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COMMENTARIES

COMMENTARY ON PRIVATIZATION: FORMS, LIMITS, AND RELATIONS TO A POSITIVE THEORY OF GOVERNMENT

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Professor Ronald Cass has provided us an invaluable review of the legal issues surrounding privatization.¹ As Professor Cass notes, the discussion of privatization thus far has centered on its economic and public policy dimensions, while the legal aspects have not attracted systematic treatment. Professor Cass' paper fills that void. In doing so, it is particularly helpful to those policymakers and economists who, like myself, are engaged in the privatization debate notwithstanding limited expertise in legal matters. Moreover, Professor Cass' general conclusion that legal impediments to privatization appear small will presumably be comforting to supporters of the concept.

These comments on Professor Cass' paper fall into three parts. First, I will venture some brief observations and minor criticisms regarding the Cass view of privatization. Second, I will discuss some ways in which the practice of privatization has weakened some of the legal constraints examined by Professor Cass. And third, I will consider certain legal questions largely ignored by Professor Cass — questions which make me a little less sanguine than he is about the future of privatization.

I. GENERAL OBSERVATIONS AND CRITICISMS

Professor Cass selects a broad definition of privatization, which includes virtually any policy, such as tax reduction, which reduces the size and scope of the public sector. Yet, Professor Cass strangely argues that the sale of government loan assets, which currently is the leading example of privatization in cash terms, is an invalid use of the term because it "does not significantly affect the nature or the amount of government activity."² By that logic, surely he should also exclude contracting out of government services.

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1. Cass, *Privatization: Politics, Law and Theory*, 71 MARQ. L. REV. 449 (1988) [hereinafter Cass].

2. *Id.* at 455.

Not only does contracting use the private sector as an agent of government power and policy, but, as I will describe later, it creates political and legal dynamics to extend government further. What first appears to be a clean and simple definition turns out to be more subjective upon closer examination. If we are to choose a broad definition, perhaps a better one would be privatization is the transfer of a function, in whole or in part, from the public sector to the private sector. Under that definition, both loan sales and contracting out would qualify.

In his discussion of the categories of privatization, Professor Cass seems to give insufficient consideration to the use of creative asset sales to establish positive externalities in the private sector as a means of pursuing public purposes without government control.³ The principal argument for land transfers (including homesteading) and public housing sales is not to raise money or to improve economic efficiency in a strict sense.⁴ Rather, its purpose is to introduce private ownership incentives which spill over as positive externalities. Thus, privatization may be appropriate in many instances to pursue public goals. This point still does not seem to be widely understood by many opponents of privatization who assume that a transfer of ownership and control to the private sector necessarily means a weakening of the public interest. This point also adds a complicating dimension to Professor Cass' otherwise tidy "comparative advantage" model of government.⁵

II. THE PRACTICE OF PRIVATIZATION AND ITS AFFECT ON LEGAL CONSTRAINTS

Professor Cass considers several instances where there may at first glance be legal limits to privatization. Generally, he concludes that these limits pose an insignificant threat to the policy. Yet a legal question can still impede a policy by making it difficult for politicians to proceed in the face of the hostility of parties with a sense of grievance. Therefore, these legal matters should be seen as a potentially greater threat in practice than Professor Cass identifies. On the other hand, privatizers have adopted a number of strategies which tend to reduce these dangers by mollifying those who might resort to legal action. A discussion of these follows.

3. Cass, *supra* note 1, at 556-58.

4. For purposes of this article, land transfers are considered as the sale of real estate from the public to the private sector.

5. Cass, *supra* note 1, at 484-87.

A. *Delegation of Government Functions and Public Liabilities*

Professor Cass notes that court decisions should enable most privatization activities, including deregulation, asset sales, and contracting out, to be carried out without undue restrictions arising from concerns regarding the power of government to delegate authority and liability.⁶ However, the use of force may raise more delicate questions. As Professor Cass explains, this issue could have significant implications for some areas of privatization, such as jurisdictions seeking to relieve prison overcrowding through the use of private prisons.

Notwithstanding this legal debate, governments have pursued privatization, while avoiding many of these concerns, by resorting to "partial" privatization. In these cases, the sensitive core function is retained firmly in government hands, but other aspects of the function are transferred in some manner to the private sector. Thus, a police officer who draws his gun to make an arrest may remain unquestionably a direct agent of government. However, the police officer may have been directed to the scene by a private dispatcher handling all emergency communications for the city; his car might be serviced by a private contractor; his morning cup of coffee supplied by a private coffee service; and his paycheck prepared by a private payroll firm. Privatization of this form appears to be on the rise at the state and local levels, enabling the private sector to enter many areas which traditionally, if not legally, have been seen as the exclusive domain of government.

B. *Public Guarantees*

Professor Cass notes that explicit commitments by government to guarantee certain services contained in state constitutions or statutes could pose obstacles to privatization. He further argues that privatization has not normally been held to contravene such guarantees, and constitutional requirements rarely rule out a private agent.

Asset sales tend to raise more difficult questions regarding public guarantees than does contracting-out or use of vouchers, because a sale implies the termination of both direct and indirect government involvement. Yet, minimum services can still be guaranteed through covenants attached to the sale. For example, consider the sale of Britain's telephone system, British Telecom, in 1984. One concern expressed at the time was that as a commercial enterprise and virtual monopoly, British Telecom would refuse to serve marginal or unprofitable customers and that it would shut down the

6. *Id.* at 522.

system of "lifeline" telephone boxes in remote areas. Thus, a covenant was placed in the sale contract to require the privatized company to continue these and other specific services. When Conrail was sold, a similar device was used to prevent the railroad from discontinuing services to certain communities. Needless to say, such covenants can easily be used by a legislature to guarantee private benefits disguised as public purposes, and that has undoubtedly been true in the case of Conrail. Moreover, as additional restrictions are placed on a privatized commercial asset, profits are likely to decrease and governments will realize a lower market value. At the opposite extreme, the burden of covenants may render an asset uneconomic to operate. Nevertheless, if used appropriately, covenants can be an effective way of maintaining public guarantees after a government has relinquished direct financial or management control of an asset.

Professor Cass agrees that statutory requirements which obligate the government to provide services may prove to be a more substantial barrier to privatization. However, he cites the record on deregulation as an indication that privatizers should feel reasonably confident that such statutory requirements can be overturned by legislative action. I am not sure the answer is so simple. The unusual political circumstances which led to the wave of deregulation in the 1970's have not, as yet, been repeated in the case of privatization. At the federal level, interest group coalitions continue to be very successful in thwarting privatization initiatives. Further, congressional opponents of privatization have been on the legislative offensive, adding new restrictions into the law. "National security" concerns, for instance, have been used as a justification for barring private contractors from bidding on many government services. In addition, Congress recently stopped the privatization of some functions, including the Power Marketing Administrations, by precluding the agencies involved from undertaking studies to test the desirability or feasibility of privatization. Such restrictions are increasing and pose a serious threat to privatization.

Public guarantees also raise questions about the continuity of service under a private contract. Some opponents of this form of privatization contend that it leads to the government's heavy dependence on the service of an organization it does not directly control, and that such a state of dependency violates service guarantees. Several local governments have faced a complete breakdown of basic services because a contractor became insolvent and breached the service contract. Of course, a public provision for a service by no means guarantees continuous service, as many New Yorkers

know.⁷ Nevertheless, several cities have experimented with ways to assure service continuity when a contractor fails. For instance, the city of Phoenix, Arizona was divided into four zones for garbage collection. Each zone was available for bidding with the condition that no one bidder could collect in more than two zones. In this way, the city could immediately call on another firm to provide temporary service should one contractor fail.⁸ Incidentally, this use of more than one supplier is routine among large manufacturers to avoid excessive dependency on any one source.

C. Externalities

Professor Cass explains that in most instances private contracts must involve a direct exchange of benefits and burdens for mutual net gain. Professor Cass further explains that public enterprises can separate burdens and benefits to achieve public policy objectives. Professor Cass suggests that two shortcomings of privatization are its tendency to fail to provide positive externalities and its tendency to be plagued with negative externalities and free-rider problems.

This view is questionable. First, privatization may, in many cases, remove negative externalities associated with government. Unless one simply defines legislative actions as being in the public interest, it is difficult to deny that many public sector activities are encumbered with burdensome requirements and special benefits that serve powerful private constituencies rather than a genuine public purpose. By eliminating these benefits, special-interest privatization may in some instances be a more efficient method of achieving a public objective.

Second, there are many cases in which privatization not only eliminates negative externalities associated with government, but actually creates positive externalities which achieve public purposes more effectively than are possible in the public sector. Two examples of privatization may illustrate this point. First, management and ownership of public housing projects by residents improves efficiency and reduces operating costs. But experience indicates that this has a greater impact than cutting housing costs for government. Once in control of a project, residents have an incentive to seek ways of reducing welfare dependency and to create employment, since these increase the rent each household can pay. These actions further the public policies of reducing dependency and generating employment in poor neigh-

7. Strikes by garbage collectors and other public employees are common in New York and other cities.

8. Dudek, *Going Private . . . Paying Less?*, ST. LEGIS. 26 (Mar. 1987).

borhoods. Thus, the private tenant-landlord relationship leads to positive externalities.

The privatization of public land can lead to similar benefits. The New Resource Economists, based in Montana, point out that the management incentives associated with public ownership of land often lead to environmental damage. For instance, with the budget of the Forest Service linked to the amount of rehabilitation work undertaken, the Service has an incentive to overcut. Similarly, public ownership of wilderness lands makes it difficult to resolve conflicts between the public policies of environmental protection and mineral exploration.

Scholars of the New Resource School point out that ownership of timberland by private companies actually would reduce environmental damage, since the companies would have the incentive to preserve their valuable assets and not overcut. The scholars also note that private ownership of wilderness lands by environmental groups has resulted in a better balance between land conservation and use of its assets, thereby achieving a public objective.⁹ For example, the National Audubon Society owns over seventy wildlife sanctuaries totaling over 200,000 acres, the largest of which is the 26,000 acre Rainey Preserve in Louisiana. This refuge is so sensitive that tourists are unwelcome, and yet three oil companies operate gas wells in the sanctuary under strict Audubon control. These wells generate approximately \$250,000 a year in revenues for the Audubon Society, which they use to purchase additional lands.¹⁰

D. *Private Entitlements*

Professor Cass assures us that private entitlements associated with a government function do not pose a serious legal barrier to privatization. That may be true, but as the Public Choice economists explain, such entitlements often constitute valuable property rights. This induces the beneficiaries to campaign long and hard against a policy change that will reduce or eliminate the value of those rights. That is one reason why public sector unions have mounted strong and effective campaigns to block privatization.

Political barriers associated with private entitlements are more threatening to privatization than the legal constraints. This has led privatization strategists to explore ways of persuading the beneficiaries of these entitlements to freely choose privatization over government control. The most successful of these approaches has involved buying out the entitlement in

9. See generally T. ANDERSON, *The Market Alternative for Land and Wildlife*, in *PROTECTING THE ENVIRONMENT: A FREE MARKET STRATEGY* — (D. Bandow ed. 1956).

10. See generally Banden & Stroup, *Saving the Wilderness*, REASON (July 1981).

exchange for an acceptance of privatization. Buy-outs usually make good economic sense for two reasons. First, privatization normally involves a net economic gain, by virtue of improved efficiency. Thus, the government can offer part of this gain as an inducement in the buy-out package at no net cost to itself. Secondly, there is a tendency among many employees to accept an immediate settlement with less value than the present value of future entitlements, such as pensions, because of the preference for cash in hand and because of the political risk associated with government control of future benefits. Thus, it may often be possible to reach a buy-out settlement for less than the liability held by the government.

Buy-out inducements have become a common feature of privatization in other countries. The British government, for example, routinely offers free and discounted stock to the employees of companies targeted for privatization. This strategy has been highly successful in breaking down the political resistance of public sector workers. Similarly, selling public housing at a discount in Britain enables the government to buy out the tenants' entitlement to below-cost rents. In the United States, the buy-out principle might prove effective in addressing politically difficult privatization cases such as the Postal Service or Amtrak. Transferring to workers those assets which cannot, in practice, be liquidated by the government might be a sufficient inducement for employees to forego the substantial benefits associated with government employment.

III. REMAINING LEGAL QUESTIONS

While Professor Cass dealt thoroughly with most of the legal issues confronting privatization, I believe he overlooked two important areas. Those of us concerned with the policy of privatization need guidance on these issues.

The first issue concerns contracting out. Those who interpret privatization as a net reduction in the scope of government often have mixed feelings about contracting out. Their anxiety stems from the fact that contracting out usually leads to pressure from the contractors to increase total government spending on contracts. Thus, even if the cost of each service is reduced through contracting out, strong contractor-generated political pressure often develops to increase the supply of services. The phenomenon is well recognized in the case of weapons procurement under contract. It is also common in the field of human services. Most government funded social services in this country are delivered by private contractors, usually nonprofit organizations. Indeed, almost two-thirds of the income of nonprofit welfare organizations comes from government, which lead Lester

Salamon of the Urban Institute to describe these groups as "third party government."¹¹

A legal question arises because these private agencies of government are increasingly resorting to regulatory, statutory and judicial means to reduce the degree of competition they face. For instance, human service organizations, including teacher unions, have been very successful in persuading states to erect barriers to entry based on credential requirements. These two barriers reduce the potential supply of contractors available to the government and thereby increase the market price of the service, reducing the economic advantage of this form of privatization. It would have been helpful if Professor Cass had addressed this, explaining whether recent decisions affecting the licensing of professions suggest a reduction in the power of contractors to limit markets.

The second issue concerns vouchers, and is much more disturbing. Vouchers have long been held by privatization supporters to be the form of privatization most appropriate to the service needs of low income people. Where a market exists, vouchers enable those with inadequate income to obtain an acceptable standard of service. However, *Grove City v. Bell*¹² brought to the surface the question of whether government aid to an individual implies the right of the government to subject an institution, providing services to such individuals, to regulations normally reserved for institutions receiving direct governmental aid. Although the Supreme Court interpreted that right narrowly under existing law, Congress seems determined to broaden the definition of a recipient institution.¹³

Congressional action could have profound effects on vouchers earmarked for education, food, housing and other services. Refusal to accept vouchers could subject an institution to a discrimination action. However, acceptance of vouchers could invite government regulation. Vouchers may turn out to be a poisoned chalice that cannot be refused. Thus, ironically, the voucher method of privatization could actually extend the power and domain of government, rather than reduce it.

Perhaps these fears are groundless or merely the exaggerated concerns of a nonjurist. But if contracting out and vouchers lead to an increase in government spending or control, then according to Professor Cass' definition of privatization, two mechanisms, once assumed to aid privatization,

11. L. SALAMON & A. ABRAMSON, *THE FEDERAL BUDGET AND THE NONPROFIT SECTOR* 44 (1982).

12. 465 U.S. 555 (1984).

13. While legislation to this effect has been submitted to the House and Senate this author will not speculate as to whether the legislation will be passed or vetoed in Congress.

would turn out to be “wolves in sheep’s clothing.” That should make us worry far more about the legal aspects of privatization than Professor Cass implies.