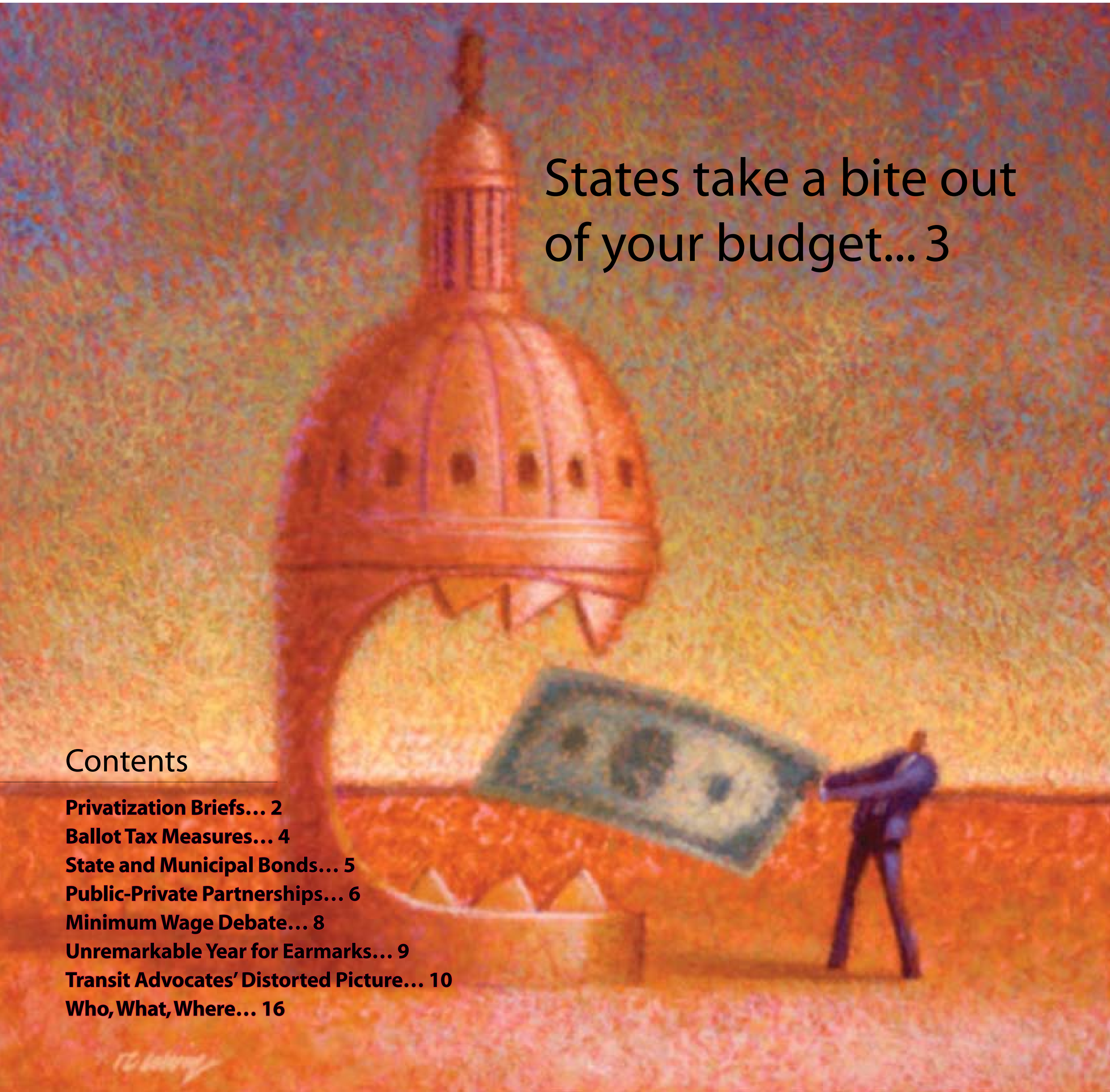
Privatization Watch

Reason

Celebrating 30 Years of Privatization and Government Reform

Vol. 31, No. 1 2007



States take a bite out of your budget... 3

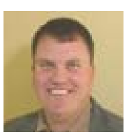
Contents

Privatization Watch

Editor
Geoffrey F. Segal (geoffrey.segal@reason.org) is Geoffrey Segal is the director of privatization and government reform at Reason Foundation. He is also editor of Reason's *Privatization Watch.*

Managing Editor
Leonard Gilroy (leonard.gilroy@reason.org) Leonard Gilroy, a certified planner (AICP), researches housing, urban growth, privatization, and government reform.

Staff Writers
Shikha Dalmia (shikha.dalmia@reason.org)
George Passantino (george.passantino@reason.org)
Robert W. Poole, Jr. (bob.poole@reason.org)
Geoffrey F. Segal (geoffrey.segal@reason.org)
Lisa Snell (lisa.snell@reason.org)
Samuel R. Staley (sam.staley@reason.org)
Adam B. Summers (adam.summers@reason.org)
Steven Titch (steven.titch@reason.org)



Vice President, Reason Foundation
Adrian T. Moore (adrian.moore@reason.org) Frequently cited by journalists and sought after by policymakers, Moore is one of privatization's leading authorities.

President, Reason Foundation
David Nott (david.nott@reason.org) Nott leads Reason Foundation, a national organization dedicated to advancing a free society through the promotion of choice and competition.

Published by Reason Foundation
3415 S. Sepulveda Blvd., Suite 400 ■
Los Angeles, CA 90034 ■
800/582-2245; 310/391-4395 (fax) ■
www.reason.org ■

Privatization Briefs

Competitive Sourcing Likely to Be First Casualty of New Congress

Republican Congressman Tom Davis (R-Va.), the ranking member of the House Oversight and Government Reform Committee, remarked that the federal government's competitive sourcing program may be the first casualty of a Democrat-led Congress.

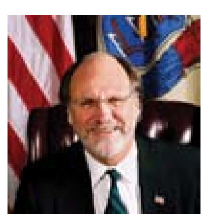
Despite facing challenges over the last few years, competitive sourcing saved the federal government more than $5 billion in the last two years alone. Further, the efforts resulted in a 27-to-1 return on investment, i.e., for every dollar spent on the administering the competitions, $27 in savings were identified.

Davis said, "[competitive sourcing] is a reasonable program to inject competition into the government but unfortunately this has turned into a very partisan issue. It has really bogged down over the last two years. And I think it is likely to get worse under the new Congress." He added, "I think A-76 [the process that guides competitive sourcing initiatives] could be one of the first casualties of the new Congress."

Concession Opportunities Continue to Emerge

The state of Pennsylvania received more than 40 expressions of interest for a possible lease of the Pennsylvania Turnpike. Rep. Rick Geist (R-Blair) has introduced enabling legislation, and Governor Ed Rendell (D) supports the concept.

In Indiana two senators, Thomas J. Wyss (R-Fort Wayne) and Sue Landske (R-Cedar Lake), filed SB 1 to create the Indiana Commerce Connector, the toll road that would arc east and south of Marion County and the Illiana Expressway in Northwest Indiana.



In New Jersey Gov. Jon Corzine's (D) State of the State address asserted asset monetization as a great revenue potential that could "literally restructure the state's finances by paying down billions of dollars of debt and, in turn, free up billions of dollars of cash flow for capital investment." Corzine has been at least mildly supportive of seeking concession bids for both the New Jersey Turnpike and the Atlantic City Expressway. State Sen. Raymond Lesniak (D-Union) recently introduced the authorizing

See BRIEFS on Page 11

State Budget Outlook

By: Geoffrey F. Segal

The 2007 Fiscal Year looks to be a good one for most state budgets, according to the National Conference of State Legislatures survey of state fiscal officers. Of the 48 states that participated (Texas and Arkansas did not) in NCSL's State Budget Update, November 2006, 23 reported that their overall revenue collection was above the original forecast. Additionally, 22 states reported their collections were on target. Only three states, Maryland, Michigan, and Tennessee, took in less revenue than was forecasted.

When looking at specific taxes, corporate and personal income tax collections were either at or above forecasted levels in most states. However, 14 states reported sales tax collections below projections. At this time last year, only seven states reported underperforming sales tax collections.

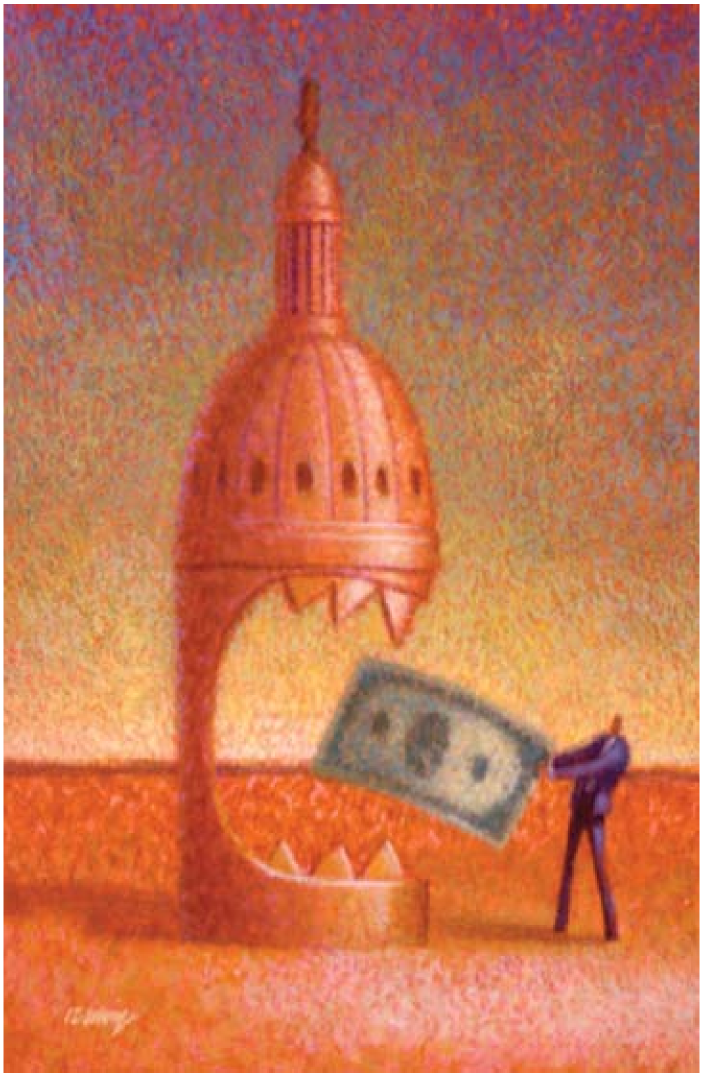
For the first time since 2002, the number of states that reported an "optimistic" outlook went down from 26 to 16. In addition, the number of states that are "concerned" tripled from the 2002 survey to six. Officials in the remaining states expect their revenues to be "stable," leaving no state with a "pessimistic" outlook for the future.

States with deficits also decreased in the latest report. However, some 14 states continue to face a deficit. Historically, this number is down by five from last year and nine less from 2005. The two most common programs over budget were Medicaid and corrections.

Spending in FY 2006 grew at a staggering rate—8.7 percent, significantly higher than the 29-year average of 6.4 percent.

The survey also asked officials to identify the budget priorities for the coming legislative session. Twenty-nine states identified education as the top priority. Medicaid and health care came in second, with officials from 23 states calling it a top priority. In this area officials specifically noted debate about funding the uninsured and expanding coverage for all citizens. In addition, corrections, transportation and public employee retirement will be high on the agenda in a number of states.

FY 2008 revenue growth is forecast between 0.5 percent (New York) to 6.5 percent (Georgia) growth—while the average growth is pegged at 3.6 percent. Less than half the states provided forecasts for FY 2009, however, that forecast is much more upbeat with the range between 2.5 percent (Maine) and 7.3 percent (Nevada), with an average of 4.7 percent.



The results of the NCSL survey largely mirror the results of the National Association of State Budget Officers/National Governors Association Fiscal Survey of the States which covers all 50 states. The NASBO/NGA survey only covers general fund spending, but found state fiscal conditions had improved in 2006 with only two states forced to make mid-year budget cuts.

The survey anticipates more modest growth in 2007, however, forecasts strong expenditure demand from programs that may have received reduced funding in the past. Further, pressure will remain in Medicaid programs while looming issues such as pensions and infrastructure will begin to take center

See BUDGET on Page 11

Ballot Tax Measures Result in Mixed Bag for Taxpayers

By Geoffrey F. Segal

The November ballot contained several tax and spending initiatives. Taxpayers won some, and lost some. Perhaps the biggest news was the Taxpayers' Bill of Rights or TABOR. Court challenges took TABOR off the ballots in several states including Ohio, Michigan, and Oklahoma, however, it ended up on the ballot in three states—Maine, Oregon, and Nebraska.

Unfortunately for taxpayers the results were not promising—TABOR lost in all three states. Despite a 3-to-1 funding disadvantage, TABOR advocates in Maine were the closest to victory. Voters in Nebraska and Oregon overwhelmingly turned back TABOR.

Even with the set back, organizers in many states have pledged to take the fight back up. This is especially true in states that saw TABOR taken off the ballot because of technical glitches.

Four statewide tobacco tax increases made it to the ballot. Surprisingly, cigarette smokers fared well with two of the measures passing and two failing. The largest proposed increase, California's $2.60 per pack increase failed along with Missouri's more modest proposal. Had California's proposal passed it would have vaulted the Golden State into the highest tobacco tax in the nation. Increases in South Dakota and Arizona both passed.

Unfortunately for taxpayers the results were not promising—TABOR lost in all three states.

Arizona actually presents an interesting twist—two separate increases passed. The first is a $.02 per pack tax to fund enforcement of a new statewide public smoking ban. The second increase is likely to be challenged in the courts. Despite having been billed as an 80-cent tax increase, the actual ballot language reads that the tax would be 0.80 cents per pack of cigarettes, or less than a penny. The Attorney General's office has issued an opinion that the tax is $.80 per pack and has begun collecting the tax at that rate. A challenge may be on the horizon.

The four proposals represent a significant shift in how tobacco taxes are presented, i.e., the proposals rarely have a direct relationship to tobacco or smoking cessation. Rather, new revenues are used for unrelated programs such as early

childhood development or expanding the state children's health insurance programs (SCHIP). For example, in California less than 1 percent of the revenues would have gone toward smoking cessation programs. A number of states are currently debating legislative tobacco tax increases. In addition, other states including Ohio and Illinois are debating whether to give local jurisdictions taxing authority.

Federal "PART" Results

Each year the federal Office of Management and Budget evaluates about 20 percent of federal programs for efficiency and effectiveness. The Bush administration has used the Program Assessment Rating Tool (PART) to rate programs and use the ratings to determine budget priorities. Each year failing or ineffective programs are outlined for elimination or reduction in previous budgets, however, Congress has rarely used the rating or the outcomes to determine funding. But in FY2006 Congress accepted more recommendations. It enacted 89 of 154 recommendations producing $6.5 billion in savings.

In the latest round of reviews, the administration recommends terminating 91 federal programs resulting in savings of $7.3 billion. Another 50 programs would see major reductions saving an additional $7.4 billion. The federal budget also calls for major reforms to 16 programs to achieve savings of $5.7 billion. In all, this round of PART has identified savings of $20.4 billion in discretionary spending. Each of these recommendations requires Congress's approval. ■

State and Municipal Bonds Do Well In General Election

By Len Gilroy

Voters decided on $76.1 billion in state and municipal bonds during the November 7th general election—a record. Voters approved nearly 89 percent of the bonds, more than $67 billion—also a record. According to *Bond Buyer*, the previous record was set in 2002 when voters approved 87.3 percent of the $47.1 billion up for consideration.

This year's passage rate exceeds the average approval rate of 84 percent over the past 10 general elections—approving 478 of the 643 state and municipal bond issues on the ballot. Only twice in the past 30 years have voters approved a higher percentage of bonds.

The table on the right provides a breakdown of bond measures.

Jurisdiction	Proposed Number	Approved Total (000)	Number	Total (000)	Volume
States	16	$43,280,698	15	$43,276,698	99.9%
Counties	77	$5,655,787	68	$4,906,402	86.8%
Cities & Towns	189	$6,045,037	150	$4,529,262	74.9%
Special Districts	358	$20,212,399	242	$14,064,536	69.6%
State Authorities	1	$800,000	1	$800,000	100.0%
Local Authorities	2	$34,350	2	$34,350	100.0%
Total	643	$76,028,271	478	$67,611,247	88.9%

The Bond Buyer, Nov. 13, 2006

Only five states had statewide initiatives on the ballot. California led the way with five measures totaling $42.6 billion in general obligation bonds. All but one of the statewide ballots won approval—a $4 million bond for a state park in Rhode Island. Proceeds are targeted for higher education, transportation, housing development (including affordable housing), and environment and natural resource protection.

By far the largest number of bonds was for K-12 and higher education facilities. Two hundred thirty-seven bonds with a value of $26.4 billion were approved with an 83 percent approval rate. This represents some 39 percent of the approved bond volume. Transportation was the second biggest winner with $23.1 billion approved in 36 measures. However, only 34 percent of transportation bonds were approved. And 99.6 percent of all utility bond measures (e.g., water and sewer) passed, representing the third largest take with $11.6 billion.

This year's passage rate exceeds the average approval rate of 84 percent over the past 10 general elections—approving 478 of the 643 state and municipal bond issues on the ballot.

Only twice in the past 30 years have voters approved a higher percentage of bonds.

Answers to the Most Common Objections to Public-Private Partnerships

By William Eggers

States and municipalities wishing to save money and circumvent their own bureaucracies to get jobs done more quickly often turn to the private sector via public-private partnerships. Yet some elected officials and special interest groups resist this form of contracting, citing various reasons.

Objections to PPPs, or public-private partnerships, tend to be markedly similar across countries. For the most part, the main objections simply reflect a sincere desire to protect the public purpose and get the most value for taxpayers. Nevertheless, some of the concerns are driven by a misunderstanding of PPPs, while others are based on outdated or incomplete information. The following answer the most common concerns.

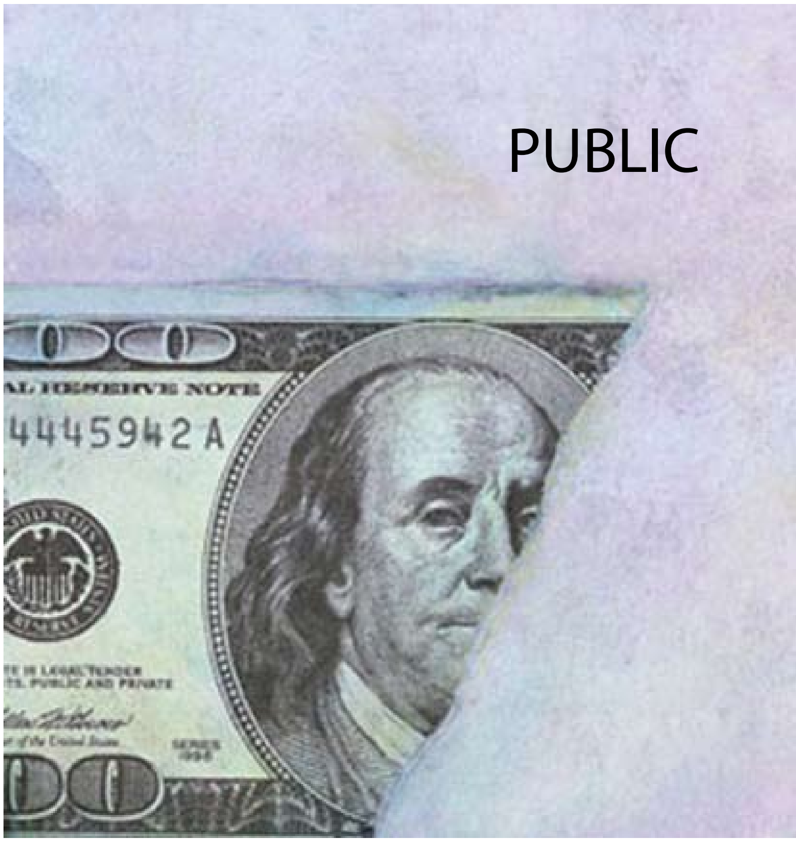
1. Higher Cost of Capital:

Government-issued debt is cheaper than the private sector's, making private financing and development a bad deal for taxpayers.

This is perhaps the major objection to PPPs. This line of argument contains some truth, but it also overlooks several important points.

Difference between cost of capital and cost of debt. First, the argument assumes that the cost of capital and the cost of debt are one and the same. However, a government's risk-adjusted average cost of capital typically exceeds its cost of debt because the public sector takes on project-specific risks such as cost overruns and delays that need to be factored into the cost of capital for each project it undertakes. Moreover, even though the private sector takes on some of the risks of construction, time overruns, and project performance, it can better control its capital costs by making efficient use of resources. The comparison should therefore be between the public sector's cost of capital (to which a risk premium must be added) and the private sector's cost of capital (which amounts to the weighted average of its cost of debt and equity), not between the two sectors' different costs of borrowing. Moreover, this is on top of the benefits achieved in terms of superior service delivery.

Gap Narrowing. Second, as the private infrastructure market has grown and financing mechanisms have become more sophisticated, the gap between the public and private sectors' cost of debt has narrowed. For example, with the



maturing of the private finance market in the United Kingdom, the financing cost difference between the private cost of capital and public borrowing is now in the range of only 1 to 3 percentage points. As Allen Grahame notes, the additional cost to the public sector should not be significant enough to risk losing the benefits of the project, provided the private sector can deliver savings in other aspects of the project.

Creative Financing Models. Last, a variety of financing approaches enables governments to combine their ability to obtain lower interest rates with the benefits of private financing and development. In the United Kingdom, the Treasury launched a program called Credit Guarantee Finance (CGF) to reduce the costs of borrowing to finance PFI (Private Finance Initiative) schemes. Under the credit guarantee program, the government provides funds to the PFI project through cash advances governed under the terms of a loan agreement. The private firm repays these loans to the government after completing the project. Taylor Wessing, the European law firm, points out that the government receives an unconditional repayment guarantee from the private financier for providing this loan facility in return for a fee.

In the United States, the Department of Transportation has allocated $15 billion in tax-exempt private activity bonds for

qualifying PPP highway and intermodal freight facilities. This approach lowers the private sector's cost of capital significantly, enhancing investment prospects.

2. Failure to Realize Value for Money

When you combine the higher borrowing costs of private financing with the often higher transaction costs—and subsequent monitoring costs—of engaging in these kinds of deals, the taxpayers end up paying far more than they would have under more traditional public financing.

The issue of value for money should be an important feature of any public infrastructure project, though it gets more emphasis with PPPs. Value for money is based on the theory that the private sector brings in benefits and efficiencies that outweigh its higher borrowing costs. In analyzing value for money, it must be recognized that lowest price does not always mean best value. Value for money is a function of, among other things, price, quality, and the degree of risk transfer. UK government officials consistently rate PPPs as a good value for money. In a survey of 98 projects by the UK National Audit Office in 2001, for example, 81 percent of the public authorities said they were achieving satisfactory or better value for money from their PFI contracts, while only 4 percent described value for money as "poor." Last, conventional procurement has resulted in very poor value for money, thanks to cost overruns, delays, and so on.

Several factors contribute to value for money, but primary among them is efficient risk allocation. Risk allocation is based on the premise that risk should be transferred to the party that is best suited to manage it. Optimal risk allocation leads to reduced cost associated with risk, which in turn leads to better value for money.

Evidence supports the view that PPPs transfer construction and maintenance risk to the private sector more effectively than traditional methods and they are therefore likely to deliver value for money where competition is strong and the projects are large. A review of eight Partnerships Victoria projects found a weighted average savings of 9 percent against the risk-adjusted Public Sector Comparator. In the case of smaller projects, "bundling" helps to spread procurement costs across several discrete projects.

3. Windfall Profits to the Private Sector

The private sector sees the opportunity to make windfall profits from infrastructure investments—particularly investment banks and financiers who often receive big, upfront fees from refinancing the debt.

Indeed, concession holders will likely seek to refinance their project debt on more favorable terms with a greater amount of leverage. However, this need not necessarily prove a particular problem for governments. For one thing, some of the biggest refinancing gains from PPP transactions came in the early stages of PPP development when the market was less mature and interest rates dropped worldwide to historically low levels. With market maturity, the likelihood of the private sector making huge gains from refinancing falls.

Second, where it makes sense, governments have the option to negotiate with their private partners to share in refinancing gains. Gain clauses can be included in contracts, where the government's share can be either taken as a cash lump-sum at the time of the refinancing or in the form of reduced service charges. It is important to recognize, however, that such "clawback" mechanisms, while they may make the profits more politically acceptable, may also result in more expensive contracts upfront.

Third, explicit sharing mechanisms don't necessarily have to be built into the contract for the public sector to share in the gains. General approval rights over changes in contracts

See PARTNERSHIPS on Page 14

The Minimum Wage Debate

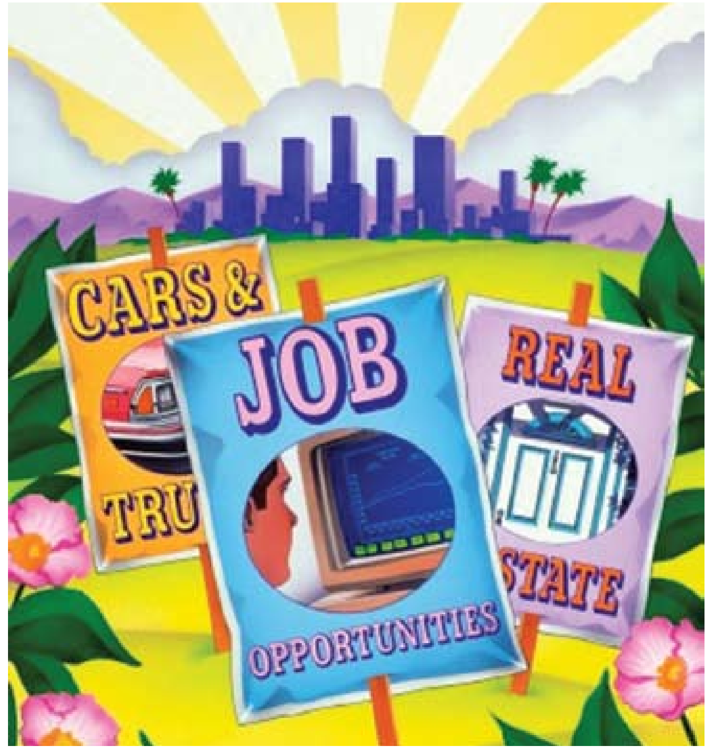
By Adam B. Summers

The minimum wage has quickly become one of the hottest political issues in the nation. It featured prominently in many state and local elections, and the Democrats in Congress have made an increase in the federal minimum wage from $5.15 an hour to $7.25 an hour (a 41 percent increase) one of their top priorities.

As of this writing, the House of Representatives has already passed a minimum wage bill (HR 2, the "Fair Minimum Wage Act of 2007") that would increase the federal minimum wage from $5.15 an hour to $5.85 an hour 60 days after the enactment of the legislation, and further increases to $6.55 an one year thereafter and to $7.25 after an additional year. The bill passed overwhelmingly on a 315-116 vote. The Senate version of the bill includes $8 billion in tax breaks for small businesses, which may be cause for some wrangling between the House and Senate. The tax incentives were included to head off a potential Republican filibuster, and President Bush has indicated support for the minimum wage increase, provided it includes tax breaks to offset additional costs to employers.

There has been a great deal of interest in raising the minimum wage at the state level as well. In 2006, there were minimum wage measures on six state ballots—in Arizona, Colorado, Missouri, Montana, Nevada, and Ohio. The wage increases passed in all six states, most of them overwhelmingly. Four of the six states—Arizona, Missouri, Montana, and Nevada—passed minimum wage hikes by margins of nearly two-to-one or better. The only close contest was in Ohio, where the measure passed with 53 percent of the vote.

The new minimum wages in these states range from $6.15 an hour (Montana and Nevada) to $6.85 an hour (Colorado). Three states—Colorado, Missouri, and Ohio—ensure continued future rises in the minimum wage by tying the wage to inflation via the Consumer Price Index.



Eighteen other states also have minimum wages higher than the federal standard. Earlier this year, both Massachusetts and California passed laws to increase their state minimum wages to $8 an hour—the highest rate in the nation—by 2008.

Several states, particularly in the Midwest, are currently waging similar campaigns:

Illinois: Illinois already has the highest minimum wage in the Midwest at $6.50 an hour, but that didn't stop it from passing a law last December that will increase the state minimum wage to $7.50 an hour on July 1, 2007, followed by annual 25-cent increases that will reach $8.25 by 2010.

Indiana: The House Labor Committee has approved a bill (HB 1027) that would increase the state's minimum hourly

2006 Election Summary: State Minimum Wage Measures

State	Ballot Measure	Yes	No	New Min. Wage	Notes
Arizona	Proposition 202	65%	35%	$6.75/hr.	
Colorado	Amendment 42	53%	47%	$6.85/hr. ($3.83/hr. for tip earners)	Tied to inflation
Missouri	Proposition B	76%	24%	$6.50/hr.	Tied to inflation
Montana	Initiative 151	73%	27%	$6.15/hr.	Or federal minimum wage, whichever is higher
Nevada	Question 6	69%	31%	$6.15/hr.	Only applies to employers who do not provide health-care benefits
Ohio	State Issue 2	56%	44%	$6.85/hr.	Tied to inflation

See WAGES on Page 12

Earmark Reform Rollercoaster

Tom Schatz, President, Citizens Against Government Waste

Pork-barrel spending was front-and-center in the "First 100 Hours" of the 110th Congress. Earmark reform became the setting for drama, grandstanding, and grassroots activism, with the ripples being felt across the country.

In the last few years, "earmarks" and "pork" became symbolic of wasteful spending under the Republican leadership. Pork-barrel spending increased from 1,318 projects totaling $7.8 billion in fiscal 1994 to 9,963 projects totaling a record $29 billion in fiscal 2006, as documented by CAGW's Congressional Pig Book. Ridiculous projects, like $50 million for an indoor rainforest in Iowa, chipped away at Congress's fiscal credibility. Taxpayers' frustration reached a crescendo when Alaska's "Bridge to Nowhere" got $232 million in the aftermath of Hurricane Katrina. Former Rep. "Duke" Cunningham's (R-Calif.) incarceration for taking bribes in exchange for earmarking legislation became the catalyst for uncovering many other nefarious back-room deals.

Democrats seized the moral high ground and promised a return to clean government and fiscal responsibility. After taking the reins in Congress, the danger was that Democrats would go just far enough to surpass Republican reforms without giving up major perks. But the reforms passed so far significantly change the dynamics of earmarking.

Taxpayers' first victory came last December when fiscally conservative Sens. Tom Coburn (R-Okla.), Jim DeMint (R-S.C.), and Jeff Sessions (R-Ala) blocked an omnibus appropriations bill that included 10,000 pork-barrel projects worth $17 billion. Incoming House and Senate Appropriations Committee Chairmen David Obey (D-Wis.) and Robert Byrd (D-W.Va.) announced that Congress would pass a joint resolution for the remainder of fiscal 2007, which would include a "moratorium" on earmarks until budget reforms get passed.

Reaction to the moratorium speaks volumes about the politics of pork. *The San Jose Mercury News* (12/22/06) reported on the loss of a $250,000 earmark to expand services to the vision-impaired in Alaska and $50,000 for the Hungry Lil' Readers Club in Minneapolis. *The Salt Lake Tribune* (12/24/06) reported that the town of Centerfield (pop: 1,100) "is running out of drinking water . . . a new water-treatment plant will have to wait because of the delay in securing $1.5 million from the federal government."

The loss of earmarks will not cause a wave of mass

dehydration. The more likely scenario is that state and local governments will re-prioritize their budgets to guarantee that essential projects receive funding.

On January 4, 2007, the House of Representatives adopted an internal rules package (H. Res. 6) that requires disclosure for earmarks. Senate earmark reforms are part of the Legislative Transparency and Accountability Act of 2007 (S. 1), still under debate.

The House rules require disclosure of the following details for each earmark: The members who requested it; name and address of the intended recipient or location of the earmark; the purpose of the earmark; and a certification that the member or spouse has no financial interest in the earmark. S. 1 requires disclosure of earmarks and their sponsors on the Internet 48 hours prior to consideration of any bill or amendment.

The definition of earmark is the most important detail in any reform. The House definition is comprehensive, covering projects included in a bills' text, projects in report language, and projects earmarked for federal agencies. The Senate definition initially excluded the latter two of these three categories, exempting approximately 95 percent of all earmarks from the disclosure requirements.

See EARMARKS on Page 13

Transit Advocates Paint Undeservingly Rosy Picture

By Robert W. Poole, Jr.

Voters considered more than 30 transportation ballot measures on Nov. 7th, and according to transit advocacy group Center for Transportation Excellence, 70 percent of them passed. That sounds like a big vote of confidence, not only in transportation in general but in mass transit in particular, since that is what the majority of the ballot measures would fund, in whole or in part. Dig a little deeper, though, and a more mixed picture appears.

Of the six statewide measures, all enacted, not a single one involved a tax increase or the imposition of a new tax. Two (CA and RI) authorized general obligation bonds, which are repaid out of the state's general fund, forcing trade-offs among spending priorities within existing revenue constraints. Arizona's measure amended the state constitution to allow cities to issue bonds for infrastructure, which they should have been allowed to do all along. And the other three (in CA, MN, and NJ) simply dedicated portions of existing taxes to transportation.

At the local level, where the rest of the ballot contests took place, only half (13 out of 26) of the measures passed. Ten California counties had transportation sales tax measures on the ballot, most of which would extend existing, time-limited, half-cent sales taxes for another few decades. Four of the eight that fund highways as well as transit passed, but the two that were rail-only failed. So overall, only 40 percent were enacted.

Of the six statewide measures, all enacted, not a single one involved a tax increase or the imposition of a new tax.

A larger variety of transportation measures were on local ballots in eight other states. The largest was a one-cent sales tax in Broward County (Ft. Lauderdale), FL, dedicated almost solely to transit. It lost by nearly two to one. A more modest transit sales tax lost in Boulder, CO. Transit-only tax measures were approved in Holland and Kalamazoo, MI; Kansas City, MO; Grapevine, TX; Utah County, UT; King County, WA; and Selah City, WA. Broader (highways and transit) tax measures were approved in Salt Lake County, UT and Seattle, WA. Voters in Spokane rejected two measures that would have begun planning and land acquisition for a light rail system.

Overall, the pattern that emerges seems to be:

- Measures that allocate more of the government's existing resources to transportation were relatively easy to pass (100 percent passed);
- Measures that fund both highways and transit did slightly better than transit-only measures (60 percent passed vs. 54 percent passed)
- Rail-only measures did poorly (only one of five passed).

This is not quite the rosy picture painted by the transit advocates. ■

Continued from Page 2
BRIEFS

legislation.

Delaware officials are also reportedly considering a concession along I-95 and Del. 1 to close an infrastructure funding gap. In her 2006 State of the State address, Gov. Ruth Ann Minner (D) said the state would explore "the possibility of a private-public partnership or other innovative financing plans for critical needs."

Beyond this, the federal Department of Transportation issued draft model legislation on public-private partnerships. The model is "based on a survey of existing State statutes that authorize public-private initiatives," with a goal of providing states with an example of what basic elements to consider and address in authorizing legislation.

Indiana Inks Welfare Privatization Contract

After securing federal approval, and a sign off from the state Attorney General, Indiana Gov. Mitch Daniels inked a deal with IBM for $1.16 billion over ten years. The contract will privatize parts of the state's food stamp, Medicaid and welfare programs. The plan is aimed at improving an outdated benefits system and bringing new technology to the eligibility determination and administration program. IBM and its partners will staff call centers, and provide automated services, including other back office functions for processing the applications for benefits. A 180-page contract guides the deal, which is expected to save the state at least $340 million. ■

Continued from Page 3
BUDGET

stage, an almost exact forecast as the NCSL report.

Spending in FY 2006 grew at a staggering rate—8.7 percent, significantly higher than the 29-year average of 6.4 percent. The survey noted this growth was largely due to states spending in programs that received cuts in recent years. In addition, growth of budget reserves counts as spending and contributed to this growth rate as many states dedicated new revenues to reserves.

FY 2007 spending is forecasted to be closer to the average and achieve a growth rate of 7 percent. Pressure will continue from mandatory programs, especially Medicaid.

The survey also reported that states enacted a net tax and fee decrease of $2.1 billion in FY 2007. While 15 states enacted net increases, 24 had net decreases. Personal income taxes saw the largest decrease, $2.32 billion, while sales taxes increased $622.4 million.

Unlike the NCSL report, the NASBO survey reported that 46 states' revenues exceeded expectations, while the other four were on target. In fact, revenues were 5.9 percent higher than originally estimated, with corporate income taxes coming in almost 21 percent above forecasts. This represents a dramatic swing from FY 2002 when 42 states reported collecting less revenue than budgeted. ■

Notable Tax Changes

Type	State	Action	Result
Sales	New Jersey	1% increase; widening of base.	$1.25 billion and $300.6 million respectively
Income	Ohio	4.2% decrease	Part of 21% reduction over 5 years
Corporate Income	Pennsylvania	Continued phase-out of capital stock and franchise	Decrease of $198.2 million
Cigarette	Texas	$0.41 per pack increase	Increase of $431.7 million
Gas	New York	Cap	Decrease of $109 million

Tax and Fee Changes in the States

Tax	Number of States	Action
Sales	15	Decrease
Personal Income	18	Decrease
Corporate Income	17	Decrease
Cigarette, Tobacco & Alcohol	4	Increase
Gas	5	Changes resulted in a decrease

Continued from Page 8

WAGES

wage from $5.15 to $6.00 on September 1, 2007, $6.75 on March 1, 2008, and $7.50 on September 1, 2008. Republican Gov. Mitch Daniels has said that he is open to a "modernization" of the state's minimum wage rate.

Iowa: The state legislature is considering bills in both the House (HF 1) and Senate (HF 1) that would raise the state minimum wage from $5.15 an hour to $6.20 an hour beginning April 1, 2007, and $7.25 an hour beginning January 1, 2008. A more contentious proposal to tie the minimum wage to inflation was excluded from the legislation. A final bill is expected to pass both houses quickly, and newly elected Democratic Gov. Chet Culver is eagerly awaiting the bill so that he can sign it into law.

Kentucky: Two bills in the General Assembly, House Bill 54 and Senate Bill 5, would increase the state's minimum wage from $5.15 an hour to $5.85 an hour immediately upon enactment, and then to $6.55 an hour starting July 1, 2008, and $7.25 an hour starting July 1, 2009.

While momentum for minimum wage increases seems to be growing, governments raise them at the peril of their own economies—and even many of the working poor who are supposed to be the beneficiaries of such measures. Numerous economists have already pointed out the negative effects raising the minimum wage has on employment (See Box on page 13). This is because minimum wage increases necessarily raise labor costs for businesses with employees that earn the minimum wage. Employers may compensate for their higher costs by increasing prices or cutting costs. They may cut costs by laying off entry-level workers or cutting workers' hours, or by postponing planned expansions or salary increases.

This is just what happened the last time the federal government raised the minimum wage in 1996-97. According to a National Restaurant Association (NRA) survey of its members, respondents reacted to the higher costs imposed by the increase in the minimum wage by eliminating 146,000 entry-level jobs and postponing the addition of 106,000 more jobs. In addition, 42 percent of respondents said they raised menu prices in response. A similar NRA survey in October 2006 sought to answer the question of how restaurants would react to the anticipated increase in the federal minimum wage. According to that survey:

- 41 percent of family dining and casual restaurant operators said they would cut jobs.
- 2 out of 5 family dining and casual dining operators said they would postpone plans for new hiring.
- 3 out of 10 quick service, family dining and casual dining operators said they would cut employee benefits.
- Nearly 9 out of 10 restaurants indicated that they would raise menu prices; 98 percent of quick service restaurants reported the same.
- Roughly one-half of the quick service, family dining and casual dining segments stated that they would reduce the number of employee hours worked.

Minimum wage campaigns tend to portray the typical beneficiary of a minimum wage increase as a single parent or head of household trying to support a family on a meager minimum wage. In reality, most minimum wage earners are not heads of household at all, but rather people new to the labor market (such as teenagers or college students living with their parents) or other family members working to provide a little supplementary income. According to the Employment Policies Institute (drawing upon U.S. Census Bureau data), the average annual family income of employees who would benefit from a minimum wage hike to $7.25 an hour is $45,558—not rich, but certainly not the destitute families portrayed in campaign ads. In addition, just 15 percent of workers affected by such an increase are single parents or single earners in a couple with children. An additional 24 percent are single or in a marriage with a single earner and no children. Of the remainder, 20 percent are secondary income earners and 41 percent are living with a parent or relative. It is also important to note that those who earn the minimum wage tend not to keep earning the minimum wage very long, since they receive raises—often within months of taking the job—and can command better-paying jobs as they gain skills and work experience.

Some have argued that increasing the minimum wage would provide a boost to local economies because the working poor will have more money to spend. While it is true that those earning the minimum wage will have more money in their pockets to spend in the local economy, again, this does not happen in a vacuum. The reason they have more money is because businesses were forced to give up more money than they otherwise would. Hence, businesses have less to invest in the growth of their companies (including job creation), which undoubtedly hurts local economies. Also, the workers whose jobs were terminated due to businesses having less money to spend now face unemployment. Furthermore, the resultant price increases will hurt consumers, including those receiving a higher minimum wage.

Mulling the Minimum Wage

In a recent National Bureau of Economic Research Working Paper, David Neumark and William Wascher review what the academic literature has to say about the minimum wage. From the abstract:

The overwhelming majority of the studies surveyed in this paper give a relatively consistent (although not always statistically significant) indication of negative employment effects of minimum wages. In addition, among the papers we view as providing the most credible evidence, almost all point to negative employment effects. Moreover, the evidence tends to point to disemployment effects of minimum wages in the United States as well as many other countries. Two potentially more important conclusions emerge from our review. First, we see very few—if any—cases where a study provides convincing evidence of positive employment effects of minimum wages, especially from studies that focus on broader groups (rather than a narrow industry) for which the competitive model predicts disemployment effects. Second, when researchers focus on the least-skilled groups most likely to be adversely affected by minimum wages, we regard the evidence as relatively overwhelming that there are stronger disemployment effects for these groups. ■

The study, *Minimum Wages and Employment: A Review of Evidence from the New Minimum Wage Research*, is available online: nber.org/papers/w12663

There are many practical economic reasons why imposing or raising a minimum wage is a bad idea, but the unasked question is this: Why should government intervene in salary negotiations in the first place? If an employer and a prospective employee agree voluntarily upon the terms of employment, what right does the government have to step in and override them? The agreement is mutually beneficial (or else the employer would hire someone else or the prospective employee would take a better job somewhere else), yet the power of government is invoked to override this agreement and impose an arbitrary standard devised by politicians and interest groups.

If government really wants to help the working poor, it would remove barriers to entry in the labor market, such as the minimum wage and occupational licensing laws, to allow the maximum number of people to compete for jobs and get a foothold in the labor market so they can start working their way up the economic ladder. ■

Continued from Page 9

EARMARKS

Sen. DeMint, backed by Sen. Coburn, proposed an amendment to broaden the Senate definition to match that of the House. But Senate Democratic leaders fought to kill the DeMint amendment as Majority Whip Dick Durbin (D-Ill.) offered a motion to table it. The Senate, including 10 Democrats, rejected the motion by a vote of 46-51, a significant defeat for the new majority. The leadership then objected to what was virtually automatic unanimous consent to pass the amendment. Words flew back and forth between Sen. DeMint and Majority Leader Harry Reid (D-Nev.), who defended the existing language on the grounds that his staff had worked really hard at it and the House did not know what it was doing.

Taxpayer activists and the blogging community got involved, bombarding the Senate with emails and phone calls in favor of the DeMint amendment. After being unable to turn the vote over the next 24 hours, Sen. Reid agreed to a compromise that closed the loopholes in the Senate language. That amendment passed unanimously.

The leadership then objected to what was virtually automatic unanimous consent to pass the amendment.

There are shortcomings in the House and Senate reforms. First, the reforms do not prohibit appropriators from adding projects to bills during conference negotiations. After the House and Senate pass their respective versions of legislation, conference negotiators often “air drop” into the final version new projects that have not been seen or voted on by either the House or Senate rank and file. Secondly, the reforms do not limit the overall number and cost of earmarks. Sen. Judd Gregg’s (R-N.H.) amendment to give the President a modified form of the line-item veto was blocked by Sen. Byrd.

After much kicking and screaming, and thanks to the determination of fiscally conservative legislators and taxpayer activists, Congress is moving forward with reforms that will shine more light on earmarks than ever before. The House still has to move forward with its own legislation before reforms become law. But the changes will help to reduce the most egregious abuses of earmarks and lead to more accountability for taxpayer dollars. However, because the effectiveness of budget rules depends on how Congress interprets and applies them, the final verdict on earmark reforms will not be known until the fiscal 2008 budget cycle begins. ■

Continued from Page 7
PARTNERSHIPS

or financing arrangements, such as termination liabilities, should put the public sector in a strong negotiating position. In numerous cases, government agencies have capped the rate of return of the provider and negotiated revenue-sharing arrangements. Both can help in certain cases to enhance the long-term political viability of the partnership.

When refinancing gains are not shared, such benefits should reflect reward for effectively managing risk and costs rather than a pure windfall gain. The key thing is to seek an equitable outcome that protects the interests of the taxpayer and is defensible publicly.

4. Customers of the Service Will End Up on the Short End of the Stick

Since the infrastructure facilities are often monopolies, the private sector can raise charges as much as they wish on consumers who end up disadvantaged by PPPs.

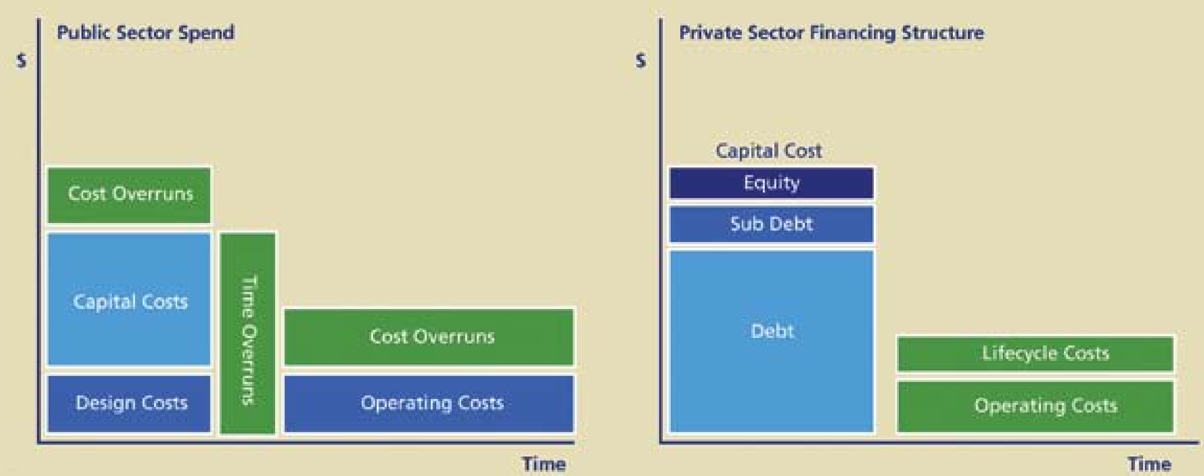
This is a complicated issue because historically political considerations have often meant that increases in user fees did not keep pace with the rate of inflation for toll roads and other public infrastructure and their associated operational and maintenance costs. This gap contributes to funding shortfalls and deferred maintenance. One goal for many governments in using PPPs—whether explicit or implicit—has been to move the issue of fee increases away from the political realm so that market, rather than political, considerations can guide fee increases.

That said, governments have several options to limit excessive fee increases and protect consumers of the infrastructure. First, fee increases can be limited by contract to the rate of inflation or some other predetermined rate, a common practice for toll road projects, or the government can retain the power to set rates based on objective criteria.

Second, private investment presupposes a revenue stream from which the private investor can earn a return. The revenue stream, however, does not have to consist solely of an interest in tolls or other fees imposed directly on users of the project. In cases where governments want a toll lower than what is needed to service/repay project debt, they can pay an "availability fee" to the private sector to make up for the difference. Great Britain likewise has used "shadow tolling" to support its PFI program.

Governments can also link the payment for the use of the

Category	Financing Type	Characteristics
User fees, revenue sources	Tolls	Tolls (or similar user charges for use of a facility) are considered a revenue source for a project, thereby providing a stream of payments that the bidders can use to determine their return on investment and to obtain financing.
	Shadow tolls	Shadow tolls are typically a means by which the government sponsor can make payment, based on usage of the facility, to the private sector operator.
	Availability	Availability payments are financial payments from the government to the private partner stipulated in a transaction to make up the difference between the government-imposed user fee (if any) and the cost of usage of the delivered service. Such payments can be in the form of tranches or in one lump sum (such as at the successful completion of the facility or for the agreed-upon maintenance requirements of the facility).



Source: Deloitte Research

infrastructure to the user's ability to pay. To offset the hardship that particular groups might experience from toll charges, for example, public officials can consider transportation vouchers or other mechanisms, like subsidies, to ease the financial burden, understanding that this will bring in less revenue.

For sectors where future needs are less certain, like water and waste, the public sector can enter into an arrangement where it buys back the facility from the private partner immediately after it is completed. The public sector can then enter into a long-term leasing agreement with the private sector to operate the facility and sell water to customers at a fixed price. Both the public and the private sector gain from this arrangement and the customer is not adversely affected. The public sector gains ownership of the facility without having to make upfront capital investments; the private sector gains more certainty about its future revenue.

5. The Government Is Forced to Bail Out PPP Projects When Demand Fails to Meet Projections

Underestimating future demand jeopardizes project returns and the fiscal solvency of the project itself.

As explained earlier, shifting risk to the private sector is a major part of the rationale for PPPs. In the United States, most road PPPs transfer all or most of the demand risk to the private sector. Down under, Melbourne's EastLink project transfers 100 percent of the project risk to the private sector. To be sure, when the private provider faces problems with demand and is unable to continue the contract, it may terminate the partnership, but it cannot take the facility with it. In most cases, the facility reverts to the public sector.

Shifting risk to the private sector is a major part of the rationale for PPPs.

A variation on the conventional DBFO/M is the DB/FO/M model, a two-stage model used in the Highway 407 project in Canada that has been successful in bringing projects with uncertain revenue streams to the market. The model is usually employed in situations when there is uncertainty about the future needs. Initially the public sector finances a design/build project undertaken by the private partner and later sells the completed facility to a private consortium responsible for its operations. This model is dependent, however, on the availability of public funds. ■

William D. Eggers is director at Deloitte Research, the thought leadership arm of Deloitte.

FIVE COMMON MISPERCEPTIONS OF PARTNERSHIPS

#1: Partnerships Have Higher Cost of Capital
Response: Private sector can better control its capital costs by making efficient use of resources and superior service delivery.

#2: Failure to Realize Value for Money
Response: Evidence supports the view that PPPs transfer construction and maintenance risk to the private sector more effectively than traditional methods and they are therefore likely to deliver value for money where competition is strong and the projects are large.

#3: Windfall Profits to the Private Sector
Response: Governments can renegotiate for better terms or for a share in any gains from refinancing.

#4: Customers of the Service Will End Up on the Short End of the Stick
Response: Governments can limit excessive fee increases, partially subsidize or fix the price of a service.

#5: The Government Is Forced to Bail Out PPP Projects When Demand Fails to Meet Projections
Response: Governments shift the risk to the private sector. Even if the project is terminated, the facility often reverts to the public sector.

Who, What, Where

Reason Studies

The Role of Tolls in Financing 21st Century Highways, Peter Samuel and Robert W. Poole, Jr., Policy Study No. 359: reason.org/ps359.pdf

The Urgent Need to Reform the FAA's Air Traffic Control System, Robert W. Poole, Jr., Policy Study No. 358: reason.org/ps358.pdf

Taxing Illegal Drugs: How States Dabble in Drugs and Why They Shouldn't, Paul Messino, Policy Study No. 357: reason.org/ps357.pdf

Privatizing University Housing, Leonard C. Gilroy, Laura J. Davis, Sarah F. Anzia, and Geoffrey F. Segal, Policy Study No. 356: reason.org/ps356.pdf

Better Prices and Better Services for More People: Assessing the Outcomes of Video Franchise Reform, Steven Titch, Policy Study No. 355: reason.org/ps355.pdf

No Choices Left Behind: Competitive Models to Restructure California's Lowest-Performing Schools, Lisa Snell, Policy Study No. 354: reason.org/ps354.pdf

Spinning its Wheels: An Analysis of Lessons Learned from iProvo's First 18 Months of Municipal Broadband, Steven Titch, Policy Study No. 353: reason.org/ps353.pdf

I Want My MTV: Reforming Video Franchises for Competitive TV Services, Steven Titch, Policy Study No. 352: reason.org/ps352.pdf

Reducing Congestion in Atlanta: A Bold New Approach to Increasing Mobility, Robert W. Poole, Jr., Policy Study No. 351: reason.org/ps351.pdf

15th Annual Report Performance of State Highway Systems (1984–2004), David T. Hartgen, Ph.D., P.E., and Ravi K. Karanam, Policy Study No. 350: reason.org/ps350.pdf

A Dynamic Perspective on Government Broadband Initiatives, Jerry Ellig, Policy Study No. 349: reason.org/ps349.pdf

Innovative Roadway Design: Making Highways More Likeable, Peter Samuel, Policy Study No. 348: reason.org/ps348.pdf

Business Jet and ATC User Fees: Taking a Closer Look, Robert W. Poole, Jr., Policy Study No. 347: reason.org/ps347_business_jets_atc.pdf

Building Roads to Reduce Traffic Congestion in America's Cities: How Much and at What Cost? David T. Hartgen and M. Gregory Fields, Policy Study No. 346: reason.org/ps345_universal-preschool.pdf

Is Universal Preschool Beneficial? An Assessment of RAND Corporation's Analysis and the Proposals for California, Christopher F. Cardiff and Edward Stringham, Policy Study No. 345: reason.org/ps345_universalpreschool.pdf

Assessing Proposals for Preschool and Kindergarten: Essential Information for Parents, Taxpayers and Policymakers, Darcy Olsen with Lisa Snell, Policy Study No. 344: reason.org/ps344_universalpreschool.pdf

Reason Foundation studies archived at reason.org/policystudiesbydate.shtml

Privatization Watch Back Issues available at reason.org/pw.shtml

PRIVATIZATION WATCH
Reason Foundation
3415 S. Sepulveda Blvd., Suite 400
Los Angeles, CA 90034
www.reason.org

Nonprofit Org.
U.S. Postage
PAID
Santa Monica, CA
Permit 81