

CATO HANDBOOK FOR CONGRESS

POLICY RECOMMENDATIONS FOR THE 108TH CONGRESS

CATO
INSTITUTE

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32. Privatization

Congress should

- privatize Amtrak by selling the passenger rail service, including operations, maintenance, stations, rails, and trains, as a single unit and ending all federal subsidies;
- privatize air traffic control by moving all operations to a private nonprofit corporation similar to Canada's;
- expand the opt-out program for federal airport security to cover more airports; allow airport operators in the opt-out program to hire security employees directly or to contract out for security services; and monitor all airport screening operations to make possible performance comparisons;
- privatize federal electric utilities by selling the Tennessee Valley Authority and the four power marketing administrations to private investors;
- support competitive outsourcing by embracing the Bush administration's management reforms and adopting the Commercial Activities Panel's recommendations on federal contracting; and
- hasten privatization of military support services by allowing private operation of the entire military housing inventory, accelerating military utilities privatization, and giving the Pentagon more flexibility in the contracting-out process.

Amtrak

For 30 years, Amtrak has provided second-rate passenger rail service to Americans at higher-than-competitive costs while consuming more than \$25 billion in federal subsidies. Today, Amtrak passengers pay a higher fare per mile than the average airline or bus passenger—and that is on top of all the taxpayer costs.

Against the backdrop of rail privatization in numerous foreign countries, Congress created the Amtrak Reform Council in 1997 to study major rail reforms. One ARC goal was to assess whether Amtrak could break even by the end of 2002 with fares covering operating costs. In December 2001, ARC issued a finding that Amtrak could not meet that target. ARC then developed reform plans that would end Amtrak's monopoly on passenger service, spin off its Northeast Corridor infrastructure, and permit states and private entities to bid for Amtrak routes.

Around the world, momentum for rail privatization is strong, although there have been a few setbacks. For example, Railtrack, the private owner of British Rail's infrastructure (track and stations), went bankrupt. But big mistakes were made in the structure of British reforms. British Rail privatization involved the separation of infrastructure from newly created private train operating companies. As it turned out, the operating companies were so successful at increasing passenger and freight volume (up 26 percent and 34 percent, respectively, in four years) that traffic overwhelmed Railtrack's infrastructure. The infrastructure had suffered decades of low investment under government ownership. Because 90 percent of Railtrack's revenue came from fixed charges, it had little incentive to expand capacity to meet the new demands.

The fatal flaw in Railtrack's privatization was the separation of track from operations. Most countries that have privatized their rail systems, including Argentina, Australia, Japan, and New Zealand, have maintained vertical integration in the rail system (sometimes with separate regional companies). Australia recently sold two more such regionally vertically integrated rail units. The Japanese government plans to sell its remaining stakes in three privatized railroad firms: JR East (of which it still owns 13 percent), JR West (32 percent), and JR Tokai (40 percent). The German government is dropping plans to separate track from train operations as it prepares to privatize Deutsche Bahn by 2005.

The United States should not fall behind the worldwide trend of rail privatization. Amtrak should be sold as a single unit including operations, maintenance, stations, rails, and trains. Americans deserve better rail service than the government has provided, and taxpayers deserve an end to federal subsidies.

Air Traffic Control

President Bush was right in saying that air traffic control (ATC) is not "an inherently governmental function" when he signed Executive Order

13180. That order is a first step toward ATC privatization in that it sets up a performance-based federal ATC agency.

During the past 15 years, nearly two dozen countries have partly or fully privatized ATC services. Some, such as Germany, have created self-supporting government corporations for ATC. Others, such as Canada, have created fully private nonprofit corporations. Canada's reforms provide an excellent model for future U.S. reforms. Nav Canada was set up in 1996 to take over all Canadian ATC responsibilities. As a nonprofit company, it has a board of directors made up of various aviation stakeholders. It is fully self-supporting from fees and charges paid by aviation users. The new Canadian system has received rave reviews for investing in the newest technology and substantially reducing air congestion.

In Britain, ATC has been moved to the National Air Traffic Services company. NATS has a public-private corporate structure with 46 percent of shares owned by the Airline Group (a consortium of the U.K.'s main airlines), 49 percent of shares owned by the government, and 5 percent of shares owned by employees. Like Canada's system, NATS is self-supporting from fees and charges.

The cutbacks in air travel following the terrorist attacks in 2001 have created challenges for the privatized ATC corporations. But Nav Canada and NATS have responded nimbly by reducing costs and postponing new expansion projects. Meanwhile, the U.S. government's ATC in the Federal Aviation Administration has done just the opposite. In response to falling traffic, it has requested more money from Congress.

The United States should be a leader rather than a follower in air traffic control, especially given this country's remarkable legacy of aviation innovation during the past century. Privatized ATC can help reduce transportation congestion, increase cost efficiencies, and provide Americans with greater safety by speeding the adoption of new technologies.

Opt-Out Program for Federal Airport Security

The federal takeover of airport passenger screening was a big mistake and has run into serious troubles. After the terrorist attacks in 2001, legislation was passed allowing the new Transportation Security Administration to take over screening of passengers and baggage at all 429 U.S. commercial airports. The TSA needs to hire and train 33,000 passenger screeners and 21,600 baggage screeners. The huge hiring demands have created large problems.

To ease the problems, a modest pilot program that allows some airports to opt out of the new government-run passenger screening system should be expanded. In enacting the new airport security legislation, Congress compromised between the Senate's bill, which called for 100 percent federal screening, and the House bill, which would have left to each airport director the decision of whether to use federal workers or outside security firms. The compromise permitted five airports to opt out of federal security as of November 2002 and allowed other airports to opt out as of November 2004.

A significant expansion of the initial pilot program is needed for a number of reasons. First, five airports with private screening are a sample far too small to provide good comparisons between private and government screening. Allowing at least 40 airports to opt out would provide far better comparative information. Second, the more airports that opt to use private contractors, the smaller the workforce that TSA needs to recruit and train. Judging by the high demand of airports to get one of the five initial opt-out chances, a large share of all U.S. airports would choose to opt out if allowed to.

Airports have important reasons for wanting to opt out of government-run screening. One is the possibility of obtaining a higher-quality workforce. For example, New York's JFK International Airport applied for the opt-out program with a proposal calling for screening by a security firm staffed by retired law enforcement officers—people with experience in explosives, weapons, interrogation, and crowd control. Unfortunately, JFK's proposal was turned down.

Another reason cited by airport directors for favoring private contractors is greater staffing flexibility. For example, flight activity levels at airports often change rapidly. Unless the passenger screening system can quickly staff up and down in response, there are unacceptable delays in screening passengers.

The United States has nationalized its airport screening, but European airports have successfully used private contractors for years. Nearly all large airports in Europe and Israel (32 of 34) have shifted from civil service workers for passenger and baggage screening to private security firms in the past decade. In those countries, the government sets training and performance standards and provides strong oversight of private contractors. By contrast, prior to September 11, 2001, U.S. airports generally used low-bid contractors for passenger screening instead of focusing on quality service.

Congress should also think further about the government's longer-term role once all airports are allowed to opt out in November 2004. Europe's experience suggests that airport security works best under a unified approach controlled by the airport director. That differs from the new U.S. approach, which has some parts of security under TSA and other parts under airport responsibility. Note also that a clear conflict of interest exists in having the TSA be both a provider of airport security and the airport security regulator.

After 2004, TSA should focus only on standard setting and regulatory oversight, and airports should adopt privatized security. The TSA has ample time before 2004 to fine-tune standards and procedures and to train a high-quality airport screening workforce. That workforce would eventually go to work for airports, either directly as employees or indirectly as employees of qualified screening contractors hired by airports.

Federal Electric Utilities

The federal government is the nation's largest electric power organization, as owner and manager of the Tennessee Valley Authority and four power marketing administrations (PMAs), which have operations that span much of the country outside the Northeast. These electricity businesses, along with federally subsidized cooperative and municipal utilities, are poorly managed and out of step with the new environment of electricity competition.

Government-owned electric power generation originally had two justifications. First, it was thought that private electricity companies would not find enough profit in electrifying rural America, thus requiring that government step in and serve those areas. Second, it was thought that government could provide power to consumers at lower prices than could private companies because it could set prices "at cost" without worrying about profit margins.

The first justification is now irrelevant because rural America has been thoroughly electrified. Moreover, 60 percent of rural America is served by investor-owned utilities. The second justification—that government power would be cheap—was socialist pie-in-the-sky thinking. Government electricity generation has proven to be more costly than private generation.

The United States lags behind other countries in freeing itself from government-owned power generation. Indeed, between 1990 and 1999 the value of worldwide electric utility privatization was \$65 billion, according to Reason Foundation figures. Major countries, such as Australia, Britain,

Canada, and Germany, have launched electricity privatization programs in recent years.

Other countries have privatized electricity for numerous reasons. One reason has been to improve the efficiency and performance of backward electric power systems. Another reason is that countries have sought to raise funds to reduce government budget deficits. Both objectives are applicable to the United States. In 1996, the Clinton administration did propose privatizing the PMAs, but Congress and various anti-reform groups shot down the proposal.

The sale of all the federal power enterprises could raise between \$20 billion and \$35 billion to help reduce the federal deficit. The Clinton plan was estimated to bring in between about \$3 billion and \$9 billion. The Congressional Budget Office has estimated that sale of the three smallest PMAs and related hydropower assets would bring in from \$8 billion to \$11 billion. Sale of the Bonneville Power Administration would bring in about \$9 billion. The former head of the TVA estimates that that utility could sell for as much as \$10.5 billion.

Government-owned power generation is a throwback to early 20th-century thinking that governments could operate business enterprises in a cost-effective and high-quality manner. Few economists believe that today, and it is time for the U.S. government to catch up to electricity reforms made in other countries to establish private competitive electricity systems for the 21st century.

Federal Competitive Outsourcing

A major fiscal theme of the Bush administration is reform of the federal bureaucracy to make it work more efficiently. As part of that agenda, the administration is promoting the contracting out of many federal functions to private companies. Indeed, surveys of private companies have found that firms are seeing substantial increases in revenue from federal contracting in recent years. In addition to the Bush initiatives, earlier legislation, including the 1994 Federal Acquisition Streamlining Act and the 1998 Federal Activities Inventory Reform Act, helped increase the level of outsourcing.

As legislation has removed barriers to outsourcing, agency demand for outsourcing has grown as staffing challenges have increased. For example, federal spending on information technology is expected to continue climbing. Yet many federal technology workers are expected to retire in coming years, thus creating difficulty in continuing to provide technology services in-house. As a result, outsourcing will likely grow in importance.

The Bush administration is promoting ambitious goals for federal outsourcing. The administration plans to have agencies competing 15 percent of all positions by 2004 and 20 percent per year after that. Under the FAIR act, agencies in 2001 identified about 850,000 positions as commercial in nature and possibly subject to outsourcing. President Bush's ultimate goal is to have agencies put half of those jobs to competition with private providers.

Both the FAIR act and the government's process for outsourcing (under Office of Management and Budget Circular A-76) have been controversial. The General Accounting Office has convened a panel to examine outsourcing in general and Circular A-76 and FAIR in particular. The Commercial Activities Panel held a series of hearings in 2001 and provided recommendations to Congress in May 2002. The recommendations strongly supported continued emphasis on contracting out.

The president's outsourcing goals do face numerous hurdles. Many agencies have been slow to embrace the challenge. For example, in January 2002 the Department of Defense announced that it would halt all competitions of its workforce. But soon after, the DoD said that it was back on board with a plan to outsource roughly 70,000 jobs over the next two years. Congress should strongly support the administration's goal of reforming the federal workforce.

Privatization of Military Support Services

Military Housing

Recent efforts have sought to make military service more attractive. At the top of the list of needed reforms is improved housing. In 1996, the Department of Defense identified about 177,000 of its 290,000 family housing units as inadequate. Initial estimates suggested that it would take 30 years to fix the housing problem using traditional military construction. In a reform spirit, Congress passed new laws to enable DoD to use private-sector financing and expertise for housing. As a result, DoD believes that it will have all military families adequately housed by 2008—more than a decade and a half sooner and more inexpensively than would have been possible using standard methods.

The fiscal year 1996 defense authorization act granted DoD broad flexibility to work with the private sector to build and renovate military housing. The DoD could obtain private capital to leverage government dollars and to enter into limited partnerships with private developers to

construct, renovate, and maintain housing. Among other benefits, the new flexibility allows DoD to deal with variations in local real estate markets.

Fort Carson in Colorado is DoD's largest privatization effort so far, and it is the first installation to fully privatize all its on-post housing. In 1999, Fort Carson Family Housing, LLC, assumed the operation and maintenance of 1,823 family housing units. The company agreed to renovate those units by 2005 and to build 840 new units by 2004. The company will own, operate, and maintain all housing on Fort Carson for at least the next 50 years. Fort Carson is being heralded as a big success, and privatization is being seen as a good way to quickly and permanently fix military housing problems.

Other military housing upgrades being performed by the private sector include those at the naval station in Everett, Washington, Camp Pendleton in California, and Elmenorf Air Force Base in Arkansas. Estimates show that all those projects will cut construction costs substantially and save federal taxpayers millions of dollars.

Military Utilities

As part of the FY98 defense authorization act, Congress passed a military utilities privatization initiative. The law allowed military services to enter into agreements with private utilities for service provision and to retain any cost savings realized. Those reforms were prompted after reviews found that DoD was wasting millions of dollars on utilities that were obsolete and unreliable.

The U.S. military currently has about 2,700 electric, gas, water, and wastewater systems on bases. About 1,000 of those are leased from contractors, owned by utility companies, or must be operated by the military for security reasons. As of 2002, only 29 of the other 1,700 systems had been privatized. The effort has been delayed by the complexity of privatization, the deregulation of the electric industry, and the California energy crisis. Also, the military has been releasing too many requests for proposals simultaneously, thus overwhelming contractors who can bid on only so many projects at a time. The original plan was to have privatized about 1,600 utilities by September 2003, but that goal has proved to be too optimistic.

More flexibility needs to be added to the process. Some observers argue that the slow pace of contracting has resulted from unattractive bids. But DoD should be able to look beyond initial bid costs and evaluate long-term benefits from enhanced operational qualities of private utility systems.

Also, new guidelines should allow the different military services to take different approaches to privatization. Privatization of functions that have always been performed by the government can be a learning experience, but the large potential benefits are well worth the hard efforts.

Suggested Readings

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