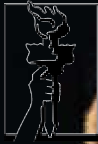

Privatization Watch

Celebrating 32 Years of Privatization and Government Reform

Vol. 32, No. 2 2009

Financial Crisis: Too Much Government

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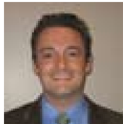

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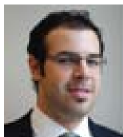

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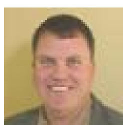

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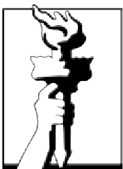

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Letter from the Editor

Advocates of limited government face perilous times. The pendulum is swinging strongly toward state intervention in the economy, and there are many indications that this interference is making the economy worse, not better. Further, the "perfect storm" of a financial crisis, global recession and growing government budget deficits has left many of us with more questions than answers. What precipitated the financial crisis? What does it mean for government budgets? What policies should we pursue moving forward?

Articles in this issue explore these important topics and more. For even more up-to-the-minute information, Reason provides an ever-growing archive of financial crisis/bailout-related coverage, available at www.reason.org/bailout.

Whether discussing bailouts, budgets, or buoying the markets, "good enough for government work" has clearly not been good enough for the American economy—quite the opposite. Now more than ever, it's vitally important to redouble our efforts to advance sensible market-based tax and fiscal policies, sustainable budget reforms, smaller government focused on core priorities, and an expanded role for the private sector in delivering government services and financing necessary infrastructure improvements. In the end, policymakers and taxpayers need to be reminded at every turn that the real problem we face is not too little government, but rather, too much.

—Leonard Gilroy

Privatization Briefs

Dunwoody Becomes Georgia's Fifth New Contract City

Dunwoody, Georgia's fifth recently incorporated city, officially opened its doors on December 1, 2008. Five new cities—Sandy Springs, John's Creek, Milton, Chattahoochee Hills, and Dunwoody—have formed in metropolitan Atlanta since 2005 and, as "contract" cities, have relied largely upon a privatized city government model in which private contractors provide almost all non-safety-related services. The first four new cities are all utilizing the same firm, CH2MHill-OMI, to provide all of their contracted services.

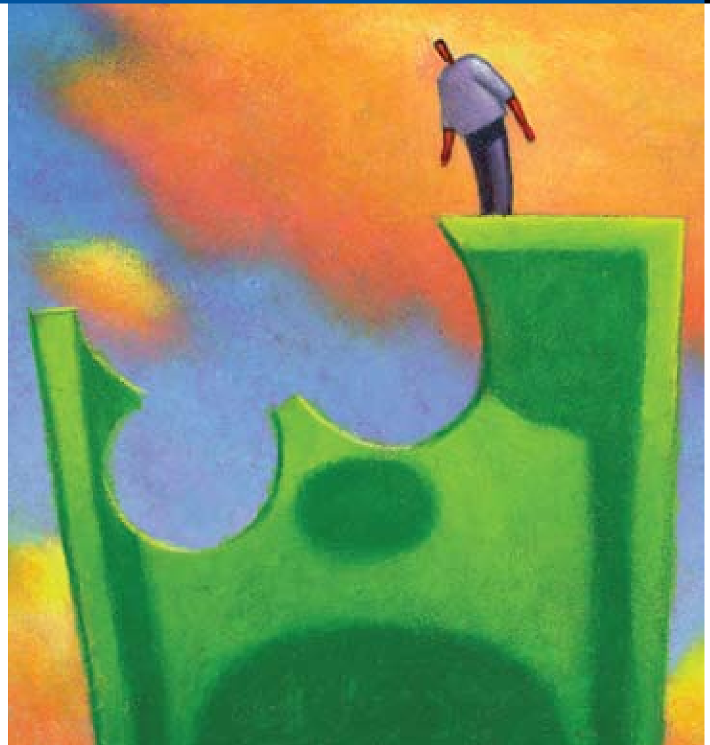
Dunwoody leaders ultimately took a different approach, opting to contract out bundles of services. The new city has hired the firm Boyken International to advise it on contracting processes, and it has also recently hired a city manager, one of the few public-sector positions in the city currently. Dunwoody will continue to receive some services from Dekalb County until all of its bundled service contracts are negotiated, and city leaders have also approved intergovernmental agreements for county provision of fire and rescue, water and wastewater, and emergency 911 services.

L.A. City Controller Report Recommends Sweeping Privatization Program

A December 2008 report commissioned by Los Angeles City Controller Laura Chick recommends that the city privatize dozens of major operations as part of its strategy to close a projected $433 million budget shortfall. The report identified Ontario International Airport as the largest potential privatization opportunity, but the report also suggests that the city pursue a wide-ranging privatization program covering such areas as residential solid waste collection, water/wastewater facility operations, fleet maintenance services, city-owned golf courses, animal shelters, and parking facilities.

In the preface to the report, Chick wrote:

> *[t]he cost of delivering essential services keeps growing at a rate that exceeds the city's ability to generate revenue, and is a major reason we've had a structural deficit for years now. When it comes to looking at how the city can fulfill its obligations to the public, and pay for it, no subject should be taboo.*



Commentary

How Much Have We Spent on Bailouts?

By Anthony Randazzo

Though significant debate over recession policy continues to rage, there has been remarkably little discussion on properly accounting for the vast sums of bailout dollars currently being spent. Incredibly enough, no one really knows precisely how much Washington has already committed or handed out—let alone to whom and for what purposes.

Estimates vary depending by source on exactly what the total commitments are, largely because there are so many programs and no one knows exactly what to count. The $700 billion TARP (Troubled Asset Relief Program), Federal Reserve programs, auto bailouts, investment guarantees, deposit insurance increases, and various other projects are funded by so many different means that it is hard to get one's mind around them all.

In December, *The New York Times* estimated bailout spending to be $7.8 trillion, while CNBC reported an approximate figure of $7.3 trillion. More recently, the Bloomberg News agency said the number had grown to $9.7 trillion. But Reason now calculates the total to be over $10.8 trillion (including the recently passed $787 billion stimulus).

Differences in estimates lies chiefly in a lack of government transparency. For instance, the Federal Reserve's website identifies what programs have been created and when money is loaned

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BAILOUTS

out. But data on exactly what money has been spent to counter the recession, and who received it, and what they used it for is tied up in a myriad of reports and figures only the Fed and Wall Street investment firms can understand and access.

The government also lacks an ability to track how the various entities receiving this money are spending it. In late 2008, the Associate Press reported it had submitted a survey to the 21 banks receiving a portion of the TARP bailout money distributed thus far, asking how the money had been used. Notably, every bank refused to report how it was spending this money, and several admitted that they weren't tracking where every dollar was going.

The inability to establish clear dollar totals should demonstrate a lack of oversight and accountability to the incoming administration. This problem has already led to questionable behavior by banks that have received funds with little oversight. Now that Congress has passed the stimulus package and the Obama administration has announced over $2 trillion to help banks and homeowners, the importance of knowing exactly where all the money is going is vital.

During the campaign, President Obama talked about "putting the government online" and making it more transparent to citizens. Nowhere is that more necessary than with the bailout:

- The Treasury and Fed should create an "online checkbook" showing how many checks it has written, when they are cashed, and offer notes about what they paid for. The government could also list whom it has loaned money to, what has been paid back, and how much interest it has earned.
- The government should consider hiring a private firm to oversee all bailout spending and act as an independent accounting source. Whether spent by the Treasury, Fed, or FDIC, all bailout money should be tracked in aggregate by a central source.
- States should learn from the failure of the federal government and have procedures in place to account for all bailout money they and their municipalities receive from any stimulus package.

The longer the government waits to account for its bailout spending, the harder it will be to assess where taxpayer money has gone. Being transparent with every dollar spent would go a long way toward increasing accountability and bringing much-needed discipline to government's bailout spending.

Anthony Randazzo is a policy analyst at Reason Foundation.

Estimated Bailout Expenditures to Date

» Federal Reserve

- § $1.75 trillion to purchase commercial paper
- $1 trillion for Term Asset-Backed Loan Facility program (TALF)
- $900 billion for Term Auction Facility lending (TAF)
- $600 billion to insure money market funds (MMIFF)
- $600 billion to purchase mortgage-backed securities (MBS) from Fannie Mae, Freddie Mac, and Ginnie Mae
- $550 billion for additional loans through the discount window
- $29.5 billion bailout for Bear Stearns debt

» Federal Deposit Insurance Corp. (FDIC)

- $1.5 trillion to insure senior subordinated bank debt
- $500 billion to insure non-interest-bearing deposit accounts
- $9 billion to insure Morgan Stanly debt
- $8 billion for IndyMac

» Treasury

- $700 billion for Troubled Asset Relief Program to recapitalize banks
- $500 billion for creating a "Bad Bank" to finance the purchase of toxic assets
- $251 billion for Citigroup debt (plus $50 billion TARP dollars)
- $400 billion for Fannie Mae & Freddie Mac bailout
- $112.5 billion for A.I.G. (plus $40 billion TARP dollar)
- $68 billion for Bank of America debt (plus $45 billion TARP dollars)
- $75 billion to help distressed homeowners avoid foreclosures
- $17.4 billion for GM and Chrysler bailout (to meet liquidity concerns)

» Congress

- $787 billion for American Recovery and Reinvestment Act (the Stimulus)
- $300 billion for Federal Housing Administration mortgage relief (July 2008)
- $168 billion for January 2008 federal stimulus package (tax cuts & rebates)

Total: $10,825,400,000,000

*These figures were compiled based on data from government websites and news reports.

The Source of the Financial Crisis: Too Much Government in the Game

By Michael Flynn

It has been three and a half months since the federal government launched the largest economic intervention in history. Since September 2008, the Treasury and the Federal Reserve, through direct financial support, loan guarantees or increased liquidity, have pumped over $10 trillion into the nation's credit markets.

And yet, the crisis shows no signs of ebbing. In many respects, our problems are the result of a perfect financial storm. Four or five underlying trends intersected to bring us to this point, not a breakdown in any specific part of the financial sector. Overlaying these trends are the unintended consequences of explicit government policy.

As Congress readies a "stimulus" package to try and jump-start the economy, it is worth examining how we got here and why recent steps have done little to stem the bleeding in the financial markets.

Throughout the 1990s and the early years of this century, politicians became intoxicated with the idea of promoting "affordable" housing. They continually pressured lenders to increase the number of mortgages to low-income households. By the time the current crisis blew up, Congress had mandated that around 30 percent of the mortgages purchased by Fannie Mae and Freddie Mac—key actors in the government's campaign to expand homeownership—were required to go to households making below their area's median income.

The roots of the crisis were planted in 1993, when the Federal Reserve Bank of Boston published "Closing the Gap: A Guide to Equal Opportunity Lending." The report was based on the belief that existing banking practices discriminated against low-income and minority households. "Closing the Gap" recommended a series of measures that lending institutions should implement to better serve this demographic, the most important of which urged banks to loosen their income thresholds for receiving a mortgage. The report noted that "many low-income households are accustomed to allocating a large percentage of their income towards rent." The message to banks was clear: Find a way to give more mortgages to poor households.

In the years since the Boston Fed produced its report, activists and government officials—especially those serving in the Department of Housing and Urban Development under both Clinton and Bush—used its findings to push banks to increase their lending to low-income households. By the turn of the century, other changes in federal government policy made these demands more achievable.

When President Bush took office in 2001 the Fed Funds rate, the key benchmark for all interest rates in this country, was 6.5 percent. Then, in response to the meltdown in the technology sector, the Fed began easing that rate. By August 2001, it had nearly halved to 3.75 percent. And by summer 2002, in the wake of 9/11, the Fed rate was 1 percent. The central bank's efforts went so far that, at one point in 2003, we had effectively negative interest rates.

Institutional investments needed a place to earn some kind of return. Investment houses began bundling individual mortgages from several banks together into a bond-like product that would be sold to individual investors. These mortgage-backed securities (MBS) became a favorite investment vehicle. Under traditional models, they were very safe and, because of Fed policy, even the most conservative fund could earn better returns with MBS than they could on treasury notes. In an era of rising house values, "safe" became "guaranteed returns."

During the first half of this decade, trading in MBS exploded. Their growth provided unprecedented levels of capital in the mortgage market. This, combined with explicit moves by Fannie and Freddie to expand homeownership, made more money available to underwrite mortgages.

The additional capital to underwrite mortgages was a good thing—to a point. Over the last few decades, the American homeownership rate had been around 60 to 62 percent. At the height of the housing bubble, it reached almost 70 percent. Now it is clear, however, that many people who got mortgages at the height of the bubble should not have.

Fannie and Freddie's roles in this crisis can't be overstated.

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Closing Growing Budget Shortfalls through Spending Reforms, Privatization

By Leonard Gilroy

One of the most visible spillover effects of the current economic crisis is that it has exposed a fiscal health crisis in state and local government. Rampant government spending in recent years and declining property values (and thus reduced property tax revenues) have combined to produce massive state and city budget shortfalls.

A December 2008 report by the Center for Budget & Policy Priorities found that 44 states have recently faced, or are facing, budget deficits this and/or next year, and 16 states face budget shortfalls in excess of $1 billion in FY09 alone, with California ($36 billion) and New York ($6.4 billion) leading the pack. In total, the report estimates that combined budget gaps for FY09-FY11 will exceed $350 billion. Also, Moody's Investor Service recently reported that 30 states are in recession, and 19 more are at risk.

Things are no better at the local level, with growing budget deficits in cities like New York City ($5-8 billion), Los Angeles ($433 million) and Phoenix ($260 million), along with numerous counties and smaller cities.

Reflecting on how governments find themselves in this position, New York Gov. David Paterson recently told *The Wall Street Journal* that, "What's actually more embarrassing than the fact that we have such a huge deficit now, when bonuses are down and capital gains are down, is the fact that when there was...wealth, we overspent."

Previous over-spending hasn't stopped state and local officials from seeking a federal bailout. In September, California Gov. Arnold Schwarzenegger hinted at possibly needing $7 billion in federal assistance to keep the state's doors open. Several weeks later saw a number of governors and mayors testify on Capitol Hill for a bailout. A few weeks still later, the mayors of three big cities—Philadelphia, Atlanta, and Phoenix—sent a letter to Treasury Secretary Hank Paulson asking the feds to use a portion of the $700 billion bailout to assist struggling cities.

State and local governments are increasingly seeking new fiscal solutions because their two usual funding sources—taxes and bonds—are going to be severely constrained in the coming years. Little political will exists to raise state and local taxes, and the tight credit market means states—especially those with big deficits—are going to have a hard time borrowing, prompting many analysts to believe we've seen the end of an era of relatively cheap money and easy borrowing for governments.

Given these constraints, states and local governments are increasingly going to need to spend within their means

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Commentary

Stimulus in the Spotlight: All Infrastructure Spending Is Not Created Equally

By Samuel Staley and Adrian Moore

The economy is officially a year into a recession, marking one of the longest periods of economic stagnation since World War II, and bolstering calls for yet another, even bigger federal stimulus package.

"There is not a governor in this country that would turn down money for roads and bridges and infrastructure projects," Gov. Michael F. Easley of North Carolina recently declared. "Infrastructure investment is not only necessary for long-term economic growth and global competitiveness—but it will also create jobs when Americans, and Californians, need them the most," said California Gov. Arnold Schwarzenegger. "With an immediate commitment to national infrastructure investment, it's possible to put shovels in the dirt and start immediately on projects across the nation."

Yet, federal policymakers need to consider much more than pouring money into the transportation sector if they want to have a meaningful, positive impact on the economy. It takes more than digging ditches and laying asphalt to ensure that investments create improvements in mobility that spur job creation and increase productivity. To maximize the impact of any infrastructure spending, the transportation investments must be the right kind, in the right place, and at the right time. Those are no small obstacles.

On the surface, transportation may seem like a logical investment if there is going to be a massive federal stimulus package. Our bridges, roads, and transit systems are crumbling. Various reports have found that the nation is underinvesting in transportation infrastructure by an estimated $70-100 billion per year. According to Reason Foundation's 2008 Annual Highway Report, 50.7 percent of America's urban interstate highways were congested in 2006. And of the nearly 600,000 highway bridges in the country, 24.1 percent were deficient or functionally obsolete.

The National Governors Association suggests $57 billion in infrastructure projects could be started within 120 days of being funded. The American Association of State Highway and Transportation Officials claims that 3,109 transit and highway projects, accounting for $18 billion in new spending, are "ready to go" once state and local transportation agencies get a funding green light from the federal government. This spending would create 630,000 jobs, according to their studies.

But not all of those projects will offer a return on taxpayers' investment. A bridge to nowhere, or a lightly traveled light rail route that will long require heavy annual subsidies isn't a good use of money just because it is infrastructure spending. Rather, it's time to rethink transportation investments in the context of the modern economy.

The highway and road system must meet the needs of a globally competitive, dynamic, services-based economy. Today approximately 80 percent of all goods, by value, are shipped by truck in this country. Only 15 percent of travel on our nation's roads is traditional commuting, and 97 percent of our total travel is by automobile. Americans don't just get up and go to work. We combine and "chain" our trips to include errands, non-office business, personal appointments and to meet friends for coffee or happy hour. Our demand for flexible and adaptable modes of transportation, primarily the car, has skyrocketed, placing unprecedented demands on the transportation system. At the same time our investment in the network has languished. Travel demand on our roads has outstripped additions to capacity by 3-to-1 over the last three decades.

The 21st century economy needs a transportation network that is fast, efficient, and flexible. Achieving this will require directing transportation investments to meet the following fundamental concepts:

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INFRASTRUCTURE

- Think 3-D. We can eliminate chronic traffic congestion and increase travel speeds by adopting cutting edge engineering solutions and embracing innovative road design to provide multi-layered access to key destinations through tunnels, flyovers, queue jumpers (or duckers) and elevated expressways.
- Recognize the hidden costs of congestion. Congestion is a job killer because it limits our access to our most valuable resource: people. For the most part, people will live within a 30-minute commute of their workplace. Congestion shrinks this "opportunity circle" for workers and employers alike, preventing businesses from tapping into the most talented and productive workers available. Transportation projects should place a premium on reducing congestion.
- Adopt a "mobility first" transportation strategy. Transportation networks in a services-based economy need to emphasize connectivity with shorter travel times and lower overall travel costs for individuals and businesses, and expeditiously connect people and businesses within metropolitan areas.
- Embrace market forces and the private sector. There's a reason almost one-third of our new road infrastructure has been built as toll roads. Modern tolling marries the powerful economic force of "willingness to pay" with new public and private capital capable of delivering the infrastructure users want. In short, toll roads put the right roads in the right place at the right time.
- Embrace innovative highway design and materials. The private sector has repeatedly shown its ability to provide new designs, using new materials, to speed up the delivery of transportation infrastructure when it has been allowed. It's time to give state and local governments more freedom to test the waters with private capital and incentivize innovations that meet real needs identified on the local and regional levels.

These concepts will be central to achieving a policy goal of improving the long-term viability and efficiency of our transportation network. Before the federal government gives governors billions for new infrastructure spending, someone should talk to Secretary of Transportation Mary Peters, who has said there is over $400 billion in private capital ready to be spent on infrastructure projects.

Public-private partnerships, like those Peters proposes, offer the best hope of prioritizing the long wish-lists of infrastructure projects. The private sector will gravitate to projects that offer steady revenue streams and the best chance for profit: new toll roads that relieve congestion in urban areas or highly traveled bridges in need of repair, for example. On the other hand, projects centered around pretty ribbon-cutting ceremonies or meant to deliver pork to congressional districts will be found wanting by investors.

Increasing private sector involvement can close the funding gap, reduce the 'need' for stimulus spending and make certain the most needed transportation projects—the ones that will deliver the most bang for our bucks—rise to the top.

The way we fund our roads is failing and out of date. Simply pouring billions more into building roads the old-fashioned way won't fix it. A modern transportation network designed to meet today's diverse travel needs would help the economy grow. Unfortunately for taxpayers simply handing a big stimulus check to governors won't deliver that network.

Samuel Staley is director of urban policy and Adrian Moore is vice president of research at Reason Foundation. They are co-authors of the new book, **Mobility First: A New Vision for Transportation in a Globally Competitive 21st Century** *(Rowman & Littlefield, 2008).*

Vital Infrastructure, or 'Tennis Courts to Nowhere'?

In a recent *Wall Street Journal* article (December 10, 2008), Reason Foundation's Searle Freedom Trust Fellow and director of transportation policy Robert Poole shed some light on the 11,391 "ready to go" infrastructure projects (totaling $73 billion) recommended by the U.S. Conference of Mayors as part of an anticipated federal stimulus plan. Poole notes, however, that the mayors' list includes many projects that may be difficult to classify as "vital" infrastructure. See box on right for list.

According to Poole, "[i]t is clear that any infrastructure stimulus money given to the country's mayors will lead to thousands of tennis centers to nowhere." Poole cautioned that any expenditure of tax dollars should be based on effectiveness and potential return on investment for taxpayers, and that policymakers should not ignore the growing interest in private sector infrastructure financing.

Projects Classified as "Vital" Infrastructure

- Hercules, California, wants $2.5 million for a "Waterfront Duck Pond Park" and another $200,000 for a dog park.
- Euless, Texas, wants $15 million for the Midway Park Family Life Center, which includes both a senior center and aquatic facility.
- Natchez, Mississippi, wants a new $9.5 million sports complex "which would allow our city to host major regional and national sports tournaments."
- Henderson, Nevada, wants $20 million to help "develop a 60 acre, multi-use sports field complex."
- Brigham City, Utah, wants $15 million for a sports park.
- Arlington, Texas, wants $4 million to expand its tennis center.
- Miami, Florida, wants $15 million for a "Moore Park Community Center, Tennis Center and Day Care" facility. The city is also seeking $3.6 million to build a covered basketball court and a new tennis court at Robert King High Park, as well as a $94 million Orange Bowl parking garage.
- La Porte, Texas, wants $7.6 million for a "Life Style Center."

Chicago Nets $1.1 Billion in Parking Meter Privatization

By Leonard Gilroy

In December 2008, Chicago Mayor Richard Daley announced the winning $1.1 billion bid for a 75-year franchise for the city's downtown parking meters, marking the first privatization of an urban parking meter system in the United States. With over 36,000 meters generating roughly $19 million per year, Chicago's is among the largest parking meter operations in the country and is likely to serve as a model for other city systems.

In exchange for an upfront $1.15 billion payment, the agreement will grant the operator—a consortium led by Morgan Stanley Infrastructure Partners—the right to maintain and operate the meters throughout the life of the contract. The deal also requires the operator to make significant investment in the system itself, replacing the antiquated coin-based meter system with a high-tech, multi-space/multi-pay meter system that will facilitate payment via cash, credit card and other pay systems.

"This is the best thing that has happened for us in regards to getting out of this business," Mayor Daley said. "This is not the core business of the city of Chicago."

The deal follows right on the heels of the $2.5 billion bid for Midway Airport—announced in September and currently awaiting federal approval—as well as the 2005 lease of the Chicago Skyway (netting the city $1.8 billion) and the 2006 lease of four downtown parking garages (netting $563 million).

Under the terms of the parking meter contract, the city retains full responsibility for rate setting, and parking regulation enforcement and fine collection remains with the city. The deal also preserves the City Council's decision-making authority over rate-setting, the number of meters and the length of time customers can park. The operator does have the ability under the contract to supplement the city's ticketing function if the city's own performance wanes in the future. But since all parking fines will continue to be collected by and to the benefit of the city alone, the operator does not stand to realize even a penny from enhanced ticketing; hence, hiring additional private ticketers would effectively represent a net cost to the operator, with no additional offsetting revenues.

Parking rates will be allowed to rise each year for the first five years of the contract; thereafter any subsequent rate increases over the remainder of the contract term will be subject to City Council approval, and increases in any given year would likely be capped to some standard measure of inflation.

Further, the contract requires the operator to replace and upgrade the entire meter system—at its own expense, separate from the $1.1 billion upfront payment—removing significant future operations, maintenance and capital expenditure costs from the city's books for decades to come.

Consumers and businesses will also benefit from the parking meter system modernization. Consumers will benefit from a 21st century parking meter system that offers more payment options and more efficient use of the spaces, with the spillover benefit of traffic flow improvements as drivers avoid the need for multiple "trips around the block" to search for available spaces.

The increased turnover in parking spaces should also benefit restaurants and other downtown businesses, as the improved availability and reliability of spots will likely be an attractive draw for those who might normally be deterred from visiting downtown due to the difficulty of parking.

Proceeds from the parking meter agreement will be split four ways. The city will put $400 million into a long-term reserve fund: $325 million into city budgets through 2012, $324 million into a budget stabilization (i.e., "rainy day") fund, and $100 million for low-income assistance programs.

Michael Smith, a projects lawyer with the firm Baker & McKenzie in Chicago that represented other bidder groups in the parking meter auction, told Reason that he sees this transaction as a watershed event for the public-private partnership market in the U.S that will likely prompt imitators in other local governments. According to Smith, "the city of Chicago was smart to recognize that the parking meter system was an asset worth more than a billion dollars in private hands, but generating little revenue for the City. It just made good business sense to let someone else operate and run the system."

Leonard Gilroy is the director of government reform at Reason Foundation. An earlier version of this article was published by the Illinois Policy Institute (illinoispolicyinstitute.org).

Outlook for Private Infrastructure Investment Remains Strong

By Robert Poole, Jr. and Leonard Gilroy

In the wake of the financial crisis and national economic downturn, many pundits and public officials have questioned whether private capital is still interested in investing in infrastructure projects such as toll roads. Broadly speaking, the answer is yes.

As the global financial markets go through a massive credit crunch, one of the few categories in which there is increasing interest in investing is revenue-producing infrastructure. There is a general consensus in the finance community that infrastructure remains a very attractive investment in the "flight to quality" seen in the markets more generally (capital flowing to solid, safe, and tangible investments with steadier returns and relatively lower risk profiles).

While analysts expect that debt is going to be more expensive and more conservatively invested, it will definitely be available for good projects. What will change is the leverage in these deals. Instead of debt/equity ratios of, say, 80/20 or 70/30 pre-crisis, going forward we will see much larger percentages of equity, at least in the near term.

There is also strong evidence that the major providers of equity—infrastructure investment funds, insurance companies, and pension funds—continue to be strongly interested in infrastructure. Probitas Partners released an October 2008 survey of institutional investors, finding that over $21 billion was raised for infrastructure funds in the first nine months of 2008, "a pace that falls just short of 2007's record fundraising but an amount already in excess of the 2006 total."

Probitas also reports a high level of interest in the infrastructure sector, generally considered a separate category by such investors, with stable and increasing allocations to this sector. And 28 percent of respondents said their allocations are likely to increase, compared with only 5 percent expecting to decrease. An appendix to the report lists large infrastructure funds already in the market or expected to come to market over the next 12 months. The total in these funds is $93.7 billion, at current exchange rates (some are quoted in Euros or British pounds). So even at a 50/50 debt/equity ratio, these equity funds could support nearly $200 billion worth of infrastructure projects.

Also appearing in October 2008 was the 18th annual *Public Works Financing* survey of public-private partnerships in infrastructure, including roads, rail, water and buildings. Since 1985, according to PWF's database, over $585 billion has been invested in such projects, of which 500 highway projects (mostly toll roads) account for $265 billion. Just over half of these road projects ($136 billion) are in Europe, with a rather paltry $14 billion in the United States thus far. There continues to be great interest in the potential of the U.S. market, given the huge difference between existing highway funding sources and the need for capital investment.

Last, two recent deals in Chicago—announced after credit markets tightened in the fall of 2008—have demonstrated an ongoing private sector interest in infrastructure investment. On September 30, 2008, Mayor Richard Daley announced a landmark agreement with a Citi-led consortium for a 99-year lease of Midway Airport in return for $2.5 billion in cash upfront. Then in December 2008, Mayor Daley announced a winning $1.1 billion bid for a 75-year franchise of its downtown parking meter system (see "Chicago Nets $1.1 Billion in Parking Meter System Privatization"). In addition, states like Florida, Virginia, Texas, and Georgia remain committed to delivering needed new highway infrastructure through similar partnerships, with several privately financed projects in each state currently in various stages of procurement.

Given the ongoing private sector interest in infrastructure investment and mounting budget shortfalls at all levels of government, it is likely that policymakers nationwide will increasingly craft policies that facilitate this investment and explore new opportunities to tap private dollars to deliver needed public infrastructure.

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Impact of the Financial Crisis on Local Governments

Interview with Former Jersey City Mayor Bret Schundler

Former Jersey City Mayor Bret Schundler, now a chief operating officer of the King's College-New York City, sat down with Reason's Anthony Randazzo recently to talk about the financial crisis, what policymakers should be doing about it, and how it is affecting local municipalities.

Anthony Randazzo, Reason: What were the policy errors that led us to today's economic crisis?

Bret Schundler: A case can be made that what I think were policy errors were not errors at the time, just like a pharmaceutical may be the right prescription for an ailment, but then lead to problems when other pharmaceuticals, with which it doesn't mix well, are prescribed later.

In the wake of the post-9/11 global recession, central bankers throughout the world cut interest rates. Gold and commodity prices turned up almost immediately, but western economies remained anemic for over a year, and overall producer and consumer inflation remained low. Central bankers faced a conundrum. Should they raise short-term interest rates, presuming rising commodity prices to be a harbinger of future inflation, or should they keep short-term rates low to spur economic growth?

They chose the latter course, and gold-standard libertarians would say that this was a major error—that excessively-low interest rates since 2003 have caused an excessive expansion of credit throughout the world, and that this led directly to today's problems. Had central bankers not ignored the soaring price of gold for so long, had they hiked interest rates early enough and high enough to stabilize gold prices, we would not have had a housing bubble, we would not have had an over-capacity problem in other credit-sensitive sectors such as the auto industry, and we would not have had financial institutions everywhere going bankrupt today. They argue that we would have had slower growth since 2003, but that it would have been sustainable growth. To avoid making such errors, gold-standard libertarians say central bankers should peg their currencies to a fixed-measure of value, such as gold. [. . .]

The counterargument is that raising interest rates in 2003 to stabilize gold prices would have caused outright deflation, and that this would have put the economy through the same kind of wringer we are going through now—only several years earlier. This counterargument defends the central bankers' decision to keep rates low, and states that today's problems are the result of an unpredictable confluence of factors ultimately mixing together to create what might be called a "perfect storm," economically speaking.

Randazzo: When it comes to regulatory debates, was insufficient government regulation of the financial markets a problem? Should we blame financial innovations or the rating agencies for not properly evaluating the risks to investors of many complex new securities?

Schundler: I don't think financial innovation should be faulted. Regarding the question of regulation, there is an important role for government regulation in the financial markets. But politicians frequently promulgate rules to serve some organized special interest, not the common good. And even when politicians try to do the right thing with a regulation, you often get unintended consequences, as was the case with the mark-to-market requirements following the Enron scandal. In fact, you can argue that is was a bad regulation which is also to blame for bond rating agencies not properly evaluating credit risk during the bubble. […]

Current regulations require that a security be positively

rated by, quote, "one of the three national bond rating agencies" before certain investors may purchase it. This gives the big three national bond rating agencies oligopolistic control of that bond rating business and puts the government's imprimatur upon their work, even when it is sloppy. It might be better to open up that market to any bond rating entity, which demonstrates to the government that it is competent. If you had had a lot more bond rating entities looking at different kinds of securities, you would have had a higher probability of some entities identifying their true risks. […]

Randazzo: Assuming the government can correct the regulatory errors still in the system, what should the federal government be doing now to spur on economic growth?

Schundler: We need a more pro-growth tax system. We need to increase our savings rate. We need to lift the burden of what should be society-born costs from the back of American business. And we need to improve the effectiveness and efficiency of government spending, so our public investments and social commitments don't bankrupt us. […]

In general, we should decrease individual taxes on work and investment.

In general, we should decrease individual taxes on work and investment, and tax consumption instead. There are a lot of different ways you can move in this direction and still maintain the progressivity of our current tax code (that is, still have rich, big-spenders pay a higher effective tax rate than poor, low-spenders). Reducing high marginal tax rates, and substituting an Armey or Forbes-type of flat income tax system with a high standard deduction would move us forward. A FAIR-type of consumption tax would move us even further. […] [I]t would be great to have people consuming more on the basis of increased income, not just increased debt.

Eliminating the capital gains tax would be a particularly pro-growth tax reform. Capital investment is the quickest way to increase a worker's earning potential. […] Don't let capital gains taxes decrease the pool of capital that is available for high-return investments, or discourage more marginal capital investments altogether. Don't let the government tax away capital, which could have helped American workers produce and earn more, just so it can misspend that money in ways that are often wasteful.

A third pro-growth tax reform would be to reduce taxes on American business. America's corporate tax rates are practically the highest in the world these days. They are higher even than in the semi-socialist welfare states of Western Europe. This is driving business investment away from America and to countries where the corporate tax rate is lower. […] Not taxing money which is left productively invested in job and income generating businesses, would help generate more jobs and higher incomes. […] [A]t a minimum, corporate tax rates should be lowered, paid dividends should be made deductible, and corporate capital investments should be more quickly depreciated.

Randazzo: What has the financial crisis meant for municipal governments and their citizens?

Schundler: I think the impact here in Jersey City is going to be a lot of increased unemployment and decreased income, because there is a lot of the financial industry here and in the regional area. I think we will see some tax appeals by property owners because as values come down on property that reduces the ratable value of their property. But then you have to increase taxes to increase income or simply have less income as a city.

So initial impacts are increased joblessness and you'll have decreased property values and decreased tax revenue. Then you have a decrease in state aid, because the state is taking a hit on those income taxes and sales taxes. So of those three factors, one of them is hitting our families directly—they're also losing wealth, their homes and so forth—but then the city itself is losing property tax revenue and state aid.

I think the thing to do is to get your spending under control. To some degree, services are so inefficiently provided by government that no one will necessarily notice a cut. They don't notice any improvements when spending goes up, they don't notice deterioration when spending goes down. There are a lot of complaints by government unions, but the average citizen won't sense it much. If you're a city, you should try on one hand to cut spending, and on the other hand work hard to expand the productivity of your government spending. So rather than have any reduction in services you try to improve services while spending less.

The question then arises, why don't governments do this all the time, why would this be something they should do when a financial crisis hits. I would argue it is something they should do all the time. It becomes especially important in times of crisis. When you can't afford to fool around anymore, you should stop fooling around.

The complete version of this interview is available at www.reason.org/commentaries/randazzo_20081218.shtml

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These quasi-government institutions made increasing the number of low-income households who could obtain a mortgage a key strategic goal. To achieve this, they signaled that they would support the subprime lending market by buying up all the subprime or Alt-A mortgages that they could find, eventually acquiring around $1 trillion of the paper.

The market responded. In 2003, subprime mortgages made up less than 8 percent of all mortgages. By 2006, it was over 20 percent. Banks knew they could sell subprime products to Fannie and Freddie. Investments banks realized that if they laced ever increasing amounts of subprime mortgages into the MBS, they could juice the returns and so earn bigger fees. The rating agencies, thinking they were simply dealing with traditional mortgages, didn't look under the hood.

Unfortunately, after several years of a housing boom, the available pool of households who could responsibly use the more exotic financing products had dried up. In short, there were no more people who traditionally qualified for even a subprime mortgage. However, Fannie and Freddie were still signaling that they wanted to buy these products. Banks realized they could make even more exotic loan products, e.g., interest-only loans, and thereby get the activists groups off their back and immediately diffuse their risk by selling the mortgage into an MBS.

Everything worked, as long as housing prices continued to rise. No one foresaw an actual decline in prices. Suddenly, though, there weren't enough buyers. At the same time, the first wave of the more exotic mortgages began to falter; a significant number moved into default and foreclosure.

No one fully understood how exposed the MBS were to the rising foreclosures. The market for them dried up, effectively becoming "illiquid." U.S. accounting standards, however, required firms to use "mark-to-market" to value their assets. That standard dictates that the value of your assets are based on what you could sell them for today. Thus, because no one would now trade MBS, most had to be "marked" at something close to zero.

This threw off banks' capital requirements. Under U.S. regulation, banks have to have a certain percentage of assets to back up the loans they make. Lots of banks and financial institutions had MBS assets on their books. With these moving to zero, they didn't have enough capital on hand for the loans that were outstanding. They rushed to raise capital, which raised fears about their solvency and compounded into a self-fulfilling prophecy.

The collapse of the MBS market then polluted other financial products. Credit default swaps—which are simply hedges against the risk of bonds defaulting, and derivatives, which are also bets against default—came due. Suddenly, stable and conservative firms like AIG were overexposed. Given a few days, AIG could have sold enough assets to cover the spread, but the ironclad accounting and regulatory requirements precluded this. So, the government stepped in.

At that point, a temporary easing of capital requirements would have provided banks breathing room to sort out the MBS mess. Instead, the government decided to simply provide the capital to meet the regulatory requirements. They moved into crisis mode, making a series of tactical moves to deal with specific, daily challenges. This may have, at times, temporarily calmed the market, but it put off the inevitable reckoning the market needs to regain its confidence. The rest, unfortunately, is now history.

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SHORTFALLS

and partner with the private sector more often to deliver services.

Texas is currently the envy of the nation with an $11 billion budget surplus, and it uses several budget and fiscal tools to control spending. For example, the Texas Constitution gives the state Comptroller of Public Accounts the responsibility to certify the state's budget and send back any spending bills that the state can't afford. Having a third-party enforce prudent fiscal forecasting and spending helps to avoid the situation so many states now face—governors and legislators gravitate to the rosiest of revenue projections to help justify new spending, and then when projected revenues fail to materialize, the state faces a budget "crisis."

Texas also engages in performance-based budgeting—tying a given program's funding to its effectiveness at meeting clear performance targets. A Sunset Advisory Commission conducts mandatory periodic reviews of all state agencies to find duplicative or unnecessary programs that must be cut. Since its inception in 1977, the Sunset Commission has eliminated over 47 governmental agencies and consolidated another 11.

Similarly, Washington state and South Carolina apply a performance-budgeting model in which state activities are ranked in order of priority and effectiveness. The administration then "purchases" (funds) the activities from the top of the list down until all available revenues have been used up, ditching the lowest priority activities and eliminating poor-performing, unnecessary, or wasteful ones.

Policymakers also seem to be increasingly recognizing that privatization and competitive service delivery are proven tools for delivering higher quality services at a lower cost. For example, under former Gov. Jeb Bush's term (1999-2007), the state of Florida engaged in over 138 privatization initiatives saving taxpayers over $550 million in aggregate during Bush's term. When many other states were raising taxes, Bush's privatization initiatives helped Florida to shed almost $20 billion in taxes and over 3,700 positions in the state workforce.

And at the urban level, Chicago Mayor Richard Daley has long been a privatization advocate. Under his watch he's privatized over 40 services and activities, saving taxpayers millions. Since 2005, Daley has initiated long-term lease agreements with the private sector for the Chicago Skyway toll road, Midway Airport, four major downtown parking garages and the city's parking meter system downtown. Chicago netted over $5 billion in the process to pay down city debt, establish a $500 million rainy day fund, establish mid- and long-term annuities and reduce unfunded pension liabilities.

As state and local governments reckon with their growing fiscal crises, privatization and more prudent fiscal stewardship will be the key to "right-sizing" government and avoiding future profligate spending when economic conditions do improve.

Leonard Gilroy is the director of government reform at Reason Foundation.

Who, What, Where

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Upcoming Conferences

The Performance Institute 2009 City and County Performance Summit, April 1–2, 2009, Las Vegas, NV

Reason Weekend 2009, April 16-19, 2009, Loews Portofino Bay Hotel, Orlando, FL

International Bridge, Tunnel and Turnpike Association, Managing in an Era of Changing Economic Times, April 19-21, 2009, San Francisco, CA

American Legislative Exchange Council, 2009 Spring Task Force Summit, May 1-2, 2009, Memphis Cook Convention Center, Memphis, TN

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