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PRIVATIZATION: A STRATEGY FOR CUTTING FEDERAL SPENDING

SUMMARY

Despite Ronald Reagan's image as a determined enemy of federal programs, spending has expanded rapidly under his presidency--in real terms and as a proportion of national output. Federal spending has risen from 22.4 percent of GNP in 1980 to an estimated 25.2 percent for 1983. The President's congressional supporters appear to have all but conceded that the federal budget cannot be cut, arguing that the focus should be changed to raising taxes.

The Administration's failure to reduce federal spending stems from a failure to understand the political dynamics of budget growth. Programs expand because the narrow interest groups affected make every effort to defeat reductions, while the savings are thinly spread over all taxpayers. The absence of any linkage between budget reductions and significant benefits to the taxpayer gives the momentum to those who wish to preserve and expand federal spending.

Rather than concentrating exclusively on the supply of government programs, the Administration should address the demand for such services. Instead of engaging in a war of attrition, it should provide incentives for beneficiaries of federal spending to choose non-governmental alternatives, and it should reduce barriers to private suppliers. Rather than merely chipping away at programs, in other words, it should attempt to move these functions out of the federal domain, by fostering private sector options that are more attractive to beneficiaries.

By pursuing this "privatization" strategy the Administration would seize the initiative and change the political dynamics of

budget-cutting. Privatization would offer Americans the option of a superior private service. In so doing, it would reduce the intensity of opposition to program cuts. The current strategy merely tries to force beneficiaries to accept a reduced public service. Privatization, on the other hand, would create a "mirror-image" of the existing political dynamics and lead to a diminishing federal role. Coalitions forming behind each private sector program could be expected to resist fiercely any attempt to eliminate it, and the coalition would press for an expansion of the private role.

The Administration should turn the privatization strategy into a coherent plan to reduce federal spending. The President should appoint a commission to identify programs that could be privatized. The Vice President's Task Force on Regulatory Reform should be resuscitated and restructured to focus on regulatory impediments to alternative service providers. And Treasury and the Office of Management and Budget should examine alternative tax incentives which would foster privatization.

WHY GOVERNMENT PROGRAMS GROW AND CANNOT BE CUT

Federally funded programs generally grow according to a pattern. The first step is usually the creation of a small program to provide for a perceived public need or distressed group--or powerful interest group. Some programs do command significant resources at the outset (such as social security or Medicare), but normally the budget allocation is small enough for the taxpayer to feel a need has been met at no identifiable extra cost to himself or herself.

Once the initial program is established, however, a coalition develops with incentives to press for increased spending. The coalition consists of three elements:

1) <u>Beneficiaries and "Near" Beneficiaries</u>: The initial program is rarely sufficient to deal with all desires of the beneficiaries. So organizations emerge to represent beneficiaries and to mobilize political support for increased funding. Moreover, there are those who fall just outside the rules for inclusion, yet feel they are just as needy as some who fall just within the orbit of the program. The original beneficiaries are likely to support near beneficiaries by pressing for an expansion of the program.

2) <u>Service Providers</u>: Public and private providers of federal services have compelling incentives to lobby for the program's expansion.
Housing contractors have much to gain from increased funding for public housing, for example, while social workers press for more welfare spending.

Every profession, moreover, tries to shut out competition and thereby increase its income. This can be achieved through regulatory barriers to entry. Federal service providers find it politically easy to obtain such restrictions by appealing to the need for "standards." Teachers and child care providers, for instance, have won government credentialling restrictions which make it difficult for those outside the narrowly defined profession to be licensed (and hence receive government funds).

These barriers to entry reduce the supply of providers, allowing them to command higher incomes. This raises the cost of the federal program. But restrictions often have another effect. Normally the same professional credentials and standards are applied to all providers, even if they are volunteers receiving no federal funding. The result: service gaps appear, because effective voluntary groups cannot afford to meet the onerous requirements, and so the demand increases for expanded federal programs. This "crowding out" effect is a significant cause of the growth of federal human service expenditures.

3) Administrators: More resources mean more jobs and promotions for the federal staff administering programs. And just as private sector executives always look for new opportunities, federal workers tackling one problem try to identify new problems--real or perceived--to be treated.

The Federal Ratchet

The coalition supporting each program provides the momentum to expand federal spending. The taxpayer may complain about taxes and spending in total, but any particular program imposes no discernable additional burden on him.

The momentum only operates in one direction, however. The coalition works to frustrate the budget cutters. One need only recollect the media attention given proposed welfare cuts--and even the possibility of social security cuts--to recognize just how effective the coalition is.

It is effective for two reasons. First, it can mobilize those affected by cuts, to give credence to the argument that the program is essential. Secondly, it can exploit the fact that there is no link between cutting a program and any significant tax benefit to each elector. Traditional budget cutting tactics fail, in other words, because the taxpayer may oppose levels of total spending, but finds it difficult to see how cutting a particular program will reduce his tax burden significantly.

THE LOGIC OF PRIVATIZATION

The privatization strategy acknowledges the federal ratchet and seeks to replace it with a private ratchet, by creating a mirror image of the pressures that expand federal spending. It envisions government as the "facilitator," rather than the provider, of services for society. The government would require private spending in some cases (such as mandatory health insurance and pension payments), provide incentives in others, and remove barriers to private service providers, rather than taxing and spending to provide these services directly. The strategy would reduce the budget by diverting demand into the non-governmental sector.

Political Dynamics of Privatization

A close examination of the political dynamics of the approach suggests that it could reduce federal spending significantly.

Deflecting Demand: Privatization alters the demand for federal spending by offering a preferred non-government alternative. Instead of cutting federal spending by forcing people to find some alternative, privatization establishes the alternative first, encourages people to use it, and then reduces spending in line with reduced demand.

Social security is a good example of this process already underway. Congress attached a provision to the 1981 tax act allowing Americans to open tax-deductible Individual Retirement Accounts (IRAs). By establishing this tax incentive, Congress planted the seeds of a private social security alternative. IRAs, indeed, are a classic example of privatization. To many Americans, the IRA option is a preferred vehicle to achieve the goals of financial security for their retirement years. With the IRA alternative in place, the demand for the federal social security system is partially deflected, and opposition to controlling spending reduced.

Constructing a Private Coalition: In addition to deflecting the demand for federal spending, the privatization strategy involves the conscious creation of coalitions of beneficiaries, providers and administrators to press for an expanded private role, just as the public sector coalitions press for increased federal spending. These private sector coalitions are the key to privatization. They supply the political pressure for the expansion of private alternatives.

The political dynamics of privatization are a mirror image of those leading to the federal ratchet. By giving a benefit (such as a tax incentive) only to people choosing the private option, it is possible to concentrate benefits on a relatively small group at a "cost" which is spread thinly and widely.[1] The beneficiaries, and the "near" beneficiaries who just fail to qualify for the incentive, can be expected to campaign for an expansion of the private option. Privatization also encourages providers and administrators of the private sector service to press for increased private provision, just as they do when a federal spending program is established.

Privatization thus stands the conventional political dynamics on their head. Each element of the coalition has much to gain from the growth of the private sector option, and will press for more incentives and wider jurisdiction. Each success the coalition receives only strengthens it, adding to its political capacity to achieve further concessions.

Again, IRAs are a perfect example of this process. Even before the new law went into effect, banks and financial institutions were engaged in a massive campaign to persuade Americans to open IRAs. Soon the coalition began to press for a wider deduction, to bring homemakers and other "near" beneficiaries under the incentive umbrella.

ADVANTAGES OF PRIVATIZATION

Choice: Privatization gives consumers of federal services an alternative. The IRA law, for instance, has led to an explosion of retirement options. An easing of the tight credentialling rules governing social service providers would have a similar effect.

Efficiency: Choice and competition also reduce the cost to society of providing services. The federal monopoly breeds inefficiencies, and barriers to entry force up costs. Reducing licensing barriers would also encourage lower cost competition providing human services.

Tax savings: The taxpayer also gains. Where non-governmental suppliers are encouraged through purely regulatory changes, private alternatives would have no impact on federal revenues. But even if a tax incentive were used to stimulate private provision, the taxpayer would come out ahead, whether or not he can utilize the incentive himself. If the tax incentive to the provider or beneficiary of the private service were less than 100 percent of the federal cost, more than one dollar's service would be provided for each dollar in revenue "lost." So the revenue needed by government to facilitate a specific level of privatized services would be less than if those services came directly from government--enabling taxes to be cut.

VARIETIES OF PRIVATIZATION

Privatization as discussed so far implies shifting both the service and funding functions out of the government's domain. Often this complete form of privatization is called "load-shedding." Many writers interpret the term privatization more loosely to mean simply the use of private service providers or the private funding of government services.[2]

A brief overview of these versions is useful, both as a guide to limited forms of the concept, and also as a warning against some of the dangers resulting from incomplete privatization.

User Fees: User fees and taxes are sometimes referred to as privatization. Yet they are only a stimulus to privatization, in that they encourage the search for private sector alternatives by assigning the real cost of a government service to its users. Examples include the airline ticket tax and road tolls. But even if these fees are based on cost--and often they are not--one may ask why the federal middleman has to be there at all.

Contracting-Out: This is the most common form of incomplete privatization. It is also open to abuse. Just as user fees represent the private funding of a government-supplied service, so contracting-out represents the private provision of a government- funded service. If there is real competition, contracting-out can lead to significant savings to the taxpayer. The budget pressures on cities in recent years, for instance, have encouraged contracting-out of many urban services, such as garbage collection, with considerable savings. But private contractors sometimes manage to persuade government agencies to restrict competition, leading to monopolies and bloated costs. Uncompetitive defense contracts and tight professional requirements sought by professional human service providers are examples of successful efforts to shut out competition. Moreover, private contractors have every incentive to join the campaign for higher government spending--the antithesis of privatization.

Vouchers: Vouchers constitute a method whereby functions can be moved completely into the private sector while ensuring that low income people, or those with unusual needs, can purchase the service in the private market. Combined with incentives for charitable deductions and the removal of constraints on voluntary organization, vouchers offer a funding instrument to enable "hard-to-privatize" functions, such as education, low-income housing, urban mass transit, and training assistance, to be moved to the private sector.

Vouchers enable poor people to become active participants in the coalition for privatization. By giving low income people the financial power to choose among the available alternatives, vouchers turn dependent clients into powerful consumers, and make it harder for government agencies to monopolize a service.

THE PRIVATIZATION AGENDA

The Reagan Administration should review the federal budget to identify programs to be privatized. The survey best could be accomplished by a presidential commission, with its own staff and the authority to work closely with federal agencies and private sector organizations. The commission should be required to report to the President within one year.

The work of the President's Commission on Privatization should be supplemented by two other groups. The Vice-President's Task Force on Regulation, recently disbanded, should be reconstituted to examine regulatory impediments to privatization, and to recommend administrative and legislative changes that would facilitate the options suggested by the commission. A joint task force of officials from the Treasury and OMB could also explore tax incentives and other financial aspects of privatization.

While a full agenda must await this full survey, existing studies and experience already suggest a number of possible candidates.

Social Security

Social security now accounts for more than a quarter of the federal budget. Analysis by Peter Ferrara and Peter Germanis has demonstrated that it is an ideal candidate for partial privatization.[3] By widening the IRA tax deduction to form a "super IRA," providing hospital, disability and other forms of coverage, a private social security alternative could be constructed.

Public Housing

Britain has privatized 500,000 public units by selling them to tenants at discounts of up to 50 percent. The Department of Housing and Urban Development should explore an American version of this asset transfer--possibly a shared-equity cooperative housing program.

Education

Various forms of privatization should be considered. Education vouchers would give low income parents real power to determine the way in which their children are educated. Improved tax deductions for companies providing financial and teaching assistance would also lead to a greater private sector role in the provision of education. Education credentialling requirements should be examined closely by the regulatory task force.

Welfare Services

Robert Woodson, of the Washington-based National Center for Neighborhood Enterprise, has shown that restrictive licensing, and expensive federal social programs designed in Washington and "parachuted" into neighborhoods, have led to poor results while preventing neighborhood organizations from delivering basic services to the community. The result, Woodson argues, is often programs that replace local self-help groups and foster dependence on welfare.[4] If the restrictive rules were lifted and vouchers replaced many federal delivery systems, Woodson maintains, privatization would lead to greater efficiency and community self-reliance.

Economic Development

Vouchers and tax incentives could be used to privatize many economic development programs. Training vouchers would open many creative private training programs to the poor. And technical assistance vouchers would allow neighborhood groups to turn to competitive private organizations for economic development advice, rather than relying solely on federal grants.

Mass Transit

Vouchers for low income people, combined with cost-based user fees, would stimulate a wide array of private sector mass transit systems. Reason magazine, World Bank scholar Gabriel Roth and others have pointed out that subsidies and underpricing discourages more efficient private mass transit, and that there are many examples around the world of highly successful private systems.[5] Electronic metering systems are now available that would allow many roads and bridges, now heavily financed by the federal government, to be transferred to private operators.

Conrail and Amtrak

The Administration is currently developing plans to privatize Conrail, as required by Congress. John Semmens has shown that Amtrak has been a financial disaster.[6] It chould be privatized in a similar way.

Air Traffic Control

Robert Poole has developed a model for privatizing the air traffic control system, based on private systems in other countries.[7] He shows that many of the deficiencies of the current system would be eliminated with the incentives implicit in private ownership. He suggests also that many federally owned and operated airports be transferred to private operators.

FDIC

Catherine England and John Palffy have shown that federal deposit insurance discourages proper risk assessment in banking, and this has been a cause of several failures. They recommend moving the entire insurance function to the private sector.[8]

Energy Research

Milton Copulos argues that many federally supported energy projects should either not be undertaken at all or should be financed privately. He suggests that by increasing the tax credits available for research, and amending the anti-trust laws, private consortia could be encouraged to take over long-term research now funded by Washington.[9]

Postal Service

Although private electronic mail systems, overnight carriers and other innovations do constitute partial privatization of the Postal Service, the Private Express statutes prevent significant private competition. Some experts have pressed for the repeal of the statutes.[10] Others, such as Postal Rate Commissioner John Crutcher, point out that the current legal framework would allow many large segments of the service, such as rural delivery, to be contracted out to private companies.[11]

Wastewater Treatment

The federal government spends more than $2 billion in grants for wastewater treatment projects. But as economist Steve Hanke points out, government-operated plants typically cost 20 to 50 percent more than equivalent private plants.[12] He shows that ownership and operation of these projects could be shifted to the private sector. Paul Langerman has noted that similar inefficiencies arise from federal rules governing solid waste disposal, and that tax and regulatory changes would spur highly efficient private alternatives.[13]

Federal Lands

The Administration has taken some steps toward privatizing certain federal lands. President Reagan issued an executive order in 1982, establishing a Property Review Board, with the goal of selling $9 billion worth of properties by 1986. Steve Hanke, one of the architects of the program, notes that privatization would improve productivity and efficient use of land, and depoliticize land-use decisions.[14]

CONCLUSION

When Margaret Thatcher and Ronald Reagan were elected in 1979 and 1980 respectively, two experiments in conservatism began. Both leaders were committed to reducing the size of the state. But while Ronald Reagan scored some stunning early legislative successes, his Administration has never experimented with new techniques of cutting federal spending. And once proponents of increased federal spending caught their breath and regrouped, the underlying momentum returned.

The Thatcher government, in contrast, re-examined the whole process of government spending, once it became clear just how difficult it is to cut the budget. Eventually, the Tories stumbled onto privatization, recognizing that the strategy altered the political dynamics of the budget battle. The British are now selling many segments of the economy that have been owned by the government. They are contracting out many urban services and parts of the national health service, and have accelerated the pace of public housing sales to tenants. Unlike her counterparts in the United States, Thatcher has set government spending in reverse as a proportion of GNP.

The Reagan Administration should learn from this. The White House has far less control over spending, than the Prime Minister has in Britain. All the more reason, therefore, that Ronald Reagan look not simply at places to cut the budget, but at new strategies to gain the initiative. Privatization is a technique ideally suited to his needs.

Stuart M. Butler, Ph.D.
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NOTES

1. For the sake of simplicity, this statement assumes that someone not availing himself of tax relief is burdened by those who do. Many would argue, however, that the presumption is incorrect--meaning that there is no burden imposed by a privatization tax incentive.

2. For an excellent analysis of privatization in this wider sense, see E.S. Savas, Privatizing the Public Sector (Chatham, New Jersey: Chatham House, 1982).

3. Peter Ferrara, Social Security Reform: The Family Plan, (Washington, D.C.: The Heritage Foundation, 1982), and Peter Germanis, "Increase the IRA Advantage," Heritage Foundation Backgrounder No. 285, August 24, 1983.

4. Robert L. Woodson, "Helping the Poor Help Themselves," Policy Review, 21, Summer 1982.

5. See Gabriel Roth and George Wynne, Free Enterprise and Urban Transportation (New Brunswick: Transaction Books, 1982). 6. John Semmens, "End of the Line for Amtrak," Heritage Foundation Backgrounder No. 226, November 9, 1982.
6. Semmens, op. cit.

7. Robert Poole, "Air Traffic Control: The Private Sector Option," Heritage Foundation Backgrounder No. 216, October 5, 1982.

8. Catherine England and John Palffy, "Replacing the FDIC: Private Insurance for Bank Deposits," Heritage Foundation Backgrounder No. 229, December 2, 1982.

9. Milton Copulos, "Privatizing Federal Energy Research," Heritage Foundation Backgrounder No. 270, June 7, 1983.

10. Robert Poole, "Is This Any Way to Run a Postal Service? No," The Wall Street Journal, October 11, 1982.

11. John Crutcher, "The Privatization of the Postal Service," The Washington Times, June 2, 1983.

12. Steve Hanke, "A Case For Privatization," The Baltimore Sun, May 10, 1983.

13. Paul Langerman, "Treating Sludge: The Case for Reducing the Federal Role," Heritage Foundation Backgrounder No. 256, March 8, 1983.

14. Steve Hanke, "The Privatization Debate: An Insider's View," The Cato Journal, vol. 2, no. 3, (Winter 1982).