewater

Because of construction and operating efficiencies, the costs of private supply typically run 20 to 50 percent lower than public supply (Hanke, Janvier, 1982). These cost savings result from the fact that it only takes about two or three years to design and construct a private plant, whereas a public plant requires seven to eight years. In addition, public plants must follow the U.S. Environmental Protection Agency's design criteria, which result in "overdesigned" plants. The public plants must also often pay construction workers wages that are higher than market wages because of the requirements of the Davis Bacon Act. Lastly, competition and private ownership put pressure on private firms to efficiently operate plants, whether they be public plants that have been contracted out for operation or plants that are privately owned.

Water Supply

Crain and Zardkooki (1978) used 1970 data from a sample of 24 private and 88 public water enterprises in the U.S. to construct an econometric cost model for water supply. They established that the private operating costs were about 25 percent less than for the public operations. Further, they found that this was caused by relatively low labor productivity in the public enterprises and also an underutilization of public enterprises' capital. Morgan (1977) generated similar results with a different data set. Monod (1982) indicated that private ownership, as well as private operating and maintenance agreements, exist in less developed countries. Not only do these private arrangements provide services at a lower cost than public enterprises but they provide a higher quality of service. Hanke (1981) found that, in accordance with the property rights theory of the firm, customer cross-subsidization was more common in public than in private operations.

Weather Forecasting

Bennett and DiLorenzo (1983) reported that the weather service was contracted out at National Airport in Washington, D.C. The contract contained an incentive for accurate forecasts, with payments being reduced for below average forecasts in any month and grounds for contract default if two consecutive below average months occur. The cost savings from this privatization was 37 percent and the quality of the forecasts improved.

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42 The Heritage Lectures

Privatization—the shifting of government functions into the private sector—has aroused much interest among policy makers. This budget-cutting strategy seems to offer politicians a solution to a perennial problem: The anger of someone denied a government service is always greater than the gratitude of the taxpayer whose dollars are saved. By providing the option of a similar—or even superior—service from the private sector, at less cost to the taxpayer, privatization allows the legislator the chance of satisfying both constituencies at once.

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