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The Pros & Cons of Privatization

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While public officials may see privatization as a panacea for government ills, privatization remains highly controversial among the public. Both proponents and opponents of privatization deals are vehement in their arguments and often talk past each other, with each group focusing on only part of the issue. Proponents of privatization tend to stress the financial gains of a deal and the potential operating efficiencies of the private sector. Opponents usually stress the social implications. In fact, any privatization deal has both financial and social implications. Only by addressing both considerations — and really thinking about the core functions of governance — will the public debate do justice to the fundamental question: When is infrastructure privatization in the public interest?

THE ARGUMENTS FOR PRIVATIZATION

Public authorities are increasingly turning to privatization as a public policy tool for a number of reasons, including a constrained capacity to build and maintain necessary infrastructure; budget challenges; a belief in the efficiency of the private sector; and a lack of viable alternatives. These drivers occur in a context of a demand for investments that both generate cash and protect against inflation, among buyers eager to take advantage of historically very low borrowing costs. Each of these is briefly examined below.

1. **Privatization Can Be an Effective Way to Fund Critical Infrastructure Needs.** In the global era, cities around the world are building and enhancing their social and physical infrastructures to become or remain competitive. They are also facing the daunting challenge of how to pay for the upgrades. It is hard to imagine a more vivid picture of underinvestment in essential infrastructure than the 2007 bridge collapse in Minnesota, in which an eight-lane bridge across the Mississippi River crumbled into the water during rush hour, killing 13 people and injuring scores more. For well over a decade, the American Society of Civil Engineers (ASCE) has given U.S. infrastructure very poor grades in its *Report Card for America's Infrastructure* across a range of categories.[1] In 2009 the ASCE reported

that the United States would need $2.2 trillion in investment just to maintain its existing stock of roads and bridges — not to mention new investments in transit, energy, communications, and other infrastructure that are necessary to make our lives better in the twenty-first century.

While the United States invests an average of 2.4 percent of its gross domestic product every year in infrastructure, Europe and China invest 5 percent and 9 percent, respectively.[2] Governments in the United States — local, state, and federal — are in no position to close this gap. Public finances in many jurisdictions (e.g., California and Illinois) were in poor shape before the financial crisis; now they are worse. Governments at every level are making cuts. Taxpayers are refusing to pay more, and often voting to pay less. Privatization can be a politically expedient tool for funding infrastructure improvements.

It is also important to recognize that privatization revenues can finance investments in infrastructure and human capital that make future generations more productive. For example, if revenues from an asset are used to improve the quality of, or the access to, education (particularly for disadvantaged citizens), the economic benefits could be quite significant. Privatization can unlock capital for investments in infrastructure that promote growth, ease congestion, improve the environment, or otherwise enhance the lives of future generations.

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2. **Privatization Can Provide a Source of Immediate Revenue for Strained Public Budgets.** Policymakers are increasingly turning to privatization as a way to deal with strained public finances. The demographic trends in most industrialized societies — and in some industrializing societies such as in China — will impose huge additional costs on the public sector in coming decades. Citizens around the world are generally living longer (spending much longer stretches in retirement) and, especially in industrialized countries, having fewer children. While this is a healthy trend in many ways, it also puts new stresses on the traditional mechanisms for funding old-age benefits, since the ratio of retirees receiving public benefits to workers paying for those benefits is growing steadily.

Aging societies — including America's large baby boom cohort, which has now reached retirement age — will create a more or less permanent fiscal crunch around the globe. The present financial crisis exacerbates the structural challenge within aging societies. Like the federal government, states and municipalities are reeling from increased financial claims just as their tax revenues are at cyclical lows. Privatization offers a large source of immediate revenue to help meet these budget challenges.

3. **Private Infrastructure Funds Are an Attractive Investment Vehicle for Certain Investors, Making Infrastructure Privatization Appealing to Potential Bidders.** It may strike some as a curious fact that a once little-known Australian bank is among the largest players in infrastructure privatization globally. Indeed, Macquarie Bank was a key member of the consortium that acquired the Chicago Skyway and, soon thereafter, the Indiana Toll Road. Macquarie also manages an infrastructure investment fund that holds, among other assets, Thermal Chicago, the world's largest district cooling system, which supplies steam and chilled water to approximately 100 buildings in downtown Chicago for cooling and heating under a long-term contract.

Macquarie was an early mover in infrastructure investment funds in part because of a 1992 Australian pension reform. Anticipating an increase in pension liabilities that would strain the public budget, Australia created a compulsory retirement scheme involving private investments. By 2006 Australians had more money in managed funds per capita than any other developed country.[3] This, in turn, drove a creative search for places to invest pension assets, including infrastructure. Fortunately for Macquarie, the Australian government was privatizing toll roads at the same time, which allowed Macquarie to package toll roads into a bond-like investment vehicle. The long-term, stable cash flow of infrastructure (e.g., tolls for 99 years) offers the predictability of a bond with the added advantage that tolls (as well as airport landing fees, port fees, etc.) generally rise with inflation, giving investors a natural hedge against inflation. Many banks around the world have since launched similar infrastructure funds to help meet the investment requirements of aging baby boomers. Financial investors have been attracted to infrastructure-related investments by the premiums they often yield over corporate and public bonds.

4. **Historically Low Interest Rates Enable Private Firms to Make Highly Leveraged Infrastructure Investments.** Debt is cheap. While historically low bond yields make it difficult for pensioners to fund their retirement, the flip side is that borrowing costs are low, making leveraged investments in infrastructure by private firms attractive. The stable, predictable cash flow generated by infrastructure assets can generally support highly leveraged transactions.

For example, the consortium in which Macquarie participated to buy the Chicago Skyway offered the City of Chicago almost 80 percent more than the next highest bidder and several times what the city believed the asset might be worth. Macquarie funds have paid similarly large premiums over what other public investors were willing to pay for infrastructure assets elsewhere in the world. These bids are largely due to Macquarie's aggressive view of how much debt these infrastructure assets can support.

5. **Because the Private Sector Can Often Deliver Greater Efficiencies than Government, Privatization Can Result in Better Service at Lower Cost.** The present wave of privatizations can also be viewed in the context of the broader liberalization programs ushered in with Margaret Thatcher in the 1980s and to a lesser degree by Ronald Reagan in the United States. Thatcher's privatization of large state-owned corporations such as British Gas was driven by her conviction that "the imperfections of state intervention in the economic field are likely to be not merely equal to, but greater than, the imperfections of the market." Poorly run private businesses must fix themselves or perish; state-run enterprises face no such constraint.[4] Today, the United Kingdom is arguably the most market-oriented of all states when it comes to infrastructure, having sold everything from the rights to operate individual London bus lines to on-site management of concessions in hospitals and elementary schools.

Reagan similarly made privatization a theme of his presidency, describing the 1987 divestment of Conrail, a large freight railroad, for $1.575 billion as "the flagship of privatization and the first of what we hope will be many government functions returned to their rightful place in the private sector."[5] While his two terms in office did see the privatization of many services through government contracting, intentions to privatize government corporations and assets gained little traction despite the creation of the high-profile Commission on Privatization.[6]

Today, much empirical evidence supports the claim that private companies are generally more efficient operators than government entities.[7] The reasons for this are various and include management incentives tied to performance, a better capacity to fund capital investments, greater operating leverage, the introduction of proprietary technology, and the de-politicization of pricing and other operational decisions (e.g., raising tolls or cutting money-losing routes).

Broadly speaking, the public appears to have more general confidence in the efficiency of the private sector than was the case several decades ago, when the fear of private monopolies outweighed concerns about public inefficiency. However, the backlash in Chicago against its poorly executed parking meter privatization has almost certainly jaded local opinion against infrastructure privatization, at least in the short run. There is also a heightened skepticism and distrust of Wall Street, as reflected by a May 2009 Pew Research Center study showing that 67 percent of the public surveyed say that "Wall Street only cares about making money for itself." There would thus likely be skepticism of many of the financial players that would be involved in any future privatization deal as well.

6. **Privatization Can Be a Politically Expedient Solution to Public Problems.** Another advantage of the private sector, unrelated to efficiency or expertise, is that its executives do not have to run for re-election, although they do have to respond to shareholders. Private operators can do things that politicians are unwilling or unable to do, such as raise tolls or parking fees. This can actually work to the public's advantage because the price of a privatization deal reflects these additional revenues that will be recovered by the private operators.

7. **The Alternatives to Privatization are Unattractive.** Privatization decisions do not take place in a vacuum, which is a policy reality often lost in the public discourse. The long-term lease of public assets has the potential to generate enormous public revenues. That point is obvious. The less obvious reality is that in the absence of those revenues — if a privatization deal is not done — a government must implicitly choose a different course. At bottom, this

is just math. Without the large influx of cash provided by a privatization agreement, a public entity has four choices:

- *Raise Taxes.* If the goal is to finance some level of spending, then whatever revenue does not come from privatization must come from somewhere else. One likely source of "somewhere else" is higher taxes, which is both politically unpopular and can have adverse economic consequences in the long run.
- *Borrow.* Most governments have the capacity to issue bonds, which provide an opportunity to make investments in the present (or to pay current bills) and then spread payments over a longer term such as 30 years — even longer in some cases. Privatization revenues are another source of revenues to make such investments (or to pay current bills) and can replace or supplement public borrowing. It should be noted that privatization and public borrowing, which are seemingly dissimilar tools, have broadly similar intergenerational effects. Both privatizing a public asset and issuing public debt provide a benefit in the present that must be paid for in the future. In the case of debt, future taxpayers must repay the bonds, with interest. In the case of privatization, future taxpayers must forgo the revenue stream that has been sold (e.g., future toll revenues). Both public tools involve spending in the present at the expense of the future; of course, both can be justified if the current spending leaves future generations better off.
- *Spend Less.* Privatization effectively packages a future stream of income (e.g., tolls or parking meter revenues) into a large dollop of public income in the present. This revenue can be used to cover deficits, invest in new infrastructure, expand social services, or do anything else that governments typically do. If a government does not earn privatization revenues and is unwilling or unable to raise taxes or borrow, then this spending cannot happen. As a result, the government will have to cut deeper to balance a budget, invest less in infrastructure, or spend less on social services, and so on.
- *Manage Assets More Efficiently, Either to Stanch the Financial Bleeding or to Improve Profits.* This may involve politically unattractive decisions that improve revenues (such as raising tolls) or that reduce costs (such as demanding labor concessions from public employees).

RISKS OF PRIVATIZATION

Privatization is an extraordinarily powerful governance tool. As with any other tool, it can be used incorrectly, in the wrong circumstances, or with malevolent intentions. Privatizing public assets has implications that stretch across generations and involve billions of dollars. The following is an inventory of potential pitfalls that ought to be considered in the context of any privatization decision.

1. **Privatization Constrains Future Options.** By definition, privatization places a public asset in private control for some period of time, if not indefinitely. A privatization contract can be written to demand all kinds of performance measures — but only those that can be anticipated at the time the contract is written. A lot can change in 20 or 50 or 99 years; the public has little control over a private entity that is adhering to a contract that is valid but nonetheless outdated because it no longer reflects what the public desires or expects.[8] In contrast, an elected government controlling a public asset is always accountable to voters. If those citizens decide that they want something different with respect to an asset (because of changes in technology, lifestyle, demographics, or anything else), then the government is unhindered in its ability to cater to those evolving preferences.

2. **Privatization May Have Social Implications, Adversely Affecting Certain Groups.** The primary benefit of privatization lies in the efficiencies of the private sector. Profit-seeking firms have a powerful incentive to increase revenues and reduce costs. This incentive, usually a good thing, can turn out to have adverse social consequences when certain kinds of public assets are put in private hands.

First, a private operator may cut costs by taking actions that harm a vulnerable segment of society, such as low-income citizens. For example, an efficient operator will cut money-losing services (e.g. bus routes to certain neighborhoods) and purge customers who aren't profitable. The subsequent reduction in service may cut off workers from their jobs or eliminate some basic service for the most needy.

Second, private operators may act in ways that create costs that spill over into the public sector. Take the example of a privatized toll road whose operator has leeway in setting use fees. It is understood that levying tolls on highways will alter driver behavior and road usage. Transportation research has shown that, in the face of rising toll costs, drivers' route selection is highly elastic, meaning that many will modify their choice of routes when confronted by relatively small increases in fees.[9] Some motorists will detour onto public roads that do not charge tolls. As drivers opt to reroute their travel, congestion levels on other roadways will increase, leading to rising costs for other drivers in the form of longer commute times and higher public costs for road maintenance and repair.

Third, making a good asset more popular, and thereby increasing revenues, may not always be in society's best interest. Consider the case of a lottery privatization. A private operator can improve the "efficiency" of the lottery by making it more popular. Revenues will go up. However, low-income citizens buy a disproportionate share of lottery tickets, so that a more popular lottery will essentially transfer income away from some of society's neediest citizens, leaving any resulting social problems for the public sector to fix.[10]

Finally, a private operator may maximize profits by limiting competition, which was the case with the British Airport Authority (BAA), which had a disincentive to invest in expanding capacity, thereby boosting profits at the expense of airport congestion (a cost borne by weary travelers). In fact, BAA invested heavily in airport retail, creating at least the appearance of a misaligned incentive, since stranded travelers have more time to shop.

3. Stealing From the Future? Privatization deals typically generate huge cash windfalls in the present in exchange for revenue streams that would otherwise accrue to citizens in the future. From a public interest standpoint, we must be concerned with how any privatization proceeds are used, particularly since public budget pressures appear to be the catalyst for the sale or lease of assets in the United States (though not necessarily elsewhere in the world).

Future generations can benefit if privatization revenues are invested in things that will increase future productivity and prosperity, such as human capital and infrastructure. Or future generations can be robbed if the cash inflows — often a large lump sum — are squandered or used to pay current expenses. In that case, current citizens are paying their own bills by tapping into a revenue stream — tolls, landing fees, and parking meters for instance — that could have been used to pay bills in the future. This is essentially a transfer of wealth from future citizens to current citizens.

From a political economy standpoint, it is worth pointing out the obvious, which is that current citizens can vote and future citizens, depending on the time frame, often cannot. If one takes a long view of social welfare, a privatization deal that passes political muster today may still not be in the public interest because the people who stand to lose aren't around to be heard and counted.

4. Privatization May Result in an Undervalued Deal. Citizens must receive the fair market value for any public assets put in private hands. Again, this is separable from deciding whether or not a particular asset is a good candidate for privatization. A good deal demands the right price; anything less than that is simply a transfer of wealth from taxpayers to the private firm or firms involved. And again, basic political economy matters: Elected officials have an incentive to accept a "bad deal" if control over the cash inflows strengthens their own political position. Machiavellian motivations aside, public servants may also simply lack the technical and financial skills to get a fair price for taxpayers.

One relatively obvious point is that shortening the duration of a privatization deal can minimize mistakes over valuation (or any other errors, for that matter. It can also decrease the gains accrued from the deal).

While historically low bond yields make it difficult for pensioners to fund their retirement, the flip side is that borrowing costs are low, making leveraged investments in infrastructure by private firms attractive.

5. **Private Entities May Fail to Fulfill Contractual Obligations.** A privatization contract is only as good as its monitoring and enforcement. Privatization is built upon "contractible quality," meaning that the contract explicitly specifies what is expected of the private operator in terms of quality and service levels, among other issues. Contracts do not enforce themselves. Government must devote resources to overseeing privatization contracts and must have a strategy in place in case a private firm does not or cannot fulfill its contractual obligations.

6. **A Lack of Public Input.** A lack of public input — real or perceived — at any point in the privatization process can compromise the outcome and leave citizens deeply disaffected. In theory, any government is designed to represent the voice of its citizens; in practice, privatization may demand public input above and beyond the normal processes of government at every step in the process. Even a "good" privatization deal in a financial sense will generate public consternation and distrust if there is a lingering belief that it did not reflect the public will.

Process matters. Every step of a privatization deal must be perceived as fair, transparent, and inclusive. The ends will not justify the means, since there is no obvious metric for quantifying the success of a privatization agreement (unlike the private sector, in which a good return on investment can redeem even the sloppiest deal). If anything, a poor public process can poison a deal that makes sense in every other respect.

CONCLUSIONS

If privatization were a prescription drug, its risks would be the warnings on the side of the bottle. There is nothing about the warnings that suggests one should abstain from taking the medicine. Yet, the more powerful the medicine, the more important it is to consider side effects and improper usage. Each of these potential concerns suggests ways in which privatization can be used to advance the public interest. We can mitigate the risks and adverse effects by selecting the right kinds of assets; by writing good contracts and then monitoring them; by demanding the right price; and, perhaps most important, by developing a good process for doing all of this.

Notes

1. *2009 Report Card for America's Infrastructure*, American Society of Civil Engineers, March 25, 2009.
2. "The Cracks Are Showing," *The Economist*, June 26, 2006.
3. "Australia 'Tops' in Managed Funds," The Sydney Morning Herald, January 23, 2006.
4. "The New Conservatism (Lecture to the Bow Group)," Margaret Thatcher Foundation, August 4, 1980.
5. Ronald Reagan, "Remarks at a White House Ceremony Marking the Sale of the Consolidated Rail Corporation," April 3, 1987.
6. Joel Brinkley, "Reagan Appoints Privatization Unit," New York Times, September 4, 1987.
7. William Megginson, "Privatization in the Developed World," Briefing to report authors, November 13, 2009.
8. Supporters maintain that privatization inoculates the government from certain long-term risk by shifting the assets' risks from government to the private sector. Since the city is paid in advance, and nobody knows the actual future value of the infrastructure, the risk (and of course any potential upside) is absorbed by the private sector.
9. Peter Swan and Michael Belzer, "Empirical Evidence of Toll Road Traffic Diversion and Implications for Highway Infrastructure Privatization," January 14, 2008.
10. Depending on how the deal is structured, popularity can also be a net gain for everyone. For example, government can accrue greater revenues once capital gains are taxed.

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