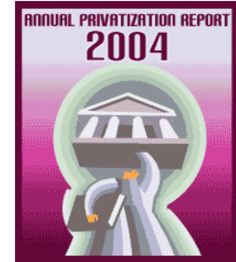
Volume 18

Annual Privatization Report 2004



Chronicling developments in privatization, outsourcing, and government reform for 18 years

A project of Reason Foundation, the world leader in privatization

Edited by Geoffrey F. Segal

In its 18th year of publication, Reason's Annual Privatization Report helps policy and opinion makers understand the fast-moving arena of privatization, outsourcing, and government reform. And now APR is evolving to better suit your needs.

For the best monthly analysis of privatization developments, subscribe to *Privatization Watch*. And for daily privatization commentary, visit our new Web log, Out of Control (www.rppi.org/outofcontrol).

Comments? Suggestions? Please send them to us.

Letter from the Editor

Geoffrey F. Segal

Entering its 18th year of publication, the Annual Privatization Report has chronicled trends, developments, and experiences of local, state, and federal governments subjecting public services to competition. It seems that what APR has been chronicling all these years has finally hit mainstream. In their new book, *The Price of Government*, David Osborne and Peter Hutchinson argue that "the fastest way to save money and increase value is to force public institutions to compete."

While saving money is important, experience shows it's not the only benefit that can be achieved through competition. Governments at every level use competition and privatization to enhance quality, spur innovation, and complete projects more quickly.

Osborne and Hutchinson further state that privatization and the many other tools they write about are "well beyond the experimental phase...[they] have proven their value in many different public contexts" and jurisdictions should "waste no time in implementing them." After 18 years of publishing APR and 27 years of publishing *Privatization Watch* we here at Reason Foundation are happy to have secured at least one vote. In this 18th Annual Privatization Report, Reason Foundation once again provides information and analysis on the benefits of privatization.

Reason Foundation staff recently helped the states of Florida and California develop and implement exciting privatization programs. Those efforts are chronicled in the "State Update," but also be sure to see the update from the federal government and President Bush's ambitious plans to privatize 850,000 federal jobs.

For those travelers out there, check out the latest developments in air travel, airport security, and ATC reform. And of course, if you prefer to drive, see the section on highways and toll roads. You can also read up on the follies of urban light rail. And Ed Hudgins delves into the idea of private space flight and its continued deregulation.

Despite the long track record of water and wastewater privatization around the world, an alarming trend is developing. Cities and counties are using eminent domain powers to deprivatize water facilities.

In this issue we also dive into private corrections, welfare and education and their recent challenges and innovations. See these sections and the States section for updates on these programs. Lastly, no annual report on privatization would be complete without a discussion of offshoring. See our article for an in-depth examination of this controversial issue. Your comments are important to me. Please feel free to contact me with questions, suggestions, or for more information. To stay abreast of these issues be sure to read our monthly newsletter *Privatization Watch*. For the most up-to-date information on the rapidly changing privatization world, visit our Web log, Out of Control.

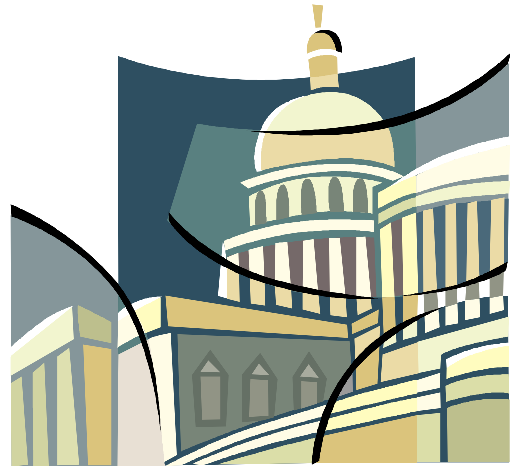
Geoffrey F. Segal, Editor

Table of Contents

Letter from the Editor i
Federal Update 1
State Privatization Update 5
  California 6
    Budget Crisis 6
    California Performance Review 7
    Reorganization 8
    Asset Sales 8
    Competition 9
    Future Optimistic, Uncertain 9
  Florida 10
  New York 13
  South Carolina 15
  Virginia 16
Corrections 17
Education 19
  Philadelphia's School Privatization Produces Student Achievement Gains 22
Environment 24
  Water/Wastewater 24
  Columbia Basin Water Transactions Program 26
  Fisheries 28
Energy: The North American Blackout Report: A "More Rules" Solution 30
Outsourcing Human Resources Management 33
  Who is Outsourcing? 33
  Why Outsource HR? 33
  Why Outsource Now? 34
  HR Outsourcing Case Studies 34
  Lessons Learned 35
A Taxpayer Bill of Rights (TABOR): Challenging the'Girly Men' in Our Legislatures 37
  Related Links 39
Offshore Outsourcing 40
  More Good Than Harm: Can America Learn To Love Outsourcing? 40
    The Politics of Offshore Outsourcing 40
    The Economics of Offshore Outsourcing 41
    Creating Jobs at Home 41
  The Outsourcing-Education Connection 42
    Would Better Schools Keep Better Jobs at Home? 42

Falling Behind ... 43
Competition Abroad, Competition At Home ... 44
When Government Jobs Go Overseas ... 45
Who's Taking American Jobs? ... 47
Machines... ... 47
…And Other Americans ... 48
Air Transportation ... 49
U.S. Airport Security ... 49
U.S. Airport Privatization ... 50
Global Airport Privatization ... 51
Federal ATC Outsourcing ... 52
FAA Air Traffic Control Reform ... 53
Overseas ATC Corporatization ... 54
Space Privatization ... 57
The Private Sector Triumph ... 57
History of Problems ... 57
A New Direction ... 58
Problems with the Report ... 59
Conclusion ... 60
Surface Transportation ... 61
State PPP Laws ... 61
Recent Public-Private Toll Road Developments ... 63
HOT and Other Forms of Managed Lanes ... 64
Transportation Legislation Updates ... 67
Overseas Toll Road Developments ... 68
Fixing Transit with Private Participation ... 70
Assigning Blame ... 70
Fixing Transit ... 71
Competition vs. Monopoly ... 72
Rail for the rich or cars for the poor? ... 72
Competitive Participation in U.S. Public Transport: Special vs. the Public Interest ... 75
Privatizing Welfare Eligibility ... 76

Federal Update



Privatization at the federal level is alive and well…barely. Competitive sourcing—President Bush's plan to bring competition to half the federal workforce—has faced significant challenges from Congress in each of the last two appropriations cycles. Members of Congress have attempted to insert language into appropriations bills that would limit, restrict, or in some cases outright kill competitive sourcing at federal agencies. Fortunately, these opponents have seen more failures than successes, but just one or two wins seriously sets back the president's plan.

Despite this, a number of successes are worth mentioning. (see: http://www.results.gov/agenda/cs_omb_647_report_final.pdf). Studies of more than 650 commercial activities completed in FY 2003 and several competitions completed in the first quarter of FY 2004 comprised of more than 17,500 full-time equivalent positions (FTE), are expected to yield $1.1 billion in savings for taxpayers over the next three to five years, approximately a 15 percent cost reduction (or avoidance). This cost savings is generated regardless of whether the federal workers or a competing vendor wins, a savings of $12,000 per position studied.

Success is tied to sound preliminary planning, grouping related activities to generate private sector interest, reorganizing inefficient in-house operations, and aligning competitive sourcing and human capital efforts to close competency and skills gaps. The driving force behind the cost savings is competition. The cost savings will likely decrease from 15 percent if Congress elects to create a disincentive for vendors to compete by balkanizing the competitive sourcing process through piecemeal legislation.

Agencies report that their incremental ("out-of-pocket") costs total about $90 million. Thus, for every dollar spent on competitive sourcing, the taxpayers saw approximately $12 in cost savings or cost avoidance.

While the goals are alike, traditional privatization differs greatly from competitive sourcing. To most people privatization or contracting are the same thing—the transfer of a service currently provided by the government to a non-governmental entity. While competitive sourcing may actually lead to contracting, it simply defines the process for comparing the costs and performance of work currently done by federal employees against alternatives available in the private sector and non-profit organizations. Thus, in competitive sourcing, if federal employees win a competition, taxpayers have saved money just as if the work had been contracted to a private entity. Whereas true privatization results in a transfer of the role, responsibility, funding obligation, and ownership of assets to another entity—this transfer does not occur under competitive sourcing.

Competitive Sourcing at a Glance: Investments & Results in FY 2003

Competitive assessments completed in FY 2003

- Number of assessments completed: **662***
- Type conducted**: streamlined =**570**; standard = **92**
- Number of FTEs studied: **17,595***
- Percentage of studies where federal agency determined best value is provided by the in-house organization (based on FTEs studied): **89%**

Competitive assessments announced but not completed in FY 2003

- Number of assessments announced: **73**
- Type conducted**: streamlined = **17**; standard = **56**
- Number of FTEs announced for competitive assessment: **7,385**

Out-of-pocket cost of competitive assessments***

- Incremental cost directly attributable to conducting completed competitive assessments: **$88 million**
- Incremental cost directly attributable to conducting announced competitive assessments: **$15 million**
- Average incremental cost per FTE studied: **$5,000**

Results: estimated savings from completed competitive assessments****

- Gross: **$1.19 billion**(over three to five years)
- Net: **$1.1 billion** (over three to five years)
- Annualized gross**: $237 million**
- Annualized net per FTE: **$12,000**

* excludes direct conversions; includes 4 standard competitions completed in the first quarter of FY 2004.

** includes streamlined and standard competitions conducted under the revised Circular and streamlined and standard cost comparisons conducted under the old Circular A-76.

*** these are one-time expenses.

**** aggregate cost and savings figures were derived from agency calculations made in accordance with the general methodologies described in OMB Memorandum M-04-07.

See Office of Federal Procurement Policy for definitions and explanations:
http://www.whitehouse.gov/omb/procurement/index.html

Privatization in the News: New Attention for Privatization Spurs Debate on National Public Radio

The use of private contractors in Iraq got a lot of attention in the last year, sometimes highlighting great results, sometimes highlighting serious problems. President Bush has put an unprecedented emphasis on competition and privatization in the Iraq war effort.

In the midst of the sound bites about privatization, NPR's *Justice Talking* aired a debate on privatization between Reason Vice President Adrian Moore and the Economic Policy Institute's economist Max Sawicky.

As NPR put it, "Supporters hail efficiencies and cost savings they predict will follow. Opponents warn of decreased services, falling wages and increased scandals like the one recently weathered by Halliburton. Will change bring better, more cost-effective services or simply put profits before people?"

You can listen to the debate at http://www.rppi.org/privatizinggovt.html.

While the bulk of activity at the federal level centers on bringing more competition to government, there are a couple of true privatization initiatives as well. Both major initiatives are housed in the Department of Defense (DOD): the Military Housing Privatization Initiative (MHPI) (see: http://www.acq.osd.mil/housing/mhpi.htm) and the Military Utilities Privatization Initiative (MUPI).

Congress established the MHPI in 1996 as a tool to help the military improve the quality of life for its service members by improving the condition of their housing. According to DOD estimates it would have taken over 30 years and $20 billion to renovate the housing stock using traditional military construction and financing techniques. Congress passed the MHPI enabling the DOD to use private sector financing and expertise to improve the situation. With the help of private enterprise, the DOD believes it will have all military personnel and their families adequately housed by 2007—three years ahead of the original 2010 goal and more than a decade and a half sooner than would have been possible using standard methods.

The first privatization projects were at Fort Carson, Colorado and Lackland Air Force Base in Texas. To date there have been 32 contracts awarded comprising nearly 62,000 housing units. Another 42 projects are pending solicitation with an additional 20 still in planning. Joe Sikes, DOD's director of housing and competitive sourcing, noted that more than 70 percent of base housing is now privatized. Sikes expects that number to rise, especially as more base commanders learn about the successes at other bases. Sikes also added that $581 million have been invested in the program not including an additional $6.5 billion investment from private firms.

Government dollar savings over the long-term is estimated to be about 10 percent of total costs. However, another big benefit is leverage—i.e., for a project to be considered it must be able to generate $3 of spending for each $1 appropriated by Congress, greatly expanding the speed, reach, and breadth of projects around the country.

DOD Housing Privatization Projects

20 Projects in Planning	34,174 Units
42 Projects Pending Solicitation	73,880 Units
32 Contracts Awarded	61,642 Units

The MUPI directed all utility systems be privatized, unless uneconomical or exempt for security reasons, by 2003. Installations got a slow start out the gate and the deadline was extended to September 2005. The objective of the Department is simple and clear: to get out of the business of owning, managing and operating utility systems through privatization. This will enable the military to focus on its core mission of defending our borders.

Despite the slow start there has been progress as 72 contracts have been awarded. While this represents less than 5 percent of the Department's utility systems, it is a significant step. Especially considering that another 915 (61 percent) are under acquisition. Additionally, 282 other utilities (19 percent) are actively pending a Request for Proposal release.

What's most impressive is that the Secretary of Defense has exempted fewer than 12 percent of utilities from privatization—for either security or economic considerations. This rate falls well below the usual exemption rate for other federal efficiency initiatives, especially competitive sourcing.

DOD Utility Privatization

Contracts Awarded	72	4.79%
Active Pending RFP Release	282	18.77%
Under Acquisition	915	60.92%
Economic or Security Exempt	176	11.72%

Sallie Mae also got into the privatization business this year. In late July, the education finance company offered to buy back $4.3 billion of its Student Loan Marketing Association subsidiary's debt, which will complete the process of turning the company into a completely private enterprise.

The privatization will be completed early next year, which is one year ahead of its current schedule and three years ahead of Congress' deadline when the process was initiated in 1996.

State Privatization Update

This past year was a banner year for privatization at the state level. A slowing economy and fewer new revenues (note: state tax revenues for the most part did increase, however, spending increased faster) opened the doors to more privatization as governors and legislatures across the country either expanded current initiatives or created new ones.

The Council of State Governments (CSG) conducted a national survey of state government officials to identify recent privatization trends. The survey was sent to 450 state budget and legislative service agency directors and heads of five executive branch agencies: personnel, education, health and human services, corrections and transportation.

In the past five years (1998-2002), the amount of privatization has largely remained the same or increased slightly. When budget directors were asked about the primary reasons for privatization, a majority pointed to cost savings—while agency heads said that a lack of personnel or expertise was the number one reason for privatization.

Savings from privatization were typically in the 5 to 15 percent range, although a number of responses suggested savings were much greater. In addition, there were some responses in which there were no savings.

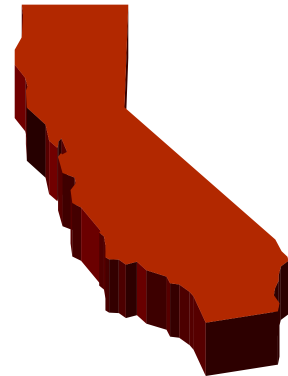
Primary Reasons for Privatization (Budget/Legislative Directors)	
Cost Savings	68.4%
Lack of Expertise/Personnel	53.9%
Flexibility	32.8%
Speedy Implementation	14.4%
High Quality Service	9.2%
Innovation	1.3%

Primary Reasons for Privatization (Executive Agencies)	
Lack of Expertise/Personnel	50.7%
Cost Savings	36.6%
Flexibility	27.1%
Speedy Implementation	20.6%
Political Leadership	13.5%
High Quality Service	12.5%

Fifteen states reported passing legislation in the past five years relating to privatization (Alaska, Arizona, Connecticut, Illinois, Kentucky, Massachusetts, Nevada, New Jersey, North Carolina, Oklahoma, Oregon, Vermont, Virginia, Washington, Wisconsin). In 2002, Washington passed a law authorizing state agencies and institutions of higher education to contract for services that were historically provided by civil service employees.

The survey also noted that privatization will likely continue in state agencies. Nearly half the state officials who responded said privatization in their state or agency was likely to increase, and the other half said that it would remain the same.

California



After California citizens recalled embattled Gov. Gray Davis in October 2003 and overwhelmingly elected mega-star Arnold Schwarzenegger to replace him, the media attraction of Hollywood migrated north to Sacramento.

California once again became a focal point of policy discussion both within the state and across the nation. Reversing years of general decline in state political reporting, numerous media outlets have reestablished bureaus in Sacramento to follow the celebrity governor and his administration.

This period of political upheaval has crafted a powerful storyline. Can a politically untested governor take on the state's Democrat-dominated legislature and powerful special interests to revive the struggling state, tackle the ongoing fiscal crisis, and "give the government back to the people" as he promised during the campaign?

Budget Crisis

While California lawmakers faced a number of challenges in 2004 including skyrocketing workers' compensation premiums, struggling schools, and fears of another energy crisis, no issue framed politics in Sacramento this year more than the state's continuing budget crisis.

The governor's inaugural budget, unveiled in January and dubbed the "California Workout Plan," evinced a new philosophy in the governor's office. Schwarzenegger described a state that had simply spent too much and accumulated more than $20 billion in deficits over the previous four years. For Schwarzenegger, this left only one answer, "…if we do not control spending today, we will put every program at risk, because California will be bankrupt. And a bankrupt California cannot provide services for anyone." The governor rejected tax increases as an option, given the fragile state of the California economy.

The governor also introduced a number of policy changes into the dialogue that would meet stiff opposition from the state's powerful labor unions. The first was a call in his budget narrative for the expanded use of

competition in the delivery of state services through a new constitutional amendment. The second was a similar call for the repeal of a law that limits local schools' ability to contract for noninstructional services like transportation, cafeteria operations, and janitorial services.

While the governor's budget included a number of controversial revenue transfers, accounting maneuvers, one-time savings, and borrowing (many proposals similar to those used by former Governor Davis), it did not raise taxes and did achieve some reductions in spending, including a historic deal with the education community that provided $2 billion less to K-12 education than what autopilot spending would have required.

The budget did not achieve the structural reform he sought and will set up a difficult budget next year with a deficit projected to be at least $6 billion. Nonetheless, Wall Street observers have responded favorably to Schwarzenegger's efforts. In August, Fitch Credit Rating removed the state from its negative credit watch in response to the budget deal. Earlier in May, Moody's upgraded the state's rating and Standard and Poor's added the state to its positive credit watch.

While success on the budget front was limited, Schwarzenegger made progress on a number of other reforms that represent a substantial departure from past practice.

California Performance Review

In his first State of the State Address, Governor Schwarzenegger declared his intent to shake up Sacramento through a comprehensive review.

> *Every governor proposes moving boxes around to reorganize government. I don't want to move boxes around; I want to blow them up.*
>
> *The Executive Branch of this government is a mastodon frozen in time and about as responsive. This is not the fault of our public servants but of the system. We have multiple departments with overlapping responsibilities. I say consolidate them. We have boards and commissions that serve no pressing public need. I say abolish them. We have a state purchasing program that is archaic and expensive. I say modernize it.*
>
> *I plan a total review of government—its performance, its practices, its cost.*
>
> *(State of the State Address, January 6, 2004)*

With those words, Schwarzenegger commenced the California Performance Review (CPR). The effort drew upon nearly 275 state employees chosen from a pool of more than 1,500 applicants. Schwarzenegger also tapped reform expert Billy Hamilton, Texas Deputy Controller and Sacramento veteran Chon Gutierrez to lead the reform effort.

Within four months, the CPR team had produced a comprehensive analysis of California state government, including the top-to-bottom review promised in his gubernatorial campaign, a complete reorganization of the executive branch of state government, and more than 1,000 different policy reform recommendations. The final report measured in at seven inches thick and 2,500 pages long.

Reorganization

The CPR reorganization plan consolidates the state's existing 11 agencies and 79 departments into 11 new "super departments" with aligned functions and consolidated administrative support services. More than 100 independent boards and commissions are also proposed for elimination. According to the plan, these reforms would increase the accountability of the governor and his secretaries while increasing the quality of service to the people. A Byzantine maze of customer-call centers would be replaced by a single point of contact for California citizens.

The report recommends the creation of a new Governor's Office of Management and Budget, which would consolidate information technology services, personnel management, procurement, budgeting activity, and other shared services. The plan also proposes a new, unified Infrastructure Department, which would consolidate the disparate responsibility for critical infrastructure including roads, water, and power, within a single entity. Various law enforcement functions across state government, along with emergency response activities, are proposed for consolidation within a newly created Department of Public Safety and Homeland Security.

Arguing for these structural reforms, the CPR report highlights that 34 percent of the state workforce is likely to retire within the next five years. Absent fundamental structural reform that leverages technology, eliminates duplication, and expands collaboration, the state has little hope of coping with this "human capital crisis."

Additionally, the plan proposes a number of significant policy reforms, including shifting more services like DMV renewals to the Internet, expediting the sale of state assets, reforming the eligibility process for state aid, streamlining the regulatory process, and charging market rate for out-of-state college tuition. CPR calculates that, fully implemented, the reform plan would save as much as $32 billion over five years.

Upon the public release of this report, Schwarzenegger assembled a 21-member commission to conduct public hearings around the state and report back to his administration with the public's response. Many of the reforms are likely to find their way into the governor's January 2005 budget. Before the report was even made public, members of the legislature declared the reform plan dead on arrival. In response, Schwarzenegger indicated that he would likely take elements of the reform plan directly to the people through the initiative process if the legislature resists the reform efforts.

Asset Sales

The governor also struck new ground by declaring his intent to raise new revenues by divesting underutilized property owned by the state. Schwarzenegger estimated that at least $75 million in new revenues could be realized by reforming the process of identifying and selling excess property. Language was inserted into a budget trailer bill that streamlined the sale process and suspended a law that enables local governments to purchase state-owned property for less than market value. A team dubbed the "strike team" has been assembled within the administration to expedite the sale process. The governor also signed executive order S-10-04, which ordered a renewed reporting of state-owned real property to a single

inventory and called for a review of potentially high-value urban property owned by the state for possible realignment or disposal. As of this writing, the Administration is asking the legislature to approve the sale of several dozen new properties, including unused portions of state prisons, urban land, and other properties that are not fully utilized.

Competition

While efforts to expand the use of privatization in local public schools did not make it into the final budget deal despite a hard push by Schwarzenegger, competition nonetheless saw renewed interest in California, particularly within the CPR report.

Among its hundreds of recommendations were renewed calls to allow local schools to subject noninstructional services to competition and expanded use of public-private partnerships in transportation, including Build-Operate-Transfer approaches. The CPR report also calls for the creation of a California Competitive Government Panel to assist state agencies in identifying opportunities to use competition and strategy and to overcome barriers to their application.

Additionally, Schwarzenegger already launched a CPR "Strategic Sourcing" proposal to reform the state procurement process, resulting in consolidated, leveraged buying. CPR estimates that the proposal would save the state approximately $850 million within five years.

The CPR report also recommends shifting to performance-based contracting and ending the monopoly on state purchases currently granted to the state-run Prison Industry Authority (PIA). Under the CPR proposal the PIA would face new competition from private vendors.

Future Optimistic, Uncertain

While there have been a number of very strong signs in California including the recent credit rating improvements, passage of a budget that did not include tax increases and the recent release of the California Performance Review report, California is not out of the woods by any stretch. California still suffers the lowest credit rating among states in the nation. A multi-billion dollar deficit awaits lawmakers when they return next year and the debate over the California Performance Review recommendations is certain to be intense.

Despite the obstacles, no previous reform-minded governor had the luxury of limo-black sunglasses and red-carpet appeal to immediately turn an otherwise mundane government event into a media spectacle. *Sacramento Bee* columnist Daniel Weintraub once pointed out that Arnold, unlike other politicians, actually has to worry about too many people coming to his events.

But it is not just cosmetic strengths. Schwarzenegger has demonstrated an affinity for principles of effective, limited government that is transparent, accountable, and competitive.

Couple these ideas with Schwarzenegger's star power and willingness to take issues directly to the people and you have the setting for serious reforms. Already, we have seen Schwarzenegger flex his media muscle with success: his workers' compensation reform succeeded, despite line-in-the-sand opposition, because of his willingness to go straight to the ballot if the legislature balked. Feeling the pressure, legislators worked out a deal.

Applied to the cause of "reforming Sacramento," the threat of populist revolt has immense potential.

Ultimately, the success of "blowing up the boxes" in Sacramento and reforming state government rests on the broad shoulders of Governor Schwarzenegger. If he pursues the reforms with the same fervor that he injected them into the public discussion, he has a great chance of success. His legacy then would be that of the modern-day Hiram Johnson who willingly took on entrenched special interests and redefined governance in California.

Florida

Florida Gov. Jeb Bush signed an executive order directing the state's Department of Management Services to create a "center of excellence" authorized to conduct a statewide evaluation of Florida's outsourcing efforts. The new Center for Efficient Government (see: http://dms.myflorida.com/administration/center_for_efficient_government) was also directed to "identify opportunities for additional outsourcing initiatives, and oversee execution of future outsourcing projects."

Bush has been an ardent supporter of privatization over the years. When asked in a recent interview to speculate on services that shouldn't be privatized, the governor paused and answered, "corrections officers... I think police functions, in general, would be the first thing to be careful about outsourcing or privatizing. This office. Offices of elected officials... and major decision-making jobs that set policy would never be privatized."

(Note: Bush's caution notwithstanding, Florida currently contracts for five private adult correctional facilities and numerous juvenile facilities.) He added, "If we can find a better way to send out payroll, handle purchasing, get licenses renewed online, provide medical services in public institutions... and we can save money and add value to services, I will look at it."

With that said, the executive order was in direct response to two reports critical of the state's outsourcing efforts from years past. In the first report issued in June 2003, the Governor's Inspector General found problems statewide with contracting. The report said agencies "often don't have in writing [exactly] what they're trying to accomplish, saving money or improving service." The audit report went on to add that government employees negotiating the contracts "often lacked training or experience to pick the appropriate vendor or write the best contract." It further stated that once the contract is in place, state agencies may have little authority to oversee services or determine if the state is getting its money's worth.

The report also revealed "there is no clearinghouse across state government that maintains records of vendor performance to insure that a bad vendor doesn't win a second state contract while failing at the first." As Inspector General Derry Harper wrote, "As documented in almost 500 audit findings over a three-year period, controls over contracting [in Florida] are in a state of disrepair."

The second critical evaluation came from Gary Van Landingham, interim director of the Legislature's Office of Program Policy Analysis and Government Accountability. He added, "It's hard to tell how things are working and whether privatization is achieving goals the policy makers were trying to reach. In some cases it's been planned well and worked well and in some cases it hasn't. There's just a lack of common business analysis."

In response, Bush has created the Governor's Center on Efficient Government. Its mission is "to be the enterprise-wide gateway for best business practices in outsourcing in order to improve the way state agencies deliver services to Florida's citizens"—in other words, to standardize how the state identifies and awards contracts for privatized government services.

The center's initial goals include:

- Develop statewide outsourcing standards and a business case template applicable to any proposed outsourcing project; and
- Review existing outsourcing plans within state agencies to ensure compliance with Center standards and business case requirements, execution of effective contract language with vendors, and implementation of successful change management.

Florida has been at the forefront of privatization for years. The past three administrations have supported several initiatives, and Bush has been an ardent supporter of privatization and results-based government. So much so that in the five years since Bush took office, the total number of authorized positions in all of state government—including the courts, lottery, the National Guard and elected or appointed officials—has fallen by 3,795. But without gains in the universities and courts, caused by higher enrollment and workloads, the falloff would have been about 6,000 greater.

The Center is setting a stronger foundation for privatization. One of its main missions is to establish that "it is the policy of the state that all agencies focus on their core missions and deliver services effectively and efficiently by leveraging the agencies' resources, and contract for services that can be more effectively provided by the private sector."

Over the years, dozens of privatization initiatives have been started in Florida. Some of the current ones:

- Aramark employees now serve food to state prisoners;
- Barton Protective Services employees collect fees on the state's tollways;
- Health Management Systems Inc. administers Medicaid billing;
- Accenture workers staff the desk that state employees call to get help with their desktop computers; and,
- Private companies clean state buildings.

The Center has developed a centralized "Gate Process," modeled after the United Kingdom for evaluating the best source to deliver services. This process consists of a robust set of standards, templates, and guidelines and a transparent method of managing each stage of any outsourcing initiative.

The Gate Process is aimed at reviewing an outsourcing project at critical stages in its lifecycle to provide validation that it can successfully advance to the next stage. It is also designed to couple a more transparent process with more predictable costs and outcomes.

There are five Gates, or points at which an Oversight Board evaluates a project, during its lifecycle: two during the planning phases of an initiative and three during implementation. The process lines up like this:

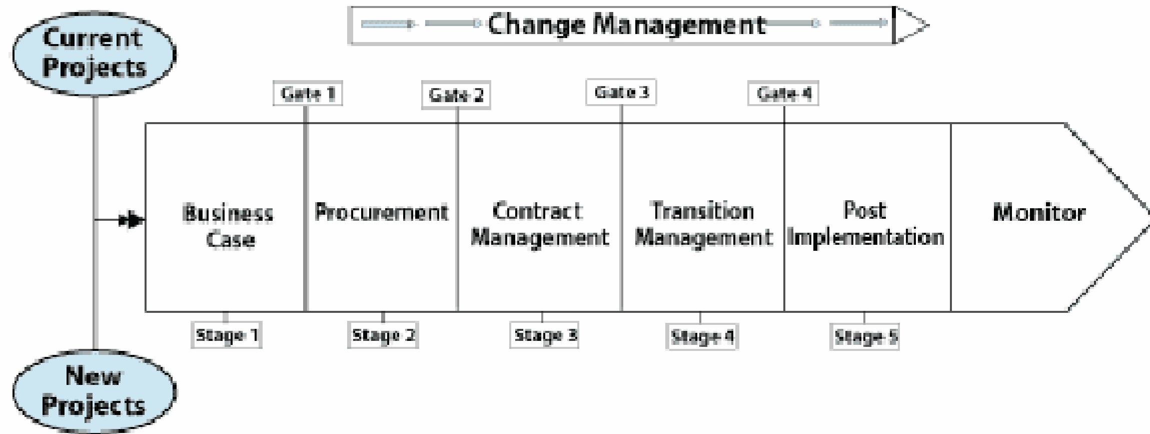
- Stage 1 – Business Case Development
  Gate 1
- Stage 2 – Procurement Process
  Gate 2
- Stage 3 – Contract Management
  Gate 3
- Stage 4 – Transition Management: Training, Communications, Workforce
  Gate 4
- Stage 5 – Post Implementation: Performance Measurement and Evaluation

The purpose is to provide a thorough assessment at key decision points in the process of outsourcing a government function or service.

The Gate Management Process provides assurance and support for agencies in transitioning their functions to a third party in order to achieve their core missions by ensuring that:

- The business need of a proposed project is justified.
- The full scope of work for a project has been realized.
- An independent entity has validated the data provided.
- The procurement phase has an added mechanism of oversight.
- The project has the necessary and appropriate resources to successfully manage the project and its contract.
- An enterprise-level approach is the driving force behind procurement strategies.
- There is a roadmap for how the project is developed, procured, implemented and managed.
- Projects are entered into within the context of what is best for the state holistically.

The Gate Management Process



The creation of the Center for Efficient Government signals a commitment to privatization in Florida. But more importantly, it also signals a serious commitment to providing the best services at the best cost for Florida taxpayers. The standards, processes, and framework that will be created over the next few months likely will serve as templates for other states to use. In fact, the Center itself should serve as a model for other states to follow.

New York

Many states in 2003 and 2004 faced significant budget gaps. In New York it was $6 billion. That size of deficit creates a powerful need to stretch taxpayer dollars and figure out how to do more with less. But, while Governor Pataki began talking about privatization in 1994 and followed through with several major initiatives—like the management of Stewart Airport and the World Trade Center and including in-state employee contracts terms governing assistance in the event of transition due to competition—10 years later the state does not have a system or a strategy for using competition to help manage the cost and quality of state services.

In 2003 two Reason Foundation researchers teamed up with the Manhattan Institute to analyze how competition could help the state bridge its budget gap and help create a system and strategy for competition that would improve management of state services for the long haul. The resulting report, published in December 2003 by the Manhattan Institute was *Private Competition for Public Services: Unfinished Agenda in New York State* (view the report at http://www.rppi.org/civicreport.pdf).

In this report, we examined a representative slice of the New York state budget—the $3 billion per year spent on highway maintenance, bus transit, corrections, human resources, welfare and Medicaid administration, mental health, and motor vehicles. Looking at best practices from around the nation in

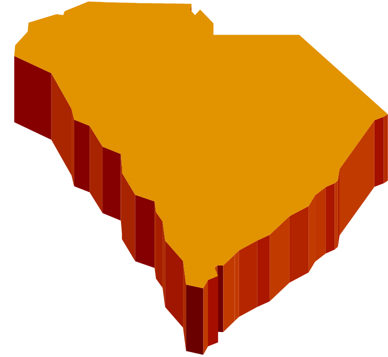
applying competition to these services, and at the research on the results of those practices, we found a range of cost savings from 5 to 50 percent. A moderate application of competition to these services in New York could easily lead to savings of 10 percent, which would mean $300 million a year towards cutting the budget gap. In the context of the state's overall $100 billion in operational expenditures, such savings from just 3 percent of spending would be just a start. An expanded use of competition could make a major contribution to closing the budget gap.

However, we point out in the report that states with a track record of successful use of competition take a strategic approach, address existing barriers to competition, and often establish systems for managing competition over the long run. In New York, the report recommends accomplishing this with a series of steps to create an effective, permanent institutional framework for competitive sourcing, one that can also serve as a practical guide for the state's counties, municipalities and public schools.

The first element of the framework is the creation of the Empire Competition Council to serve as an oversight agency and institute competition as a standard way of doing business. A key task of the Council would be an annual inventory of activities of state agencies that distinguishes between those that are inherently governmental and those that are commercial in nature, which would allow public officials to know where applying competition would be appropriate. The Council would also indicate which activities are the highest priority for applying competition, based on challenges that need to be overcome and the track record of success of competition of similar activities in other states. Finally, to ease the burden of conducting competitions and make sure the process is fair and transparent, the Council would also create for state agencies accounting models to determine the fully allocated and unit costs of commercial activities. The report also examines how to complement the work of the Competition Council with a permanent Sunset Review Commission that focuses on identifying opportunities and methods for state government to cut costs, reduce waste, and improve efficiency and service levels. The recommended goal is for the Commission to review 20 percent of state programs each year, evaluating the importance of each agency function, and recommend the elimination or consolidation of unneeded or outdated programs or adoption of innovations and best practices from elsewhere that would help improve services or costs or both.

While some in New York have embraced the use of competition, others have resisted strenuously, most notably public employee unions. Rather than erect more barriers to competition and further tying the hands of state leaders to control spending and service quality, the Manhattan Institute report argues that New York's taxpayers would be better served by strategic use of competitive sourcing.

South Carolina

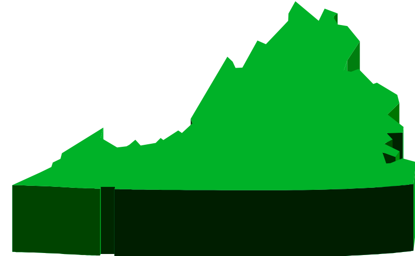


Gov. Mark Sanford pushed through five projects this last legislative session. While none of the five projects is guaranteed to move forward, Sanford has put these projects in motion. Pending study and acceptance from the Budget and Control Board these initiatives will be implemented soon.

- Close and sell a nearly vacant 180-acre Mental Health Hospital campus.
- Contract corrections health care. An RFP has been issued, and naturally the state employees are gearing up to fight the proposal. Among their concerns were a loss of benefits and possibly their jobs, with quality healthcare coming as an afterthought. A spokesman for the governor added, "this is an idea that the governor has thrown out there, first in an effort to see if it is feasible, if there are potential cost savings and if services can continue to be delivered at the same level they are currently being provided."
- Outsource part of the state's vehicle fleet including selling about 6,000 of the state's 20,000 vehicles. Eventually, Sanford wants to privatize ownership and management of the state fleet entirely.
- Outsource some or all of state school bus operations. A task force was formed to study privatizing school bus operations. South Carolina is currently the only state in the country that owns and manages state school buses. In fact, over 40 percent of the Education Department's work is on student transportation.
- Outsource management of state inns, golf courses, restaurants, and camping facilities at state parks.

The governor is reportedly looking at a number of other projects for this upcoming budget cycle and has entertained the concept of initiating a process similar to Jeb Bush's Center for Efficient Government in Florida.

Virginia



It was the General Assembly that got into the privatization mood in Virginia. This year's legislative session saw many privatization-related bills passed, spearheaded by Delegate Chris Saxman who chairs the bipartisan cost-cutting caucus—and only one vetoed. Working with Reason, Saxman offered several innovative cost-saving initiatives, several of which were signed into law.

Perhaps the most noteworthy is HB 1043, the Competitive Government Act, which requires every state agency to analyze its workforce and identify competition opportunities. The process is similar to the rules and guidelines of the federal competitive sourcing plan and procedure.

Senator Jay O'Brien pushed SB 304. It requires performance budgeting for drug and alcohol treatment and job training programs in the state. The concept is simple: stop funding ineffective programs and focus efforts only on those services that achieve goals. The bill will inherently bring more transparency to the programs and potentially more competition and privatization as the true costs of programs are identified.

Two other bills, Saxman's HB 1037 and Delegate Ed Scott's HB 1447, authorize the attorney general to contract for long-term debt collection and require agencies to implement recovery auditing, respectively. By improving the collection of monies owed the state, and finding and eliminating fraud and overpayment, the state can reduce its reliance on tax increases.

Saxman also authored HB 1042, which requires the state Department of Corrections to conduct a cost-benefit analysis between public and private facilities before any new prison can be built in the state. Saxman considers prison privatization an important opportunity to save money in the state budget.

An executive order issued by Gov. Mark Warner mirrors a bill (HB 973) that passed the House but failed in the Senate. It creates a working group to bring more transparency, accountability, and performance into the budget process. At print time, the order had not been activated.

Corrections

Corrections privatization had a strong year in 2004. Rising costs for medical care, continued fiscal constraints, and increasing incarceration rates all led governments at every level to seek private corrections as a solution.

Currently there are 209 private facilities with a capacity of 127,171 in the United States. Of those, 103 facilities have achieved American Correctional Association accreditation—nearly 50 percent, a much higher rate than publicly operated facilities.

The federal government operates 42 facilities with an operational capacity of 34,775, while states operate 105 facilities housing up to 74,413 inmates. Fifty-seven private facilities cater to county and city governments for 18,259 beds, and private corrections currently operate at every security level of inmate. In addition, countries like Canada, Australia and the United Kingdom operate 9597 international beds.

Capacity by Security Type

Security Type	Male	Female	Either	Total
Maximum	9,024	1,384	7,224	17,632
Medium	72,112	2,246	5,327	79,685
Minimum	17,153	1,133	663	18,949
Residential - Secure	2,453	419	1,399	4,271
Residential - Open	1,071	267	1,779	3,117
Non-Residential	50	39	3,428	3,517
Total - All Types	101,863	5,488	19,820	127,171

Source: Association of Private Correctional & Treatment Organizations, www.apcto.org

Three new studies showed that privatization has had a major impact on overall state corrections budgets. A report released by two professors from Vanderbuilt University found that the use of private prisons in a state resulted in the reduction of daily incarceration costs for the public corrections system by 4.45 percent annually. This could result in a cost avoidance of approximately $20 million for states with a typical annual budget of $445 million.

The second study, completed by the Rio Grande Foundation in New Mexico, compared per-prisoner department of corrections budgets across 46 states. By measuring an entire department's spending rather than just a particular prison's spending, the study accounts for the cost savings public prisons can achieve in response to private competition. The study uses the percentage of prisoners under private management as its measurement of the extent of privatization in each state.

Holding other factors constant, this study found that states with 5 percent of their prison population in private prisons spent about $4,804 less per prisoner in 2001 than states without any privatization. As the extent of privatization increases, so do savings. New Mexico, for example, has 45 percent of its prison population under private management; it spent $9,660 less per prisoner in 2001 than did counterpart states with no privatization. New Mexico has gone farther down the prison privatization road than any other state, saving $51 million in 2001 alone, according to the Rio Grande study.

Finally, a research report by the Washington Policy Center cited findings that states with at least 20 percent of their prisons privately operated had a lower net increase in their overall state budget during the study period. Those states using private prisons also had an average increase in their corrections budgets of 38 percent as compared with those states that chose not to privatize correctional facilities increasing 50 percent over the time period.

Corrections privatization received another boost at the annual meeting of the American Legislative Exchange Council in July. The criminal justice task force, chaired by Texas Representative Ray Allen, approved model legislation: "Targeted Contracting for Certain Correctional Facilities and Services." The bill provides the state agency charged with operating the prison system the authority to contract for facilities and services with the private sector or a political subdivision. It includes contract requirements relating to qualifications and standards, and limitations on authority over inmates. The model also allows options to privatize individual services (e.g., food service, health care, and transportation) and/or entire facilities.

Speaking of services contracting…in January the Council of State Governments (CSG) issued a "Trends Alert" about the rising health care costs associated with prisons. It concluded that competition through privatization was one of several options available to states to control costs.

In addition, the report chronicled the rapid growth of prison health care privatization. In 1997, 12 states had contracts for their entire system and another 20 had contracted for a portion of their system. By 2000, 34 states had some component under contract, while 24 entire state systems were privatized.

Education

In 2004 outsourcing continued to help school districts cope with declining budgets and direct more resources to the classroom. When the St. Louis school district faced a $90 million deficit, the school board hired William Roberti and his corporate turnaround firm to fix the district's financial troubles and return more money to the classroom. A July 2004 report on the corporate management experiment found that in 13 months Roberti's team cut $80 million from the budget, privatized divisions such as maintenance and food services, and fixed the district's snarled bus system. Outsourced services included payroll handling, warehouse operations, buildings and grounds maintenance, and electronic purchasing. Outsourcing saved the schools $60 million out of a $450 million budget, enabling them to add 131 teachers, hire literacy coaches for each school, begin computerized reading tests for students in grades 3-12, and fill vacancies in magnet schools.

Similarly, in 2002, the Philadelphia school district faced a $28 million deficit. However, by relying on privatized transportation, custodial, food service and other support services, the district saved $29 million over two years and by 2004 had quickly erased its deficit. Philadelphia made these financial cutbacks while running a robust teacher recruitment program and without firing any teachers.

In Michigan, school districts told the *Flint Journal* that in the 2004-2005 school year they would be outsourcing more services than ever to save money. "We are looking at the big picture and trying to look at the future," said Jeffry Morgan, superintendent of Kearsley Public Schools. His district will outsource its custodial services in fall of 2004, saving an estimated $500,000. "We had to solve a financial problem like all districts did this spring." The *Flint Journal* reported that the 21 school districts in Genessee County will save $35.8 million this year and more than $85 million during the next three years, in part due to outsourcing measures. Goodrich Board of Education President Michael J. Thorp, whose district privatized its custodial staff seven years ago, pointed out that the district saved enough money to avoid layoffs. "It saved us a significant amount of money. It was enough that we took the heat for it," he said.

The federal No Child Left Behind Act (NCLB) has increased outsourcing opportunities for K-12 education in areas such as tutoring, student assessment, and online content. Companies in the K-12 education sector saw their revenues grow 2.7 percent in the 2003-2004 year to $50.1 billion, according to Eduventures Inc., a research firm in Boston that tracks for-profit education businesses. Across the United States, an estimated 15,000 for-profit education businesses offer their services. Under NCLB, schools that fail to make adequate yearly progress in student achievement over time must set aside a portion of their Title I budgets to allow children to transfer to other schools or to receive after-school tutoring. Private companies make up a majority of approved providers of supplemental services under the No Child Left Behind law. For example, Sylvan Education Solutions tutors more than 25,000 students under contract with states and school

districts. Similarly, the New York City-based Platform Learning Inc. provides tutoring to 10,000 public school students in 15 states.

The trend toward privatizing school management continued as the number of contract and charter schools increased in 2004. According to *Profiles of For-Profit Education Management Companies, Sixth Annual Report, 2003-2004*, 51 for-profit management companies operated 463 public schools in 28 states as of the 2003-04 school year. The study also found that 81 percent of these schools are charter schools and that Michigan and Arizona have the most schools managed by for-profit companies. Overall, with over 684,000 students enrolled nationwide and more than 2,700 contracts between charter schools and their government authorizers, charter schools may be the most common example of education privatization.

Urban school districts with large numbers of failing schools are increasing the opportunities for both charter schools and contract schools. In the 2003-2004 school year, 365 of Chicago's 600 schools had to offer students the option to transfer to a better-performing school because they had not met federal academic goals under the No Child Left Behind Act. Yet because of a lack of school capacity and overcrowding at higher-performing schools, only 1,100 out of 240,000 students who were eligible to transfer were allowed to do so.

In June 2004 Chicago Mayor Richard Daley announced his six-year, $150 million "Renaissance 2010" plan to shut down Chicago's failing public schools and open 100 new schools by 2010. Mayor Daley, whom state legislators gave legal control of the schools in 1995, has more control over Chicago's public schools than other urban school leaders. His plan will allow the creation of 30 new charter schools and 30 new contract schools created by private groups that sign five-year performance contracts with the district. The proposal would sell some school buildings and reopen some high schools and elementary schools into new configurations of smaller schools catering to no more than 350 to 500 students each. The plan will also allow 60 of the 100 schools to operate outside the Chicago Teachers Union contract.

The effort will be partially funded with $50 million in private donations. The Civic Committee of the Commercial Club of Chicago, an organization comprised of 75 of the Chicago region's largest corporate, professional, and university leaders, played a key role in selling Schools Chief Arne Duncan and Daley on the idea of creating independent schools. The committee is leading the effort to raise $50 million to cover startup costs at the new schools, half of which has already been committed by the Chicago Community Trust, the Gates Foundation, and others.

About 60 schools will be closed over six years as new models come online, for a total gain of 100 new schools. There will be some new construction, but in most cases, especially in large high schools, the buildings will be divided into several smaller schools. The plan includes a vision for many different types of specialized schools and the replication of existing successful specialized schools and charter schools. Some of the proposed schools already online or under consideration include:

- Five new magnet schools that will be supported by a $9 million federal grant.
- A new public military high school for Chicago's North Side for fall 2005 through a partnership with the Naval Service Training Command at the Great Lakes Naval Station.

- A new charter school developed by the law firm of Sonnenschein, Nath & Rosenthal scheduled to open in September 2005 in the city's North Lawndale neighborhood. The firm will spend about $200,000 a year to start its school with pre-K classes and kindergarten, and then add a grade each year.
- Replication of existing charter schools such as Chicago's Noble Street Charter School, where kids have a longer day and study in smaller classes and at Perspectives Charter School in the South Loop, where every student must land a job or show a college acceptance letter to get a high school diploma.
- A new "early college" high school linked with DeVry University.
- A "Knowledge Is Power" program, which has two charter schools in Chicago and dozens across the country that run from 7:45 a.m. to 5 p.m. daily, as well as a school linked with Outward Bound, the outdoor adventure group.
- Other possibilities include partnerships with Catholic schools, universities, nonprofits, social service agencies and the Chicago Historical Society. For example, Chicago public schools officials have invited leaders of the San Miguel Catholic School to run a new public school as part of the Renaissance 2010 plan. A non-profit secular arm would be established for the contract.

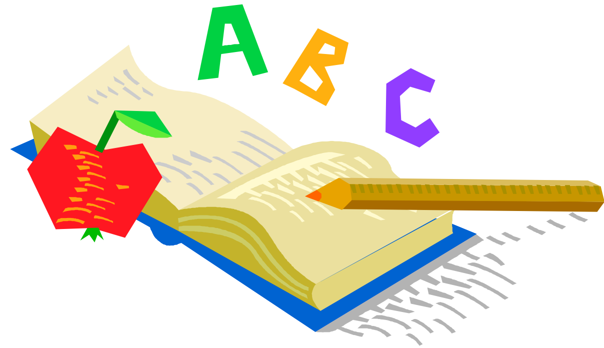
Several other urban school districts have introduced more limited versions of Mayor Daley's Renaissance 2010 plan. In Boston, nearly 10 percent of students attend independently run "pilot schools" with the flexibility to decide their budgets, curriculum and school policies. The Boston initiative has attracted millions in private donations from the Gates Foundation and local philanthropies. The Boston Foundation, for example, granted $50,000 to $100,000 to schools that converted from traditional to pilot schools.

The pilot schools have higher student attendance rates, lower percentages of students who transfer, and some of the lowest suspension rates. On state tests, the schools score better on average than the district's neighborhood schools. These schools are reviewed every four years, and none has been closed for poor performance since the initiative was launched in 1994.

In Philadelphia, 45 of the city's lowest performing public schools are managed through contracts with independent firms. Test score data from 2004 reveal that these schools have improved academic achievement for the city's most needy students.

Similarly, in fall of 2004, New York City will open eight new charter schools as part of Schools Chancellor Joel Klein's plan to develop 50 new charter schools over the next five years. Three of the new charter schools will open in the Bronx, two will be in Brooklyn, two will be in upper Manhattan and one is planned for Far Rockaway, Queens. Private sector involvement has been embraced in New York City, where private donors have invested $41 million to help create 50 new charters in the next five years. In a plan similar to Chicago's, New York school officials will give the charter schools space in their buildings and provide start-up funds.

Philadelphia's School Privatization Produces Student Achievement Gains



In August 2004, the state of Pennsylvania released the first substantial evidence that Philadelphia's public-private school management experiment to turn around the district's lowest-performing schools has produced achievement gains for students in both the contracted "partner" schools and the traditional public schools.

In 2002, the state of Pennsylvania took over the school district of Philadelphia and appointed a School Reform Commission, led by Chairman James Nevels, who hired Paul Vallas as the district's CEO. The School Reform Commission's most controversial reform targeted 64 of Philadelphia's lowest-performing schools for special intervention. Forty-five of those schools were partnered with a for-profit or nonprofit education provider. Edison was assigned 20 of those 45 schools, making it the district's single largest partner with more than 12,000 students. The other 19 schools were partnered with the school district and received extra resources and special interventions.

Pennsylvania's annual Adequate Yearly Progress report (AYP) showed that 160 of Philadelphia's 265 schools met AYP standards in 2003-2004 school year, up from 58 schools the previous year. Outside management partners managed 23 of the city schools making the AYP list.

Philadelphia's school district CEO, Paul Vallas, gave considerable credit to Philadelphia's "partners," including Edison Schools, Foundations, Victory Schools, Universal Companies and Temple and Pennsylvania Universities, and called the partners "a key part of the school district's dramatic turnaround."

More specifically, the case of Edison schools demonstrates the usefulness of analyzing the gains made by low-performing students rather than just absolute student proficiency rates. Edison schools had 12 of its 20 schools make AYP, up from just one school last year. Edison's Philadelphia schools posted an average annual gain of approximately 10.2 percentage points in 5th and 8th grade students scoring at "proficient" or above on the 2004 Pennsylvania System of Schools Assessment in reading, and approximately 9.6 percentage points in math on the 2004 PSSA. In the years prior to the Edison-district partnership, those same 20 schools had averaged annual gains of less than one-half of 1 percentage point.

Edison also had the largest increase in the percentage of students scoring "proficient" or above, and the largest decrease in the percentage of students scoring "below basic." In addition, the state Department of Education data also shows that:

- Edison was a district standout in helping schools to make adequate yearly progress, or AYP, under the No Child Left Behind Act. Of the 64 schools targeted by the district for extensive reforms, 21 made AYP for the first time in 2004. Edison produced more than half those 21 schools (11 of 21), even though it operates less than a third of the targeted reform schools (20 of 64).
- In reading, the Edison-district partnership schools reduced the percentage of students at the below-basic level at four and a half times the state rate.
- In math, Edison-district partnership schools reduced the percentage of students at the below-basic level at four and a half times the state rate.

In addition, Edison also helped raise student achievement for the entire district of Philadelphia by modeling the benefits of a comprehensive benchmarking system to increase student achievement. Edison's benchmark testing program, which is aligned with the Pennsylvania System of School Assessment (PSSA), has an instant feedback loop that allows teachers to immediately know their students' academic weaknesses and tailor their lesson plans to meet student needs.

The district of Philadelphia adopted a similar benchmarking program that was provided through a contract with Princeton Review and SchoolNet to assess students every six weeks for their progress toward state grade-level standards.

Competition between public and privately managed schools in Philadelphia has allowed all public school students to benefit from best practices and has led to overall achievement gains for Philadelphia students that are dramatically above the state average. The average test score gain in Pennsylvania in 2004, according to the Department of Education, was five points in reading and six points in math. The school district of Philadelphia exceeded those rates, posting average gains of 10 in reading and 10 in math.

Environment

Water/Wastewater

This year has been challenging for water privatization. Despite the cost savings available through privatization, at least two jurisdictions have reversed pursuing privatization, and time will tell how much these moves will cost taxpayers.

In New Orleans Mayor Ray Nagin announced in May that the city has scuttled all plans to privatize the system. The decision ends years of debate over which entity could best handle a crumbling infrastructure and federally mandated repairs that included a Ralph Nader "Public Citizen"-led initiative to stop privatization (see http://www.rppi.org/apr2003/navigatingthepolitics.html and http://www.rppi.org/neworleanswater.html). Two private companies and a group of public managers were vying for the contract, which would have been worth $1 billion.

Nagin had originally turned to the private sector because New Orleans's decrepit water system needs billions of dollars worth of repairs. Nagin did not answer how the city would finance or complete the repairs required by the federal government.

In Kentucky, Lexington-Fayette Urban County Government (LFUCG) is attempting to condemn the Kentucky-American Water Company (part of the German utility RWE AG) from its rightful owners and convert it into a government entity because of political and philosophical reasons. Using eminent domain, the county seeks to strip the company of its assets. Why? The county asserts that water should not be treated as a commodity, nor operated by a foreign-owned company. Also, the LFUCG claims the profits earned by Kentucky-American Water are "drained" from the pocketbooks of Fayette county water customers, and should be retained for their benefit.

This scheme offers Fayette County's taxpayers a lose-lose proposition. Not only will they be stuck with a multi-million dollar legal bill necessary to pull this off, but they also will be forced to pay increased water rates to subsidize a bond issue needed to complete the transaction. How can LFUCG deliver water at the same rate to its citizens if it substantially increases its costs?

George Raftelis, LFUCG's hired gunslinger, predicts it will cost taxpayers $158 million. Raftelis also estimates that municipal bonds issued at an interest rate of between 4.75 percent and 5.25 percent are necessary to complete the transaction. Given these parameters, the annual principal and interest payments on this bond would approximate $10 million per year. Is this a realistic estimate? Not if LFUCG pays the market price for these assets.

Normal acquisitions of corporate assets generally are priced on a reasonable valuation agreed to by a willing seller and an able buyer. Kentucky-American Water Company believes its market value to be between $500 million and $750 million, and it has no interest in selling.

Given this huge difference in price estimates between the buyer and unwilling seller, only the legal system can ascertain what this plunder would cost water customers. No one—not taxpayers, Raftelis or the government—knows what this takeover would ultimately cost.

The water company earned a profit of $5.3 million in 2002. Assuming it earned that same profit during each of the next 30 years, LFUCG would still have to find $4.7 million every year to make up the difference between the estimated $10 million bond payment and the expected annual profit. That gap is sure to be filled by water customers forced to pay much higher rates to cover the astronomical costs of condemnation.

Perhaps in response to municipalities struggling with water contracting, last September, the Water Partnership Council (WPC) issued a "blueprint" for public-private partnerships to mayors and other municipal officials at the U.S. Conference of Mayors' Urban Water Summit in Chicago. The handbook, Establishing Public-Private Partnerships for Water and Wastewater Systems: A Blueprint for Success (http://www.waterpartnership.org/), offers guidance to communities considering whether to partner with the private sector and how to manage public-private partnerships to meet their water and wastewater needs.

WPC President Don Evans noted that the handbook "is the result of our members' three decades of experience in serving communities across the country—it presents the facts about water and wastewater partnerships and the value they can provide to communities." Chapters cover everything from the basics of partnering and cost savings, to taking care of employees and developing an effective contract.

Columbia Basin Water Transactions Program

In the arid western United States, fights over water have been common for well over a century. Despite the existence of strong water rights throughout the West, these rights are only to "use" water. And just what constitutes an acceptable "use" is subject to state law. Conservation rarely counts, so there is little incentive to reduce water consumption. For example, under this scenario the only benefit to a farmer who invests in drip irrigation, is a slightly lower water bill. There is no compensation for the water itself, which simply passes on to the next person in line.

As demands for water to be put to environmental purposes such as maintaining wetland habitat or stream flows for fish like salmon have grown, so has the frustration grown between many farmers and ranchers and environmentalists, whose only choice to get water for wildlife is often expropriation. A number of states, however, have expanded the definition of "use" to include environmental purposes, which has allowed groups like the Oregon Water Trust to lease and buy water from farmers and ranchers to keep water instream for salmon. Until that change in the law, farmers and environmentalists fought like cats and dogs; now they are making deals.

Contracting for water has not only created a number of private conservation groups like the Oregon Water Trust, it has also created an opportunity to use water markets to mitigate for habitat loss. When the National Marine Fisheries Service issued a biological opinion in 2000 that forced the Bonneville Power Authority (BPA) to mitigate the effects of its hydroelectric power generation on species listed under the federal Endangered Species Act (ESA), the BPA came up with a novel and effective way of meeting its obligations—it outsourced improvements in stream flows to a number of groups who use markets to supply water. Outsourcing allowed BPA to use a market process to come up with the water it was forced to provide by court order at the least cost and disruption.

By 2002, BPA had provided the majority of funds to create the Columbia Basin Water Transactions Program through the National Fish and Wildlife Foundation, a federal organization that applies both federal and private grant monies to environmental projects. The hallmarks of the program, which are especially unusual for an ESA enforcement measure, are to improve fish and wildlife habitat while respecting private property rights and irrigated agriculture through market-based approaches.

In the Basin states of Idaho, Montana, Oregon and Washington, ten organizations receive funds from the Program, including the Bonneville Environmental Foundation, the Deschutes Resources Conservancy (OR), the Idaho Department of Water Resources, the Montana Water Trust, the Oregon Water Resources Department, the Oregon Water Trust, Trout Unlimited, the Washington Department of Ecology, the Washington Water Trust, and the Walla Walla Watershed Alliance (WA).

These organizations use the funds provided to contract with local irrigation districts and landowners—the water rights owners—to put water that otherwise would have been diverted back instream. Purchases have taken the form of short or long-term leases, outright purchases, partial leases that only affect the driest months of the year, and options to lease water rights during especially dry years. Some money has also been spent on improving irrigation efficiency, for example by switching from flood irrigation to sprinkler or drip irrigation, with the savings put back instream. In fiscal year 2004, the Columbia Basin Transaction Program made 25 transactions at a cost of $1,655,907 of which BPA paid $780,654. For that they purchased 1,142,561 acre feet of water to be left instream.

At the opposite end of the spectrum is the Imperial Valley of California, which is a water rich area that took over five years to reach an agreement to transfer water to San Diego (and still faces numerous lawsuits from both the agricultural and environmental communities). This was despite pressure from both the state and the federal government because the transfer was an explicit part of California's obligation to cut back its use of Colorado River water. Imperial's water rights are held in trust for the farmers by the Imperial Irrigation District, which is elected at large, so that its primary motivation is to redistribute Imperial's water wealth, rather than to maximize it. Another problem was that the transfer would affect the Salton Sea, a hyper-saline body of water that is home to a number of threatened and endangered species. Under law, however, it was illegal to put fresh water directly into the Salton Sea. Instead its flows could only come from irrigation runoff. With stronger water rights, both to the water itself and the uses that water is put to, the Imperial imbroglio could surely have been solved peaceably, both through private conservation and outsourced environmental mitigation.

For more information on the Columbia Basin Water Transactions Program, see http://www.cbwtp.org/

Fisheries

The Red Snapper fishery in the Gulf of Mexico is a textbook example of a regulatory nightmare. The fishery is open for nine days a month, creating a crazed race to fish that results in a vast amount of waste and habitat damage as the fishermen try to catch as much as they can as fast as they can, rather than targeting their trawls to maximize the quality of their catch and minimize the environmental effects of their operations. For example, when the snapper season is closed, snapper caught while fishing legally for other fish species must be thrown back. And during the open snapper season, undersized fish must also be thrown back. Millions of snapper die as a result of a throw-back mortality rate of at least 70 percent.

A recent (2003) study estimated that about 87 boats, out of the current fleet size of 387 vessels, would be enough to harvest the entire snapper fishery. Those 300 extra boats that are the result of a regulatory nightmare are certainly adding to the ecological footprint of the fishery.

In March 2004, however, the participants in the Red Snapper fishery overwhelmingly passed a referendum directing the Gulf Fisheries Management Council to design a new fishing rights system for the fishery—one that is rooted in private rights to fish. Ninety-two percent of eligible fishermen, or 145 individuals, voted in the referendum. Eighty-one percent of the weighted votes, cast by 104 fishermen, supported the development of a fishing rights program, commonly referred to as an Individual Fishing Quota system. Once this task is completed, the fishermen will have to pass another referendum on whether to accept it or not, but the ball is rolling.

Fisheries depletion is widespread in the United States and around the world. At the heart of the matter is what is commonly known as the "tragedy of the commons," a phrase coined by Garret Hardin in 1968 to describe what happens when valuable resources are free for the taking; they are quickly depleted. Fisheries are a classic case because even when fishermen know that they are destroying their own source of livelihood, they have little choice but to keep fishing, because any fish left in the water may simply be caught by someone else.

One of the most successful responses to the tragedy of the commons in fisheries is to create harvest rights commonly known as Individual Fishing Quotas (IFQs) or Individual Transferable Quotas (ITQs). These rights assign a percentage of a scientifically determined total annual allowable catch to specific fishermen. If the health of the fishery increases, then so does the tonnage assigned to the harvest right, and vice versa, giving fishermen an incentive to keep available catch numbers high. These rights do not privatize the fishery per se, but they do strictly define who has the right to go fishing and how much they can catch in any given year.

When fishermen own a right to a percentage of a total harvest, healthier fish populations translate into an increase in the value of that harvest right. Under an ITQ system the rights are transferable, and so owners can realize the gains from any improvements in the fishery, encouraging them to invest time, effort, and

capital into research and stewardship. ITQs are not well-suited to every fishery, and they do not translate directly into private ownership of actual fish and/or habitat (which would create even stronger stewardship incentives), but they are a definite step in the right direction.

ITQs have only been applied to a limited number of fisheries in the United States (most notably the Alaskan halibut fishery and the Mid-Atlantic surf clam and ocean quahog fishery), but are widespread in places like Iceland, New Zealand, and Australia. The Alaskan halibut story is an especially telling one.

The Alaskan halibut fishing season was once almost ten months. When regulators decided that overfishing was a problem, they began reducing the length of the fishing season. Before long, however, the season was down to 48 hours, with almost no change in the amount of fish caught. The motivation to catch as many fish as possible, as quickly as possible, remained, and so ingenuity and technology overcame restrictions.

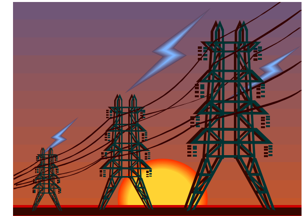
The halibut season is once again measured in months because an IFQ system was created. Critics are quick to point out that the Alaskans haven't invested very much in conservation, but the rights to fish in Alaska are legally revocable at any time, and antitrust laws make it difficult for fishermen to cooperate. In New Zealand, on the other hand, rights to fish are certifiable property rights, and the fishermen have developed innovative quota-owning management groups that invest heavily in fisheries science and enhancement, and tend to fish conservatively.

IFQs have been politically controversial in the United States, primarily because of interstate competition (the powerful Alaskan congressional delegation does not want the fish in Alaska's water assigned to the fishing fleet of Washington State) and the fact that ITQs will alter the market relationship between fishermen and fish processors (i.e. the fishermen will be able to delay harvests until they like the price offered). As a result, a five-year moratorium on any new IFQ programs was instituted by Congress in 1997. Fishery managers initially waited for Congress to explicitly authorize tradable quotas, but since there has been no legislation since the moratorium expired, some fisheries are moving ahead anyway.

For more information see: www.ifqsforfisheries.org

Energy: The North American Blackout Report: A "More Rules" Solution

By Lynne Kiesling and Michael Giberson



On August 14, 2003, one of the largest blackouts in North America caused power outages in eight U.S. states and one Canadian province, affecting almost 50 million people. The overall costs of the blackout are estimated at $4.5 to $10 billion. In an effort to investigate the causes of the blackout and prevent future such events, the U.S.-Canada Power System Outage Task Force spent six months doing investigative engineering analysis.

The report ruled out weather, deregulated power markets, unusual loads or cross-region power flows as the causes. While "what failed" were physical components of the system, the report rightly focuses on the systemic problems that allowed the failure of a few lines in Ohio to turn into an event that knocked out the power system throughout a substantial portion of the Northeastern United States and Canada.

The US-Canada Joint Task Force final report on the blackout, *The U.S.-Canada Power System Outage Task Force Final Report* (available at https;//reports.energy.gov.), provides a thorough examination of the blackout's causes and consequences. The report explains the technical and institutional workings of the North American power system clearly and carefully, offering a snapshot of system conditions on August 14th, a sense of the system dynamics leading up to the blackout, and a highly regulatory solution to the problem of transmission. This comes as no surprise since the report comes from a regulatory body.

What will be challenged, and should be, are the report's 46 policy recommendations. The blackout report is a fine example of engineering detective work—they've done an excellent job of getting the details right—but the recommendations clearly show that they are missing much of the bigger picture.

The organization of transmission operations is very complicated and not particularly transparent. Currently most transmission is owned by regulated public utilities, though federal agencies and other entities own a large chunk of transmission, especially in the West. In the northeastern United States and in California, an independent transmission provider called the Regional Transmission Organization (RTO) or an Independent System Operator (ISO) manages the transmission, and in the rest of the United States the local monopoly utility company manages most transmission.

Most reliability rules, governing a great deal of the terms of transmission operation and the costs involved, are established by the North American Electric Reliability Council (NERC) and implemented in conjunction with 12 regional reliability councils. In regions with RTOs/ISOs, that organization usually acts as the reliability coordinator. The reliability coordinators oversee control area operators. The control area operators are the "front line" system operators with the job of keeping the interconnected grid up and running.

This complex organizational structure to control reliability arose out of the 1965 blackout, which occurred at a time when wholesale power transactions were few, and not much trade crossed control area lines. Now, with power flows crossing between reliability coordinators and through multiple control areas, things have changed. Any lack of clarity or transparency—about who is responsible for system status, about information flow among control areas, or about funding of reliability investment—becomes problematic as trade increases and the quest for efficiency shines light on these worn out, opaque institutions.

Investment in transmission has been lagging for years, and the regulatory response has been to offer more incentives and more assurances that cost recovery is available. The Federal Energy Regulatory Commission (FERC) continues to support policy statements on reliability that assure transmission owners that prudent reliability costs could be passed along in transmission rates. It is more of the same regulatory approach, with the same empty promises implied.

A recent paper by Paul Kleindorfer, a professor at the University of Pennsylvania, offers a different vision for promoting investment in the grid: treat transmission service as a commercial, for-profit business (available at http://www.ksg.harvard.edu/hepg/Papers/Kleindorfer.ec.reg. Under distrib.owner.23.Jan.04.pdf). He argues that "the complexity and interdependence of the power grid … [make it] difficult for distributed owners to come to grips with who should pay for reliability." Kleindorfer points out that the existing transmission ownership and operation do not have the transparency and clarity of rules and rights that are crucial to commercial ventures and that provide proper incentives and a stable institutional framework for trade.

His discussion focuses on four commercial principles that he argues would make transmission a forward-looking venture that would attract investment in, among other things, reliability. First, transmission entities (let's call them RTOs for brevity) have to face performance standards and be accountable for their achievements and failures. This is the role that capital markets and shareholders play in for-profit companies. Second, RTOs should focus on customers. Third, operations and planning in RTOs must integrate the engineering of the system with its economics. Finally, the RTO governance structure must be responsive and decisive. FERC's current "ideal" organizational structure for transmission, in which transmission assets from several companies are combined and turned over to an independent organization to manage, just doesn't connect the economic dots well enough to inspire the commercial creativity necessary to motivate capital markets to pony up.

Kleindorfer further observes that the underlying structural issues may not just be vague, but even actively harmful, as incumbent transmission owners may face economic incentives contrary to overall system quality and performance. He asserts that the benefits of network quality improvements may go disproportionately to the creative upstarts in the industry, but the quality of the network is largely determined by the investment decisions of larger, established firms. If you are the established firm, how much do you want to pay in order to throw the door open wide to your new competitors?

The most obvious lesson learned from the blackout report is that the electric power industry and its regulatory organizations are better at diagnosing system failure ex post facto than at divining ways to foster growth of a self-correcting, self-reinforcing, and dynamically reliable system. The blackout report does an excellent job of diagnosing the recent failure, while providing a helpful tutorial on power system operations

for the non-specialist. But the 46 recommendations it offers won't get us the success we want. In some sense the report is trapped by its "one big interconnected machine" picture of the grid, and an accompanying view that reliability can only be attained by a mixture of planning, regulation, spending and hope.

The current regulatory/administrative approach to transmission planning and operations has, along with a substantial dose of regulatory uncertainty, given us the current mess in the transmission business. The solution may be to treat the transmission business, as more of a business. Reliability on the transmission system is not the mystery that it once was. The relevant factors that add to or subtract from system reliability are well understood. Most of these factors are attributed to, or could be measured and attributed to, the responsible party. The responsible party could then be either charged or paid an appropriate amount. The key is to bring reliability into the commercial realm, where choices can be made in the presence of relevant tradeoffs.

As the blackout report says "reliability is not free," and the way to ensure that we get what we pay for, and not too much more or less than we want, is to move reliability into the market. The report agrees that "market mechanisms should be used where possible," but worries that there may be conflicts between reliability and commercial objectives that cannot be reconciled. In such cases, says the report, high reliability must trump commercial concerns.

We need a more flexible, dynamic transmission system and a transmission grid that better adapts to the demands that are placed upon it. The recommendations should help us reach that goal. Instead, the recommendations propose more rules, mandatory reliability standards, more government oversight, penalties for non-compliance, regulatory review of a reliability surcharge to fund an electric reliability organization redesigned by government committee, and a number of other initiatives to achieve central control of a single, predetermined level of transmission system reliability. The primary ultimate impact of the 46 recommendations would be the expansion of regulatory oversight over supply-side reliability decision-making. A more useful approach may be streamlining the regulatory institutions and commercializing transmission grid operations, not subjecting grid owners to more mandatory regulations.

The ultimate objective is healthy, thriving wholesale power markets, which rely on transmission networks. Reliability is a crucial element in enabling those power markets to continue developing. But that doesn't mean that reliability is a "one-size-fits-all" characteristic of the network. Treating reliability as a public good leads to conflicts; treating it as a private good could avoid those conflicts. The metering, monitoring and switching technology exists to treat reliability as a private good. Now we just need the institutional and legal structure.

In the end, the most important changes to make in the industry are really just a continuation of industry restructuring. Let's commercialize reliability, reforming the reliability rules to properly line up incentives and information flows. Reliability is valuable to consumers. What has been lacking is a way for consumers to express that value, and for suppliers to be appropriately paid for providing it.

The regulator's report provides a regulatory solution. That fact in itself is not too surprising. But the regulatory solution won't give consumers what they could really use, which is a more efficient, more resilient and more dynamic power grid.

Outsourcing Human Resources Management

In spring of 2004 the Conference Board released the first comprehensive look at outsourcing human resource activities by government agencies. "HR Outsourcing in Government Organizations" provides an excellent overview of the subject and is chock full of valuable information for government officials or others looking into outsourcing HR functions.

The report examines who is outsourcing HR and why it is happening, along with how-to tips, lessons learned, answers to concerns about outsourcing, case studies, and more. You can get the full report at (http://www.conference-board.org/publications/describe.cfm?id=830), but meanwhile here are some highlights.

Who is Outsourcing?

The Conference Board report highlights the case studies of government who are blazing the trail in HR outsourcing (see box) and states that "industry experts estimate that another 10 to 15 states are currently actively exploring HR outsourcing—that is, these entities are developing a business case and preparing for any necessary legislative approval needed to make the move."

In addition, the federal Office of Personnel Management has been examining competitive sourcing of some HR functions. Right now it appears that larger scale outsourcings are the most attractive, so most of the action is at the federal and state level.

Why Outsource HR?

The motives for governments outsourcing HR are not much different from what we have seen driving the large HR outsourcing trend in the private sector. The Conference Board identifies three basic financial drivers behind HR outsourcing:

- Save money (ongoing expenditures);
- Avoid capital outlay (often a more important consideration than direct cost savings); and
- Turn a fixed cost into a variable one (thus, if the workforce shrinks, HR costs can be reduced accordingly).

The strongest motive in governments is often to avoid capital outlays as they replace very old mainframe systems and upgrade software. Outsourcing inevitably brings new, up-to-date hardware and software, and upgraded services for customers and HR administrators that run the gamut from checking the status of a

paycheck to filing an insurance claim online for customers and from automated payroll and online performance reviews for administrators.

Why Outsource Now?

The timing for the surge in HR outsourcing by governments in the last few years is the result of several factors working together. Many governments have very old IT systems for managing HR, systems that need to be replaced before they collapse. But capital outlays to replace systems for a state can often approach $100 million, and financing such upgrades often moves slower than the pace of technology changes, dooming a new system to be behind before it is even up and running. State government budget shortfalls in recent years have exacerbated the problem of financing needed upgrades to HR systems.

Finally, the Conference Board argues that "a cadre of business-minded government bureaucrats has emerged." The broader trends in government outsourcing and privatization coupled with rising expectations of more efficient government services has created interest and willingness among government managers and political leaders to explore HR outsourcing.

HR Outsourcing Case Studies

The Conference Board report provides a detailed examination of the following case studies:

HR Outsourcing Case Studies

U.S. Transportation Security Administration

- Employees: 55,600 passenger and baggage screeners hired by December 2002. Since December 2003, TSA has had 45,000 full-time equivalent screeners, as directed by Congress.
- Budget: $5.3 billion requested by President Bush for FY 2005.
- Outsourcing began: 2001
- HR functions outsourced: Total
- Estimated cost savings through outsourcing: 20–25 percent

Texas Health and Human Services Commission

- Employees: Approximately 46,000
- Budget: $20 billion annually
- Outsourcing began: 2004
- HR functions outsourced: Total (excluding policy and planning)
- Targeted cost savings: $1 billion for reorganization within first two years of implementation, $63 million in HR savings over five years

State of Florida, Department of Management Services

- Employees: 118,000 (with university system employees, 189,000)
- Budget: $400 million (administration), $1.1 billion (benefits)
- Outsourcing began: August 2002 (Expected completion date September–October 2004)
- HR functions outsourced: Total
- Targeted cost savings: $173 million over seven-year contract

Detroit Public Schools

- Employees: 26,000 (largest employer in Detroit)
- Outsourcing began: February 2001 (Implementation completed January 2002)
- HR functions outsourced: Medical benefits administration
- Direct savings realized: $5 million initially; $1 million per year

State of Victoria, Australia

- Employees: 1,100 initially (two agencies); 1,800–2,000 today (three agencies)
- Outsourcing: began 1996
- HR functions outsourced: Payroll, HR information systems and reporting, HR policy
- Cost savings realized: 30 percent

City of Copenhagen, Denmark

- Employees: 60,000
- Outsourcing began: 2003
- HR functions outsourced: Payroll, HR information systems (HRIS), online employee data, and benefit plan information
- Targeted cost savings: $8.5 million over first five years

Lessons Learned

The report points out that "although public-sector HR outsourcing is still evolving, the pioneers already have many lessons to share." Here are the lessons learned highlighted in the report.

Get support from the top for the effort: executives, legislators, and the governor.

Develop a communications program for employees, the public, and the press about the benefits outsourcing can bring—not just internally but for taxpayers. Publicize the efforts under way to take care of affected workers.

Work within the government budget process. Because budgeting is different (generally, annual) in government organizations, it helps to have proposals completed and ready for review in time for regular budget appropriations. Also, contracts must often be renewed and re-approved every year, so a multiyear contract provides stability. The renewal process affords the vendor the chance to boost service quality if it has slipped.

Establish clear-cut, rigorous procedures for the vendor selection process to ensure fair consideration and avoid even the appearance of impropriety.

Seek a vendor with experience in the public sector. Policy guidelines and union agreement requirements make for strict processes and procedures.

Negotiate and concur on service-level agreements that contain useful performance expectations and metrics, for example, using a metric on providing a satisfactory response to a caller within 24 hours instead of answering calls to the call center on the third ring.

Ensure adequate staffing throughout the effort on both sides. Involve IT personnel, not just HR personnel, from the outset.

Allow for flexibility. Certain services initially contracted may prove unnecessary over time; others overlooked at first may later seem attractive or vital. However, delivery dates and penalties should be built into the contract.

Consider requesting legislation to streamline procedures before implementation. Doing so can make data entry and IT work vastly easier—and save considerably.

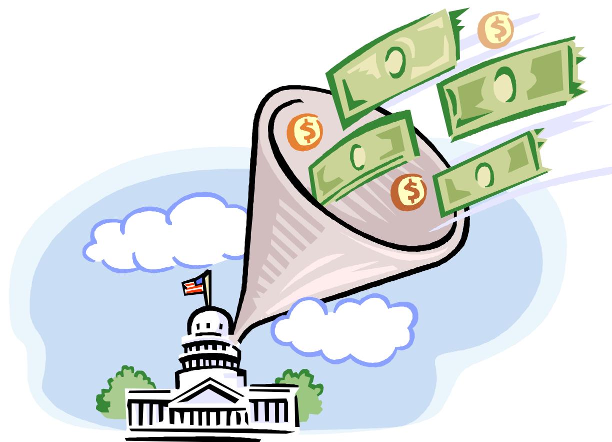
If workforce reductions will be significant, create early job placement assistance with the vendor that taps the resources of job placement agencies and programs. Explore with vendors what job opportunities they may be able to offer displaced employees.

Engage the appropriate unions early by communicating the benefits of outsourcing, offering to help transfer union employees, and helping them retain their union status.

Avoid an overly aggressive implementation timetable. Delays cost dearly, not only in dollars and public support, but also in the goodwill of the employees who must operate with reduced head counts before the new services come online.

A Taxpayer Bill of Rights (TABOR): Challenging the'Girly Men' in Our Legislatures

By Barry W. Poulson, PhD.



In 1973 Governor Reagan launched a tax revolt when he proposed the first tax and spending limit, Prop 1, to the California legislature. That referendum was narrowly defeated at the polls, but it set the precedent for tax and spending limits later adopted in California and 25 other states. California's GANN Amendment was an effective limit on the growth of state government until 1990. In that year the tax-and-spend politicians in the California legislature, whom Governor Schwarzenegger has referred to as'girly men,' gutted the GANN Amendment. While Governor Schwarzenegger may have been politically incorrect, he accurately identified the source of California's current fiscal crises. The education lobby convinced California legislators to significantly increase state spending for education K-12, and to exempt such spending from the limits imposed by the GANN Amendment. The result was a decade of unconstrained growth in spending, creating a structural deficit in the California state budget.

In 1992, through citizen initiative, Colorado enacted the Taxpayer Bill of Rights (TABOR) Amendment to the Colorado Constitution. The TABOR Amendment has proven to be the most effective tax and spending limit in the United States. TABOR requires voter approval for any increase in taxes or debt. Since TABOR was passed Colorado has not enacted a single tax increase at the state level. TABOR limits the growth of state revenue and spending to the sum of inflation and population growth. Since TABOR was triggered in 1997, state spending has increased less rapidly than state income. TABOR requires that surplus revenue be offset by tax rebates or tax cuts, and surplus revenue of $3.25 billion has received just that treatment.

The TABOR Amendment has also come under attack from tax-and-spend lobbies. The education lobby has attempted the same'fiscal double play' in Colorado that they successfully carried off in California. In 2000, a citizen initiative, Amendment 23, mandated a sharp increase in spending for education K-12. The education lobby argued that the increased spending could be funded from surplus revenue rather than increased taxes. In fact, the increased spending created a structural deficit in the Colorado state budget, just as it did in California's budget. That structural deficit only became apparent in the current recession. The education lobby now argues that the only way to sustain this increased spending is to gut the TABOR

Amendment and significantly increase the tax burden on Colorado citizens. Neither the Colorado nor the California education lobby has been able to show that increases in spending for education K-12 have been accompanied by significant improvements in education performance. In both states student test scores remain abysmally low, and graduation rates are among the lowest in the nation.

A number of proposals have been introduced in the Colorado legislature to eliminate the TABOR Amendment or replace it with a watered-down tax and spending limit. None of these proposals has secured the two-thirds vote required for a referred measure to be placed on the ballot. A citizen initiative to replace TABOR with a weaker tax and spending limit has recently been withdrawn after receiving the requisite number of signatures to be placed on the ballot. These efforts to remove the constraints imposed by the TABOR Amendment on the growth of state revenue and spending face some formidable opponents in both the public and private sectors. Governor Owens has challenged the'girly men' in the Colorado legislature. The governor and Republican leaders in the Colorado state legislature, such as John Andrews, have vowed to fight any referendum or initiative that would gut the TABOR Amendment. The Independence Institute has thrown its resources in support of the TABOR Amendment. Most importantly, Colorado citizens support the TABOR Amendment; surveys show that a larger majority of Colorado citizens support TABOR now than when the Amendment was initially passed.

At the same time, many people in the public and private sector would like to correct flaws in the TABOR Amendment. One flaw is the "ratchet down' effect" that occurs when revenue falls in a recession. That lower revenue then sets the base against which the limit is applied. When revenue recovers the limit is triggered, requiring tax rebates even though revenue has not recovered to pre-recession levels. Another flaw is that TABOR does not specify how surplus revenue is to be rebated to taxpayers. While some surplus revenue has been returned to taxpayers through broad-based sales tax rebates and income tax cuts, much of the surplus has been offset by tax rebates and tax cuts targeted to special interest groups.

It is possible to correct these flaws in TABOR and yet retain the stringent limits imposed on revenue and spending. State Treasurer Mike Coffman and several state legislators have proposed such legislation. The ratchet down effect can be eliminated by holding the limit constant whenever revenue falls in a recession, and then triggering the limit again when revenue recovers. Some revenue can be set aside in a budget stabilization fund in periods of prosperity, and then used to offset revenue shortfalls in periods of recession. Offsetting surplus revenue with broad-based tax rebates/cuts would preclude special interests from capturing the surplus revenue through targeted tax rebates/cuts.

The model legislation recently adopted by the American Legislative Exchange Council incorporates these refinements in a Taxpayer Bill of Rights (TABOR) Amendment. More than a dozen states have recently introduced tax and spending limit legislation that incorporates the provisions of this TABOR Amendment. In virtually every case the tax-and-spend lobby has attempted to either block this legislation or substitute a watered-down tax and spending limit. In states such as California, Washington, and Missouri, which had effective tax and spending limits, these special interests have suspended the constraints imposed on state revenue and spending.

It is now clear that only a constitutional tax and spending limit, similar to the TABOR Amendment, is likely to constrain the growth of state revenue and spending in the long run. This sets a high hurdle for enactment of a TABOR Amendment through referendum or initiative. But statutory tax and spending limits have proven to be less effective for several reasons. Legislators often design weak tax and spending limits to preempt more stringent limits that might be imposed by citizen initiative, they exempt special interests such as education from the limits, and they suspend or ignore the limits when under pressure to increase spending. Governor Schwarzenegger and other governors have successfully confronted the tax-and-spend lobbies, but if they are to be successful in constraining the growth of state spending in the long run, they should support referendum and initiative efforts to introduce a Taxpayer Bill of Rights (TABOR) Amendment in their state constitutions.

A coalition has now formed to introduce a Taxpayer Bill of Rights (TABOR) Amendment in the U.S. Constitution. An effective tax and spending limit is needed more at the federal level than in our state governments. All of the states have provisions requiring a balanced budget, but a balanced budget is not required by the U.S. Constitution. For the first two hundred years of our history the federal government adhered to the'old time fiscal religion' of balanced budgets. Deficits incurred in periods of war were offset by surpluses in periods of prosperity. But for the last half century the federal government has, with rare exceptions, incurred deficits in periods of peace as well as war. A TABOR Amendment to the U.S. Constitution could return us to the'old time fiscal religion' of balanced budgets. Winning the "war on terror" could then yield a true peacetime dividend of surplus revenue used to reduce the national debt. Surplus revenue should not be used to bail out Social Security or Medicare programs. We need to keep the pressure on to either abolish these transfer programs or at least make them fiscally viable. Nor should we allow special interests to capture surplus revenue through targeted tax rebates or tax cuts, as they have in Colorado. We must challenge the'girly men' in our federal legislature as well as our state legislatures.

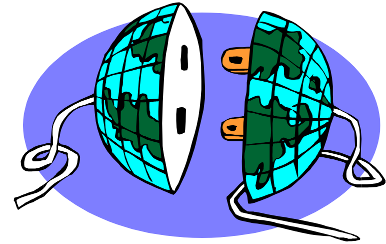
Related Links

For the historical background on tax and spending limits in California and other states see Barry W. Poulson, "Tax and Spending Limits: Theory, Analysis, and Policy," Issue Paper 2-2004, Independence Institute, Golden, Colorado, January 2002. The paper may be downloaded from http://i2i.org.

For a discussion of the current debate regarding Colorado's TABOR Amendment see Barry W. Poulson, "Colorado's Tabor Amendment: Recent Trends and Future Prospects," Issue Paper, Americans for Prosperity, July 2004. The paper may be downloaded from http://americansforprosperity.com

For recent tax and spending limitation legislation in the states and model legislation see the American Legislative Exchange Council publications at http://www.alec.org

Offshore Outsourcing



More Good Than Harm: Can America Learn To Love Outsourcing?

Offshore outsourcing, the practice that sends service jobs to India, China and other developing nations has many people worried. Over two dozen states have considered banning or restricting the practice, CNN's Lou Dobbs rails against the "Outsourcing of America," and John Kerry hopes blaming "Benedict Arnold" CEOs will land him in the White House.

Those worried about outsourcing are certainly right that it is not a passing fancy. It is the latest stage in the ongoing evolution of the economy. And just like every other stage in that evolution, from interstate commerce to international trade, the change will offer more benefit than pain. But, just like every other stage in the evolution, a lot of people do not want change.

The Politics of Offshore Outsourcing

The offshore outsourcing debate simply places the politics of globalization and international trade in a white-collar setting. The new free-trade opponents are white-collar employees and executives who long believed that their education protected them from foreign competition.

Workers grow anxious when faced with layoffs and job changes, and we should help them cope with the destructive side of market creation. But the objections to the evolution of the economy are like a broken record. Once we thought all you had to do was to work hard on a plot of fertile land, and you could make a good living farming forever. Then we thought if you got a job working at one of the nation's industrial giants, you effectively had a job for life. More recently, people believed that if you stuck it out through college and got your degree, you'd always have a job. None of those approaches proved to be a failsafe route to job security, and Americans are learning that they have to provide skills that the market demands, and yet, even with the churn of the market, today's workers enjoy ever-improving standards of living. More than ever, job security is about personal improvement and flexibility to work within the changing market.

British Prime Minister Tony Blair recently told his nation's industry, "What I can't do is shield you from the world. The economy out there will be decided by knowledge, skills, and education, by value-added goods and services."

When White House Chief Economist Gregory Mankiew took a beating over his comment that offshore outsourcing is just international trade, most people overlooked that at least four top economic advisors from the Clinton administration publicly agreed with Mankiew.

But in politics, protectionism sells because it comforts people. Voters hope politicians can shield them from change, and often protectionism only delays the pain, making it more acute in the long run.

The Economics of Offshore Outsourcing

The media buzzes with stories about American jobs going offshore. High-end estimates predict that between now and 2015 3.3 million U.S. information technology jobs will move offshore. But that prediction ignores that the information technology industry continues to grow and now job creation outpaces job loss.

It was widely reported that the nation lost 2.3 million jobs during the last economic downturn. What gets overlooked is that about two-thirds of those jobs were "tech bubble" jobs, not permanent jobs in the economy. The remaining 800,000 jobs are what we would expect to shed with normal cyclical fluctuations in the economy.

But even as the market churn cuts some jobs, it adds many more. At the end of World War II, there were about 138 million Americans. Today about 138 million Americans have jobs. From 1980 to 2002 the U.S. population grew by 23.9 percent; meanwhile the number of people with jobs grew 37.4 percent. In other words, an efficient market is the best jobs program.

Creating Jobs at Home

When companies save money by sending rote work overseas, they invest more to create new jobs at home. An analysis by the Institute for International Economics (IIE) shows that while more than 70,000 computer programmers have lost their jobs since 1999, more than 115,000 higher paid consumer software engineers have been hired. Even with a slower economy and with the offshore movement in full swing, the U.S. IT industry created 148,000 new jobs in the last quarter of 2002.

The story is the same for the service sector as a whole. While recently 10 million jobs per year have been lost, 12 million per year have been added. The IIE finds that most of the jobs that will be lost offshore pay less than the U.S. average wage and are likely to be eliminated through technology whether outsourced offshore or not.

What gets outsourced overseas are jobs that have become routine and commodified, and where U.S. worker productivity no longer beats foreign workers. Meanwhile, two-thirds of the economic benefit from offshore outsourcing accrues in the United States in the form of lower prices, expanded overseas markets for U.S. products, and improved profits that are reinvested to create new jobs. A recent McKinsey Global Institute study notes that offshore outsourcing creates value in four ways:

- Cost savings: For every dollar of spending on business services that moves offshore, U.S. companies save 58 cents. Reduced costs are by far the greatest source of value creation for the U.S. economy.
- New revenues: Indian companies that provide offshore services need goods and services themselves, ranging from computers and telecommunications equipment to legal, financial and marketing expertise. Often they buy these from U.S. companies.

- Repatriated earnings: Many Indian offshore service providers are in fact U.S. companies that repatriate earnings. Such companies generate 30 percent of the revenues of the Indian offshore industry.
- Redeployed labor: Beyond the direct benefits to the United States in the form of savings, new exports and repatriated profits, offshoring can indirectly benefit the economy as capital savings can be invested to create new jobs.

Politicians who pump up public fears hope that voters will regard offshore outsourcing as a newly invented threat to jobs. Of course, outsourcing is not a new creation; it's merely the latest evolution of a process that has been around for a long time—trade. Trade has given people ever-rising standards of living, as well as more and better jobs. Like trade in general, outsourcing will continue to create more than it destroys.

An efficient economy can offer hope even to its victims, for victimhood itself is a temporary state. According to Bureau of Labor Statistics, most of the unemployed find new jobs within three months, and the efficiency-seeking forces that fire workers are the same forces that will ultimately rehire them. Sending 1,000 call center jobs to India saved Delta Airlines $25 million, allowing for the hire of 1,200 reservation and sales positions in the United States. Choosing inefficiency over outsourcing means slowing the most robust job-creating machine the world has ever known. It means less money will be reinvested, fewer firms will seek to expand, and ultimately fewer jobs.

Job security no longer means fighting to keep the same job for 30 years; it means keeping oneself marketable. Just as the market searches for ways to do things better, so will tomorrow's workers—by gaining new knowledge and skills—seek to better themselves.

The Outsourcing-Education Connection

Would Better Schools Keep Better Jobs at Home?

While today's fears about losing high-tech jobs to offshore outsourcing may be overblown, a faltering education system could eventually prompt employers to look overseas for skilled labor.

Recently several prominent sources have called for strengthening American education as the crucial strategy to prevent the excessive outsourcing of high-tech jobs. A report by the American Electronics Association (AEA) argues that American public education is the reason why so many companies are exporting jobs to other countries (see Sidebar on page 45). The AEA suggests that because students do not get a strong enough education in math and science, high-tech firms are forced to look for skilled workers in other nations. In other words, as other nations catch up to us in terms of education, companies will ship jobs overseas looking for smarter, not cheaper, workers.

In a recent speech, Federal Reserve Chairman Alan Greenspan agreed that the United States must produce more highly skilled workers. Greenspan noted that even though incomes continue to rise there is reason to be concerned about the future:

> *[W]e have developed a shortage of highly skilled workers and a surplus of lesser-skilled workers.... More broadly, in considering the issue of expanding our skilled workforce, some have a gnawing sense that our problems may be more than temporary and that the roots of the problem may extend back through our education system. Many of our students languish at too low a level of skill, and the result is an apparent excess of supply relative to a declining demand.*

Similarly, in March 2004 testimony before the U.S. House of Representatives Committee on Education and the Workforce, Robert Grady, president of the National Venture Capital Association highlighted the importance of improving education.

> *The health of our schools is essential to the health of our country," said Grady. "In this regard, legislation that ensures that our schools are performing, our kids can read, and parents of children in failing schools have more rights to do something about it is critical. In particular, we would urge support of programs to increase the number of students pursuing mathematics, science, and engineering education in the United States.*

Falling Behind

Mounting evidence shows American students are falling behind in math and science:

- Eighty-two percent of our nation's twelfth graders performed below the proficient level on the 2000 National Assessment of Educational Progress (NAEP) science test.
- The longer students stay in the current system the worse they do. According to the 1995 Third International Mathematics and Science Study, U.S. fourth graders ranked second. By twelfth grade, they fell to 16th, behind nearly every industrialized rival and ahead of only Cyprus and South Africa.
- Recently the National Science Board has noted the decline in the number of American students training to be scientists. It states that the number of 18 to 24 year olds who receive science degrees has fallen to 17th in the world, whereas the United States ranked third three decades ago.
- More than 50 percent of all engineering, math and science degrees awarded at U.S. universities go to foreign nationals.

Not only are many high school graduates not prepared for high-level college courses in math and science, they often graduate without basic skills in language and mathematics. For example, a 2003 report by California's Legislative Analyst's Office notes that in the California State University system close to 50 percent of all enrolled college freshman must take remedial education courses in math and writing before moving on to college-level courses. What's worse is that these students are allegedly representing the top one-third of California's high school graduates. Yet, the state of California must spend a huge amount of tax dollars subsidizing remedial courses for students who have been accepted into California's higher education system.

Over the years several legislative fixes attempted to increase the math and science knowledge of American students. Most recently, the No Child Left Behind (NCLB) Act called for The National Science Foundation and the U.S. Department of Education to provide an estimated $1 billion over five years for results-oriented partnerships between local districts and universities and colleges. The NCLB also requires that beginning in 2007 states measure students' progress in science at least once in each of three grade spans (3-5, 6-9, 10-12) each year.

Competition Abroad, Competition At Home

In addition to attempts to legislate math and science curriculum, the outsourcing debate gives us one more reason to support a competitive education system that will offer parents more education choices including an enhanced math, science, and technology curriculum. Legislation that helps break up the monopoly that traditional public schools have over school curriculum and offers parents more school choices may be a more efficient mechanism to increase the supply of higher-skilled students. Many parents are already choosing innovative private, magnet, and charter schools that have an explicit focus on math, technology, and science. However, the demand far exceeds the supply of these schools.

A substantial number of the 3,000 charter schools nationwide specialize in math and science, including schools like the Anvil City Science Academy in Alaska, The Sonoran Science Academy in Tucson, and High Tech High in San Diego. These schools offer parents a chance to give their child a competitive math and science education. For example, at the Sonoran Science Academy students have the opportunity to participate in math, science, robotics, rocketeering, and engineering competitions.

In addition charter schools have created a demand for research and development of science curriculum. For example, more than 200 schools use E.D Hirsh's highly regarded Core Knowledge math and science curriculum and other schools use Bill Bennet's K12 interactive math and science curriculum. These innovative curriculums cannot be created without breaking up the financial monopoly that public schools hold over education. These alternative schools often have long waiting lists and illustrate the demand to build more capacity in schools that focus on these high-tech subjects. An efficient way to increase math and science knowledge would be to meet parental demand for schools that offer these high-performing options through a more competitive education marketplace.

As low-skill computer work gets sent overseas, the U.S. market will increasingly need American workers with high technological skill levels and also managerial skills, as these are the jobs that are staying in this country. Allowing schools that provide education opportunities demanded by parents who understand the needs of the coming market is essential to meeting this goal.

Techies Tout Outsourcing: More Findings from the AEA Report

- The magnitude of offshore outsourcing is unknown.
- A weak international and domestic economy and productivity improvements are the primary cause of the lost jobs over the last three years—not outsourcing.
- Changes in the international marketplace are posing far more significant new competitive challenges for U.S. companies than is offshore outsourcing.
- The United States experienced a similar anxiety to offshore outsourcing in the late 1980s and early 1990s when there was a common view that Japan was going to take over the world. It didn't.
- We should not forget that the United States remains an immensely attractive location for foreign direct investment and insourcing by foreign companies, employing millions of Americans.
- Although some people will be hurt, offshore outsourcing is likely to be a long-term benefit for the United States.
- If protectionist legislation should emerge from the states or Congress, high tech, as the largest exporter, stands to lose the most.

Source: "Offshore Outsourcing in an Increasingly Competitive and Rapidly Changing World," available at: rppi.org/outsourcingmyths.pdf

When Government Jobs Go Overseas

In the midst of current debate, small in scale but important to many people is the outsourcing of government services, some of which have gone offshore. Programmers in India are helping revamp South Carolina's unemployment tax system. In 40 states and the District of Columbia people collecting food stamps use foreign help desks.

Various House and Senate proposals would halt or hinder offshore outsourcing by the feds, and dozens of states are considering banning their agencies from using foreign offshore labor (see Sidebar on page 47), and some states have already reversed course on offshore outsourcing. Last year, Indiana cancelled a $15 million contract with an Indian consulting firm that would have handled calls in India. In March, North Carolina legislators voted to spend $1.2 million to bring 34 child support call center jobs back from India. Perhaps the most famous case comes from New Jersey, where roughly 10 unemployment assistance call center jobs went overseas, only to return again after much negative publicity.

The New Jersey example is instructive. It cost the state about $100,000 per year per job brought back to American soil. For each outsourced job, the state could have spent $50,000 for training, education and employment support and still enjoyed large savings in subsequent years.

Purchasing lower cost services could have allowed New Jersey to spend less or to devote more funds to higher priorities. Such decisions keep taxes lower which stimulates business activity and generates more tax revenue for the state. New Jersey would experience a boost in productivity and living standards, and everyone in the state would be marginally better off.

This is another version of the long running debate over privatization, of which outsourcing is but a type. All levels of U.S. government currently outsource close to $500 billion in contracts. The New Jersey story tells us why—outsourcing can dramatically reduce costs. Kansas could not resist the cost savings. Lawmakers were initially so outraged by a plan that would send food stamp call center jobs overseas that they wrote a ban into this year's contract. Once legislators learned the move would make the contract nearly 40 percent more expensive, they discarded the ban.

Even with high satisfaction rates (over 90 percent of outsourced services stay outsourced) and well-established savings, some resist outsourcing on different grounds, like privacy. The government possesses personal information about many citizens, and when many kinds of services are outsourced, some of that information is handled by contractors, some of whom might be overseas.

Certainly only careful handling of such information can protect privacy. But why might offshore information handling pose a greater risk? Say a young woman in India answers a help call and in the process sees financial, medical or other private information about the customer. Does she have more reason and opportunity to abuse that information than a contractor in the United States? Actually, she may have less incentive and opportunity to violate customer privacy. Her company has every incentive to protect privacy. The company rides the most exciting wave to hit India in years, and the surest way to get knocked off the wave is to do something that drives customers away, like violating privacy agreements.

When customer complaints prompted Dell to bring its help center business back to the United States, Indian firms reacted quickly. They placed more emphasis on improving English language skills and guaranteeing customer satisfaction.

Privacy concerns are not new. Since the first time an outsourcing agreement included information sharing, contractors have sought to protect privacy. From outsourcing of general services to medical transcription to IT, outsourcing practitioners have developed means of ensuring privacy.

Of course, the evolution of outsourcing into a more international market may require some changes in order to integrate U.S. law with existing international laws that guard against privacy invasion. But while they address small changes, legislators should take care to not quash the benefits of outsourcing. The technology industry is too dynamic and complex for legislators to answer legitimate concerns about the downside risks and consequences of using offshore resources. Trying to create bright distinctions in a rapidly changing market will only invite outcomes in which the taxpayer loses.

Who's Taking American Jobs?

Machines...

Just ban it? States considering banning state agencies from offshore outsourcing (As of May 10, 2004)		
Alabama	Indiana	Nebraska
Arizona	Iowa	New Jersey
California	Kansas	New Mexico
Colorado	Kentucky	New York
Connecticut	Louisiana	North Carolina
Florida	Maryland	Ohio
Georgia	Michigan	Rhode Island
Hawaii	Minnesota	South Carolina
Idaho	Mississippi	South Dakota
Illinois	Missouri	Tennessee
Vermont		

Source: National Conference of State Legislatures

From the save-our-jobs perspective, the new protectionists have more to fear from machines than from foreign workers. After all, those soulless slaves to efficiency have stolen more American jobs than any foreigner. Hollywood visionaries use films like The Terminator and The Matrix to warn us of the coming war against the machines. Well, the war is here. Actually, it's been here for a long time.

The printing press swallowed human scriveners and the photocopier and personal computer destroyed countless office jobs. Machines like the tractor have overrun agriculture so much that, during the last century, farmers' share of the American workforce has fallen from 40 to 3 percent. Recently, a Kentucky city mourned when a machine replaced its last human elevator operator, and even the recently resolved Southern California grocery strike may turn out to be another victory for machines. Here man and machine used to work together in peace—for example, human checkers appreciated how scanners would remember thousands of prices for them. But now some stores have begun phasing in automated checkout machines, which means human checkers work alongside machines that may eventually take their jobs. Moreover, an analysis of Bureau of Labor Statistics data notes that even without outsourcing technology would have eliminated most of the jobs now going overseas. Sometimes it seems like our society is so mechanized that there's almost nothing left for us humans to do.

Of course, cursing machines misses the point because it tells only half of the story. Pundits can point to a specific sector or a narrow time frame and tell a tale of woe. And the quest for efficiency does kill jobs, but, in the long run, it creates more than it destroys. Sometimes an industry disappears or shrinks to a nub of its former self, and yet new life continues to sprout. It would be tough to find many scriveners today, but the printing press and the PC haven't wiped out office jobs. In fact, there are 19.5 million of them.

Still, can we connect the dots from efficiency gains to job growth? Some imagine that CEOs fire humans, hire machines, and then throw the extra cash on their money pile. This view may not be far off the mark in assuming ambition—perhaps even greed—motivates the CEO. However, the truly greedy won't simply stash the cash—they will reinvest it and dream of an even bigger payday. Since reinvestment spurs job growth, in

order to accept the efficiency gains-job growth link you simply have to assume that corporate greed is alive and well. For most of us, this isn't a huge leap.

As the market evolves, we don't just exchange fewer jobs for more, we also trade up for better jobs. Since today's office mates squabble over a couple of clicks on the thermostat, it's a good thing few of them will have to find out how they'd survive in, say, a mineshaft. During the past 50 years we've lost over a quarter-million mining jobs, but we've gained 78 million service sector jobs. Today, 19 times more Americans work in finance than in mining, 22 times more work in hospitality and 54 times more work in heath and education.

It's often difficult to track job growth by a particular occupation, because many of today's jobs were created recently. Today's jobseeker has more choices than ever, which means that we are more likely get paid to do something we enjoy. Americans hold millions of jobs that did not exist a century ago. For example, our nation is home to 758,000 software engineers, 299,000 fitness workers and 128,000 aircraft mechanics. And many of the old-style jobs—far from being outsourced into oblivion—are more plentiful than ever. Our nation has 6.5 million teachers, 718,000 hairdressers, 281,000 chefs and 112,000 biologists. The chance for work to aid rather than hinder our quest for fulfillment is a truly historic development. How many miners stuck deep within the earth would have rather been video editors, web designers or car customizers?

…And Other Americans

Most outsourced jobs never leave American soil, the U.S. Labor Department noted in a June report. The report suggests fears over losing American jobs to cheap foreign competition may be overblown.

According to the Labor Department, 9 percent of non-seasonal U.S. layoffs in the first quarter were due to outsourcing, but less than a third of those jobs were sent overseas. "In more than 7 out of 10 cases, the work activities were reassigned to places elsewhere in the U.S," the Bureau of Labor Statistics said in its report on mass layoffs for the January-to-March period.

In other words, Americans are taking American jobs. Interstate outsourcing may be more palatable than offshore outsourcing to some, but for an outsourced worker, whether the job goes across the nation or across the world, it is just as lost. Should workers scorn the CEO who decided to move to a different state or legislators who make the cost of doing business unnecessarily expensive?

States, like nations, compete for capital and jobs by offering business-friendly climates. The Electrolux refrigerator plant recently moved 1000 jobs from Michigan to South Carolina. New York's Scalamandre, a luxury fabric manufacturer, also recently relocated to the Palmetto state and CEO Mark Bitter was clearly motivated by the same forces that move jobs overseas. Bitter notes that in South Carolina "you have lower overhead, lower taxes, lower occupancy costs, lower labor costs, lower everything."

It would seem that high tax states that lose jobs to low tax states would have two options: lower taxes to produce a better business climate or lobby the federal government to ban interstate outsourcing. Of course, then some might get upset with intercity outsourcing…

Air Transportation

U.S. Airport Security

When Congress passed the Airport & Transportation Security Act of 2001 in the wake of the 9/11 attacks, it reached a compromise on the issue of airport screening. While the Senate bill had called for a 100 percent federal takeover, the House had called for federal standards and oversight of screening provided by each airport, using either its own staff or contractors. The compromise called for creating a federal screening workforce under the Transportation Security Administration (TSA), but allowed five airports (PP5) to opt out during an initial two-year period, obtaining their screeners from TSA-certified private contractors. And after the two years were up, in November 2004, all airports would get the option of continuing with TSA or using certified private contractors.

The five-airport pilot program (San Francisco, Kansas City, Rochester, Tupelo, and Jackson Hole) was evaluated by three separate entities, whose reports all appeared early in 2004: the Inspector General's Office of the Department of Homeland Security, the consulting firm Bearing Point, and the GAO (recently renamed the Government Accountability Office). All three reached broadly similar conclusions. The screening services at the PP5 airports were about the same as those of other airports of comparable size with TSA screeners. The classified versions of the reports also pointed out that overall screening quality was not that good at either type of airport, but that's a separate issue.

All three reports criticized TSA for grossly overcentralizing operations, to the point that all screener hiring and training is controlled from its Washington headquarters, which makes it impossible even for potentially quicker and more flexible screening contractors to respond to changes in airline service that increase or decrease the numbers of passengers and bags to be screened. And in a dynamic, highly competitive airline industry, that is a very serious mismatch. Despite this overcentralization, the reports noted that the PP5 contractors still managed to come up with some ways of increasing their effectiveness, e.g., by hiring lower-cost "baggage handlers" to move checked bags to and from explosive detection machines so that more costly baggage screeners can spend their time on actual screening.

With November 2004 on the horizon, and several members of Congress pointedly asking questions about the broader opt-out, the TSA in June 2004 issued preliminary guidance on how the opt-out program will work. Though it still plans to keep control of contractor selection, it promises to give airport directors serious input into the selection process. And it is willing to let airports themselves act as security contractors, which would permit a fully unified approach to airport security, under a single management. But although acknowledging problems with its centralized approach to hiring and training, it announced no decision about a more localized approach for opt-out airports and their contractors. And despite the November 2004 date being in the legislation, TSA interprets that date to be when it will first begin to receive applications from airports wishing to opt out. Under its draft schedule, it would be spring or summer 2005 before any new airport actually waved good-by to its TSA screeners.

While House Aviation Subcommittee Chairman John Mica (R, FL) continued to predict that as many as 25 percent of airports (over 100) would opt out, mid-2004 discussions in the airport community suggest that this overstates the likely participation rate. Between the restrictions contained in the legislation itself and TSA's interpretation of them, it's not clear that many airports would gain much from shifting to a contractor. The most important problem many of them face—the serious mismatch between screener numbers and workload—is unlikely to be solved by the opt-out program, as presently defined.

Another area where private contractors may be able to improve airport security is the forthcoming Registered Traveler program. Under this approach, airlines would be able to offer frequent flyers the opportunity to submit to a background check, and if they pass, to enroll as "pre-cleared" travelers carrying a biometrically encoded ID card. That card would grant members access to an express screening lane and exemption from selection for "secondary screening" at checkpoints. TSA launched a five-airport Registered Traveler pilot program in June, each involving a single airline. After evaluating the results, it is expected to roll out a nationwide program open to all airlines. It will likely involve significant roles for private contractors, working with the airlines and TSA.

U.S. Airport Privatization

To judge from the lack of media coverage, you would think nothing is going on in this country regarding airport privatization. While that's almost correct (certainly compared with the rest of the world), there is still real private sector activity in this area.

First, private firms run a number of passenger airports under management contracts, including Albany, Bob Hope (Burbank), Indianapolis, and Westchester/White Plains. Second, there are several passenger terminals developed and operated under long-term agreements with private firms, the most notable being Terminal 4 at Kennedy International in New York and the two terminals at Orlando-Sanford Airport in Florida. And private firms run dozens of general aviation airports (serving private planes) under lease or management contract arrangements.

Then there's the federal Airport Privatization Pilot Program, which permits up to five airports to be sold (if general aviation) or leased (any kind of airport), after obtaining approval from the Federal Aviation Administration. Though enacted in 1996, the Pilot Program has only led to one airport being privatized: Stewart International in Newburgh, New York, which was leased for 99 years to a British company in 2000. Three other proposals were submitted to FAA, of which one, Niagara Falls, was rejected and two were withdrawn. A fifth proposal, to lease the New Orleans Lakefront Airport to American Airports Corp., has languished at the FAA since late 2002 without a decision being reached.

Why have so few proposals been submitted to the Pilot Program? The reason no large or medium-sized airport has applied stems largely from a provision in the enabling legislation that requires approval of a super-majority of incumbent airlines, giving them veto power. Since U.S. airlines have generally opposed privatization, most city officials have considered it not a battle worth attempting to fight.

Nevertheless, outside the scope of the Pilot Program, several new airport projects may take the privatized route. First is the proposed third Chicago airport at Peotone, Illinois. Backers have proposed a public-private partnership model under which the state would own the land and the private sector would develop and operate the facilities under a 40-year franchise agreement. With no federal funding involved, the airport would not be subject to FAA economic regulation, allowing the private sector to earn a return on its investment and to do things like charging market-based landing fees. The airport would be aimed at attracting low-cost carriers that would have difficulty gaining enough access to Midway or O'Hare to provide serious levels of air service.

The intergovernmental authority called the South Suburban Airport Commission issued a request for proposals in November 2003. But the picture grew more complicated in December, when Will County (where Peotone is located) decided to put forward its own more traditional proposal using federal funds. The SSAC selected a team led by LCOR/SNC-Lavalin, which produced a $200 million phase 1 design concept. Will County's design is for a $338 million project, unveiled in April 2004. In June, the FAA approved passenger forecasts submitted by the Illinois DOT, which supports the project and has purchased most of the required land. Which group's approach will prevail remains to be seen.

A second proposal to develop a new passenger airport privately, without federal funds, is moving forward in Branson, Missouri. The proposed Branson Regional Airport, now in the design stage, would provide this tourist-attraction community with its own air-carrier airport as an alternative to Springfield, 50 miles away. Branson Airport Authority, Inc., a private company, expects to develop and operate the airport with no federal, state, or local tax funds.

Much less well-known is the successful privatization of the former Clinton County Air Base in Wilmington, Ohio. In the mid-1970s, a local community development group persuaded the predecessor of Airborne Express to locate its air-freight operations at the former air base. By 1980 the hub had become so valuable to the company that it purchased the entire 500-acre airport property for $800,000. In 2003 DHL acquired Airborne, but had its own hub in nearby Cincinnati. By June 2004, however, DHL had decided to consolidate its hub operations at Wilmington. Over an 18-month period, it will upgrade and expand the hub, as part of DHL's $1.2 billion investment in its North American operations.

Global Airport Privatization

In sharp contrast with the U.S. situation, around the world airport privatization keeps expanding. In 2003 Asia paved the way to privatize some of its largest airports, including Hong Kong, Tokyo, Bangkok, and several airports in India. Hong Kong's Chek Lap Kok Airport will be sold in late 2004 or early 2005 via a public share offering on the Hong Kong Stock Exchange. Privatization of Tokyo's Narita International Airport will take somewhat longer. It was converted to a government corporation in spring 2004 and will have three years to get ready for listing on the Tokyo Stock Exchange. Thailand sold a 30 percent stake in Airports of Thailand (AOT) in March 2004; AOT owns Bangkok International and four regional airports.

Airport privatization has long been a political football in India, with plans announced, postponed, and then abandoned, so many were skeptical when India's parliament passed an airport privatization law in summer

2003 calling for the sale of New Delhi and Mumbai (Bombay) airports. The law also provided a better framework for the proposed new privately developed airport to serve booming Bangalore. But when Indian voters threw out their government and installed a new coalition government in spring 2004 on a program downplaying privatization, it looked like the same old story would be repeated. But this time it appears things are different. In June the new government announced that it would accept bids for up to 74 percent of New Delhi and Mumbai Airports (with Airports Authority of India holding the remaining 26 percent). In July, 10 teams submitted preliminary bids. Also that month, the government signed a concession agreement with Bangalore International Airport, Ltd. to proceed with the $284 million greenfield airport project. Besides two Indian firms, BIA includes Siemens and Unique Zurich Airport.

Privatization continues to spread across more of Europe. The Dutch cabinet approved the long-awaited privatization of Schiphol Group, which owns and operates Amsterdam Schipol Airport and two others in The Netherlands, as well as having part interests in several airports overseas. The government will sell a portion of its 75.8 percent stake in the company, via a public share offering. The move comes just as Schiphol Group itself is bidding for the 70 percent of Brussels International Airport being offered by the Belgian government; Schiphol is teamed with Germany's privatized Fraport AG in making the bid. Several other global airport companies were also expected to bid. And the German government in April 2004 announced plans to sell shares in Frankfurt (already largely privatized), Cologne-Bonn, and Munich airports. It hopes to realize about $3 billion via these sales to reduce its budget deficit. And under Spain's reformed concessions law, two greenfield airports are being developed as public-private partnerships, one in Castellon and the other in La Mancha.

Latin America continues to be a venue for airport privatization. In the late 1990s Mexico sold controlling 15 percent stakes in three regional groups of airports via competitive bids, thereby privatizing all major airports except Mexico City. The second step was to sell the remaining shares to the public via stock offerings. The first such sale took place in 2000 for ASUR, the southeastern grouping that includes Cancun. But the other two were postponed in the wake of 9/11. Now the government has resumed the process. Next in line is its 85 percent holding in Grupo Aeroportuario del Pacifico (GAP), a 12-airport grouping that includes Guadalajara and Tijuana. The preliminary prospectus for GAP was posted on the Mexican Stock Exchange Web site in June 2004, with the sale expected before the end of the year.

Colombia has returned to airport privatization with the announcement in February 2004 of a 25-year concession agreement for modernizing Bogota's El Dorado International Airport. Barranquilla and Cartagena airports entered into similar deals in 1996 and Cali as well in 2000. And Bogota obtained a new runway in 1995 under a 20-year concession agreement. The new concession, due to begin in March 2005, calls for the winner to add a new passenger terminal and cargo facility, followed by a maintenance facility and control tower and an extension of the non-privatized runway. In June 2004, KPMG was selected as the government's advisor for the privatization process.

Federal ATC Outsourcing

The 2003 reauthorization of the Federal Aviation Administration ended up becoming a battleground over the role of privatization in U.S. air traffic control (ATC). As part of the President's Management Agenda,

the FAA had to inventory all its activities, designating which ones are “inherently governmental,” and, for those deemed not to be, determine which ones it would subject to competition. The battle arose over the designation of ATC functions as not inherently governmental.

ATC’s status had never been explicitly addressed until Pres. Bill Clinton, in December 2000, included the “inherently governmental” language in an executive order dealing with ATC reform. In June 2002, President Bush issued a brief executive order reversing that language, which otherwise would have left the highly successful Contract Tower program (under which 219 smaller airport control towers are operated by FAA-approved private contractors) subject to legal challenge. Indeed, for about a decade, the principal controllers’ union, NATCA, has been in litigation attempting to overturn this program. Studies by the Government Accountability Office (formerly the General Accounting Office) and the DOT Inspector General’s Office have found that contract towers operate at least as well and as safely as comparable FAA-run towers, but cost only one-third as much to operate.

Bush’s executive order led NATCA to launch an 11-month campaign, starting at the Christmas 2002 holidays, against privatization of air traffic control. It began with leafleting at airports, and included TV commercials, the funding and distribution of an anti-privatization white paper, and extensive lobbying efforts to have Congress include anti-outsourcing provisions (and a reversal of the Bush executive order) in the 2003 legislation to reauthorize the FAA for four years. Reason Foundation published a policy paper responding to the NATCA white paper (www.rppi.org/ps307.pdf).

When elements of the NATCA provisions were included in both the House and Senate bills, the White House issued a veto threat, which eventually led to passage, by voice vote, of a bill stripped of anti-outsourcing language. As a compromise, FAA Administrator Marion Blakey agreed that no new contract towers would be authorized during FY2004, and that no decision on any other outsourcing would be made within that fiscal year. (Ironically, not a single tower has been added to the 219 contract towers during the four years of the Bush administration, while 116 had been added to the program during Bill Clinton’s two terms.)

As permitted by the reauthorization language, the FAA was able to proceed with launching a competitive process under OMB Circular A-76 concerning the operation of the FAA’s network of Flight Service Stations. These are facilities that provide weather briefings and flight plan filing services mostly to private pilots. The system costs in excess of $500 million per year, and is widely acknowledged to be technologically backward and excessively costly. The principal private pilots’ organization, AOPA, has endorsed the A-76 competition, agreeing that FSS costs are too high and its systems are sorely in need of modernization. Ten companies responded to the FAA’s solicitation, with proposals due by August 2004. No final decision is expected until early 2005 (well after the September 30, 2004 end of the federal fiscal year).

FAA Air Traffic Control Reform

After the Clinton administration’s 1994-95 effort to create a government ATC corporation failed to gain traction in Congress, a national commission headed by former Congressman (and now DOT Secretary) Norman Mineta in 1997 proposed that the ATC system be restructured as a “performance-based

organization" within FAA. It would operate like a business, have a quasi-board of directors, and be funded by user fees paid by its aviation customers. Congress ignored the part about user fees, but in its 1999 AIR-21 legislation authorized the creation of the new unit, to be headed by a chief operating officer (COO), and the creation of the quasi-board.

Although the quasi-board was created, it had very little to do until recently, because it took the FAA until late 2003 to find someone willing to take the job of COO. That person is Russell Chew, former chief pilot with American Airlines. With Chew coming on board, the new Air Traffic Organization was formally launched early in 2004. Chew has selected 10 vice presidents, five line and five staff, drawing two of them from the private sector. He also lost no time in making visits to several of the leading overseas ATC corporations, to learn first-hand how entities like DFS (Germany), NATS (United Kingdom), and Nav Canada transformed their bureaucratic cultures into commercial ones. He shared the stage with the CEOs of DFS and Nav Canada at the Air Traffic Control Association's March 2004 technical conference in Atlantic City, giving a progress report on the ATO's start-up.

Also announced in March was the separation of ATC safety regulation from ATC service provision, a key goal of ATC reform worldwide. The FAA has created a third regulatory branch that will be responsible for ATC oversight, as it already oversees the safety of flight operations and aircraft design and production. This separation was required to be accomplished by the end of 2003 under U.S. obligations as a signatory to the International Civil Aviation Organization. Critics such as former FAA Administrator Langhorne Bond, however, called attention to the fact that the new ATC safety office will not actually be issuing Federal Air Regulations (FARs), as do the other two regulatory offices, which means there are questions about how transparent and arms-length this new regulatory approach really is.

Meanwhile, increased competition from low-fare airlines is leading to ever-lower ticket prices, which in turn means that the 7.5 percent ticket tax is bringing in less revenue for the Aviation Trust Fund (the principal source of ATC funding) than projected. This is leading to cuts in ATC modernization funding, just as the recovery in air travel is leading to the return of congestion. The Mineta Commission's ignored recommendation for shifting from taxes to ATC user fees looks more relevant than ever, since user fee revenues would parallel the growth in flight activity.

Overseas ATC Corporatization

The worldwide slowdown in air travel following the September 11, 2001 attacks put fiscal stresses on many ATC corporations around the world. But it did not halt the steady shift of air traffic control from government departments to commercial-type corporate entities.

Starting with New Zealand in 1987, the world has witnessed a large-scale transformation of ATC operations and funding. The general pattern is not outsourcing; rather, it is the conversion of former government ATC departments into corporations that, while often still government-owned, operate in a fully commercial manner. They are typically 100 percent funded by charges paid directly to them by their aviation customers, bypassing the governmental budget process. Hence, those predictable revenue streams can be used to float revenue bond issues to pay for capital expenditures. Those expenditures typically

include (1) technology upgrades, and (2) facility consolidation. Also integral to the corporatization process is arms-length safety regulation by government, generally by a unit of the transport ministry.

Various countries have corporatized their ATC systems in this manner, including Australia, Canada, Denmark, Germany, Italy, Norway, South Africa, Sweden, Switzerland, and the United Kingdom. ATC corporations that follow this model generally become full members of a global trade association called the Commercial Air Navigation Services Organization (www.canso.org). Nearly a dozen new members joined CANSO in 2003-04, bringing the total number of full members to 36 as of mid-2004.

While the circumstances of CANSO members vary, several general trends are appearing. There is generally a reduction in administrative costs and management layers, which often leads to reductions in the level of user fees over time. Modernization programs seem to make greater use of commercial, off-the-shelf technology rather than very costly developed-from-scratch systems. And significant economies are achieved by taking advantage of technology to operate from a smaller number of ATC centers. Australia has gone from six to two centers, South Africa from five to two, and the United Kingdom is on the way from four to two.

The post-9/11 fall-off in air traffic was especially pronounced on the North Atlantic, which hit very hard at the revenues of Nav Canada and NATS. The former, in operation since 1996, had built up a reserve fund, which enabled it to get through the crisis years with a combination of cost-cutting and modest rate increases. NATS, however, had been launched just a few months prior to 9/11, with a high level of debt and with no reserves. Consequently, it required a financial bail-out in the form of $208 million capital investment by its two principal owners, the U.K. government (49 percent) and the Airline Group (45 percent). Subsequent to that rescue, NATS was able to proceed with a $1 billion modernization bond issue, earning a AAA rating from both Moody's and Standard & Poor's.

Countries with Self-Supporting Air Traffic Control Corporations

Corporation Name	Country
AENA	Spain
Aerothai	Thailand
Airservices Australia	Australia
Airways New Zealand	New Zealand
ANS	Czech Republic
ATC the Netherlands	The Netherlands
ATNS	South Africa
Austro Control	Austria
Avinor	Norway
AZANS	Azerbaijan
Belgocontrol	Belgium

Countries with Self-Supporting Air Traffic Control Corporations

Corporation Name	Country
CAA Uganda	Uganda
DFS	Germany
ENAV SpA	Italy
EANS	Estonia
HungaroControl	Hungary
IAA	Ireland
Kazaeronavigatsia	Kazakhstan
LFV Sweden	Sweden
LGS	Latvia
LPS	Slovakia
MATS	Malta
MoldATSA	Moldova
NAMA	Nigeria
NANSC	Egypt
NATS	United Kingdom
Nav Canada	Canada
Naviair	Denmark
NAV Portugal	Portugal
Oro Navigacija	Lithuania
Roberts Flight Information Region	Sierra Leone, Liberia, Guinea
ROMATSA	Romania
Skyguide	Switzerland
UkSATSE	Ukraine
AAI	India
Slovenia Control	Slovenia

Source: CANSO

Space Privatization

By Edward Hudgins

The year 2004 marks a turning point for America's space program and for private space efforts. Both a presidential commission report and the first flight of a manned private craft into space show that free markets offer the best chance to make America a spacefaring civilization. But progress will depend on whether reforms proposed by the report are quickly implemented or even further steps taken to get the government out of space activities.

The Private Sector Triumph

This year saw significant private sector space efforts come to fruition. Some two dozen teams have invested nearly $200 million to date to win the privately funded Anasi X-Prize, a $10 million purse offered for the first private party to launch a rocket capable of carrying three people into space twice in a two-week period. Scaled Composites, a company headed by Burt Rutan and funded by Microsoft co-founder Paul Allen, launched the first private astronaut 100 km into space on a private craft on June 21st as a test of its competition vehicle. Rutan is the designer of the Voyager, the first plane to fly around the world non-stop, without refueling. He hopes to create a profitable business to carry customers on short hops into space.

This triumph shows what the private sector can do if given the opportunity and if governments at least keep out of the way.

History of Problems

By contrast, President Bush announced on January 14, 2004 an ambitious goal of returning to the moon and going on to Mars, in part to salvage NASA after the 2003 loss of the shuttle Columbia and its crew, which intensified criticism of that agency. Indeed, NASA's history since the Apollo moon landings has been riddled with financial failure. The space shuttle system was supposed to launch as often as once a week and radically reduce the costs of putting humans in space. Instead, the costs went up and at best there were five launches annually. When the space station was proposed in the mid-1980s it was supposed to house a dozen astronauts, cost about $8 billion and be in orbit in by the mid-1990s. Instead the station is still under construction, will only house three astronauts when completed, will facilitate little useful science and will cost at least $50 billion with another $50 billion in operating costs over a period of a decade.

Added to NASA's failings have been barriers to private space efforts. Over the decades private sector providers were frustrated in their efforts to get NASA to contract with them for services. The Space Commercialization Act of 1998 called on NASA to look more to the private sector but NASA often has

drug its feet or used creative accounting to argue that the private providers would not be less costly than government.

A major problem today originated in the 1998 Strom Thurmond National Defense Authorization Act, which transferred export licensing from the relatively reasonable Department of Commerce to the State Department, which has tightened controls, harming ongoing and future ventures between American entrepreneurs and Russian, European and other partners.

A New Direction

To determine how to meet his new space goals, President Bush appointed a Commission on Implementation of U.S. Space Exploration Policy, which issued a report in June. The report contained many positive recommendations though it falls short of what ultimately must be done to allow the private sector to supplant government in space activities.

Private sector in Low-Earth Orbit: On the positive side, one recommendation from the commission calls on NASA to "implement a far larger presence of private industry in space operations with the specific goal of allowing private industry to assume the primary role of providing services to NASA, and most immediately in low-Earth orbit. In NASA decisions, the preferred choice for operational activities must be competitively awarded contract with private and non-profit organizations…" This suggestion could pave the way for NASA to drop most of its launch functions and turn the business over to private providers.

Prizes: Prizes played an important role in the development of aviation. Charles Limbergh won the $10,000 private Orteig Prize for becoming the first man to fly solo across the Atlantic and the U.S. government offered prizes in the 1920s and'30s to meet its aviation needs. The X-Prize already has stimulated private manned space activities.

The space report calls on NASA to use prizes to develop and promote enabling space technologies, and NASA now has authority to issue some small prizes. This approach is superior to traditional government contracting and takes advantage of the emerging private space sector. The report even suggests consideration of a $1 billion prize for the first private party to place humans on the moon and sustain them there for a certain period of time.

Tax incentives: The report recommends the use of various tax incentives to promote space enterprise. Removing tax barriers to an industry with large start-up costs certainly could be helpful; a number of such proposals have been circulating on Capitol Hill for years. Special tax breaks do have the problem of being a form of national industrial policy. But some, for example, Rep. Dana Rohrabacher's (R-CA) "Zero-G, Zero Tax" proposal that would create a kind of enterprise zone in orbit, might be thought of as providing a tax sanctuary analogous to the tax-free status of Internet commerce.

Perhaps the most innovative use of tax policy was suggested by former Rep. Bob Walker (R-PA) who was a member of the space commission. In a chapter of the book *Space: The Free-Market Frontier* he proposed a total tax holiday of perhaps 25 years for any business or non-governmental organization that could build a

permanent base on the moon. Such an approach would not require tax expenditures and since the tax holiday would start only after the base had been built, the government likely would reap significant revenue from the research and construction activities to offset potential revenue lost from the tax break.

Regulatory relief: The space report observes that over-regulation can be a problem for the private space sector. It mentions the need for liability law reform concerning implied consent so that individuals will be allowed to take risks in pursuit of space ventures. It also calls for reviews of regulations concerning the occupational safety environment that might burden such ventures. These would be important positive steps. But reformers will need to go further, also addressing problems like export controls.

Property rights: Property rights are the key to any free market. Yet the 1967 Outer Space Treaty, to which the United States is a signatory, and the 1979 Moon Treaty, to which it is not, bar property rights in space and on other planets and bodies. The Outer Space Treaty, however, can be interpreted as establishing de facto property rights. Still, the space report is correct to call attention to the possible future need to clarify and secure a property rights regime by revising international agreements.

Problems with the Report

The report is not without shortcomings. Since President Bush wished the report to pave the way for a return to the moon and a possible manned trip to Mars, the question of whether government should be engaged in such activities is not discussed.

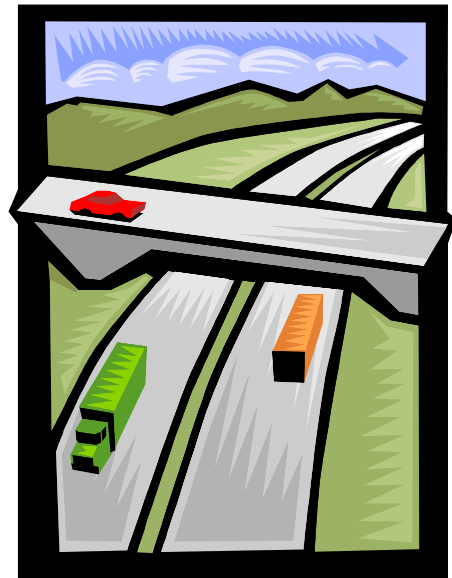
The report does recognize that the 10 NASA centers do not necessarily further the focused goal of exploration. But rather than recommending shutting down and consolidating centers—a move that would meet with political resistance—the report suggests a half-way measure: making them into Federally Funded Research and Development Centers (FFRDCs). One NASA center, the Jet Propulsion Laboratory, already is so organized. FFRDCs are managed by universities or other private groups and have much more flexibility and ability to innovate than do pure government facilities.

The most serious flaw of the report is that it calls for completion of the international space station, with the shuttle as the principal construction vehicle. The report does rightly call for the shuttle to be phased out after station completion. Yet the station and shuttle, which consume most of NASA's $7 billion budget for manned space efforts, are of little scientific use and do not provide stepping stones to the moon or Mars. The report is charitable in maintaining that the station can be used to study the efforts of long-term space stays necessary for voyages to the planets. But we have been studying these effects since the first men few into space in 1961. Further, because of sanctions against Russia for its business dealings with Iran, after 2006 NASA will not be allowed to pay that country for use of its Soyuz spacecrafts, the only vehicle that can carry people off of the station in case of emergency. In practice this would mean that Americans could not travel to the station.

Conclusion

The success of the private X-Prize efforts promote private manned space flights and the market-oriented recommendations in the report of the presidential space commission point the way to a potentially profitable future for humans, their businesses and their scientific ventures in space. But as with all privatization and deregulation, follow-through will be critical. Without the political will, the fine rhetoric in the commission report will remain just that and we will remain chained to the ground by the government bonds that have kept us there in decades past.

Surface Transportation



State PPP Laws

After several years of little activity on the highway privatization/public-private partnership front, 2003-04 has seen a revival of activity. Texas enacted a sweeping revision of its tolling and PPP laws, and Florida reformed its PPP law to make it workable. Delaware and Georgia enacted new PPP laws, and both Colorado and North Carolina created state toll agencies authorized to enter into PPP agreements.

Texas legislators in 2003 passed HB3588, and voters approved two constitutional amendments enabling all of its provisions to go into force. Texas now requires all limited access highway projects to be reviewed for toll feasibility, and if toll financing cannot cover their full costs, the law permits a mix of state and private capital. Toll projects can be carried out directly by toll agencies or via PPPs. Urban areas are now empowered to create regional mobility authorities (RMAs) that can act as toll road agencies and can partner with the private sector in the same ways as Texas DOT and its Texas Turnpike Authority. The state is also proceeding with the first of a planned set of multi-modal Trans-Texas Corridors to be done as PPPs.

Florida's legislature in 2004 modernized its 1991 highway PPP law, whose shortcomings had prevented it from ever being used. The new law removes the requirement that every proposed PPP project must be voted on by the legislature before it can go forward, which created far too much risk for potential toll road developers. It also emulates Texas in now permitting a mix of private and public (gasoline-tax) funding for PPP projects.

Delaware and Georgia enacted flexible PPP laws in 2003. Both permit unsolicited proposals as well as responses to RFPs, and both avoid limiting the number of PPP projects to a small number of pilot projects. Georgia received its first unsolicited proposal early in 2004, and under the law's provisions, invited competing proposals from others, receiving two more. The project would upgrade a congested arterial between Atlanta and Athens into an electronically tolled expressway.

Both Colorado and North Carolina are getting their recently authorized state toll authorities up and running. In both cases, the laws allow the authorities to enter into PPPs to develop and operate the new toll roads.

The table below summarizes several key features of transportation PPP laws enacted during the past 15 years.

State Transportation Public-Private Partnership Laws

State	No limits on number of projects?	Accepts unsolicited proposals?	Have projects been proposed?	Are any projects in operation?
Alabama	X	X	X	X
Arizona	X	X	X	
Arkansas	X			
California *			X	X
Colorado	X	X		
Delaware	X	X		
Florida	X	X		
Georgia	X	X	X	
Louisiana **				
Massachusetts **			X	
Minnesota	X	X	X	
Missouri	X	X	X	X
Nevada ***				
New Jersey ****				
North Carolina	X		X	
Oregon	X	X		
South Carolina	X		X	X
Texas	X	X	X	X
Utah *****				
Virginia	X	X	X	X
Washington	X		X	
Wisconsin	X	X		

*repealed in 2002
**one pilot project only
***prohibits toll roads and toll bridges
****expired 2002
*****regulations never adopted

Source: Grant Holland, *Public Works Financing*, February 2004.

Recent Public-Private Toll Road Developments

The first proposed sale of an existing U.S. toll road, a $6 billion toll road system under construction in Texas, and a whole new approach to toll road financing in San Diego are among the major recent developments.

The city of Chicago, which had hinted for several years that it might sell the once money-losing Chicago Skyway, finally decided to go for it in March 2004, inviting investors to bid for a 50-year franchise to operate and manage the 7.8-mile elevated toll road. The Skyway links downtown Chicago to the Indiana border. Due to the high cost of building an elevated route of this length, the Skyway suffered through many years of revenue insufficient to service its construction debt. In recent years, though, thanks to congestion on alternate routes and the attraction of casinos just across the border, the Skyway has been profitable. Goldman Sachs is advising the city on this historic privatization.

In California, after 11 years of environmental studies and litigation, the SR 125 toll road near San Diego was financed and put under construction in 2003. But what makes this project unique is not its status as the second private toll road project under California's now-repealed private toll roads pilot program law. Rather, it is the dramatically different approach to its financing. Nearly all U.S. toll roads have been financed 100 percent by debt (toll revenue bonds). For a stand-alone, start-up project that can be very risky, since it is quite difficult to forecast accurately the first five years or so of traffic (and hence toll revenue). But debt service is a contractual obligation that must be paid, or the project goes into receivership. By contrast, the $640-million SR 125 toll road was financed without any use of toll revenue bonds. Between $160 and $180 million will be equity put in by developer/owner Macquarie Infrastructure Group; another $140 million is a 38-year low-interest TIFIA loan, with a five-year grace period after construction. The balance is 18.5-year European bank loans, which will eventually be replaced by toll revenue bonds. Thanks to this innovative financing structure, only about half the capital requires debt service payments during the high-risk first five years of operation.

The country's largest set of toll road projects is under way in Austin, Texas. Major portions are already under construction of the $3.6 billion Central Texas Turnpike Project, whose largest component, SH 130, is a PPP project. And in July 2004, the metropolitan planning organization for Austin approved an additional $2.2 billion worth of toll roads for the region, bringing the total to 11 toll roads by the end of the decade. Some of these projects, too, will likely be developed as PPPs. Since all new limited access highways in Texas must now be considered for toll financing, studies are under way from Brownsville to Waco on possible new toll roads. In addition, TxDOT has requested detailed proposals from three pre-qualified teams for the 800-mile Mexico-to-Oklahoma Trans-Texas Corridor. This would be the first of a series of major new transportation corridors, bypassing existing cities, and providing separate infrastructure for passenger vehicles, trucks, rail freight, passenger rail, and utility corridors. All would involve toll-like user-fee financing. Truck toll lanes are likely to be among the first elements of this Corridor to be developed.

Truck toll lanes are also on the agenda for Virginia–though the Virginia Trucking Association is not happy with the approach that's been proposed by the private-sector Star Solutions team, which won the franchise to add new lanes to the entire 325-mile length of I-81 in Virginia, a major truck route. The $7 billion project would add two lanes in each direction, to be paid for by truck tolls. Truckers complain that the mandatory tolls (on trucks only) would be unfair, and that a large fraction of trucks would avoid I-81 and congest other highways.

A different approach to truck toll lanes is being pursued by the Southern California Association of Governments, with trucking industry support. SCAG has included in its 2030 long-range transportation plan a $16 billion system of toll truckways, extending from the ports of Los Angeles and Long Beach north along I-710, east along SR 60, and north to Barstow along I-15. To make it worth trucking companies' while to pay the high tolls needed to finance such a huge project, SCAG has adopted Reason's concept of higher-productivity trucking. Specifically, double- and triple-trailer rigs that are not currently street-legal in California would be allowed to operate on these barrier-separated truckways, enabling a trucking company to haul twice the payload of conventional 18-wheelers. The bigger rigs would operate only on these truckways, with individual street-legal trailers delivered singly by conventional tractors from the truckways to their ultimate destination.

HOT and Other Forms of Managed Lanes

The 2003-04 period has seen a proliferation of proposals for what used to be called High-Occupancy Toll (HOT) lanes. But at the same time that proposed applications of the concept have been going mainstream, the concept itself has been evolving. As part of what the Texas Transportation Institute has dubbed "managed lanes" (any form of lane restricted to certain types of use, aimed at achieving certain performance goals), the idea of value-priced, congestion-relief lanes now includes Express Toll Lanes (ETL) being considered in Florida, Maryland, and Texas thus far. The difference between HOT and ETL is that in the former, carpools generally are allowed in at no charge, while in the latter all vehicles (except emergency vehicles and buses, and perhaps vanpools) must pay the market price.

ETLs first popped up in Florida, where carpool lanes are few and far between, and much of the expressway system (at least in Miami, Orlando, and Tampa) already consists of toll roads. Both the Miami-Dade Expressway Authority and the Tampa-Hillsborough Expressway Authority seek to add premium-priced express lanes to their existing toll roads, as does the Florida Turnpike Enterprise for its urban Homestead Extension in Miami-Dade County. Florida DOT has proposed ETLs for the median of highly congested I-4 in Orlando.

Other advocates of ETLs include Maryland Transportation Secretary Robert Flanagan and State Highway Administrator Neil Pedersen, whose department is studying the addition of such lanes to virtually all major urban-area highways including the Maryland portion of the Beltway (I-495), I-270, I-95, and the proposed new Inter-County Connector. And although Maryland lacks a PPP law, it has asked for informal proposals from the private sector. The ETL concept is now also showing up in Texas as well, most recently in a proposal to add such lanes to four miles of I-10 and 18 miles of TX1604 in San Antonio; that city already has a federally funded study under way on adding some form of managed lanes to I-35. And in Minnesota,

Gov. Tim Pawlenty has embraced Congressman Mark Kennedy's concept of adding electronically tolled FAST lanes to congested Interstates in the Twin Cities area; there is no mention of free passage for carpools in Kennedy's bill.

One of the most visible HOT lane proposals is Fluor's plan to add two such lanes in each direction to the southwest quadrant of the Washington Beltway. Accepted by Virginia DOT and getting very strong support from northern Virginia businesses and governments, the concept is now undergoing environmental review. Fluor also leads one of two consortia that have proposed adding HOT lanes to congested I-95 leading up to the Beltway from the south and continuing to the DC line on I-395, about a billion-dollar endeavor. Major HOT lane additions are an integral part of two huge freeway modernizations in Texas. Reconstruction of the Katy Freeway (I-10) in Houston includes four HOT lanes with guaranteed access for Houston's extensive freeway express bus service. And the multi-billion-dollar expansion of the LBJ Freeway (I-635) in Dallas includes two, four, or six HOT lanes (depending on the section), some of which will be built in tunnels under the freeway.

As of mid-2004, two conversions of existing HOV lanes to HOT lanes are under way. In Denver, the venue is I-25 North, while in Minneapolis the project is on I-394. The latter is being done by a private sector team.

The table below provides a recap of HOT lanes projects and studies nationwide, as of mid-2004.

HOT Lanes Recap

Jurisdiction	In Operation	Being Implemented	Proposal Stage	Feasibility Study	In Long Range Plan	Task Force Report
ARIZONA						
Phoenix				network of HOT lanes		
CALIFORNIA						
Alameda Co.				I-680		
Los Angeles Co.					US 101	REACH task force
Marin Co.				US 101		
Orange Co.	SR-91			SR-57		
San Diego Co.	I-15	I-15 expansion			I-5, I-805, SR-52	
Santa Clara Co.						US 101, I-880, SR-87
Sonoma Co.				US 101		
COLORADO						
Denver		I-25N	I-70	C-470		
FLORIDA						
Miami				I-95, SR-821, SR-836	SR-836	

HOT Lanes Recap

Jurisdiction	In Operation	Being Implemented	Proposal Stage	Feasibility Study	In Long Range Plan	Task Force Report
Orlando				I-4		
Tampa		SR-618				
GEORGIA						
Atlanta			GA-316	HOT and TOT lanes		
MARYLAND						
Baltimore				I-95, I-695		
DC suburbs				I-495, I-270, US-50, ICC		
MINNESOTA						
Mpls/St. Paul		I-394		network of HOT lanes		
N. CAROLINA						
Piedmont Triad				I-40		
Research Triangle			I-40			
OREGON						
Portland				Hwy 217		Pricing task force
TEXAS						
Dallas		I-635		network of HOT lanes		
Houston	I-10, US 290	I-10		network of HOT lanes		
San Antonio				I-35, I-10, TX160		
VIRGINIA						
Hampton Roads				Value Pricing Piloting Program study		
DC suburbs			I-495, I-95	VPPP study		
WASHINGTON						
Seattle				SR-167		

Transportation Legislation Updates

Although TEA-21, the legislation authorizing the entire federal surface transportation program, expired September 30, 2003, Congress was unable to agree on replacement legislation. Hence, TEA-21 ended up being extended for several months at a time for the entire following year. While the biggest focus of debate was the overall size of the program and whether it would include an increase in the rates of federal gasoline and diesel taxes, another battle raged over the provisions dealing with tolling and HOT lanes.

The Bush administration's SAFETEA bill proposed to give states far more flexibility in making use of tolling and pricing. It would "mainstream" the Value Pricing Pilot Program, allowing all 50 states to use electronic tolls to address congestion and/or emissions problems on any Interstate highway. (Interstates are the only roadways where federal restrictions on tolling still apply.) It would liberalize a three-state pilot program under which states could use tolls to finance rebuilding Interstates. It would make it easier to convert HOV lanes to HOT lanes. And it would reduce tax-code discrimination against privately provided toll roads (and PPPs) by permitting up to $15 billion worth of tax-exempt toll revenue bonds to be issued by private tollway developers.

The Senate adopted similar provisions, though changing some of the language regarding the uses of toll revenues, and importantly, adding language to retain an office within the Federal Highway Administration to assist with pre-project planning and post-project evaluation of pricing projects. The House Transportation & Infrastructure Committee passed a similar measure, but when the bill was debated on the House floor, Rep. Mark Kennedy (R-MN) offered his FAST Lanes bill as a substitute for the whole set of pricing provisions. That amendment was adopted, with the result that the House bill would permit only the tolling of new lanes added to congested Interstates, and requiring that the tolls be removed once the initial financing was paid off.

In subsequent months, four coalitions organized to attempt to influence the conference committee. Supporting a fine-tuned version of the Senate provisions were the Tolling Coalition, largely comprising state DOTs and highway construction interests and the Value Pricing coalition (consisting of think tanks, environmental groups and some toll agencies and metropolitan planning organizations). On the other side, supporting the House approach, were two coalitions: one of conservative and taxpayer organizations and the other of trucking associations and auto clubs.

Regardless of which version (or compromise) of the pricing provisions prevails, the result will likely be an expansion of tolling, with the blessing of the federal government. If the more restrictive House language prevails, the existing 15 states that are Value Pricing Project Partners could continue to use pricing on their existing projects, but could not price any new ones except new FAST lanes. HOV to HOT conversions would still be permitted, though with new restrictions. All 50 states would be able to add value-priced lanes to congested Interstates. And of course state highways (including urban expressways) could use pricing any way they saw fit.

If something closer to the Senate language prevails, pricing could be used more broadly, including the conversion of existing free lanes to HOT lanes, tolling existing lanes to help pay for new ones, and

rebuilding several Interstates with tolls. PPPs would flourish, thanks to the availability of tax-exempt revenue bonds for such projects. And more pre-project planning and post-project evaluation would surely speed up the use of pricing.

Overseas Toll Road Developments

Australia continues to set the pace for investor-developed and operated urban toll roads, with continued activity in its two largest urban areas: Sydney and Melbourne. Over the past decade, new urban tollways have created a modern urban expressway system in Sydney. Currently operational are the Sydney Harbor Tunnel (1992), M2 Motorway (1997), M4 Motorway (1992), M5 Motorway (1992), and Eastern Distributor (2000). Under construction are three more: the $500 million M2 Cross-City Tunnel, the $1.3 billion M7 Western Sydney Orbital, and the $815 million Lane Cove Tunnel.

Mobility in Melbourne dramatically improved via the opening, in 2000, of the $1.4 billion Melbourne CityLink, which connected three major freeways near the center of the city. Now bidding is under way for a second major project, the $1.35 billion Mitcham-Frankston Motorway in the eastern suburbs. It, too, will link three existing freeways, greatly improving mobility. One of the two finalist consortia plans to finance the project partly via a public stock offering. Two toll road mutual funds already exist in Australia.

Closer to home, Canada's limited experience with private toll roads has been going through a bumpy stretch. The showcase project, Toronto's Highway 407ETR, was developed as a kind of public-private partnership, though financed by the province of Ontario. After it was up and running, the government sold a 99-year franchise to the highest bidder willing to build east and west extensions. The winning consortium paid $2.6 billion for the franchise, and built the extensions, as required. But last year when it raised toll rates, the new Liberal government filed suit, claiming that each rate increase required its consent. In summer 2004 the arbitrator ruled in favor of the consortium, based on the clear terms of the franchise agreement. But the government is appealing, and is refusing to enforce toll payment by denying license plate renewals to serious violators. So the situation remains muddled, raising concerns about future private investment, precisely at a time when a new infrastructure finance paper suggests that Ontario may need as much as C$25 billion in private capital over the next 30 years. A considerable number of other public-private toll motorway and bridge projects are on the agenda in other provinces, and it remains to be seen whether the troubles in Ontario will have spillover effects elsewhere.

Meanwhile, Mexico is attempting to restart its concession-based toll roads program, after about a decade's hiatus. Mexico was among the first Latin American countries to bring in the private sector to develop modern toll highways, but poorly structured concession agreements led to most of those projects (from the early 1990s) being financial failures. But the government has now designed a new program aimed at developing 800 km of new toll roads. This time around, concession terms will be a more realistic 30 years, not the 10 to 15 years that led to unsustainably high toll rates in the earlier program. The first project, with bidding in November 2004, will be for the 238 km Tepic-Villa Union highway. Elsewhere in Latin America, large-scale toll motorway concessions programs continue in Argentina, Brazil, and Chile.

Across the Atlantic, the United Kingdom's first privately developed toll motorway opened late in 2003. Formerly known as the Birmingham Northern Relief Road but now known as the M6Toll, the $1.4 billion, 27-mile bypass of the congested M5-M6 intersection has proved highly popular with drivers. That success has led the Department for Transport to consider authorizing a tolled alternative to congested M6 between Birmingham and Manchester. The United Kingdom has several privately financed toll bridges, as well as more than a dozen privately financed motorway upgrades in which the private franchise-holder is paid by the government in the form of "shadow tolls." DfT is considering several more such projects, which may include a $4.2 billion widening of London's M25 orbital and of the M1 in central England. Longer term, DfT is looking into the possible replacement of some or all of the current fuel taxes (which are not earmarked for transportation, as are U.S. fuel taxes) with nationwide road pricing, probably using GPS technology.

France is Europe's pioneer in tolling, with a national network of toll motorways financed, developed, and operated by a set of companies (some private, some state-owned) under long-term concessions. The largest new project is the $2 billion toll tunnels to complete the missing link in the A86 Paris ring road, currently more than 50 percent completed. And in mid-2004 the French government issued a decree creating a legal mechanism for public-private partnerships for a variety of infrastructures, including highways. This will permit PPPs to be used for projects that cannot be fully self-supporting via user fees.

Germany's initial effort to switch from general funding of highways to tolling fell victim to an overly ambitious schedule. That project was supposed to have required all heavy trucks using German highways to pay tolls, using a complex GPS-based tolling system, beginning in autumn 2003. But the winning bidder, a consortium of Deutsche Telecom and DaimlerChrysler called TollCollect, was unable to meet the very compressed schedule. After much renegotiation, the start-up date was shifted to January 1, 2005. Less noticed in all the TollCollect press coverage was the enactment of the Private-Sector Funding of Trunk Road Construction Act. It authorizes the federal government to enter into long-term agreements with private companies to finance, build, operate, and maintain new federal trunk roads and to improve existing ones, by charging tolls. Under this law, 14 segments of the autobahn encompassing 350 miles have been defined as eligible for the addition of privately developed Express Toll Lanes.

Spain privatized a major portion of its state-owned toll road sector in 2003, reaping $1.8 billion in exchange for a range of concessions to operate existing toll road systems for terms ranging from 34 to 75 years. In doing so, Spain followed in the footsteps of Italy, which privatized the Autostrade for $6.7 billion in 1999 and Portugal, which privatized BRISA for $2 billion, also in 1999. Less wealthy European countries, including Greece, the Czech Republic, Poland, and Romania, are all making use of long-term concessions to finance the development of modern toll motorways. In most of these cases, international development banks provide part of the initial capital, generally at below-market rates.

Israel in 2002 opened the first sections of its Cross-Israel Highway, an $833 million, 86-km toll motorway, being developed under a 30-year concession agreement. A second project, the $135 million Mt. Carmel Toll Tunnel, is under construction with a projected 2005 opening date. And competition is now under way for Israel's first HOT lane project: the addition of an $80 million Fast Lane to congested Highway 1 between

Tel Aviv and Ben Gurion Airport. Vehicles with four or more occupants would use the Fast Lane at no charge; all others would pay a variable-rate toll.

Fixing Transit with Private Participation

If bread on supermarket shelves were moldy and increasingly expensive, we'd expect fewer people to buy bread. When faced with paying more for a worse product, it's not surprising that more customers simply refuse to buy the product. We should be similarly unsurprised to discover that—after years of fare increases and degraded service—transit ridership continues to fall.

Between 1960 and 2000, transit's share of work trips fell from over 12 percent to under 5. And while ridership falls, costs rise—not just for bus riders, but for taxpayers, too. Again, between 1960 and 2000, federal transit subsidies nearly tripled and total government subsidies ballooned to over seven times 1960 levels. In other words, taxpayers—whether they use transit or not—have clearly endured their own kind of fare hike. Moreover, transit's remaining customers often receive poor service. Why do costs continue to rise as transit serves an ever-shrinking slice of America?

Assigning Blame

Some blame the bus itself, and there's no doubt the lowly bus suffers from an image problem. Decades of slow, spotty, unpleasant and unpredictable service have earned the bus the reputation as the transportation option of last resort. Of course the cause-and-effect behind the bus's fall may blur. As fewer people ride the bus, transit agencies anxious to control costs may reduce service even more. Ridership continues to fall, while a service that wasn't great in the first place degrades even further.

Some argue that the bus is simply too unappealing to attract a sizeable number of patrons. It's this perception that leads many transit agencies to pursue other transit modes, such as light rail. Light rail, they say, is hip and appealing while the bus is simply lowly.

But the research tells us there's nothing inherently lowly about the bus. For example, a 2001 GAO report notes: "While transit officials noted a public bias toward light rail, research has found that riders have no preference for rail over bus when service characteristics are equal."

Rider surveys reveal that patrons have straightforward requests for improved service, and these requests have little to do with a bias against the bus. Bus patrons simply want more routes, and faster, more frequent, more reliable service.

Others look at the dismal state of public transit and say the problem is much bigger than the bus. They say the problem is that transit has largely outlived its usefulness. After all, in most any society where wealth increases, private auto ownership and suburbanization will likely follow. Public transit simply lacks the speed, flexibility and convenience to be relevant in modern America.

Those who hold this view have a point. And we must be realistic about how much public transit can contribute to American's transportation needs. After all, transit simply cannot compete with the car in terms of speed, flexibility and convenience. And auto ownership has become prevalent even among transit's primary clientele—the poor. Three-fourths of households earning less than $20,000 have at least one car.

Still, millions of Americans do rely on transit to get them to work, to school and to other appointments. So if we agree that the problem isn't the bus itself, and that transit is still relevant for millions of Americans—what does account for transit's woes?

Fixing Transit

From the point of view of the bus rider, the problem is customer service. Again, bus patrons have very straightforward requests: more routes, and faster, more frequent, more reliable service. From the point of view of the taxpayer, the problem lies with incentives. Our current system lacks the incentives to emphasize cost containment. So what could satisfy both the transit patron and the taxpayer? Often the answer is private sector participation.

Whenever we consider doing something new, whether it's buying a car or privatizing a transit system, we should always do our homework. One way to allay fears about doing something new is to examine the experience of those who have gone before us. Are these people satisfied with their decision? Private sector participation in transit—specifically competitive contracting—enjoys very high satisfaction rates. A recent Transportation Research Board survey notes that when asked if they had to do it over again, roughly 80 percent of transit managers who chose contracting say they would stick with it a second time.

That 80 percent approval rating is even more impressive when you consider who these transit managers are. They aren't cheerleaders for private sector participation. They aren't executives from firms who might benefit from increased private sector participation. They are public employees who needed a way to improve service and cut costs. They're pleased with private sector participation simply because it works.

In the United States and Europe, competitive contracting has reduced operating costs from 20 to 51 percent, with savings of about 35 percent being the norm. And improved service often accompanies lower costs. After decades of subsidies, outside money has become more important to agencies than revenue from fares. And as in any service, when customer patronage is detached from revenue, customer service falters. However, since companies bid for the right to serve bus patrons, competitive contracting can bring customer service back to transit.

The question is often asked: "Which transit services can be privatized?" The most obvious answer is the bus service itself, but that's just the beginning. Here are examples of some more:

- Accounting
- Construction management
- Customer information
- Human relations
- Emissions testing

- Equipment maintenance
- IT
- Printing
- Risk management
- Web site design and management

Since the list goes on and on, the question should be turned on its head. We need not ask, "Which transit services can be privatized?" but rather, "Which cannot?"

Foothill Transit in Los Angeles shows the validity of the new question. The agency has essentially no employees. A management company handles all the central office functions and oversees the contract transit operators. The results? As of 2000, the Foothill buses were operating at a unit cost 42 percent lower than that of L.A. County Metro's publicly operated lines.

Of course, private sector participation is not an all-or-nothing proposition. An agency may decide to privatize some functions and keep others in-house, and certainly these decisions will vary from agency to agency.

Competition vs. Monopoly

We must also take care to understand why private sector participation works. The key distinction isn't so much private vs. public, but competition vs. monopoly. Private transit operators who are shielded from competition have shown that they will become inefficient, while public agencies exposed to competition have improved efficiency. Competition prods service providers to offer an appealing product at a competitive price, and local oversight ensures the fulfillment of performance measures.

Transit exists first to serve those who have no other transportation alternatives. Welfare researchers of all ideological stripes agree that one of the best ways to spur upward economic mobility is to improve physical mobility. When the transit-dependent poor and handicapped have better access to education and employment, they are better able to pull themselves up the economic ladder and realize greater personal fulfillment. In other words, the bus can serve a very important role, and private sector participation can help it become the best it can be.

Rail for the rich or cars for the poor?

Like so many government services, the reason behind transit's inability to innovate lies buried deep within a law that most people have long forgotten. The Urban Mass Transit Act of 1964 was the federal government's attempt to resuscitate a transit system suffering ridership losses. The law began the practice of lavishing local transit agencies with federal grants and—in a bow to unions—protected transit employees from any changes that would cause them financial harm.

The changes created the worst of both worlds: the federal money ensured that transit would not be allowed to fail, while the protections ensured that innovations would never emerge. The feds would now treat transit the way a sadistic doctor would tend to someone in critical condition—artificially maintaining a faint pulse, but refusing to either pull the plug or fully revive the patient.

The law could not stop transit's slide. Between 1960 and 2000, transit's share of work trips fell from over 12 percent to under 5. Meanwhile, federal transit subsidies nearly tripled and total government subsidies ballooned to over seven times 1960 levels. As transit agencies relied less on fares for revenue, they treated riders less like customers. Costs rose and service faltered.

Those who suffered most have been those who need transit most—the poor and handicapped. Yet in order to try to reverse transit's slide, many agencies have tried to woo those who already enjoy high levels of mobility—middle and upper-middle class motorists.

Today, transit agencies often turn away from relatively low-cost transit (e.g. bus, rapid bus and Bus Rapid Transit) and toward high-cost transit (e.g. light rail). Officials justify the higher project costs on grounds that motorists who would never set foot on a bus would trade in their sedans for seats on a sleek light rail car. However, research from the GAO and others shows customers care about features—speed, convenience, cleanliness—and less about mode—that is, bus vs. rail. And, more importantly, as Americans grow wealthier, they buy cars for their convenience and thus the transit-dependent population shrinks. Commuting to work via transit is only one aspect of transit use. It is hard to argue the benefits of transit for such common activities as weekly grocery shopping, hauling children with all their equipment to sports practice, taking a sick pet to the vet, or running several errands in a short period of time. Once people buy cars, they rarely go back to public transit, and we should not expect them to do so.

But many believe rail transit will somehow change the American lifestyle, and despite rail's costly infrastructure and declining ridership, pursue it as a noble goal. As preference for rail transit makes transit more and more expensive, another option becomes more and more comparatively cost-effective—getting the transit-dependent poor and handicapped into cars.

In a recent report entitled "Light Rail: Boon or Boondoggle?," the Federal Reserve of St. Louis, found that buying cars for that city's transit-dependent population would make more sense than building rail lines:

> *Based solely on dollar cost, the annual light-rail subsidies could instead be used to buy an environmentally friendly hybrid Toyota Prius every five years for each poor rider and even to pay annual maintenance costs of $6,000. Increases in pollution would be minimal with the hybrid vehicle, and 7,700 new vehicles on the roadway would result in only a 0.5 percent increase in traffic congestion. And there would still be funds left over—about $49 million per year. These funds could be given to all other MetroLink riders (amounting to roughly $1,045 per person per year) and be used for cab fare, bus fare, etc.*

This finding squares with research done by Wendell Cox, who asserts that it would be more cost effective to lease cars than to build rail lines (http://www.publicpurpose.com/ut-2000rail.htm).

Transportation analysts have long advocated taxi vouchers for the poor. Although cities have been slow to break with the status quo, in August, one Iowa town announced plans to provide vouchers to residents with limited mobility. A private taxi service will provide the rides and turn the vouchers in to city hall for reimbursement.

The car voucher option would also bring much more mobility improvement than light rail, and even more than bus. At average transit operating speeds of 15 miles per hour, a transit patron can access a "job shed" of 175 square miles in 30 minutes. Driving in a car, that same person can expect to average 30 mph and access a job shed of 700 square miles in 30 minutes.

Welfare advocates from across the political spectrum see auto ownership as an essential precursor to upward mobility. Pres. Bill Clinton proposed relaxing auto ownership restrictions for food stamp eligibility requirements. As the Progressive Policy Institute put it: "In most cases, the shortest distance between a poor person and a job is along a line driven in a car."

Transit agencies may discover that the best solutions to help the poor and handicapped (and the taxpayer for that matter) cannot be found in a rail car.

Competitive Participation in U.S. Public Transport: Special vs. the Public Interest

By Wendell Cox, PhD.

There is always a conflict between the interests of consumers and producers. Quite simply, the consumer wishes to obtain the most within the constraints of his available income. At the same time, the producer wishes to obtain the most in income for each unit of production. Competition, which operates through the market, forces producers to compete with one another for the business of customers, which lowers prices, to the general advantage of the consumer.

Producer interests prevail in monopolistic (and oligopolistic) situations, which is why governments tend to regulate monopolies, partly because of the belief that they are not driven by the same profit motive that impels private monopolies to force prices higher. And, while the same profit motive does not operate in government, another profit motive does, and one that may sometimes impose even higher prices than would occur in a non-regulated private monopoly. The difference is that the monopoly premiums are buried on higher-than-market payroll (wage and employee benefit) costs, which trade unions are able to obtain in the non-regulated, non-competitive environment. Monopoly premiums are also hidden in staff sizes, as managers perceive their career advancement to be enhanced by larger bureaucracies and as trade unions seek work practices that make production more expensive and thereby less productive.

These inherent costs of government monopoly have brought about a world-wide trend toward competition in urban transport. Public transport monopolies around the world have tended to deliver less than would have been provided at market rates. Yet, the necessity of subsidy, at least in the West, made it difficult to rely upon an unregulated private market, and instead many jurisdictions turned to the market and tendered services competitively under fixed-term contracts that were re-competed at their expiration. Generally, the results have been favorable, with substantial cost savings in places as far apart as London, Stockholm, Copenhagen, Florence, Washington, Denver, Johannesburg, Adelaide, Perth, Auckland and Melbourne.

Such favorable results have sparked international interest in using the competitive sector to develop public transport infrastructure. In some cases, major projects have been completed with little or no government subsidy, as in the case of the Eurotunnel and the Heathrow Express. Even where government subsidy has been provided, competition has often been viewed as a method for more effectively delivering needed infrastructure, maintenance, and operation.

Having perhaps the world's leading reputation for relying on free markets, the United States might be expected to lead the charge in implementing competitive approaches to public transport operations and investment. On the contrary, progress in the United States has been slower than virtually any other high-income nation in the world, except for perhaps Canada.

Privatizing Welfare Eligibility

Welfare reform in 2004 shows that a few states have moved closer to the goal of integrating social services and streamlining the welfare eligibility process to provide families with access to a wide selection of services through a single point of contact. While technology is now available to radically transform the way eligibility for social services is determined, the federal government has been reluctant to grant states the right to allow the private sector to determine welfare eligibility. Federal law requires government employees to make the decisions about who qualifies for aid. The federal government has not yet granted a waiver to allow private contractors to determine service eligibility.

However, even without a federal waiver, Texas is on track to become the first state to privatize welfare eligibility. The Texas Health and Human Services Commission (HHSC) has proposed a plan that would allow Texans to apply for state services in person, through the Internet, over the phone, and by fax or mail. The state would establish call centers to receive and process applications, and consumers would be able to track the progress of their applications through an automated phone system. Rather than eliminating all state eligibility workers, Texas would meet federal eligibility requirements by keeping about 800 state employees in field locations to meet with applicants and make final decisions.

According to the HHSC business case, the current system was designed in the 1960s and has not incorporated modernized business processing and new technology to make it more effective. HHSC conducted an in-depth examination of the current system and found that it places a huge administrative burden on workers. Other findings include:

- Applicants usually make multiple visits to determine eligibility and, on average, interact with three to four employees at each visit.
- In 72 percent of the face-to-face cases observed, eligibility was not determined during the initial interview and the cases were pended for additional verification.
- Applicants may receive numerous pages of notices (some 15 pages in length) when applying for multiple programs.
- Faxes are retrieved at each office, sorted, logged and manually distributed. Once the intended individual receives the fax, the information is transcribed into the program application.

Under the new model, Texans would not have to take off work, pay for transportation or arrange child care to apply for services, and the process would also be much faster when consumers visit offices to initiate benefits. The plan would consolidate 600 DHS field and hospital-based offices into 164 field offices, where families would have to travel no more than five miles for services in urban areas, 15 miles in suburban areas and 30 miles in rural areas. By way of comparison, there are 71 Social Security offices and 233 full-time drivers' license offices in Texas. In addition, HHSC would maintain staff in 211 hospitals. Consumers

would be able to complete most recertifications and make basic changes, such as addresses, without an office visit by using the phone, mail or Internet. Eligible families will be able to access a variety of services, even across agency lines, with one application.

HHSC projects a net savings of at least $400 million over the next five years. It anticipates additional savings can be achieved by streamlining central office administration, information system support and other eligibility support functions. Currently, the Texas HHSC is accepting bids to run two to four in-state call centers that would help needy Texans apply for food stamps, cash assistance, Medicaid and long-term care through Sept. 30, 2004.

In Florida the Department of Children and Families is also moving toward privatizing benefits eligibility determination. Florida has struggled with its welfare system. DCF plans to streamline programs now run by three agencies, making it easier for whole families to enroll for multiple programs at a single site. Instead of waiting weeks to find out what aid they are eligible for, low-income residents would be guaranteed answers in three days. DCF estimates savings of $125 million over the life of a five-year contract. The welfare contracts are estimated to be worth $3 billion and would represent Florida's largest privatization effort. The plan is pending based on federal waivers to allow private contractors to determine welfare eligibility. In March 2004 Florida sought comments from potential bidders and several companies have proposals in the works.

In California, the governor's California Performance Review Commission recommended that the responsibility for deciding who is eligible for welfare, food stamps, and MediCal become a state-level responsibility. The CPR authors envision an Internet-based application for all three programs that would be run by a private contractor. California has a similar program in place for Healthy Families, the state's child health insurance program. CPR estimates that outsourcing welfare eligibility at the state level could save California $4 billion over the next five years.