

PRIVATIZATION: A STRATEGY TO CUT THE BUDGET

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Introduction

Even the most die-hard supporters of Ronald Reagan are waking up to a very unpleasant fact: He has not cut the federal budget—in real or nominal terms—and there is little reason to suppose that he will do so in the remaining years of his tenure at the White House. As a proportion of GNP, spending surged in the first three years of Reagan's initial term, ending any hope of even bringing spending down to the proportion of output consumed by Washington during the Carter "big spending" years, let alone achieving Reagan's original objective of a dramatic rollback of the federal sector. And even though the step-up in military outlays was clearly an element in the growth of government, that was factored into the original White House spending projections. The real problem has been a failure to win congressional approval for significant cuts in domestic social programs.

Some social programs have certainly been cut. To judge from the media coverage, one might suppose that these cuts have been draconian. Far from it. Means-tested welfare spending actually increased over 7 percent between 1980 and 1984. More important, the entitlement programs benefiting middle-class Americans, including Social Security, Medicare, and federal retirement, expanded by more than 17 percent in real terms during Reagan's first term.

This inability to turn the spending tide slowly transformed David Stockman from a can-do *wunderkind* into a frustrated and embittered cynic. Those who still urged a determined attack on entitlement

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programs he dismissed as “dreamers” in a 1984 *Fortune* interview. Forget the idea of getting spending down below 20 percent of GNP, said the budget director, “The minimum size of government achievable appears to be 22 percent to 23 percent of GNP.”¹

The easiest reaction to this utter failure to cut spending would be to join the chorus now excoriating the White House and its congressional supporters for their supposed lack of resolution in holding the budget line. Yet it is hard to fault the Reagan administration on its determination to follow through with the 1980 election pledge to reduce the size of government. The lost Battle of the Budget has had nothing to do with any absence of will—but it has much to do with obsolete political weaponry. The critical strategic mistake of the administration was its assumption that the only way to contain and then cut the budget was to seek legislation to cut the supply of dollars leaving Washington—one might call it a “supply side” view of the budget. This led the White House to view spending in aggregate terms and to regard the budget problem solely as one of managing and restraining expenditures. Congressional tactics then centered on identifying program cuts that would add up to the aggregate target.

The fatal flaw in this supply-side view of the budget process is that it largely ignores the demand side of the political process. It overlooks, in other words, the subtle process by which government programs grow and are defended by the efforts of powerful coalitions. These coalitions do not compete for a fixed amount of spending set by Congress. Quite the opposite. Total federal spending is the cumulative result of successful political demands by these coalitions. Trying to cut down the size of government by holding down total outlays, without first tackling this constituency pressure, is like trying to stop a pot from boiling by clamping down on the lid.

The Reagan administration will prove no more successful in its second term at cutting spending unless it devises a strategy to block or divert the demand pressure for spending. Only if the constituency heat is turned down will congressional supporters of smaller government be able to vote their principles—and be reelected. To change the underlying political dynamics of spending, the administration should look hard at the enormous potential of privatization, that is, the shifting of government functions to the private sector. So far the Reagan administration has viewed privatization simply as a way of bringing down the cost of government programs by utilizing more efficient private-sector suppliers. But a closer look at the dynamics of the budget reveals that privatization could become a potent polit-

¹“David Stockman: No More Big Budget Cuts,” *Fortune*, 6 February 1984, p. 54.

ical weapon to eliminate programs. With suitable incentives as a catalyst, a privatization strategy would create "mirror image" coalitions in opposition to the constituencies now pressing for federal spending, which would divert the demand for many services out of the public sector and into the private sector. Privatization thus offers an opportunity to turn down the political heat for federal programs.

Why Spending Increases: The Federal Ratchet

To appreciate why privatization could be so effective, it is first important to understand how spending increases and why programs are so resistant to demands for cutbacks.

Government programs tend to grow according to a now-familiar pattern. The first step is the creation of a relatively small program to aid a limited group. This might be a group of distressed or disadvantaged Americans, such as impoverished single parents with dependents (note more recently, pressure to provide federal aid to the homeless). It might involve a specific industry or sector with supposedly special problems, such as agriculture or small business. Or it might be a traditional All-American pork-barrel project to help politically sensitive areas of the country, such as urban development assistance. Normally the budget allocation is so small that the program can be financed without any significant extra burden on the individual taxpayer.

Once this initial funding has been voted and the new program created, however, a constituency soon coalesces around the program. The resulting coalition consists of three powerful elements:

1. *Beneficiaries and "Near" Beneficiaries.* New programs rarely satisfy the expectations of the targeted beneficiaries: The original Social Security benefits seemed meager after a while, for instance, and recipients of food stamps never have quite enough to eat. So it is not long before beneficiaries of programs form organizations and enlist lobbyists to press for more spending. Moreover, there are inevitably those who do not quite make the eligibility criteria of the original program, yet still feel they meet the intent of the law: They may have just one more employee than the criterion set for "small" business assistance, or be a poor neighborhood in an otherwise prosperous city ineligible for development grants. These "near" beneficiaries, as one might call them, soon begin to argue vociferously that they have been "unfairly" excluded from the program. Usually it is far less painful, politically, for Congress to expand the program to include them than to spread existing funds more thinly. But once

this group of near beneficiaries is accommodated, another group invariably appears.

2. *Administrators.* More federal spending means more jobs and promotion opportunities for federal employees who administer programs. So officials have good reasons to join with beneficiaries, albeit discreetly, in lobbying for the expansion of the programs that employ them. And even if officials are not motivated by self-interest, the very fact that they are in government service tends to lead them to the conclusion that government—indeed their own agency—must play a significant role in solving the country's problems. As Martha Derthick notes in her study of the growth of Social Security: "The prevailing technique of policy analysis [within the Social Security Administration] was to identify a social problem, such as lack of health care, and to develop the arguments and methods for dealing with it through social insurance."²

3. *Service Providers.* The private sector is not immune from the lure of federal largesse. When roads are built with federal money, private construction firms prosper. When there is a defense buildup, that means jobs in the aircraft industry. When welfare spending is increased, a corps of human-service professionals can look forward to a more secure future. So segments of the private sector are inevitably drawn into the coalition lobbying for more spending.

These three-pronged coalitions provide the underlying momentum for increased federal outlays. And the balance of political advantage is with the spending coalitions. The outlays are concentrated on only a small segment of the entire population, yet the tax and borrowing cost of the outlays is spread over all taxpayers. Since most of these costs are not even in the form of explicit individual taxes, but are hidden in corporate taxes (passed on in higher prices), government borrowing, or inflation, the direct tax burden of any particular program on any particular taxpayer is usually trifling. So the taxpayer has little financial incentive to spend time or money opposing any one program, even if he grumbles about spending levels in general. Yet the coalition member often has every reason to engage in time-consuming and expensive campaigns to convince the public that preserving his program is essential to national well-being, or to win congressional approval for new outlays.

Success in this process is made easier by two techniques routinely used by the public-spending coalitions. First, whenever possible lobbyists press for a federal program rather than a state or local

²Martha Derthick, *Policymaking for Social Security* (Washington, D.C.: Brookings Institution, 1979), p. 25.

government program. The reason for this is very simple—the tax costs of benefits are spread wider and thinner in a federal program, and so the determination of any taxpayer to oppose the program is reduced. Second, sophisticated lobbyists make sure that they do not ask for everything at once. An expensive new program may be voted down in a head-to-head confrontation in Congress, but a modest program may seem insignificant. Yet it provides the nucleus around which a coalition can form, leading to a build-up of political pressure for incremental expansion.

This balance of political forces, of course, only operates in the direction of increased spending. Cutting or, worse still, eliminating a program strikes hard at the interests of the concentrated coalitions supporting it. Yet savings achieved by cutbacks are spread thinly over all taxpayers—at least in theory. Usually they are not spread at all—it is a long time since Americans received a tax rebate because Congress cancelled a program. Consequently, when budget cuts are threatened, powerful lobbies spring into action. “Studies” are commissioned by the coalitions and their congressional supporters to show the calamitous results that would surely follow spending cuts, distraught witnesses are paraded through well-publicized hearings, and, for good measure, proponents of reductions are portrayed as anti-poor, dogmatic, soft-on-defense, or whatever epithet most effectively isolates them from good Americans. And as Ronald Reagan discovered when his budget request landed on Capitol Hill earlier this year, his backbone middle-class constituency becomes the most implacable defender of a federal role when its own programs, such as Social Security, are threatened.

The whole process is like a ratchet. Movement occurs only in one direction. The underlying political dynamics leads to “creeping” federal spending, as small new programs are quietly launched, additions grafted on to existing ones, and cuts blocked with fierce determination. Even when taxpayers are sufficiently aroused to demand cuts by Congress, supporters of an active federal government are careful to ensure that although outlays may be trimmed, as few programs as possible are actually eliminated. In this way the coalitions remain intact, ready to fight another day.

Constructing a Private-Sector Ratchet

Complaining about public-spending coalitions achieves little more than high blood pressure. But developing methods to entice the public to choose a private rather than a public way of promoting their self-interest may achieve a great deal. Privatization seeks to shift

functions out of the government sector by using a carefully crafted set of inducements. The privatization strategy recognizes the existence of the federal ratchet and imbalance of political forces favoring spending. But instead of trying to win an unwinnable war of attrition over the budget, privatizers attempt to turn the political flank of the spending coalitions.

Privatization does not necessarily deny that government, as the instrument of society, has an obligation to ensure that goods and services should be provided for certain public purposes. But a distinction is drawn between government as a *provider* (implying that government should levy taxes and deliver services itself), and government as a *facilitator* (implying that it should encourage or require those services to be provided by the private sector). Privatization, in other words, means seeking to transfer programs into the private sector using the carrot of incentives, not the stick of aggregate cut-backs. Rather than trying to frustrate political demands for spending, it means *deflecting* that demand into the nongovernment sector.

In this emphasis on the consumer's reaction to incentives and the "price" of alternative ways of satisfying his demands, privatization is analogous to microeconomic analysis, whereas traditional budget management is more akin to macroeconomic attempts to manage the economy. Indeed, one of the leading privatization theorists, Madsen Pirie, coined the term "micropolitics" to distinguish the privatization approach from other budget strategies:

Micropolitics is the art of generating circumstances in which individuals will be motivated to prefer and embrace the alternative of private supply, and in which people will make individual and voluntary decisions whose cumulative effect will be to bring about the desired state of affairs. The process of transfer from [the] public to [the] private economy is most securely achieved when its progress is evolutionary, arising from free decisions.³

While deflecting demand in this way constitutes the broad strategy, the political tactics to achieve it consist of using incentives and other devices to create coalitions of beneficiaries, near beneficiaries, service providers, and private sector administrators to lobby for an expanding private role in delivering what is now a federal program, just as the pro public-sector coalitions currently lobby for increased federal spending.

These privatization coalitions are the mirror image, so to speak, of the public-sector coalitions. And they are at the heart of the strategy

³Madsen Pirie, *Dismantling the State* (Dallas: The National Center for Policy Analysis, 1985), p. 29.

to create a “privatization ratchet” to counter the federal ratchet. By providing a targeted benefit (such as a tax incentive or some regulatory relief) to those who demand or provide a private alternative to government, considerable rewards can be guaranteed to individuals within the coalition. Members of that coalition can be expected to press for deeper incentives and to oppose any move to eliminate existing incentives. Similarly, near beneficiaries can be counted upon to demand inclusion under the terms of the incentive. On the other hand, the cost of the incentives spread thinly and widely—even assuming, for the sake of argument, that tax relief for one group implies an additional burden for everyone else. So there is little will to resist the coalition’s demands.

Privatization thus turns conventional political dynamics on its head. Lobbying pressure develops for less taxation (if a tax incentive is given), and for private, not public, programs. Moreover, each legislative victory won by the coalition, however small, serves to strengthen it, thereby adding to its capacity to achieve further legislative concessions and a corresponding growth in the private program.

As the privatization coalition grows, and constitutes an attractive alternative to government programs, the equivalent public-sector coalition becomes less powerful. Thus a government that assiduously cultivates privatization becomes increasingly able to confront proponents of government programs and to win budget cutbacks in the traditional way. Yet it is only by altering the underlying political balance, through a privatization strategy, that victories in Congress can be obtained.

The Case of IRAs

To appreciate how the politics of privatization work in practice, consider Individual Retirement Accounts (IRAs) and Social Security.

Social Security is a classic example of the federal ratchet in operation. Established in 1935 to provide Americans with modest retirement benefits financed by a payroll tax, Social Security has mushroomed into an enormous program accounting for one-fourth of all federal outlays, guaranteeing a retirement income, disability benefits, spousal benefits, and medical care. As Ronald Reagan has learned the hard way, any politician who even talks about trimming these benefits significantly invites the wrath of an extremely powerful constituency.

Yet a minor provision in the 1981 tax act may eventually break up that coalition, if the White House seizes the opportunity it has been given. By allowing all working Americans to open tax-deductible

IRAs, Congress planted the seeds of a private alternative to Social Security. The \$2000 annual deduction now available is a concentrated benefit only available to those choosing to open these accounts, while the “cost” (again, assuming that there is a corresponding cost) is spread over all taxpayers, ensuring that the political advantage is with the supporters of IRAs.

It was not long after the passage of the 1981 act that banks and other financial institutions (the administrators and service providers of IRAs) began a massive campaign to encourage Americans to open retirement accounts. Soon after that, nonworking married women began to complain that limiting their deduction to just \$250 was unfair and discriminatory (near beneficiaries). And politicians were quick to propose accommodating the near beneficiaries and increasing the standard IRA deduction. A privatization coalition was born. The “tax loss” (as the Treasury puts it) of IRAs has vastly exceeded the original Reagan Administration projections. Yet repealing or reducing the deduction is already politically unthinkable—the coalition is too powerful and the privatization ratchet is in place.

There can be little doubt that in the years to come, IRAs will be seen increasingly by Americans—especially younger workers—as a more attractive retirement plan than Social Security. The IRA industry has every reason to support this, while avoiding any direct criticism of Social Security. In short, the incentive has begun to divert the pressure of demand for a secure retirement income away from the publicly provided system (Social Security) and to the private alternative (IRAs). Any modest legislative concessions won by the IRA coalition (such as a supplemental “medicare” IRA or a full deduction for nonworking spouses) will enhance the attractiveness of the IRA and further deflect pressure. From the budget-cutter’s point of view, the growing power of this IRA coalition offers the only real hope for spending reductions in Social Security, since the more Americans prefer IRAs as their primary pension vehicle, the weaker will become support for retaining Social Security in its present form.

Developing a Privatization Strategy

The techniques available to the privatizer are extensive and varied. Different combinations and emphases are appropriate for different types of programs. But there are six tactics that must form the foundation of a general strategy. The first three tactics aim at weakening the public-sector coalitions while the last three tactics attempt to foster private-sector coalitions.

1. *Press for Existing Programs to be Administered and Financed
"Closer to the People."*

If it is impossible to shift a program out of government, every effort should be made to shift the funding and delivery of the program down the federal system as a precondition for privatization. It is no coincidence that privatization in America has been spreading most rapidly at the municipal level. When the costs of a service are imposed on a relatively small group of taxpayers, resistance to spending increases is stronger and the demand for economies is greater. The centralization of government services and funding sources has been critical to the success of public-spending lobbies. Decentralizing government is critical to successful privatization.

2. *Apply User Charges Whenever Possible.*

The more the user of a publicly provided service has to pay, the more attractive the private alternative becomes. When combined with a tax incentive favoring private provision, a user charge can be a strong inducement for the public to switch its demand.

3. *"Buy Out" Key Elements of the Spending Coalition.*

Detaching powerful elements of a coalition supporting public spending strengthens the relative position of the corresponding privatization coalition. Britain's Conservative government was able to thwart union opposition to the privatization of the nationalized telephone system last November—the world's largest stock offering—by giving employees a special discount price for shares. Ninety-five percent of the unionized workers eagerly bought shares, despite the union hierarchy's total opposition to the sale.

4. *Deregulate Government Monopolies.*

Shifting consumer demand into the private sector is not likely to be successful if private-service suppliers are barred from freely entering the market. Consequently deregulation of service supply is essential for privatization. It should be noted here that this requirement also applies when private-sector organizations supply services under contract to government. Arguments abound as to whether contracting out should really be called privatization (since the funding is governmental), but one thing is clear: private-sector suppliers immune from competition raise costs and erect barriers to entry. Professional licensing requirements, won by private human-service providers, have long been used to shut out competition.

5. *Advocate Vouchers for Low-Income Americans.*

Some critics of privatization maintain that competition—indeed privatization itself—is meaningless in the case of services to the poor, since poor people do not have the financial means to buy adequate private services. Yet vouchers for such services as education, housing, or medical treatment overcome this objection.

6. *Provide Tax Incentives to Encourage Privatization.*

As mentioned earlier, tax incentives concentrate benefits on a small number of people and they act as the nucleus for the growth of privatization coalitions. Incentives are to the emergence of privatization coalitions as new, small spending programs are to public spending coalitions.

Because tax incentives are so essential to a privatization campaign, supporters of the approach should be cautious in their support of tax simplification. Flat tax proposals could be dangerous for privatization because they call for the elimination of deductions as a *quid pro quo* for reduced marginal rates. Privatizers should thus resist the elimination of any deduction that encourages the private provision of a service if otherwise there would be pressure for that service to be provided by government. Eliminating a deduction favoring a private coalition while allowing the equivalent public-spending program to remain on the statute book is like unilateral disarmament in the budget war.

Reversing the Growth of Government

The privatization strategy is essentially incrementalist, or conservative, in nature. While supporters of federal spending rarely neglect an opportunity to create a sweeping new program, spending growth has generally come from a slow but steady stream of small additions to programs. Successful privatization will no doubt occur in the same manner. The privatizer should seek to get his foot in the door with a modest regulatory change, or a small tax break, that will begin the process of coalition building. After that the momentum for growth will develop.

By adopting the privatization strategy, Ronald Reagan could ultimately achieve his objective of achieving a historic reversal in the growth of government, by turning the political flank of the opposition to budget cuts. And by creating permanent coalitions committed to private alternatives to federal spending, the privatization momentum would remain long after President Reagan leaves the White House. But if this administration continues to pursue a head-to-head con-

frontation with the interest groups, it will be back to business as usual when the Reaganites leave Washington, and Ronald Reagan will merely have won, at best, a short pause in the inexorable expansion of the state.