

# **Carnegie Council\DRT International Privatization Project**

## **Privatization in the United States**



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**No. 6**

The Carnegie Council\DRT International Privatization Project has been made possible by a generous grant from DRT International, of which Deloitte & Touche is a member.

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January 31, 1992

James C. Miller III

I would like to make two points regarding privatization in the United States. The first is that I view privatization versus government ownership and control as a continuum, not an “all or nothing” proposition. Whether some government function should be privatized is an empirical question, not an ideological question. If the service in question is purely private—as in automobile production—the question is whether these private goods would be more efficiently produced and distributed by the market or by the government. Fortunately, we have a wealth of studies on this point—nearly all of which conclude that the market does a better job. In other instances we must take a closer look. Some services intricately tied to the core functions of government (for example, interpretation of—as opposed to argument of—laws) might appropriately remain provided by government. Ronald H. Coase, this year’s winner of the Nobel Prize in Economics, conducted great work in *The Theory of the Firm*. Coase asked, “Why do firms exist? Why can’t the marketplace be relied upon to provide and to organize; even to the extent, for example, of organizing a factory for sale?” He concluded that centralized control was appropriate where the inefficiency of transaction costs exceeds the inefficiencies of making decisions without the benefit of the knowledge that markets provide. Similarly, in many cases one has to judge whether the loss of control from privatizing a government service is greater or less than the probable efficiency gain from having that service privately provided.

Let me clarify the difference between public financing and public provision. It may be desirable for government to ensure that people don’t go hungry. One remedy would be for the government to set out government owned and controlled grocery stores to provide food for the needy. Instead, in this country this function has been privatized through an institution known as food stamps. Food stamps are vouchers. People who are needy receive the vouchers from the government, and they go to any food store and purchase goods and food for a very cheap price.

Making laws, on the other hand, is a function of governments, not the private sector. But there are other examples of public financing and provision and of private financing

and provision of basically the same function. Protection of property is one. We have police who are publicly financed and provided, and then we have security guards who are privately financed and privately provided. In communist and non-communist social countries we have seen the ebb and flow of functions under government ownership and control being privatized, and then returning to government ownership, and so forth. It is a continuum and it is an empirical question. You have to make decisions as facts change. The appropriate decision may be to leave the function in the hands of the government, or to take it out, depending on the situation.

The second point I’d like to make is that in the U.S. we have much less to privatize than the rest of the world. None of our major conventional industries is in government hands. We are not in the situation found in Great Britain, let alone that of Bulgaria, Czechoslovakia or Ukraine. However, at the Federal level we do have a good many more prospects for privatization—and potential efficiency gains—than are generally recognized or understood. That is the reason why

I set up a privatization office in the Office of Management and Budget when I was its director and had it headed by an Associate Director—which is the next level. I gave it every bit of visibility and importance as any other unit and had it headed by a very able economist by the name of Ron Utt. I took over OMB just as Phil Gramm announced his proposal which became known as the Gramm-Rudman-Hollings Act, and I helped shepherd it through Congress. If you remember, Gramm-Rudman-Hollings essentially said, “If you don’t realize a decline deficit target, total outlays will be cut,” and it ended up being passed by Congress with half of the cuts coming out of defense and half out of domestic spending. I thought that in that circumstance making the first year’s target was going to be very difficult, because the deficit in the previous year had been \$221 billion and the target for the following year was \$144 billion. It would have been the largest reduction in the budget deficit in the history of the country. As it turned out, we hit \$151 billion, which in itself was the largest deficit reduction in U.S. history. I proposed privatization partly to ease the transition to that first year, thinking it might make reach-

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ing our target a little easier. In other words, we'd be able to have realized the goal without having some kind of mutiny. In the end, however, I misjudged Congress' interpretation of Gramm-Rudman-Hollings. In the first year of Gramm-Rudman-Hollings there was no tax increase, but congress-

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sional leadership, especially on the other side of the aisle, was determined to raise taxes, and they viewed Gramm-Rudman-Hollings as a means to force President Reagan to go along with a tax increase. I was arguably naive on that point, thinking that Congress would go along with some privatization in order to make the system work; in part it resisted privatization because the congressmen knew they wanted to use Gramm-Rudman-Hollings to force the President's hand. Neither did they go along with the idea of privatization by and large on its merits. Opposition to privatization is entrenched on Capitol Hill, and those that are threatened by privatization lobby very hard to retain their privileged position. The concept of privatization is generally hard to sell to the American people. (We looked long and hard for an alternative word to “privatization,” because it sounds somewhat commercial and selfish, but we didn't find anything).

It was because of the problem of selling privatization generally that Ken Grab and I came up with the idea of setting up a Privatization Commission. Its purpose was to give some bipartisan support to the notion of privatization and to educate the public about what was at stake. The Commission did very fine work, but unfortunately its report was not that widely reported on, discussed, or analyzed, so it didn't have quite the effect that we had hoped.

So, what kinds of privatization initiatives am I talking about? Our first target was to sell commercial paper; to collect student and agricultural loans and sell them to the private sector. This was along the lines of what President Bush said in his State of the Union address about the existence of certain things the President can do without getting Congress to go along. Part of the motive of such a recommendation was that it would raise funds, and part was the way it would be treated in the budget—it is considered a “negative outlay”. But I also had another reason. I thought it would increase the efficiency of decision making; to help those in the administration understand what they were doing.

If you had to sell the loan portfolios, the quality of the loan portfolios would be reflected in the price you could get for them, and so you would have incentives on the part of bureaucrats to do a better job; to make more credit-worthy loans. In the Reagan administration, we were the first to

successfully institute credit checks on people borrowing money from the government. Can you imagine the private sector lending money to people without a credit check? Some loan programs deliver a very high proportion of repayment, such as the loan program that builds dormitories on university campuses, which repays 99 cents on the dollar; while there are other programs where 60 cents on the dollar is repaid. But you won't find one Congressman in a hundred who has

even the remotest idea of how much implicit subsidy is involved in these programs. By selling the portfolios to the private sector, I wanted to increase the efficiency of Congressional decision making because they would then know how much subsidy was in the programs they were approving. I tried to institutionalize that program, but it ran into heated opposition on Capitol Hill, in part because our Representatives did not want the public to know how much money was involved in the subsidies.

Here are some other examples of programs—all of which did require Congressional concurrence. One was the proposed sale of Amtrak. There is hardly any justification for public provision of the kind of passenger rail system we have in the United States. Amtrak—including the potential uses of the corridor for communications purposes which have yet to be explored—could be sold, leaving a corridor on the Eastern Coast, one on the Western Coast, and perhaps a hub-and-spoke operation out of Chicago. The cross-country trains that eat up enormous subsidies from the government would be a thing of the past. Naval petroleum reserves are another example. These are a legacy of the past; today's need for reserves could be met by the Strategic Petroleum Reserve.

We also proposed privatizing the power marketing administrations. Nine out of ten watts of power in this country are distributed by private entrepreneurs. Utilities want this out on the West Coast because they have access to Federal Treasury funding at about 3% interest. The Radio Magnetic Spectrum is



another example—why is that publicly owned? Why shouldn't broadcasters be able to use that spectrum however they want? I think this is a First Amendment matter. The Department of Agriculture, in another example, has a crop insurance program which is a big drain on the Treasury. Commercially provided crop insurance is available, but it costs more because the government subsidizes the Department of Agriculture's version. I proposed privatizing the Federal Housing Administration in our first budget, and the FHA went crazy. We also proposed privatizing the National Institutes of Health—it is a research organization, so why shouldn't it be in the private sector? We did not, however, get very far with these proposals.

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Consider, too, others that we didn't put in the budget; for example, bank and S&L insurance. Rather than have a monopoly organization within the Federal government that insures banks and savings and loans, this function could be competitively provided for at the private level. Government-sponsored agencies such as Fannie Mae, Freddie Mac, and Sallie Mae have access to the Treasury at very low rates of interest. As another example, the Federal government owns a helium production facility that ought to be privatized. And, you would think that you wouldn't know what the weather was if you didn't call the National Weather Service—that's what they tell you anyway. The fact of the matter is that there are a lot of entrepreneurs out there that forecast the weather. When the hurricanes come down on the Texas coast and the bayous of Louisiana, they don't call up the National Weather Service, they call up “AccuWeather” to find out what's going to happen. Another candidate for privatization is NASA, which has held tenaciously onto space exploration. That should be privatized. Janitorial services, security guards, printing, analyses, etc. are all other examples of functions which may be better provided by the private sector. Of course, today there is much more privatization action at the state and local levels than there is at the Federal level. For example, prisons, fire protection, waste collection, and waste water treatment.

Let me now talk a little about two privatization prospects; one is at the Federal level, and one is at the state level. Both trace their history not to broad governmental takeover, but to the very beginnings of our nation, and they represent two of the largest government enterprises. They are the Postal Service and public education. First, the Postal Service. The U.S. Postal Service is an enormous enterprise: \$44 billion a year, 750,000 employees, and 180,000 vehicles. It's larger than most every kind of business you or I have ever been associated with. It traces its history to the mention in the Constitution of giving Congress authority of establishing post roads and post offices. While I was at the OMB, I had the

temerity to suggest that the Post Office be privatized. Well, that triggered considerable resistance, which was a reflection of the fact that the Post Office has monopoly rents, and they want to keep their privileged position. I immediately had congressional inquiries down my neck, and one of the labor unions produced “WANTED” posters of “Postal Enemy Number One” which featured an unflattering caricature of me. But the Post Office was able to defend its existence, and in the process it created a lot of myths about the Postal Service. Let me address them.

The first myth is that the Postal Service is required by the Constitution. That is not true. It is authorized by the Constitution; it is not required. Myth number two states that postal wages are in line with pay for comparable work. And that is not true, demonstrated by the fact that there are long queues for people to go to work for the Postal Service; that's a market test for their proposition. Myth number three says that Postal Service productivity is excep-

tionally high. I agree that it has increased a little in the last few years, because until a couple of years ago they were using Ben Franklin-era technology. Myth number four is that postal rates are a bargain. In West Germany it costs 60 cents to send a letter; here it costs 29 cents. But for 60 cents West Germans get overnight delivery in all parts of the country, a service for which our Postal Service charges \$8.75. Myth number five is that the quality of postal service has been increasing; even their own figures show that is not the case. Myth number six says that the Postal Service receives no taxpayer subsidy. There are a couple of billion dollars in the budget every year for Postal Service subsidies having to do with hospital care and pensions for postal retirees, etc. The seventh myth says that the Postal Service must be granted a monopoly because it's characterized by enormous economies of scale. If that were the case, why would the Postal Service care if they were privatized? If you have enormous economies of scale, you are going to be able to beat everybody else. The eighth myth is that the Postal Service must be granted a monopoly in order to tie the nation together; other forms of communication such as radio and TV serve



*President Robert McPhail, partner, DRT International (left) and James C. Miller.*

*Photos by Larry Lettera.*



better in tying the nation. Myth number nine is that without a monopoly some people wouldn't receive mail service. The worst way to ensure efficient service is to directly subsidize the receipt of that service. Why don't we experiment? Take the biggest loss market you have and then open that to privatization. I bet that private carriers could

provide better service. That way, the Post Office would not have losing markets, and the public would get better service, but the Postal Service didn't buy that. Myth number ten is that the success of small competitors means nothing since the Postal Service is so big. Does that mean you ought to close down the 7-Elevens because you have a Safeway down the street? And finally, myth number eleven is that privatization of the Postal Service wouldn't work. But the fact is that it already works—about 12% of all rural mail is currently delivered by private contractors. And privatization would mean big bonuses. I proposed privatizing the Postal Service and giving the employees about half of the equity proceeds. This painted a different picture for postal employees than the one painted by the labor union leaders, and many postal employees were thinking, "\$32,000! That's pretty good!"

Let me now switch to public education, and just briefly describe the situation in the State of Virginia. Public education in the United States accounts for about a quarter of a trillion dollar expenditure each year. That's a big enterprise. In Virginia there are over a hundred districts; some spend \$6,000 per pupil while others spend \$3,000 per pupil. The idea is to bring all the ones on the lower end up, and so bring the average up, which in the end will bring everybody up. Spending more money on education can be worthwhile *if* it improves student performance. I think you have to have the relevant measure there and that's student performance. You should not manage the input, which is cost per student, but the output, which is student performance, and more specifically, the value added or the increase in performance. Based on what we know, however, about the relationship between performance and money, we ought to raise questions. There is a widely accepted proposition among professional researchers that there is very little correlation between variations in financial expenditures and in performance. In other words, if you try to explain variations in performance by variations in expenditure per pupil, you don't get a very good fit. In fact, I did just that for Virginia, and only 6% from the mean of the variations of student performance can be explained by variations in expenditures per pupil—and the differences are quite marked. Also, in Virginia, you find that the lowest spending districts had some of the highest SAT scores, whereas some of the

highest spending districts had some of the lowest SAT scores. Why is there so little correlation? Because under public school administration, in Virginia at least, only about half of the money goes to instruction. The other half goes to overhead of various dimensions. Another reason is that public schools have relatively little incentive to be efficient. The usual link between consumers' and producers' choice is missing there, which explains a lot. For example, if your lawyer doesn't do a good job, you can change lawyers. Knowing that could happen makes your lawyer stay on her toes. The same thing occurs with your grocery store: if your grocer doesn't provide you with reasonable prices and fresh foods, you'll go somewhere else. And knowing that keeps your grocer on his toes. Public education is different. Your local school knows that if you are unhappy with what it is doing, your alternatives are very limited. You might pick up and move to another school district, or you might try to get involved politically and put pressure on the school and try to change its behavior, but your choice is exercised in a very indirect way. One incomplete but nevertheless useful way of judging this is to compare private schools and public schools in Virginia. The per capita expenditure in the pri-

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private schools in Virginia is about two-thirds that in public schools, and the SAT scores and other standardized test scores are much higher in private schools. There is a selection process there, I understand. But that is, I think, something that school proponents need to overcome. Privatization, or partial privatization of public education, could be accomplished through a voucher program. As the President has recommended, educational funds from state and local government would be given directly to the parents who would then be able to use that voucher to cover the cost of the school of their choice. The role of the bureaucracy at the state and local levels would be to qualify schools for admission to the program, to set standards, and also to serve as a clearing house so that parents would know what was available.

Choice is a proven idea; it has a lot of adherents. It has proven itself in Harlem, and in areas all over the country. It is, not surprisingly, generating extraordinary opposition from the vested interest. I heard the Secretary of Education saying yesterday that we have to wake up in this country and realize that we can no longer afford to have an inefficient system of delivering educational services to our children. We must look for ways not only to cut costs but to increase efficiency and direct people's attention to performance—maybe even pay people according to performance rather than the way we do it today. ■

## Questions and Answers

**Q** You proposed the sale of Amtrak, but that would mean that most of the United States would be without the means of getting around, as many areas no longer are serviced by bus or by airline. Compared to Switzerland and France and other European railroads, the United States is still in the horse and buggy stage. Could you comment?

**A** If you look at a historical perspective, the history is that countries had stage coaches, then railroads, and then cars. We are way ahead of everybody else inasmuch as most of our inter-city travel is through automobile and so for that reason we are advanced. Secondly, I contest the predicate of one of your questions: the supposition that people have access by rail. They have it in New York and Washington, but the vast majority of the population in the United States does not have access by rail today, so it would not be as though you were taking people with access to rail and leaving them without it.

**Q** The Board of Education in New York is a disgrace, but I don't know how vouchers would work here. I'd like to hear you talk about it.

**A** In Virginia there is both local and state support, and I gather that's typical across the nation. The state government has a formula and allocates money to the districts based on the number of children that attend schools there. The reason for the divergence, in Virginia primarily, is the amount contributed locally. In poor districts they contribute very little, and in rich districts they contribute a lot. In a privatized educational system, the situation would exist where there would be a pot of money to be divided between schools. The question is how do you use that money? How do you finance, or how do you provide? One way is the current situation, to own all the schools and have a single school system that people can opt out of only if they will pay all the cost themselves. The other is essentially to give a ticket to the parent, and let the parent say, "I like this school over here because I hear that it produces smart students who can get into college, and I want my child to go to college." That is a dream of many, if not most, parents. So, they would have an opportunity to choose the school based on what they thought it could do for their child. The school would take that ticket and turn it back in to the government for the cash. As far as adapting to shifting levels of demand, schools are fungible; they can expand, contract, and relocate. Private schools do it all the time; public schools can do it, too.

**Q** On the question of education, I was under the impression that vouchers will pay for partial tuition and parents will probably have to make up the rest. Obviously not all schools would charge the same tu-

ition which means that people with money can afford to send their children to the more desirable schools whereas people who don't have money will be forced to send their children to the less desirable ones.

**A** You can configure the voucher system however you like; you can make it pay for the entire tuition. But the margin of the difference would be much smaller than it is today. Today, in order to go to private school, you have to pay the whole tuition. Under a voucher system, let's suppose the private school charges \$8,000, and suppose the voucher paid \$7,000. Now you only have to come up with \$1,000 and if you're a poor person, you're much more likely to come up with \$1,000 than with \$8,000 to send your child to the private school. Poor children don't have a choice today; they either go to the local school or they don't. If you had a voucher system, they would have a choice; parents could choose among different schools. In fact, some of the strongest supporters of a voucher system or a choice plan are poor people and minorities.

**Q** On your Post Office point, I'd just like to raise a couple of questions. I disagree about price. I think 29 cents is very cheap indeed, and I think it should be heavily subsidized. Your counter example is Germany, where you say it's 60 cents and they go overnight to any place in Germany; I would argue that perhaps that has something to do with the size of Germany, which is much smaller than the United States of America. Secondly, do you have any examples of privatization of a postal service in other countries?

**A** Germany is much smaller than the United States, but on the other hand, the Postal Service cannot assure overnight delivery on the island of Manhattan, which is a lot smaller than all of Germany. In fact, when the Postal Service came out with this counter argument, I challenged them to find any area of the United States as large as Germany that they could guarantee overnight delivery—and they couldn't. All I would ask is that private entrepreneurs be allowed an opportunity to compete. If they could compete and provide the service, more power to them. I don't think the onus is on anyone to prove that private entrepreneurs would do a better job; I think the onus is on the Postal Service to prove why it has to have a monopoly. New Zealand is an example of a country that has privatized its postal services. Not entirely, but to a great degree, and the access to postal services has gone up while the price has gone down.

**Q** Given our mixed market of public and private providers of health care, the current movement toward national health insurance, and the growing percentage of GNP which is spent on health care, how would you apply privatization to health care in the United States?

**A** You have put your finger on a most complicated issue. We ought to maintain as much private provision of medical services as can possibly be done. Right now we have a monopolistic purchase of medical services known as Medicare that tends to be wagging the dog everywhere it turns, and some changes need to be made in the way that medicine is competitively provided. But probably most of all, we as a society have got to think long and hard about some very important questions having to do with longevity. That is not easy to think or talk about, but one of the reasons that medical services and care costs are rising as a proportion of the GNP is that we're finding more and more costly ways of prolonging life artificially or semi-artificially. We're going to have an enormous inter-generation conflict in about two decades over Social Security. Our politicians won't talk about these issues, however; they'll just rant and rave about doctors earning too much, or hospitals earning too much, or people not having access to medical care. In my judgment, that doesn't answer the questions.

**Q** You said that most privatization decisions are empirical and not ideological. I think unfortunately they're neither empirical nor ideological; they are basically political. What could the Federal government do to encourage state and local privatization?

**A** You could propose experimental programs—demonstration programs—that would provide financial incentives for states to use Federal funds in certain directions. The decision to privatize or not is an empirical versus ideological one; but the implementation of privatization is political. For example, the Senate a couple of days ago

voted down President Bush's proposal to include vouchers in school funding. It's just very difficult to get privatization across. The National Education Association is a very strong lobby on this, although I think it's not altogether in the interest of the NEA to hold out against some experimental voucher programs.

**Q** Although I absolutely approve of privatization, my concern is in moving from a public monopoly to a private monopoly. In the case of telecommunications, the breakup of AT&T resulted in regional telephone companies—regional monopolies instead of a national monopoly. Shouldn't we temper privatization with a practical ability to deliver competition?

**A** I'll return to my point that it's an empirical question, not an ideological question. The degree to which you could not establish competitive provision might give someone pause to question whether simply rote privatization is the way to go. I supported the AT&T breakup, even though the President of the United States would frequently say: "We broke up AT&T, it was a bad idea." And I would say, "No, Mr. President, it was a good idea." The reason it was a good idea is that you took that part of the monopoly that was capable of being competitive, that is, longline transmission, and made it competitive and made the rest, which is the distribution network at local levels, a regulated monopoly.

The kinds of things that I have talked about here today are all capable of competitive provision if privatized. For example: if you could make one change in the Postal Service, would it be to privatize the Postal Service and not change the private express statutes, or to eliminate the private express statutes and not privatize the Postal Service? I would eliminate the private express statutes and not privatize the Postal Service because I think the improvement in postal services would be far greater from the added competition than from transforming a government monopoly to a private monopoly. ■

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