The Heritage Foundation Backgrounder

No. 488 The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002-4999 (202) 546-4400

February 20, 1986

# PRIVATIZING FEDERAL SERVICES: A PRIMER

## INTRODUCTION

A new word--privatization--has entered the lexicon of federal budget making. Put simply, privatization means the transference of federal assets or activities to the private sector. That can take many forms. Facilities owned by the federal government can be sold to the private sector; these same facilities can be kept in federal hands but managed by private firms or groups; federal services can be provided, under contract, by private firms; or low-income Americans can be given the means to obtain services in the private sector. These forms of privatization enable the deficit to be reduced without cutting necessary services. The reason: by turning over functions to the private sector, bureaucratic decision-making is replaced by competitive private management incentives. So resources are used more efficiently, to the benefit of both the taxpayer and service recipients.

Ronald Reagan's FY 1987 budget draws heavily on privatization to meet the deficit reduction targets required under the Gramm-Rudman legislation. This makes good political and economic sense. Privatization offers politicians the attractive alternative of cutting spending without necessarily eliminating programs; all that is changed is the mechanism by which programs are delivered. And privatization revenues obtained from the sale of federal assets, such as power generating facilities or the student and farm loan portfolios, provides a substantial inflow of immediate revenue. This gives Congress breathing space to find sensible ways to reform and restructure programs to meet the deficit reduction targets, rather than resorting to disruptive across-the-board cuts.

While privatization may be new to many Washington policy makers, it is practiced extensively at the state and local level, and by many foreign governments. Their experience proves that privatization can bring relief to budget heart burn, and that it can be very popular with voters. As Congress explores ways to cut the deficit within the Washington political climate, privatization should become increasingly attractive to lawmakers.

## WHAT IS PRIVATIZATION?

Privatization can take many forms. Each has different economic and political effects.

### The Sale of Assets

The most complete form of privatization, obviously, is to sell government-owned assets to private buyers. This removes government entirely from any involvement in the activity and the sale provides revenue to the Treasury. Example: The Reagan Administration's budget proposal to sell the federal Power Marketing Administrations, which generate and distribute electricity. Britain has done this by selling several government-owned firms and nearly 1 million public housing units to the public, earning $20 billion for the Exchequer.

Asset sales are particularly attractive because they can provide a considerable amount of revenue to the government in a very short time. Other forms of privatization, where the private sector involvement enhances the efficiency of performance, often take time to yield substantial savings.

The potential for the sale of federal assets is enormous. The federal government, for instance, has a portfolio of outstanding loans in excess of $200 billion. This includes loans to students, small businessmen, and farmers. The federal government also owns over 700 million acres of land--the majority of which long has been in commercial use for timber or grazing land--valued at hundreds of billions of dollars. Uncle Sam owns many other assets of significant value, including two of Washington's airports, over one million public housing units, and many valuable lots in the nation's cities.

By selling assets, the federal government "cashes out" the future income they generate--just as an investor will sell a stock certificate for a price based on its anticipated income. Predictably, this has led critics of this form of privatization to claim that the strategy is a shortsighted and inefficient response to the deficit problem--like selling the furniture to pay the rent.

But every successful businessman knows that it is often prudent to liquidate assets during a crisis to provide a cushion to permit essential restructuring of the firm. The federal government is in a financial crisis. It must meet strict deficit reduction targets required by the Gramm-Rudman law. The up-front revenue from asset sales would make it easier for Congress to meet the Gramm-Rudman ceilings for the next couple of years. It could use this breathing space to make sensible, structural reforms in federal programs. This would avoid the meat ax of across-the-board cuts mandated by Gramm-Rudman if the ceilings otherwise are not met.

Privatization, moreover, does far more than merely allow the government to cash out its future income. Such sales are likely to yield a better price than the present value of the government's probable income from the asset. The reason is that managers of publicly owned assets are subject to constant political and budget constraints. They also lack the positive incentives influencing private sector managers. This is why the Forest Service manages to lose money in managing millions of acres of valuable timberland, and why the Postal Service is constantly outgunned in those areas where it faces competition, such as overnight package delivery.

The price a private buyer of a federal asset is willing to pay reflects the income the buyer estimates he can make--not the lower expectations of the public managers. Selling federal assets, therefore, means the full value of the asset is realized. As important to the economy, the resources would be used more wisely. In private hands, the rangeland would not be overgrazed, delinquent student loans would tend to be collected, and Washington's airports run more smoothly because private owners would have the incentive to manage these valuable assets more carefully and efficiently.

<u>Deregulation</u>

A second form of privatization involves simply allowing the private sector to provide a service now monopolized by the government. Take the Postal Service. Private carriers compete with the Postal Service for the delivery of parcels; the result is that 70 percent of that business is now in the hands of the United Parcel Service. It is a different story when it comes to the letters sent by American individuals and businesses. A federal law, the Private Express Statutes, makes it illegal for anyone to compete with the Postal Service in the handling of first class mail. Deregulation would allow private carriers to compete for first class mail business. These new entrants would succeed or fail solely on their ability to serve the public. The federal Treasury would gain both from the contract fees paid by the new private mail delivery services, and from corporate taxes the private firms would pay. And the consumer would gain enormously if first class mail were handled as efficiently as UPS and Federal Express deliver packages.

The Social Security System also could be improved by privatization. American workers and employers are forced to save for their retirement through the government-run pension system. Benefits under the program are a political football, while studies indicate that few younger workers can expect a return on their Social Security contributions comparable with the yield on private pension plans.[1] Giving workers the option to put their Social Security contributions into a private plan would privatize the system by allowing private firms to offer better pension plans.[2]

In this form of privatization, deregulation breaks a government-sponsored monopoly. This leads to more competition and choice, to the benefit of the consumer, and it cuts the budget by reducing the need for government provision of a service.

Contracting Out

In this form of privatization, the government still funds the service, but invites private firms to bid for the right to provide the service under contract. The cost of the service is reduced because the successful contractor must outbid his rivals.

Hundreds of American cities routinely use private contractors to supply basic municipal services, such as garbage collection, maintenance work and even, in some instances, fire protection. At the federal level, the so-called A-76 program enacted in 1955 requires agencies to compare the in-house cost of routine commercial services with those obtainable from private suppliers. In theory, each agency is supposed to use the least expensive supplier of the appropriate quality of service.

In practice, there is little contracting out at the federal level.[3] One reason is that Congress buckles to pressure from the public employee unions, and places obstacles in the path of privatization. Spurious national security considerations, for instance, have been used to rule privatization out of bounds in many programs. Example: Congress has blocked cost-saving contracting out of much supply, maintenance and repair work despite requests from the Pentagon. Agencies have also been instructed not to even consider a private bidder unless the saving is at least 10 percent of the in-house cost.

Another factor inhibiting federal contracting out is the mechanism used to compare costs. Instead of an independent commission

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1. Peter Ferrara, "Rebuilding Social Security, Part 1: The Crisis Continues," Heritage Foundation Backgrounder No. 345, April 25, 1984.

2. Peter Ferrara, "Rebuilding Social Security, Part 2: Toward Lasting Reform," Heritage Foundation Backgrounder No. 346, April 25, 1984.

3. See Stuart M. Butler, Privatizing Federal Spending (New York: Universe Books, 1985), pp. 53-56.

making these comparisons, each agency determines whether it or a private bidder is more economical. Needless to say, employees of the agency have the incentive to use every possible accounting trick to minimize their own stated costs. Until a truly independent method of cost comparison is used in the A-76 program, the deck will be stacked against the private contractor--and hence the taxpayer.

The savings from contracting out are likely to be greatest when the degree of competition within the private sector is most intense. Tough competition means the government knows that the contractor will keep on his toes, for fear of losing the contract.

<u>Vouchers</u>

In this form of privatization, the government also continues to fund the service. But instead of a federal agency giving a contract to a specific firm to provide a service, the agency gives the users of the service the means--probably a voucher--to purchase a specific service in the open market. In this way the government provides individuals with the power to become consumers. This approach is most appropriate in cases where a healthy market for a service exists, but where households have insufficient income to obtain an adequate supply.

The first widespread use of vouchers has been the Food Stamp program. Low-income families were provided with stamps of a certain value, which they could use only to purchase food. Recipients had the incentive to shop around to obtain the best value for their stamps--and supermarkets had to compete for their business, ensuring efficient provision of food to the poor.

Vouchers could provide low-income Americans with other basic requirements as service providers compete for the consumer's dollar. Rather than continuing a system of expensive public housing and subsidies for landlords, for instance, a housing voucher could be given to the poor. It would empower them as consumers and thus open the competitive private rental market to low-income families. The Administration's FY 1987 budget requests Congress to create 50,000 such housing vouchers, to replace part of the spending on other housing programs.

Similarly, a medical voucher for low-income and elderly Americans would provide them with the incentive to seek the most efficient health insurance available, or the lowest cost subscription to an adequate health maintenance organization.

As with contracting out, vouchers do not reduce the federal government's commitment to provide the service involved. But by encouraging voucher holders to seek the most efficient provider, privatization enables the government to keep the cost of the service as low as possible.

## THE RECORD

Privatization is underway in over 50 countries.[4] Canada is looking into the sale of several "crown corporations," and Mexico has earmarked over 200 state firms for sale to the private sector. Even Cuba is busily transferring the ownership of public housing stock to the tenants.

Several Asian countries are turning to privatization to help state finances and resuscitate stagnant government corporations. In South Korea, for instance, the government has divested itself of several major banks, an oil company, and several other enterprises. Malaysia intends to privatize the telephone system, its national airline, and various government facilities. Other Asian countries are taking similar steps. Perhaps most important of all, Japan will soon be selling stock in the state-owned Nippon Telegraph and Telephone, the country's telephone company, and is planning to restructure and partly privatize its heavily money-losing government railroad system.

Privatization is also becoming a trend in Europe. Turkey has already sold stock in the Bosphorus Bridge and the Keban Dam, and is drawing up plans to sell two dozen other government concerns. In West Germany, many municipalities contract out such services as public housing management and health clinics. Even in socialist-ruled France, the government of Francois Mitterrand is taking steps toward returning to the private sector many of the corporations it hastily nationalized during the past four years.

By far the most extensive privatization is occurring in Britain. Since Margaret Thatcher became prime minister in 1979, there has been widespread contracting out at all levels of government, approximately $20 billion worth of government assets has been sold to private buyers, and over 400,000 government workers have been moved to private payrolls. Over 800,000 public housing units have been sold to tenants, while various commercial firms and the entire telephone system have been sold to the public.[5]

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4. See "Privatization--Everybody's Doing It Differ[illegible]y," The Economist, December 21, 1985; Privatization Around the Globe, Policy Report #120 (Dallas, Texas: National Center for Policy Analysis, January 1986).

5. See Butler, op. cit.; Madsen Pirie, Dismantling the State (Dallas, Texas: National Center for Policy Analysis, 1985).

## The American Experience

Privatization is not new to the U.S., even though the term itself has only recently become familiar to most Americans. At the state and local level, governments are increasingly turning to privatization to reduce the cost of services. A recent survey by the National Center for Policy Analysis found that approximately 35 percent of local governments now have private firms to collect residential garbage, 42 percent use private firms to operate and maintain their bus systems, and 80 percent contract out vehicle towing and parking.

Other functions routinely undertaken by the private sector in U.S. towns and cities include street repair work, traffic signal maintenance, tree trimming, utility billing, ambulance services, health and welfare programs, park landscaping and maintenance, and legal services.[6] Even fire departments and prison facilities are operated by private firms in many cities. A study by the International City Management Association found a 50 percent rise in the number of cities privatizing one or more of the services during the past ten years.[7] The use of private firms to collect garbage has more than doubled during the decade, private street repair operations have risen 600 percent, and the use of private firms to manage parks has skyrocketed 2,700 percent.[8]

The overriding factor leading local officials to privatization is cost: the competitive private market generally provides routine services much cheaper than a government department. Study after study confirms the significant cost savings when private contractors are used.[9] A recent study of the Los Angeles area, for instance, reveals that street cleaning by city employees typically costs 43 percent more than the equivalent service provided by a private firm; janitorial services cost 73 percent more than the private alternative; and road resurfacing 96 percent more. Of the eight services analyzed, only in

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6. Privatization in the U.S., Policy Report #116 (Dallas, Texas: National Center for Policy Analysis, June 1985).

7. E. S. Savas, "The Efficiency of the Private Sector," in Stuart M. Butler, ed., "The Privatization Option, Heritage Foundation Lecture Series No. 42, 1985.

8. Privatization in the U.S., op. cit. See also Robert Benenson, "Privatizing Public Services," Editorial Research Report, Vol. II, No. 4, Congressional Quarterly, 1985.

9. Savas, op. cit.; see also E. S. Savas Privatizing The Public Sector (Chatham, New Jersey: Chatham House, 1982).

payroll preparation were public sector costs comparable with those in the private sector.[10]

As a sizeable bonus, of course, the private firms that win contracts to perform public services pay local taxes. The municipal bureaucracy pays nothing to the town treasurer.

At the federal level, there have been relatively few privatization initiatives, even under Ronald Reagan. One reason is that many government activities in other countries are already delivered by the private sector in America. Another reason is that the Reagan Administration's political experiences with privatization have not been pleasant--mainly because it has failed to profit from the tactical lessons learned the hard way by foreign governments. Margaret Thatcher, for instance, carefully builds coalitions of those who have or will have a vested interest in privatization. The Reagan Administration has not. It thus ran into a political buzz saw when it attempted to sell the weather satellite system and a small portion of federal land holdings to the private sector.[11]

Even contracting out routine services to the private sector has not been expanded to the degree that might be expected of a conservative administration. The Administration has done almost nothing to remove the obstacles to the fulfillment of the A-76 program by which federal agencies are required to compare the in-house cost of providing commercial services with bids from private firms, and to choose the lowest cost option.

## THE POLITICS OF PRIVATIZATION

The Reagan Administration has set bold privatization goals for the FY 1987 budget. It has proposed selling such assets as the Power Marketing Administrations, the Naval Petroleum Reserve, and a part of the federal loan portfolio. In addition, it is pressing for a full voucher program for low income housing and compensatory education. These and other privatization initiatives, says the Administration, could cut the deficit by $7 billion in FY 1987, and many billions more in later years.

The outlook for these initiatives has been improving dramatically. The passage of balanced budget legislation, and the mounting wealth of tactical experience from abroad, suggests that

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10. Barbara Stephens, "Company Public and Private Sector Efficiency," National Productivity Review, Autumn 1984.

11. Butler, op. cit., pp. 82-91.

privatization could be the key to bringing federal spending under control.

### The Impact of Gramm-Rudman

The Gramm-Rudman-Hollings deficit reduction timetable marks a turning point in the debate over federal spending. Even if the Supreme Court upholds the lower court ruling invalidating part of Gramm-Rudman, Congress is committed to reducing the deficit. Reagan's determination to veto any tax increases leaves lawmakers with only one deficit reducing option--cut spending. This could be stingingly painful for Congressmen. What could spare them this pain, while meeting deficit reduction guidelines, is privatization.

As a model, Congressmen need only examine recent state and local experiences. Trapped between the rock of voter resistance to tax increases and the hard place of reduced assistance from Washington, the country's mayors have found that through privatization they can maintain the quality of services at lower cost. This already makes for good politics at the local level.

It would make good politics at the national level. Instead of slashing services to meet spending targets, as traditional budget cutting requires, privatization allows lawmakers to continue supplying the services. The only difference is that a new sign will hang over the programs proclaiming: "Under New Management."

It should not take long for Congressmen, like their local counterparts, to recognize privatization's attractiveness.

### Privatization Coalitions

A major reason why even the most wasteful or redundant federal program can be impervious to budget cutting efforts is that a tight coalition forms around it. This coalition consists of program beneficiaries, those who serve these beneficiaries, and the political and bureaucratic constituencies whose careers depend on the program's existence. When the program's budget is challenged, this coalition has a strong vested interest to wage a ferocious campaign to preserve it. As the Reagan Administration has discovered, it may be possible to dent programs supported by these coalitions, but it is usually impossible to eliminate them.

These coalitions win because it is difficult to find congressional and grassroots allies who will support budget cutting with tenacity. The average taxpayers will denounce spending in principle, but in practice will rarely join in an all-out effort to trim or eliminate a particular program.

Privatization changes these dynamics. The creation of a private mechanism spawns groups of beneficiaries and supporters which create a "mirror image" coalition to that defending the existing programs. Like the coalitions supporting government programs, the mirror image coalitions consist of individuals who will receive services and the providers of those services--in this case private firms and groups. And these private coalitions have the incentive to campaign hard for stepped-up privatization.

Privatization at the local level has produced a multitude of private sector organizations that have lobbied intensively and successfully against "public sector coalitions." These coalitions can often draw strength from the groups that once supported the government provision. In Britain, for instance, giving public housing tenants the right to buy their units at a discount turned one-time advocates of public housing subsidies into cost-conscious homeowners. Similarly, giving British public sector workers free stock in the privatized companies that replaced their public agency converted privatization's fiercest opponents into some of its strongest supporters.

While these privatization coalitions quickly and almost automatically form when privatization takes place, they need to be mobilized in advance if privatization proposals are to gain the support they need to become law. Thatcher's government has taken careful steps to build a constituency for privatization, primarily by giving key groups, such as employees, management, and customers, an ownership stake in the designated privatized firm.[12] So far the Reagan Administration has ignored this lesson. It is this that has caused its privatization initiatives to be delayed or abandoned.

## CREATING THE POLITICAL CLIMATE FOR AMERICAN PRIVATIZATION

The Reagan Administration must create a political environment conducive to privatization and design initiatives to win the support of key constituencies. To accomplish this, several steps should be taken. Among them:

### 1) Organize Coalitions

Even before announcing a privatization initiative, officials should identify and mobilize those constituencies likely to gain directly or indirectly. In some cases this may involve helping organize such constituencies into an effective political force to ounter the established constituencies favoring government delivery of services. Example: the greatest beneficiaries of an education voucher

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12. Butler, op. cit., Chapter 2.

program would be low-income parents and the small neighborhood private schools that cater to lower income parents. Helping these groups form national networks and recognizing leaders of these networks as legitimate spokesmen on education issues would strengthen the voucher movement.

2) Attempt to erode anti-privatization coalitions

Public employees understandably are concerned that privatization may endanger their jobs. This concern, and the opposition to privatization that it produces, may be reduced in a number of ways. The pace of contracting out, for instance, can be limited such that the number of jobs lost in the private sector corresponds to the usual rate of attrition. In that way the existing workforce is not threatened--there is simply a freeze on new hiring. Or the employees may be given an ownership stake, even outright ownership, of a privatized asset. When the British government privatized the government-owned National Freight Corporation in 1982, the employees were allowed to purchase 85 percent of the trucking company. With the incentive of ownership, the workers became advocates rather than opponents of the privatization. Private ownership, meanwhile, has turned the money-losing drain on the taxpayer into a highly profitable, taxpaying company.

Steps may be needed to quell the public's fear about private ownership of government assets. It is a fear often fanned by the opponents of privatization. For instance, when the Reagan Administration sought in 1982 to sell five million acres of commercial range and timberland--a tiny fraction of the 750 million acre federal inventory--it faced a crippling barrage of criticism. The argument in effect was that it was selling the national parks to developers, desecrating the memory of Smokey the Bear. Public outcry stymied the sale.

Such a reaction could be averted in the future. The management of parks and wilderness areas, for example, could be given, under contract, to environmental organizations. This should reassure the public that these lands will not be part of any sale policy.[13] Similarly, any proposal to introduce an element of privatization into the Social Security system should be preceded with an iron-clad guarantee that existing retirees and those nearing retirement would not be affected.

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13. John Baden, "Let Environmentalists Manage Wilderness Lands," Heritage Foundation Backgrounder No. 461, October 8, 1985.

3) Spread ownership widely

A key lesson of the British experience with asset sales is that spreading the private ownership widely, especially among groups that might otherwise be hostile to the sale, helps win political support for privatization. It is now almost routine for Britain to structure sales of government enterprises as stock offerings to the public. But preference is given to purchasers who are employees, users of the asset, and small investors. Sometimes even free stock is given to these groups. When Britain's telephone system was privatized in 1984, 96 percent of the employees and two million Britons bought stock in a tidal wave of enthusiasm for the sale.

The Reagan Administration should heed this lesson. Its sale of the federally owned freight railroad, Conrail, to the Norfolk-Southern Railroad, for instance, would be an excellent deal for the taxpayer. But the sale has been slowed, perhaps fatally, by opposition from key beneficiaries of federal ownership of the freight railway system. Yet these key constituencies might have been converted to supporters of Conrail's privatization if attractively priced blocks of stock had been reserved for employees, shippers and other groups. When the Administration attempts to win congressional support of its plan to sell the five huge Power Marketing Administrations, it will have a better chance of success if it adopts a stock sale strategy favoring employees and customers.[14]

4) Recognize the importance of tax incentives

A tax incentive can provide the focus around which a privatization coalition can develop. Favorable tax treatment of sale-leasebacks, for instance, encouraged construction firms to press municipalities to explore innovative, lower cost wastewater treatment plants. The deduction for Individual Retirement Accounts has stimulated the growth of a powerful new constituency for private pensions.

The powerful stimulus to privatization provided by tax incentives should be part of the effort to simplify the tax code. The purpose of raising taxes is to pay for government spending. Privatization reduces the need for government spending. But eliminating certain tax incentives would reduce the level of privatization, because deductions stimulate charitable contributions, private pension plans, and other alternatives to government programs. Ending such tax incentives would discourage these private options, and that may result simply in more demands for spending and ultimately higher taxes.

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14. Milton R. Copulos, "Cutting the Deficit by Selling Federal Power Marketing Administrations," Heritage Foundation Backgrounder No. 485, February 13, 1986.

5) Adopt an independent method of comparing costs

The current method of comparing the bid of a private contractor with an in-house cost estimate is heavily biased against the contractor. This could be rectified, leading to more privatization, if the role of comparing costs and deciding when to contract out were transferred to an independent commission staffed by government and private sector accountants.

## CONCLUSION

Privatization allows federal spending to be reduced without denying services that Congress agreed to provide. And by using vouchers, private contractors, or asset sales, services can be provided more efficiently. Replacing direct government spending on low-income housing with a system of housing vouchers does not cut the housing budget by providing less shelter--it does so by giving tenants the incentive to seeking better housing for fewer voucher dollars. And selling the Bonneville Power Administration to the private sector does not mean that generators will fall silent--it means that the utility's management will have to pay closer attention to the needs of their customers.

Privatization recognizes that it is possible to reduce the cost of government by changing the role of government. Government is not very good at running railroads, or building housing, or picking up garbage. By recognizing this simple fact, and drawing on the competitive private sector to perform such functions, Congress can cut the deficit by ensuring that more efficient services, not fewer services, are provided to the American people.

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