



**Chronicling developments in privatization, outsourcing, and government reform for 19 years. A project of Reason Foundation, the world leader in privatization**

**Edited by Geoffrey F. Segal**

In its 19th year of publication, Reason's Annual Privatization Report helps policy- and opinion-makers understand the fast-moving arena of privatization, outsourcing, and government reform. And now APR is evolving to better suit your needs.

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Comments? Suggestions? Please send them to us.



## Editor

- **Geoffrey F. Segal**

## Principal Authors

- **Ted Balaker**
- **Michael DeAlessi**
- **Adrian T. Moore**
- **Robert W. Poole Jr.**
- **Lisa Snell**
- **Samuel Staley**
- **Adam B. Summers**

## Contributing Authors

- **Chris Atkins** *is a staff attorney with the Tax Foundation*
- **Ronald Bailey** *is Reason's science correspondent*
- **John Berthoud** *is the president of the National Taxpayers Union*
- **Chris Edwards** *is the director of tax policy studies for the CATO Institute*
- **Chris Fiscelli** *is a Senior Fellow at Reason Foundation*
- **Steven J. Fisher** *is the founder and CEO of SlipStream Air, an aerospace company focused on providing logistics solutions to the private jet and space industries*
- **Michael D. LaFaive** *is the director of fiscal policy at the Mackinac Center for Public Policy*
- **Wayne Lusvardi** *is a real estate analyst with a large regional water supplier in Southern California*
- **Francois Melese** *is an associate professor of economics at the Defense Resources Management Institute, Naval Postgraduate School in Monterey, CA*
- **Max Pappas** *is the policy director for FreedomWorks*
- **James Shikwati** *is the director of the Inter Region Economic Network and coordinator of the Africa Resource Bank.*
- **Charles B. Warren** *is a real estate consultant and appraiser with Warren and Warren, San Francisco, and a Visiting Professor of Real Estate at the Technical University of Istanbul, Turkey.*



## Letter from the Editor



### Geoffrey F. Segal

Welcome to the 19<sup>th</sup> *Annual Privatization Report*, the world's longest running and most comprehensive report on privatization news, developments, and trends.

President Bush has continued to push his ambitious management agenda in Washington D.C.—achieving significant results including saving billions of taxpayer dollars. Read about new federal initiatives and Reason's role in implementing them.

Reason Foundation staff has been very active in the states again this year—working closely with several state officials in developing plans to improve government services and save taxpayer dollars. Read about those efforts and other exciting news in the “State Update.”

This year's issue includes an expanded section on TABOR—taxpayers bill of rights—a tax and spending limitation measure. All eyes have been on Colorado for years—the first to fully enact a modern TABOR—as the poster child for successful implementation. TABOR saved Colorado from massive deficits akin to what California experienced just after the dot com bubble burst. Jon Berthoud, president of the National Taxpayers Union gives an update about the progress other states have made on enacting similar measures.

Our Emerging Issues section includes discussions about Social Security (Max Pappas, Freedom Works), the Arctic National Wildlife Refuge (ANWR), and a distillation of a new Reason study on Offshore Outsourcing—hopefully Lou Dobbs will read APR.

Eminent domain abuse has been a hot button issue with the U.S. Supreme Court hearing the *Kelo vs. City of New London* case. Reason created a resource center with information on the debate, including a discussion of the case, recent developments, and possible policy alternatives. See “A Green Light for Eminent Domain” in this issue of APR.

Housing has long been one of the staples of American society and the United States' economic prowess has afforded its citizens an abundance of safe and decent housing. However, some Americans are finding it increasingly difficult to afford housing in their communities. Unfortunately, most of the political remedies aimed at making housing more affordable to these families don't consider the real world functioning of housing markets and wind up making the problem worse. The “Affordable Housing” section discusses some policy alternatives.

This year's Annual Privatization Report chronicles transportation developments, both domestically and internationally, and discusses the future of air, rail, surface, and space travel. By all accounts, more and more governments are seeking private-sector innovation, expertise, and resources to meet future needs.

In this issue we dive into private corrections and the school choice movement, both of which are gaining steam. In addition, for the first time APR includes a section on health care privatization featuring



“Mandatory Health Insurance Now!” written by Reason’s Science Correspondent Ron Bailey, as well as an article revisiting Michigan’s State Accident Fund privatization ten years later.

In another first, APR includes pieces on privatization in developing nations. Has privatization led to Rwanda’s rebirth? Developments in Zambia and Egypt are also included, as is a discussion about “Trade or Aid?”

Your comments are important to me. Please feel free to contact me with questions, suggestions, or for more information. If the 19<sup>th</sup> *Annual Privatization Report* doesn’t fulfill your need for privatization news check out *Privatization Watch* now in its 28<sup>th</sup> year. For the most up-to-date information on the rapidly changing privatization world, visit our Weblog, Out of Control ([rppi.org/outofcontrol](http://rppi.org/outofcontrol)).

Geoffrey F. Segal, Editor



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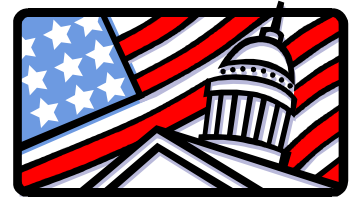


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## Federal Update



On January 15, 1955 Pres. Dwight Eisenhower issued Bureau of the Budget (now the Office of Management and Budget) Bulletin 55-4 to declare that the federal government should rely on the private sector for goods and services. More directly the policy stated, that:

*(I)t is the policy of the Government of the United States to rely on commercial sources to supply the products and services the government needs. The Government shall not start or carry on any activity to provide a commercial product or service if the product or service can be procured more economically from a commercial source.*

The directive had one goal: avoid direct competition with the private sector.

Even while this policy has been supported and applied by every administration since, today, more than 800,000 federal employees are in jobs that the agencies themselves consider “commercial” in nature—like cutting grass on federal property and writing software—these jobs, and countless others are readily available in the private economy.

Upon entering office President Bush initiated an ambitious plan to subject these jobs to competition from the private sector (as reported here). Bush’s plan, known as “competitive sourcing,” may be a slight departure from the intent of the Eisenhower bulletin, but it is still good for taxpayers.

### Competitive Sourcing Continues to Save Billions

The Office of Management and Budget released data on public-private competitions in FY2004. Federal agencies completed 217 competitions involving 12,573 full-time-equivalent employees (FTEs). An additional 76 competitions have been announced but not yet completed. The competitions are estimated to generate net savings or cost avoidances totaling approximately \$1.4 billion over five years. When combined with the \$1.1 billion savings from last year, competitive sourcing has saved more than \$2.5 billion. This equates to about \$552 million in annualized gross savings. One-time, out-of-pocket expenses for conducting competitions were \$74 million. This represents a return of \$20 for every dollar spent on competition.

What’s more impressive is the greater potential for savings. Competitions resulted in savings of \$22,000 per position studied—nearly double the estimated net savings from FY2003—yielding more than 27 percent in savings. Given the number of commercial positions in the federal government, competitive sourcing can potentially generate in excess of *\$5 billion in annual savings and/or cost avoidance*.

**Table 1: Competitive Sourcing Results in FY 2003 and 2004**

	FY 2003	FY 2004
<b>Total competitions completed</b>	<b>662</b>	<b>217</b>
Streamlined	570	116
Standard	92	101
<b>Total FTEs competed</b>	<b>17,595</b>	<b>12,573</b>
Streamlined	5,474	1,201
Standard	12,121	11,372
% of competitions where agency determined best result provided in-house (based on FTE studied)	89%	91%
<b>Results from completed assessments</b>		
Gross savings (over 3-5 years)	\$1.2 B	\$1.5 B
Net savings (over 3-5 years)	\$1.1 B	\$1.4 B
Annualized gross savings	\$237 M	\$285 M
Annualized net savings per FTE	\$12,000	\$22,000

**Examples of Improvements Due to Competitions Completed or Announced in FY 2004**

Management Objective	Cost-Saving Changes and Other Improvements Facilitated by Competition	Estimated Savings
FAA (DOT): Modernize Automated Flight Service Stations	Consolidation of stations from 58 to 20. Modernization of facilities and technologies.	\$1.7 billion over 10 years
IRS (Treasury): Reengineer support operations	Consolidation of distribution centers from 3 to 1. Leveraging of technology. Reduction of labor costs.	\$ 207 million over 5 years
Forest Service (USDA): Improve IT support	Consolidation of operations from 150 locations to 10 server farms. Reduction of labor costs.	\$147 million over 5 years
Navy (DoD): Make facilities management more cost-effective	Leveraging of technology. Restructuring of workflow to adopt customary commercial practices.	\$73 million over 5+ years
SSA: Make IT support more efficient	Consolidation and streamlining of help desk and administrative support activities. Redeployment of labor to understaffed IT-related positions.	\$36 million over 5 years
Education: Achieve better payment processing	Consolidation of accounts payable operations. Leveraging of technology. Reduction of labor dedicated to payment processing. Customer-focused performance standards.	\$34 million over 5 years
Energy: Make the delivery of financial services support more efficient	Consolidation of financial services operations from 15 to 2. Restructuring of job mix. Leveraging of telecommunications technology.	\$31 million over 5 years
Public Buildings Service (GSA): Obtain less costly custodial services	Reliance on a more cost-effective mix of federal and contractor support (identified through a series of regionalized competitions).	\$14 million over 5 years

<b>Examples of Improvements Due to Competitions Completed or Announced in FY 2004</b>		
<b>Management Objective</b>	<b>Cost-Saving Changes and Other Improvements Facilitated by Competition</b>	<b>Estimated Savings</b>
FBI (DOJ): Reduce the cost of vehicle maintenance	New performance standards. Consolidation of operations. Reduction of labor costs. More efficient use of resources.	\$11.5 million over 5 years
OPM: Reengineer test administration services	Leveraging of technology to automate test scheduling and materials ordering. Reduction of labor costs. Restructured customer-focused processes.	\$10 million over 5 years
Bureau of Land Mgmt (DOI): Improve maintenance operations	Restructuring of management. More effective use of resources (sharing of road and maintenance crews between districts). Use of temporary and term positions to maintain a flexible workforce.	\$9 million over 5 years
Coast Guard (DHS): Make public works support for the Academy more effective and efficient.	Streamlined work order process and reporting. Fewer FTEs dedicated to administration. Clear, customer-focused performance standards.	\$ 6 million over 5 years

The report also identified steps that the OMB was taking to better incorporate competitive sourcing with strategic human capital management. Steps include strategic human capital management, for example, identifying and creating appropriate crosswalks between the human capital and competitive sourcing standards for success. In addition, the OMB will work with the Office of Personnel Management's (OPM) Human Capital Officers and other human resources officials to identify practices for leveraging the shared interests of the human capital and competitive sourcing initiatives.

Reason originally outlined the need for such linkages in a 2003 study *Getting the Right People for the Right Job: Solving Human Capital Challenges With Competitive Sourcing* ([rppi.org/ps312.pdf](http://rppi.org/ps312.pdf)).

## **New Attempts from Congress to Stall**

Despite the growing success of competitive sourcing, a number of legislative barriers continue to limit its application. Barriers in FY 2005 agency appropriations include:

- Restricting the type of health benefits plans private companies can provide, placing small businesses at a competitive disadvantage against in-house Department of Defense teams;
- Restricting resources available to conduct competitions at the Forest Service and Department of Interior, despite savings of over \$178 million to these agencies as a result of competitive sourcing;
- Limiting the Department of Homeland Security's ability to use competition; and
- Blocking the USDA from applying competitive pressures to its rural development and farm loan programs.

Similar attacks on competitive sourcing are anticipated over the coming years.



## Opening Up More Jobs to Competition

The Bush administration is considering a plan to open inherently governmental jobs to competition—with other federal employees. Inherently governmental jobs—such as security officers, law enforcement officers and acquisition officers—have never been subject to competition before, and doing so will bring more efficiency and cost savings to those positions.

“The goal is to drive performance in inherently government functions the same way as public-private competitions drive performance in commercial functions,” said David Safavian, administrator of federal procurement policy at the Office of Management and Budget.

In addition, a May 23<sup>rd</sup> memo from Safavian directed agencies to reconsider commercial federal jobs they had determined were off-limits to competition because they are considered critical to the agency’s mission. He said, “a function should be considered core to an agency’s operation only if—and only to the extent that—loss of in-house performance of the function would result in substantial risk to the agency’s ability to accomplish its unique mission.” So-called “Reason Code A” commercial functions (the OMB designation exempting them from competition) have been scrutinized for years. Some agencies like the Bonneville Power Administration have shielded thousands of commercial jobs from competition under Reason Code A. This marks the first time that OMB has publicly and seriously scrutinized the widespread practice.

However, the OMB also is considering new rules that would shield some functions from competition altogether. “High-performing organizations” (HPOs) could exempt themselves from competition if they demonstrate efficient service delivery. The difficulty will lie in establishing the rules determining what qualifies as an HPO to validate bypassing the numerous benefits of competition that go beyond simple efficiency.

## Feds May Include Strategic Sourcing on PMA

The Office of Federal Procurement Policy (OFPP) has added “strategic sourcing” to the President’s Management Agenda. Strategic sourcing is a technique aimed at improving purchasing power and saving money. It involves keeping track of how purchases are made, identifying how they could be made in a better way, and then negotiating contracts to fit those goals. Agencies must start analyzing their buying habits and using the data to cut better deals with vendors by October 1<sup>st</sup> of this year.

A widely accepted practice in the private sector, strategic sourcing has rapidly infiltrated government in the last couple of years. Several states, including California, Illinois, Ohio, Florida, and Texas have fully implemented programs and saved millions of dollars. Perhaps the biggest success story is Pennsylvania, where over \$140 million has been saved to date.

As Safavian said, “private sector experience tells us that when companies conduct spend analyses and use strategic sourcing, they cut commodity costs by as much as 30 percent.” The potential that strategic sourcing holds can be seen in a couple of examples.



The Agriculture Department saved \$2.5 million off a \$28 million office supply budget simply by asking, and the Internal Revenue Service estimates that it saves \$4 million annually on photocopiers alone. The Postal Service (the model of efficiency) saved over \$600,000 on rubber bands—and has saved nearly \$15 million on office products in general.

David Cooper, a director of acquisition and sourcing management at the Government Accountability Office suggests that, “the potential [for savings] is in the billions and billions of dollars.” Still the federal government is years behind both the private sector and the states.

## **Shared Services Concept Expands**

Following successful implementation at the General Services Administration and the Departments of Defense, Agriculture, Interior and Health and Human Services, NASA created a shared services center.

The ten-year, \$230 million contract with Computer Sciences Corporation will centralize administrative and transactional duties at one location—these functions currently take place throughout each NASA center and its headquarters. The activities include human resources, procurement, financial management, and information technology operations. NASA expects to save between 20 and 30 percent with the deal in addition to allowing NASA to focus on science and engineering rather than administrative tasks.

## **Reason’s Call for Land Asset Inventory Heard**

In December Reason co-produced a policy brief with TSAugust, called *What’s in the Government’s Attic*, on the need for an inventory of federal government land assets to determine what they actually hold. And more importantly what lands and assets are excess, unneeded, or underutilized and could be divested.

On March 17<sup>th</sup> Rep. Chris Cannon (R-UT) introduced the Federal Land Asset Inventory Reform Act ("FLAIR," H.R. 1370), which would direct the Secretary of the Interior to develop a multipurpose inventory of federal real property to assist with federal land management, resource conservation, and development of federal real property. Included in the inventory is the identification of any such property that is no longer required to be owned by the federal government, i.e., surplus and unneeded federal lands.

Similar efforts are taking place in state governments, for example: Florida, Maryland, California, and Virginia.

## **President Bush Expands Real Property Management Effort**

In February, President Bush signed Executive Order 13327 requiring agencies to inventory and track real property assets. At the end of FY2003, the federal government owned about \$1 trillion in buildings and equipment, \$200 billion in inventory, \$550 billion in land, and \$650 billion in mineral rights. Among other things it called for the creation of a senior manager position responsible for the development of asset-management plans. The plans include the identification and cataloguing of all real property owned, leased or otherwise managed by the federal government.



This development can be linked to the August 2003 Government Accountability Office report that the General Service Administration, the Veterans Affairs Department and the Postal Service controlled 927 vacant or underutilized properties. In addition, it found that the federal government continued to waste money maintaining these properties—for example, that the VA spent \$348,000 in fiscal 2001 to maintain a building in Milwaukee that had been vacant for 14 years. What’s worse is that the Department of Energy has 1,200 excess facilities and that the Pentagon spends up to \$4 billion each year maintaining its excess facilities.

## Other Federal Opportunities

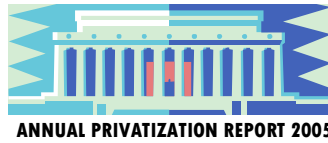
The federal government operates numerous business enterprises that could be converted into publicly traded corporations, including the USPS, Amtrak, and a number of electricity utilities. Other countries have in-depth experience in privatizing such services that Congress can use when it moves ahead with reforms.

*Postal Services*—A 2003 report by the President’s Commission on the U.S. Postal Service and other studies have concluded that the USPS outlook is bleak because of declining mail volume and rising costs. Moving forward calls for privatizing USPS and repealing the first-class mail monopoly that it currently holds. New Zealand and Germany have implemented reforms that Congress should examine. Since 1998, New Zealand’s postal market has been open to private competition, with the result that postage rates have fallen and labor productivity at New Zealand Post has risen markedly. Germany’s Deutsche Post was privatized in 2000, with the result that the company has improved productivity and expanded into new lines of business.

*Electricity Utilities*—Publicly traded corporations have always dominated the U.S. electricity industry. The exceptions are the federal government’s Tennessee Valley Authority and four Power Marketing Administrations, which sell power in 33 states. These government power companies have become an anachronism as utility privatization has proceeded around the world from Britain to Brazil and Argentina to Australia. TVA and PMA privatization would reduce the federal deficit, eliminate the utilities’ artificially low power rates that encourage excess consumption, and increase efficiency in utility operations and capital investment. President Clinton proposed to sell off the four PMAs in his FY1996 budget. It is time to dust off those plans and move ahead with reforms.

*Loan Programs*—The federal government runs a large array of loan and loan guarantee programs for farmers, students, small businesses, utilities, shipbuilders, weapons purchasers, exporters, fishermen, and other groups. The Federal Credit Supplement in the federal budget lists 59 different loan programs and 70 loan guarantee programs. Loan guarantees are promises to private creditors that the government will cover borrower defaults. At the end of 2003, there was \$249 billion in outstanding federal loans and \$1.2 trillion in loan guarantees.

In the 1970s, federal loans and loan guarantees grew rapidly as politicians discovered that they could pay off special interests with loan programs, while not paying any political cost for supporting higher spending directly. Like other federal programs, loan programs that make no economic sense can survive by creating an “iron triangle” of interests that resist reform. Loan program supporters include loan beneficiaries, financial institutions, federal loan administrators, and congressional committees that authorize loan programs.



In the 1980s, the Reagan administration tried to cut federal loan programs, but did not have much success. Policymakers should revive Reagan's initiatives and begin terminating or privatizing federal loan programs. The provision of credit is a centuries-old market institution that does not need government help, especially given the sophistication and liquidity of financial markets today.

Some federal loan programs target borrowers who could have received private financing. In such cases, there is no need for government loans because they simply displace private loans. Other loan programs target borrowers who cannot secure private financing. In this case, federal loans support borrowers who are poor credit risks, and taxpayer money is likely to be wasted when loans are defaulted on. For example, Farm Service Agency loans are aimed at farmers who are unable to obtain private credit at market interest rates. But such farmers are probably bad credit risks with poor business prospects. Indeed, FSA loans have high default rates.

The FY2005 federal budget says that government loan programs are needed because private markets suffer from "imperfections," such as lack of perfect information about borrowers. For example, banks might be more hesitant to lend to start-up businesses because they do not have lengthy credit histories. But rather than an imperfection, it is appropriate that start-up firms face more scrutiny and pay higher interest rates because of their higher risk of failure. Since failure creates economic waste, thus it is good that creditors are more hesitant to lend to riskier businesses. Government loan subsidies result in too many loans going to excessively risky and low-value projects.

Free market allocation of credit is far from perfect, but markets have developed mechanisms to fund risky endeavors. For example, venture capital and angel investment (people who invest in a business venture, providing capital for start-up or expansion looking for higher rates of return) pump tens of billions of dollars of investment into new businesses every year. There is no need for the government to compete with such private financial mechanisms.

Government distortions are a bigger problem than market "imperfections." For example, federal loan guarantees make financial institutions over-eager to lend to those with shaky credit because the government will cover losses in case of default. Also, federal loan programs are generally poorly managed. For example, federal student loans have been on the GAO's high-risk list for waste, fraud, and abuse every year since 1990. Lax enforcement of student loan repayments has led to large losses from defaults, costing taxpayers billions of dollars.

# State Privatization Update

## Florida



Florida continues to be a hotbed of activity. Opponents of competition and privatization have launched an all-out attack against competitive sourcing. Over the years, not every initiative has gone perfectly—with 138 since 1999 there are bound to be a few bumps along the way. Recently, some high-profile projects have been criticized for disappointing results.

The target of most of the criticism is the state’s massive human resources outsourcing to Convergys. Under the contract, Convergys administers almost all of its routine personnel functions, including payroll, insurance benefits, employee training and recruiting.

Initially, the contract was touted to save \$173 million over seven years has fallen to “only” \$103 million. Included in that is an \$80 million cost avoidance in capital spending to replace an aging computer system.

Implementation has not been perfect. The full rollout was at least a year behind schedule, diminishing some of the savings. In addition, total functionality and user satisfaction remain lower than originally anticipated. However, after working out some initial kinks, service in all contract areas is to standard and beyond “acceptable.”

Despite the negative press, the state has pressed forward with new initiatives. In March the state finalized a major contract turning over all foster care and adoption programs in Miami-Dade and Monroe Counties to private administrators in likely the largest child welfare privatization project in the nation. In a prepared statement, Florida Department of Children & Families Secretary Lucy Hadi said, “This agreement brings to reality the prospect of improved outcomes and services for children in Miami-Dade and Monroe Counties. The entire state will now benefit from qualified experts that are equipped to know and meet the needs of their communities.”

The 14-month \$75 million contract makes Florida the first state in the nation to fully privatize its child welfare programs. DCF hopes that the move will dramatically improve a foster care system often described as one of the worst in the United States. Miami's child welfare system has, through the years, spawned heartbreaking scandals, including the disappearance—police now say murder—of Rilya Wilson from the home of a department-approved caregiver and the alleged killing last year of Angel Hope Herrera by her mother, herself a former foster child.

Furthermore, a study co-produced by Reason and the James Madison Institute finds that Florida has a long bi-partisan tradition of competitive sourcing stretching the past three administrations and party lines. The study also found that recent efforts to modernize the competitive sourcing process have led to the creation of the most robust, transparent, and accountable process in the nation. Given the tremendous wave of initiatives over the years, there was much to learn about what has worked and what has not. The review of Florida’s competitive sourcing experience identified challenges and lessons not unique to Florida





that needed improvement—all of which were addressed in the Center for Efficient Government’s GATE Process. Some of the more prominent challenges (and the inherent lessons) include:

- A general lack of understanding or purpose. Either through a failure of communication, lack of transparency, or dissemination of misinformation, employees and the public often fail to understand why initiatives are put in place.

*Lesson: Communicate and document processes to help employees, other stakeholders, and the legislature understand and appreciate the process.*

- A failure to define goals and/or desired results upfront. Without clearly defined goals it is difficult to communicate and conduct comparisons to identify the bid that provides the best value.

*Lesson: Before a competition initiative begins, document goals and desired results.*

- A lack of transparency for stakeholders. Too often stakeholders have been left in the dark regarding competition initiatives. Their input has not been sought, the lines of communication have been unclear, and they’ve lacked access to relevant public records.

*Lesson: Seek stakeholder input, establish clear, standard lines of communication, and make public documents readily available.*

- A lack of trained or specially skilled workforce to manage contracts. Procurement staff members are often inadequately trained and/or inexperienced in conducting competition initiatives.

*Lesson: Develop a core group of procurement officials who assist other agencies in developing their procurement and competition documents.*

- A weak mechanism for setting acceptable performance metrics and measuring the success of an initiative. Similar to the problem of failing to define goals, some initiatives failed to use performance-based contracting or adequately develop monitoring and evaluation mechanisms.

*Lesson: Think about how to monitor the service contract before issuing the request for proposals or signing the contract. The monitoring plan defines precisely what a government must do to guarantee that the contractor’s performance complies with the contract. The better the performance standards, the easier it will be to monitor the contract effectively.*

- A lack of consistency and a centralized enterprise-wide approach to competition. Over the years, several different standards and processes have been used in identifying competition initiatives and carrying out the competitions themselves, preventing agencies from sharing best practices, or applying lessons learned. Finally, a lack of a comprehensive approach limited the possibility of enterprise-wide solutions.

*Lesson: Establish a coordinated, standard process to guide future competition initiatives and identify deficiencies in existing contracts. In addition, create a central point of accountability and responsibility for overseeing initiatives to manage the process and build up a critical mass of knowledge to identify best practices and adopt lessons learned.*



- A lack of focus on changing antiquated business processes. Competition provides a unique opportunity to reevaluate and redefine how services are provided. Contracts should focus on results, not the process.

*Lesson: Make flexibility and innovations central to competition initiatives and don't constrain ingenuity by basing initiatives on current agency practices. In addition, technology has enormous power and potential to change the way governments operate and change antiquated business practices. Its power should be harnessed.*

The study focused on the Center for Efficient Government (CFEG), created by Executive Order last year by Governor Bush (discussed in 2004 APR). In the current legislative session, Senate Bill 1146 was passed to codify that order into statute. Governor Bush vetoed the bill because it would create "an overly cumbersome process." In his veto letter, Bush noted that under the provisions of the bill, procurements could be substantially delayed waiting for legislative approval, resulting in ineffective and inefficient operations. Furthermore, Bush felt the bill would have created an additional bureaucracy that would have complicated rather than simplified and strengthened the procurement process. Since the center was not created in statute, it does not have authority to enact rules. In addition, under the current organization CFEG's reach does not extend beyond those agencies whose heads are appointed by the governor; it does not affect the entire executive branch. But this statutory authority signals the state's commitment to continuing to find opportunities for competition and privatization.

Yet, a couple of sections of the legislation are especially troubling. For starters, it requires agencies to receive specific authorization from the legislature before entering into any contract. Second, it gives the state's Chief Financial Office broad oversight authority to review state agency contracts—an extra level of transparency and accountability is good, however, the CFO in Florida is an elected official.

The Reason/James Madison study noted that competitive sourcing is purely a management decision and should not become part of the political process and/or debate. Both examples above open the door to the politicization of competitive sourcing decisions. Elected officials, while keeping the best interests of the state in mind, inherently are political. Their job is different from that of managers—and their efforts often include an agenda or a conflict of interest. This is a road Florida should want to avoid. In this case, the extra layer of administration would have politicized the process.

## Georgia



The General Assembly passed legislation and a resolution in the 2005 session that would encourage additional privatization. Senate Bill 270, signed into law on May 2<sup>nd</sup>, refines the state's 2-year-old law governing public-private road-building partnerships like the proposed expansion of state route 316. More importantly, however, was the study committee created to explore ways for the Georgia Department of Transportation to privatize highway maintenance functions. In addition, the Senate passed Resolution 503 "urging the Department of Transportation to proceed with the initiation in 2005 of a pilot performance based asset maintenance project for highway maintenance." A study committee will evaluate whether or not the Department of Natural Resources can contract out the construction and environmental permitting process. However, not every privatization measure fared so well. SB 5, which would have expanded the public-private road building law to include all types of infrastructure projects, failed to pass.

## Indiana



Former U.S. Office of Management and Budget (OMB) director Mitch Daniels was elected and sworn in as governor. One of his first executive orders was the creation of a state OMB. One of their first tasks included a top-to-bottom review of competition and privatization opportunities. In addition, OMB is reviewing the state's procurement procedures and asset portfolio to find cost-saving opportunities.

Chuck Schalliol was appointed as director and commented that Gov. Mitch Daniels wants to introduce "zero-based budgeting" for the next spending plan. That means instead of building off the previous budget and making adjustments, every agency would start with a clean slate. Schalliol says baseline budgeting sometimes leaves line items withering on the vine, since they've been cut too much in past budgets to accomplish their goals. He says that means the money they are receiving is wasted.

While zero-based budgeting is at least a year away, numerous other projects have been initiated. In his second day in office the governor signed an executive order ending collective bargaining rights for state employees. In addition, he cancelled existing agreements with unions already representing state employees.

Daniels noted that collective bargaining agreements would make it more difficult to make changes in state government, suggesting that the changes his administration wants to make "would have been delayed...for months and months." Many of the settlements included restrictive work rules including the times employees could work. New child welfare chief James Payne noted that work rules in his agency meant that most caseworkers could only work from 8:00 am to 5:00 pm; even though "we know from research, that most of the abuse doesn't happen between 8:00 am to 5:00 pm and that's when the workers work." The change will also make it easier to fire some state employees who fail to perform.

Another of Daniels' early moves was to privatize the Commerce Department. The Indiana Economic Development Corp., a public-private body, was established when Daniels signed HB1003. Daniels said the new corporation will be a "much more nimble and effective enterprise" than the now-defunct Indiana Department of Commerce, which was hampered by some state rules and regulations the new corporation will not have to follow.

Similar to his tenure at the federal OMB, Daniels has instituted a competitive sourcing initiative. Several projects are already underway with many more to come in the near future. For example, the dietary department at Logansport State Hospital was forced to compete. The employees were given an equal opportunity to participate. Indeed, simply by thinking outside the box, with a focus on the bottom line, state employees found many cost-savings ideas; three rather elementary changes will save \$40,000 annually. In the end, the employee team was able to identify enough savings to win the bid and save about \$1 million a year.

Food service at the Department of Corrections was also put out to bid. The state was able to cut meal costs from \$1.41 to only 99 cents by contracting with Aramark to operate the food service—a savings of nearly \$12 million a year. Both of these examples demonstrate the importance and value of using competition to save taxpayer dollars.

The Department of Corrections has also issued an RFP for operating the New Castle Correctional Facility. The facility is currently underused and a funding shortage has prevented full use. The corrections commissioner hopes that the RFP will bring significant interest from the private sector and that a partnership could lead to full utilization of the facility.

Daniels and his team are also considering leasing the 157-mile Indiana Toll Road. The road runs east-west across north Indiana. It is a westward extension of the Ohio Turnpike and leads into the Chicago Skyway (which was recently leased by the city of Chicago netting \$1.8 billion).

## Kentucky



State leaders were considering convening a panel to review the possibility of privatizing state functions in Kentucky. The panel would have conducted a review of other states' experiences with privatization and a calculation of potential cost savings to Kentucky. Unfortunately, funding for the review was stripped during budget negotiations—leaving the likelihood of privatization in Kentucky in doubt.

The idea for the panel was largely due to debate about privatizing the state's new \$92 million prison, the Little Sandy Correctional Complex. However, in mid-March Governor Fletcher pulled the plug on the idea, announcing that the state would operate the facility. He further added that he “absolutely has no plans for going back” to study the privatization of the prison again.

Officials in the Fletcher administration have already taken steps to privatize functions such as prison food service and are considering turning certain jobs in state parks over to contractors. However, one must wonder about the political feasibility and political will given recent developments.

## Pennsylvania

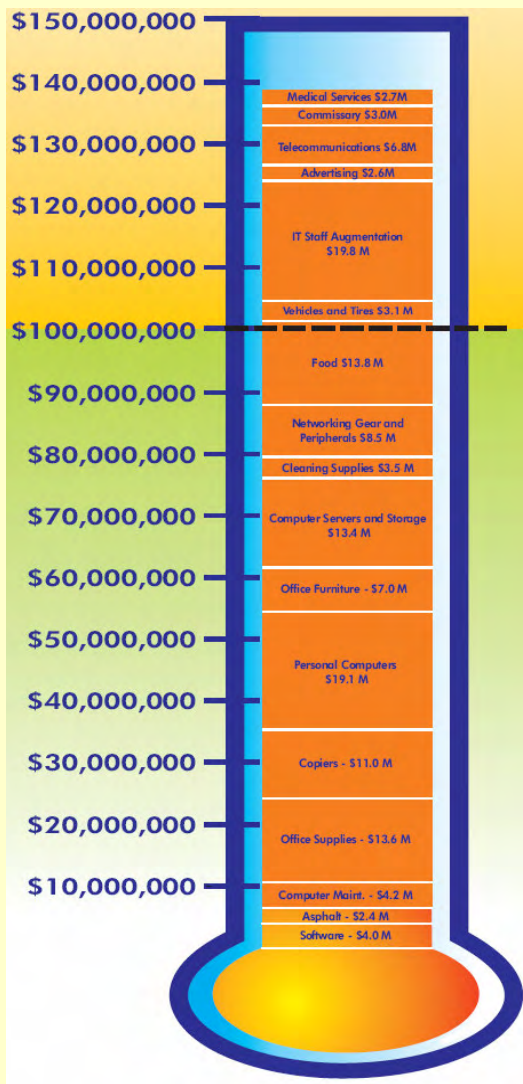


The Rendell administration continued its stellar record with strategic sourcing in 2004 and early 2005. The announcement of a new contract for medical services (bringing the total of strategic sourcing contracts to 20) will bring annual savings to Pennsylvania taxpayers upwards of \$140 million (see graphic for list of savings). The commonwealth has become a leader in strategic sourcing among states.

Temporary medical staffing at commonwealth healthcare facilities statewide will fall under the new contract with Pennhurst Medical Group; it should save \$2.7 million annually. In addition, the administration recently awarded a contract for commissary services for the state's 26 correctional institutions. Previous to the award, each of the facilities separately purchased goods and supplies. Using the volume of the entire prison system, Keefe Supply Group was able to generate \$3 million in annual savings.

The state also expanded its use of best-value contracting, making it standard practice for all construction contracts worth \$5 million or more. Under the arrangement, price will consist of 60 percent of the weight with technical qualifications consisting of about 30 percent. The final criteria could be any number of

**Figure 1 – Pennsylvania's Savings**



factors including timeliness of delivery, minority participation, or quality guarantees. Best-value contracting has been an emerging trend for a number of years and gives governments a great deal of flexibility to achieve multiple goals and needs beyond simple, low-cost contracts.

## South Carolina

Under Gov. Mark Sanford's leadership, the governor's office offered a new approach to budgeting. It's a process that focuses on outcomes and achieving state priorities and goals. Fifteen hundred different activities were divided into purchasing priorities regardless of the agency performing them. By focusing on the programs that delivered the greatest results, and purchasing those, the administration was able to shave \$160 million from the budget (based on a total annual budget of \$16.9 billion) resulting in the suspension or elimination of about 67 activities (or 4.4 percent of the total number of activities) currently performed by government.

Essentially, available dollars are spread across the goal and priorities areas (i.e., what the state wants to purchase or achieve). Spending was allocated from the top of the priority list working down until they "ran out of money." Using this approach, some activities and programs will not be funded or fall below the "spending line." In other words, they do not provide as good a public investment relative to other programs. Some will disagree with this method of prioritizing spending. However, we believe that it is the most responsible way to spend taxpayers' dollars.

Unfortunately for Sanford, the legislature doesn't see eye to eye with his administration's effort. In fact, the legislature passed a budget that swelled with pet projects or "pork," leading one state senator to describe the budget as having more pork than a bar-b-que. With his emphasis remaining on fiscal restraint, Sanford issued 163 budget vetoes of \$96 million. While the method starkly contrasted the previous year's budget veto process, the outcome was the same. All but 10 of the governor's vetoes were overridden in a very slow, methodical process (compared to the previous year where 105 of 106 vetoes were overridden in only 99 minutes).

In addition to the budget, the legislature took up other measures to limit the governor's authority and ability to use alternatives to current service delivery—primarily competitive sourcing and privatization. One of the veto overrides severely limits the administrative flexibility and management options of the state Parks, Recreation, and Tourism (PRT) department. A budget proviso requires the agency to seek approval from the legislature and budget control board before moving forward with a competitive sourcing initiative.



The proviso was introduced in reaction to an RFP issued by PRT to explore the feasibility of contracting-out the operation of a golf course at Cheraw State Park.

In his veto message, Governor Sanford argued that this reaction to one proposal “would tie the hands of the agency from pursuing any kind of competitive sourcing arrangement for any activity, no matter how minor, at any of its parks.”

Prior to this proviso, PRT had contracted-out the campsite and cabin reservation system state-wide. The new system was developed by ReserveAmerica, which also provides reservation services for the National Forest Service and the U.S. Army Corps of Engineers. The reaction from most of the park’s customers has been positive as the contractor has improved services, lowered costs, and led to higher revenue for the state.

Last year, APR reported that a task force had been formed to study the feasibility of privatizing the state’s school bus fleet. South Carolina is the only state in the union that owns and operates the entire school bus fleet (two individual districts have privatized their fleet). After months of study and careful review the school bus privatization task force determined that privatization was feasible in South Carolina school districts. The recommendation requires the legislature to support it; only one house has passed the initiative at press time.

## Virginia



For the second straight year the Virginia General Assembly was a leader in the privatization movement. Under the leadership of Delegate Chris Saxman, the Cost Cutting Caucus offered several bills aimed at making Virginia’s government less obstructive, more transparent, efficient and effective. Working with Reason, Saxman and the caucus saw passage of several key bills while forcing the debate on a few unsuccessful initiatives.

Two victories are more significant than the other small concessions. First, HB 1948, the Administrative Process Act, requires the state to periodically review regulations and eliminate overly burdensome and costly regulations to minimize the economic impact on small businesses. Both the National Federation of Independent Businesses and U.S. Small Business Administration have advocated for similar legislation around the country.

Second, HB 1945 expands the definition of a qualifying project under the existing Public-Private Education Facilities and Infrastructure Act to include any undeveloped or unused (“surplus”) state-owned land, thereby allowing for expanded asset divestiture or public-private development projects throughout the state.

Additional legislation made changes to the state’s gainshairing program and ‘fast tracked’ initiatives under the state’s Public Private Transportation Act.



## Tax and Spending Limitations

There's a slightly funny-sounding new word increasingly at the center of state budgetary politics: "TABOR," which is an acronym for Taxpayer's Bill of Rights. For both supporters of expanded government and proponents of limited government, TABOR has become a lightning rod in the fight over public policy.



The TABOR story starts in Colorado. After having been defeated twice, TABOR was once again on the ballot in 1992. Recognizing the potency of TABOR, pro-government forces left no stone unturned in their scare campaign. Leading the opposition was Gov. Roy Romer, who said that stopping TABOR was the “moral equivalent of defeating the Nazis at the Battle of the Bulge.” Lead TABOR proponent Douglas Bruce was vilified and labeled by Romer as “a terrorist who would lob a hand grenade into a schoolyard full of children.” Despite this demagoguery, TABOR was approved by voters. As a footnote to this bitter campaign, Romer was later appointed Chairman of the DNC by Bill Clinton at about the time the Democratic Party was making a push to civilize political discourse.

Colorado's TABOR contains the most comprehensive fiscal limits in the nation, including requirements for voter approval before higher state or local taxes or debts may be enacted, a ban on local income taxes and state property taxes, a flat-rate income tax, emergency reserves and comprehensive state and local spending limits tied to inflation increases and population growth. Any surplus revenues must be returned to taxpayers.

The greatest fear of opponents is that TABOR would do exactly what it promised: create some reasonable restraints on the growth of government. TABOR has indeed done this. Dr. Michael New, an academic who has studied state tax limits, summarizes, “Colorado's Taxpayer Bill of Rights has quietly become America's most effective limitation on government. It has kept spending in check, provided tax relief to Colorado residents, and deserves a great deal of credit for Colorado's strong fiscal position.”<sup>1</sup>

The most repeated substantive claim of TABOR opponents has been about economics. Supposedly, TABOR was going to destroy Colorado's economy. Romer and others claimed that TABOR would lead to the posting of signs on Colorado's borders that “Colorado is closed for business.” Here, the results have been exactly opposite of these claims:

- TABOR has enabled Colorado to lead the nation in cutting taxes. From 1997-2001, TABOR returned \$3.25 billion to taxpayers (about \$3,200 for a family of four).<sup>2</sup>
- Colorado has not passed a single tax increase at the state level since enacting TABOR.
- Between 1995 and 2000, Colorado was first in the nation in growth of gross state product, and second in personal income growth.

There have been non-economic benefits too. Accountability is one. Dee Hodges of the Maryland Taxpayers Association offers this summary of the fiscal benefits of Colorado's TABOR: “TABOR works because it forces state and local governments to live within a budget, to set public priorities, to make wiser choices, and to find ways to meet state goals—not by spending more—but by spending smarter.”<sup>3</sup>



Citizen involvement is another. As the new Democratic Speaker of the Colorado House of Representatives Andrew Romanoff has bluntly stated, “Voter approval of tax increases is extremely popular, and politically untouchable.”<sup>4</sup> Opponents rarely criticize this aspect of TABOR, instead focusing on how it limits the growth of government.

And ultimately, TABOR has proven popular with voters (if not special interests seeking more government funding). A recent survey showed that over 70 percent of Coloradans back TABOR—that’s greater support than when it was enacted 13 years ago.<sup>5</sup>

## Reaction in Colorado

TABOR’s strong impact on Colorado fiscal policy (and economy) has earned it admirers and detractors. The former camp has sought to spread the TABOR concept across America. The latter group has sought not just to stop TABOR elsewhere but to gut it in Colorado.

In Colorado, because TABOR is now forcing some tough budgetary choices, Gov. Bill Owens (formerly a TABOR champion) has teamed with the Democrat-controlled legislature to put Referendum C on this fall’s ballot. The measure would suspend TABOR for five years. The effects would be two-fold: first, it would mean Coloradoans would have \$3.1 billion less than they otherwise would have. And second, it probably would mean the end of TABOR. If TABOR gets waived for five years, the political class would certainly seek sometime during that time period to finish it off entirely. The aforementioned popularity of TABOR makes a head-on repeal effort impossible. So opponents are trying to slay Colorado’s TABOR in a way that they can claim they are “reforming” and “preserving” it.

Not unexpectedly, public employee unions and others who benefit from government largesse are funding a multi-million dollar campaign in support of Referendum C. As Jon Caldara of the Independence Institute has observed, “The tax-and-spending lobby wants to have a victory against TABOR so they can run around the country and scare other states about the ‘Colorado Experience.’”<sup>6</sup>

Supporters of Referendum C include others who, like Owens, probably used to count themselves among supporters of limited government. One such person is Bruce Benson, a Republican “Super Ranger” (big dollar fundraiser), who will be spearheading the drive for Referendum C. Despite his advocacy of this \$3.1 billion tax hike, Benson nonetheless professes, “I like smaller government and lean government.”<sup>7</sup> The added \$3.1 billion for government coffers led House Republican leader Joe Stengel to observe that Referendum C will be “a five-year spending spree.”<sup>8</sup>

## Reaction Elsewhere

Colorado’s limitation may be the best in the nation, but many other states have limitation provisions of some sort. Twenty-six states have enacted some variant of a Tax and Expenditure Limitation (TEL).<sup>9</sup> More than a dozen states incorporate voter approval or legislative “supermajority” mechanisms in their tax policies. And roughly two dozen states limit all or part of their budget increases to economic measurements such as inflation or personal income growth.



In 2005, a large number of states have begun the process of taking a look at the benefits of enacting the full array of protections embodied in TABOR. Efforts for enacting a Taxpayer’s Bill of Rights have begun across the nation. Table 2 provides a listing of states where proposals either have been introduced or will likely soon be introduced.

<b>Table 2: 2005 TABOR Proposals: States Where TABOR Proposals Have Been Introduced or are Expected to be Introduced</b>		
<ul style="list-style-type: none"> <li>▪ Alaska</li> <li>▪ Arizona</li> <li>▪ California</li> <li>▪ Florida</li> <li>▪ Idaho</li> <li>▪ Illinois</li> <li>▪ Indiana</li> <li>▪ Kansas</li> <li>▪ Maine</li> </ul>	<ul style="list-style-type: none"> <li>▪ Maryland</li> <li>▪ Minnesota</li> <li>▪ Mississippi</li> <li>▪ Missouri</li> <li>▪ New Hampshire</li> <li>▪ New Mexico</li> <li>▪ North Carolina</li> <li>▪ Ohio</li> </ul>	<ul style="list-style-type: none"> <li>▪ Oklahoma</li> <li>▪ Oregon</li> <li>▪ South Carolina</li> <li>▪ Tennessee</li> <li>▪ Texas</li> <li>▪ Vermont</li> <li>▪ Virginia</li> <li>▪ Wisconsin</li> </ul>

Sources: National Taxpayers Union, American Legislative Exchange Council, Dr. Barry Poulson, and Reason Foundation.

A typical TABOR bill is that of Maryland Delegate Herb McMillan. McMillan’s measure (HB 1206) would require voter approval of any state or local tax increase. Under the bill, state and local spending could not rise by more than the growth of inflation and population (adjusted for approved revenue changes). The measure would create a rainy day fund and also stipulate that if general fund revenues exceed projected revenues by at least 2 percent, the total amount of the excess (minus administrative costs) must be returned to taxpayers.

There are several key themes driving the move for TABOR around the country:

- **Citizen Involvement.** Voters like the idea that they should be asked before government takes more of their money. In a poll of Virginia residents last year, the National Taxpayers Union found strong support (76 percent to 19 percent) for the idea that citizens should be given “the right to vote directly on most tax increase proposals by the Virginia State Legislature.”<sup>10</sup>
- **Tax Relief for Families.** Under the leadership of State Representative Frank Lasee, the idea of TABOR is moving forward in Wisconsin. Central to Lasee’s argument for a Wisconsin TABOR has been the increasing tax burdens on families at all income levels in Wisconsin. By one estimate, if a TABOR had been in place in Wisconsin from 1990-2001, Wisconsin families would have saved a total of \$10,241 per household.<sup>11</sup>
- **Economic Growth.** Again, the TABOR era has been part of a great economic success story in Colorado. Making the case for enacting a TABOR in Kansas, Dr. Barry Poulson argues, “The contrast between Colorado and Kansas in that time is striking: while the two states experienced similar economic trends in the 1970s and 1980s, there was a major divergence in the 90s, when income per capita increased 70 percent in Colorado, while it only increased 53 percent in Kansas.”<sup>12</sup>



TABOR has even gone to Washington, D.C. The Heritage Foundation, the Tax Foundation, and other groups are now actively promoting the idea of a federal version of TABOR to rein in Washington's excesses.<sup>13</sup> The federal government is in need of spending restraint as much as any state government. The President's Office of Management and Budget is projecting that total FY 2005 outlays will be a stunning 33 percent higher than outlays in FY 2001.<sup>14</sup> The biggest obstacle facing this effort is the inability of voters to act directly to affect federal policy. Research by the National Taxpayers Union Foundation has shown that citizen-driven tax and spending limits are far more effective than those emerging from the legislative process.<sup>15</sup>

## Prospects

The battle in Colorado this fall will be herculean. While opponents recognize that well-heeled supporters of Referendum C will handily outspend them, each side will bring substantial resources to the fight. At stake is whether Colorado citizens can put a limit on the size and scope of government. And ultimately, what happens in Colorado this November could have far-reaching consequences in state capitals around the nation.

By: John Berthoud, President, National Taxpayers Union (<http://www.ntu.org/main/>).

## Dispelling the Myths of TABOR

TABOR has not only slowed the growth of taxes and spending in Colorado, but it has succeeded in softening the blow of the last recession. While other states were struggling with massive amounts of red ink during 2002, TABOR allowed Colorado to manage the recent downturn with comparatively mild deficits and no tax increases. Lawmakers in other states should learn from Colorado's success with TABOR, and not believe everything they hear about its perceived failures.

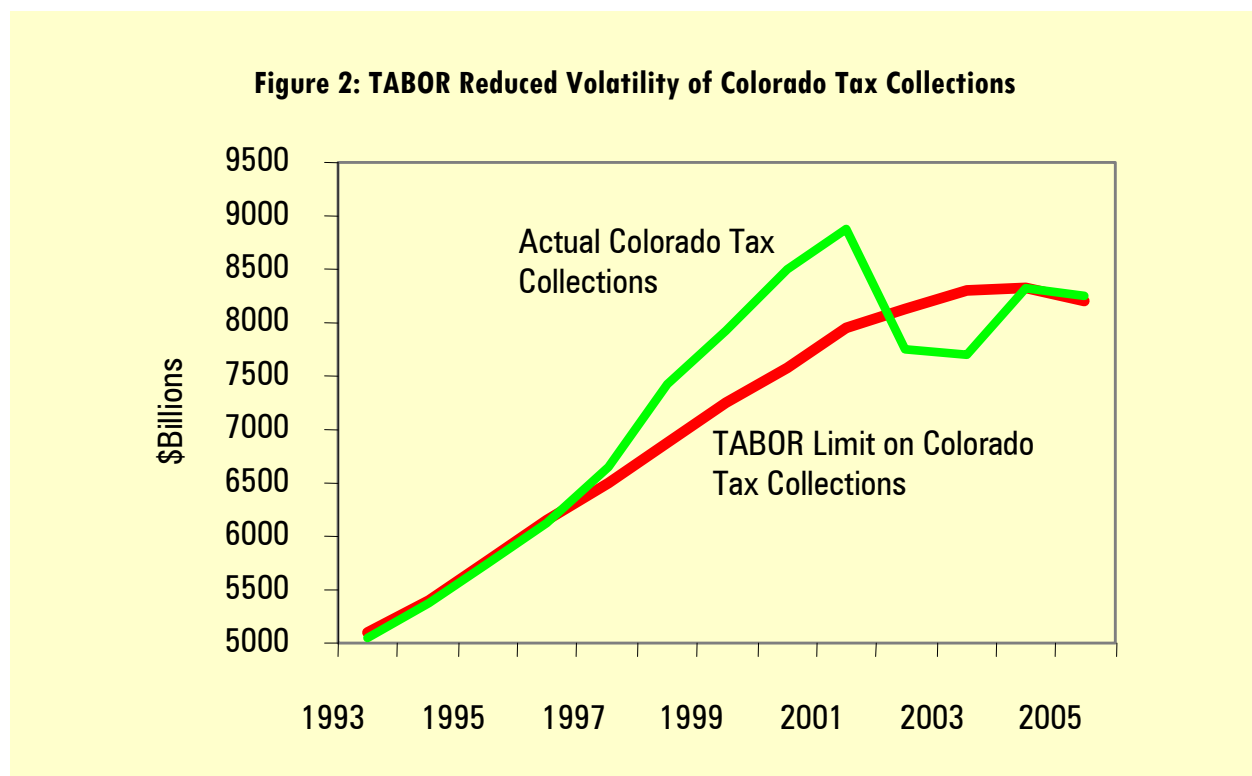
### TABOR Reduced Colorado's Revenue Deficit During the Recession

A popular criticism of TABOR is that it magnified the effect of the recession on the Colorado budget, forcing more than \$1 billion in cuts.<sup>16</sup> In actuality, TABOR reduced the impact of the recession on Colorado's budget by requiring lawmakers to refund, and not spend, over \$3.1 billion in taxpayers' money during the economic boom of the 1990s. Ironically, Governor Owens and others now want to ask the voters to give up over \$3 billion in surpluses in the next five years, which would wipe out the benefit of the tax cuts enacted in the late 1990s.

TABOR allows Colorado revenues to grow at the same rate as population plus inflation, requiring excess revenues to be returned to the taxpayers. When revenue growth dips below the allowed rate, the budget must "ratchet-down" its spending to the level of revenues, unless tax increases are approved. The ratchet-down is not unique to Colorado or TABOR. In fact, a ratchet-down happens in every state where revenues decline, since all states except Vermont are constitutionally restricted from spending in excess of revenues.

What makes Colorado different then? TABOR requires voter approval of tax increases so that lawmakers find it harder to raise taxes in Colorado than in other states. Colorado voters have, on occasion, approved tax increases under TABOR, particularly at the local level.

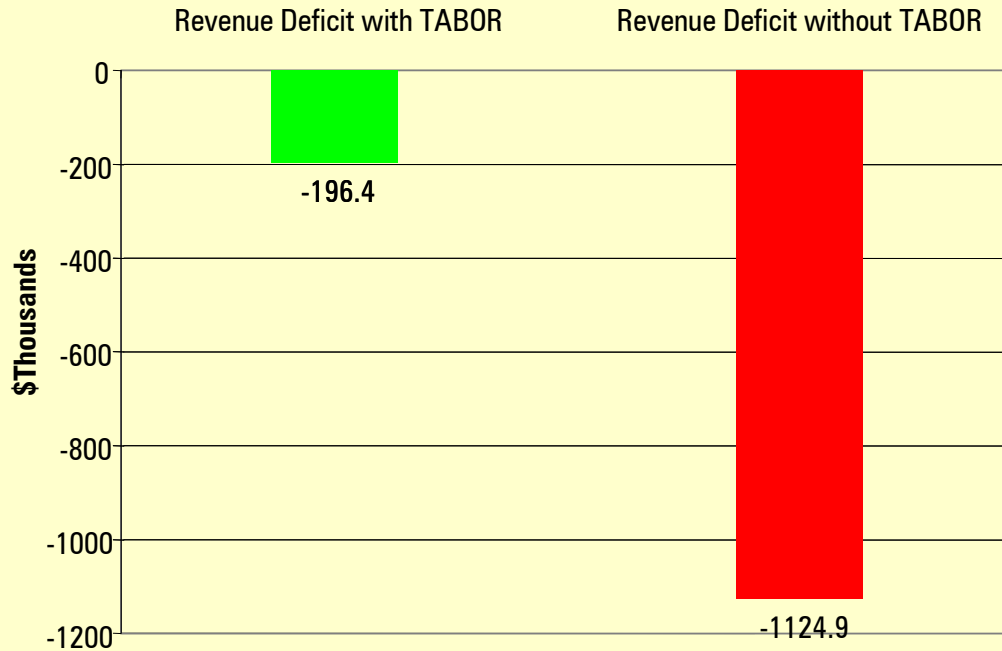
But an even more important distinction of Colorado's state finances was the impact of TABOR during the years of the boom and bubble from 1997 through 2001 (see Figure 2). Many states had large surpluses that they spent expanding government programs at an unsustainable rate. Meanwhile, TABOR forced Colorado to return surplus revenues to the taxpayers. Thus the 2002 revenue decline caused worse deficit problems in other states than it caused in Colorado where TABOR had moderated the growth of government spending. Had Colorado spent its surplus revenues from 1997 to 2001, its 2002 and 2003 deficits would have been much worse.



In 2001, Colorado received \$8.9 billion in revenues, but had to return over \$1 billion because TABOR only allowed the state to keep and spend \$7.9 billion.<sup>17</sup> Thus, when revenues dropped to \$7.8 billion in 2002, the state's revenue deficit was actually \$196.4 million (the difference between actual revenues in 2002 and the TABOR limit in FY 2001) instead of \$1.124 billion (the difference between actual revenues in 2002 and 2001) (see Figure 3). This is an 83 percent decline in the state's revenue deficit for FY 2002.

States without tax and spending limits would have spent almost the entire \$8.9 billion the previous year, making the revenue decline much more painful by forcing the state to cut spending even more. TABOR saved Colorado from a more severe revenue shortfall and smoothed Colorado's spending over the business cycle. States like California that do not have a strong TABOR limitation were much more severely impacted by their steep revenue decline.

**Figure 3: TABOR Reduced Colorado's FY 2002 Revenue Deficit by 83%**



The alternative to TABOR's ratchet-down is what happened in many other states: the ratchet-up. States that raise taxes during a recession to cover revenue shortfalls will generate even larger revenues during the ensuing recovery. The state will usually keep and spend this new money, then have to raise taxes again to cover a new shortfall during the next recession. Thus, taxes are continually ratcheted up over the long-term business cycle. TABOR is a check on this fiscal spiral, requiring lawmakers to return surpluses in the good years and limiting the ability of lawmakers to raise taxes during the bad years. TABOR maintains the status quo for taxpayers, unless they give their explicit approval of faster tax and spending growth.

The charge that the Taxpayer Bill of Rights magnified the effect of the budget crisis also overlooks the role that mandated spending increases played in worsening Colorado's deficit. Amendment 23, passed by voters in 2000, requires the state to increase education spending by the rate of population growth plus 1 percent every year from 2001-2011—regardless of whether the state's revenues increase or decrease. It carves out a special source of funds for education—7.2 percent of personal income tax revenues—and places those funds in a special education trust.<sup>18</sup> Amendment 23 puts a major squeeze on other parts of Colorado's budget, like higher education, which are funded from the part of the budget still subject to the limits of the Taxpayer Bill of Rights.

Even if we grant the claim that the Taxpayer Bill of Rights depressed revenue at an inopportune moment—the remarkable revenue drop in 2002—TABOR allows state lawmakers to spend above and beyond its limits if the voters approve. All lawmakers have to do is ask permission to raise taxes.



Amendment 23, by contrast, contains no such provision. Short of a constitutional amendment, education spending must rise even during a period of recession and revenue decline.

Another popular criticism of TABOR is that the large tax refunds in the boom years kept the state from putting money into a rainy day fund or making other investments that could have eased the crisis when it arrived.<sup>19</sup> This is simply false.

Colorado already has several reserve funds at its disposal, including a statutory reserve equal to 4 percent of appropriations, to be used in case of revenue shortfalls (though the money has to be replaced in the future).<sup>20</sup> Lawmakers spent a large portion of this reserve on capital construction, an unsustainable course during a revenue shortfall.<sup>21</sup> The Taxpayer Bill of Rights also requires the state to set aside an emergency reserve fund, to be used in case of natural disasters. Finally, the Taxpayer Bill of Rights allows Colorado lawmakers to ask the voters to keep surplus revenues to use in a rainy day fund.

This fall, Governor Owens and other like-minded lawmakers in Colorado will ask the voters to allow them to keep TABOR surpluses over the next five years in order to spend “sufficient” amounts of money on public services. TABOR allows this sort of referendum, but they could just as easily ask the voters to allow them to set aside the money in reserve, to use in case of a future shortfall. This could have been done in the 1990s as well, but apparently lawmakers then (including Governor Owens) were content to allow the voters to keep surplus tax collections.

## Conclusion

Lawmakers who want to exercise good fiscal stewardship should seriously consider adopting TABOR in their states. Of course, TABOR does slow the growth in government spending, but that’s exactly the point. It imposes much more strict spending discipline on lawmakers and requires them to prioritize government programs and eliminate those programs that do not work effectively. In this way, TABOR is more than a limit on government growth; it’s also a tool for more effective management and oversight of government spending. Those criticizing TABOR are criticizing it because it works exactly the way it’s supposed to. How many other laws can we say that about?

*By Chris Atkins, Staff Attorney, Tax Foundation (<http://www.taxfoundation.org/>)*

## Americans for Prosperity Grades Nation’s Tax and Expenditure Limits

In 1973, Ronald Reagan launched the tax and expenditure limit movement by supporting Proposition 1, the nation’s first tax limit proposal. While Proposition 1 failed, it ignited a national tax limit movement that, over the last three decades, has seen 28 states enact various forms of tax and expenditure limits (TELS). These TELS have had varied success in their actual ability to limit the growth of state taxes and spending.

In a new report for Americans for Prosperity Foundation, Dr. Barry Poulson of Colorado University graded the effectiveness of each state’s TELS. Poulson evaluated each TEL based on five different criteria. Colorado’s Taxpayer’s Bill of Rights amendment scored the highest of the nation’s TELS—scoring 24 out of 25—earning an A-. The median grade was a D-. Not surprisingly, the great majority of the states fared poorly, with 36 states earning D’s and F’s.



“This study highlights the need for states to enact real tax and expenditure limits that actually constrain the growth of state government spending,” Dr. Poulson explained. “Fortunately, we have seen renewed interest in the national tax and expenditure limit movement. This year, more than a dozen states will be considering well-designed TELs, and states such as Ohio and Maine are expected to have a TEL measure on the ballot in 2005 or 2006.”

The study, “A Fiscal Discipline Report Card: Grading the States’ Tax and Expenditure Limits,” is available on the Americans for Prosperity Foundation Website at [www.AmericansForProsperity.org](http://www.AmericansForProsperity.org).

<b>Table 3: State Tax and Expenditure Limits: Ranking and Report Card 2005</b>		
<b>State</b>	<b>Total</b>	<b>Grade</b>
Colorado	24	A-
Florida	21	B
Missouri	21	B
Louisiana	20	B-
Michigan	20	B-
Washington	20	B-
California	18	C+
Hawaii	18	C+
Oregon	17	C
Oklahoma	16	C
Alaska	15	C-
Connecticut	15	C-
South Carolina	15	C-
Massachusetts	14	C-
Montana	13	D+
Nevada	13	D+
New Jersey	13	D+
North Carolina	12	D+
Delaware	11	D
Tennessee	11	D
Rhode Island	10	D
Texas	10	D
Utah	10	D
Arizona	9	D-
Idaho	9	D-
Mississippi	9	D-
Iowa	8	D-
Kentucky	8	D-
South Dakota	8	D-
Arkansas	7	D-
Alabama	0	F
Georgia	0	F

**Table 3: State Tax and Expenditure Limits: Ranking and Report Card 2005**

State	Total	Grade
Illinois	0	F
Indiana	0	F
Kansas	0	F
Maine	0	F
Maryland	0	F
Minnesota	0	F
Nebraska	0	F
New Hampshire	0	F
New Mexico	0	F
New York	0	F
North Dakota	0	F
Ohio	0	F
Pennsylvania	0	F
Vermont	0	F
Virginia	0	F
West Virginia	0	F
Wisconsin	0	F
Wyoming	0	F

# Emerging Issues

## Social Security Reform

Social Security, the largest government program in the world, is finally getting the attention it deserves. The inherent contradictions that would eventually leave the program bankrupt have been known about for years, but have for so long been swept under the rug by politicians too afraid to touch the so-called “third rail” of politics. Those days are over as the president and many members of Congress continue to shine the spotlight on Social Security, exposing the danger and problems of requiring Americans to rely on a pyramid scheme for their retirement. Personal retirement accounts would fundamentally change the system from one that is unfunded to one that is pre-funded—a change akin to that taking place across corporate America as companies change from defined benefit programs they cannot fund to defined contribution programs that workers fund as they work.



To understand what is wrong with Social Security, we have to first understand exactly how Social Security is structured—because the problem with Social Security is its very structure, not simply a temporary future shortfall of money that can be permanently solved with more tax dollars.

Social Security is a pay-as-you-go system, which means that the Social Security taxes collected today immediately go out to pay benefits to those who are currently retired. The money is not set aside anywhere with anyone’s name on it.

In fact, the Supreme Court decided in 1960, in a case called *Fleming v. Nestor*, that we have no legal right to our Social Security dollars. The court decided that “To engraft upon the Social Security system a concept of 'accrued property rights' would deprive it of the flexibility ... it demands.” This is Washington-speak for, if we owned it, the government would have a hard time taking it away.

So today’s workers have to hope that the next generation of workers will continue to pay increasing amounts of taxes to support their retirement, and so on and so on.

This worked fine when there were a lot of workers supporting each retiree. In 1950, for example, there were 16 workers supporting each retired person. Today there are about three workers supporting each retiree, and soon there will be just two workers per retiree.

To put this in dollar terms, in 1950, for one retiree to receive \$1,000 a month, each worker had to contribute just \$62.50 a month. Today, the three workers supporting each retiree each have to contribute \$333 a month for that retiree to receive \$1,000. And when there are just two workers per retiree, each worker will have to pay \$500 in Social Security taxes per month for one retiree to receive \$1,000.





This is why there is a crisis and something needs to be done. Those opposed to reform have wasted a lot of time arguing that there is no crisis. They insist, instead, that it's just a really big problem. Even if we accept that it is a problem and not a crisis, the fact remains that there are fewer and fewer workers contributing to the system and more and more people receiving benefits.

And the longer we put off doing something about it, the worse it is going to get. With every dollar a person pays in Social Security taxes, that is one more dollar the government is going to have to collect in the future to pay him when he retires.

On the other hand, for every dollar a person is allowed to put into a personal retirement account, that is one less dollar the government is going to owe him when he retires, so one less dollar they'll have to take from the next generation.

In fact, if in 1983, the last time they made major changes to Social Security, they had allowed workers to put about 6 percent of their income into personal accounts, Social Security would have reached permanent solvency 4 years from now. Instead, it is going to start running permanent deficits in just 13 years. So there's clearly a problem with Social Security as we know it.

President Bush isn't the first to notice this. President Clinton, in the mid-90s, acknowledged Social Security's inherent flaws. Some may recall that the rallying cry of the Democrats at the time, in response to proposed tax cuts, was "Save Social Security First." Many of the same people today are saying there is no problem, no "saving" needed. President Clinton accepted there was a problem and said there are three ways to deal with it:

1. Raise taxes
2. Cut benefits
3. Get higher rates of return through market investment

He was right. Raising taxes would temporarily solve the problem. But this has already been done 20 times. When Roosevelt began the system in 1935, the Social Security tax was 2 percent on your first \$3,000 dollars—that's a maximum Social Security tax of just \$60 a year. After 20 tax increases to "fix" the problem it is now 12.4 percent on your first \$90,000—a maximum of \$11,160 a year, or a \$11,100 tax increase.

There are plenty calling for fixing the current problem by raising taxes one more time. This would fix the problem—until it won't and taxes need to be raised one more time.

The problem could also be dealt with by cutting benefits. Some readers may remember when the government supposedly fixed the Social Security problem in the early 80s. One of the solutions was to start taxing Social Security checks—that is a benefit cut, more for the government, less for us. They also decided to raise the retirement age—that is also a benefit cut. If you are going to live to 85 and they raise the retirement age from 65 to 67, that is 24 months of checks they are taking away that had already promised. That is less for you and more for the government.



And these are the two options guys like Senate Minority Leader Harry Reid and the AARP are talking about when they say they system just needs to be “tweaked” or “a few moderate changes” will solve the problem. Sure, raising the Social Security tax from 12.4 percent to say 14 percent may be a moderate change that would help for now—but it is not a moderate change when it has already been done 20 times and increased the tax from \$60 to \$11,160. And it will not be a moderate change when they have to keep raising the tax until it eventually hits 20 percent of our income—which the Social Security Administration says is the amount that will have to be taken in the foreseeable future to simply pay already promised benefits.

That brings us to option three, personal retirement accounts, which is what President Bush is proposing. This is a proposal to begin pre-funding retirement by allowing us to keep some of the Social Security tax dollars we are already paying in an account we own and control.

Personal Retirement Accounts would allow every American the chance to build a nest egg for retirement, and have ownership in our society. It would break down the old division between labor and capital by making every worker an owner. The workers, as Karl Marx had hoped, would own the means of production.

We keep hearing about the president’s “plan” but all we really have are some general principles he has said he’d like to follow. A few bills have been introduced on Capitol Hill, but none is specifically being pushed by leadership at this time. Some are better than others, but all the good bills do have several things in common that will probably be part of any bill the president signs, as they are consistent with the principles he’s proposed.

One is that personal retirement accounts would be voluntary. Workers under 55—because those over 55 would see no change in the program—would simply be allowed to opt into the personal accounts. Every worker would have the choice of where he or she wanted his or her payroll taxes to go when they were taken out of each paycheck—either into a personal retirement account, probably administered by the Social Security Administration, or to be spent as they are now. Those not interested in personal accounts would be free to continue under the current system.

Because this money is coming from Social Security taxes already being paid, no one would need to come up with new money to fund his accounts. Most who can afford to do so already are, in the form of an IRA or a 401(k). This is particularly important for lower income workers who may not have extra money to fund an extra account, like the add-on accounts some out-of-touch politicians are proposing. Personal retirement accounts would give every worker in the country access to the same powerful savings vehicle of investing that those who can already afford it have. It would be the democratization of investing.

Another common feature is that the money would only be allowed to go into an approved, well-diversified fund of bonds and stocks. No one would be able to put all his money in Enron, for example, or on red at the roulette wheel in Vegas, as Harry Reid, the Democrat leader of the Senate suggested. Of course, he represents Las Vegas, so maybe he was hoping we would. Age-appropriate guidelines would be provided—for example, older workers would be advised to protect themselves by having more money in bonds as they neared retirement. And there would most likely be an “automatic option” that would automatically shift a worker’s funds into the mix most age-appropriate.



And, of course, these accounts would be owned by each worker so they could be passed on when the owner passed away. This cannot be done under the current system where when a worker dies at 65, for example, after paying into the system for 45 years, he basically gets nothing for his 45 years of being an honest, hard-working, taxpaying citizen.

These conservative, diversified funds would be similar to the ones available in the Thrift Savings Plan (TSP)—the retirement savings option available to every single federal employee in the United States from our postman to our congressman. TSP offers federal workers the choice of five funds from which to choose. TSP.gov has information on how these accounts have performed over the years. According to that site, the five funds have returned 5.45, 5.75, 7.72, 11.84 and 11.99 percent over the past 10 years. Social Security will most likely offer returns between negative 1 and 1 percent for many of those who will retire in the years after Social Security begins to run a deficit.

The government gets to keep the workers' contributions—which, of course, is why so few in the government are interested in changing the system. Not only would they lose out on this money, but they would also lose control over our retirements, which we would be put in control of if we were allowed to own our Social Security tax dollars.

Personal retirement accounts that we own and control would mean the end of the days when every senior has to go hat-in-hand to the government for his Social Security check. The government, instead, would have to come to us—and I think we'd all turn the tables and tell them we'd rather keep more for us and less for the government.

*By Max Pappas, Policy Director, FreedomWorks (<http://www.freedomworks.com/>)*

## Arctic National Wildlife Refuge

Every year for the last few years, Congress noisily debates whether to allow drilling for oil and gas in the Arctic National Wildlife Refuge (ANWR) in Alaska. This year is no different, with the House passing an Energy Policy Bill in April that includes a provision to open a portion of the Coastal Plain of ANWR, while in the Senate, an amendment to prohibit exploration was defeated by the narrowest of margins (51-49) in March. Sounds like we can expect this spirited debate to continue plodding along for some years to come, unless some of the lessons of private land management, and especially performance measurement, are incorporated into any political compromise.



Why is finding a resolution so difficult? For one, opposing sides frequently take absolutist views (not uncommon in politics). The pro-development side claims that opening up ANWR to development is necessary for jobs and energy security, among other things. Environmentalists and other opponents dispute the projected number of jobs and amounts of production, and believe that the arctic environment and its wildlife are too precious and fragile to risk any significant impact from oil and gas development.

To date this polarized debate has produced little more than rancor. For example, environmental groups like the National Audubon Society claim that oil and gas exploration in ANWR will endanger millions of birds and other wildlife. The American Petroleum Institute, on the other hand, believes that wildlife can be protected, and cites advances in technology that will reduce the impact of any drilling operations. They have a point. A U.S. Department of Energy study showed that if today's technology could have been applied to the Prudhoe Bay field on the North Slope of Alaska, "its footprint would be 64 percent smaller, the drilling impact area would be 74 percent smaller, roads would cover 58 percent less surface area, and operating facilities would take 50 percent less space." Nevertheless, the Sierra Club has a point too—that these new technologies "have been shown to be completely unreliable in safeguarding the arctic environment."

Political differences aside, there is no doubt that ANWR lies atop a rich oil field. Just how much oil and gas might be exploitable depends on uncertain geological measurements, fluctuating world oil prices, and the ever-changing state of technology. Current estimates peg oil reserves at between 6 and 16 billion barrels. According to the U.S. Geological Service (USGS), using current technology, if the price of oil fell to \$12 a barrel, there would likely be *no* economically recoverable oil in the coastal plain, while at a price of \$24 a barrel, about 9 billion barrels would be recoverable.

Of course, the most pertinent political question is not whether or not drilling will take place, but what will the environmental effects of drilling be? Economic results aside (they are uncertain and should be left for the market and the oil companies to sort out), the most important issue is how to realistically balance any exploration that does take place with an effort to minimize the environmental impacts of that exploration. But as long as ANWR remains a political game, absolutism will rule the day.

## Managing Outcomes

Economical viability is crucial for industry. Environmental groups prioritize environmental protection. Government is split and has advocates from all sides. And native groups are split also—the Gwich'in have been opposed to opening ANWR, while the Inupiat welcome development. What is left for the middle ground is a tradeoff; a way to ensure that economically viable development also minimizes environmental and cultural impacts. And that means measuring performance.

If drilling in ANWR must meet a set of environmental performance measures, then industry will have the certainty it needs to plan its operations, and environmental groups will have not only the assurance that a certain level of environmental protection will be met, but the leverage to hold industry and government to those standards.

Some possible performance measures include:

- Increases or decreases in specific species population numbers over time; likely species include porcupine caribou, musk ox, grizzly bears, wolves, and many species of birds
- Well-defined recovery targets for these species, such as minimum population size over a specific area
- Increases or decreases in other species that may be common or unthreatened, but which may be good indicators of overall ecological health
- Increases or decreases in acreage of specific wildlife habitat types
- Specific measures of water quality such as parts per million of nutrients such as phosphorus and nitrogen
- Specific measures of pollution releases
- Percentages of targeted habitat that meet specific criteria for ecological health

In addition, it would not be unrealistic to expect that some of the revenues from developing ANWR would go to conservation, much as they do on private land. This is the reason why some, such as the CATO Institute, have proposed turning over ANWR to a conservation group, which, faced with the possible revenues, would almost surely allow for some drilling in ANWR, but just as surely, would demand that any contractors meet a high standard of environmental performance.

## Private Land as a Model for Conservation Through Commerce

Despite the rhetoric in politics and in the media that there must be a choice between conservation and commerce, and despite what we so often read about loggers loathing owls and developers fighting every regulation in the book, conservation is happening out there. And it's going on amidst commercial activities, especially on private lands.

For every spotted owl controversy, there are thousands of cases where conservation and commerce happily get along, from ranchers protecting stream beds to the Louisiana Audubon Society, which operated oil and gas drills in one of their bird sanctuaries for over 50 years. On its own land, Louisiana Audubon understood the tradeoffs involved and the opportunity to turn oil and gas revenues into more conservation elsewhere.



And it trusted itself to ensure that its land was developed responsibly. It is also an especially interesting case because it mirrors the ANWR controversy.

## The Rainey Wildlife Refuge

Deep in the marshes of Louisiana, from the 1940s until drilling stopped in 1999, oil and wildlife mixed. The Paul J. Rainey Sanctuary's 26,000 acres of brackish and freshwater marshes are a rich feeding area for wintering waterfowl. In fact, it is such an important bird sanctuary that even the public was not allowed to visit, but because it owned the land, Audubon weighed the benefits of oil and gas development against the environmental hazards, and chose to go ahead.

In the early 1980s, gas wells in Rainey brought in close to a million dollars in revenues; money that could then be reinvested in protecting other sensitive areas. The wells at Rainey were in operation for decades, and the wildlife didn't seem to mind. The National Audubon Society now claims that canals built in the refuge caused permanent damage to their wetlands. That may very well be, but it was also in the latter half of the 1990s that the media started paying attention to the difference between the National Audubon's public stance on drilling and the Louisiana Audubon's private actions in Rainey. The difference, however, is perfectly understandable and logical. On public lands National Audubon understands perfectly that it doesn't have the power to ensure that drilling is environmentally responsible, nor does it have the ability to turn some of the revenues from that drilling into other conservation projects. So National Audubon vehemently opposes any exploration of ANWR.

## Oil and Gas Exploration on Other Public Lands

There is also significant oil and gas activity already taking place within the nation's system of federal wildlife refuges, but unfortunately there has been little or no measurement of the environmental performance of these activities. For example, a 2003 GAO report on oil and gas activity within the refuge system reported that approximately one-quarter (155 of 575) of all refuges either have or have had oil and gas activity. The GAO also found that "The Fish and Wildlife Service has not assessed the cumulative environmental effects of oil and gas activities on refuges" which range from negligible to substantial, and from temporary to long term. In fact, the GAO found that U.S. Fish and Wildlife didn't even know how many oil and gas wells were operating within its refuge system.

## Legislation

The House bill that passed in April—The Energy Policy Act of 2005 (HR6)—does contain some environmental safeguards, including to:

- "ensure the oil and gas exploration, development, and production activities on the Coastal Plain will result in no significant adverse effect on fish and wildlife, their habitat, and the environment."
- "require the application of the best commercially available technology for oil and gas exploration, development, and production on all new exploration, development, and production operations."
- "ensure that the maximum amount of surface acreage covered by production and support facilities, including airstrips and any areas covered by gravel berms or piers for support of pipelines, does not exceed 2,000 acres on the Coastal Plain."

And more specifically:

- “Seasonal limitations on exploration, development, and related activities, where necessary, to avoid significant adverse effects during periods of concentrated fish and wildlife breeding, denning, nesting, spawning, and migration.”
- “That exploration activities, except for surface geological studies, be limited to the period between approximately November 1 and May 1 each year and that exploration activities shall be supported, if necessary, by ice roads, winter trails with adequate snow cover, ice pads, ice airstrips, and air transport methods” unless the Secretary finds that there will be “no significant adverse effect on the fish and wildlife, their habitat, and the environment of the Coastal Plain.”

These are all important steps in the right direction, but it is worth noting that these measures are all negative. That is, they are all prohibitions on adverse effects, rather than positive measures such as population targets or habitat improvements that could come from the revenues generated, and which might do more to mollify opposition.

A better template for approaching environmental performance is a set of principles known as Enlibra, a made-up word that originated with an effort by the Western Governor’s Association to deal with the declining effectiveness of many federal environmental regulations, which means that stricter regulations often result in very little or even no improvement in environmental quality, while imposing much higher costs and regulatory burdens. Enlibra is an attempt to shift regulation to measuring results instead of inputs, and any efforts to impose performance measures on drilling in ANWR should follow that same principle.

## Conclusion

Until the ANWR debate moves forward and toward positive performance measurement, it is unlikely that Congress will produce much more than bickering—or even worse, Congress may push through provisions that do not contain effective environmental safeguards. Uncertainties over just how many barrels of oil will be recovered or what new technologies may allow will never be resolved. We do, however, have the management/performance tools and the guiding principles of Enlibra to work with to ensure that whatever development does take place is done so in an environmentally responsible manner.

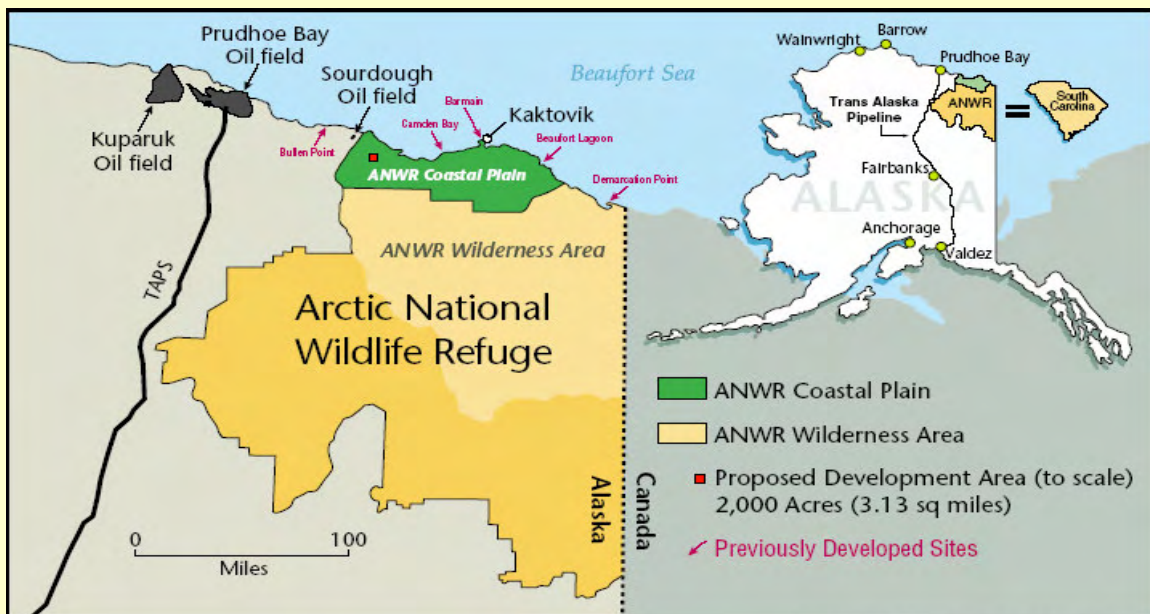
Environmentally responsible development is just the start, however. To really move things forward, all sides would benefit by making the correlation between commerce and conservation more explicit. Environmentalists often take the high road by claiming to have society’s interests at heart, and environmental protection is indeed a good thing. But wealth creation is good for society too, and the fact that the United States today is a wealthy society is the reason we can afford to expend so much concern over environmental issues. Following the models of many private landowners, whether individuals, corporations, or environmental non-profits, by using revenues to pay for measured environmental benefits—i.e. making the connection between commerce and conservation explicit—may be the only way to reach a effective compromise.

*For more information and links to other studies, see “Digging Our Way Out of the ANWR Morass” ([rppi.org/pb37.pdf](http://rppi.org/pb37.pdf))*



### Facts about ANWR

- The total acreage of ANWR is 19.8 million acres.
- The 1.5 million-acre coastal plain of ANWR, the 1002 Area, is the only area potentially open for development.
- Area 1002 of ANWR was set aside as a possible exploration area by Congress in 1980.
- Within the 1002 Area, the USGS estimated in 1998 that there are between 15.6 billion and 42.3 billion barrels of oil in place, with a mean of 27.8 billion barrels. Of this, between 5.7 and 16.0 billion barrels, with a mean of 10.4 billion barrels, are estimated to be technically recoverable with the technology of the mid-90s. This 5.7 to 16 billion barrel range, with a mean of 10.4, is the range cited by industry.



Source: Alaska Department of Natural Resources



## Offshore Outsourcing

Industries wishing to save money by subcontracting some of their work to foreign companies, a practice known as “offshore outsourcing,” are hitting more walls than ever. Even outsourcing to American companies in different states is hitting roadblocks. In recent years, state and federal legislators have proposed over 200 pieces of anti-outsourcing legislation. The National Foundation for American Policy notes that lawmakers have actually picked up the pace of anti-outsourcing bill-writing. Legislators have introduced more anti-outsourcing bills in the first three months of 2005 than they did in all of 2004.

Governors in Alaska, Massachusetts, Michigan, Minnesota, New Jersey, and North Carolina have issued executive orders designed to restrict outsourcing, and recently seven states passed laws designed to discourage the practice.<sup>22</sup>

Table 4: State-level Anti-Outsourcing Laws	
State	Effect of law
Alabama	Encourages state and local entities to use in-state services. Does not restrict or place mandates on procurement decisions.
Colorado	State agencies can contract for personal services performed outside the United States if it is clearly demonstrated that there will be no reduction in the quality of services and contracts contain confidentiality and right to privacy safeguards.
Indiana	Preferences between 1 and 5 percent for Indiana companies in the awarding of state contracts.
New Jersey	Prohibits state contracts to be performed by anyone other than U.S. citizens or those authorized to work in the United States.
North Carolina	Preference for in-state or U.S. products and services within bounds of federal law provided that there is no loss of price or quality.
Tennessee	Preference for U.S. contractors in state contracts for the provision of data entry and/or call center services.
Missouri	Preference to in-state providers for state contracts.

Source: National Foundation for American Policy, *Star Ledger*

Since January 2004, some 40 states had considered various anti-outsourcing bills. Nearly all would do one of the following:

- Ban foreign or out-of-state bidders from competing for state contracts.
- Give preferences to U.S. or in-state contractors competing for state projects.
- Impose restrictions on certain fields, such as call centers.

Several pieces of federal legislation would mirror state-level proposals by placing restrictions on government contracting, but federal legislation would have more impact on private-sector outsourcing. Certain bills would, for example:

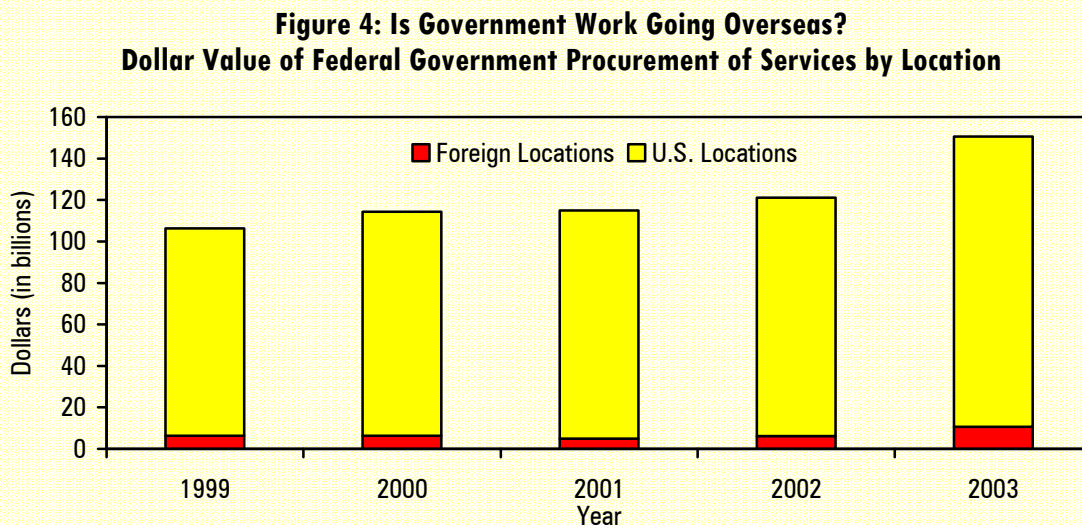
- Alter the tax code in an attempt to discourage outsourcing.
- Place restrictions on those seeking foreign visas.

## How Widespread is Government Offshoring?

Legislators' attention to government offshoring may seem especially curious since the practice is especially rare. Though growing, the amount of private-sector offshore outsourcing is still quite small. Government-sector offshore outsourcing is smaller still.

Although precise figures are hard to come by, offshore outsourcing by the federal government has increased in recent years, from \$6.4 billion worth of service contracting in 1999 to \$10.6 billion in 2003.<sup>23</sup> Yet offshore outsourcing has remained a small portion (about 6 percent) of total federal government outsourcing.

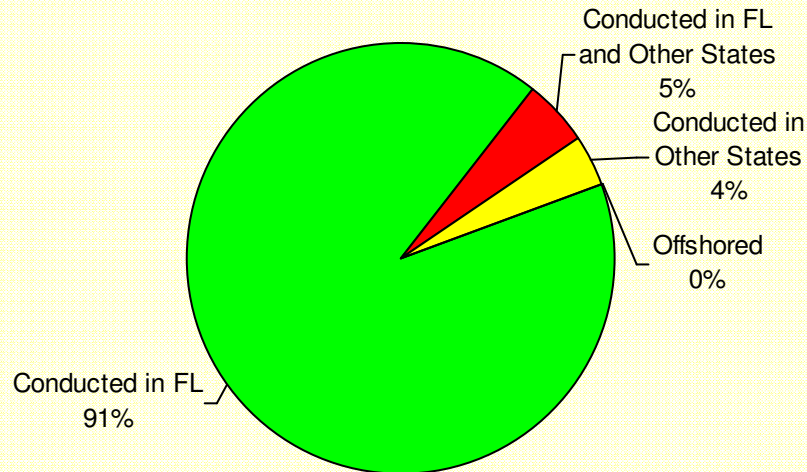
It is even more difficult to assign a dollar figure to the amount of offshore outsourcing done by state governments, largely because the practice is so uncommon. For example, an analysis by the California State Auditor concluded that the available evidence suggests "the state is spending little on services performed offshore."<sup>24</sup> An anti-outsourcing group recently documented roughly \$75 million worth of government work sent overseas by the 50 state legislatures.<sup>25</sup> Although the report was intended to stir fears about the rise of offshore outsourcing, it actually revealed how infrequently states make use of the practice. Seventy-five million dollars may seem like a huge amount of money, but state and local governments contract for over \$100 billion in services, so offshore outsourcing does not even amount to one-one hundredth of a percent of government outsourcing.



Source: United States Government Accountability Office, "International Trade: Current Government Data Provide Limited Insight into Offshoring of Services," GAO-04-932, September 2004.

And yet, much like the private-sector variety, the outcry over government outsourcing has been grossly disproportionate to its actual occurrence. Most of the anti-outsourcing bills under consideration take aim at the tiny amount of offshoring done by states, thus much effort is devoted to a very small part of actual operations.

**Figure 5: Where Florida Government Outsourced Services Are Conducted**



Source: The Center for Efficient Government

In some cases states have offshored services, only to bring them back after getting stung by bad publicity. Last year, North Carolina legislators voted to spend \$1.2 million to bring 34 child support call center jobs back from India. Perhaps the case that received the most attention was New Jersey’s decision to bring back a dozen call center jobs that had gone overseas, a move that cost taxpayers \$100,000 per job. Indiana’s cancellation of a \$15 million contract was probably even more costly.<sup>26</sup> The cancelled bid was \$8.1 million less than the next closest competitor, and by one estimate, state taxpayers paid \$162,000 for each of the roughly 50 jobs “saved.”<sup>27</sup>

## Should Government Provide Jobs or Services?

Can we give government two conflicting goals—providing services and providing jobs—and expect both to be done equally well? At some point one goal must be compromised to benefit the other. The more a government operates as a jobs program, the more leery it will grow toward efficiency improvements. And unlike a wasteful private company that hurts only itself by sinking into bankruptcy, a wasteful government just keeps sinking, dragging others down with it.

Instead of charging taxpayers \$162,000 for each job brought back from India, Indiana could have spent tens of thousands in severance pay and job training for each outsourced worker. The state could have used the savings for higher priority issues, returned the savings to taxpayers, or devised some combination of the two.

Citing the outrage the Defense Department provoked when it sought to purchase black berets from China, a Commerce Department official notes how the controversy surrounding offshore outsourcing can compromise a department’s core mission:



*Lawmakers were incensed that U.S. tax dollars in the Defense Department, of all places, were not being used to support American manufacturers, and the hats were procured from a domestic supplier. Yet unfortunately this question is a bit more complicated. Since even the Defense Department faces a ceiling on its budget, Defense planners are forced to make tough decisions every day. Every dollar spent on clothing is a dollar less for improving soldier's pay (to keep military families off food stamps), supporting forward deployments, designing new defense systems to better protect our men and women in harm's way, and improving the accuracy of our precision-guided munitions to minimize noncombatant casualties.<sup>28</sup>*

Kansas lawmakers were initially so outraged by a plan that would send food stamp call center jobs overseas, that they moved to ban it. Once they learned the ban would make providing the service 40 percent more costly, they discarded it. The governors of Maryland and Massachusetts vetoed anti-outsourcing bills passed by their legislatures in 2004, and Governor Schwarzenegger did the same in California when he shot down five such bills.<sup>29</sup> And yet the anti-outsourcing bills keep coming. Five more emerged in California, and nationwide well over 100 were written in just the first three months of 2005. Since most are still under consideration, we are now entering a crucial period, one that will likely determine the direction of American policy for many years to come.

# Improving Parks Funding and Services with User Fees



State and federal budget crunches are causing funding shortfalls in public parks across the nation. Facilities are deteriorating, maintenance backlogs are increasing, and budgets are shrinking as funds are shifted to more “vital” services. To raise revenues for parks while improving recreational services to visitors, governments should switch from general tax appropriations to a user-fee funding system.

## Greater Fairness

User fees are a more fair way of financing parks because they ensure that only those that use the parks and all the facilities they have to offer must pay to maintain them. By contrast, general tax appropriations tax everyone for benefits that may only be realized by a relatively small portion of taxpayers. At the federal level, for example, Californians subsidize parks in Connecticut and Virginians subsidize parks in Alaska.

## Greater Freedom of Choice

The shift from general tax revenue to a voluntary fee system provides park visitors more choice over where their hard-earned dollars are spent and what they get in return. Under a user fee system, people have the freedom to enjoy the recreational services offered by the parks, seek alternative forms of recreation, or simply decide to do without and find other uses for their money. This enables the park visitor to vote with his feet and also communicates market demand to the park manager.

## Better Incentives for Improving Park Management and Visitor Services

This brings us to another point: parks must be allowed to keep the user fees they collect so that these revenues may be reinvested in the park where they were collected, rather than shipped off to state capitols or Washington, D.C. where they may never be seen again. This allows park managers to more accurately assess visitor demand—to obtain better information on park visitors’ wants and needs—and adjust their spending accordingly. It also provides managers with greater ability and incentives to respond to those wants and needs.

To this end, Congress established the Recreational Fee Demonstration Program (Fee Demo) in 1996, which authorized the National Park Service, Forest Service, Bureau of Land Management, and Fish and Wildlife Service to experiment with user fees and stipulated that at least 80 percent of fees collected must be maintained by the park of origin. The pilot program has been extended several times, most recently in the omnibus appropriations measure for FY 2005, which added the Bureau of Reclamation to the Fee Demo program and continued the program for 10 more years.



A user fee system allows people more choice over where and how dollars are spent than tax appropriations and lets them “vote with their feet.” This allows the “market” for recreation to determine necessary services and projects, not arbitrary decisions by politicians and bureaucrats or politically driven pork-barrel (or, in this case, “*park-barrel*”) projects. A funding system driven by supply and park visitor demand, rather than political aspirations, would not be likely to support unnecessary or otherwise wasteful projects.

## Eliminating “Park-Barrel” Spending

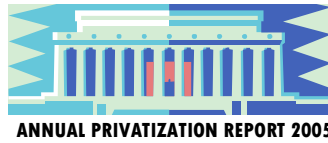
Under the current system, cost savings is one of an agency’s last considerations because any money appropriated to the agencies that goes unspent must be returned to the Treasury. Even worse, since unspent funds imply that an agency is overfunded, bureaucracies have an incentive to exaggerate or overestimate their costs in order to maintain an environment of fiscal crisis sufficient to justify ever-increasing budgets, and pork-barreling abounds. As Richard J. Ansson, Jr., noted in a 1998 article in the *Journal of Land Use & Environmental Law*, “Over the past thirty years, the appropriation of funding for pet congressional parks and construction projects has diminished the Park Service’s ability to adequately care for its parks.”<sup>30</sup> Examples of such “political entrepreneurship” include:

- A \$333,000 “state-of-the-art,” “environmentally-friendly” outhouse at the Delaware Gap National Recreation Area in Pennsylvania (“The two-toilet outhouse has a gabled roof made of Vermont slate, a cobblestone foundation built to withstand earthquakes, and porch railings made from quarried Indiana limestone.”);
- A \$1 million outhouse in Glacier Park;
- An \$8 million civic center in Seward, Alaska [population: approximately 4,000]; and
- Numerous new employee housing units in Yosemite at a cost of \$584,000 per unit.<sup>31</sup>

Self-sufficient national parks could realize significant cost savings as the federal level of the bureaucracy would diminish, allowing managers to devote more of their valuable time to actually managing parks, and costly “park-barrel” projects contrary to the interests of park users (and even conservationists) would not be forced upon park administrators. The Fee Demonstration Program may be a vast improvement over decades past, but until the national parks become completely self-sufficient, expenditure decisions and other management policies will continue to be based on the preferences of Congress and special interests, not the average park-going member of the public.

## Effects on the Poor

Some have voiced concerns that the cost of self-sufficient, user-fee-supported parks would prevent the poor from enjoying the nation’s natural resources. First of all, self-sufficient parks would be more efficient, and thus cheaper to run, than those supported by general tax appropriations. Self-sufficient parks have inherent service-maximization/cost-minimization incentives that tax-reliant parks do not, and the reduction in bureaucracy necessary to administer funds would keep costs even lower. In addition, self-sufficient parks would not be forced to embark upon legislators’ pet projects (such as “state-of-the-art” outhouses) that currently swell the maintenance backlog and often take precedence over needed visitor services and facilities improvements. Moreover, critics often ignore that it is the travel costs—simply getting to and from state or national parks—that are cost prohibitive, not the user fees themselves.



All of this notwithstanding, the poor could be accommodated by offering “fee-free” days, free passes for those who volunteer at park sites, or a certain number of free or reduced-price “first-come, first-served” passes that would allow people to compete for the passes based on their time (i.e., queuing up in line) rather than their disposable income.

## Effects on the Environment

Other critics have claimed that outsourcing or increased reliance on user fees will lead to the destruction of natural resources and the “Disneyfication” of the nation’s parks. Yet, most people visit parks because they want to enjoy nature and get away from urban development for a time. Thus, self-sufficient parks have no incentive to overdevelop. In fact, they have the best incentives to balance preservation and recreation.

In addition, overdevelopment concerns are often overblown. Consider the following:

- Less than 5 percent of the nation’s land is developed, and three-quarters of the nation’s population lives on 3.5 percent of its land area.<sup>32</sup>
- Over three-quarters of the states have more than 90 percent of their land in rural uses, including forests, cropland, pasture, wildlife reserves, and parks.<sup>33</sup>
- Acreage in protected wildlife areas and rural parks exceeds urbanized areas by 50 percent.<sup>34</sup>
- 99 percent of the people visiting Yellowstone stay within the developed areas, which comprise less than 2 percent of the park.<sup>35</sup>

Moreover, a more market-oriented pricing system would actually help to *prevent* the depletion of natural resources by eliminating underpricing. Pricing park services below market prices (i.e., below those determined by supply and demand) encourages overuse of facilities and resources. If everyone is allowed to use the parks essentially without having to bear the cost of their use, then no one has an incentive to care for or preserve the park’s facilities and natural resources. This is known by economists as the “tragedy-of-the-commons” problem.

Some parks, particularly very popular parks such as Yellowstone, will tend to be more commercialized and cater to people who demand many services and accoutrements. Others will appeal to those seeking the “rugged outdoors” and will show no signs of commercialization.

Put simply, there is no single ideal, “one-size-fits-all” park mold, despite the efforts of a top-down bureaucracy to make it so. Such variety offers park visitors many choices and people will be able to vote their preferences with their feet—and their dollars.

## Double Taxation

One very valid concern, given the current financing structure of the National Park System, is that the use of both taxes and user fees constitutes double taxation. “Why should I have to pay user fees,” one might rightly argue, “if I am already paying taxes to fund the parks?” Why, indeed? As one senate staffer argued,



one of the biggest constituent complaints regarding the Fee Demonstration Program is that “[t]here has been no decline in congressional appropriations as a result of Fee Demo.”<sup>36</sup>

While the double taxation argument is often espoused by those opposed to user fees, the argument is best suited to advocates for the elimination of tax funding. Congress should thus eliminate the practice of double taxation by eliminating tax appropriations for national parks and forcing the parks to rely solely on user fees (or other private sources of funds).

## Case Studies

### New Hampshire

In 1991, New Hampshire passed a law requiring all of the state’s parks to be self-sustaining. By using a variety of pricing strategies, cutting costs, and entering into corporate sponsorships to obtain additional funding for educational programs, the state’s park system quickly was able to generate enough revenue to cover its entire operating budget of nearly \$5 million—and even pay for some capital investment. After 14 years of self-sufficiency, New Hampshire’s parks are still in solid financial shape.

### Vermont

State parks have similarly been self-sustaining in Vermont since 1993. As recently as 13 years prior, nearly 40 percent of the park system’s operating budget came from general funds—a dramatic change. The parks sustained themselves through increased fees, downsizing, and marketing efforts. In addition, concessions from state-owned ski areas now provide nearly half of the parks’ operating budget. While the ski areas are managed by the state, they are quite profitable and operate similar to private enterprises. A portion of all park revenues is set aside in a sort of “rainy-day” fund for emergency maintenance and periods of poor weather.

### Texas

Texas state parks took a different approach to moving toward self-sufficiency when, in 1991, the state legislature directed the Texas Parks and Wildlife Department (TPWD) to become self-supporting and announced that general funds, which funded half of the department’s operating budget, were going to be cut off by 1994. Faced with this drastic loss of funding from the state and the prospect of closing a number of parks, the TPWD developed the entrepreneurial budgeting system (EBS) to encourage park managers to cut costs and increase revenues. The EBS offers the managers incentive contracts that establish performance goals. Managers that beat spending-limit goals, for example, are allowed to carry a portion of the unspent funds over to the following year. The program was initially tried in a few select parks and was so successful that soon most other parks were clamoring to join in. As a result, the TPWD did not have to close a single park. The parks no longer receive any general funds from the state, although they do receive some money from a tax collected on sporting goods.<sup>37</sup>



## Conclusion

The mere implementation of user fees alone will not solve all park funding problems. Park managers must have incentives to collect and use them properly as well. To this end, 100 percent of park revenues collected should be maintained by the park responsible for collecting the fees so that: 1) parks have the greatest incentive to collect fees in an efficient manner and 2) those funds may be reinvested where the parks' patrons, the park visitors, will actually realize the benefits. In addition, park managers should have the flexibility to change user fees as visitor preferences and economic conditions change. Changes may be required by the year, by the season, by the week, or even by the day, and regulatory hurdles should not prevent managers from responding accordingly.

State and national parks hurting from recent budget cuts should look to user fees as a way to increase revenues while maintaining—and even improving—visitor services and facilities. In order to prevent double taxation, as well as maximize efficiency and improve park managers' incentives, user-fee funding should be seen as an *alternative*—not a supplement—to general tax funding. This elimination of the political process will offer the greatest incentives to both preserve the nation's parks and provide quality recreation services for park visitors.

*For a more detailed analysis of user fees as a solution to parks funding, see Reason Policy Study: “Funding the National Park System: Improving Services and Accountability with User Fees” ([rppi.org/ps325.pdf](http://rppi.org/ps325.pdf))*

# Contract Management and Performance

The 2005 *Municipal Yearbook* from the *International City/County Management Association* includes an analysis of “Why do some contractual relationships between local governments and private providers succeed while others fail? Why do some local governments get what they need from a private provider while others do not?”

*Seeing that contracting for services has become firmly entrenched in the United States and that governments across the country will likely continue to contract out hundreds of billions of dollars in services and programs, the issue of performance becomes more urgent than ever. Researchers must begin to examine more closely and with greater rigor those factors that account for performance in the area of contracting for services.*

The authors, Sergio Fernandez of Indiana University and Hal Rainey of the University of Georgia surveyed 439 specific contracts between local governments and private providers. Their analysis of the contracts, outcomes, and management systems is chock full of useful information and advice. Perhaps the most important general finding is that privatization is overwhelmingly successful.

<b>Table 5 - Types of Service Contracts Surveyed (percent)</b>	
Public works/transportation	44
Public utilities	3
Public safety	6
Health and human services	13
Parks and recreation	7
Cultural and arts programs	1
Support functions	26

## Contract Characteristics

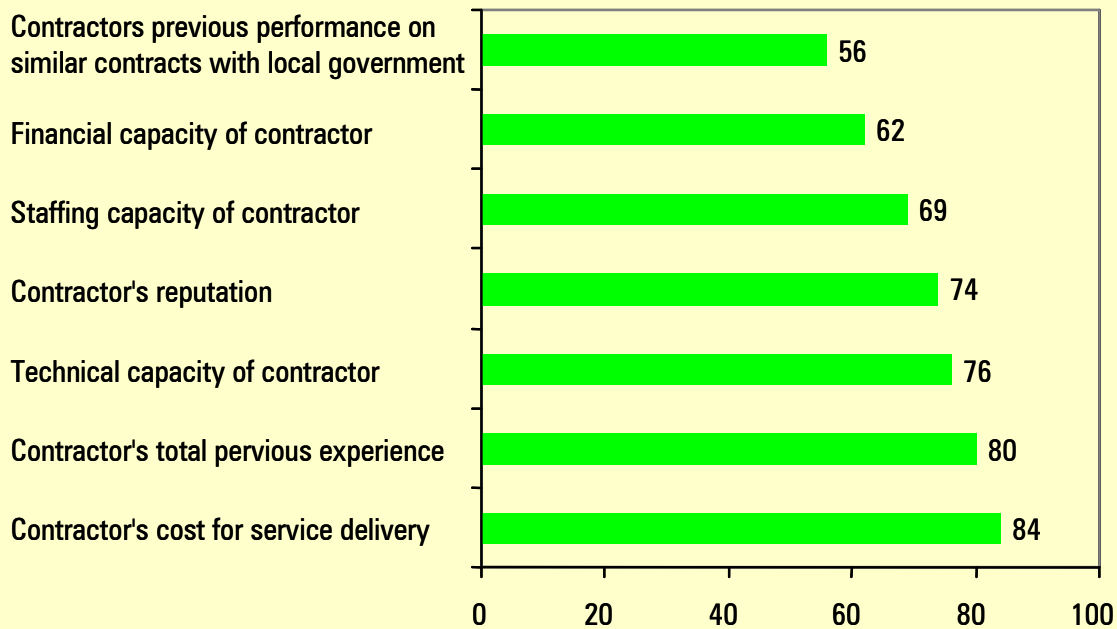
The survey compared characteristics of the contracts, such as:

- Type of bidding procedure used: 42 percent by RFP, 35 percent by invitation-to-bid, 18 percent sole source, 5 percent multistage solicitation.
- Previous contractor: 64 percent of the contracts went to a contractor that had been used by the local government in the past to provide the same service.
- Contract incentives: 52 percent of contracts included offered an incentive of contract renewal based on good performance, 5 percent offered gain sharing, 2 percent included bonuses for reaching specific goals.

## Contract Monitoring

The authors wanted to learn how broad in scope are the contract monitoring practices of local governments and how many aspects of contracts are evaluated. One of the most interesting findings is that there is very little use of citizen surveys, even though that is considered in some sense the ultimate measure of performance. In general, though, their results are not surprising in that “those types of monitoring that are more expensive and difficult to implement, such as citizen surveys and performance measurement systems, tend to be adopted with lesser frequency.” [Note: For information on the importance of making contract management a part of local governments core capabilities, see *Governing by Network* and *Reason’s How-to Guide* for performance-based contracting.]

**Figure 6: Factors Considered in Evaluating Contractor's Capacity to Perform Prior to Awarding the Contract (% Reporting)**

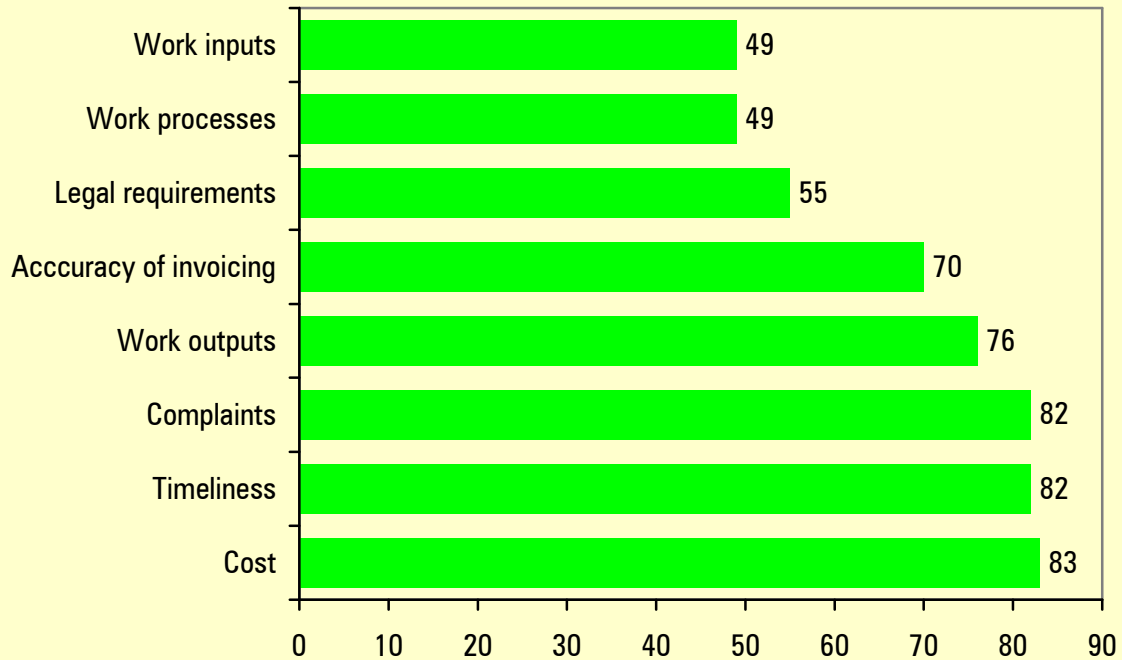


**Table 6: Use of Different Monitoring Tools and Procedures**

	Frequency of use					
	Never	A few times a year	About once a month	About every 2 weeks	About once a week	Several times a week
Inspections of work in progress	12	20	15	7	21	26
Inspections of work completed	11	17	19	7	24	22
Complaints monitoring	12	18	16	8	18	28
Examination of contractor reports	21	20	35	6	11	7
Performance measurement system	46	18	20	3	6	6
Citizen surveys	74	22	3	1	1	1

*Percentages not equal to 100% due to rounding*

**Figure 7: Types of Data Collected to Monitor the Contractor's Performance (% Reporting)**



### Political Support and Contractor Performance

It is no surprise that management and elected officials tend to support privatization more than do frontline employees (Table 7). But it is surprising that 9 percent of frontline workers are at least somewhat supportive. The high degree of political support found in the survey isn't entirely surprising given that these are cities that do contract out services. Past surveys show that local governments experience success with privatization. And the survey does not tell us to what extent political support led to privatization, and to what extent the success of privatization has increased political support, but the local governments rate the performance of privatization very highly (Table 8).

**Table 7: Political Support for Contracting Out (percent)**

	Not at all supportive	Not very supportive	Somewhat supportive	Very supportive
Top management	<0.5	1	19	80
Elected officials	<0.5	1	30	69
Middle management	<0.5	4	32	65
Frontline workers	1	9	40	50

*Percentages not equal to 100% due to rounding*

<b>Table 8: Dimensions of Contractor Performance (percent)</b>				
	<b>Poor</b>	<b>Fair</b>	<b>Very good</b>	<b>Excellent</b>
Actual cost in comparison to projected cost	1	12	61	26
Actual costs in comparison to in-house service delivery	3	14	55	29
Quality of work	1	15	55	29
Responsiveness to government requirements	1	15	53	31
Timeliness	2	17	57	24
Continuity of service (no disruptions)	2	16	50	32
Compliance with the law	<0.5	7	55	38
Customer satisfaction	1	14	64	21
<i>Percentages not equal to 100% due to rounding</i>				

Finally, the authors scoured through the survey responses to try to determine what contract elements seem to lead to successful contractual relationships. They conclude that success is most often seen when:

- The parties work together to arrive at solutions to problems that arise during the life of the contract;
- The parties trust each other;
- Public managers and employees support (or do not oppose) the contracting initiative;
- The contracting process is well funded;
- The task performed by the contractor is relatively simple to accomplish;
- Public managers rely on the occasional threat or sanction to enforce the agreement;
- Public managers conduct a more thorough evaluation of the contractor's capacity to meet the local government's needs; and
- The parties engage in frequent communication during the life of the contract.

Again the information summarized here is only a fraction of the good stuff in the article.

## Privatization Going Postal in Japan



While the United States Postal Service (USPS) has *proposed another postage increase* for 2006 (from 37 cents to 39 cents for a first-class stamp),<sup>38</sup> and the government monopoly on mail delivery shows no sign of yielding to competition in this nation's "free-market" economy, significant privatization efforts are underway in Japan.

Prime Minister Junichiro Koizumi has made postal privatization his top priority. It is a goal he has pursued for over 20 years, since he first became an elected official.<sup>39</sup> As Koizumi recently explained to the Japanese House of Representatives, "Accomplishing postal privatization is the structural reform I'm proceeding with, and (it) is my political responsibility to the people. As the postal privatization bills, which are the most important task for the Koizumi administration, are presented for deliberation at the Lower House plenary, I feel more strongly that the bills must be given final approval by the Diet."<sup>40</sup>

### Koizumi's Privatization Plan

Koizumi's proposal would privatize postal services over a 10-year period beginning in April 2007. Japan's postal privatization involves much more than privatization of mail delivery services, however. In addition to delivering the mail, the Japanese postal system offers financial services, offers life insurance and serves as a savings depository (people can set up savings accounts but cannot borrow money). Seven years of deflation have resulted in a virtually zero interest rate,<sup>41</sup> which prevents banks from offering interest payments on deposits. Government postal savings, however, are allowed to accumulate a nominal interest fee, making postal savings a more attractive investment option than commercial banks.<sup>42</sup> This incentive has turned the Japanese postal system into the largest financial institution in the world, with \$3.6 trillion in savings and insurance assets.<sup>43</sup> This is three times greater than the savings deposits in Mitsubishi Tokyo Financial Group Inc., the nation's largest private holder of deposits,<sup>44</sup> and represents the wealth of approximately one-fourth of individuals' total assets.<sup>45</sup>

Koizumi's plan would break up the Japan Postal Services Public Corporation (Japan Postal) into four independent companies to operate the mail delivery, postal savings, life insurance, and branch management/over-the-counter services. During the 10-year transition period, the government would sell off all shares of the postal savings and life insurance companies. In addition, it would gradually sell off shares of a holding company that would own all of the mail delivery and over-the-counter businesses, although it would retain control of at least one-third of these shares and mandate that mail services are made available nationwide.<sup>46</sup>

Koizumi has already had to make a number of concessions to advance his proposal to the Diet. In addition to allowing the government to maintain control of a portion of the holding company, instead of divesting all ownership as Koizumi wanted,<sup>47</sup> Koizumi has assented to the establishment of a ¥2 trillion (\$18.4 billion) fund to help offset expected losses in post offices in rural areas.<sup>48</sup> In addition, the revised proposal would allow the partially government-owned holding company to purchase shares of the savings and life insurance



companies on the open market, thereby allowing the government to continue to exert indirect control over these “privatized” businesses.<sup>49</sup>

## Political Obstacles to Japanese Postal Privatization

The postal privatization plan has also been hampered by political maneuvering. There is much division over the proposal, even within Koizumi’s ruling Liberal Democratic Party (LDP). This intra-party division stems from fears of losing the support of Japan Post workers and relatives, a substantial LDP voting bloc. Japan Post’s 270,000 employees (plus their families and friends) “are reputed to be able to mobilize hundreds of thousands of votes for the LDP.”<sup>50</sup> LDP privatization opponents fear that privatization may result in job (and, consequently, vote) losses in rural areas that are traditionally strong bases of support for the LDP. Among other dissenters, some are opposed to privatization altogether, others support privatization but take issue with perceived flaws and concessions in the legislation, and others have simply been put off by what is, in their view, Koizumi’s abrasive style and overzealous efforts to force the legislation upon the Diet.<sup>51</sup>

Koizumi has not backed down in view of these concerns, however. He replaced two top officials in charge of postal policy whose views on privatization he deemed out of line with his own.<sup>52</sup> To further shore up LDP support, Koizumi has made it known that members’ actions on the postal privatization issue will be taken into consideration when he considers candidates for positions in his Cabinet, which he intends to reshuffle this fall.<sup>53</sup> He has also threatened to dissolve Parliament and call new elections, should his privatization measures fail.<sup>54</sup> New elections are a risk the LDP does not want to take at this time because victory would be far from certain.<sup>55</sup> In addition, if new elections are called, Koizumi may punish LDP dissenters by preventing them from running as official party candidates.<sup>56</sup>

## Benefits of Privatization

Despite the partisan bickering, postal privatization would mark a very positive development in Japan. Market incentives ensure that a privatized postal system will be more efficient than the current system. The profit motive will lead to the elimination of current bureaucratic fat, as the private companies will seek to minimize costs and enhance customer service to improve business. Many government employees may lose their jobs (up to about 30 percent of the existing workforce, by some estimates<sup>57</sup>), benefits may prove to outweigh these losses: One, the vast majority of labor reductions can likely be obtained through attrition or early retirement incentives (see the international case studies below), and two, this just illustrates the level of waste in the current system. Considering that, according to a *Shukan Post* investigation, Japan Postal is “rife with corruption;”<sup>58</sup> greater incentives to weed out incompetent or criminal employees should be welcomed by customers and taxpayers.

In addition to the benefits of market incentives, the near-elimination of *political* incentives and influences should spell even more relief for taxpayers. The postal system “has long been criticized for devouring the financial assets of Japanese individuals and funneling them to public projects.”<sup>59</sup> Furthermore, “Most of the funds held by Japan Post have been invested in government bonds to support debt-ridden state coffers and keep inefficient government-backed corporations afloat.”<sup>60</sup>

In essence, government intervention has squeezed private firms out of profitable financial markets and wasted the profits on inefficient programs. This waste and diversion of private resources (taxpayer dollars)



have suppressed economic growth and made Japan less competitive in the world market. Privatization would eliminate such pork-barrel spending and direct revenues to their most productive uses while lowering costs for consumers.

## Postal Privatization Around the World

Within the last 20 years, a wave of postal privatization has swept Europe, Australia, New Zealand, and elsewhere. Consider the following successful postal privatization and de-monopolization efforts:

**New Zealand.** While New Zealand has not shed its government-owned postal services company, it eliminated its monopoly, allowing for full competition—with impressive results. In 1986, New Zealand began the postal reform trend when it allowed full competition for letters that weighed at least 500 grams (1.1 pounds) or cost at least NZ\$1.75 (about 4.5 times the stamp price at the time). New Zealand gradually relaxed these restrictions until the entire monopoly was eliminated in 1998. The government required New Zealand Post (which it continues to own) to maintain universal service, but not to charge uniform rates. Under competition, New Zealand Post has delivered more mail while dramatically cutting costs, increasing worker productivity, and *reducing* prices. This even impressed the U.S. Postal Service, which noted: “Since corporatization, NZP has modernized its technology, transportation network, and retail facilities, and invested in subsidiary businesses, all funded by retained earnings and the sale of surplus assets. By 1995, with 30 percent more mail to deliver, costs had been reduced by 30 percent, and labor productivity had doubled.”<sup>61</sup>

Basic postage rates fell 11 percent—from NZ\$0.45 to NZ\$0.40—in 1995, and the real price of a letter dropped approximately 30 percent between 1987 and 1995. Moreover, New Zealand Post has earned a profit every year since 1986.<sup>62</sup>

**The Netherlands.** The Netherlands privatized most of its postal service when it sold off 52 percent of Royal PTT Nederland (KPN), including PTT Post, through two public offerings in 1994 and 1995. In August 1996, PTT Post purchased Australian transportation conglomerate TNT. The current postal service company was formed when KPN spun off TNT Post Group (TPG) in June 1998. Though mostly privately owned, TPG maintains a monopoly over the carriage of letters weighing 500 grams or less. TPG has pronounced its support for the repeal of its monopoly, provided other European carriers repeal their monopolies as well. Results in the Netherlands have likewise been encouraging. According to an international survey, the Netherlands, along with Sweden, provides the most efficient postal service in Europe.<sup>63</sup>

### Other Nations:

- **Germany.** Like the Netherlands, Germany partially privatized its postal services through a public stock offering. In November 2000, the government sold approximately 31 percent of Deutsche Post in a public offering. Postal reforms in 1997 allowed Deutsche Post to retain a monopoly on the carriage of letters weighing 200 grams or less and costing no more than five times the basic stamp price until 2002, when the monopoly was scheduled to be phased out, but the deadline was extended to 2007. Deutsche Post also holds a majority stake in DHL, the largest courier company in the world.<sup>64</sup>





- **Denmark.** Denmark recently sold a 22 percent stake in Post Danmark to CVC Capital Partners, a British investment company, for 1.27 billion kroner (\$171 million). An additional 2.5 stake was made available to the postal company's employees and another 0.5 percent of the shares were set aside in an incentive program for senior employees. Deutsche Post and TPG had also bid for the stake. The sale is part of a larger privatization effort. Denmark sold its postal service's banking system, Girobank, in 1993 and intends to sell stakes in its national broadcaster, TV2, as well.<sup>65</sup>
- **France.** Even France is getting in on postal deregulation. In May, the postal monopoly enjoyed by national carrier La Poste was reduced from letters weighing less than 100 grams or costing three times the basic stamp price to letters weighing less than 50 grams or costing 2.5 times the basic stamp price.<sup>66</sup>
- **European Union.** The European Union has been working to reduce mail monopolies for all member nations in recent years. In 2003, EU rules reduced the size of a letter that national carriers are allowed to monopolize from 350 grams to 100 grams, thus opening up an additional 11 percent of the market to competition. The limits are scheduled to drop to 50 grams in 2006, opening up a further 7 percent of the market. It should be noted, however, that 75 percent of all letters carried weigh less than the 50-gram threshold.<sup>67</sup>

Most of the privatization concerns in Japan (and elsewhere) seem to center on two issues: job losses and universal service. While newly cost-conscious privatized or de-monopolized postal companies often do significantly reduce their workforces—by 40 percent in New Zealand, 38 percent in Germany, and 30 percent in Sweden, for example—the reductions typically come mainly through attrition and early retirement and incentive packages.<sup>68</sup> These strategies allow companies to cut the workforce—and costs—without significant layoffs. The universal service issue is similarly overblown. As a *Hoover Institution article* notes, “de-monopolized postal services have not sacrificed delivery to rural areas. Universal service is an important business asset, and firms facing competition have an incentive to maintain it.”<sup>69</sup> In a truly free (de-monopolized) market, for example, even if a major carrier stopped serving certain areas of the country or stopped delivery on certain days of the week, consumers could simply decide to do business with another carrier that better met their service needs. In cases where the defecting business is the only carrier in town, there would be an obvious demand and profit opportunity that other carriers (or potential, yet-to-be formed companies) would be happy to serve.

### Postal Reform in the United States?

Unfortunately, postal reform is much more advanced in the “Old World” than it is here in the “land of opportunity.” Although both the House and Senate unanimously passed postal reform bills out of committee in 2004, the reforms were modest at best and never made it to the floor of either chamber due to relatively minor differences over pension accounting issues.<sup>70</sup> The cost of communication has dropped dramatically in recent years—most notably due to e-mail and falling long-distance telephone rates—resulting in a decline in first-class mail, which accounts for roughly half of revenues. The USPS has responded by *adding* 5.4 million delivery points between 2000 and 2003;<sup>71</sup> engaging in “non-core” businesses such as selling phone cards, T-shirts, and mugs (which the USPS lost \$85 million on during the 1990s<sup>72</sup>); and merely crossing its fingers and hoping that revenue from third-class (advertising, or “junk”) mail can pick up the slack (it has in the past year or two, but how long will this last?). In addition, according to Robert Cohen, formerly a member of the U.S. Postal Rate Commission, the USPS suffers from



a high wage premium (it pays an estimated 21.2 to 35.7 percent more than would a comparable private-sector employer, which represents 12 to 20 percent of total costs) and low productivity increases (only 9.2 percent from 1970 to 1999).<sup>73</sup>

As an open letter from the National Taxpayers Union to members of Congress observes, “Given that the United States is generally regarded to possess one of the freest economies in the world, it is perplexing that more centrally planned countries are the ones pursuing postal privatization options. Germany, New Zealand, Sweden, Japan, South Africa, the Netherlands, and even the Philippines and Jordan have implemented or are considering some degree of privatization for mail services.”<sup>74</sup> In light of the aforementioned inefficiencies in the USPS and the success of other nations around the world in privatizing and deregulating postal services, it is time the United States eliminated its postal monopoly and allowed consumers to realize lower prices and better service through privatization.

## Conclusion

Japan is well on its way to significantly improving not only its mail delivery services but its financial services sector as well through Prime Minister Koizumi’s privatization proposal. While the premier’s plan would still allow for some government control—direct and indirect—and the plan would not be fully implemented until 2017, privatization of the Japanese postal system would represent a sizable step in the right direction.

There is no question that postal services *can* be rendered adequately by the private sector. Just look around the world! Postal privatization and deregulation are reducing prices and wasteful spending, increasing productivity, and improving resource allocation. In addition, privatization and competition will surely lead to greater quality, customer service, and choice. As Belgian Senator and deregulation advocate Philippe Bodson has noted, “as long as markets remain closed or only limitedly opened to competition, postal users will continue to lack choice and . . . pay excessive prices.”<sup>75</sup>

# Military Housing Privatization



Over the years, military housing took a back seat to other defense spending priorities. This resulted in dilapidated, decades-old housing, high maintenance costs, and low service member morale. In recognition of the importance of the quality of life of military personnel, however, military living conditions have been made a higher priority in the past decade. Realizing that housing construction and management is not a core government competency, the military has turned to the private sector for answers. Privatization has proven to be a

great success, delivering higher-quality housing to satisfied service members at lower costs to the government—and, ultimately, taxpayers.

By the mid-1990s, military housing had fallen deep into disrepair. Military housing was decrepit and in short supply. There were too few quality housing units on base and the quality units that existed off base were unaffordable for many military families, particularly those of junior enlisted personnel. At the time, the Department of Defense (DoD) estimated that 60 percent of military housing units were inadequate, and that it would take 30 years and at least \$20 billion for the government to refurbish them all using the traditional military construction approach.<sup>76</sup> To improve the living conditions and morale of service members, Congress established the Military Housing Privatization Initiative (MHPI) under the National Defense Authorization Act for Fiscal Year 1996 (Public Law 104-106 110, Stat 186, Section 2801). The Bush administration later designated military housing privatization a President's Management Agenda Initiative.<sup>77</sup>

The military housing privatization program has proven so successful that the government has continually expanded the program and found it to be a crucial tool to repair and replace inadequate military housing. According to Philip W. Grone, Deputy Under Secretary of Defense, Installations and Environment:

*[The Department of Defense] has used privatization to . . . obtain maximum benefit from its housing investment and rapidly improve the quality of life for our Service members. Installation commanders and Service members welcome privatization efforts to revitalize their family housing.*<sup>78</sup>

The housing privatization program has expanded rapidly in recent years. The number of privatized housing units rose from 5,894 at the end of 2000 to 87,512 this year.<sup>79</sup> Current plans are to privatize a total of over 185,000 units—84 percent of all U.S. on-base housing—by the end of 2007.<sup>80</sup> As of February 2005, the DoD had awarded 43 military housing privatization projects.<sup>81</sup>

In light of the MHPI's success and expansion, Congress removed a sunset clause that would have caused the program to expire in 2012, thereby making the program permanent, and removed a budget authority cap of \$850 million in the Ronald W. Reagan National Defense Authorization Act for 2005 (Public Law 108-375 107, Section 2805).



## How It Works

While the MHPI is governed by DoD policy guidelines, each service branch runs its own privatization program. The Army's program is called the "Residential Community Initiative," the Navy's program is "Public Private Ventures," and the Air Force's program is "Housing Privatization." After an initial evaluation and feasibility study is conducted, the project concept is approved by the Office of the Secretary of Defense, and Congress has been notified of the solicitation proposal, the service may seek out private partners to address its housing needs. After the request for proposal (RFP) is issued, the service holds an industry forum to introduce the project and organizes local meetings to answer developers' and financiers' questions about the project.

The developer selection process varies somewhat among the services. The Air Force and the Navy select a developer through a two-step process, based first on the developers' qualifications, and second on their project development and management plans. The Army bases its decision solely on the developers' qualifications, and then works together with the selected developer to come up with a Community Development and Management Plan (CDMP). If the Army is satisfied with the CDMP and the working relationship with the developer, it will give the developer the green light to proceed with the project.

After the contract has been awarded, there is typically a series of stakeholder meetings and community forums to solicit comments from enlisted personnel and their spouses, as well as members of the local community and local governments. Frequent "management review committee" meetings between the developer and the service ensure that the project stays on track and that any concerns or problems that arise may be addressed quickly and to the satisfaction of all parties.

Typically, the service and the developer form a limited partnership to develop the project. The developer receives a 50-year ground lease and is responsible for asset, property, and maintenance management. The private developer assumes virtually all of the financial burden of developing the project. Financing sources include developer and government equity investments and private-sector loans.

Rents are set equal to the Basic Allowance for Housing (BAH), a housing stipend issued by the DoD to military personnel living off base (and now provided to those living in on-base MHPI projects as well). BAH is determined based on a service member's geographical location, pay scale, and whether he or she has dependents. In addition, the developer is required to provide a standard renter's insurance package. Since service members may be forced to transfer or deploy on short notice, they are allowed more leeway in breaking their leases without penalty than a typical renter in the private sector.

Developers are also offered some protection for their investments. If the military base on which their project is located were to close, they would continue to own and manage the leased property and housing development, and so would be able to rent out their units on the private market. In addition, if occupancy rates fall below a certain threshold, the developer can rent to others at market rates using the following priority list: (1) unaccompanied (single) service members, (2) federal civil service employees, (3) retired military personnel, (4) guard and reserve military personnel, (5) retired federal civil service employees, (6) DoD contractors/permanent employees, and (7) members of the general public.<sup>82</sup>



The government's oversight does not end with the completion of the project. Privatization projects are continually evaluated with the use of Program Evaluation Plan (PEP) reports. The DoD collects PEP information from the services and conducts semi-annual reviews. The Department also holds quarterly meetings with the services to share best practices, lessons learned and areas of weakness, and other ideas regarding the housing privatization programs.

## Benefits of Military Housing Privatization

### Cost Savings

One of the most palpable benefits of military housing privatization is that private project development is significantly cheaper than government housing construction and management. According to the DoD, it would cost \$16 billion to make the necessary housing improvements based on the traditional military construction (MILCON) program.<sup>83</sup> Privatization is expected to cost only \$14 billion, a savings of \$2 billion.<sup>84</sup> Indeed, even after factoring in BAH (rent) payments to military personnel who previously lived on base and did not draw allowances, the DoD concluded in 2004 that private development is much cheaper: "Life cycle analyses have shown privatization to be less costly than military construction for all projects so far. Our most recent data reflects for the 20 projects we've analyzed thus far, a life cycle advantage for privatization of about 10-15 percent."<sup>85</sup>

Under the MHPI, the private developer pays the vast majority of the development costs. DoD policy requires that a privatized housing project must generate at least \$3 of housing development (as estimated by MILCON) for every \$1 appropriated by Congress to support the project, or a "leverage ratio" of 3 to 1.<sup>86</sup> For the 43 projects awarded as of February 2005, government construction costs totaled \$767 million for developments that would have cost \$11 billion under the traditional MILCON approach.<sup>87</sup> This represents a leverage ratio of over 14 to 1, far exceeding program guidelines and expectations.

### Speed in Addressing the Shortage of Adequate Housing

Not only are private-sector housing developers cheaper than government developers, they are also much quicker.<sup>88</sup> Using MILCON, the DoD estimates it would take another 20 years to fix all of the military's substandard housing.<sup>89</sup> Assuming the DoD's budget requests are fulfilled, the Department anticipates eliminating all inadequate military housing units in the United States by the end of FY 2007—and all inadequate units overseas by the end of FY 2009—through the use of privatization.<sup>90</sup>

It is interesting to note that while one of the main justifications given by the DoD for the MHPI is "a shortage of quality affordable private housing,"<sup>91</sup> *The President's Management Agenda* of FY 2002 decried *excess* military family housing units.<sup>92</sup> So by maintaining *inadequate* housing and not developing *quality* affordable housing, the DoD had created both a surplus and a shortage in military housing at the same time! Only the government could accomplish such a feat.



## Better Housing Quality and Property Management

Prior to the introduction of the MHPI, DoD-owned housing was notorious for its old age, poor condition, lack of funding, and “anachronistic features.”<sup>93</sup> According to the DoD, in January 2001, approximately 180,000 of the Department’s 300,000 family housing units worldwide were deemed “inadequate.”<sup>94</sup> (“Inadequate” is defined by each service as housing which requires significant renovation or repair of kitchen, bathroom, infrastructure, plumbing, [or] electrical beyond a certain dollar level.”<sup>95</sup>) Primarily because of the military housing privatization program, however, the DoD expects to reduce the number of inadequate units to 67,079 units out of a total of 136,017 units worldwide by the end of FY 2005, and to eliminate all inadequate units by the end of FY 2007.<sup>96</sup> While nearly half of the military’s existing housing units are still substandard, this represents a dramatic improvement from the 60 percent inadequacy rate of just a couple of years ago.<sup>97</sup>

Approximately one-third of military families live on base.<sup>98</sup> Unfortunately, these families have had to put up with aging and deteriorating housing. On-base housing has an average age of 33 years, and 25 percent of it is over 40 years old.<sup>99</sup> The housing privatization program is now offering military families brand new (or newly renovated) homes that are larger and contain more modern features.

Private-sector companies have a strong interest in providing and maintaining high-quality housing for their military customers. If pride in developing and sustaining quality communities is not enough, private companies have the added incentive of the profit motive: they must offer attractive living spaces to keep up occupancy rates and profits, or else lose out to private off-base housing competitors. Under the government (bureaucracy) system, there is no such incentive, and housing quality is determined by arbitrary political priorities and (typically insufficient) budget allocations—with disastrous results.

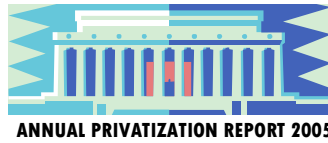
In contrast to the poor state of government-maintained military housing, the DoD has been highly complimentary of the quality of privatized housing:

*The private sector provides a high quality product. According to tenant surveys administered annually by most of the Services at our housing projects, Service members and their families are pleased with privatized housing—in particular, those living in new and renovated homes.*<sup>100</sup>

In addition, a Defense Communities article on Air Force housing privatization reports:

*New and renovated homes not only meet, but often exceed, DoD standards for square footage per unit. The larger sizes especially benefit the lower ranks, who usually cannot afford as much space off base at most duty locations. Typically, an on-base, privatized house for the lower enlisted ranks is 20 to 30 percent larger than what they can get off base for the same amount of BAH.*<sup>101</sup>

Quality improvements are not limited to the mere construction of privatized housing units, however. Privatized military housing also offers better property management and maintenance. Private management companies reportedly fix maintenance problems much quicker, for example.<sup>102</sup> According to the DoD, “many tenants are initially impressed by improved response to trouble calls even prior to housing improvements being completed.”<sup>103</sup> In addition, “awarded projects show vastly improved operation and maintenance, better customer service, and greater Service member satisfaction, as measured in the customer surveys used to support the President’s Management Agenda metric for tenant satisfaction.”<sup>104</sup> Chris



Crennan, Vice-President of Lincoln Military housing, Mid-Atlantic Region, whose company is taking on a housing privatization project at NAS Patuxent River, proudly reported his company's maintenance track record: "97 percent of calls are received within 24 hours and . . . emergency calls are addressed within 30 minutes."<sup>105</sup> At Fort Meade, the base handed over a maintenance backlog of 4,000 repairs to the new private management company. All problems were fixed within 8 months.<sup>106</sup> Base Commander Col. John W. Ives noted that the civilian management team was able to quickly make decisions and respond accordingly, "something you couldn't do in the Army system." Added Ives, "[Privatization] is the right answer for families."<sup>107</sup>

More and more military and DoD personnel are realizing that not only is private-sector property management beneficial because it is more efficient, it removes the burden of management from the military altogether. Said Joseph K. Sikes, DoD's director of housing and competitive sourcing, "After 2007, more and more bases will determine it's easier not to take care of the houses yourself. It's better to have a private developer maintaining it and operating it, and so I think we'll see even more projects become privatized."<sup>108</sup> Under Secretary of Defense Grone was even more blunt:

*The Department [of Defense] recognizes that maintaining and operating family housing is not a core competency and that, historically, we have not done it well. These projects allow us to get out of those ownership responsibilities and the last thing we want to do is take them back over in the future.*<sup>109</sup>

The management efficiency gains from housing privatization can greatly improve military operations. Privatization is beneficial not only because it allows the military to redistribute money saved to more productive uses, but also because it allows the services to achieve efficiency elsewhere by freeing up personnel for more core military duties. The use of private housing developers thus maximizes both financial and human resources.

### **Higher Service Member Morale**

The importance of quality military housing stretches much further than efficiency or aesthetics; it goes to the very preparedness and morale of the military. In 1995, just before the establishment of the MHPI, a Defense Science Board report concluded that military family housing "made daily activities a trial and lowered morale."<sup>110</sup> More recently, the DoD echoed this sentiment, asserting that the poor housing situation that developed over the decades "has led to a decline in readiness and morale among Service members."<sup>111</sup> By reversing this trend, the Military Housing Privatization Initiative represents an effort not only to save the government money and improve the quality of life of the United States' military personnel, but also an effort to improve the demeanor and quality of the military overall. As Under Secretary of Defense Grone maintains, "Sustaining the quality of life of our people is crucial to recruitment, retention, readiness, and morale."<sup>112</sup>

Indeed, housing quality has proven to be an important tool for service member recruitment and retention. The DoD reports that service retention rates at bases with high-quality housing are about 15 percent higher than at bases with lower-quality housing.<sup>113</sup>

It is important to note that the housing quality must impress not only service members, but their families as well. As Col. Ives explains, "In the Army, we have a mantra: 'You enlist the soldier but you reenlist the family.'"<sup>114</sup>





Privatized housing communities provide plenty of amenities and social activities to improve the quality of life for service members and their families. Amenities may include adequate parking, high-speed Internet capability, swimming pools, community centers, tot lots, meeting rooms, athletic fields and facilities, fitness centers, jogging paths, and bike paths. In addition, private property managers organize such social activities such as family events, BBQs, ice cream socials, town hall meetings, date nights, military spouse activities, children's programs, and educational programs. Sometimes these social activities are conducted in conjunction with the YMCA or other local organizations.

These amenities and community activities are already helping to ease the burdens of military life and improve the quality of life of service members and their families. The military is taking advantage of these benefits offered by private developers to strengthen its forces. As one recruiter remarked of the housing privatization project at Fort Meade, "We're going to use this as a selling technique, to show [potential enlistees] the quality of life they can expect one day."<sup>115</sup>

## Government Official Testimonials

As the results above indicate, the military housing privatization program has been nothing less than a smashing success. Perhaps the truest evaluations of the program's success come from those charged with implementing it. The reactions and conclusions of military and DoD leaders speak for themselves:

- *Rear Adm. Jeffrey B. Cassias, Commander of the Naval Facilities Engineering Command's Northeast Region:*

*"Navy family housing privatization initiatives have proven to be very successful and are an important tool in the Navy's efforts to put quality homes in the hands of sailors faster."<sup>116</sup>*

- *Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics Web site, "Military Housing Privatization FAQs":*

*"For DoD, MHPI results in the construction of more housing built to market standards, for less money than through the military construction process. Commercial construction is not only faster and less costly than military construction, but private sector funds significantly stretch and leverage DoD's limited housing funds."<sup>117</sup>*

- *Philip W. Grone, Principal Assistant Deputy Under Secretary of Defense, Installations and Environment, 2004 congressional testimony:*

*"Increased availability of quality private sector options will ease pressure on on-base housing, reduce the need to maintain old, costly housing, and allow us to spend our operations and maintenance funding more wisely."*

*"Based on the performance of each project to date, we are confident in reporting that the program is meeting expectations and that all projects are fiscally and financially sound."<sup>118</sup>*





- *Philip W. Grone, Deputy Under Secretary of Defense, Installations and Environment, 2005 congressional testimony:*

*“The [President’s Management Agenda] Scorecard evaluated DoD in four areas: 1) elimination of inadequate housing units; 2) privatization of housing inventory; 3) average housing costs covered for Service members living in non-governmental housing; and 4) satisfaction of Service members who choose to live in revitalized private housing. In FY 2005, DoD’s housing privatization efforts received a **green** score for showing substantial progress in achieving these goals and/or progress in all these areas. Privatization of housing was the only individual federal initiative to receive the highest scorecard rating.”*

*“Through privatization we have leveraged DoD’s resources with private sector capital to revitalize inadequate housing faster and [at] lower lifecycle cost to the taxpayer than traditional construction. We are pleased to be a part of these initiatives to eliminate inadequate family housing and increase the quality of life for our Service members and their families.”*

*“All projects are financially sound.”*

*“The housing privatization program is crucial to a decent quality of life for our Service members.”<sup>119</sup>*

## **Conclusion**

The Military Housing Privatization Initiative has proven to be a remarkable success since its creation in 1996. In less than a decade, the military services have made impressive strides in utilizing private housing developers to replace inadequate on-base housing. These private developers have shown that they can build, renovate, operate, and maintain higher-quality housing communities at less cost than traditional military construction methods. The results have been greater efficiency for the services and greater quality of life and morale for service members and their families.

The Navy is now experimenting with barracks privatization for single service members.<sup>120</sup> Like much of the military family housing units (particularly before the implementation of MHPI), the barracks have been described by the DoD as “often substandard, inadequately maintained, or obsolete.”<sup>121</sup> Given the success of the MHPI, the Navy and other services should seek to expand the privatization program to include more barracks projects. It is encouraging to see that the DoD “is also interested in working with Congress to determine whether privatization authorities can be used in other areas including lodging facilities and overseas facilities to address [the Department’s] needs.”<sup>122</sup>

While the military housing privatization program has allowed the government—and thus taxpayers—to achieve significant cost savings, it has brought many other benefits as well. In fact, as the DoD observes, “the biggest advantages of privatization are not monetary, but rather are the speed at which these houses can be renovated and constructed by the private sector, and the quality of the housing and housing maintenance that the residents receive almost immediately.”<sup>123</sup> These quality improvements translate into higher service member morale and, ultimately, a more efficient and effective military.

# Housing and Land Use

## Supreme Court Unleashes Eminent Domain in Cities



On June 23<sup>rd</sup>, the U.S. Supreme Court gave a rubber stamp to government efforts to seize private property for economic development purposes. In *Kelo v. New London*, a small band of property owners challenged the city of New London, Connecticut's authority to seize their homes and businesses for the sole purpose of redeveloping the land to generate higher tax revenues.

The Supreme Court sided with the city in a split decision. "Promoting economic development is a traditional and long accepted function of government," wrote Associate Justice Stevens for the majority. "There is...no principled way of distinguishing economic development from the other public purposes that we have recognized." The decision effectively makes private property rights non-issues for local governments as long as they follow proper legal procedures.

Eminent domain is the government power to forcibly confiscate, or "take," private property as long as it is for a legitimate "public use" and property owners receive "just compensation." Traditionally, public use has meant activities for *public* use such as roads, schools, municipal buildings, canals, or parks. Cities offer these services and programs for the use of the public at large with equal access. The power was reserved for government use, under specific circumstances, and was not intended as a tool for private individuals and businesses to dispense with private markets and compel others to sell their land to them.

Yet, a recent analysis of takings cases for redevelopment purposes by Reason Foundation suggests this distinction is fuzzy at best.

### Eminent Domain Resources

- Reason has a Web page with links to resources on eminent domain issues at ([reason.org/emdomain/index.shtml](http://reason.org/emdomain/index.shtml)).
- *Eminent Domain, Private Property, and Redevelopment: An Economic Development Analysis* ([rppi.org/ps331.pdf](http://rppi.org/ps331.pdf))
- Reason's Amicus Brief on the Supreme Court's 2005 review of eminent domain for economic development *Kelo v. New London* ([rppi.org/kelamicusfinal.pdf](http://rppi.org/kelamicusfinal.pdf)).
- *Public Power, Private Gain*. A report documenting the extent of use of eminent domain to turn land over to private parties ([castlecoalition.org/report](http://castlecoalition.org/report)).
- The Castle Coalition. A group organized to fight eminent domain abuse ([castlecoalition.org](http://castlecoalition.org)).
- Eminent Domain Watch. A Web site and blog on eminent domain abuse ([emdo.blogspot.com](http://emdo.blogspot.com)).



## A Green Light for Eminent Domain

The New London case is a direct descendant of the judiciary's "hands off" approach to eminent domain, and the Supreme Court effectively said as much in *Kelo*. Case law, including the groundbreaking decision in the mid-1980s by the Michigan Supreme Court in *Poletown v. the City of Detroit*, broadened the power of local governments and gave them license to effectively void individual property rights at their discretion as long as they say it is for a public benefit. The *Poletown* case, in particular, was important because the Michigan Supreme Court allowed a city to raze an entire neighborhood to accommodate a new General Motors plant in order to meet an explicit economic development goal.

While *Poletown* was a state court decision, the decision had nationwide impact. Building on federal law that granted increasingly broad scope to state and local governments, cities and states across the nation used eminent domain to seize private property and hand it over to other private property owners using economic development as a justification.

The result, perhaps inevitably, was *Kelo*. Local government officials targeted a 90-acre section of the city for redevelopment, condemning 115 properties in the Fort Trumbull neighborhood to clear the way for new offices and luxury apartments to complement a recently completed research facility developed by Pfizer, Inc.

The Michigan Supreme Court overturned *Poletown* in July 2004 when it ruled against a county's use of eminent domain for a private business and office park in *County of Wayne v. Edward Hathcock*. The effects of this reversal are likely to be limited given the U.S. Supreme Court's decision in *Kelo* (although the Court explicitly noted the ability of states to adopt more strict guidelines than in federal law).

The Institute for Justice, a Washington D.C.-based public interest law firm that defends property owners in eminent domain cases, estimates that eminent domain was used to threaten or "take" more than 10,200 properties nationwide between 1998 and 2002 where the primary beneficiary would be another private property owner.

The change in attitudes toward property rights among urban policymakers has corresponded with changing the legal definition of public use and the scope of activities that could fall under eminent domain. Even though governments are still responsible for paying "just" compensation when private property is seized, they often don't. Local officials often attempt to minimize payment for the property. Many of these and other abuses were chronicled in a recent book by Steven Greenhut, *Abuse of Power*. Cities will:

- hire appraisers to low-ball property valuations;
- use the threat of eminent domain to intimidate property owners to sell at below-market rates;
- compensate property owners at assessed valuation even though market values are significantly higher;
- avoid paying relocation costs for businesses and homeowners;
- ignore the value of "good will" and other intangible value implicit in a business's reputation or location; and/or
- underestimate start-up and marketing costs involved after a business moves.



Whether the courts will scrutinize compensation decisions more rigorously in the wake of *Kelo* has yet to be seen.

## Razing Arizona

The case of Bailey’s Brake Service in Mesa, Arizona provides a case in point. Randall Bailey had been operating his family-owned and operated business on Site 24 for decades. He remained the principal tenant (and landowner) even after Redstone Property began purchasing the businesses and land around him on behalf of Lenhart’s ACE Hardware. As other buildings were purchased by Redstone and left vacant, Bailey kept his business open and thriving at the location based on references, reputation, and an intergenerational client base.

Neither Lenhart nor Redstone Development approached Randall Bailey about purchasing his property. In fact, when Randall Bailey approached Redstone to discuss the possibility of incorporating his business into their redevelopment plan, representatives referred Bailey to the city of Mesa, which was acquiring property for the redevelopment project.

Further analysis of the case found:

- Eminent domain was a tool of first resort, not last resort in Mesa;
- Properties targeted for redevelopment were identified by potential private investors, and the city then proceeded to condemn the properties in order to sell them to the private developers;
- The city’s redevelopment agreement with private developers would have amounted to effective subsidies ranging from \$176,000 to \$592,000 dollars.
- Existing small business owners and homeowners were effectively shut out of the negotiations and redevelopment decisions; and
- Many properties seized were viable and growing. Property values in the neighborhood increased by 19.3 percent between 2000 and 2002.

Mesa’s case may be unique in that the city relied almost exclusively on eminent domain to achieve its redevelopment objectives. The mechanisms used, however, are common in the redevelopment community. In fact, the statutory requirements for using eminent domain—initiate a planning process, adopt a redevelopment plan, acquire the property, then transfer the property to a private developer—could serve as a template for other communities across the nation. As long as Mesa had an approved development plan, and had adhered to procedures for determining blight, the city could effectively seize one person’s property and transfer it to someone else.

After several years of litigation, the Arizona Court of Appeals upheld Bailey’s right to keep his business and property, but the decision was very limited and did not implicate the redevelopment techniques used by the city of Mesa. Eminent domain was struck down because the only significant beneficiary of the project was another private party (in this case Lenhart and the local developers). Moreover, the ruling stipulated that eminent domain cases needed to be reviewed on a case-by-case basis, and did not set new precedent for limiting the scope of eminent domain beyond the narrow circumstances surrounding Randall Bailey’s case.

## Grassroots Flood Control in Lakewood

The city of Lakewood, Ohio, a “first tier” suburb immediately adjacent to Cleveland, provides another telling example of how eminent domain has become a cornerstone of city redevelopment initiatives. Lakewood isn’t one of the suburban communities mired in decline. On the contrary, the average home sells for \$146,605, 15.9 percent higher than Cuyahoga County and almost on par with suburban Cleveland communities. The city’s assessed valuation increased by 15 percent between 1994 and 2000 according to the Cuyahoga County auditor, significantly faster than the average for Cleveland’s suburbs. Despite being boxed in by surrounding communities, the city managed to issue 1,645 residential building permits between 1999 and 2000 as well. By all significant indicators, Lakewood has a robust economy.

Nevertheless, like most cities, not all neighborhoods fare equally well. The West End is one neighborhood like that. The West End consists of 31 acres on the western edge of Lakewood. The area has substantial scenic value, looking over the Rocky River protected by the Cleveland park system. Almost 3,000 people lived in the neighborhood in 2000, occupying more than 1,700 housing units.

The West End neighborhood was developed primarily in the decades spanning the turn of the 20th century. Almost all the non-apartment residential and commercial buildings were built between 1897 and 1925 and the area exhibits the structural limitations common to older buildings and roads.

During the summer of 2002, planning consultant D.B. Hartt and architectural consultant Square One, Inc. conducted surveys of the buildings in the West End. Surveys of the buildings and city records led them to conclude that the West End neighborhood had “sufficient deficiencies...which together are detrimental to the public health, safety and welfare and which impeded the sound growth, planning and economic development of the City of Lakewood” and “that substantial portions of the” community development area met the definitions of blight as defined in the city’s ordinances.

Yet, the consultants’ report does not provide evidence that the majority, or even most, of structures in the West End neighborhood meet the criteria for blight. The conclusions rest on inferences from small samples of buildings and a fundamental belief that older buildings are inherently inferior to new, comprehensive development. In fact, there was virtually no evidence presented regarding ill health, transmission of disease, infant mortality, and juvenile delinquency, or moral hazard in the West End. Almost all the evidence presented highlighted features of buildings and sites typical of neighborhoods 80 years old outside the primary growth path of a region.

While significant differences appear to exist in different areas of the West End, these differences would be expected when some areas are characterized by very high densities and others by lower densities.

Moreover, this kind of diversity is part of the natural evolution of neighborhoods. This diversity should be expected in a neighborhood more than 80 years old. In short, homes and buildings built in the early 20th century did not conform to the city of Lakewood zoning code in 2002, and these discrepancies became evidence that the homes and businesses should be razed and redeveloped according to plans created by the city. An analysis of trends in the neighborhood found:



- Property values in some parts of the West End were increasing faster than for the city as a whole, suggesting a strong real estate market;
- Residential vacancy rates for homeowners were falling faster in the West End neighborhood than for the city as a whole;
- Homeownership rates had increased in the West End neighborhood between 1990 and 2000; and
- The West End neighborhood was healthy, growing, and stable using standard criteria of neighborhood development.

The city's primary motivation for redeveloping the site, it appeared, was the potential for substantially increasing its tax base. The city's redevelopment plan for the area estimated that the total value of real estate in the West End could increase from \$31.3 million to \$131.1 million by transforming the area from an older, affordable residential neighborhood to a mixed-use "lifestyle center" with offices, high-end restaurants, luxury apartments, and movies theaters. Significantly expanding the commercial mix of the land and replacing the existing affordable homes with upscale housing would increase the total value of real estate to between \$79.8 million and \$131.1 million dollars. Real estate taxes would triple and income taxes would double. Redevelopment could boost city tax revenues from just \$638,694 to as much as \$1,657,733.

In razing the affordable housing and the small businesses that serve that neighborhood (generally convenience stores, fast food, and discount establishments), the city of Lakewood sought to fundamentally change the character of the neighborhood, shifting it from an affordable residential neighborhood to an upscale commercial mixed-use area.

In the end, the West End was saved at the ballot box. Grassroots opposition rose to ward off local politicians and planners despite heavy financial and political support from Lakewood's political and business establishment. Unfortunately, a political solution is as permanent as the next election cycle, and no judicial precedent was set in Ohio. The majority decision in *Kelo* makes it clear, however, that Lakewood's efforts to oust its residents from the growing West End would be legal and legally legitimate.

### **Is There an Alternative?**

Eminent domain destabilizes the investment climate for everyone except those negotiating directly with the city for a piece of the development project. Even in these cases, investors cannot be certain their investments and property are safe. If the neighborhood or commercial area continues to decline, or fails to achieve the investment objectives established by the redevelopment plan, their property rights will be at risk as well. In fact, based on the conventional wisdom in the economic development community, cities would be obligated to reinitiate the redevelopment process, putting each property at risk again. Few people will invest in homes or small businesses if they are unsure if they will be in the home or neighborhood for long. Yet, this is the climate the broad-based use of eminent domain for redevelopment purposes creates.

Cities increasingly think of redevelopment as large-scale, comprehensive projects. An incremental approach to redevelopment is discouraged even when a project's timetable for completion (build out) may be 10 or 15 years.

An alternate approach is to look for more incremental and property-rights-friendly approaches to redevelopment. Dozens of less draconian tools exist, however, including:



- Upgrading roads, sewers, public transit and other infrastructure;
- Implementing zoning regulations that restrict land uses to certain types and densities;
- Employing tax rates, tax abatements, and tax incentives to promote certain types of development;
- Reforming zoning codes to allow faster and streamlined project approvals;
- Incentive zoning to encourage private-sector development of specific types of projects;
- Landscaping and streetscaping;
- Offering loans, grants, and direct subsidies to developers and builders; and/or
- Voluntarily purchasing land.

Citizens and local policymakers must take a fresh look at how the economy repositions itself in an information-driven, globally competitive world market and what, if anything, public policy can do to influence these shifts. The following key observations and principles may help redefine how public officials approach redevelopment in urban areas.

- **Focus on the Achievable.** Vision is not enough. A practical key to successful economic development policy is the ability of local leaders to be realistic in their expectations and in the programs they create to achieve them.
- **Provide Core Services Efficiently for Long-Term Success.** Government investment does not create long-term job growth. Certain types of investments, such as road and sewer infrastructure, help lay a broad-based foundation for private investment.
- **Create Sustainable Economies Through Private Investment.** The vast majority of jobs come from local small businesses starting up, expanding and diversifying over time. These are the businesses hurt the most by eminent domain proceedings and large-scale redevelopment plans catering to the wants of large developers.
- **Lead with Focus, Drive and Simplicity.** A more effective strategy has been for local leaders to identify two or three key areas and goals, and then develop a timed, phased action plan to achieve them. The results are easier to measure, and implementation is clearly and more likely to succeed.
- **Respect the Rights of All Citizens.** Government should focus on providing core services that serve the broad-based citizenry and avoid the trap of believing the biggest or wealthiest citizen has more rights or more to offer than the hundreds of homeowners and businessmen that make up the city's foundation.
- **Encourage Voluntary Investment and Redevelopment.** Cities should work with developers to accommodate property rights protections to create a business climate more supportive of property rights, greater investment certainty, and a more cohesive community. Most redevelopment projects are implemented in phases, and few projects depend on all properties being acquired in order for them to be successful.
- **Evaluate the Process Rigorously.** A more rigorous definition of "blight" or "deteriorating" would provide guidance regarding which neighborhoods do in fact degrade community welfare. Public officials should also be required to consider the feasibility of accomplishing the project's goals by less aggressive means.





## Commentary: Making Way for the Government Bulldozer

You may think your home is your castle, but the Supreme Court decided it isn't. It's just on loan from your friendly local government who can bulldoze it anytime it wants as long as a majority agrees, they held the right number of public hearings, and they have a plan.

That's what any reasonable person reviewing the Court's decision in *Kelo v. New London* might think. Hundreds of local governments already do it. The Supreme Court just gave them the rubber stamp they needed.

*Kelo v. New London* involves a hardy band of home and business owners in the historic neighborhood of Fort Trumbell in New London, Connecticut. The city, acting through its redevelopment agency, condemned the homes and businesses to make way for professional office buildings, swanky retail shops, and luxury condos and apartments.

The city's "vision" for the neighborhood, local officials thought, would generate more tax revenue. The newer buildings, bigger tax base, and more tax revenue constituted a "public use" and the Supreme Court agreed.

Of course, eminent domain is not a new government power. It's been around for centuries and enshrined in the Fifth Amendment to the U.S. Constitution.

What's new is the brazenness in which governments use it. Eminent domain is supposed to help governments when they need to provide a "public use". In the past, public use was considered as something open to the public or something necessary but could be provided by the private sector. Building roads, canals, acquiring land for public buildings, or providing parks qualified.

In the mid-1980s, that changed with the Michigan Supreme Court allowed the city of Detroit to demolish a close-knit, working-class neighborhood called Poletown to make way for a factory. The city condemned the properties, bulldozed the homes, and handed the land over to General Motors to build its plant.

The Michigan Supreme Court reversed itself in 2004, but the damage was done. The decision unleashed a wave of condemnations like New London's that shoved long-time residents and businesses aside in the name of economic development.

"Promoting economic development is a traditional and long accepted function of government," Justice Stevens wrote in the majority opinion. Apparently, public use can now be interpreted as any function of government, and private property can be seized as long as the former owners are compensated.

Indeed, this is exactly what Justice Sandra Day O'Connor fears. In her stinging dissent, she validated the danger inherent in upholding the New London case: "The specter of condemnation hangs over all property. Nothing is to prevent the state from replacing any Motel 6 with a Ritz-Carleton, any home with a shopping mall, or any farm with a factory."



Sound extreme? Read the words of New London’s lead attorney during oral arguments on page 30, lines 3-9:

Justice Sandra Day O’Connor: For example, Motel 6, and the city thinks, well, if we had a Ritz-Carlton, we would have higher taxes. Now, is that okay?

New London’s Attorney: Yes, Your Honor. That would be okay.

At least he showed respect to Justice O’Connor.

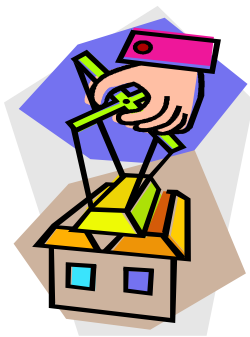
Sad as it may be, many people ignored eminent domain in the past because it seemed to apply mainly to the poor—removing so-called “urban blight.” The poor have always been at a disadvantage because they were renters or couldn’t afford attorneys to fight city hall. Now, eminent domain is removing the middle class. Only the rich may be safe from the government bulldozers.

Private property rights were once a hedge against government corruption and abuse. This protection was so essential the Founding Fathers explicitly limited its use to special circumstances—public uses and as long as “just compensation” was provided to homeowners.

Now, there appears to be little “right” left in private property rights. Columbia University law professor may be correct when he told the Associate Press “The message of the case to cities is yes, you can use eminent domain, but you better be careful and conduct hearings.”

As long as the city holds the requisite number of public hearings, and a majority of the city council agrees, private property no longer serves as a check against government abuse. The U.S. Supreme Court just told every city, county, and state government that. They even put it in writing.

## Affordable Housing



Housing has long been one of the staples of American society and the United States’ economic prowess has afforded its citizens an abundance of safe and decent housing. The national homeownership rate as of Q1, 2004 is 68.6 percent, according to the National Association of Realtors. But this success is tempered by the fact that some Americans are finding it increasingly difficult to afford housing in their communities. Housing prices are growing faster than incomes in some areas, in severe cases, pricing low-income buyers out of the market. The real estate boom of the last few years has caused housing prices to skyrocket, making it difficult for low- and middle-income families in many areas to purchase a home.

Unfortunately, most of the political remedies aimed at making housing more affordable to these families don’t consider the real world functioning of housing markets and wind up making the problem worse. “Affordable housing” is now in the lexicon of seemingly every state, city, and housing advocacy group.



Housing affordability is largely a function of income. One of the best available measures for determining affordability is the Housing Opportunity Index (HOI). This index simply states the percentage of homes sold in a given area that would have been affordable to a household with the area's median income. Affordability is defined as a house payment no greater than 28 percent of gross household income. Housing advocates have further defined affordability to include rental affordability (rent payment not exceeding 30 percent of household income). The nationwide HOI as of Q1, 2002 is 64.8 (the most recent data) implying that households earning the national median income can afford nearly two-thirds of all houses sold. HOIs in the 1990s hovered in the 50s and mostly 60s implying that there has been no dramatic shift in the last decade. However, aggregate HOI data do not tell the whole story. HOIs in selected markets are extremely low, particularly the West Coast and parts of the Northeast. Many of the California markets are below 30, for example. The data indicate that the perception of widespread housing unaffordability is largely exaggerated, but that selected markets are experiencing unacceptably wide gaps in housing prices and income.

#### Related Information

- *New Approaches to Affordable Housing* ([rppi.org/pu20.pdf](http://rppi.org/pu20.pdf))
- *Housing Supply and Affordability: Do Affordable Housing Mandates Work?* ([rppi.org/ps318.pdf](http://rppi.org/ps318.pdf))
- *Smart Growth in Action: Housing Capacity and Development in Ventura County* ([rppi.org/ps288.pdf](http://rppi.org/ps288.pdf))
- *Smart Growth and Housing Affordability: Evidence from Statewide Planning Laws* ([rppi.org/ps287.pdf](http://rppi.org/ps287.pdf))
- *Repairing the Ladder: Toward a New Housing Paradigm* ([rppi.org/ps207.pdf](http://rppi.org/ps207.pdf))

Housing policy is in dire need of a paradigm shift. “Affordable” has become the buzzword of choice as a euphemism for “subsidized.” Furthermore, the debate has centered on the housing unit as a measure of affordability, when in fact the hard construction cost of a housing unit is not necessarily an indication of its value. Given the shortcomings of current housing policy and the overall perspective of the housing issue, a new approach to housing policy is needed. Several options that address the concerns of both low-income renters and low-moderate renters and homebuyers include:

1. *Stop policies that reduce the supply of housing and drive up prices.* Land use controls are a significant contributor to high house prices, especially urban growth boundaries, growth moratoria, tangled and lengthy entitlement processes, and excessively high impact fees. Loosening such restrictions will increase “for sale” housing construction and the additional supply would almost certainly relieve some pricing pressures.
2. *Encourage the use of market innovations such as location-efficient mortgages.* Location-efficient mortgages (LEM) allow borrowers to increase their gross monthly income-to-mortgage payment ratio higher than the conventional loan standard of 28 percent (36 percent total debt). In order to qualify, the borrower must live in a location the lender deems efficient in terms of auto commuting. The

premise is that by lowering a household's automobile transportation costs, the family will have more money to allocate to their mortgage payment.

3. *Take advantage of non-profit efforts.* Community groups can help provide affordable housing in many ways. For example, local affiliates of Habitat for Humanity (HFH) have built 50,000 safe, affordable, decent homes for U. S. households alone. HFH builds simple, small homes and keeps them affordable by using community volunteers and the new owners themselves to build the house and offering qualified households interest-free mortgages.
4. *Focus on the people, not the housing.* Most state and local government plans to tackle affordable housing issues focus on how to build subsidized supplies of new housing. A better approach is to identify folks who need help affording housing and provide them assistance to buy or rent housing in the market. The concept of traditional HUD voucher programs like Section 8 is sound, though the execution has been problematic. Local governments, through cooperative agreements or through their Metropolitan Planning Organizations (MPOs) could offer flexible housing vouchers to earned-income tax credit qualified households tailored to local conditions. Vouchers could be offered on a sliding scale to those in need and could be used for rental or mortgage payments.
5. *Deal with civil service compensation issue directly.* In some communities the affordable housing dilemma hinges on local government workers like police officers and teachers being able to afford to live in the community. Creating subsidized housing for civil servants or teachers does not solve the problem. Instead, the problem is usually supply, discussed in point number 1 above, and that the local government organizations are not paying salaries commensurate with the cost of living in the community and should confront that problem directly.

### Empirical Research on Affordable Housing Mandates

Three Reason Foundation studies of affordable housing mandates (aka "inclusionary zoning," or "inclusionary housing") were conducted by Benjamin Powell and Edward Stringham of San José State University.

In the San Francisco area study titled *Housing Supply and Affordability: Do Affordable Housing Mandates Work?* ([rppi.org/ps318.pdf](http://rppi.org/ps318.pdf)) they found that few affordable units actually get built, totaling about 4 percent of the amount needed in the San Francisco Bay Area. The costs of the program are high, about \$45 million per jurisdiction. In addition, the costs of the program are borne, to some degree, by other homebuyers in the range of \$22,000 to \$44,000 per unit in a typical Bay Area city.

The second study titled *Do Affordable Housing Mandates Work? Evidence from Los Angeles County and Orange County* ([rppi.org/ps320.pdf](http://rppi.org/ps320.pdf)) focused on Los Angeles and Orange Counties in Southern California. Results indicated that the 13 Los Angeles and Orange County cities using inclusionary zoning produced only 6,379 affordable units, and that after passing an ordinance. The typical city produces less than eight affordable units per year. The cost of inclusionary zoning in the average jurisdiction is nearly \$300 million annually. In addition, inclusionary zoning increased the cost of market-rate homes in a typical city by \$33,000-\$66,000 per unit.

The third study, *Affordable Housing in Monterey County* ([rppi.org/ps323.pdf](http://rppi.org/ps323.pdf)) analyzed the affordable housing element of the Monterey County General Plan Update. The authors identified affordable housing contradictions in the original Monterey County General Plan Update, such as restricting the supply of residential land and imposing price controls on new development and how that will likely make housing less affordable in the county.

## Inclusionary Zoning

As housing prices rise around the nation, there is great pressure on state and local governments to “do something” about the housing affordability crisis. One of the most popular responses has been “inclusionary zoning” ordinances that mandate developers sell a certain percentage of the homes they build at below-market prices to make them affordable for people with lower incomes. A report in the mid-90s estimated that about 10 percent of cities over 100,000 in population had inclusionary zoning requirements, and many advocacy groups predict the trend will accelerate in this decade.

The way inclusionary zoning tries to tackle the affordable housing problem is by mandating that developers sell a certain percentage of new homes at a cut rate. But inclusionary zoning tends to lead to less housing and higher prices. If developers are required to sell some houses at prices below market rates, they will have to make up the difference by raising the prices of the other homes in the development. And if that does not work, they can simply shift development to other communities where there are no inclusionary zoning mandates. Either way you get higher prices or less housing.

More important, inclusionary zoning tries to make the wrong end of the housing market affordable. Affordable housing is not new homes, it is older homes. The housing market is akin to a ladder, a natural economic process [see *Repairing the Ladder: Towards a New Housing Paradigm.*]. Typically, people rent when they are young. As incomes rise and family situations change, people tend to move up the housing ladder. Maybe they first seek a better apartment, then a starter home, then a bigger home, etc. Along the way, they make trade-offs regarding a number of factors—location, home size, community amenities, school districts, pricing, discretionary spending, etc. Subsidizing rents or houses in all communities breaks the housing ladder because it allows households to avoid these tradeoffs. For example, a lower-income family may find that it can live in a less expensive city within the same metropolitan area, share a car or own an older one, rent or buy a smaller residence, or lower discretionary spending. Trying to force entry-level buyers into the new housing market turns the natural market on its head and ensures we won’t get the most efficient outcomes.

In some instances, “density bonuses,” or rewards given for constructing housing with a higher density, are granted to developers to make up for lost revenue, but there are problems with this approach to compensating developers for providing low-income housing. First, the initial allowable density was likely artificially restricted through zoning and the land purchase price may have a density bonus factored into the price. In this way, density bonuses try to solve a problem created by regulation with more or “counter”-regulation. Second, the developer may believe that the project is not suited to higher density and therefore, chooses not to “capitalize” on the additional allowable density.

Empirical research published by Reason on the effects of inclusionary zoning in cities in California confirms that the hopes for inclusionary zoning are false. In most communities the number of affordable homes being built declines after inclusionary zoning is put into practice, and home prices go up.

# Air Transportation

## U.S. Airport Security



In May 2005, the Government Accountability Office (GAO) released classified and unclassified versions of an assessment of the performance of airport passenger screeners. Although no numbers were included in the unclassified version, the overall conclusion was that screening performance today, after several years of operation by federal Transportation Security Administration screeners, was little or no better than the performance of minimum-wage private-contract screeners in place at the time of the 9/11 attacks.

Moreover, the performance of the new private screeners at the five pilot-program airports called for by Congress (San Francisco, Kansas City, Rochester, Tupelo, and Jackson Hole) was better than that of TSA screeners.

These results raised concerns in Congress and the news media over the value gained by tripling the cost of airport screening by “federalizing” it. And they also suggested that, to the extent that the new federal mandates remain in place, it might be more cost-effective to phase out TSA as the operator of screening in favor of a performance-contracting approach. Just such a change has been advocated by Rep. John Mica (R, FL), chairman of the House Aviation Subcommittee.

Under current law, all airports have been permitted, since November 2004, to opt out of TSA-provided screening, making use of a TSA-certified contractor instead. As of May 2005, however, only two small airports had applied to do so. This is in part because of continued airport concerns over liability if TSA is not the provider. But it also reflects on the centralized nature of the TSA’s opt-out program. If an airport decides to opt out, it is not allowed to seek bids from a set of TSA-certified contractors, hire the most responsive one, and then integrate its operations into the overall airport security program. Instead, it must apply to TSA, and TSA assigns it a contractor, hired by and supervised by TSA. Thus, most airport directors see little value in such a minor change.

During 2004, the TSA began a five-airport pilot test of a Registered Traveler program, under which frequent flyers can volunteer to become pre-cleared and receive a biometrically encoded ID card. When they arrive at the passenger checkpoint, the idea is that they will proceed through a special lane, for expedited processing, after verifying their identity by showing that their physical feature (fingerprint, iris scan) matches that encoded on the card. By year-end, about 10,000 people were taking part in the program at the five airports. And it appears that instead of expanding the program itself, TSA is willing to accept proposals from private firms, working with airports and airlines, to offer such programs as a feature for frequent flyers. A New York-based company, Verified Identity Pass, Inc., is developing such a service, to be launched at Orlando International Airport in the first half of 2005.

## U.S. Air Traffic Control

### Outsourcing Flight Service Stations



In early 2005 the Federal Aviation Administration announced the winner in the largest non-military outsourcing competition to date. It involves 58 Automated Flight Service Stations (AFSS) around the country, which provide flight-plan and weather-briefing services to private pilots. This technology used at these facilities is obsolete, they are very labor-intensive (most such services can easily be provided on-line, rather than by voice over the phone), and there is no particular reason why there are 58 such stations scattered about the country. Moreover, the cost of the program was in excess of \$500 million per year. And since the fuel tax revenue from private pilots amounts to a small fraction of that sum, the credibility of the idea that private planes were “paying their way” was increasingly at risk.

There was a lively competition for the contract to take over, modernize, and operate the AFSS program, held under the standard federal A-76 outsourcing rules. One team consisted of the current employees and Harris Corporation—the so-called “Most Efficient Organization” approach (internal restructuring in the face of real competition). The others were all aerospace contractors. The winning bid, announced by the FAA in January 2005, came from Lockheed Martin. By consolidating the program into 20 facilities instead of 58 and equipping them with state-of-the-art equipment to maximize on-line services, Lockheed Martin was able to bid \$1.9 billion over 10 years (an average of \$190 million per year, versus more than \$500 million today). There will be no more “walk-in” briefings for pilots, but only 2 percent of pilots got their briefings that way in any case. The principal private pilot group, Aircraft Owners & Pilots Association, supported the competition from day one, and cheered the results in its publications and on its Web site.

As for the 2,500 existing staff, Lockheed Martin expects to downsize with minimal layoffs. First, it will offer all the positions in the consolidated facilities to current employees. Second, it will take advantage of the fact that about half the staff will become eligible to retire over the next several years, as the consolidation takes place (by March 2007). Third, the FAA is encouraging those who are qualified to apply to become air traffic controllers (where thousands need to be hired over the next decade to replace upcoming retirees). And the FAA is also encouraging transfers to other vacancies within its Air Traffic Organization.

In March the MEO team filed a protest of the award, claiming that it should have been judged the winner of the competition. At press time, that issue had not yet been resolved.

### FAA Funding Crisis

Early in 2005, FAA leaders began giving briefings on the emerging funding crisis facing the agency, two-thirds of whose budget and staff is devoted to operating the nation’s air traffic control (ATC) system. The largest FAA funding source is the 7.5 percent tax on the value of airline tickets. Over the past five years, increased competition from low-cost carriers (LCCs) has pushed air fares downwards, such that the ticket



tax is producing far less revenue than had been projected by the FAA in each of the previous five years. But at the same time, the agency's budget has increased from \$9.8 billion in FY1999 to \$13.9 billion in FY2004. Both Transportation Secretary Norm Mineta and FAA Administrator Marion Blakey have begun calling for a new FAA funding system, one more directly related to the cost of providing ATC services.

Reason Foundation released a report in May 2005 calling for a replacement of the current user-tax regime with a system of direct payments by ATC customers to the ATC provider, "Resolving the Crisis in Air Traffic Control Funding." It pointed out that the United States is the last developed country in the world that funds ATC via taxes rather than direct user fees. And it summarized a whole set of advantages of creating a customer-provider relationship between the Air Traffic Organization and its aviation customers—in contrast to the status quo, in which the ATO must satisfy Congress, from which its money comes. Part of the proposal is a new governance mechanism, consisting of a board of directors with the power to hire and fire ATO management, set the operating budget, and determine the capital budget. This board would directly represent key aviation groups.

Many of the concerns about the ATC budgetary problems were echoed a week later in a report from the FAA's Management Advisory Council. It decried the recent cutbacks in capital investment (modernization), just when flight activity is reaching new highs that suggest a return to serious congestion and delays. It called for serious consolidation of ATC facilities, taking advantage of modern telecommunications technology to provide the same service at less cost. It called for outsourcing the remaining 71 non-radar towers, based on the track record of 226 that are operated by contractors at less than half the cost of equivalent FAA-run towers. And it called for the FAA to regain control of its workforce, via negotiating a much more productivity-oriented contract with the controllers union in 2005.

The current aviation taxes expire in FY2007, so Congress has about 18 months to consider alternatives.

## Overseas Air Traffic Control Reform



Since the wave of reform began in 1987 with the corporatization of Airways New Zealand, a total of 40 air traffic control systems have been converted from a department of government to a commercial entity. The key features are (1) having a corporate form of organization (with a CEO and a real board of directors), (2) being self-supporting from fees paid by users for its services (and hence outside the government budget process), and (3) being regulated for safety, at arms length, by the government. Most of these air navigation service providers (ANSPs) are government corporations. The two notable exceptions are NATS in the United Kingdom (which is owned 49 percent by the government, 46 percent by airlines and airports, and 5 percent by its employees) and

Nav Canada, which is a non-profit corporation with a largely stakeholder board of directors. Countries with ATC provided in this way include Australia and New Zealand, Thailand, India, South Africa, Turkey, and in Europe: Austria, Belgium, Czech Republic, Denmark, Germany, Hungary, Ireland, Italy, Netherlands, Norway, Portugal, Slovakia, Spain, Sweden, and Switzerland. These ANSPs all belong to an organization called the *Commercial Air Navigation Services Organization*.



The GAO produced an interim report on the performance of some of the larger ANSPs, at the request of members of Congress. It's called "*Air Traffic Control: Preliminary Observations on Commercialized Air Navigation Services Providers*." As part of an ongoing project on the subject, a GAO team visited and obtained data on the ANSPs of Australia, Canada, Germany, New Zealand, and the United Kingdom. As they reported to the House Aviation Subcommittee in April 2005, all five have maintained safety, controlled costs, and improved efficiency. All five have invested in new technologies that reduced costs by increasing the productivity of controllers and reducing delays, which generally resulted in lower fees for major airlines.

There is no current support for privatizing the U.S. ANSP (the Air Traffic Organization). But making it operate more commercially—by giving it a governing board of directors representing its customers, making it self-supporting from fees paid by its customers (thereby getting it out of the federal budget process), and increasing its arms-length separation from FAA's regulatory branch—could go a long way toward producing the kind of improved performance we're seeing overseas.

## U.S. Airport Privatization



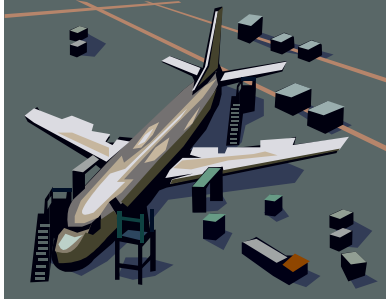
The first (and thus far still the only) airport privatized under a 1996 law authorizing a five-airport pilot test of airport privatization is Stewart Airport in Newburgh, New York. That airport received FAA approval in April 2000 of its 99-year lease to a British company, National Express. Hence, April 2005 was the fifth anniversary of its operation in private hands. The airport has managed to attract several new tenants providing aviation services. And its passenger count increased by 33 percent in 2004, topping the growth rate of all other U.S. airports. Still, at 526,745, that number was far below the airport's 1996 peak of 800,000. National Express has also helped to pay for a new access road to I-84, though construction has been held up by environmental litigation.

At one point, applications had been submitted to the FAA for the other four "slots" in the pilot program, but three were subsequently withdrawn for various reasons. The only one that remains in play is for the New Orleans Lakefront Airport, a large general aviation field. The district that owns it held a competition and selected American Airports Corp. for a long-term lease back in 2002. But the application is still pending at the FAA, awaiting resolution of an issue dealing with federal grants to the airport.

The real action in U.S. airport privatization is in Illinois, where proponents of private development of the long-discussed third Chicago airport continue to make headway. In 2004, the South Suburban Airport Commission held a competition and selected a team led by LCOR and SNC-Lavalin to finance, design, build, and operate what is now called Abraham Lincoln National Airport. The Illinois DOT is buying land at the preferred site in Peotone, 40 miles south of downtown Chicago. The basic model is a public-private partnership, with government owning the land and the private entity owning and operating the facilities. The \$200 million phase 1 project involves a single runway and a five-gate terminal building that will be readily expandable to 12 gates as traffic develops. In April 2005 the state submitted its plan to the FAA, which by law must do a detailed review, expected to take about 18 months. The project has the support of a coalition of suburban officials and is being championed in Congress by Rep. Jesse Jackson, Jr. (D, IL).



## Global Airport Privatization



By contrast with the minimal U.S. privatization activity, airport privatization continues to be the predominant trend worldwide. More than 100 large and medium-size airports are either owned outright by investors or are being managed under long-term lease or franchise agreements in countries such as Great Britain, Germany, Italy, South Africa, Argentina, Chile, Colombia, Mexico, Australia, and New Zealand. More privatization decisions were made in 2004 and early 2005, and a number of transactions were completed.

### Europe

The prevailing model for airport privatization in Europe is outright sale, as pioneered by the Thatcher government in the United Kingdom with its historic initial public offering of 100 percent of the shares in the former British Airports Authority in 1987. BAA, plc has become one of the large global players in the airport business.

The largest recent sale was of a 70 percent stake in the Brussels International Airport, in late 2004. The winning bidder was Macquarie, already the world's second-biggest airport owner (with stakes in the airports of Birmingham and Bristol in England and Rome's main airport, in addition to airports in Australia). Macquarie's winning bid was \$950 million. The Belgian government, which retains 30 percent ownership, will use the proceeds to pay down debt.

Nearby, one of the next to be privatized will likely be Amsterdam's Schiphol International, though in this case the government may keep a majority stake. It currently owns 75.8 percent, and announced in July 2004 that it would sell a minority stake to investors at a "financially opportune time." Schiphol Group is already corporatized, and owns a portion of Australia's Brisbane airport and Terminal 4 at JFK International in New York.

Two other major airport corporations are to be privatized within the next year. The first is Aeroports de Paris, which owns the two major Paris airports and a number of smaller airfields. ADP has recently been transformed into a public limited company, and a minority stake may be sold before the end of 2005. Greece has also decided to sell the 55 percent of Athens International Airport it owns, via a public share offering in 2005. The developer/operator of the new airport, Germany's Hochtief group, owns 39.8 percent, with the balance owned by two other companies. Greece expects proceeds of about \$2 billion from the share offering.

In Germany, Frankfurt and several airports have been investor-owned for several years, but the second-largest airport, Munich, has remained in government hands. But that appears to be changing, as the German government and the city government (which together own 49 percent) have expressed interest in selling. But thus far the state government of Bavaria, with 51 percent, has been cool to the idea. *Dow Jones Newspapers* reported in March 2005 that Munich officials plan to raise the issue with the state government in 2006. On a much smaller scale, New Zealand utility corporation Infratil has announced a deal to buy 90 percent of



Lubeck Airport, near Hamburg. Infratil owns Glasgow Prestwick Airport in Scotland and two-thirds of the Wellington, NZ airport. Infratil has agreed to a deal with leading European low-fare airline, Ryanair, to bring major new service to the airport.

Also on Europe's airport privatization agenda for 2005 is the Budapest Airport in Hungary. The government plans to sell 75 percent of the airport to a strategic investor who would develop it into a regional hub. Both BAA and the privatized Copenhagen airport have announced plans to bid. The Copenhagen airport in April 2005 was selected to modernize and operate Bulgaria's two Black Sea airports, via a 35-year concession agreement.

Airport privatization is even an issue in Moscow. In 1998 the city's second airport, Domodedovo, was leased for 75 years to East Line Group. Thanks to greatly improved facilities, it has grown rapidly and has become the airport of choice for many international carriers, even though Sheremetyevo Airport is considered the main international airport. The contrast has led to high-level calls to privatize the latter, or at least to outsource its management. But those plans were put on hold in February 2005 when a court ruled the lease of Domodedovo illegal. East Line continues to operate that airport while the decision is on appeal.

## Asia

Announcements were made in 2004 that major airport privatizations would be taking place in Hong Kong, Tokyo, and India within the next year or two. As of spring 2005, however, none of those has yet taken place. Tokyo's Narita International Airport was corporatized on schedule, in 2003. But under the government's plan, it will not issue shares to the public until 2007. Hong Kong's Airport Authority will issue shares in either 2005 or 2006. But it is already acting more like a commercial company. In April 2005 it purchased 30 percent of China's 10<sup>th</sup>-largest airport, Hangzhou, for \$120 million.

In India, the privatization law passed in 2003 called for the sale of Mumbai (Bombay) and New Delhi Airports, and the new congress government elected in 2004 reaffirmed those plans. It accepted preliminary proposals in July 2004, promising to define a short-list by the following February. It failed to meet that deadline, but on March 31, 2005 announced that nine of the 10 bidders had made the "short" list and would have 12 weeks to submit technical and financial bids. The government will sell 49 percent of each airport to a global company, and 25 percent to a domestic financial partner, with the Airports Authority of India retaining the balance. Bidders include Germany's Fraport and Singapore's Changi Airport.

The final stages of a privatization gone awry are being played out in the Philippines. The government some years ago entered into a long-term build-operate-transfer concession with Fraport and local partners to finance, build, and operate a new Terminal 3 at the international airport in Manila. The terminal was completed in October 2002 but has stood empty since then due to a bitter contractual dispute between the government and the private team. Although the dispute is in arbitration with the World Bank and on appeal to the International Commercial Court in Singapore, the government expropriated the terminal in December 2004, and in March 2005 announced that it was up for sale. It says it will use the proceeds to compensate the private contractors.

## Latin America

Mexico is in the process of completing its privatization of its major airports. The first step, in the late 1990s, was to sell 15 percent stakes in three regional groups of airports to experienced global operators. The second step was to sell the balance via public share offerings. One such sale took place in 2000 for ASUR, the southern group that includes Cancun. But the government retained 11 percent of ASUR until early 2005, when that final stake was sold for \$100 million. Public offerings for the other two groups were delayed by the airline recession following 9/11. But they are resuming this year. The remaining 85 percent of GAP (which operates Pacific airports including Guadalajara) will be sold in summer 2005; it's expected to bring in \$800 million. Thereafter, the remaining 85 percent of Centro Norte (which includes Monterey) will be sold around the end of 2005.

Peru is using the long-term concession approach for a major modernization of Jorge Chavez International Airport serving Lima. The 30-year concession, held by Bechtel, Changi Airport, and Fraport, will invest \$1.2 billion in runways, terminals, and security over the life of the agreement. A new \$148 million terminal was opened in January 2005, three months ahead of schedule. However, the association of international airlines serving Lima has demanded that the government review the airport's charges, which they say are much higher than at comparable airports like Buenos Aires or Miami.

Ecuador is also using the concession model, in this case to develop a completely new international airport for Quito. The Quiport consortium includes a large Brazilian contractor, Toronto-based Aecon Group and Airport Development Corp., and Houston Airport System Development Corp. They are developing the \$535 million airport under a 35-year concession. Separately, the government is seeking bids for a concession to build a 24 km. toll road linking the new airport to downtown Quito.

Argentina was the first South American country to privatize its airports, awarding a long-term concession in 2000 to Aeropuertos Argentina 2000, an international consortium. AA2000 took over the operation of 33 airports, including the two in Buenos Aires. There have been ups and downs in the subsequent four years, and most recently the government has called for changing the ownership structure of the concession. Under its proposal, AA2000 would retain 51 percent, with 29 percent offered via the stock market and the government acquiring 20 percent.



# Surface Transportation

## State PPP Laws

Thanks in part to continued fiscal pressures and in part to encouragement from the federal Department of Transportation, more state legislatures took action on public-private partnership laws during the past year.

The only completely new law was enacted in Washington State. HB 1541 is the Transportation Innovative Partnerships Act. This legislation repeals the 1995 law under which a number of franchises were issued but the projects were not built due to later amendments to the law that made it unattractive to the private sector. The new law provides for both solicited and unsolicited proposals, as well as a mix of public and private capital (as in Texas and Virginia). The Washington legislature also enacted SB 6091, which allocated \$1.5 million for a comprehensive tolling study, as called for by HB 1541.

Considerable interest has followed the progress of a bill to enable tolling and public-private partnerships in California, AB 850. The bill was introduced in February 2005, with bipartisan support and the backing of Gov. Arnold Schwarzenegger (as part of his Go California transportation package). At press time, the bill had cleared the transportation committees in both houses. The Senate committee version removed a 35-year limit on the length of franchise agreements, thereby permitting the longer terms that can lead to significant equity investments in projects. California currently has no enabling legislation for tolls or highway PPPs, due to the repeal of the previous pilot program law, AB 680, at the end of 2002. The need for a replacement was highlighted in Reason Foundation's policy study 324, *Building for the Future: Easing California's Transportation Crisis with Tolls and Public-Private Partnerships* ([rppi.org/ps324.pdf](http://rppi.org/ps324.pdf)).

Several state legislatures enacted revisions to existing highway PPP laws. In Georgia, SB 270 newly allows the state to issue RFPs for such projects, instead of only dealing with unsolicited proposals. In addition, in the case of the latter, it increases to 135 days (from 90 days) the time during which potential competitors can respond to an unsolicited proposal.

The Texas legislature took up revisions to its landmark HB 3588, enacted in 2003. The main point of contention has been the law's provision allowing the conversion of existing free lanes or highways to tolled operation as part of tolled and/or PPP projects. That prospect set off a huge political backlash in Austin, inspiring amendments in both houses of the legislature. The House version (HB 2702) at press time had passed both houses. It would require a popular vote for any such conversion from free to toll. The bill also limits toll franchises to 50 years.

The Virginia legislature enacted the first revisions in 10 years to that state's Public Private Transportation Act. The revised version clarifies the point that any "responsible public entity" may authorize PPTA projects, not just the Virginia DOT. And it permits both RFPs and unsolicited proposals to be used by such entities. In addition, if permitted by other federal and state laws, a private partner may toll existing free lanes under revised language that no longer requires expansion of capacity to accompany tolling.



Colorado also saw legislative action. The legislature passed two bills dealing with the proposed private Front Range Toll Road, which would parallel congested I-25 to the east of Denver International Airport. This project has been proposed under a 19<sup>th</sup> century Colorado law, still on the books, under which some 80 pre-auto-era private toll roads were developed. But under that law, county governments regulate the toll rates, and there are seven of them along the Front Range's planned route. HB 1342 would modernize the old law, including a shift to the state of control over toll rates. It passed both houses in May and Gov. Bill Owens has indicated he would sign it. He also said he would veto SB 230 which would have repealed the old law's utility-like powers to acquire right of way. (Most proposed PPP toll roads in Colorado are proceeding under the 1995 Public Private Initiatives legislation.)

In New York, Gov. George Pataki proposed legislation that would permit tolls and PPPs for both existing and new transportation infrastructure. It would apply to both state and New York City entities, would permit the sale or lease of existing projects, and provides for both RFPs and unsolicited proposals. As of mid-May 2005, the bill was being marked up in the Senate, and observers hoped that at least a pilot-project version would be enacted.

## **Sale/Lease of Existing Toll Roads**

An issue that had not previously been part of the U.S. transportation policy debate—the sale of existing toll roads—burst onto the scene at the end of 2004 when the city of Chicago announced that it had reached agreement with a global consortium to lease the Chicago Skyway for 99 years, for \$1.83 billion. The winning bid from the CINTRA/Macquarie team dwarfed the other two bids, both of which were less than \$1 billion. The lease will run for 99 years, and toll rate increases are limited to the rate of inflation. Chicago is using the proceeds largely to pay down debt and for one-time public-works improvements. Even before the Skyway funds flowed on January 24, 2005, officials in other states had begun to consider whether they might do likewise with respect to toll roads in their states.

Acting New Jersey Gov. Richard Codey in January called for looking into a similar transaction involving the New Jersey Turnpike and/or the Garden State Parkway. The state has a multi-billion-dollar budget shortfall, and the state's transportation trust fund's resources are nearly all committed to paying debt service on a series of bond issues. The two facilities generate about \$750 million a year in toll revenue, 17 times what the Skyway generates. Assembly Transportation Committee chairman John Wisniewski told local reporters that "It is something we should examine to understand whether it is something that can work for New Jersey." As noted above, the response of New York's Gov. George Pataki was to introduce legislation that would, among other things, permit the sale or lease of existing toll facilities such as the New York Thruway and the toll bridges and tunnels in New York City.

In the Midwest, newly elected Indiana Gov. Mitch Daniels had campaigned on a platform that included greater use of tolling to finance highway investments, so it was no surprise that on taking office in January 2005 he proposed looking into the privatization of the Indiana Toll Road. Daniels has said asset sales will be a key part of his fiscal reforms, and he also continues to see serious possibilities in using toll revenues to finance such new projects as the proposed extension of I-69 from Indianapolis to Evansville near the state's southern border and the expansion and modernization of US31 from Indianapolis north to South Bend.



Most recently, in April 2005 Delaware Secretary of Transportation Nathan Hayward proposed the possible privatization of the state's 51-mile Route 1, from I-95 south to Dover. With \$31 million per year in current toll revenues, DE 1 may not be that attractive a proposition on a stand-alone basis. Hence, this project may be combined with a \$500 million widening of US301 from Route 1 to the Maryland border. Delaware's legislature enacted a PPP law in 2003, under which it has received bids for a project to make improvements to I-95 (Delaware Turnpike).

## PPP Toll Road Projects

The idea that the private sector can play a larger and more meaningful role in addressing the nation's transportation funding needs, and better meeting highway users' needs, got a large boost when the U.S. Department of Transportation published its 164-page *Report to Congress on Public-Private Partnerships* in December 2004. It provides a good overview of the types of PPPs applicable to surface transportation, ranging from outsourced highway maintenance to long-term build-operate-transfer (BOT) concession agreements. It includes profiles of 21 such projects from around the country. The report is available in hard copy and also on the Web ([fhwa.dot.gov/reports/pppdec2004](http://fhwa.dot.gov/reports/pppdec2004)).

### Texas

The biggest single proposed PPP to date was announced in December 2004 when TxDOT announced the winning bidder for TTC-35, the first major project of the Trans-Texas Corridor. A team of CINTRA and Zachry Construction proposed a \$7.2 billion project, all privately financed, for the new corridor from north of Dallas to south of San Antonio, parallel to congested I-35. An estimated \$6 billion of that total would fund construction of the all-new four-lane toll road; the other \$1.2 billion would be a franchise fee, paid out in installments during the construction period, in exchange for the right to toll the project for 50 years. TxDOT has suggested that it may use that sum to complete TTC-35 on the north to the Oklahoma border and on the south to the Mexican border. In March 2005 TxDOT and CINTRA/Zachry signed a one-year comprehensive development agreement (as PPPs are known in Texas) to develop a master plan for the project.

Texas is also the site of another large proposal, this one unsolicited. A team headed by Kiewit proposed to add tolled managed lanes to the median of the Airport Freeway in Dallas (SH 183 and I-820), a length of 27 miles. The project has an estimated cost of \$650 million. The Perot Group has separately proposed adding tolled express lanes on 20 miles of I-35W in downtown Ft. Worth. Also in the DFW Metroplex, the North Central Texas Council of Governments has received a federal Value Pricing Pilot Program grant to plan for and design tolled managed lanes on I-30, another major east-west freeway. The new lanes would extend from Dallas to Arlington.

Yet another unsolicited proposal was submitted in January 2005 by Skanska, for the proposed extension of SH 121 from north of the DFW Airport to US75. The Texas Transportation Commission, acting under the terms of HB 3588, asked for competing proposals, to be due by June.

## Virginia

The largest proposed PPP project in this state calls for truck-only toll lanes to be added to the entire 325-mile length of I-81, a major truck route across the state. The project resulted from an unsolicited proposal submitted several years ago by STAR Solutions, a multi-company consortium. Virginia applied for and received preliminary approval to take part in a federal pilot program (under TEA-21) to rebuild selected Interstate highways using toll revenue financing. But the \$7 billion project is bitterly opposed by the trucking industry, whose studies project significant diversions of trucks onto other highways if the plan for mandatory truck use of the toll lanes goes through. As of mid-2005, the overall reconstruction of I-81 is still in the environmental review process. The final form that tolling might take is not yet decided.

The northern Virginia suburbs of Washington, D.C. are the location of not one but two private-sector HOT lane projects. The first, proposed by Fluor several years ago, received VDOT approval in April 2005, pending final environmental clearance expected early in 2006. It would add four HOT lanes to the median of the Beltway (I-495) from I-95 on the south to the Dulles Toll Road on the north. Fluor has added Australian firm Transurban to its team as both equity investor and toll-road operator. With an equity-plus-debt funding approach, the entire \$900 million project is expected to be supportable with private capital, meeting VDOT's desire for additional ramps without requiring VDOT funds. Instead of an all-debt, 30-year nonprofit corporation approach (which would require about 15 percent public funding), the new approach of debt plus equity would require a 50-60-year franchise term, to enable the equity provider to earn a return on its investment.

The second DC-suburbs HOT lanes project still has two competing proposals—from Fluor and from Clark/Shirley—in the running. Both would convert the existing HOV lanes on I-95 south of the Beltway to HOT lanes, and would extend those lanes further south. Fluor's would also convert the HOV lanes on the Shirley Highway (I-395) to HOT lanes, all the way to the Potomac River. Preliminary numbers suggest that these projects could also be self-supporting from value-priced toll revenues. Virginia also has competing private-sector proposals pending for an ambitious project to create a third river crossing in the Hampton Roads area.

Virginia's first modern-day private toll road, the Dulles Greenway, is looking healthier than ever. Though plagued by low traffic in the first few years after it opened (which pushed the toll road into a financial restructuring), the road now faces some degree of congestion, thanks to booming development in Loudoun County. In February 2005, after winning approval of a toll rate increase, the company issued new toll revenue bonds to pay for a \$72 million expansion, to widen the entire 14 miles from two lanes to three lanes. The expansion will also provide a direct connector ramp to Dulles Airport.

## Georgia

Under its 2003 PPP law, Georgia has received three unsolicited proposals thus far. The first, early in 2004, was from the Parkway Group, headed by Washington Group International (WGI). The \$800 million project would add a third lane each way to SR 316, from Athens to Atlanta, paid for by turning the entire highway into a toll road. That conversion feature sparked considerable opposition, and in January 2005, the Georgia Transportation Board put the process on hold, until WGI and GDOT have time to assess the impact of the state's revised PPP law.



In November 2004, a second unsolicited proposal was submitted, this time by a team led by Bechtel and Kiewit. The \$1.2 billion project would add express toll/bus rapid transit lanes to I-75 and I-575 in the Northwest Corridor. Toll revenues would finance about \$500 million of the cost (about 42 percent). Adding truck-only toll lanes would increase the cost to \$1.8 billion, but thanks to higher commercial tolls, the fraction of the cost met by tolls would increase to 67 percent.

And in December 2004, WGI submitted a \$2.8 billion proposal to widen GA 400 and I-285. All of 31 miles of GA 400 would become a toll road (the four miles inside the I-285 perimeter already is tolled). The WGI team would add elevated HOT lanes along 13 miles of I-285. Overall, toll revenues would fund an estimated 80 percent of project costs.

## California

A new private-sector proposal emerged in California in April 2005. Macquarie Group proposed to rescue the troubled San Joaquin Hills (SR 73) toll road from possible default, by leasing it for something like 50 years. The company would refinance the road and take on the risk of paying off the debt from toll revenues over the 50-year period, relieving the public-sector Transportation Corridor Agency of that risk. Initial local reaction was mixed.

## Maryland

Although it does not have specific PPP enabling legislation on its books, the Maryland State Highway Administration (SHA) thinks it may be able to use this approach via the parent transportation authority. SHA continues to study the feasibility of adding express toll lanes (with no special HOV privileges) to the Washington and Baltimore Beltways, I-270, and I-95. In addition, they plan to develop the long-postponed InterCounty Connector as a value-priced toll road.

Table 9: HOT Lanes Recap, 2005						
Jurisdiction	In Operation	Under Construction	Approved	Proposed	Feasibility Study	In LR Plan
<b>Arizona</b>						
<i>Phoenix</i>					Network of HOT lanes	
<b>California</b>						
<i>Alameda Co.</i>			I-680			
<i>Los Angeles Co.</i>					I-710, SR 60, I-15	I-710, SR 60
<i>Marin Co.</i>					US 101	
<i>Orange Co.</i>	SR-91				SR-57	
<i>San Diego Co.</i>	I-15	I-15 expansion				I-5, I-805, SR-52
<i>Santa Clara Co.</i>					US 101, SR 87, SR 85	
<i>Sonoma Co.</i>					US 101	
<i>Bay Area region</i>						Network of HOT



**Table 9: HOT Lanes Recap, 2005**

Jurisdiction	In Operation	Under Construction	Approved	Proposed	Feasibility Study	In LR Plan
<b>Colorado</b>						
<i>Denver</i>		I-25N		I-70,C-470	Network of HOT lanes	
<b>Florida</b>						
<i>Miami</i>				I-95	I-95, SR-821, SR-836	SR-836
<i>Orlando</i>					I-4	
<i>Tampa</i>		SR-618				
<b>Georgia</b>						
<i>Atlanta</i>				GA-316, GA-400, I-75, I-285, I-575	HOT and TOT lanes	
<b>Maryland</b>						
<i>Baltimore</i>					I-95, I-695	
<i>DC suburbs</i>					I-495, I-270, US-50, ICC	
<b>Minnesota</b>						
<i>Mpls/St. Paul</i>	I-394				Network of HOT lanes	
<b>North Carolina</b>						
<i>Piedmont Triad</i>					I-40	
<i>Research Triangle</i>					I-40	
<b>Oregon</b>						
<i>Portland</i>					I-205, SR 212/224	
<b>Texas</b>						
<i>Dallas</i>			I-635	I-35W, I-820, I-30, SH 183	Network of HOT lanes	
<i>Houston</i>	I-10, US 290	I-10			Network of HOT lanes	
<i>San Antonio</i>					I-35, I-10, SH 160	
<b>Virginia</b>						
<i>Hampton Roads</i>					VPPP study	
<i>DC suburbs</i>				I-495, I-95, I-395	VPPP study	
<b>Washington</b>						
<i>Seattle</i>			Sr 167			

## HOT Lanes and ETLs

As of the start of 2005, four high occupancy toll (HOT) lanes were in operation in the United States: the 91 Express Lanes in Orange County, California, the SR 125 HOT lanes in San Diego, the reversible HOT lane on the Katy Freeway (I-10) in Houston, and a similar HOT lane on US290 in Houston. By the end of 2005, there will be two more in operation, in Denver and Minneapolis, both conversions of underutilized HOV lanes.



The latter project, on I-394, went “live” in May 2005, to generally positive user and media reaction. It is the first HOT lane project to use only a white stripe buffer for separation from the adjacent lanes (rather than plastic pylons or a concrete barrier). It is also the first to use dynamic pricing on a HOT lane with multiple access points. The Denver project, on I-25 North, is expected to begin operations before the end of 2005. It will be the first HOT lanes project to require all carpool users to register and acquire transponders. This is expected to ease enforcement difficulties.

Two more HOT lane projects have received permission to be implemented, both via legislation. In 2004 the California legislature approved a bill to let Alameda County implement a long-planned HOT lane on I-680’s Sunol Grade, a major commuter route between Silicon Valley and the East Bay. (The same bill also permits Santa Clara to consider HOT lanes and San Diego County to expand its I-15 HOT lanes.) And in early 2005, the Washington legislature approved WSDOT’s plan to convert the underutilized HOV lanes on SR 167 (between Renton and Auburn, paralleling congested I-5) to HOT lanes. This will be the pilot project for a potential network of HOT lanes in the Puget Sound region.

The Miami, Florida area is also the site of HOT/managed lanes activities. Both the Florida Turnpike Enterprise and the Miami-Dade Expressway Authority have done feasibility studies on adding value-priced express toll lanes to the medians of, respectively, the Homestead Extension of Florida’s Turnpike and the Dolphin Expressway. Meanwhile, under a federal Value Pricing grant, FDOT is doing an investment-grade traffic and revenue study of alternatives for converting the HOV lanes on congested I-95 into some form of HOT lanes. FDOT is also researching tolled express lanes for Orlando (I-4) and Fort Lauderdale (I-595).

Two large new HOT lanes projects are currently under construction. In Houston, the Katy Freeway (I-10) is being rebuilt in a \$1.2 billion project. As part of this, the existing single reversible HOT lane is being replaced by four HOT lanes, two in each direction, with variable pricing. The HOT lanes will be operated by the Harris County Toll Road Authority, which is providing \$250 million for their construction. And San Diego is under way on the first phase of expanding the existing I-15 managed lanes project from the current two lanes (reversible) extending eight miles to four lanes (two each direction, with a movable barrier) extending 20 miles.

Another major project involving HOT lanes is the reconstruction of the LBJ Freeway (I-635) in Dallas. This \$1.7 billion project will add HOT lanes for a considerable portion of its length. One several-mile section of HOT lanes will be in mined tunnels, beneath the freeway right of way. This project is currently in the design stage.

Large-scale studies of whole sets or networks of managed lanes are under way in several major metro areas. Atlanta’s HOT lanes study final report was released in April 2005. Among its conclusions was that to maximize revenue and minimize enforcement problems, a policy of permitting only super-high-occupancy (HOV-4+) vehicles to gain free passage would be best. Other comprehensive studies of possible networks of priced managed lanes have been completed in Minneapolis/St. Paul and the Denver area, as of early 2005. Each evaluated a number of corridors and several alternative basic network possibilities. The Twin Cities study estimated that toll revenues could cover an average of 22 percent of the capital costs of a \$3.5 billion system, while the Denver study, using somewhat different criteria, estimated 50-60 percent coverage of capital costs for a \$4.8 billion system.

Currently under way are other large-scale HOT network studies in both Dallas and Houston. And two metro areas have put networks of managed lanes into their long-range transportation plans. The Metropolitan Transportation Commission for the nine-county San Francisco Bay Area included consideration of a \$3 billion HOT Network in its year 2030 plan, adopted in February 2005. SANDAG, the metropolitan planning organization for San Diego, was the first to include a set (though not really a network) of managed lanes in its 2030 plan, adopted in 2003. And the task force on value pricing for transportation of the Metropolitan Washington (DC) Transportation Planning Board in 2004 developed a Proposed Regional Variably Priced Lanes network for 2030, along with a set of principles and goals for such a system.

## Federal Reauthorization of Surface Transportation

The current federal surface transportation program and the excise taxes (on fuel, tires, etc.) that support it expired September 30, 2003. But Congress failed to reauthorize the program in 2003 or 2004, debating and passing bills but not reconciling them. Hence, in January 2005 the new Congress began again, once again debating tolling and pricing issues.

As of late May 2005, both houses had passed their respective bills, and another extension of time, past the May 31 deadline, was in the works. The House bill (HR 3) would continue the current Value Pricing Pilot Program, but revert to its original name (Congestion Pricing) and limit the number of toll-charging projects to 25. (The current Value Pricing program provides for up to 15 “project partners” who can do any number of pricing projects.) It would retain the present pilot program for rebuilding up to three Interstate highways with tolls and adds another pilot program for building new Interstates with tolls. It would permit conversion of HOV lanes to HOT lanes without limit. But it would ban states from entering into non-compete agreements for toll facilities (which may be necessary in some form in order to finance the projects). It also fails to include an Administration-backed provision to permit private firms to issue tax-exempt toll revenue bonds on the same basis as government toll agencies.

The Senate bill (S.732) would replace the Value Pricing Pilot Program with a FAST lanes program with no limit on the number of projects, but would reduce to one state (Virginia) the pilot program for rebuilding Interstates with tolls. Like its House counterpart, it would permit conversion of HOV to HOT with no limit. It would permit states to add electronically tolled FAST lanes to Interstates without limit, but tolls could not be added to any currently free general-purpose lanes. It includes authorization for private companies to issue up to \$15 billion in tax-exempt toll revenue bonds over a 10-year period.

## Overseas Toll Road Developments

### North America

The hemisphere’s largest private toll project, Toronto’s Highway 407 ETR, won important court victories that uphold key provisions of its 99-year lease agreement with the province of Ontario. The current government challenged a routine 2004 toll increase as requiring its permission, but the lease agreement



clearly provides for toll increases to be done by a formula spelled out in some detail, as a matter of right. By early 2005, the government had lost both at arbitration and in court, but as of April 2005 was considering another appeal. The highway itself is showing signs of congestion, despite annual toll increases, and hence lane additions in some segments might be on the horizon. The right of way can accommodate 10 lanes, compared with the six currently in place.

Several new PPP transportation projects are under way in Canada. In British Columbia, a long-term concession approach is being used for the \$500 million Golden Ears toll bridge project across the Fraser River. Three private-sector teams have been short-listed to provide formal proposals. BC is using a design-build-finance-operate approach to modernize the (non-toll) Sea-to-Sky Highway in time for the 2010 Winter Olympics. The concession for the \$340 million project will run for 25 years, and the government will provide shadow toll payments over the life of the agreement. A similar approach is being used in Alberta for a \$400 million project to design, build, finance, and maintain an 11 km. section of the ring road around Edmonton. The term of this deal will be 30 years.

Mexico, which had numerous problems with a poorly designed PPP toll roads program in the 1990s, is trying again on what looks like a more realistic basis. Although the Transport and Communications Secretariat (SCT) is far behind its ambitious schedule of holding dozens of competitive procurements, the build-operate-transfer concessions it has awarded seem much better thought out than those of the previous program. The first-generation program sought to limit the private-sector role to as short a period of time as possible. Winners were often those who proposed the shortest concession term, sometimes as little as 10 or 15 years. Two results were that most of the competitions attracted construction firms that had no long-term interest in operating a toll road. And to recover construction costs in such a short time period, the firms set toll rates at such high levels that very few were willing to pay them.

The new Mexican toll concessions are for much longer terms, typically 30 years. And the financing includes significant equity investments by the winning consortia, which means the toll roads are much less vulnerable to going into default if early traffic is below projections. It also means the consortia have a real stake in the project's long-term success. Among the recent projects are a \$190 million toll tunnel under the Coatzacoalcos River in Veracruz (21 percent equity is being invested by the bidder), and a \$334 million 52 km. bypass of northern Mexico City (40 percent equity). Leading European firms such as Spain's Sacyr-Vallehermoso and Fomento de Construcciones y Contratas are among the players this time around.

## **Latin America**

Argentina, Brazil and Chile continue to be the leading practitioners of long-term concession-based toll roads in South America.

Brazil has by far the largest program, with over 9,000 km. of toll highways run by private operators, under 36 concession agreements. The largest firm, CCR (1,290 km., five concessions) made a stock offering in 2004, giving it funds to buy up concessions from other operators. Near year-end it did just that, buying the Via Oeste network in Sao Paulo state, bringing its size up to 1,452 km. It plans to invest \$226 million in upgrading that network. The Brazilian government in 2005 plans to offer a new round of concessions, representing another 2,500 km. and potential investment of up to \$3 billion.

Argentina has two concessioned toll road networks, both in the Buenos Aires metro area. One consists of radial commuter routes into the city (six concessions) and the other comprises longer-distance access routes to Buenos Aires (five concessions). All have been in financial difficulties due to Argentina's several years of devaluation and defaults on bonds. Most had contracts denominated in dollars, and their financing costs continued to be in dollar terms, while their toll revenues since 2002 have been in devalued pesos. Most are still negotiating large toll increases with the government and working on debt relief with their creditors.

Chile has used long-term toll concessions to upgrade much of its major north-south road (the Pan American highway). But recent attention has focused on the new urban tollway system, which began to open in early 2005. Developed by four separate concessionaires, the system uses an interoperable all-electronic toll system, with no tollbooths at all. It comprises 150 km of urban expressway, at a cost of about \$1.5 billion.

## Europe

Great Britain has only one true private toll road, the M6Toll, which opened late in 2003. Users save about 30 minutes by using it to bypass the congested M6 motorway in the Birmingham area. Thanks to its popularity, the Department for Transport is considering several other projects to be funded by tolls and developed under long-term concession agreements. One is a toll road parallel to M6 from Birmingham to Manchester, about 50 km. Another would be adding tolled lanes to the M25 ring road around London and the M1 arterial route in central England. DfT continues to talk about the possibility of shifting to direct road pricing for the entire highway system in about 10 years. Transport Secretary Alistair Darling has said that, based on recent studies, a national pricing scheme could cut congestion in half. The UK Road Users Alliance has responded cautiously, expressing willingness to support such a system if the funds would be invested in a better road system. The United Kingdom also has a number of DBFO highway projects, under which private firms design, build, finance, and operate various highways, but no tolls are charged. Instead, the government makes annual payments under a long-term concession agreement.

France, which pioneered the long-term concession model to develop its tolled motorway system, continues to make use of this method for additions to its system. Cofiroute continues construction on the \$2 billion tunnel beneath Versailles, to complete the missing link in the A-86 ring road around Paris. The world's highest bridge (and longest cable-stayed bridge)—the Viaduc de Millau—opened to traffic in late 2004. Developed under a 75-year concession by Compagnie Eiffage, the \$536 million project is financed solely via toll revenues. It completes a missing link in the A-75 toll road between Paris and the Mediterranean coast. In early 2005, infrastructure giant Vinci finalized a 65-year concession to develop and operate the \$800 million A-19 in central France.

Germany's long-delayed truck tolling project met the revised deadline for opening to traffic at the beginning of 2005. The Toll Collect consortium uses a GPS-based system to charge all heavy trucks using the autobahns (about 1.2 million vehicles). Early reports were that the system worked as expected, and initial revenues were as high as projected. Half the revenues are earmarked for highway improvements; the other half goes to railway and canal improvements. The government has begun the highway improvement program, using what it calls its "A Model" approach: privately financed and developed, but without tolls being charged; the government will provide payments ("shadow tolls") based on the traffic served. In March 2005 the Transport Ministry published information on the first five such projects, all 30-year



contracts to widen various motorways. It also plans a small number of “F Model” projects: stand-alone projects (such as bridges and tunnels) to be funded directly by tolls.

Greece has decided to privatize its entire national toll motorway system. The existing 1,425 km. of toll motorways will be parceled out among the winners of concessions to develop and operate 761 km. of new toll roads, to complete the national network. Annual toll revenues (E150 million) will thereby help to support the E7 billion cost of the new toll roads. The government and the EU will each provide E1 billion, with the private sector providing the E5 billion balance.

Spain continues to expand its toll motorway system. In spring 2005 the financing was completed for a \$798 million toll motorway between Madrid and Toledo, under a 36-year concession to a Spanish-Portuguese joint venture. Portugal’s government made a historic decision in 2004 to cease developing shadow-toll projects and, in fact, to convert the six shadow-toll motorways (590 miles) into tolled projects. It will cost the government an estimated \$1.5 billion in transition costs, but will save nearly a billion dollars a year in what it would have been paying out in shadow tolls later this decade.

Tolling and concessions are playing a role in developing modern motorway systems in Central and Eastern Europe, too. The Czech Republic is close to a decision on road tolling, given the huge increase in truck traffic, especially now that Austria, Germany, and Switzerland all charge tolls for trucks. Hungary has experienced significant political opposition to tolling on its M5 motorway, and a refinancing deal in 2004 changed the concession to shadow tolling instead. The new financing will permit the M5’s remaining 47 km. to be constructed. In early 2005, Hungary finalized a 22-year DBFO concession for the M6 motorway, under which the consortium will be paid annual “availability fees” for the non-tolled highway. Poland is still wrestling with the best way to develop modern motorways, with a shadow toll concession awarded to a Skanska-led consortium in late 2004 for the 118 km. A-1 motorway south of Gdansk. One recently opened toll road is suffering from significant truck diversions, causing political opposition. Bulgaria has awarded a 35-year concession to a Portuguese-led consortium for the 443 km. Trakia toll motorway, but the decision is being challenged in court.

Even Russia is moving in this direction. Early in 2005 the government gave the Federal Road Agency permission to proceed with a high-speed toll road between Moscow and St. Petersburg, a distance of 650 km. The financing and delivery model have yet to be specified, but a tender is expected in 2006, with construction to start in 2007. Other routes planned for toll roads include Moscow-Minsk-Berlin, a St. Petersburg ring road, and several smaller projects near Moscow.

### **The Middle East and Africa**

Israel is proceeding with the next phase of the TransIsrael Highway, an all-electronic toll road whose first phase opened in 2002. Developed under a 30-year concession agreement, the toll road uses the Raytheon electronic toll system developed for Toronto’s Highway 407 ETR. The final section is 18 km. in length and will cost \$130 million.

The only private toll roads in Africa are in South Africa, where this sector is thriving. The massive, 383 km. Bakwena Platinum toll road opened to traffic in 2004. It was developed under a 30-year concession by a consortium owned 50 percent by Spain’s Dragados and partners, 25 percent by South Africa Investment



Fund, and 25 percent by various South African businesses. The already completed N4 toll road saw a change of ownership in 2004. The concession company, TRAC, which built the 503 km. project, is now mostly owned by South African financial institutions, after France's Bouygues sold its 25 percent share. Another significant investor is the U.K. CDC Capital Partners.

## **Australia and Asia**

Over the past decade and a half, nearly all the new motorways in Sydney and Melbourne have been developed as toll roads by the private sector, operating under competitively awarded long-term concessions. This process continued in 2004 with the award of a \$3 billion toll road project in the suburbs of Melbourne. The Mitcham-Frankston Freeway was awarded to ConnectEast, a consortium of Macquarie Bank and two major construction firms. The 24-mile, six-lane expressway will include 17 interchanges, numerous bridges, and a mile-long tunnel. It will use the same fully electronic (no toll booths) toll system as the Melbourne CityLink. In early 2005 the Queensland government gave the okay for a \$775 million toll tunnel under the Brisbane River on a long-term concession basis. It is the first of five new river crossings in Brisbane. And in Sydney, the 1.3 mile, \$520 million Cross City Tunnel will open in June 2005 on-budget and four months ahead of schedule. Two other toll tunnel projects are in the planning and bidding stages in Sydney.

The Philippines cut the ribbon on the \$253 million modernization of the 84 km. North Luzon Expressway. The project was financed with commercial debt and equity, and to repay the investors, tolls were raised in February 2005 from the previous 0.25 pesos per km. to 2.5 pesos (\$0.046). Despite the tenfold increase, traffic was virtually unchanged at around 160,000 vehicles per day.

Malaysia is going forward with an innovative toll tunnel project. The 10 km., \$525 million project combines flood relief and congestion relief in a single, double-deck tunnel. When needed for flood relief, either the lower deck or both decks will be closed to traffic. Given the project's dual uses, the government provided \$340 million of the cost, with the private concession company providing the balance.

China is emerging as the champion tollster in Asia, if not the world. The government is creating the equivalent of the U.S. Interstate highway system, a \$150 billion National Trunk Highway System of 35,000 km, connecting the 100 largest cities. An increasing fraction of the system is being developed under concession models, with toll financing covering much of the cost.

India's previous government talked about plans for a 45,000 km. toll highway system in 2004, but little action has been visible since the new Congress Party government took over around mid-year. State governments also have highway responsibilities, and a number of them are planning to use tolls and concession models. Maharashtra already has a billion dollars worth of toll projects completed, and has invited bids for another \$1.5 billion worth. Overall, according to the head of Consolidated Toll Network Ltd., India has completed 3,470 km. of national toll roads and 800 km. of state toll roads.



# Rail Transportation

## Amtrak: Time to Abandon this Train Wreck



The Bush administration has sent a powerful signal to Amtrak in proposing virtually no government funding for the struggling passenger train operation for the coming fiscal year. Amtrak has been persistently plagued by cost overruns, project delays, poor on-time performance, maintenance problems, missed goals, poor management, and government bailouts—not to mention the fact that it has never posted a profit—since its inception in 1971. Congress must realize that, with the rise of relatively cheap transportation alternatives such as airlines, buses, and cars,

subsidized intercity passenger rail is no longer necessary or desirable. Privatization would allow those Amtrak assets that hold true value and promise to be operated more efficiently by private firms—which would be not be hampered by political directives that often conflict with sound management practices—and save the American taxpayer from wasting any more money on unprofitable and unnecessary operations.

The National Railroad Passenger Corporation, or Amtrak, was established by Congress through the Rail Passenger Service Act of 1970 and began operations on May 1, 1971. It currently serves more than 500 stations in 46 states and had a total ridership of over 25 million in fiscal year 2004.<sup>124</sup> Amtrak operates over more than 22,000 route miles, most of which is owned by freight railroads. It owns 650 route miles of its own, primarily in the Northeast Corridor route between Boston and Washington, D.C., and in Michigan.<sup>125</sup>

According to a February 2004 General Accounting Office (GAO) report, Amtrak was created “because existing railroads found such service [intercity passenger rail] to be unprofitable.”<sup>126</sup> Indeed, the 1970 bankruptcy of Penn Central—which was created by the merger of the Pennsylvania Railroad and the New York Central, the two largest railroads at the time—prompted lawmakers fearful of an industry-wide failure to ensure the future of intercity passenger rail.<sup>127</sup> However, the GAO report neglects to note that it was government regulation that was killing the railroad companies in the first place! The Interstate Commerce Commission strictly regulated railroad rate schedules and routes, among other things.<sup>128</sup> The inability of freight railroads to discontinue unprofitable intercity passenger routes and reduce freight rates to compete with truckers (who had become an increasing threat since the development of the Interstate Highway System) ultimately crippled the industry and led to bankruptcies such as Penn Central.

When Amtrak was created, Transportation Secretary John Volpe asserted that it “could be profitable within perhaps three years.”<sup>129</sup> In its 34-year existence, however, it has consumed \$29 billion in taxpayer dollars, and not once has it posted a profit.<sup>130</sup> Last year’s cash loss exceeded \$600 million.<sup>131</sup> In addition, despite the fact that it is currently \$4 billion in debt, Amtrak is requesting an increase in federal subsidies of *more than 50 percent* over last year’s allotment, from \$1.2 billion to \$1.82 billion.<sup>132</sup> The \$1.2 billion subsidy for the current fiscal year represents approximately one-third of Amtrak’s total budget.<sup>133</sup>



Numerous reform efforts have been made over the years, but to no avail. According to a Congressional Budget Office (CBO) report, “By 1978, the Congress had apparently given up on the notion that Amtrak could become profitable and free of federal subsidies.”<sup>134</sup> The Amtrak Improvement Act of 1978 sought to improve customer service and set a goal for Amtrak to provide service between Boston and New York City in 3 hours and 40 minutes and between New York City and Washington, D.C., in 2 hours and 40 minutes. These goals would not be “substantially achieved” for about two decades.<sup>135</sup> The Amtrak Reorganization Act of 1979 sought to reform the organization by allowing it to generate greater revenues and improve on-time performance while establishing a reduced-fare program for the elderly and handicapped. Thus, it directed Amtrak “to act like both a business and a public-service agency.”<sup>136</sup> These dual—and oftentimes conflicting—roles would serve as the policy throughout the 1980s and most of the 1990s.

In 1997, the Amtrak Reform and Accountability Act loosened restrictions on business decisions (of which Amtrak failed to take advantage) and authorized appropriations of approximately \$5.2 billion between 1998 and 2002, in addition to about \$2 billion in funds available from the Taxpayer Relief Act of 1997<sup>137</sup> (an ironic bill title, it would seem). This money was to be used to make the investments necessary to get Amtrak on solid financial footing once and for all and end its dependence on federal subsidies. The legislation also created the Amtrak Reform Council (ARC) to oversee Amtrak, and required Amtrak to submit a liquidation plan to Congress if the ARC determined that it would not be able to achieve self-sufficiency by December 2002.

On November 9, 2001, the ARC found that “Amtrak is no closer to self-sufficiency today than it was in 1997.”<sup>138</sup> ARC Chairman Gilbert E. Carmichael had few kind words to say about Amtrak. Among his findings:

- “Sadly, Amtrak has proven that it cannot concentrate on its core mission of running trains and running them well.”
- “[Amtrak] has too much to do, and does little of it well.”
- “The chronic difficulties that Amtrak experiences—year in and year out—are not due principally to lack of funding. They spring primarily from an organization that is obsolete, that cannot do all the things that it is charged to do, that will not consider recommendations for change, and that desperately needs to be redesigned.”
- “Over its lifetime, the increase in Amtrak’s ridership has barely kept pace with the growth rate of the U.S. population.”
- “No matter what the Congress decides to do about Amtrak one thing is very clear—the Northeast Corridor will continue to exist, with or without Amtrak . . . . Based on historical funding patterns . . . having Amtrak as the owner of the NEC [Northeast Corridor] may be the worst outcome.”<sup>139</sup>

Of course, Amtrak was not liquidated. To get around the Amtrak Reform and Accountability Act mandate, Congress prohibited Amtrak from preparing such a plan in an amendment attached to a defense-spending bill.<sup>140</sup> It also provided a bailout in the form of a \$100 million loan and a \$205 million supplemental appropriation.<sup>141</sup> Not surprisingly, the same problems that existed in 1997 and 2002 remain to this day.



## The Current Amtrak Struggle: Echoes of 1997

In an attempt to generate significant reform of the troubled passenger rail “company,” the Bush administration proposed no federal funding for Amtrak, except for \$360 million specifically dedicated to preserving the valuable Northeast Corridor commuter route.<sup>142</sup> Amtrak officials and Transportation Department inspector general Kenneth Mead have warned that Amtrak will face bankruptcy within months or even weeks of the end of the current fiscal year (September) if its budget request is not met.<sup>143</sup> According to Amtrak Chairman David M. Laney, “At current funding levels, existing operations and capital investment will have to be severely curtailed or discontinued beyond FY05.”<sup>144</sup> Added Laney in Amtrak’s 2005 Annual Report to Congress, “Any significant reduction in the infrastructure investment program will likely force Amtrak to suspend high-speed operations on the Northeast Corridor. This will potentially balloon the operating deficit due to erosion of revenues.”<sup>145</sup>

If all this sounds familiar, recall that in 2002, after the ARC report was issued, Amtrak threatened that if it did not get the \$1.2 billion it was seeking it would discontinue its unprofitable cross-country routes at the end of the fiscal year.<sup>146</sup> According to Joseph Vranich, a former Amtrak spokesman and a critic of the organization, the latest scare tactics are a form of “blackmail” and “hostage-taking” because no one wants to suspend service in the important Northeast Corridor (which crosses numerous political districts). Argues Vranich, “Would we permit a small, badly-run airline on the brink of bankruptcy to somehow have the power to shut down the entire commercial aviation system if Congress wouldn’t give it more money? No, of course we wouldn’t.”<sup>147</sup>

The Bush administration seeks to shift the responsibility for intercity passenger rail from the federal government to the states. States would be primarily responsible for developing and funding rail service and would be permitted to bid routes to providers other than Amtrak.<sup>148</sup> Yet, while this would get the monkey off the government’s back, it would largely just shift existing problems to the states (although outsourcing strategies might result in some efficiency gains, depending on how strictly providers are regulated). Amtrak claims that if Congress would just fork over another \$1.8 billion, it will be able to eventually bid competitively with other rail lines for service routes.<sup>149</sup> (Where have we heard this before?) This begs the question, however: Assuming that *this time* the statement is true (a dubious proposition at best), why should we pay just so Amtrak can compete with other rail companies? Why should we spend nearly \$2 billion so that Amtrak can compete when we could instead sell Amtrak’s assets, realize an *influx* of capital from those asset sales, and simply allow existing competitive firms to take over Amtrak’s operations?

## Amtrak Benefits Debunked

A number of supposed public benefits of Amtrak are put forth to validate its existence. Among these are: (1) Reducing congestion, (2) Improving air quality, (3) Increasing transportation capacity, and (4) Offering travel choice. All of these arguments fail to provide reasonable justification for Amtrak’s government subsidies, however.

Intercity passenger rail clearly will not have any significant impact on long-distance travel since “rail travel is not time-competitive with air travel.”<sup>150</sup> The only possible congestion relief would be on shorter-distance travel in certain densely populated areas of the country, and even then the impact is likely to be minuscule. according to a GAO report, “[I]n 1995, we reported that each passenger train along the busy Los Angeles-



San Diego corridor kept about 129 cars off the highway (about 2,240 cars each day)—a small number relative to the total volume.”<sup>151</sup>

Claims of the superior energy efficiency, and thus improved air quality, of Amtrak trains are similarly unconvincing. While the Congressional Research Service has found that Amtrak is much more energy-efficient than airplanes, it is much *less* energy-efficient than intercity bus transportation and about equally energy-efficient as automobiles for trips greater than 75 miles.<sup>152</sup>

While Amtrak has argued that rail transportation is more cost-efficient than other modes of transportation and can carry 5 to 10 times as many passengers as highways for the same amount of money, the assertions turns out to be just plain false. As the GAO noted, a 1999 study found, for example, that the investment costs of providing highway and high-speed rail service between Los Angeles and San Francisco were about the same, while air service was significantly cheaper than either of these.<sup>153</sup> Moreover, “If the added capacity is underutilized (say, for example, because it is not cost competitive or offers inconvenient travel), then the foreseen benefit will not be realized.”<sup>154</sup>

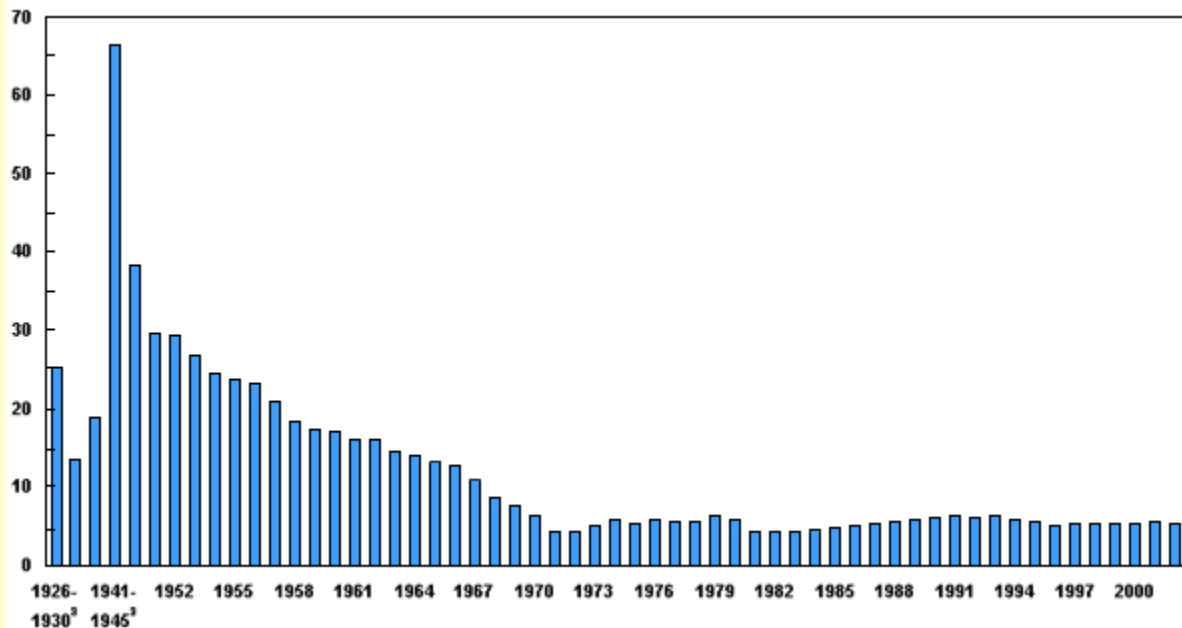
This last point leads us to the travel choice argument. To justify Amtrak’s existence (not to mention its government subsidies), one must demonstrate not only that it offers an alternative to other forms of transportation, but that it offers an *attractive* alternative to a significant segment of the population. (A national rickshaw network would also provide travelers another transportation option, but surely the time and cost necessary to get anywhere would prevent any serious person from advocating for government subsidies to run such an operation.) Depending upon the source, intercity passenger rail makes up between 0.3 percent and 1 percent of all intercity travel.<sup>155</sup> To be sure, people have been given another transportation option in Amtrak—and they have decided that it is not worth it.

### **The Need for Subsidized Passenger Rail?**

Despite record ridership (which, as explained previously, still does not amount to much), Amtrak continues to fail. As Figure 8 illustrates (see below), intercity passenger rail travel declined substantially after World War II and has remained relatively constant since the creation of Amtrak. The development of the Interstate Highway System beginning in 1956 significantly reduced the cost of automobile travel, which also contributed to the growth of suburbs and increased reliance on the automobile for transportation. Technological innovations such as improvements in fuel economy reduced the relative price of automobile travel even further. Air travel also became cheaper, and the reduction in travel time it offered (though you might not know it from the security lines at airports these days) made it a more convenient option for long-distance travel. So, generally speaking, automobiles have become more attractive than rail for short-distance travel and airplanes have become more attractive for long-distance travel. Where does this leave Amtrak? The answer is “nowhere.”

If there ever was a need for subsidized intercity rail transit, there is none today. Technological advances and falling (relative) prices in the automobile and airline industry have rendered Amtrak obsolete except in very specific locations with dense populations where large cities are close enough that rail can time compete with other forms of transportation, such as in the Northeast Corridor.

**Figure 8: Intercity Railroad Passenger-Miles, 1926-2002 (billions)**



Source: Congressional Budget Office based on data from the Association of American Railroads, the Eno Transportation Foundation, Amtrak, and the National Association of Railroad Passengers. See Congressional Budget Office, *The Past and Future of U.S. Passenger Rail Service*, September 2003, p. 6, <http://www.cbo.gov/ftpdocs/45xx/doc4571/09-26-PassengerRail.pdf>.

Note: The first five bars in the table show five-year annual averages (1926-1930, 1931-1935, 1936-1940, 1941-1945, and 1946-1950); the subsequent bars show annual totals, beginning in 1951 and running through 2002.

As Amtrak President and CEO David L. Gunn himself noted in a 2003 article, the notion that Amtrak or passenger rail can be profitable is a “myth.”<sup>156</sup> Added Gunn, “The economics of passenger rail haven’t improved in the past thirty years and won’t change much in the next thirty years.”<sup>157</sup> So if Amtrak has proven to be an unattractive transportation option for over 99 percent of the population, then why expend so much time, energy, and money to preserve it? Taking taxpayers’ money and diverting it from their preferred (and cheaper) transportation alternatives—such as automobile, bus, and airplane travel—to a higher-cost, less efficient transportation system that the vast majority of them shun clearly makes them worse off. One explanation may lie in the difference between free-market business incentives and political incentives.

### The Negative Influence of Politics on Business Decisions

Unlike in the private sector, political decisions are not driven by supply and demand, by finding the optimal balance between making profits and satisfying consumer demands, but rather by the interests of those in power (and those special interests that support them). Amtrak is no different in this regard. According to the CBO, early in Amtrak’s history, it “became evident that Amtrak would be guided by politics as much as



by business decisions”<sup>158</sup> and that “the accommodation of political interests has been a more important factor than business experience in the selection of board members.”<sup>159</sup>

It is no secret that a number of Amtrak’s long-distance routes are highly unprofitable. The Sunset Limited, for example, which runs from Los Angeles to Orlando, lost \$466 per passenger in 2004.<sup>160</sup> Obviously, there is insufficient demand to justify such a route. What keeps such routes in existence is the fact that they run through influential politicians’ districts. As a Cato Institute scholar noted, “It’s political pressure that keeps money-losing, half-empty trains running 12-hour routes when for not much more money, one could fly between the cities served by those trains in an hour.”<sup>161</sup>

Sadly, there is bipartisan support for such pork-barrel spending. Support for Amtrak funding has come from political figures as disparate as Republican Senators Arlen Specter (Pennsylvania), Rick Santorum (Pennsylvania), and Trent Lott (Mississippi) and Democratic Senators Frank Lautenberg (New Jersey), Joe Biden (Delaware), and Byron Dorgan (North Dakota).<sup>162</sup> Senator Lott even called the Bush administration’s zero-funding proposal “ridiculous.”<sup>163</sup> Some would think it is ridiculous to continue sinking money into a venture that has done nothing but fail for 34 years! That has not stopped a House committee from unanimously approving legislation to authorize an additional \$6 billion for Amtrak over the next three years, however.<sup>164</sup>

There is another political element that cannot be ignored. There is a persistent bureaucratic thinking in Washington that rewards failed government programs. If a program is performing “well” (by whatever arbitrary standard), the thinking goes, it should be rewarded with more taxpayer funding. If it is performing poorly, it is obviously because of a lack of funding and even *more* money should be appropriated to “fix” it. The taxpayer just can’t win. It is in this spirit that Amtrak is requesting a 50 percent increase in government funding.<sup>165</sup>

There is a different saying in economics: “Sunk costs are sunk.” In other words, just because you are in for the dime does not mean you should go in for the dollar. You will only be 90 cents poorer.

### **Ineffective Management**

As if all this were not enough, the sheer incompetence of Amtrak’s management should be enough to send this boondoggle to its grave. Among Amtrak’s managerial failures are the following:

- Ignoring vital capital improvements, such as in the important Northeast Corridor, while spending money on short-term projects that would help it reach its operating self-sufficiency goal;<sup>166</sup>
- Launching new routes in low ridership areas;<sup>167</sup>
- Not taking advantage of the increased flexibility in business practices afforded by the Amtrak Reform and Accountability Act (for example, Amtrak’s union laborers are still allowed to collect up to five years in severance pay);<sup>168</sup>
- Spending millions of dollars to fix long-distance sleeper cars instead of fixing or replacing Amtrak bridges in 2004;<sup>169</sup>



- Failing to meet the 3-hour trip-time goal established by the 1992 Amtrak Authorization and Development Act, or even to prepare a comprehensive management plan to do so;<sup>170</sup>
- Delaying the introduction of the Acela Express trains between New York and Boston for several years due to design flaws.<sup>171</sup> (A 2002 *Wall Street Journal* editorial complained of the Acela: “The Acela ‘Express’ between New York and Boston operates at its top speed of 150 mph on only 18 of the route’s 231 miles. After billions of dollars of investment, the Acela runs only a half hour faster than the train covering the same route in 1950.”<sup>172</sup>); and
- Entering the costly—and, of course, unprofitable—mail and express businesses, which it finally exited in recent years.<sup>173</sup>

Things are still in disarray today. In April, cracks were found in 300 of the Acela fleet’s 1,440 disc brake rotors, forcing a long-term suspension of the service.<sup>174</sup> Some have speculated that excessive car weight or the poor condition of the tracks on which the trains run may have contributed to the cracks.<sup>175</sup> In addition, not satisfied with past and present failures, Amtrak is seeking to expand them through the development of new passenger rail corridors.<sup>176</sup> Moreover, Chairman Laney asserts, “The capital program is now in full swing, and we must increasingly rely upon appropriations to meet our needs.”<sup>177</sup> In other words, “We embarked upon a capital program that we can’t afford, so now you (Congress) have no choice but to continue to fund our indiscretions or else we will go broke and shut down the Northeast Corridor!”

### **The Solution: Privatization (Case Studies)**

We have established that Amtrak is an undesirable entity, but the next question is: What to do about it? As Will Rogers famously said, “If you find yourself in a hole, the first thing to do is stop digging.” This means an end to government subsidies. Those assets that may actually have commercial value, such as the Northeast Corridor, should be auctioned off to private companies. Those that do not should be left until a more productive use can be found for them. In Great Britain, for example, an Institute for Economic Affairs article recommended converting rail lines to roads. According to the article, in Britain, trucks and buses could take over the functions of trains at significantly reduced cost while maintaining a lower accident rate and utilizing 20-25 percent less fuel and 25-33 percent less land.<sup>178</sup> Such a conversion would not be unprecedented in the United States. In fact, the Pennsylvania Turnpike, Dallas North Tollway, and Westpark Toll Road in Houston were all built on former rail rights of way.<sup>179</sup> Rail privatization, in one form or another, has taken place in dozens of countries, including Great Britain, New Zealand, Australia, Japan, and Canada.<sup>180</sup> If rail privatization can be successful in other parts of the world, it certainly can be in America as well.

### **Conclusion**

After 34 years and \$29 billion in government subsidies, Amtrak’s unblemished record of failure should be self-evident. It is wasteful, obsolete, unnecessary, inefficient, and caters more to political and special interests than it does to its customers. Today there is a plethora of cheap transportation alternatives available to travelers. There simply is no reason to “invest” in intercity passenger rail when such superior options exist. Furthermore, as a *Providence Journal* piece argued, “if those who choose to take the train refuse to pay the costs, why should taxpayers fund it?”<sup>181</sup>



The Bush administration's zero-funding proposal would be welcome if it were sincere, not merely a stick to pressure Amtrak to adopt reforms that will largely just shift Amtrak's problems onto the states. Selling off Amtrak's assets to private businesses will ensure that they are put to the most productive uses, where they are valued most. Establishing a regulation-free business climate will ensure that railways have the ability to compete fairly and keep the government from repeating the mistakes of the Interstate Commerce Commission during the 1950s and 1960s. Money-losing cross-country passenger routes likely will not survive, which is for the best since the costs of service greatly outweigh the benefits. The highly valued Northeast Corridor, and perhaps some other routes, would simply be assumed by private operators (and state operators that share the system). These private operators would have an incentive (profit motive) to serve customers rather than political interests. Such entrenched interests will prove difficult to overcome, even for such an obviously failed program as Amtrak. (Indeed, the fact that it has survived this long, given its numerous failures and bailouts, is testament to the strength of these interests.) On the other hand, how can we hope to achieve a greater, more accountable government if we cannot eliminate the worst and most wasteful of our government programs?

# Space Travel

## "It's Mainly Just for Fun"



*Space entrepreneur Burt Rutan discusses how private space flight policy should emphasize innovation, safety—and having a helluva good time.*

Lots of hard work. Big burst of publicity. Lots of hard work. That's been the pattern for Burt Rutan.

He is the model of persistent performance, averaging more than one new aircraft design per year for over 30 years. Then, last October 4, Rutan and his team at Scaled Composites grabbed the world's attention. They became the first private operation to send a man into suborbital space twice within two weeks, using the same vehicle. Rutan and company nabbed the \$10 million Ansari X Prize, and proved that entrepreneurial creativity could extend beyond the earth's atmosphere. Now it'll take more hard work—both scientific and political—to make space tourism a reality.

Ted Balaker, Jacobs Fellow at Reason Foundation, interviewed Burt Rutan in April.

***REASON: After the X Prize you enjoyed a huge amount of media attention. Do you think this burst of positive publicity will help improve the regulatory climate in which the private space flight industry operates?***

Burt Rutan : Well, first of all we're working the regulatory climate very hard. We just had a two and a half hour meeting with an FAA administrator a couple of weeks ago, and we have a very specific regulatory plan for this new industry that we call private space flight. And it's a very specific plan on what's appropriate for, not just research testing, but also for the certification of things that will fly ticket-buying passengers.

I think that it is good that the public know what's going on. For example, FAA is having difficulty staffing their airplane certification staff with their budgets now, and for them to build additional staff to certify, not just airplanes but spaceliners, that's going to need, I think, public support in order to help their funding for this. So I think in general if you look back before May of last year, even though we developed some 36 different manned airplanes, we had never invited the press and the public to a research test flight. But starting in May of last year we had CNN, and we had print media out for one of our test flights. And then of course the big one was June 21st for the first manned private space flight where we invited the world's press and we had hundreds of print and broadcast media, and I think some 90 broadcast media video cameras.

***REASON: There was that excellent documentary.***

BR: Oh yeah, and the fact that we filmed in house for two and a half years and then made the deal with Discovery. They did a very good job with Black Sky (<http://dsc.discovery.com/convergence/raceforspace/raceforspace.html>). They've shown *Black Sky* at least three times now and it's a full three hours, so we look





back on that and realize that this was the right thing to do. It's not the right thing to do to bring in the public and the media for most research testing, but we realize that it is the right thing to do now, and answering your question, it really will be positive in terms of meeting the goals that we need for regulatory [policy]. It will be very positive, the fact that the public is not only knowledgeable, but is strongly behind us.

*REASON: And you mentioned how you're trying to hash out a new kind of policy. What would you like that policy to look like?*

BR: We've asked for a research airplane-like environment while a developer is doing his research testing in order to allow innovation, allow the test to be run with efficiency. And then we actually are asking for more regulation than the new legislation edicts. We do feel that the FAA needs to be accepting or proving the safety of the ship as it pertains to the passengers that get flown. Whereas their focus has been on only protecting the non-involved public who live on the ground below. We think that the industry will prosper only if there is some acceptance of [responsibility for] the safety of the ship as it pertains to the passengers.

*REASON: What's the best balance to strike there? Because obviously informed adults already do all sorts of risky things from catching crabs off the Alaskan coast, to taking adventure vacations, or even just smoking three packs of cigarettes per day.*

BR: Yeah, well for decades informed adults have taken treks to the top of Everest, even though more than 10 percent of those who've reached the summit have died on the mountain.

Now I don't object to that. I think that's fine. There should be freedoms. That people know that they have a one in 10 chance of dying by doing this and they still want to do it anyway, I'm the first one to say, hey, let them. However, I don't feel that that's the right thing to develop and sustain [for] a private space flight industry. Our goals are much more aggressive than that. Our goals are to have the same level of safety that the early airliners enjoyed, and a lot of people don't realize, but those early airliners 1927, 28, 29, 1930, 31, and so on, those were the first regularly scheduled commercial airliners. They were dangerous as hell compared to airlines today, however they were a hundred times safer than all of manned space flight. Not 10 times, 100 times safer.

Now I don't believe that it's right to say, listen, we'll let people take risks and we'll go and build the kind of systems that have been used historically for manned space flight, and somehow solve the affordability problem, and that's the only problem. We strongly feel that the biggest problem is the safety problem, not the affordability problem. If you fly dozens of people every day, you'll get affordability with almost any kind of system. The safety problem is the biggie, and that's why we think the most significant thing that came out of the SpaceShipOne program was not just showing that the little guy can fly above a hundred kilometers, without government assistance, and government technology, and government funds.

The real thing that we did here is to develop three new breakthroughs, and each one of them is going to have enormous effects on safety. The "care-free reentry" [in which the craft realigns itself automatically] is just one of those, so we think this is the right way to go and we think that we can get that level of early airline safety if we adequately do our flight tests ahead of time. We are developing a process that will not be debilitating like doing a Part 25 airline certification. That's where we're headed and I think it's the right thing to do.



*REASON: Do you see the Commercial Space Launch Amendments Act as a step in the right direction?*

BR: Well, it didn't address the problem that I'm discussing, getting an FAA acceptance of the safety of passengers. It doesn't address that. However, everything else in it is positive, there's nothing negative in it. It does address asking FAA to develop an experimental research category for launch licenses. However, it's not specific and we think it needs to be more specific to force FAA to regulate these tests more like airplane research rather than like they did our program.

The license process for our program actually decreased safety and it involved an enormous amount of monitoring. It forced our people to defend the product where our safety policy is to never defend it, but always question the safety. We have to get that changed.

*REASON: How did the process compromise safety?*

BR: We have, I think the count now is 39 new types—new airplanes from scratch—in 30 years. We have yet to injure a pilot. We've had things like landing gear failure, but we've never had a real accident. And that's a record that no one has come close to, and we maintain that a major reason we have a superb record is our safety policy, that we always require of, not just people building it, but those designing, flying, and testing it. But to never, ever put themselves in a position where they defend the safety. Once they do, you're screwed.

We always want them in a mode in which they question the safety. If you're always questioning it, you can turn around and find something better and immediately incorporate it. For example, if you had turned in last week a report to a government agency in which you've told them the product, as it is, is safe, if you discover something better next week, you have two choices.

One, you can go and write an addendum to that report and essentially tell the government, that, gee, I was wrong last week, it wasn't the safest that it can be, and now it is because I've discovered this new thing. And then you'll find yourself debating that with them and losing your credibility with them. We make changes almost every day when we're in a research mode. So you can see you get into this big back and forth in which they see you making changes after you defend the safety to them. Now the solution there is to never tell anybody that it's safe, but always question it, which then allows you to immediately incorporate safety features and go on. And, instead of firing somebody who designed something unsafe, you reward whoever found a better way and congratulate him.

The other choice that people have is they'll see something safer and they'll realize they just told the government that it was safe last week. And then they make the decision that, well, you know, last week's configuration—it's safe enough. Another thing too is that we're a small company. We don't have a big safety department that works with the government regulators. We have the people that are there testing the product and we can only afford to have the team that's there. And now we get our team, instead of focusing on the job of making it as safe as possible, they're distracted to write reports and provide data for the government.

Another thing too is it forced us into flying trajectories and glide paths back over the airport that weren't the safest ones to fly because they, the government, was only interested in the best safety for people on the



ground. Now if you look at it, for many decades, you go back to the 40s and you find that all the research flight testing done up here in this desert, there's been hundreds of accidents with research airplanes, but nobody's ever been hurt on the ground. So why would you compromise the safety of the test pilot in order to make it more safe for people on the ground?

*REASON: Let me read you something from a recent interview in Wired magazine with [then NASA Administrator] Sean O'Keefe. He's addressing the SpaceShipOne launch, and says yes it was amazing, "but let's put this in a relative context. Mike Melville went half the altitude that Alan Shepard did, for a fraction of the amount of time, did it 40 years later, and flew in a plastic airplane fueled by laughing gas. From a technical standpoint, this was a modest objective, except for one major point: They did it themselves. It's like a bunch of guys doing this in their garage."*

BR: And what he didn't say is that we developed three new breakthrough technologies, which will allow us immediately to launch a commercial spaceline industry in which people can fly at the same safety level of the early airlines. What Alan Shepard flew in was an expendable booster with a parachute recovery, and for 44 years of NASA manned space flight, they have not made significant improvements in concepts that will allow safe access to space.

*REASON: For those interested in space policy, it seems like there were two camps when the question was—what's the biggest barrier to private space exploration? Some people said it was a regulatory, government-imposed barrier, and others said it was a perception barrier, that people could not imagine a small group of people doing what you did. How do you see it?*

BR: People may interpret the regulatory barrier as the government won't let you fly something that is safe enough to fly. That's what people may think the regulatory barrier is, and I want to make it very clear that that's not my opinion at all, and this is true with airplanes, too. The regulations for light planes, which is called Part 23, there isn't anything there [that doesn't let] you fly something that otherwise should be safe. In fact, if you make an airplane that just barely makes Part 23, it'll be a lousy airplane that in my opinion is not very safe.

But it's a process that [involves] working with naïve, and sometimes inexperienced, regulators who won't make a quick decision, so it drags your program out. I don't see anything in the regulatory rules that's restrictive. I think it's too early to regulate because they don't know what new ideas will come out. For example, if you assume that something is like a V-2 Rocket or something is like a Mercury Redstone, you can regulate that, and they have been regulating things like that for 10 years under the Office of Commercial Space Transportation. However, for them to apply those rules for something that flies to space like an airplane does not work. So they can't sit down and write regulatory rules for things that will happen in the future because you can't know what's going to happen in the future.

I have a solution for that, and that's what I'm working on right now. The developer himself [should] define the testing that is needed for his system to show that it is safe, and he negotiates that test plan with the FAA, and they approve the fact that he did it. I think that it's the only way to do it. You can't regulate spaceships like you can airplanes because every one of them is different.



*REASON: Let's talk about the possible job creation effect of the private space flight industry. Because you look at, for example, the Wright brothers. They couldn't have anticipated professions like airport manager or flight attendant, and yet today the aviation industry employs millions of Americans.*

BR: When people think of the Wright brothers they think of 1903. I think a more important thing to look at when you make the point you're making is 1908 to 1911, early 1912. We're talking about only a three and a half year time period that started when only 10 people had flown, and ended three and a half years later when thousands of pilots flew hundreds of airplanes in 39 countries.

Those people were doing it just for fun because they weren't developing airliners yet, developing the World War I airplanes yet, or even the mail planes yet. What happened later were the applications, but people wanted to fly. People the world around wanted to fly with a barnstormer, people wanted to go to air shows and see them do loop-the-loop. You know, this is all kind of fun.

Go back to 1977 when you could first buy an Apple computer. This was a big deal that people could have computers, but the personal computer was mainly for fun. Most people used them for games, and balancing our checkbook with a personal computer really wasn't why we bought personal computers. I mean, people said, well that's why we need them, but if you think about it, until we had the Internet, we didn't know what computers were *really* for. Now it's our communication, it's our commerce, it's our—everything.

I like to think that's what suborbital space tourism is; it's going to be a big industry. Just like personal computers. But it's mainly just for fun.

You've got to have thousands, tens of thousands, of people enjoying it in order to figure out what to do with it. We never would have invented the use of the Internet, the communication, and the commerce, and everything if you had just a few dozen people with computers. So I look at this suborbital phase that we'll go through, and I think we'll always have suborbital space flight, but I think the main thing is, is that people are going to flat enjoy it. And it's going to be absolutely thrilling. They're going to be floating their bodies around big cabins. It's not going to be just like the SpaceShipOne flights. There's going to be a lot more things you can do for the experience.

To answer your question, I think it's going to be a huge industry. And it's going to be competitive very early in the game, and ticket sales will come down to the point where hundreds of thousands of people will fly.

*REASON: And I think the concept of fun you mentioned is hugely important and at NASA it's very different—they can't justify something on the basis of fun.*

BR: No, and they don't understand the concept of taking risks in order to find breakthroughs. I hate to say that because we send billions to them for what we think is research but they don't do research, they only do development. They won't reach out and look for new concepts.

The same thing is happening with this Bush initiative, the Crew Exploration Vehicle. NASA's going to award multi-billion dollar contracts in September for the primes, and the primes are going to go out and they're going to fight to make sure that they win the next phase after spending billions, and because of that, they're not going to try new, innovative stuff. They're just going to just build some new capsules, and



they're going to get launched by expendable boosters, and they won't go out and solve the safety problems that are preventing us from having resort hotels in orbit.

## After the X Prize

Will space exploration return to aviation's freewheeling roots?

Who could have imagined that a small team would need only three years and \$25 million to send a private astronaut into space twice within one week. Besides fulfilling their own curiosity, the team members behind SpaceShipOne had the extra incentive of the \$10 million Ansari X Prize, offered by a private foundation. But however inspiring SpaceShipOne's story might be, it is hardly unprecedented.

Aviation began with a great burst of decentralized experimentation, in which inventor's ambitions were stoked by more than 100 private incentive prizes. When Charles Lindbergh crossed the Atlantic alone and without stopping, he collected a privately funded purse, the \$25,000 Orteig prize.

This environment produced all sorts of rickety contraptions, but the good ideas separated themselves from the pack, and the march of progress was brisk. Imagine that only 24 years separated Lindbergh's trans-Atlantic trip from the Wright Brothers' herky-jerky jaunt into history.

Still, many find it difficult to trust small groups of private people to continue such progress into space. Leaving the ground is one thing, they say, but leaving Earth's atmosphere requires the kind of might only government can muster.

Indeed space exploration has proceeded differently than aviation. A presidential declaration spurred Neil Armstrong's moon walk, and space exploration has always been dominated by top-down government control. The recently released Aldridge Report, the product of a presidential commission on space policy, notes that "today an independent space industry does not really exist." However, the same report suggests changing course, recommending that:

*NASA recognize and implement a far larger presence of private industry in space operations with the specific goal of allowing private industry to assume the primary role of providing services to NASA, and most immediately in accessing low-Earth orbit. In NASA decisions, the preferred choice for operational activities must be competitively awarded contracts with private and non-profit organizations ...*

Recalling the spirit of the early days of aviation incentive prizes, the reports suggests that the government could offer as much as \$1 billion "to the first organization to place humans on the Moon and sustain them for a fixed period."

Meanwhile, the private sector is already dangling new carrots. The X Prize Foundation has plans for at least six more competitions, including prizes for the highest altitude and most passengers carried. And the day after SpaceShipOne made its claim on the original X Prize by reaching a suborbital altitude of 62 miles, hotel magnate Robert Bigelow offered \$50 million to the first private craft that can go four times higher and reach orbit.



Chances are the most lucrative prizes won't be announced in advance, but will be offered by investors eager to get in on a project that shows early promise. British billionaire Richard Branson has already joined with the team behind SpaceShipOne and committed over \$100 million to create his Virgin Galactic space-bound passenger service.

NASA has long turned away would-be space tourists like Dennis Tito and pop singer Lance Bass who were willing to fork over tens of millions of dollars to tag along on a trip into space. Already, the private sector has dropped the price of space travel to \$200,000 and found a new market. Roughly 7000 people have joined actor William Shatner on the waiting list, and Burt Rutan envisions a day when such trips cost about as much as a luxury cruise, meaning that the market will continue to expand.

A larger private-sector presence in space could also mean more jobs. It's always tricky to predict what sort of job creation figures a given innovation will yield, but if it turns out to be at all analogous to the aviation industry, the space industry gushes with job growth potential.

Over 100,000 Americans get paid to fly planes, but most of those with aviation-related jobs are not pilots, they're engineers, mechanics, airport managers, aviation educators, crew schedulers, and so on. Just one century after the Wright Brothers, the aviation industry employs 2.2 million American civilians.

Just as the Wright brothers could not anticipate airport managers or crew schedulers we cannot know what kind of space-related jobs will someday become commonplace.

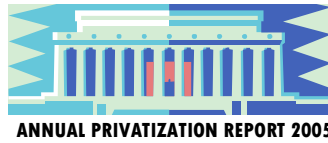
With the right legal framework, perhaps some day entrepreneurs will offer same-day parcel delivery, super fast transcontinental shuttles or even lunar honeymoon packages.

## **The Era of Personal Spaceflight**

When people look back in the history books, 2005 might be known as the beginning of the era of the Space Entrepreneur. Tremendous progress has been made since this report was last published. The X Prize has been won, the X Prize Cup has been established, and new space ventures were announced. Progress in privatizing space is dependent upon overcoming emerging policy issues and increased investment in entrepreneurial endeavors.

On October 4, 2004, Scaled Composites became the first private manned spacecraft to exceed an altitude of 328,000 feet twice within the span of a 14-day period, thus claiming the \$10 million Ansari X Prize. Just as Charles Lindburgh won the Orteig Prize in 1927 to usher in the era of commercial air travel, the X Prize has ushered in the era of commercial space travel.

Granted, Space Adventures was the first to charge a tourist to go into space and it should be recognized for its landmark achievement in helping found the Space Tourism industry. The fundamental difference between the two is that the X Prize was focused on a sub-orbital flight that lasts a few minutes while the first space tourists took an orbital flight lasting a full week. With the price of an orbital experience still



around \$20 million, it is out of reach of almost everyone. To contrast, the initial cost of a sub-orbital experience is around \$200,000 and is projected to go down as more flights and providers launch service.

Most importantly, this has demonstrated to the whole world that the space industry is most productive when privatized and placed in the hands of entrepreneurs. The use of prizes and competition has ignited a market for people to push the envelope and achieve something most people only dream of.

In a move of marketing brilliance, Virgin Galactic sponsored the historic flights and has subsequently licensed the Scaled Composites design and related technology to develop the world's first privately funded spaceships dedicated to carrying commercial passengers on space flights. According to testimony given at a hearing of the House Science Committee's space subcommittee on April 20, Will Whitehorn, president of Virgin Galactic, the subsidiary of Richard Branson's Virgin Group, said as of the date of the hearing that "29,000 people have said they're willing to pay deposits of up to \$20,000 for spaceflights within a range of prices of up to \$200,000." He expanded upon that comment saying "100 people have signed contracts with Virgin Galactic to pay the full \$200,000 up front."

According to testimony given at that same hearing, Burt Rutan said, "By the twelfth year of operations 50,000 to 100,000 astronauts will have enjoyed that black sky view." This is amazing since as of the date of this publication, only 500 people have traveled into space. With flights scheduled for 2008 and new competitors preparing to launch service, we can confidently say that the "Era of Personal Spaceflight" has begun.

### **NASA Still Having Problems**

Over the past year, NASA has seen a change in leadership with the appointment of Dr. Michael Griffin as the new administrator. He is coming into an organization that is still suffering the effects of the Columbia disaster and as of this date, the Space Shuttle sits on the launch pad waiting to go. This "analysis paralysis" has placed the future of the program and much of the organization into a position that it must fight for its relevance. From this fight emerged what is called "The Vision." "The Vision" or "Vision for Space Exploration" is based on the conference President Bush gave on January 14, 2004 and was covered in detail in the previous edition of this report. The essence of "The Vision" is to focus the goal of NASA on purely exploratory missions. This means more missions like the extremely successful Mars Rover, Cassini-Huygens (Titan) and Deep Impact (Comet Tempel 1). Other essential goals are to send a robotic mission to the moon by 2008, laying the groundwork for the return of astronauts.

In 2010, they plan to retire the shuttle and build a new spacecraft, the Crew Exploration Vehicle (CEV). The plan is to send astronauts to the moon no later than 2020, and establish a moon base similar to what they have got down in Antarctica. They plan to keep the Space Station on an exploratory mission but there is a serious gap because Russia doesn't have any obligations to transport U.S. crew members to and from the ISS after the return of Main Expedition 12 in April 2006. As of the date of this publication, Russia's obligations toward NASA for the training of crews and their delivery aboard Soyuz spacecraft expire in 2006.

This game of "space chicken" is set to hit a critical point next year as all missions by NASA that leverage the Soyuz program must be paid for out-of-pocket. This is compounded by a stickier policy problem: U.S.





law forbids NASA from paying the Russians any real money, except under specific conditions that have not been met. In an attempt to squeeze the Russian government into enforcing existing nonproliferation agreements, the Iran Non-Proliferation Act or INA was signed in 2000. This act forbids NASA to send any money to the Russian Space Agency until the White House has certified that technology transfer to “rogue states” has stopped. Since no certification has been made, there is a deadlock looming on the horizon.

This shift of NASA as a pure exploration organization and the need for orbital flight alternatives leaves a large gap in the final frontier. One perfectly suited for the new “Space Entrepreneur.”

## **The New Space Entrepreneur**

The Internet boom of the last decade created many new millionaires and billionaires. With this new-found wealth, many of these tycoons are dipping their toes in the pool by creating space ventures. Many of these are close to bearing fruit because the same innovation these smart people applied to the Internet is working for the space industry. However, there are many opportunities emerging that are not the exclusive realm of the ultra-wealthy.

Privatization of space relies on those daring individuals to take monetary risk, but it also leaves room for early adopters with good ideas that have a good return on investment. For the most part, this is dedicated to the realm of angel investors that share the passion and understand the vision an entrepreneur has for their venture. There are some space companies one could start now (12-24 months) and some in the near future (five to eight years). Let’s break down the categories of space entrepreneurship:

### **Launch Entrepreneurs**

These companies are focused on the launch process, which includes the traditional use of rockets or moveable platforms. The use of rockets is not new, but companies like SpaceX are currently rethinking all aspects of this method to dramatically lower the cost of delivery by a factor of four. This means that all types or increased frequency of missions are now within economic reach of government agencies and corporations. They already have contracts and are launching their first rocket in 2005.

Looking a little farther out are moveable platforms, or what is being called the “Space Elevator.” A space elevator is a physical connection from the surface of the Earth via an ocean- or land-based platform to a platform located in geostationary Earth orbit. The goal is to move people, payloads, power, and gases between the surface of the Earth and space. Current Space Elevator ventures like LiftPort and education foundations like Elevator:2010 are working hard to push through the technology barriers (i.e., carbon nano-tubes, beam power) by 2010 to place a Space Elevator into use by 2020.

### **Tourism Entrepreneurs**

The space tourism market is not new; it is just getting tremendous press these days with the X Prize won by Scaled Composites. There are companies like Space Adventures that have been around since 1998. They designed trips as simple as visiting Cape Canaveral for a shuttle launch to brokering the flights of Dennis Tito and Mark Shuttleworth to the International Space Station. Another company providing service is Zero-G founded by Dr. Peter Diamandis, Chairman of the X Prize Foundation. Zero-G offers parabolic flights to experience weightlessness and has appeal for adventure travel, movie companies and government agencies.

What the X Prize has done is made people open to the possibility and opened up a whole new world of tourism opportunities that most people just dreamed about. In the next 12-24 months, Virgin Galactic will launch service and charge the general public for sub-orbital flights. There are many competitors preparing their own craft and over time, cost will come down and these companies will make the leap to orbital flights bridging the gap from early adopters to everyday space travel services.

Once companies do provide orbital service, space hotels will start to be built. Already, visionaries in the travel industry, like Robert Bigelow of Budget Suites, have started companies with a practical approach to creating destinations in space. So it won't just be about the fun of getting up there, there will be fun things to do when you get there. When you tie this into technologies like space elevators to deliver supplies and new launch vehicles to take passengers there it doesn't seem so out of this world.

#### **Data Service Entrepreneurs**

This is an interesting area because these companies are repurposing existing data services and building software for the current marketplace. EarthSat and DigitalGlobe are examples of service providers that use government or privately owned satellites to collect the data and do just that.

These companies then sell the data and related services to government agencies and private companies that have requirements in the areas of Geographic Information Systems (GIS), Agriculture, Weather Services, Geological Surveys, National Security objectives and much more.

Some of the more prominent examples where these services are used by the general public are TerraServer from Microsoft which leverages data from USGS or Google Maps which leverages data from EarthSat and DigitalGlobe.

#### **Communication Entrepreneurs**

These companies are focused on leveraging the communication aspect of space systems. They are usually grouped into two areas: media entertainment and space communications systems. Companies in media entertainment are launching new communication services, opening up a whole new media channel. Primary examples of these companies are XM and Sirius radio. Both are pioneering the XM band of radio and looking to add real-time GPS traffic services, data services and video feeds as the service grows in popularity.

The space communications systems segment is a mix of companies that provide monitoring software, GPS hardware, and mobile device communications. In monitoring software space, Deimos Space is an example of companies that provide parallel computing and database systems to control and monitor satellites. Global Positioning Satellites (GPS) is one of the most popular technologies companies leverage to provide hardware-related mapping software. There are many companies in this segment, the most popular being Garmin and Magellan. In the mobile communications area, cellular phones are the dominant path, but entrepreneurs are leveraging satellites to provide something as straightforward as satellite phones (i.e., Iridium, GlobalStar) to accelerating the delivery of digital content and making information access more ubiquitous.



The new space entrepreneur is working now to uncover new opportunities that create jobs for communities and generate wealth for shareholders. As for those entrepreneurs working on longer-term (5-10 years) enterprises, they are currently making breakthroughs in areas such as materials and propulsion. While these breakthroughs have far-reaching implications, there is an immediate upside for technology transfer and licensing opportunities. This allows space entrepreneurs to make a very big business out of innovation to enable their long-term vision. The only things standing in their way are the policy roadblocks that hinder trade and free enterprise in this global economy.

## **Overcoming the Red Tape: Policy Issues**

We discussed earlier in this report the issues NASA must deal with regarding the Iran Non-Proliferation Act of 2000. However, there are broader policy issues that impact the privatization of space. These come from improving export controls handling private space launches, providing incentives to accelerate the privatization of space.

### **Export Controls**

Problems still exist from the 1998 Strom Thurmond National Defense Authorization Act, which transferred export licensing from the Department of Commerce to the State Department. As of this report, controls are tightening and jeopardize future collaborations from entrepreneurs from various countries.

However, its distant cousin, the International Traffic in Arms Regulations or ITAR has become a serious problem. The recent launch of a Chinese rocket with a European-built satellite did not have any U.S. components. Also, Virgin Galactic is having serious problems getting access to Burt Rutan's designs for the next generation of suborbital vehicles, which they have financed. These two recent events are signs that the ITAR process is doing more and more serious harm to the U.S. space industry.

Congress has heard the cries and not answered them, so alternatives to resolving the problem must be found.

### **Private Space Launches**

In Washington, some of the regulatory hurdles for the industry were removed with the passage of HR 5382, the Commercial Space Launch Amendments Act, in the final hours of the 108th Congress.

The press surrounding the SpaceShipOne flights accelerated its passing, which establishes the process for private citizens to fly on spacecraft launched from the United States. The Act is not perfect, but it is a solid beginning, and aerospace companies at least now know where to go for licensing. Ironically, the only critique of the law comes from SpaceShipOne's designer, Burt Rutan.

He has been a harsh critic of the office of the associate administrator for commercial space transportation, known as the AST. AST's stated mission is to "ensure protection of the public, property and the national security and foreign policy interests of the United States during a commercial launch or re-entry activity, and to encourage, facilitate and promote U.S. commercial space transportation." Mr. Rutan stated at the April 20<sup>th</sup> House Science Committee's space subcommittee that the policy of the AST "resulted in cost overruns, increased the risk for my test pilots, did not reduce the risk to the non-involved public, destroyed



our ‘always question, never defend’ safety policy, and removed our opportunities to seek new innovative safety solutions.”<sup>182</sup>

He believes that craft like SpaceShipOne should be regulated like aircraft. He noted that “the airline experience has shown us that it is not just technology that provides safety but the maturity that comes from a high level of flight activity”. His contrarian views place him in a controversial position that goes against the Commercial Space Launch Amendments Act, which leaves the regulation of suborbital spacecraft within AST.

While he supports the other parts of HR 5382, the certification process for “SpaceShipTwo”, the vehicle under development for Virgin Galactic, is forcing the FAA and AST to work together. The results of this new working relationship are still to be determined.

### **Incentive and Relief Programs**

The attention-grabbing events of the X Prize and President Bush’s “Vision for Space Exploration” reinvigorates a timeline for companies to explore the stars to chase that entrepreneurial spirit and create new space ventures. As mentioned earlier in this report, there are many new types of space entrepreneurs emerging. Some have an eye on making money in the next 12-24 months and some have a 10-20 year vision.

What they share in common is what the government does to foster innovation and growth. Right now, the U.S. government has treaties in place that prevent them from offering land grants on the moon or securing monopolies for companies that develop and build new, low-cost and reliable space transportation systems. This means finding a starting point for incentives and various relief options.

In last year’s report, the book “*Space: The Free-Market Frontier*” by Edward L. Hudgins was mentioned because of innovative tax policies suggested by former Rep. Bob Walker (R-PA).<sup>183</sup> This 25-year tax holiday is intriguing, but we must make small steps to accelerate change. We are optimistic with a new vision put forth and a reinvigorated interest in space that new legislation will move forward to increase the incentive for privatization.

One of those core legislative moves is the push to eliminate tax burdens. A few years ago, Rep. Dana Rohbacher (R-CA) proposed a “Zero-G, Zero-Tax” incentive. This has been reintroduced to the House as the “Zero Gravity, Zero Tax Act of 2005.” This bill includes capital gains exclusions and investment credits to create an enterprise zone in orbit similar to the advantages Internet commerce has with a tax-free zone.

Another alternative is to be more earth-based and follow some states motivating companies with tax credit awards. A perfect example is the state of Oklahoma awarding Rocketplane \$18 million to fund its space plane program and transform the former Clinton-Sherman Air Force Base into the Oklahoma Spaceport. This is also happening in New Mexico and in California at Mojave Airport where Scaled Composites, builder of SpaceShipOne, is located. These “Space Incubators” could be the focal points necessary to share resources and promote this emerging industry.



## Conclusion

This has been a landmark year with the X Prize won and the beginning of the era of the space entrepreneur. Privatization of space seems more and more potentially profitable by private industry, which motivates government agencies and business to innovate and meet this emerging market opportunity. However, with all of the advancement and enthusiasm, there must be the will to overcome regulatory and policy disagreements that hinder our progress. As we move forward, new policies will be introduced and old treaties updated to fit the needs of the global economy. This is our chance to answer the call for a new future where all of humanity has the opportunity to go to the stars.

*By Steven J. Fisher, founder and CEO of SlipStream Air.*

# Health Care

## Politics vs. Patient Care: Why Public Hospitals Are Turning Private

The impact of private ownership on performance is neatly illustrated in a retrospective study of 92 expeditions made to the Arctic over the period 1818 to 1909. Most major discoveries were made by privately funded expeditions. Most tragedies (lost ships and lives) occurred on publicly funded expeditions. Why? It turns out that incentives matter.

Private expeditions more clearly aligned the rewards for discoveries. This resulted in systematic differences in the way public and private expeditions were organized. The same is true of most government-funded enterprises.

Take hospitals. Public and private hospitals are organized very differently, and for good reason. One must satisfy a community of *stakeholders*, the other a community of *shareholders*. In the former case, a conflicting mix of social, political, and business objectives results in weak incentives to control costs.

### Incentives Matter

Public hospitals are expensive, but unfortunately, high cost doesn't buy better care. Instead the cost burden comes from inefficient accounting, restrictive personnel and procurement regulations, a tangled web of bureaucracy and a general lack of accountability.

Consider the case of Natividad, a public hospital owned and operated by Monterey County in California. Most private hospitals don't actually employ physicians. They act as workstations where doctors perform services. After surgery, the surgeon and anesthesiologist each bill the patient, and the hospital bills for services it provides. So doctors who use private hospitals have an incentive to keep track of their patients. Natividad's doctors don't. They're staff. They get a salary regardless of whether or not procedures are recorded. Predictably this contributes to a dismal recording system filled with gaps (unreported procedures and uncollected co-payments), incorrect coding (one out of four bills contains an error), and lack of follow-through (missed billing deadlines).

The best run hospitals typically collect payments within 50 to 60 days. Natividad's average is around 70 days and has been as high as 133 days.

While incentive problems conspire to shrink revenues, Natividad is also afflicted with inflated costs. Personnel rules such as fixed salary schedules make it difficult to recruit and retain hard-to-fill positions. So the hospital turns to overtime and temps that cost up to three times as much. Revealing the dismal state of the hospital's cost accounting system, the last CEO complained, "We didn't know how many positions we had." Besides obvious potential for fraud and abuse, sluggishness in adopting new computerized accounting reflects a weakness that partly stems from a tangled bureaucracy. Bureaucracy and red tape slow decisions and inflate costs.



## Politics vs. Patient Care

The many stakeholders in public hospitals have a conflicting mix of social, political, and business objectives. It is often unclear who is in charge: the CEO, board of supervisors, trustees, employee unions, doctors, patients, inspectors, or taxpayers. Ideally, the elected County Board of Supervisors outlines broad health-care policy, and approves major expenses and the yearly budget. Together with oversight from appointed trustees, the hospital CEO drafts a budget, and approves expenses and plans that follow the Supervisors' guidelines. In reality, unresolved issues of authority and accountability complicate the budget process, interfere with construction and procurement decisions, and slow innovation. A University of Arizona study notes that elected boards are likely to micromanage operations to satisfy political objectives that create inefficiencies and might not always coincide with taking care of the poor.

For instance, in 1993 construction began to replace Natividad's main building at a cost of an estimated \$75 million. Five years later the project was finally completed, and costs had mushroomed over 50 percent to \$116 million. Cost overruns translated into hiring freezes and slowed innovation, restricting investments in new medical equipment and, ironically, in computerized accounting systems.

Faced with shrinking revenues and inflated costs, public hospitals squeeze funding for other programs. This leads to calls for higher taxes, reinforced by threats of cuts in health services. In the case of Natividad a recent tax measure (Proposition Q) was voted down. Limited in their ability to raise taxes, county governments like Monterey face the decision whether they can continue owning and operating a hospital.

## The Evolution of Health Care

Although the public hospital has been a fixture of American life for decades, urbanization and ongoing revolutions in health-care delivery challenge conventional wisdom that a public hospital is the best way for government to deliver health services. Yet bad news for public hospitals can be good news for patients.

## Politics vs. Patient Care in Los Angeles

The *Los Angeles Times* recently completed a five part series, *The Troubles at King/Drew*, which analyzes the county's long-troubled Martin Luther King Jr./Drew Medical Center. The series covers the severity of the hospital's recurring medical lapses, its managerial shortcomings and the political conditions that have thwarted effective reform.

### Part One

Deep Trouble: A hospital inspired by the civil rights movement fails — sometimes kills — those it was meant to serve.

### Part Two

The Myth of Poverty: King/Drew isn't underfunded. It's mismanaged.

### Part Three

Unheeded Warnings: How one pathologist got hired and remained on staff despite misdiagnoses and legal woes.

### Part Four

Broad Failure: Beyond individual workers' shortcomings, whole departments are in disarray.

### Part Five

Timidity at the top: The County Board of Supervisors shies away from reform, paralyzed by community protest and racial politics.

### Epilogue

Overhaul urged: County board must give up its control of King/Drew, experts say. Some also suggest closing for a time to regroup.

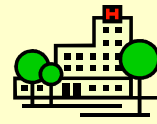
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New technologies and drugs have radically reduced the number and length of hospital stays. The result, according to a study by the Urban Institute, was a 14 percent drop in total hospitals in the United States from 1979 to 1998. Over that same period almost one-third of public hospitals were either converted or closed. In California, no new public hospital districts were formed between 1978 and 1998. While hospital districts were first conceived in the aftermath of WWII when Congress saw a need for rural public hospitals, rapid urbanization, telemedicine, remote monitoring, and the Internet are revolutionizing rural health markets, and attracting competition from private clinics and hospitals.

### Fewer Public Hospitals



- Public Hospitals in 1980: 1,800
- Public Hospitals in 2000: 1,200

Out of 574 hospital conversions studied between 1987 and 1999:

- Government to private-non profit was the most common kind of conversion (189 hospitals).
- Another 130 hospitals went from nonprofit to for-profit.

Sources: *Governing Magazine*, Urban Institute

A recent study reminds us of the benefits of competition. It turns out that for-profit hospitals have important spillover benefits for medical productivity. They exert a “peer effect” when their not-for-profit counterparts mimic their behavior. Where there are for-profit hospitals, those areas have lower levels of hospital expenditures, but virtually the same patient health-care outcomes. [This effect has been noted in other areas, as well. See, for example, “Indirect Competition Reduces Prison Costs,” *PW* Nov. 2003]

The economic argument for government ownership and control usually rests on some perceived market failure. In the case of public hospitals, it is mostly the fear that the poor and under-insured will fall through the cracks. In California counties have a statutory obligation to address the needs of the indigent under Welfare and Institutions Code section 17000: “First and foremost, public hospitals were meant as a safety net for “all incompetent, poor, indigent persons, and those incapacitated by age, disease, or accident...[and] not supported...by their relatives or friends [or] by their own means, or by...private institutions.” We do need a safety net, but we need to modernize the safety net.

### Modernizing the Safety Net

Benevolent citizens have learned the hard way that running a hospital is a tough business and more public hospitals are turning private. Municipalities are refocusing on meeting the needs of the disadvantaged, rather than the business of running a hospital. In California the rush to the exits is reflected in the fact that less than 15 percent of the state’s hospitals are public while 85 percent are private. In seven counties, MediCal obligations are now being carried out by a sort of county-operated HMO. For example, in Orange County, Cal Optima contracts with a panel of health-care providers—hospitals, pharmacies, physicians and clinics, who agree to offer discounted services to MediCal enrollees.

### Texas’s Conroe Medical Center

After retiring public bond debt, the residual “profit” from the privatization was used to establish a nonprofit foundation to meet ongoing community health needs. The community also collected new taxes from property and other payments made by the now private, for-profit hospital. Indigents fared best of all. Here privatization raised cash, reduced debt, and created a better system for serving indigents.



Around the country municipalities have demonstrated they can serve indigents more efficiently and effectively by selling their hospital assets. Communities get a cash payment that can be used to retire debt and establish a trust fund for community health care. Since 1994, over 100 charities have emerged from hospital sales that control nearly five billion dollars.

Privatization can bring the best of both worlds: lower taxes and better services. The time has come for local governments to become selective purchasers of health care for the poorest and sickest among us, and to get out of the business of running hospitals.

*By Dr. Francois Melese*

## **Mandatory Health Insurance Now!**



*It will save private medicine—and spur medical innovation.*

Why not tell Americans they are responsible for buying their own health insurance from now on? If people couldn't pay for medical care, either through insurance or out of pocket, they wouldn't get it. "After people begin to notice the growing pile of bodies by emergency room entrances," Tom Miller, former director of health policy studies at the Cato Institute, wryly suggests, "they will quickly get the message and go get medical coverage."

But that's not going to happen, says Mark Pauly, a health-care economist at the University of Pennsylvania's Wharton Business School. "Americans don't want to see their neighbor dying bleeding in the street," he says. "Therefore we already make sure that everyone gets some medical care when they need it. The alternative would be a world in which voluntarily uninsured people wore a bracelet that read: 'In case of an accident, do not take me to the nearest hospital. I've made my choice.'"

Since it's unlikely that Americans will allow their improvident neighbors to expire without medical care in the streets, is there a politically palatable alternative that can preserve and expand private medicine in the United States? Yes: mandatory private health insurance.

The New America Foundation, a liberal policy shop in Washington, D.C., has outlined some elements of how such a system would work. The slogan for its proposal is, "Universal coverage in exchange for universal responsibility." The devil is in the details, of course, but the plan offers some interesting possibilities. For example, mandatory health insurance coverage might be combined with medical savings accounts that would encourage people to save and invest for future medical emergencies.

The New America Foundation proposal preserves private insurance and allows consumers to choose among competing insurance plans and coverage options. Most intriguingly, the plan offers a way out of the dysfunctional employer-financed, third-party-payer model that is so grievously distorting our health-care system. Employers eventually would devolve responsibility for health insurance to their employees by giving them the money the companies currently pay to insurance companies. Employees would then have a strong incentive to shop around for the best health-care deals, putting pressure on insurers to keep costs low.



Even some Republicans are suggesting that mandatory health insurance be required for at least some Americans. Senate Majority Leader Bill Frist (R-Tenn.) recently argued that it is unfair to expect taxpayers to pick up the health-care tab for the third of Americans without health insurance who make incomes over \$50,000. "I believe higher-income Americans today do have a societal and personal responsibility to cover in some way themselves and their children," the senator said in a speech at the National Press Club in July.

### **Privatizing Medicaid and Medicare**

Uninsured Americans currently receive health care for which they don't have to pay. Their bills are paid by tax dollars spent on Medicaid or the state Children's Health Insurance Programs, or through higher insurance premiums and medical charges to make up for the losses doctors and hospitals incur when they treat the uninsured. Why shouldn't we require people who now get health care at the expense of the rest of us to pay for their coverage themselves?

There's a big bonus. "Mandated coverage would replace Medicaid and state Children's Health Insurance Programs because lower-income and unemployed people would receive a voucher to purchase private health insurance," says Wharton's Mark Pauly. "This would mean full privatization for people under age 65." He holds out an even brighter prospect: "Actually, in principle, mandated coverage could replace Medicare too." The entire medical system could be privatized. The slowly expanding Medicare, Medicaid, and SCHIP behemoths that are inexorably absorbing more and more of the U.S. health-care system could be eliminated.

Mandatory health insurance would be not unlike the laws that require drivers to purchase auto insurance or pay into state-run risk pools. They also resemble the libertarian Cato Institute's proposals for reforming Social Security, which do not *eliminate* mandatory payments; they *privatize* them. Similarly, school voucher plans generally mandate that children receive an education. As the Rose and Milton Friedman Foundation notes, universal school vouchers would allow "all parents to direct funds set aside for education by the government to send their children to a school of choice, whether that school is public, private or religious." This system separates "the government financing of education from the government operation of schools."

Once government and health insurers have defined a standard basic package of health-care benefits, the current dynamic of constant government meddling in health insurance and health-care markets that leads to higher and higher costs should change. Consumers, transformed from passive recipients into direct purchasers, can be expected to be vigilant about government interference that would increase their rates or reduce their services.

As Rep. Bill Thomas (R-Calif.) noted at a recent National Center for Policy Analysis conference, if everyone had to buy his or her own coverage the way people buy car or homeowner's insurance, and if the size of the tax breaks didn't hinge on employment status, you would have the beginnings of a real market. Thomas said he wanted to make basic, low-cost catastrophic health-care coverage widely accessible through tax subsidies and credits. More extensive coverage would be available to individuals who wanted it, but they would have to pay for it with after-tax dollars.



Under a mandatory insurance scheme, all Americans would be required to purchase a basic high-deductible catastrophic health insurance policy from a private insurance company. "Let's say you cap the deductible at \$4,000 and set a limit that out-of-pocket health-care costs can't exceed 10 percent of an individual's or family's income," suggests Pauly. "That would mean that a family earning \$30,000 per year would receive \$1,000 in a health voucher." In other words, the family would pay the first \$3,000 of medical expenses out of pocket and receive a \$1,000 voucher to cover expenses up to the \$4,000 deductible.

A high deductible would encourage people to be more careful about the services they purchase. They would shop around for good deals on drugs and scrutinize the costs of various treatment options more closely. Of course, some people inevitably would try to save a penny or two by delaying a visit to the doctor for their stomachache, only to find out later that it's cancer, but no system can make people perfectly prudent.

Health insurance policies covering catastrophic expenses today typically cost under \$300 per month for a family of four. So that's \$3,600 per year for insurance. Assuming employers pay between \$6,000 and \$9,000 to cover an employee and his family, that means workers would be getting an extra \$2,400 to \$5,400 in their paychecks. Even a \$3,600 policy would be expensive for a family living on \$18,000 a year, so perhaps they would be required to pay 10 percent of their income, \$1,800, for insurance and receive a voucher for \$1,800 to cover the rest of their premiums.

### **Money in the Bank**

This plan differs from the mandatory health-care schemes in Germany and France, which are financed by payroll deductions set at a percentage of wages up to a certain income level. In the United States today, an employer generally pays the same health insurance premium for each employee. So if the premium at a company is \$5,000 a year per employee, under this plan each employee would get \$5,000, tax-free, to purchase insurance. That money would make a lot more of a difference to an employee earning \$20,000 than to one earning \$80,000.

A second component of the new private insurance scheme might encourage (or even mandate) that families and individuals make annual contributions to health savings accounts (HSAs) similar to those included in the otherwise very flawed Medicare prescription drug law. As currently formulated, HSAs allow employees to set aside pre-tax money to cover routine checkups, co-payments, prescription drugs, vaccinations, and so forth, while costly medical procedures are covered by high-deductible insurance policies. HSAs permit employees to keep their own money, rolling over any unspent funds in their HSAs at the end of the year and investing the money for future medical expenses or saving it for retirement; the money can be passed on to heirs. Since it's a real asset, people have an incentive to manage it frugally.

HSAs have several attractive features. Employers as well as employees make contributions, so instead of paying insurers for low-deductible policies, companies can give the money directly to their workers. Best of all, for those worried about the instability of linking health insurance with steady employment, people who lose their jobs can withdraw funds from their HSAs to continue their families' health insurance coverage. Employers will be attracted to HSAs because they will be able to lower their health-care expenses by offering their employees higher-deductible insurance plans. Such plans generally cost 20 percent to 60 percent less than conventional low-deductible health insurance policies.

There's no reason to put off the campaign for a mandatory private system until we've worked out all the details. To keep the great American health innovation machine running, it is vital to keep medicine private and consumer-driven, and that means going on the offensive now.

Maintaining our private medical system is vital because American health care and medical science are the most advanced and innovative in the world. If a national single-payer health-care system is adopted, most medical progress will be stopped in its tracks. The proposal for mandatory health insurance offers a way to maintain our private system, expand consumer choice, lower costs, and allow medical progress to continue.

*By Ronald Bailey is Reason's Science Correspondent*

## A Glimpse: Health-Care Privatization in Western Democracies



Sweden has long been known for its extensive social welfare programs, but now it's developing a reputation of a different sort—health-care privatization. Sweden, or more specifically, Stockholm began experimenting with private-sector participation in health services during the early 1990s when waiting lists for care were growing longer and longer.

In 1991 the County Council pushed for market-based reforms that transformed Stockholm's health services into a laboratory of privatization experimentation. The County Council introduced competition and private-sector participation in hospitals, home care, ambulance services, and other areas of health care.

Lab and X-ray services costs dropped by nearly 50 percent, waiting times for examination and treatment fell 30 percent in one year, and competitive procurement lightened costs by about 10 percent for ambulance service and 40 percent for medical laboratories. After St. Goran's public hospital was leased to a private provider in 1999, costs dropped by 30 percent and the hospital was able to serve 100,000 more patients per year. Local leaders even turned to the privatized hospital for performance benchmarks, which were used to exert competitive pressure on other public hospitals.

The reforms that began in Stockholm eventually spread to other major cities.

Johan Hjertqvist of the Swedish think tank Timbro notes that today private entrepreneurs deliver roughly 10 percent of all health-care services nationwide. Private provision is less common in remote areas and more common in larger cities. In metropolitan Stockholm private contractors provide nearly 50 percent of primary care services and 20-25 percent of all services.

Australia has also moved toward private health-care provision. In particular, hospital privatization has experienced much growth. State and federal governments have introduced private participation in more than 50 public hospitals, and Mildura hospital has emerged as an impressive success story. The government selected a private operator to design, build, own and operate a new hospital under a 15-year contract. The contract specifies that the private operator must provide service to all. The contract also includes provisions for third-party performance monitoring and penalties for noncompliance.



The results were encouraging. The new hospital cost 20 percent less to build compared to the public sector. Patient volumes increased, all performance targets have been met and the provider even made a profit.

The trend toward health-care privatization has spread to other unlikely corners, such as Germany and Great Britain, where the National Health Service has turned to the private sector to build and operate new surgery centers. Writing for the World Bank Rob Taylor and Simon Blair point out that in recent years Great Britain has used public-private partnerships in financing, construction, and facilities management for many public hospitals.

For more information on Swedish health-care reform:

Johan Hjertqvist, *The End of the Beginning: The Health Care Revolution in Sweden, Part II*, Timbro Health Policy Unit. (<http://health.timbro.se/pdf/theendofthebeginning.pdf>)

*Impatient for Change: European attitudes to health care reform, The Stockholm Network* ([timbro.se/bokhandel/health/pdf/impatient\\_for\\_change.pdf](http://timbro.se/bokhandel/health/pdf/impatient_for_change.pdf)).

## Water/Wastewater

In early 2003 the city of Atlanta canceled its contract with United Water and took back water system operations. During the past year, many people have weighed in on the question of “What went wrong?” Although much can be learned from considering this question, we first must think clearly about two issues central to any privatization effort—performance and cost.



The city terminated United’s contract for poor performance, but how did the firm’s performance compare to the city’s? While far from perfect, United’s performance was significantly better—and much cheaper—than what the city had been providing for years. In just a short time, United was rehabilitating the water system and completing more repairs than were ever completed under city operation.

Critics also claimed United failed to save the city money. A city audit that found millions in savings claimed this wasn’t really savings at all, since the money was “subsidizing other government functions.” Before privatization the city spent approximately \$40 million on municipal water operations. United received a service fee of approximately \$21.5 million, amounting to a difference of \$18.5 million. Only very creative accounting practices can overlook the cost savings. Moreover, United had no control over how the city manages its money and if it decides to divert savings elsewhere.

### Learning from Atlanta

Public officials can improve future privatizations by examining what happened—or what failed to happen—in Atlanta:

#### **Communication is essential.**

A lack of understanding or agreement about performance expectations can lead to disputes and even termination. Establishing a trust relationship requires structuring the right risks, rewards, benefits and opportunities early in the contract negotiation stage. Also, the more that the expectations of the contract are based on measurable outcomes and outputs (costs, quality, reliability), rather than inputs (like work levels, hours, personnel, etc.), the less subjective everyone’s assessment will be, and the less likely conflicts will arise.

Expectations and definitions need to be clearly established and understood by both parties. Open and consistent communication both before and during the contract period will help eliminate ambiguities. Both sides must commit to their due diligence, which should be agreed upon and confirmed with data. Additionally, both parties must have a realistic understanding of the condition of the infrastructure.

Communication during the contract period is just as crucial. The first half is really about management and oversight. Few would disagree that accountability is important. A contract is only as strong as the monitoring, reporting and direct oversight that are built into it. Periodic reporting and monitoring are standard in privatization contracts. The higher the risk and uncertainty, the stronger these requirements should be.



**Update from New Orleans....**

At the same time of Atlanta’s demise, the city of New Orleans was considering a similar long-term privatization arrangement.

After months of study and consideration the city seemed to move forward. However, Public Citizen and other activists groups got engaged and launched a successful citizen initiative that would require voter approval of any privatization contract. One of Public Citizen’s key arguments was (and always is) that privatization leads to rate hikes.

Shortly after the citizen initiative passed, the city decided to terminate its privatization plans. Since that decision, the city has decided to or asked for a rate increase *five* times while operations remain under public management, resulting in nearly a doubling of rates in just five years. Unfortunately, Public Citizen is nowhere to be found.

**Rate Hikes in New Orleans**

2002 .....	12 percent
2003 .....	15 percent
2004 .....	15 percent
2005 .....	14 percent
2006 (proposed) .....	14 percent

How the two parties speak about each other—especially in the media—is also important. Over the last few months of the contract, Atlanta Mayor Shirley Franklin painted herself into a corner leaving her with little room to maneuver even though performance was improving.

**Contracts should develop appropriate long-term business models.**

Atlanta was the first city to take advantage of new legislation that allowed for long-term contracts. This new territory provoked some missteps. The contractors attempted to take the existing operations and maintenance model (typically three to five-year contracts on individual plants) and simply extend them, both in terms of scope and length. The industry has since recognized that it isn’t healthy to simply extend a boilerplate approach, and is now readjusting its approach to long-term contracting.

**Contracts should be value-based.**

Thus the contract criteria should not only address cost, but performance measures to ensure system integrity. Very low-bid contracts may be too cheap to ensure quality, and cost-plus contracts that don't specify the price up front but let the contractor add on as needed provide little incentive for contractors to hold down their costs.

**Most privatizations succeed.**

Over 90 percent of cities that have privatized do not de-privatize. With the dire status of our nation’s water and wastewater infrastructure, privatization will continue to be an important policy tool. Both the Environmental Protection Agency and Government Accountability Office recognize privatization’s ability to improve services, meet tougher environmental standards and lower costs.

## Watering the West: The Status Quo Versus Water Pricing



It has often been said that the West faces a perpetual water crisis. But is it because water is always in short supply, or could it be because there is too much cheap water? Government-subsidized water and crops allow farmers to grow rice, cotton, alfalfa and other water-hungry crops that suck up 75 percent of raw water supplies. Contrary to popular opinion, water is priced so low that about 90 percent of it goes to irrigating urban greenscapes with only about 10 percent needed for the essentials of living—drinking, cooking, washing, and industrial uses. The water crisis in California is not a misfortune of nature or the failings of the market—it is a social and political creation.

A potential solution may have bubbled to the surface during California's recent electricity crisis. When policymakers ineptly tried to deregulate electricity, water agencies briefly followed suit—only to abandon such efforts when they saw what a mess politicians made of electricity deregulation (See *How to Keep the Lights On*, Oct. 2003). Politicians got cold feet at the notion of privatizing water, but maybe they should have at least considered “price-a-tizing” the system.

Because the cost of wholesale water is socialized and thus underpriced, consumers may exploit it for “wasteful” uses such as lawns, golf courses, gardens, and non-native vegetation. Newer command-and-control water conservation policies that seek to solve the problem by drought landscaping (xeriscaping) get more to the core of the ongoing urban water crisis. But without an economic structure, xeriscaping is bound to offer mere drops in the big regional water policy mud puddle. As with electric power, the most promising solution to the long-term water crisis in California is full-cost pricing.

### How the System Operates

The government industrial water system at the wholesale level is comprised of a backbone of massive aqueducts, reservoirs, pipelines, and pumping and treatment plants that draw and filter water from snowpack-fed rivers, lakes, and deltas. Urbanization and corporate agriculture in the western United States depend on this huge water hydraulic system. Most of this water infrastructure was put into place under Works-Progress Administration Programs in the Depression Era. Water supply at the local level is comprised of ground water and/or water purchased from wholesale government water suppliers.

Water is handled by a dizzying array of both small and large agencies, districts, departments, private regulated companies, mutual water companies, and agricultural water-stock cooperatives. At the bottom of the cascade of water entities is the small mutual water company that may serve only a neighborhood (e.g. Rubio Canyon) or a small city (e.g., Sierra Madre) at a price of say \$50 per acre-foot. This compares to government-supplied “manufactured” water that may be purchased for around \$500 per acre-foot, a ten-fold price difference! (An acre-foot supplies about two families for one year.)

At the after-market level in Southern California, water is recaptured, retreated, and recharged into groundwater basins. Urban storm water is controlled in flood channels, catch basins, and settlement basins to avert floods and replenish local aquifers. Wastewater is recycled through sewer plants and reclamation facilities. In many cases all that municipal water departments do is serve as a mere distributor of water



purchased from government wholesalers. In other cases, such as the city of Los Angeles, the water department may hold a monopoly as a wholesaler, retailer, and recycler.

### **Water is Free, But Getting It Isn't**

Like air, water is a free natural good, but the cost to dam, pump, treat, and deliver it is what reflects its cost to the consumer. For example, the cost to pump water from Parker Dam on the Colorado River through the Colorado River Aqueduct mostly reflects the huge pumping costs needed to lift the water across the mountains of the Mojave Desert to a point east of Palm Springs where it can flow by gravity into Southern California.

Ironically, the Coachella and All American Canals also take water from the Colorado River at a spot south of Parker Dam for agricultural irrigation purposes and transport it by gravity flow to almost the same destination as the Colorado River Aqueduct east of Palm Springs, only without the huge pumping costs! Ideally, water conveyance systems should follow gravity flow engineering. Instead water is pumped over mountain chains at enormous cost mainly for political reasons. This proves the popular dictum in water economics that “water flows uphill toward money.”

### **Transforming Water and Electricity**

Water and electric power are reciprocals of one another. Hydroelectric plants generate power. In turn, power lifts water over mountain chains. Without huge pumping plants that run on electric power, the California Aqueduct could not pump water over the Tehachapi Mountains nor could the Colorado River Aqueduct transport water over the mountains of the Mojave Desert.

During the California Energy Crisis of 2000-01, the huge spike in electricity costs amounted to nearly \$500,000 in pumping costs per peak hour extra for Southern California water wholesalers. However, this was entirely offset by the hydropower credits generated from shipping nearly double the annual allotment of water through the California Aqueduct to Southern California during that same period. If this had not occurred California would probably have suffered through an energy crisis of greater proportions. In other words, Northern California relies on sending raw water to Southern California in order to generate cheap wholesale hydroelectric power for its own needs. Both electricity and water may find the greatest hope for reform in the same concept—full-cost pricing.

### **Enter Pricing**

Full-cost pricing, or congestion pricing, involves a host of measures including lifeline rate pricing and submetering apartments like electricity. Lifeline rates are where the charge for an amount of water service considered to support the essentials of living (sanitary drinking water) is kept low, but much higher charges are levied on “luxury” water consumption beyond that threshold amount (swimming pools). At the very least we know that when prices rise, quantity demanded falls and vice versa. The Federal Congressional Budget Office estimates that combined water and sewer bills only average a half percent of income in this nation. Curiously, however, submetering is deemed “selling” water and is subject to the full requirements of the Safe Drinking Water Act.



Some price discrimination already occurs in water policy, but it is not market-based. Urban users typically subsidize the cost of water for agricultural producers, which results in cheap retail prices of agricultural products subsidized through taxes. This blurs the line between public and private systems and thus hides the true price.

## Enter Politics

But is full-cost water pricing too risky for public policymakers to consider? Or does the conventional subsidized system result in exploitation and waste of an under-priced natural asset?

The history of California is replete with water policy failures such as the voter rejection of the proposed Peripheral Canal to bring water from the Sacramento Delta to Southern California, the Arizona vs. California Supreme Court case diverting Colorado River Water from Southern California to Arizona, Colorado, and Nevada, and the more recent reclaiming of Owens Lake water from Los Angeles by environmental lawsuit. Recent Southern California water policy efforts to divert political water allocations from farmers, from the Bay Delta, and from the upstream urban users of the Colorado River in Denver, Phoenix, and Las Vegas are equally bound to fail in the long run because they externalize the problem and depend upon shifting political currents. The present supply of Southern California water is a diminishing asset as it is being politically “diced” by ever-growing urban populations in surrounding states and by growing jurisdictions within the state. California is projected to run out of “low-cost” water by 2030. What should policymakers do—wait until this tipping point arrives?

Continuing to depend on political solutions for water policies is like depending on luck—it will eventually run out. Successful privatization of retail water will depend not merely on privatizing municipal water agencies, but on full-cost demand pricing. If water were continuously priced at retail prices to reflect demand and, thus, peak and off-peak prices, then there would be no disparity, no losses and no ongoing crisis. For local water services that will mean more than new computerized meters. It will require the political will to price the commodities rationally. Full-cost pricing of water at the consumer level may even result in a ripple effect of creating more market rigor to the entire larger water pond of the government water system.

Unfortunately, many politicians prefer to tell people that somehow they don't have to pay the full cost of essential services and utilities. Politicians want the public to believe in such mythical things as free clean air, free clean water, free and clean renewable energy, cheap agricultural water, or that the public will conserve water without an economic incentive. If California resists reform the political precariousness of water resources may lead to more conflict. For example, in Santa Clarita, California environmentalists have taken over a local water board and have blocked large new tract home developments because they believe water is priced so low that it will result in the natural environment drying up in favor of urban gardens and swimming pools. The continued dependence on such demand-side policies as politicized Colorado river and state delta “water allocations,” “agricultural fallowing contracts,” and “water transfers” on one hand, and xeriscaping, environmental lawsuits and the political takeover of water boards on the other hand, will only cast the fortunes of politicians to the unpredictable currents and eddies of a political river that is ever drying up. Full-cost water pricing may not be too risky when compared to the long-term political fortunes of those who raft down the rivers of politics.

*By Wayne Lusvardi and Charles B. Warren*

## Milwaukee Water Contractor Scores Well on Audits

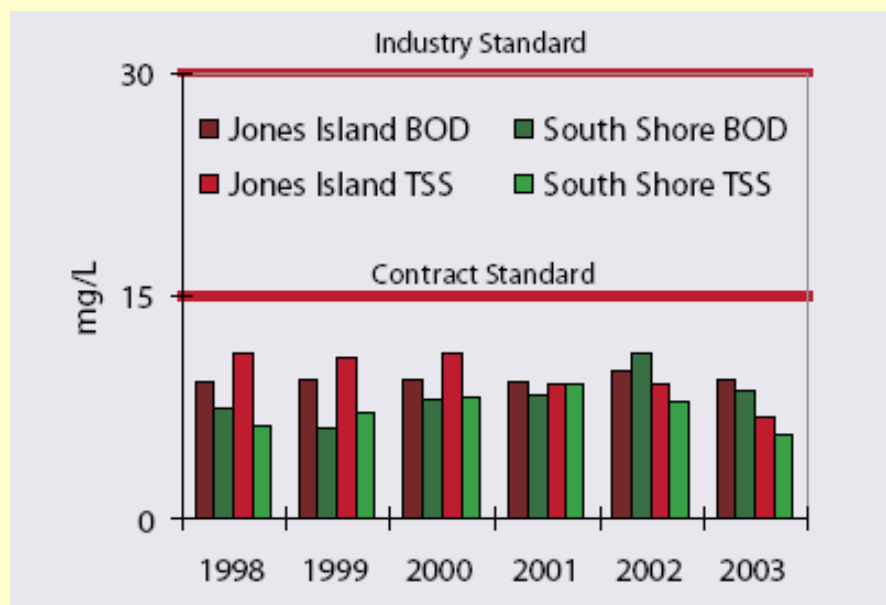
Speculation about quality oversights prompted the Milwaukee Metropolitan Sewerage District to carefully examine its contractor, United Water. MMSD Executive Director Kevin Shafer hired a Seattle sewerage district manager to head the audit.

The audit—which took nine months and cost \$157,000—found generally high levels of quality: “The treatment performance levels place the system in the top rank of systems in the nation. The number and volumes of combined sewer and separated system overflows are much lower than in similar systems.”

New Jersey-based United Water took over wastewater operations in 1998, when it entered into a 10-year agreement with MMSD. A service area population of 1.1 million made the Milwaukee contract the nation’s largest wastewater public-private partnership, and other features made it the most complex. The Milwaukee facility has a biosolids program, two wastewater treatment plants, an inline storage system and a 30-megawatt power plant. Most facilities would not, for example, have their own power plant.

The audit gave especially strong marks to the two wastewater treatment plants, noting that special recognition by the Association of Metropolitan Sewerage Agencies demonstrates that “the treatment system in particular is being operated in a very good manner.” Both treatment plants have received AMSA’s Platinum Award, given to agencies that go five or more consecutive years with no discharge violations. Prior to the United Water contract, the wastewater system had never received the platinum distinction. The audit goes on to note that United Water has also “consistently been awarded the incentives for superior effluent quality” contained in the contract.

**Figure 9: United Water's Milwaukee Treatment Plants Contaminant Level**





Systems often gauge quality on TSS (total suspended solids) and BOD (biochemical oxygen demand) levels, with TSS and BOD levels measured in milligrams per liter. A TSS/BOD standard of 30/30 is considered typical. However, United Water Project Manager Terry Tobel points out that the Milwaukee contract sets a more stringent 15/15 standard, and that his company's 9/9 performance has bettered even that.

Although the audit was mostly complimentary of United Water and described MMDS as "generally well run," the report did include some concerns, such as the maintenance of non-critical equipment and the contractor's relatively low staffing levels.

Tobel thinks such criticisms put too much faith in previous management models. "There are those who don't understand privatization and think that we don't have enough people, but that's just because we do our business so differently," he says. "We've downsized by about a third, and at the same time we've had an increase in water quality."

Since United Water guaranteed there would be no layoffs, the company has downsized through attrition. When an employee leaves, United Water reviews the position and decides whether or not to find a replacement.

A different approach to staffing and the implementation of other efficiencies have allowed United Water to stay on pace with the goal of saving 30 percent (\$140 million) over the term of the contract. Customers have felt efficiency gains in the form of lighter water bills as rates have dropped 16 percent.

New maintenance strategies demonstrate how efficiency can serve quality. "Before there were three separate maintenance systems," says Tobel, "and we brought it down to one." A computerized maintenance system called MAXIMO has improved tracking and allowed for the development of a predictive maintenance program. Meanwhile, an internal program known as Performax evaluates factors such as water quality, maintenance, cost and energy use on a daily, weekly and monthly basis.

Because the right information allows employees in the field to perform more effectively, Tobel credits Performax with helping to foster continuous improvement. "They know how much energy or how much chemicals they should be using," notes Tobel. "We review so often because you don't wait a month and realize you've used too much chemicals."

## **Don't Believe the Hype: Successful Water Privatization is the Norm**

If private involvement in water provision were the high-risk endeavor that critics claim, we would see disaster all around us. After all, water privatization is more common than most people realize.

- 2 of every 5 drinking water systems nationwide are privately owned, regulated utility systems.
- 1 of every 6 Americans gets drinking water from privately owned, regulated utility systems.
- Roughly 1 of every 25 communities in the rest of the nation has a government-owned and privately operated water utility.



Of course, we aren't sinking in disasters. In fact, when the anti-privatization group Public Citizen set out to report the most heinous examples of privatization gone bad they came up with only one substantiated case of a private operator running amok, buried in the midst of stories of such terrible things as the publicly appointed utilities commissions granting rate increases.

In a rich irony, the researcher for Public Citizen who wrote that report and other early attacks on privatization quit soon after. He came out publicly to explain that his work had taught him that privatization works when done right, and that critics have failed to show any problems with it beyond a few anecdotes (See: [rppi.org/pb22.pdf](http://rppi.org/pb22.pdf)).

### **Widespread Support**

Privatization has bipartisan support as a means of improving the environment and the health of citizens. In a 1999 study President Clinton's EPA endorsed privatization as a means by which local governments could meet environmental standards. Indeed the EPA wrote that privatization creates a classic "win-win" situation. The former Public Citizen researcher now says that his work to dig up dirt on private operators convinced him that "private operators have a respectable record of providing quality water and complying with environmental standards." Comparisons of compliance performance all find that privately operated utilities are less likely to violate safe drinking water standards.

### **Satisfied Customers**

At renewal time, 91 percent of communities choose to continue privatization. And this is not because they are captive to the private firms—6 percent of communities switch to another private company when existing contracts are up, and each year about 10 communities bring services back in house. Ninety-four percent of communities say they would recommend their private water manager to other communities.

### **Common Concerns**

Even after 1500 contracts, some people still misunderstand privatization's real record. They may worry about accountability for private operators: Will contractors put the bottom line before quality?

However, the market provides us food and medicine, child seats for our cars, and in fact, most of the things we put in our bodies or use to make us safer come from the private sector. And—as noted earlier—for many Americans that includes water. Just as with government-run facilities, private employees and managers and their families live in the community and drink the water. And companies that consistently fail to deliver expected service will soon find no more willing customers.

Others have different accountability concerns. They may, for example, raise the specter of foreign ownership. However, like the private sector in general, most of us already seem quite comfortable with foreign ownership. We trust foreign-made cars with our lives—and they are far more likely to be the cause of our death than our water is. We ingest foreign-made pharmaceuticals, we eat imported foods, we strap our children into foreign-made car seats, all without really worrying about where they are made. Why? Because there is a system for ensuring they are safe products. Privatization of water and wastewater services does not change the system for ensuring the water is safe and reliable. Government remains responsible for





establishing and enforcing quality and reliability standards, and with a good contract, contractors have every incentive to ensure the same.

The partnership in a privatization and the contract that binds it must be based on visible, measurable performance, and must reward private companies only if they meet the goals and performance they have promised. Community leaders have to apply the best practices and lessons learned from past privatizations to their own decisions. Communities may even turn to specialized consultants to help them negotiate new contracts with private operators.

Still, water privatization is neither inherently bad nor inherently good. It is not a White Knight that can ride in and rid a city council of all its water utility worries. Privatization does enjoy a solid track record of success, and research and experience shows that—in the right time and place—it is a viable option.

# Corrections



According to the Association of Private Corrections and Treatment Organizations there are 213 private facilities operating in the United States with a rated capacity of 131,037 beds. One hundred and six of those facilities have achieved American Correctional Association accreditation—many as a stipulation of their contract.

Each level of government uses private facilities, however, the largest individual customer is the federal government with 45 facilities and bed space of 38,685—slightly up from 42 and 34,775 last year.

State government, when grouped together, total 112 different facilities with a capacity of 80,882. This reflects an increase of 8.7 percent in bed space and 6.7 percent in the number of facilities over last year (105 and 74,413 respectively)—representing the largest growth in several years. Fifty-nine facilities cater to local units of government (city and county) with a capacity of 19,423—up slightly from 57 and 18,259 a year ago.

**Table 10: Capacity By Security Type**

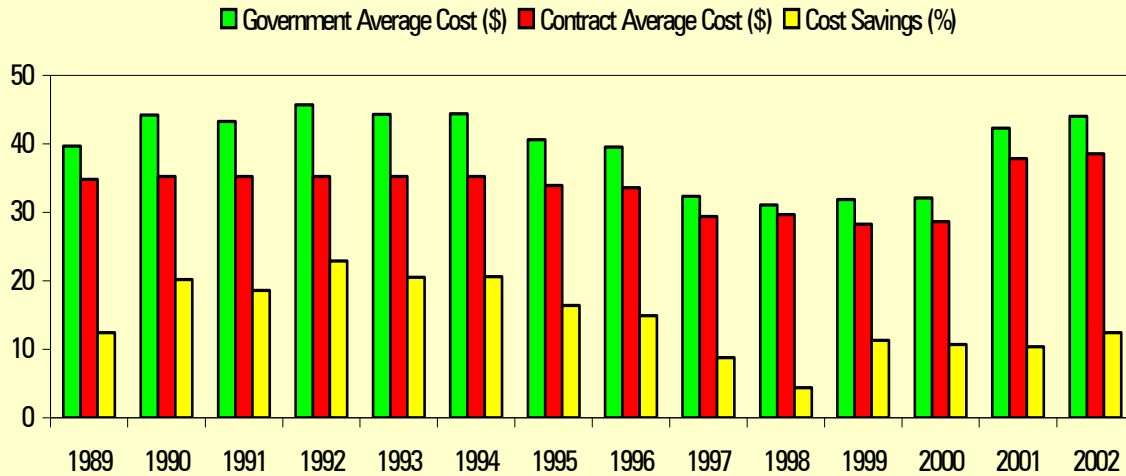
Security type	Male	Female	Either	Total
Maximum	10336	1384	7994	19714
Medium	72550	2266	5133	79949
Minimum	18279	1133	1057	20469
Residential - Secure	2453	419	1399	4271
Residential - Open	1071	267	1779	3117
Non-Residential	50	39	3428	3517
Total - All Types	104739	5508	20790	131037

In addition, countries like Canada, Australia and the United Kingdom operate 11 facilities with 9,597 beds. There was not any growth from last year.

## Mangos to Mangos

Late last year the Texas Criminal Justice Policy Council issued its latest biannual review of the costs of incarceration in Texas per legislative decree. The review is longest standing public vs. private operational cost comparison providing the best historical and trend data. The average daily cost of operation in a government-run facility was \$42.28 and \$44.01 in 2001 and 2002 respectively. Costs in private facilities under contract in Texas were only \$37.87 and \$38.57 representing savings of 10.4 and 12.4 percent. Savings are even more dramatic when the operational costs of jails are compared. Savings with private contracts was 17.4 and 19.3 percent in 2001 and 2002 respectively.

**Figure 10: Texas Criminal Justice Policy Council: Time Series Data**



## Private Prisoner Care in Michigan



The state of Michigan has substantial prison-related privatization experience. It has privatized operation of the Lake County-based juvenile correction facility in a contract with the GEO Group. Since 1997, it has also competitively contracted for medical services in the remainder of Michigan’s correctional system. Indeed, the state’s extension of that contract through 2007 suggests that competitive contracting has proved to be a valuable management tool — one that could be employed in all aspects of the prison system.

The state of Michigan contracts for prison medical services with St. Louis-based Correctional Medical Services Inc. CMS provides medical services to 225,000 local jail inmates and state and federal prisoners in 27 states. The Michigan Department of Corrections estimates the contract’s projected cost over its first six (of 10) years at \$347 million.

The state originally hired another vendor in 1997 to provide many of the services now provided by CMS. Early in this contract, however, the state became concerned about the vendor’s ability to provide the performance quality it had promised. After some negotiation, the contract was reassigned to CMS in March 1998. In April 2004 the state extended the CMS contract three years, through April 2007.

According to Rich Russell, administrator of the Bureau of Health Care Services for the Michigan Department of Corrections, the state of Michigan has enjoyed both qualitative successes and financial savings as a result of its relationship with CMS and the firm’s elaborate system for demonstrating accountability. “We have had a good, cooperative relationship with CMS, and together we look for ways to save money without lowering the quality of care,” said Russell.



For instance, CMS has worked with the state to implement an electronic medical record-keeping system, which will be operational statewide by the end of 2004. Both parties hope that the system will improve efficiency and the flow of information about inmates' medical histories. CMS has also increased staffing levels by adding more physicians and physicians' assistants, and it has helped the state maintain its accreditation with the Joint Commission on Accreditation of Healthcare Organizations, a private, nonprofit outfit that ensures that health facilities maintain acceptable standards of care.

While CMS provides the prison system's medical services, a state chief medical officer and four regional medical officers are the system's gatekeepers, and they determine the level of treatment CMS and its subcontractors should provide to prison patients. If CMS does not think a certain treatment is necessary for an inmate, but the state's regional medical officer does, the dispute is resolved by submitting it to a committee that includes representatives from both the state and CMS.

A summer 2004 telephone survey of state corrections departments by the Mackinac Center for Public Policy found that 32 states contract with private firms for some degree of health services for their prisoners, and that another state, South Carolina, is in the process of doing so. Some states have contracted for health services across their entire prison system, while others target a single prison. Still other states split health delivery contracts by service: One vendor provides physical health services, for instance, while another provides mental health services. The state of Texas has contracts with University of Texas Medical Branch and Texas Tech Health Science Center, both public entities. Contracting solutions are as diverse as the states themselves.

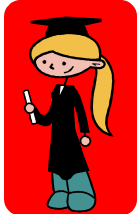
One company, America Service Group Inc. of Tennessee, estimates that the national health market for prison and jail inmates is \$7 billion annually. With health-care costs and the number of prisoners expected to increase, the country may see more inmate health-care privatization by states and counties.

State governments nationwide are trusting some of their most important and expensive prison spending to private firms, and there are bolder steps for Michigan to consider. The Mackinac Center for Public Policy has recommended that the state examine the privatization of its entire system — that is, outsourcing management of its corrections department to a for-profit firm. In 1998, the state of Tennessee almost did so, and savings were then estimated at 22 percent. Similar reductions in Michigan would shave nearly \$350 million from the state's general fund appropriation for state prisons, which, given the state's chronic structural deficits, would certainly be a welcomed development.

*By Michael D. LaFaive, director of fiscal policy, Mackinac Center for Public Policy  
This article appeared in Michigan Privatization Report: [mackinac.org/pubs/mpr/](http://mackinac.org/pubs/mpr/)*

# Education

## Charter Schools



Charter schools continue to be the largest example of school privatization. According to the Center for Education Reform, as of April 2005, approximately 3,400 charter schools are operating across the United States serving close to 1 million children. For the 2004-2005 school year, 459 new charter schools opened serving an additional 76,000 school children. In addition, according to Arizona State University's Profiles of For-Profit Education Management Organizations, as of the 2004-05 school year there were 535 public schools being operated by 59 for-profit management companies in 25 states and the District of Columbia, enrolling approximately 239,766 students. The virtual charter school market is also growing. More than 31,000 students were enrolled in 86 online charter schools in the United States at the end of 2004, with 62 of them opening in 2000 or later.

There has also been substantial growth of charter schools in the nonprofit sector, resulting in specialization and branding of nonprofit charter schools. For example, the New Schools Venture Fund has a \$40 million charter school accelerator fund focused on fueling rapid, scalable growth of nonprofit charter systems. In California alone some of the branded nonprofit charter networks include Green Dot Public Schools, Aspire Public Schools, High Tech High, and Leadership Public Schools. In addition the California Alliance for Student Achievement has begun a new network of College Ready High Schools, and well-known national nonprofit brands such as KIPP Academies and the Seed Charter schools that continue to expand nationally.

The philanthropic community plans on continuing huge investments into branding chains of charter schools. For example, the Philanthropy Roundtable has made a strategic commitment to charter school principles and views charter schools as its main vehicle for school reform. This group includes many business and foundation leaders from the Walton Family Foundation to the Broad Foundation. Some of these leaders are adopting or developing their own specific chains of charter schools—like Frank Baxter with College Ready charter schools.

In addition, the No Child Left Behind Act has created increased opportunities for charters. Urban school districts with large numbers of failing schools are increasing the opportunities for both charter schools and contract schools.

Daniel Weintraub describes this trend in San Diego in a June 12th column in the *Sacramento Bee*.

*First, look at what is happening in San Diego, where determined parents are showing how people in some of the state's toughest neighborhoods can take back their schools from the bureaucracy.*

*Michelle Evans, 35, says the schools let her down. Promoted through the grades without having to achieve, she dropped out of high school barely able to read and write. But she is a fiercely proud woman, and she was not about to let the same thing happen to any of her three children, or to her community—the long-depressed Chollas View section of this otherwise wealthy city.*

*"Public education as it stands now is not working for minority children," says Evans, who is African-American. "It's not."*



*So earlier this year, Evans helped marshal a massive grass-roots campaign that culminated in a declaration of education independence in her neglected neighborhood. More than 700 parents, representing about 70 percent of children in the Gompers Secondary School attendance area, signed petitions demanding that the San Diego Unified School District relinquish control of the campus and hand it over to a board of parents, teachers, academics and community activists. After initially resisting, the district's trustees approved the request.*

*This fall, the site will reopen as Gompers Middle Charter School under a partnership with the University of California, San Diego. It will have a longer school day, many new teachers and high expectations. The school will combine intense instruction in basic subjects with strong discipline and close attention to the problems many children from this area deal with outside of school.*

*Three other San Diego neighborhood groups took control of their schools the same day Gompers did. And what is happening here increasingly is happening throughout California.*

In Philadelphia, 45 of the city's lowest-performing public schools are managed through contracts with independent firms. Test score data for 2004 reveals that these schools have improved academic achievement for the city's most needy students.

In June 2004, Chicago Mayor Richard Daley announced his six-year, \$150 million "Renaissance 2010" plan to shut down Chicago's failing public schools and open 100 new schools by 2010. Mayor Daley has more control over Chicago's public schools than other urban school leaders because the state legislature gave him legal control of the schools in 1995.

The plan will allow the creation of 30 new charter schools and 30 new contract schools created by private groups that sign five-year performance contracts with the district. The proposal would sell some school buildings and reconfigure some high schools and elementary schools into smaller schools catering to no more than 350 to 500 students each. The plan will also allow 60 of the 100 schools to operate outside the Chicago Teachers Union contract.

The effort will be partially funded with \$50 million in private donations. The Civic Committee of the Commercial Club of Chicago, an organization comprised of the leaders of 75 of the Chicago region's largest corporations, professional firms, and universities, played a key role in selling Schools Chief Arne Duncan and Daley on the idea of creating independent schools. The committee is leading the effort to raise \$50 million to cover startup costs at the new schools, half of which has already been committed by the Chicago Community Trust, the Gates Foundation, and others.

Daley's plan also points to the tendency of the charter movement to specialize in many different types of schools and replicate existing charters. For example, some of Daley's proposed schools include:

- A new military charter high school for Chicago's North Side for fall 2005, through a partnership with the Naval Service Training Command at the Great Lakes Naval Station.



- A new charter school developed by the law firm of Sonnenschein, Nath & Rosenthal scheduled to open in September 2005 in the city's North Lawndale neighborhood. The firm will spend about \$200,000 a year to start its school with pre-K classes and kindergarten, and then add a grade each year.
- Daley plans to replicate existing charter schools such as Chicago's Noble Street Charter School, where kids have a longer day and study in smaller classes and Perspectives Charter School in the South Loop, where every student must land a job or show a college acceptance letter to get a high school diploma.
- A new "early college" high school linked with DeVry University.
- Daley is also considering the Knowledge Is Power program, which has two charter schools in Chicago and dozens across the country that run from 7:45 a.m to 5 p.m. daily, as well as a school linked with Outward Bound, the outdoor adventure group.
- Other possibilities include partnerships with Catholic schools, universities, nonprofits, social service agencies and the Chicago Historical Society. For example, Chicago Public Schools officials have invited leaders of the San Miguel Catholic School to run a new public school as part of Renaissance 2010 plan. A not-for-profit secular arm would be established for the contract.

Similarly, in fall of 2004, New York City opened eight new charter schools as part of Schools Chancellor Joel Klein's plan to develop 50 new charter schools over the next five years. Three of the new charter schools opened in the Bronx, two were in Brooklyn, two were in upper Manhattan and one opened in Far Rockaway, Queens. New York City has embraced private-sector involvement, where private donors have invested \$41 million to help create 50 new charters in the next five years. In a plan similar to Chicago's, New York school officials will give the charter schools space in their buildings and provide start-up funds.

### **Charter School Achievement**

The Center for Education Reform has found a strong link between student achievement and states with strong charter school laws. Nearly two-thirds of the 26 strong-law states saw significant gains in student achievement in test results and *No Child Left Behind* data during the most recent two-year period. In the 15 weak-law states, where charters fall under traditional school district management, only two states produced gains in student achievement.

- A 2004 report commissioned by the U.S. Department of Education found that charter schools are smaller than conventional public schools and serve a disproportionate and increasing number of poor and minority students.
- A 2003 national report by the Brookings Institution shows that test scores at charter schools are "rising sharply" and out-gaining conventional schools.
- A December 2004 Harvard University study finds that charter school students are more likely to be proficient in reading and math than students in neighboring conventional schools. The greatest achievement gains can be seen among African-American, Hispanic, or low-income students.
- Charter schools that have been open for significant periods of time boast even higher achievement rates; Harvard found that charter schools that have been operating for more than 5 years outpace conventional schools by as much as 15 percent.



- California’s classroom-based charter schools were 33 percent more likely to meet student performance goals in 2004 than were regular public schools, according to a May 2005 research report released by EdSource, an independent nonprofit education research organization.

<b>Table 11: Charter Management Organizations</b>					
<b>CMO</b>	<b>Web Site</b>	<b>Geographic Focus</b>	<b>Grades</b>	<b>Schools</b>	<b>Students Served</b>
Aspire Public Schools	www.aspirepublicschools.org	California	K-12	11	3,900
Green Dot Public Schools	www.greendotpublicschools.org	Los Angeles area	9-12	5	1,400
Partnerships to Uplift Communities	www.pucschools.org	Los Angeles area	K-8	6	1,050
Inner City Education Foundation	www.icefla.org	Los Angeles area	K-12	3	550+
Leadership Public Schools	www.leadps.org	Northern California	9-12	2	300+
Alliance for College-Ready Public Schools	www.laalliance.org	Los Angeles area	9-12	1	200
<b>California Total:</b>		<b>28</b>	<b>74,000</b>		
Amistad Academy / Achievement First	www.achievementfirst.org	Conn. and N.Y.	K-8	3	420
Lighthouse Academies	www.lighthouse-academies.org	East Coast /Midwest	K-8	1	120
Mastery Charter High School	www.masterycharter.org	Philadelphia, Pa.	9-12	1	400
<b>East Coast Total:</b>		<b>5</b>	<b>840</b>		
Noble Street Charter High School	www.goldentigers.com	Chicago	9-12	1	475
Perspectives	www.perspectivescs.org	Chicago	6-12	1	275
<b>Chicago Total:</b>		<b>2</b>	<b>750</b>		

Note: Charter management organizations, or CMOs, are nonprofit groups formed to start and run centrally managed systems of brand-name charter schools.

Source: NewSchools Venture Fund

## School Choice Popular in State Legislatures in 2005

The year 2005 was a banner year for school choice legislation, when at least 17 states considered school choice proposals. As many state legislative sessions drew to a close for 2005, the fate of several school-choice initiatives was decided for the year.

In 2005 Utah became the first state to enact a new school choice program. Children with autism and other special needs in Utah received help on March 10<sup>th</sup> when Gov. Jon Huntsman signed a law providing 600 special-education students with private school vouchers.

The new program was named the Carson Smith Special Needs Scholarship Act, after an autistic Salt Lake City student who attends the Carmen B. Pingree School for Children with Autism. In 2004 over 60 percent of Utah's registered voters supported it, and the state House and Senate narrowly approved the bill in the 2004 legislative session. Citing potential legal concerns, then-Gov. Olene Walker (R) vetoed the measure, but she left intact the \$1.4 million the legislature had appropriated for the scholarships.

The bill did not have enough support in the House to override her veto, so the funds remained unspent.

Rep. Merlynn Newbold (R-South Jordan) worked with opponents between the 2004 and 2005 legislative sessions to craft a bill that addressed Walker's legal concerns. The legislature appropriated \$2.5 million for the scholarships. Less than 2 percent of Utah's 54,000 eligible special-needs children will be able to receive a Carson Smith Scholarship in the 2005-06 school year. However, the legislature reappropriated the \$1.4 million left from last year to fund scholarships for children who would have been eligible in the 2004-05 school year. Future legislatures will decide annually how much to appropriate for the scholarships.

## Governors Led the Way



Although the majority of school choice initiatives have died in state legislatures, in 2005 the governors led the charge for more school choice on the state level. For example, South Carolina Gov. Mark Sanford (R) proposed a tax credit program that would have given families earning up to \$75,000 a credit on their state income taxes for the cost of public or private school tuition up to 80 percent of the state's average per-pupil cost.

Public school districts would still have received the local and federal per-pupil dollars, but the state's per-pupil aid would follow the student. The plan also would have created a corporate tax credit scholarship program. Unlike similar programs in Arizona and Florida, the South Carolina plan would have let businesses make unlimited contributions to nonprofit scholarship groups in lieu of paying state corporate taxes. Those groups would then provide tuition scholarships to low-income children.

In a March 2004 report of the South Carolina Policy Council, *Fiscal Impact of the Universal Tax Credit Proposal*, Clemson University economist Cotton Lindsay found the state would save hundreds of millions of dollars in education costs by implementing a tax credit program.

"Public school spending is tied very closely to the number of students in the school—each child who leaves results in immediate cost reductions. The public school no longer has the cost of educating a tuition-tax-credit child, but still keeps all the local and federal dollars that would be spent on that child," Lindsay



concluded in the study. "As a result, South Carolina public school districts will have more money each year per student."

However, a fiscal impact study of the Put Parents in Charge Act by the state Board of Economic Advisors, released in mid-April, claimed paying private school tuition would cost South Carolina as much as \$231 million in revenue in five years. Opponents cited the fiscal impact report in condemning as too costly the idea of creating tax credits for private school tuition. The state Board of Economic Advisors estimated the proposal could cost up to \$231 million in state revenue over the next five years.

On May 4, legislators in the House voted 60-53 to table the tax credit bill. By tabling the bill—a version of the “Put Parents in Charge Act” proposed last year by Gov. Mark Sanford (R)—the legislators essentially killed it for the rest of the 2005 session.

The revised bill, however, proposed May 4<sup>th</sup> by Reps. Shirley Hinson (R-Goose Creek) and Jim Merrill (R-Daniel Island), aimed to correct that problem by giving only students in failing schools in the state’s 85 districts the option of attending private school, combining tax credits with vouchers for low-income families.

The plan would have affected about 187 of the state’s 1,119 schools, including about 50 in the Charleston area. Members of the House refused to let the measure come up for debate.

In Texas, Gov. Rick Perry (R) proposed a pilot school choice program to help children in failing schools. The Texas Freedom Scholarship would have offered scholarships to students in the seven largest urban schools with the greatest percentage of economically disadvantaged students. In addition, the funds a district receives for a student (such as for special education, ESL, etc.) follow the student and are not subject to the 90 percent cap.

Any chance for school vouchers was scuttled as the legislative session ended May 30<sup>th</sup>. It was the first time in eight years that the House debated giving students public funding to attend private and parochial schools. In 1997, the effort failed on a tie vote and the current House debate ended in a similar fashion. The school choice measure would have allowed up to 5 percent of low-income or at-risk students in each of seven large urban districts to receive state money to use at the school of their choice.

The GOP majority in the House narrowly defeated early anti-voucher amendments while Speaker Tom Craddick (R-Midland), a voucher supporter, overruled the parliamentary challenges. However, after supporters won some initial rounds on the bill with tie votes, Rep. Charlie Geren (R-Fort Worth) ended the debate by offering two amendments that killed the measure. One stripped out the Dallas and Fort Worth districts, and the other removed private and parochial schools—essentially making the program a public school choice option, similar to what already exists in many school districts.

Missouri Gov. Matt Blunt (R) endorsed a tax credit scholarship for lower-income families with children enrolled in failing schools. The \$40 million tax credit proposal would have allowed businesses and individuals to donate to nonprofit groups, which would award students scholarships to attend private or better-performing public schools. Sponsors said that more than 10,000 of the state's neediest children could receive scholarships. An average scholarship would be \$3,800, up to a maximum of \$6,500.

However, Missouri legislators killed the proposal by adding three amendments that made it unfeasible. One would have delayed implementation of the tax credit until after the state's education formula was fully funded, in a state where the economy is so weak that doing so could take several years.

Minnesota Gov. Tim Pawlenty (R) proposed a \$4 million tax credit scholarship plan that would allow 1,500 low-income students in failing schools in Minneapolis and St. Paul to attend private schools. The scholarships would come from corporate donations made to nonprofit organizations in exchange for tax breaks. The Senate Education Committee voted on April 5<sup>th</sup> to keep it from moving on to another committee, and the House Education Committee voted to table the House version of the bill on April 3<sup>rd</sup>.

In Indiana Gov. Mitch Daniels (R) supported a school choice program that would give parents money to transfer their children to other public or private schools if their current public school fails to meet annual academic targets. In addition to the voucher provision, the bill would have given tax credits to parents who pay private school tuition or pay a fee to send their children to another district.

In Indiana, state legislators deleted the school voucher component from a bill that would have allowed students in Indiana's 51 lowest-performing schools to exit to the public or private school of their choice. The remainder of the bill gives Indiana families \$1,000 in tax credits to offset the extra expenses associated with private and home schools.

The plan creates tax credits for families who make less than \$33,000 a year. Those making up to \$66,000 would be eligible within two years. Supporters of the more robust voucher proposal say the \$1,000 tax credit isn't enough to help the poorest children, whose families can't afford to make up the balance of tuition. The revised version of the bill had yet to make its way through both the House and Senate at press time.

## Other States Considering School Choice



Several other states also had school choice bills in the 2005 legislative session:

- **Illinois:** the Opportunity Scholarship Act includes a \$15 million pilot program offering \$500 scholarships in Chicago for after-school tutoring services from approved providers, or \$3,500 to help meet tuition costs at qualified and participating public, private, nonsectarian, or religious schools of the eligible family's choice;
- **Iowa:** on April 20<sup>th</sup>, the state House of Representatives passed the School Tuition Organization Tax Credit, which allows individuals

to receive a tax credit for donations to a tuition organization, creating scholarships for low-income children to attend the school of their choice. The organizations must give priority for the scholarships to students from families whose incomes are less than 200 percent of the federal poverty level. The bill is currently being considered in a Senate Ways and Means subcommittee.



- **New Hampshire:** a modest plan for 1,200 vouchers for first graders was dropped in the Senate Finance Committee on April 7<sup>th</sup> after a dispute over its funding. The "School Choice Certificate," proposal would have established 1,200 vouchers for first graders in the initial year of the program, with the total number of vouchers expanding to a maximum of 16,000 after eight years for students in grades 1 through 8. The voucher would be worth 80 percent of the state adequacy grant each district receives per student. The state adequacy grant is expected to be \$3,580 next year, which means the maximum a voucher would have been worth is \$2,864.
- **New York:** a bill to provide income tax credits up to \$3,000 for families sending children to private schools has died in the state legislature.
- **Vermont:** a voucher bill allowing parents to receive certificates worth \$5,000 (for high school) or \$2,500 (for elementary grades) to educate their children at independent schools.
- **Virginia:** a tax credit proposal allowing scholarships for students in under-performing or crowded schools to attend another public or private school failed.

While many governors led the charge for school choice legislation in the states, a few governors vetoed their legislature's school choice bills.

In Arizona Gov. Janet Napolitano (D) has vetoed school tax credits twice in the 2005 legislative session. On March 28<sup>th</sup> she rejected a bill, introduced as part of Arizona's overall budget package, to expand the state's tuition tax credit for private and parochial scholarships by allowing corporations to participate.

The second veto came as a shock to school choice supporters. The legislature thought they had reached a budget agreement with Gov. Janet Napolitano (D) on May 6<sup>th</sup> to create corporate income tax credits for organizations that contribute to K-12 scholarship programs, and to eliminate the marriage penalty on individual scholarship donations.

Napolitano agreed to an increase in the number of scholarships created by the existing state tax credits, in exchange for legislators dropping a voucher proposal and increasing funding for all-day kindergarten. The school choice provisions would have created an additional \$5 million in tax credits beginning in 2006, to provide scholarships for low-income children.

Unfortunately, on May 20<sup>th</sup>, Gov. Janet Napolitano vetoed the corporate tax-credit legislation that school-choice supporters expected to become law as part of a budget deal made a few weeks earlier. However, the budget Napolitano signed included her funding priorities such as a new medical school branch campus, expansion of all-day kindergarten and funding for social programs that she negotiated in exchange for approving the tax credit legislation.

Napolitano said she vetoed the tax credit initiative because Republicans did not include a five-year sunset on the legislation. School choice advocates accused the governor of breaking her promise to Arizona children.



“It’s unfortunate that for the moment this bipartisan agreement has been turned on its head,” Milton & Rose D. Friedman Foundation President Gordon St. Angelo said in a May 20<sup>th</sup> press release. “Children in Arizona shouldn’t have to wait for greater educational freedom because of legislative wrangling.”

The tax-credit legislation would have allowed scholarships for 1,000 economically disadvantaged children to attend private schools. At press time, Napolitano was considering calling a special session to resolve the matter, indicating she may approve the corporate tax credit legislation if it includes the five-year sunset term.

Senate Republicans are leaning toward bypassing the governor and taking their case for tuition tax credits directly to voters next year. Republicans say they have enough votes to move a tax credit initiative directly to the ballot in 2006.

According to a survey sponsored by the Milton and Rose D. Friedman Foundation, 91.4 percent of Arizonans supported one or more of the five school choice proposals pending in the legislature this spring, with 65.6 percent "strongly" in favor of one or more of the programs.

In addition, on March 24<sup>th</sup> the U.S. District Court upheld Arizona's scholarship tax credit program as constitutional, dismissing a lawsuit from the state American Civil Liberties Union (ACLU) chapter.

Since Arizona enacted the Tuition Tax Credit Program eight years ago, it has been under almost continuous legal assault by opponents of school choice, first in state courts and more recently in federal ones.

"The Tuition Tax Credit is a neutral, secular program whose benefits are available to all Arizona taxpayers and students," U.S. District Court Judge Earl H. Carroll declared in *Winn v. Hibbs*. "Furthermore, multiple layers of private choice ensure that the State itself does not aid recipients with regard to their religion."

In Wisconsin, the state legislature passed a bill to raise the Milwaukee Parental Choice Program's enrollment cap by 1,500 students, for a total of 16,500 students. Unfortunately, on April 29<sup>th</sup> Wisconsin Gov. Jim Doyle vetoed the bill to lift its 15,000-student enrollment cap.

The Milwaukee Parental Choice Program (MPCP), which turned 15 years old on April 27<sup>th</sup>, provides vouchers for the city's low-income children to attend the private schools of their parents' choosing. Since 1995, the law has mandated that no more than 15 percent of students enrolled in the Milwaukee Public Schools (MPS) system may receive the vouchers. Based on current MPS enrollment, approximately 14,800 students would have been permitted to receive vouchers.

But the number of children enrolled in the MPCP jumped from 12,900 in the 2003-04 school year to 15,000 in 2004-05, prompting the Department of Public Instruction to propose a seat-rationing program for the 2005-06 academic year, displacing approximately 1,500 students. About 100 private schools participate in the program, with 50 more lined up to begin participating this fall.

The bill was popular in the legislature, where it passed 58-35 in April, and also among the Wisconsin public. Polls show support for school choice stands at about 60 percent statewide and close to 80 percent in the poor neighborhoods of Milwaukee.



A Manhattan Institute study by Senior Fellow Jay Greene, published last year, found Milwaukee's choice students graduate from high school at much higher rates than those enrolled in the city's public schools—64 percent in 2003, compared to 36 percent in public schools.

In Florida, the 2005 session closed May 6<sup>th</sup> with the legislature failing to agree on school choice accountability legislation. The proposed measure would have barred schools that accept vouchers from discriminating on the basis of religion, required student progress to be measured using one of four standardized tests, and subjected voucher schools to unscheduled visits by an auditor. On the last day of the 2005 session, House members tacked 281 pages of amendments onto the bill, and the Senate did not take it up again. Gov. Jeb Bush (R) has promised to tighten up school choice accountability and monitoring through an executive order.

In addition, Bush had hoped to dramatically expand the state's voucher program this year. The Reading Compact Scholarship would have given a taxpayer-funded voucher to any student scoring at the lowest level on the reading portion of the Florida Comprehensive Assessment Test for three consecutive years. The Senate voted down the program, saying it didn't want to expand vouchers before the state Supreme Court rules on the Opportunity Scholarship program.

However, Florida's corporate scholarship tax credit program cap increased from \$50 million to \$88 million. According to a May 8<sup>th</sup> press release from the Alliance for School Choice, the tax credit expansion—passed by the legislature as part of an omnibus budget package—nearly doubles the current program and will enable up to 9,000 low-income students to use scholarships to attend private schools over the next 18 months.

Approximately 11,500 students are currently enrolled in the scholarship tax credit program. That number could potentially swell to 15,000 students this fall, and to 20,000 students by the 2006-07 school year. Scholarship funding organizations may award up to \$3,500 per student.

A new study by two Harvard University scholars concludes the vouchers offered under Gov. Jeb Bush's (R) A+ Accountability Plan in Florida are spurring gains in student achievement. Researchers Martin R. West and Paul E. Peterson of the Program on Education Policy and Governance at Harvard's John F. Kennedy School of Government found Florida's vouchers have been more effective than the choice provisions of the federal No Child Left Behind Act (NCLB) in bringing about test score improvements.

Under A+, Florida students become eligible for vouchers to transfer to a private school if their public schools receive an "F" on accountability measures twice in a four-year period.

West and Peterson found Florida's fourth- and fifth-graders made modest but significant gains in math and reading when their schools were in imminent peril of losing students to vouchers. Students in schools that received their initial "F" in 2002 scored from 4 to 5 percent of a standard deviation higher the following year than did students in "D" schools, which did not face an imminent voucher threat.

The stigma of publicly receiving a low grade seemed to provide some reform impetus to "D" schools as well. Their students improved by 5 percent of a standard deviation relative to students in "C" schools.



## Existing School Choice Programs Continue to Expand in 2005



Building on the success of the 10-year-old Cleveland Scholarship and Tutoring Program, the Ohio House of Representatives on April 12<sup>th</sup> approved legislation to create a new statewide scholarship program.

The expanded school choice program would allow as many as 18,000 children in 30 school districts the state deems to be on “academic watch” or “academic emergency” to receive scholarships to attend the school of their parents’ choosing.

Under the new rules, the state would provide \$4,000 to private elementary schools for each voucher participant, \$4,500 to middle schools, and \$5,000 to high schools. The scholarship amount will increase annually with the Consumer Price Index. Currently, students in 34 “academic watch” school districts and several charter schools across the

state qualify for the program.

In addition, the Cleveland scholarship program would be expanded to provide vouchers for high school juniors and seniors, and its funding would increase to \$20.5 million by 2007. Approximately 5,000 Cleveland students received vouchers to attend 45 private schools in the 2003-04 academic year. The U.S. Supreme Court ruled the program—one of the first of its kind in the nation—constitutional in 2002.

Clint Bolick, president and general counsel of the Phoenix-based Alliance for School Choice, which lobbies for school choice programs nationwide, praised Ohio State Rep. Dixie Allen (D-Dayton) for proposing the program-expansion bill.

“The success of the Cleveland school choice program in opening doors of opportunity to disadvantaged schoolchildren has provided inspiration for a major expansion of school choice in Ohio,” he said in a statement released April 13<sup>th</sup>.

The House voucher proposal dramatically increases Gov. Bob Taft’s (R) proposal to increase funding for the state’s voucher program by \$9 million and offer vouchers to approximately 2,600 children. To qualify for Taft’s proposed program, children from kindergarten through eighth grade would have to attend a school that failed to meet state test standards in reading and math for three years. Under Taft’s plan, students at 70 Ohio elementary and middle schools would be eligible for scholarships based on state test scores.

The House version also differs from Taft’s plan in terms of the financial impact on public schools. Taft’s voucher proposal would have subsidized tuition out of a new \$9 million state account, not out of local school district funds. The House version calls for money to be deducted from local district coffers.



Rep. Dixie Allen of Dayton, the only Democrat to vote for the budget with the voucher proposal, told the *Beacon Journal* on April 18<sup>th</sup> that there is a need for more parental choice in Dayton. Allen said, “there is a privately funded voucher program in Dayton now. Last year, 600 children received vouchers, and there was a waiting list of more than 1,100.”

The Senate version of the state budget, released May 24<sup>th</sup>, maintains the statewide voucher program passed by the House on April 12<sup>th</sup>. The Senate kept the concept, but scaled the voucher plan back to 10,000 students in low-performing schools.

On May 10<sup>th</sup> Pennsylvania parents celebrated the fourth anniversary of the state’s landmark Educational Improvement Tax Credit Program (EITC). Signed into law in 2001 by former Pennsylvania Gov. Tom Ridge (R), the EITC provides tax credits ranging from 75 percent to 90 percent to companies contributing to nonprofit scholarship, educational improvement, and pre-kindergarten scholarship organizations. Nearly \$27 million is allocated annually for scholarships, a little more than \$13 million for innovative programs in public schools, and \$5 million for pre-K scholarships.

In the 2004-05 school year, the EITC program helped fund more than 25,000 scholarships and countless educational improvement programs in Pennsylvania’s public schools. To date, more than 2,200 Pennsylvania businesses have participated in the EITC program, contributing more than \$140 million to create private school scholarships and to help establish innovative public school programs.

In its first two years, the EITC was capped at \$30 million—\$20 million for scholarships and \$10 million for public school improvement programs. In response to overwhelming demand, however, in 2003 the Pennsylvania General Assembly increased funding by \$10 million, doubled the maximum tax credit from \$100,000 to \$200,000, and created a similar program for pre-K scholarships.

Thanks to the EITC, Pennsylvania currently has more than 165 scholarship, 230 educational improvement, and 50 pre-K scholarship organizations. The cap on the scholarship portion of the EITC program was reached in 70 days last year; the educational improvement portion was reached in one day. A new round of funding will begin on July 1<sup>st</sup>.

The REACH Alliance plans to lobby for expanding the EITC program this year in order to allow more businesses to participate. During the 2004-05 school year, more than 100 businesses that wished to participate in the EITC program were unable to do so because the tax cap had already been reached. If the program is expanded, more businesses will be able to participate, creating more opportunities for children to receive scholarships and for additional innovative educational programs to be provided in the state’s public schools.

## Federal Update



In addition, Pres. George W. Bush's 2005-06 budget calls for expanding the federal school choice plan: The \$50 million "Choice Incentive Fund" would allow cities to receive federal funds to pay for tuition vouchers at private and religious schools. The federal school choice proposal would support school choice pilot projects similar to the Washington D.C. scholarship program.

Increasing numbers of students and parents in the District of Columbia are taking advantage of the nation's first federally funded scholarship program, according to an independent evaluation released April 5<sup>th</sup> by the U.S. Department of Education.

In 2004-05, more than 1,000 students enrolled in 58 private schools through the D.C. Opportunity Scholarship Program, created by the D.C. School Choice Incentive Act of 2003. Applications are up for 2005-06, with about two students applying for each available scholarship; approximately 85 percent of the applicants currently attend public schools.

The landmark legislation, resulting from cooperation between the Bush administration and D.C. Mayor Anthony Williams, was passed in January 2004. The Washington Scholarship Fund (WSF) was charged with implementing the program in just a few short months.

# Insurance

## State Accident Fund—10 Years Later



During the early 1990s, Michigan, like other states, faced a difficult recession and reduced state tax revenues. State officials desperately needed to save money and to generate more of it. Among other techniques, they used privatization, most strikingly in 1995, when they load-shed a state-owned and -run worker's compensation insurer, then known as Accident Fund of Michigan, from the government balance sheet.

Accident Fund (now known as Accident Fund Insurance Company of America) was sold to Blue Cross Blue Shield of Michigan for \$262 million, the largest such state-based privatization of its time. Previous to privatizing Accident Fund, the largest known state asset sale involved a \$56 million power plant in Wisconsin.

Accident Fund should never have been a public entity in the first place. Other states left worker's compensation to private, for-profit businesses, and they still do today. But the seeds of Accident Fund's socialization were planted by the Michigan Legislature in 1912, when lawmakers passed a bill making a centralized worker's compensation fund possible.

Thus, the Accident Fund was established, and for more than 80 years, it was run independently of the government that had created it. As a quasi-state agency, Accident Fund had its own private employees, and it was run by people elected by policyholders, not appointed by bureaucrats.

All of that changed in 1989, when the Michigan Supreme Court refused to hear a challenge to a 1976 ruling by the state attorney general that Accident Fund was a state agency, and that its employees fell within the state civil service system. Placing Accident Fund under state control had an almost immediate impact on its operations. In a 1992 article, "Selling off the Accident Fund," my colleague Lawrence Reed described the outcome:

*The results were predictable: political manipulation of rates and staffing, and reduced competition in the industry as private insurers began to withdraw from the market. Because of civil service rules it has been difficult for the Fund to fill key positions with qualified experts. An unwarranted 20 percent rate cut ordered by the Blanchard administration and timed to impact the 1990 election resulted in a \$53 million financial loss for the Fund that year.<sup>184</sup>*

Newly elected Gov. John Engler called for privatization of Accident Fund during the first months of his administration, and he fought hard to win the necessary legislative and legal battles to get Accident Fund back into private hands.

Or at least *semiprivate* hands. The winning bidder for Accident Fund was Blue Cross Blue Shield of Michigan, an entity so regulated that it is practically an agency of state government. The Mackinac Center



for Public Policy once compared selling Accident Fund to BCBSM to selling the state lottery to the University of Michigan.

The BCBSM enjoys tax-exempt status that competing firms do not, which effectively ensures that people who do not have BCBSM insurance are indirectly subsidizing those who do. Ideally, BCBSM would become an investor-owned, private, for-profit business—a step the company is legally permitted to take—and the state legislature would take other steps to free Michigan’s insurance market.

In fairness, it should be noted that BCBSM’s regulatory advantages may be offset to some degree by burdens, such as the mandate to insure companies regardless of health status. Still, some believe that the benefits of converting BCBSM to an investor-owned, for-profit business would be a net plus for insurance consumers.

Regardless, the sale of Michigan’s Accident Fund was a slam-dunk for the state financially. It generated a large, one-time revenue hike for the state treasury, while it increased, by all indications, the quality of services provided to the fund’s many customers.

There isn’t a strong case to be made for government being in the insurance business (or most other businesses, for that matter). Just five states still operate monopoly worker’s compensation agencies: North Dakota, Ohio, West Virginia, Washington and Wyoming. These states proscribe all competition for workman’s compensation from private insurance carriers. Another 21 states operate worker’s compensation agencies, but allow some form of private competition, just as Michigan did when the Accident Fund was a state agency.

While Michigan was the first to sell off its worker’s compensation insurance agency, it was not the last. Nevada began working toward selling off its system as early as 1995, depending on how you define the start of the transition. In 1999 the state passed enabling legislation to facilitate the privatization of the worker’s compensation agency.

According to a press release from Nevada Gov. Kenny Guinn’s office, doing so removed 500 people from the state payroll. As of January 1, 2004, state employers began receiving premium cuts of an average 12.4 percent. In addition, the state’s taxpayers were no longer on the hook for \$1.6 billion in unfunded liabilities. West Virginia is scheduled to convert its public system into a private, competitive one beginning in January 2006. Officials expect an initial average drop in premiums of 15 percent as a result.

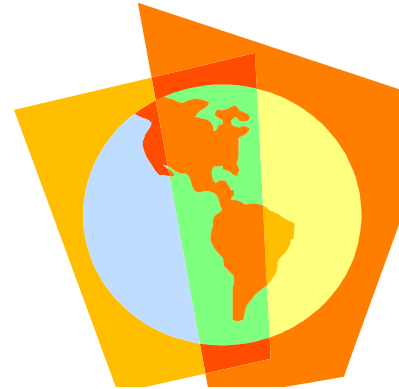
State insurance is not required by the U.S. Constitution, and it was never required by Michigan’s. The state was wise to divest itself of its insurance albatross. Others would benefit from doing the same.

*By Michael LaFaive, fiscal policy director, Mackinac Center for Public Policy*

# Developing Nations

## Privatization Aids Rwanda's Rebirth

In 1994, nearly a million of Rwanda's 8 million citizens were slaughtered in ethnic violence between the Tutsi and Hutu tribes. Perhaps many people wondered if anything good ever happens in this poor and benighted place.



Touring the genocide memorial site leaves one both angry and humbled. It illustrates the danger of a people surrendering their minds to their leaders. It depicts the extent to which politicians can go to attain their objectives. But behind this heavy cloud of sorrow, a peaceful Rwanda is emerging; it will certainly take years for the wounds to heal. A new Rwanda, with clean and safe cities has emerged from the ashes.

Rwanda, in the heart of Africa, is engaged in the continent's most ambitious privatization campaign. It may be the *most* ambitious and systematic of any country anywhere. After experiencing the kind of stifling, socialist rule that consigned virtually all of Africa to grinding deprivation for ages, this is a country that is now embracing the private sector with deliberate policy and enormous enthusiasm. Private businesses, schools, and universities and tour farms are competing with state-owned facilities.

Tea is a top Rwandan export and it too is going private. Ten tea factories exist in Rwanda—nine owned by the government and one, Sorwathé, in private hands. With only 10 percent of the national tea plantation acreage, Sorwathé produced 17 percent of the nation's black tea in 1999 and boasted a yield that was more than double the national average per acre. In 2003 the government began a program that will soon culminate in the sale of all nine of its tea factories and most, if not eventually all, of its tea plantations.

Since the privatization drive started in 1996, other assets sold by the Rwandan government include its hotels, a fruit-juice factory, a printing firm, and companies that make insecticides, tobacco products, sugar, dairy products, processed fish, and coffee. Among many others slated for the auction block over the next couple of years are chicken hatcheries, paper mills, rice products, the national telecommunications company, and even all water distribution and electricity generation. Robert Bayigamba heads the government's Privatization Secretariat. He says Rwanda will remain on this path until it creates a genuine free market economy complete with something else it has never had before—a stock market.

Africa earned the moniker "Dark Continent" because of its reputation for tyranny, isolation, and deprivation. To outside observers, Africans seemed incapable of or uninterested in the improvement of their situation through enterprise and private property. But the Rwandan case illustrates the fact that, despite the past traumatic experience, individuals are rising up to change their economic circumstances for the better.

*By James Shikwati, Director of Kenya's Inter Region Economic Network and Coordinator of the Africa Resource Bank*

## Privatization in Egypt



Egypt's privatization program was identified as one of the keystones in its economic reform process in the early 1990s, when the country was trying to fit into a rapidly changing world environment. Partly, the privatization process was mandated upon Egypt with IMF assistance in 1991, when one of the conditions under which the loans were provided was a requirement to privatize. Yet, more importantly, poorly performing state-owned enterprises (SOEs) were a drag on the economy, accounting for roughly 40 percent of GDP during the 1980s. The SOEs required substantial financial resources to keep them afloat, yet the government could no longer provide the resources.

Although there was a general realization of the need to restructure, the process wasn't an easy one to implement. Government insiders, who were heavily involved in exploiting public enterprises, were not interested in changes. Also, employees and managers also resisted changes—privatization of the overstuffed SOEs was bound to leave a large number of them unemployed.

Egypt, unlike some developing countries that rushed into large-scale privatizations, focused on a gradual approach. Originally, the government offered 316 companies for privatization. A total of 133 companies were fully privatized by 2003 and another 55 were partially privatized, resulting in proceeds of \$3.4 billion. The largest portion of the proceeds (45 percent) went to the Ministry of Finance, over 30 percent went to SOE debt settlements, 18 percent was used for early retirement pensions, and less than 5 percent was spent on restructuring. The government employed several different privatization techniques: 28 percent of companies were privatized through shares offered on the stock market, 26 percent through sale to the Employee Shareholder's Association (ESA), 24 percent by the means of liquidation and asset sales, and 22 percent through the sales to anchor investors.

After the initial privatization boom in the late 1990s, the process stagnated. The government still retains control over big and important enterprises and has been only willing to give up ownership rights to smaller companies. There is also a concern about how the government is spending the privatization proceeds. Statistics suggest that funds are often used simply to finance the money-losing SOEs.

Yet there are positive developments as well. Privatization and the subsequent improvement in the investor climate aided a creation of a strong stock market. The number of companies listed jumped to 1,100 in 2003 from less than 700 in 1991, and the market capitalization of those companies rose from \$3.2 billion in 1992 to almost \$20 billion in 2003. The number of loss-making SOEs decreased by more than 50 percent, and the rise in the return on investment was four-fold. And the effect of privatization on the labor market has not been negative. Many of the 500,000 who lost jobs in privatizations took early retirements and others have obtained new jobs in the private sector. In some cases companies even increased their employment after privatization as they took on new markets and new opportunities. The financial burden of the underperforming SOEs was reduced and privatization had a positive effect on the development of markets, competition, investment climate, and trade. The key now is to build on the experience, reduce government control in several areas, and privatize on a larger scale.



## Restructuring State-Owned Firms in Zambia



Zambia represents a classic case of the pitfalls of the state-led approach to development, a model that brought the country a bloated public sector and the attendant fiscal problems. The government of President Frederick J. T. Chiluba, who was elected in October 1991, initiated a structural adjustment program with privatization as a central component of the reform effort. The program targeted 90 percent of Zambia's SOEs for privatization within five years and the remaining SOEs were to be restructured. Progress in privatization, however, has been slow from the start, with opposition building and the government lacking a strategy to build public support for the process.

The economic decline attributable to state-owned firms could be traced back to the early 1970s, when Kenneth Kaunda nationalized the copper-mining industry and used the revenues from this operation to create a large holding company, the Zambia Industrial and Mining Corporation (ZIMCO), that assumed control over 120 SOEs. By the early 1990s, the public sector came to control nearly the entire Zambian economy—80 percent of the industrial workforce was employed, directly or indirectly, through the public sector, and SOEs accounted for 80 percent of industrial output and generated 93 percent of Zambia's foreign exchange. The copper mines alone provided 80 percent of the country's foreign exchange, despite having outdated technologies that reduced productivity.

The dominant role of the public sector created serious economic distortions. Tight wage and price controls disrupted supply and demand. Financial restrictions, trade barriers, and extensive local regulations were used to restrict competition and create SOE monopolies. The majority of these companies lost money and were kept afloat by direct government subsidies, creating an enormous budget deficit and preventing the private sector from gaining access to domestic capital. The tide of debt forced the new Chiluba government to adopt a structural adjustment program under the auspices of the World Bank.

Yet, despite the overwhelming need to reduce the size of the public sector, progress in the early stages of the Zambian privatization was slow, largely because of an original strategy that emphasized reforming and restructuring SOEs rather than an actual transfer of ownership. The government maintained ownership of the firms as a means of controlling employment and the movement of foreign exchange, using management contracts and restructuring to attempt to improve profitability. This strategy led to delays in the overall reform of the economy, as Zambia's fiscal imbalances worsened due to the continued payment of subsidies, assumption of further losses, and loss of revenues from actual divestitures. An addition, by not divesting, the government prevented the firms from obtaining new technologies and investment and left them susceptible to politically motivated decisions, factors that dampened efforts to improve their operating efficiency.

Eventually, the government realized the futility of attempting to reform SOEs that continued to realize huge losses. The new privatization program was introduced and it quickly gained speed and vitality by focusing on actual transfers of ownership, with emphasis on enhancing the participation of Zambian individual investors as much as possible.



The first step in the privatization process was the Privatization Act of 1992, which was passed by the Zambian National Assembly. The Privatization Act established the Zambia Privatization Agency (ZPA), which replaced the steering and technical committees from the previous government and the purpose of which was to plan and coordinate the privatization activities. The agency was not a government entity; rather, it was created to ensure the private-sector participation in the privatization process. The government appointed only three members (out of 12), and the rest were the representatives of private-sector organizations such as the Federation of Employees, Confederation of Chambers of Commerce and Industry, and the Bankers Association of Zambia. The law also specified activities of the ZPA; specifically, it ensured that all operations as well as enterprise-bidding must be concluded in a fair and transparent manner. The Act was constructed to protect small investors—it prohibited insider trading and government officials by law were required to state publicly their interest in a company so they would not be able to take advantage of their privileged access to information.

The privatization process was done in several stages. First, ZPA chose the companies to be privatized. There were a number of privatization techniques to be used, all of which were included in the Privatization Act: public offering of shares, private sale of shares through negotiated or competitive bids, issue of additional shares to dilute state ownership, sale of selected assets, reorganization/breakup of the SOE, management/employee ownership, as well as lease and management contracts. The next step was publishing the privatization note on the chosen SOE in the *Government Gazette* and acceptance of the applications from the potential investors, the purpose of which was to ensure that only those capable of running the privatized company would participate in the process. After approving investors for participation in the bidding process and providing them with the necessary evaluation reports, ZPA allowed anywhere from one to three months for potential investors to further investigate companies for sale and prepare their bids. After accepting and evaluating the bids, ZPA chose the investor and signed a sales contract. After the contract was signed, to ensure fairness of the process and transparency, ZPA published all the information regarding the process (participants and their bids, as well as prices of share and other relevant data) in the *Government Gazette*.

Originally, the government decided to offer 150 state-owned firms for sale. As of 1992, bids for the first group of 19 small companies were closed. It was hoped that initiating the process with small companies would enable Zambian officials to develop the expertise necessary to divest the more complex, larger companies. In the early stages the process was slow, mainly due to concerns that privatization would put a lot of people out of work. However, the effect of the privatization on employment has been minimal, in fact, in some cases privatization worked to the benefit of workers. If companies were not privatized their growing financial burden could necessitate liquidation. In this case all company employees would be out of work.

As the benefits of privatization became more evident and the public support for the program strengthened, the process slowly picked up by the mid-1990s. The major signal that privatization was real was the closing of the country's giant ZIMCO. By 1997 167 companies had been privatized and by January 2003 the number grew to over 250. An additional 24 companies are currently slated for privatization.

The privatization program in Zambia has achieved some impressive results and it is considered to be one of the most successful on the continent. Most of the enterprises (97 percent) became successful profit-making companies within a few years after privatization and they have also attracted foreign capital. The



privatization program has stimulated economic activity in many sectors, especially agriculture. It helped reduce budgetary pressures on the government and through increased economic activity helped spur growth. In 1993, the year after the privatization program was launched, Zambia reversed years of negative economic growth and achieved a real GDP growth of 5.1 percent. Throughout the 1990s and into the 21<sup>st</sup> century Zambia enjoyed relatively stable economic growth.

*The preceding have been excerpted from Privatizing State-Owned Companies by John D. Sullivan, Ph.D., Jean Rogers, and Aleksandr Shkolnikov. The report is a product of the Center for International Private Enterprise and is available in its entirety ([www.cipe.org/publications/education/prosperity/ipo403.pdf](http://www.cipe.org/publications/education/prosperity/ipo403.pdf)).*

## Trade or Aid?: What's the best way to help the world's poor?



The world may never really know how many hundreds of thousands of lives the Asian tsunami claimed. The tragedy spurred a massive relief effort, and it also renewed old debates about how to help the world's poor.

A recent UN report suggested that rich nations should double the amount they currently give to developing nations. The report noted that, while the tsunami received great attention, other, larger, less publicized tragedies persist. Take for example, the scourge of malaria, which the lead author of the UN report calls the "silent tsunami." Each year roughly three thousand people die from malaria, and most of the dead are African children. Would more aid improve conditions in Africa?

James Shikwati worries that more aid would actually undermine Africa's pursuit of progress. Shikwati is Director of Kenya's Inter Region Economic Network and Coordinator of the Africa Resource Bank. He has observed how different approaches to helping Africa's poor have yielded different results. He argues that trade, not aid, is what Africans need more of.

Recently, *PW*'s Ted Balaker interviewed James Shikwati.

Pic of interview subject: [http://www.utoronto.ca/jcb/genomics/images/ACTSimages/james\\_shikwati.jpg](http://www.utoronto.ca/jcb/genomics/images/ACTSimages/james_shikwati.jpg)

### *Do you think wealthy nations should give more aid to poor nations?*

Wealthy nations should not give more aid to poor nations without taking an audit of the previous aid initiatives. A lot of what wealthy nations call aid has tended to benefit the wealthy nations in form of tied aid at the expense of poor nations.

### *Has foreign aid improved conditions in Africa?*

Foreign aid has politicized life in Africa making conditions even worse. Jostling for what politicians call the 'national cake' is a common phenomenon. Instead of Africans solving their own problems, they leave everything to the donors.



Poor nations need to surface their own entrepreneurs in order to solve their problems. Poor nations need to urgently take ownership of the problems afflicting them—what wealthy nations do is take over issues that affect poor nations leading them to be complacent. Aid is doing more harm to the poor nations in the long run; it encourages corruption both local and international, it kills the private sector and promotes a politically driven private sector and increases dependency.

*What has improved conditions?*

Open information flow, open travel, open trade is slowly opening the eyes of Africans to the benefits in a competitive world. Investors' attraction is another aspect that has helped streamline institutions in Africa. Governments are quickly learning that to get local and international investors a good business environment is needed. This is slowly putting Africans on the path of productivity.

*What should rich nations do to help the world's poor?*

Rich nations if they want to genuinely assist poor nations must leave the poor nations alone. They must open up for trade, open up for travel—that is, lift their extreme visa requirements because travel will expose Africans to more productive culture in the rich nations. Former colonial governments must lift their undue influence on their previous African colonies that has hampered efforts to create an African regional market leading to intra-Africa travel restrictions too. An African regional market will serve as a springboard to enable Africans to fit competitively in the global market. The rich nations should not interfere with private investors who might choose to invest in Africa; they should not interfere with private initiatives to develop Africa.

*The UN reports that each month 150,000 African children die of malaria because they don't have bed nets to keep mosquitoes out. What should be done about this?*

African children and adults alike are perishing because of malaria, however because of aid-driven policies, Africans have been forced to use bed nets even when the evidence indicates that they are failing. This is the best illustration of how donors arm-twist poor nations in order to achieve their own ends.

Wealthy countries should know that poor countries do have solutions to their own problems but they have been suffocated with aid. They need freedom from aid in order to trade.

*Foreign aid can come from other governments or from private donations. Do you see any difference in the effectiveness of government aid versus private aid?*

Government-to-government aid is the worst culprit in the aid fiasco. It's difficult to monitor what governments do with the aid. In poor nations, it helps subsidize poor policies, encourages corruption and political cronyism and simply makes leaders lose focus. Private donors have incentives to see it work because it is their own money as opposed to government funds, which are basically public officers in wealthy countries spending taxpayers' money. It is common knowledge that nobody spends somebody else's money as careful as he spends his own.



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