Competitive Enterprise Institute
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Advancing Liberty – From the Economy to Ecology

October 26, 2007 **No. 123**

The Continuing Value of Privatization

A Primer on How to Do It Right, and What to Avoid Doing Wrong

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As mayor of Indianapolis, Stephen Goldsmith applied what he called the "Yellow Pages Test" to the government of America's 12th largest city: If at least two firms advertised in the local Yellow Pages to provide a service, he would work to see if the city could turn that service over to the private sector.[1] This way, Goldsmith turned many of Indianapolis's government services over to the private sector: From running the airport to collecting trash, Goldsmith brought in private firms and, on balance, improved services throughout the city.[2]

Throughout the world, it has become clear that private enterprise generally outperforms government in proviing a large number of services. Not everything currently public can or should be made private, but a growing body of research indicates that government works best when it draws on the private sector to deliver services.[3]

Three Key Advantages. The private sector enjoys three great advantages over most government organizations: market forces, flexibility, and creativity. This paper provides a brief overview of how these advantages can improve the provision of public services.

Unlike government entities, which are either funded through taxes or operate under a guarantee that government will bail them out, private firms must sink or swim on their own. They need to provide things that people actually want and provide them better, with better service, and more cost effectively than their competitors. If they fail, only their stockholders, not taxpayers, bear the cost.

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Private firms also have a greater ability to roll with the punches and to innovate. When a product or service is no longer desired by consumers, private firms can introduce a new one without the need for legislation or bureaucratic rule making.

They are also more creative: In theory, at least, private companies can do anything they want which the law does not prohibit. Government, on the other hand, can only do things specifically authorized by law. A government employee with a good idea needs to negotiate a million hurdles to act on it. Although some private firms have become at least as bureaucratic as the government, individual entrepreneurs need only to get investors and customers excited about their ideas.

Of course, there are arguments against privatization. Some oppose privatization citing concerns about equality and access to a service—for medical care and education, most prominently. In other areas—mainly national defense and criminal justice—concerns about security and honor may well make privatization difficult or impossible.

Privatization still makes sense in a great many cases but, after years of advances both in the United States and around the world, it has entered a period of retreat. Consider the following examples:

- In Florida, the government of the fourth largest state recently socialized the bulk of property insurance against hurricanes while imposing a variety of regulations that allow the state to set prices for nominally private in-state companies.
- Around the country, previously private airport screening operations have come under the control of the new federal Transportation Security Administration.
- The U.S. Postal Service enjoys nearly total protection from competition in the delivery of letters, bills, and magazines. It has often lost money and, in recent years, has raised stamp rates faster than inflation.
- Although technically owned by stockholders, two major marketers of mortgage backed securities, Freddie Mac and Fannie Mae, remain a significant hidden liability for taxpayers. Efforts to remove them from the public purse have failed.

The same trend has continued around the world.

- In the United Kingdom, the Conservative Party (yes, the *Conservative* Party) has proposed reducing the role of the private sector in the nation's successfully privatized social security system.
- In Europe, publicly-owned utilities such as Electricité de France have acquired stakes in privatized utilities across the world.
- Russia has renationalized several major companies, mainly in the profitable energy sector, following popular disquiet at the fortunes made by well-connected businessmen—the maligned "oligarchs"—who took over collapsing companies after the collapse of the Soviet Union.
- In Venezuela, the leftist government of President Hugo Chavez has taken control of most energy producing companies and extorted large bribes from other private companies. Bolivia has largely followed Venezuela's lead, and Ecuador appears ready to do the same. Currently, around 80 percent of the world's oil industry is in the form of nationalized companies.

Given the current global mood, it is not surprising that plans to move the United States towards greater private sector provision of services in areas like food inspection and air traffic control have gone nowhere. One key reason for it is the lack of clarity over what privatization entails and what it ought to achieve. Many activities that governments push forward under the label of "privatization" are in fact nothing of the sort. These efforts may help improve government's delivery of services, but they do not and will not help taxpayers reap the true benefits of privatizing services. In fact, they may sometimes simply serve as a way to guarantee the profits of politically connected businesses.

To jump-start privatization, it is necessary to introduce a theoretical framework for it. This paper advances a simple argument: Assumption of downside risk, not ownership, determines whether a service actually has become privatized.[4] *An entity truly deserves to be called " private" when a group or corporation independent of political control assumes all or nearly all of the downside risk implicit in its operation. Entities are relatively more private by the degree to which non-political entities assume the downside risk.*

This paper does not take a position on which particular services ought to be privatized: It simply argues that if government privatizes a service, it should do so in a way that truly releases the government taxpayers from the risks implicit in supporting it. A "private" service that benefits its investors when it profits but also has a guarantee of a taxpayer bailout when times turn bad is simply a cumbersome mechanism for redistributing money to the owners of the enterprise in question. It does not represent a true privatization.

Two examples illustrate why it is not always possible to tell what is private and what is not simply by looking at ownership. In the United States and Canada, technically private doctor-owned Blue Cross/Blue Shield Associations service all Part B Medicare policies, most Medicaid plans, and the majority of provincial health insurance. Government both funds and heavily regulates all of these programs, so hardly anybody considers Medicare, Medicaid, or provincial health insurance private.

On the other hand, it is possible for government to own a business as a passive investor, even if a degree of political interference is almost inevitable. For example, the government of Singapore indirectly controls a large block of Singapore Airlines stock, but appears to let the airline operate without political interference. Among other things, the government has announced it will neither subsidize Singapore Airlines nor protect its dominant position in Singapore's airport. [5] If the airline went under, the company's private stockholders would bear the brunt of the burden, while Singapore taxpayers would likely see little downside. Therefore, it is fair to consider Singapore Airlines a private company that happens to have a government as a large shareholder.

In this context, we examine three types of activities that fall under the label of privatization: Those that involve full risk assumption, those that involve full assumption of a portion of the risk, and those where government retains the risk behind a "private" façade.

Full Risk Assumption. In the U.S., devolution of a service to the private sector can entail one of three activities, which the Office of Management and Budget labels as:

- Service shedding, the government's wholesale decision to give up the provision of a service by stopping it altogether;
- Divestiture, whereby the government sells the service provider to investors; and
- Employee stock ownership, whereby the government sells the service provider to its own employees.[6]

All involve full risk transfer away from the government.

Service shedding. Service shedding is particularly rare: Regardless of its value to society, nearly every government agency develop a constituency of its own employees and beneficiaries. As a result, it is very difficult for any democratic society to discontinue a government service altogether when no direct replacement exists. Occasionally, however, there is enough public support to end the government provision of a service that can be provided perfectly well by the private sector. From 1910 to 1966, for example, the United States maintained a Postal Savings System that allowed individuals to make small deposits at their local Post Office into accounts that paid 2 percent interest. Since the system was neither safer, nor better, nor more beneficial, nor more convenient to consumers than the services offered by private banks—who nonetheless saw it as stealing their business—Congress abolished it with little protest, selling books and customer lists to whatever local banks bid on them.[7] (Most customers were simply given checks for their money and cashed out of the system.) The move met with no protest; since then, the array of banking services available to Americans has expanded enormously

Divestiture. More often, governments sell operations through divestiture: Again, the private sector takes responsibility. The story of Conrail provides a good example of how this can happen.[8] During the early 1970s, the American federal government took over many of the major Northeastern freight railroads' operations after overregulation, mismanagement, and changing market dynamics drove most of them into bankruptcy. At first, the federal operation lost $1 million *a day*. However, using federally backed loans, managers from the freight industry modernized Conrail's infrastructure, spun off unprofitable commuter rail operations, and purchased new rolling stock. Soon, it was making money, and in 1987 private investors snatched it up in the largest Initial Public Offering in U.S. history up to that time. The company later sold most of its assets to two private competitors—CSX and Norfolk Southern—both of which remain profitable today. Conrail remains as the owner of a few trunk lines and some infrastructure. If it fails, the taxpayers will not pick up the tab.

Employee Stock Ownership. Some government-run entities which the private sector could take over cannot easily attract private investors in the short term. In some cases, the nature of the business—providing services largely to the government— may not have a private sector analog. For example, in 1996 the federal Office of Personnel Management (OPM) spun off its background check division to create USIS, today a subsidiary of the Carlyle Group.[9]

Because the nature of government background checks is specified in federal law and had never been contracted out before, few people beyond the agency's employees had the ability to manage the service. The need for massive numbers of people with security clearances further complicated the matter of simply selling the operation to investors outright: In the short term, the operation's revenue potential was not known and could not easily be released. As a result, OPM sold USIS to its own employees through an Employee Stock Ownership Plan. A few years later, The Carlyle Group purchased it from the employees. As a private equity concern, Carlyle does not break out results for USIS so its current profitability is unknown. But taxpayers are no longer on the hook. Moreover, background check times have fallen since USIS's creation and the company has expanded into other services including records storage and consulting.[10] USIS has also lost some business doing background checks to other companies.

The above examples are all straightforward and began with a clear end in sight: the government would either get out of the way entirely, move to shed the asset with reasonable speed, or spin off a service to private enterprise. However, not all services can be privatized quite so easily.

Full Assumption of a Part of the Risk. In some cases, it is either impossible or politically impractical for the private sector to take full assumption of the risk. This leaves several different possibilities: vouchers, contracting out, and managed competition. Although some contracts and managed competition schemes involve little more than restructuring of government agencies, these types of plans can sometimes involve true risk transfer. These efforts need to be assessed on a case-by-case basis to determine exactly how much risk the private sector actually takes on and how much the government continues to bear.

Vouchers. Vouchers offer a measure of privatization. In effect, they subsidize the private sector for an alleged market failure by directly giving people money that may only be used to purchase a specific good or service, rather than having the government provide that service directly. For example, the U.S. government, rather than hand out food directly to hungry individuals, issues food stamps to subsidize food purchases from private grocers.[11] Grocers are not required to accept food stamps; those who do participate in the program remain private and compete for customers. Although the food stamp program is entirely government-run, it operates within a mostly private food distribution system. The risk for producing, processing, and marketing food remains largely in the private sector.

Contracting out. Contracting out can also involve a partial assumption of risk. When it needs to construct a new office building, procure a new jet fighter, or inspect cars, government might turn to a private contractor rather than one of its own agencies. The government determines the quality of the service being provided and can fire the contractor if it performs poorly. Within the range of contracted-out services, the actual assumption of risk varies a great deal. For example, a single company has provided all the paper for United States currency for 125 years and does not appear to be at risk of losing the contract any time soon.[12]

At the other end of the spectrum, a local government might bid out every street repaving contract to a different company and purchase the services in much the same way that a private firm might. While some contract terms might allow companies to receive payment for shoddy or substandard work, the contractors have a real chance of losing the contract if they fail to perform. This involves a certain assumption of risk, but if a contractor becomes important enough or politically connected, it is possible that the government *de facto* assumes the risk for its failure.

In many cases, however, the value to taxpayers of contracting out can be negated by overly intrusive client management. In many cases, politicians wish to retain a significant degree of control over the contracted-out service, so contracts are often designed to give them significant powers in determining performance standards, which lowers the degree of innovation that the private sector could bring to bear. As private sector firms tend to pay higher wages than public sector equivalents, a too-restrictive contract can simply deliver the same quality of service as the public sector at a higher price. When this happens, private enterprise often gets the blame, even though it was government micromanagement that created the problems in the first place.

Finally, government can engage in managed competition: The government provides a service but allows or encourages the private sector to compete under certain terms. Charter schools provide a good example of this type of privatization. Although the specifics of charter school laws differ from state to state, charter schools typically operate outside of the "official" public school system and are free of most of its regulations. In most cases, charter schools are allowed to raise money privately but must accept a set per-student grant for each student, and cannot charge tuition.[13] A charter can be revoked if a school fails to meet certain standards set largely through the political process. Since the schools do not strive for profits, the people running charter schools rarely take on financial risk, but, under certain circumstances, they can lose their jobs and ability to operate. Because it can be subject to as many—or more—rules than full government service provision, managed competition, can rarely, if ever, substitute for true privatization. In some cases, it can move towards greater private assumption of risk.

Government Retains Risk Behind a Private Facade. Finally, government can pretend to privatize something without actually doing so. It can do this in three ways: the creation of government corporation or government supported enterprise, false divestiture, and unsustainable privatization.

Government corporation. A government corporation—usually an entity that sells products or services directly to the public—often gains freedom to operate like a business while retaining some special government benefits, such as tax exempt status.

Amtrak is a good example of a government corporation. Created from the wreckage of America's inter-city passenger railroad services, Amtrak is a corporation run by a CEO.[14]

Although a few railroads control shares in the company, the shares pay no dividends and no market exists for them. If Amtrak shares were offered on the market, they would probably be worthless, since Amtrak has never come close to turning a profit. Although it has the freedom to do things that other government agencies cannot do—such as mortgage its own real estate, purchase some services without competitive bidding, and keep books that could not pass a government audit—Amtrak remains a government entity for all intents and purposes. It loses money year after year, and, for a variety of political reasons, would have a very hard time shedding its unprofitable routes. Each year, Amtrak needs a cash infusion from the federal government just to keep going. Taxpayers are also on the hook for Amtrak's liability, pensions, and capital costs.

Nearly everyone considers Amtrak to be a government agency with a different structure, but some government corporations do a better job of maintaining a private façade. For example, the Federal National Mortgage Association (Fannie Mae), which markets mortgage-backed securities in the United States, was originally created as part of Franklin Roosevelt's New Deal as a way of adding liquidity to the mortgage market. Known as a government supported enterprise, it purchases mortgages from banks, packages them into securities, and markets the securities. It is the second largest financial institution in the United States and its stock trades on the New York Stock Exchange. Unlike Amtrak, it has full flexibility to hire and fire employees, pursue business opportunities, and purchase products just like any other private firm. So where's the problem?

Fannie Mae is allowed to sell mortgage-backed securities with half the capital required of private institutions. While its securities include an explicit warning that the government will not back them and federal law technically forbids a bailout, investors believe that a bailout will happen and consider them less risky. As a result, Fannie—and its sister organization Freddie Mac—can pay less interest than a private firm to sell the same product. Furthermore, Fannie Mae's debt is printed as an addendum to the federal debt.[15] Thus, while the company's investors and executives run its operations as if it were a private company, Fannie does not assume the full downside risk for its own failure. So, while Fannie or Freddie *look* private, the American taxpayer will ultimately bear the full downside risk should they ever implode.

Finally, government can privatize something in a way that makes it impossible for the private sector to run it. This can burn both investors and taxpayers. An example is the British government's privatization of RailTrack, the body created out of the restructuring of the nationalized industry British Rail to provide infrastructure services for the British railroads. Several government decisions constrained RailTrack's ability to provide services to its customers. Its maintenance arm, for example, was unnecessarily split off for privatization as a separate company when it made sense for a degree of vertical integration to continue. Worst of all, years of public ownership and the consequent lack of capital investment had led to the railroad track reaching a degraded, dangerous state, much worse than anyone had foreseen at the time of privatization. This became apparent after a series of fatal accidents around the turn of the century.

Safety restrictions imposed by the rail regulator led to a collapse in the company's stock value and the government's refusal to bail out RailTrack led to its de facto renationalization under a national emergency law. The replacement company, Network Rail, is still technically a private company in that its liabilities do not appear on the national balance sheet, but it is funded almost exclusively by the government, which also appoints members to its board. Despite the seeming transfer of risk, political realities dictated that no British government would allow the passenger rail system to fail, no matter what the cost.

Conclusion. For many public services, privatization simply makes sense. Governments often get better results and free resources for productive use when they turn things over to the private sector. Privatization, however, does not and should not involve guaranteeing profits to favored, or government-created, companies. Simply contracting out a service does not necessarily place the risk in private hands.

Markets thrive on risk-taking. When government insulates a service from risk, it decreases opportunities for innovation and improvement. Privatization will work best when the private sector assumes all or almost all of the downside risk. This will only be possible when politicians are prepared to allow services out of their personal control. Ironically, it may be politicians' risk aversion that keeps them from releasing risk to the private sector.

Notes

[1] Donald F. Kettl, *The Transformation of Governance: Public Administration for 21st Century America*, Baltimore: Johns Hopkins, 2002, 128.
[2] Stephen Goldsmith, *The 21st Century Cit*,. Regnery: 1998.
[3] See e.g. Stephen Goldsmith and William Eggers, *Governing by Network: The New Shape of the Public Sector*, Washington, D.C.: Brookings, 2004.
[4] For a good general reference on some of the vocabulary of privatization, see Office of Management and Budget, "Terms Related to Privatization Activities and Processes," GAO/GGD-97-121. http://www.gao.gov/special.pubs/gg97121.htm.
[5] Bloomberg News, "SIA Could Lag as Challengers Enter," January 15, 2004.
[6] Office of Management and Budget, supra.
[7] Edward J. Lincoln. "Time to End Postal Savings," *Sentaku*, June 2, 2001.
[8] Joseph Vranich, *End of the Line; The Failure of Amtrak Reform and the Future of America's Passenger Trains,* Washington, D.C.: AEI Press, 2004, 157-8.
[9] Office of Management and Budget, Supra.
[10] USIS, "Background Investigations – Services," http://www.usis.com/investigativeservices/bi_services.htm.
[11] The Federal Government does sponsor direct food provision through the school lunch and breakfast programs as well as the food surplus distribution program, but these are tiny compared to the Food Stamp program.
[12] Government Accountability Office, "Currency Paper Procurement: Additional Analysis Would Help Determine Whether a Second Supplier is Needed," April 2005, GAO-05-386.
[13] Dan Lips and Evan Feinberg, School Choice: 2006 Progress Report. Washington: The Heritage Foundation, 2006, http://www.heritage.org/Research/Education/bg1970.cfm,
[14] Joseph Vranich, *End of the Line: The Failure of Amtrak Reform of the Future of America's Passenger Trains.* American Enterprise Institute, 2004, 9-11
[15] See e.g. Peter Wallison et al. *Privatizing Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Why and How,* Washington, D.C.: American Enterprise Institute: 2004.