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FEDERAL BARRIERS TO STATE AND LOCAL PRIVATIZATION

HEARING

before the

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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Monday, February 5, 1996

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met at 1:02 p.m., in Room 106 of the Dirksen Senate Office Building, the Honorable Connie Mack, Chairman of the Committee, presiding.

Present: Senators Mack and Santorum.

Staff present: Roni M. Singleton, Robert Mottice, Bill Spriggs, Greg Williams, Jerry Ellig, Brian Wesbury, Shelley Hymes, and Wayne Palmer.

OPENING STATEMENT OF SENATOR CONNIE MACK, CHAIRMAN

Senator Mack. I think we'll go ahead and proceed. I don't know how many other Members will be here. Not many had the choice that I had -- be in Florida, where it's a little cooler than it has been, or to return to snow-covered Washington.

I'd like to welcome all of you to this hearing of the Joint Economic Committee.

We're going to be looking at the barriers that the Federal Government has created to privatization efforts at the state and local level.

As we will see, these barriers can include Federal regulations, grant restrictions, and counterproductive tax policies. This JEC Report has been circulated. And for those of you who might have an interest, there are some of these Reports in the back of the room.

The Report will be released today and it analyzes the effects of these policies and makes the case for change.

Today, the Committee will hear from three panels of witnesses. The first will focus on the opportunities privatization has to offer, as well as roadblocks the Federal Government has erected that keep state and local governments from taking advantage of those opportunities.

The second panel, featuring the esteemed governor of New York, George Pataki, will explore the practical effects that Federal barriers have on state governments' initiatives.

And our third panel will consider Federal barriers to privatization at the grassroots level of local governments and private companies who have been affected by these barriers.

I think this issue -- how the Federal Government impedes innovation and keeps state and local governments from doing what's best for their citizens -- gets to the heart of why Americans are becoming increasingly dissatisfied with their government.

I have a formal opening statement, but I'm going to submit that for the record.

In addition, the Honorable Pete Wilson, Governor of the State of California; the Honorable Scott Klug, Congressman from the State of Wisconsin; the Honorable David McIntosh, Congressman from the State of Indiana; the Honorable Stephen Goldsmith, Mayor of the city of Indianapolis, Indiana; Robert Zauner from Hughes Transport Management Systems; and Peter Cook, executive director of the National Association of Water Companies have submitted testimony for the record.

[The prepared statement of Senator Mack and the Committee Report entitled *The $7.7 Billion Mistake: Barriers to State and Local Privatization* appear in the Submissions for the Record.]

Senator Mack. Our first panel consists of two individuals: Mr. Ron Lauder, who is chairman of the New York State Advisory Commission on Privatization and former chair of the New York State Senate's Advisory Commission on Privatization, which produced the study, "Privatization for New York -- Competing for a Better Future," which served as a basis for privatization programs throughout the United States and the world, including privatization efforts in the newly freed nations of Central Europe.

Mr. Poole is the founder and president of the Reason Foundation and is a nationally known expert on privatization and transportation policy.

Mr. Poole has advised the White House during the Reagan and Bush Administrations, as well as served on numerous state and local privatization advisory commissions and has authored a study outlining the major federal impediments to state and local privatization.

Mr. Poole received his bachelor's and masters' degree in engineering from MIT.

I want to welcome both of you to the Committee this afternoon.

Mr. Poole, if you would go ahead with your opening statement.

PANEL I

STATEMENT OF ROBERT W. POOLE, JR., PRESIDENT, REASON FOUNDATION

Mr. Poole. Thank you very much, Senator Mack.

I am Bob Poole, president of the Reason Foundation, based in Los Angeles.

We have been researching privatization for 17 years now and have advised not only the Reagan and Bush Administrations, but also recently the Clinton Administration, on this subject.

My focus today is specifically the privatization of state and local infrastructure.

We all know by now from many, many studies that funding for infrastructure is simply not keeping pace with the needs that we can project over the next 10 to 20 years and that Federal assistance is much more likely to shrink than it is to grow in the years ahead.

Other countries all over the world are facing similar problems and their response, for the most part, is to turn to the private sector and private capital for their infrastructure needs.

The latest global survey that came out from the newsletter, Public Works Financing, reports that 356 privatized infrastructure projects worth $146 billion had been financed and put under construction in 42 countries during the past decade. But only a handful of these projects are in the United States.

I find it ironic that USAID goes around the world telling foreign governments why they should privatize infrastructure. But the United States relies primarily on government ownership and operation for airports, highways, seaports, water supply and waste water treatment.

Yet, there's strong evidence that private ownership of these kinds of facilities leads to great efficiency, wiser investment decisions, and greater user-friendliness.

Those types of infrastructure where the United States has relied primarily on the private sector, such as electricity and telephones, are universally acknowledged to be the world standard in those fields. But we cannot honestly say the same thing about the U.S.'s quality of airports, highways, seaports, water supply or waste disposal facilities.

The most advanced infrastructure in those fields is in places like Britain, France, Italy, Japan, and Hong Kong, where long-term private franchises or outright private ownership are the order of the day and becoming increasingly standard.

Why does the United States lag so far behind in this field?

This study which we did last May which your Committee's report has referenced found that Federal law in many ways is biased against private capital and private ownership and infrastructure. There are tax code barriers, regulatory barriers and grant policy barriers.

The most important of these is the Federal tax code, clearly.

The infrastructure facility that's owned by investors has to pay Federal corporate income taxes and can usually finance its construction and modernization only with taxable debt.

The identical facility, if it's owned by a state or local government, pays no taxes and can borrow at tax-exempt rates.

Now that plus local taxes, constitutes about a 17 percent higher cost imposed on the private sector than the public sector.

Now this policy may not have meant to, but it sends a clear message from Washington to cities and states and the private sector -- we, Washington, prefer that you use the government rather than private enterprise to own and operate infrastructure.

And I don't think that's the message we want to send. If you tax something, you get less of it. If we want more private sector investment in America's infrastructure, Congress should provide consistent tax treatment regardless of ownership.

In other words, either remove the tax exemptions from state and city facilities that are actually businesses, or extend tax exemptions to facilities owned and operated by private investors.

That's the tax situation.

The second type of barrier is regulatory barriers. There are many examples of biased treatment. I'll just cite three of them real quickly.

RCRA -- the Resource Conservation and Recovery Act -- provides effluent standards for plants that treat municipal waste water that are less stringent than those that apply to industrial facilities.

But somehow, the Federal law equates treating municipal waste water with being government owned because right there in the law, it spells out publicly-owned treatment works for the less costly standards.

Second example -- in the highway field, although ISTEA, the Surface Transportation Act, permits private investment and tolling of certain segments of Federally-aided highways, it absolutely rules out the most important and commercially attractive routes -- namely, the Interstate Highways.

And that clearly, again, sends a message -- privatize a little bit, but don't get serious.

In the airport field, the Airport Improvement Act, at least the way it's interpreted today by the FAA, prohibits cities from making use of any proceeds from selling or leasing their airports.

This removes a major and completely legitimate motivation for airport privatization -- namely, a city's desire to shift its resources out of commercial functions and into its core functions -- to beef up police forces and vital services that only government can handle.

The third type of barrier -- now we've had tax and regulatory barriers -- the third type involves Federal grant policies.

Federal regulations today, despite the efforts of the Bush Administration, still require repayment of a portion of grant funds if a facility is to be sold or leased. This amounts to a transfer tax on privatization. It's the Federal Government saying, okay, we'll let you privatize. But we're going to tax it if you do, by requiring this payment each time, which makes those transactions more costly and therefore, discourages them from occurring.

Congressman McIntosh has introduced legislation that would eliminate any repayment requirement, and I testified on that last fall, and would codify other procedures of President Bush's Executive Order on privatization.

The objection we hear from Treasury and OMB is concern that if there were large-scale privatization, the Federal Government would somehow lose revenue. I think those concerns are completely ill-advised.

The Federal Government in fact will benefit handsomely if cities and states privatize infrastructure facilities. But the Federal Government will reap no benefits at all if these privatizations don't occur.

Let me give you a few numbers and they're in more detail in my written testimony.

The Reason Foundation previously estimated that cities and states have at least $227 billion worth of user-fee-funded infrastructure in transportation and environment that would be good candidates for privatization by means of sale or lease.

Now if they did sell $227 billion worth, that would be a big one-time infusion of capital for the state and local governments, about half to cities and about half to states.

But, in addition, every level of government would start receiving new tax revenues if those transfers took place. These facilities would start paying taxes like ordinary businesses.

I put a table in my written testimony that shows there would be $3.4 billion a year in new local property taxes for city and county governments, $2.6 billion a year in new state taxes, and around $8 billion a year in new Federal tax revenues from these privatizations being carried out, and this would be ongoing revenues year after year indefinitely.

Finally, let me wrap up by just pointing out that the kinds of issues that we're talking about today are increasingly gaining bipartisan support.

For the past three years, I've been discussing many of these issues with people at DOT, at EPA, with the National Performance Review, and with the White House National Economic Council.

What's impressed me very much in these discussions is how much agreement there is now on three main points.

First, that we cannot modernize America's infrastructure with business as usual. It is going to require significant amounts of private capital. And Congress' task is going to be figure out how to change policies to unleash that capital.

Secondly, shifting to direct user fees for infrastructure produces many important economic benefits, including congestion relief and incentives for conservation of resources like water supply, thanks to the incentives provided by pricing.

So it's a good thing to make the shift for those reasons alone.

And third, for infrastructure that's inherently monopolistic, there does need to be a continuing government role to protect consumers from potential monopoly abuses. And so, there is going to be a role for government, and a continuing role for government, although not in an ownership role, in many of these cases.

So I suggest that it's time to seize this opportunity and build on this growing bipartisan consensus by removing Federal barriers to infrastructure investment. That will give cities and states an important tool that they're going to need in this era of downsizing and devolution of power, to help rebuild America in the way that we all need it done.

Thank you very much, and I'll be happy to answer questions, either now or after Mr. Lauder speaks.

[The prepared statement of Mr. Poole and reports appear in the Submissions for the Record.]

Senator Mack. Thank you very much for your comments. I think we will go to Mr. Lauder first, and then I will raise some questions after his presentation.

Mr. Lauder?

STATEMENT OF RONALD S. LAUDER, CHAIRMAN, NEW YORK STATE RESEARCH COUNCIL ON PRIVATIZATION

Mr. Lauder. Thank you. Good morning.

I'd like to thank Chairman Mack and the members of the Joint Economic Committee --

Senator Mack. If you would, pull that just a little closer to you.

Mr. Lauder. All right. Thank you. I'd like to thank Chairman Mack and members of the Joint Economic Committee for sponsoring this hearing.

I am testifying as Chairman of the New York State Privatization Commission and a concerned citizen.

I believe the Federal Government's policies towards state and local privatization is one of the most important issues facing the nation.

Six years ago, when I became the first public figure to advocate privatization of sanitation services in New York City, I was publicly accused of being in bed with the mob.

Undeterred by this less than enthusiastic reception, I set about to promote the value of privatization. The result was the publication of "Privatization for New York -- Competing for a Better Future."

Today, New York's mayor and governor are articulate proponents of privatizing a wider range of government services and assets, many of which were introduced in "Privatization for New York."

In addition to my modest efforts in New York, political and economic realities across the nation have caused America's mayors, governors, and county executives to explore and adopt the privatization options in the delivery of services.

Faced with severe budgetary constraints, elected officials are discovering that privatization can reduce public expenditures, while providing necessary services and infrastructure needs.

Later today, you will hear from elected officials and expert witnesses on how privatization has brought the benefits of competition to taxpayers, particularly in Indianapolis, Milwaukee, and Massachusetts.

Democrats, such as Mayors Norquist and Rendell, and Republicans like Mayor Goldsmith and Governor Weld, have employed the privatization option very successfully.

A recent Mercer Group study concluded that there has been a substantial increase in the use of privatization on the local level. In the decade from 1985 to 1995, there has been a significant increase in the use of privatization for a wider range of services. Seventy percent of local governments have privatized janitorial services. Fifty percent employed private waste collection. And 42 percent -- up 10 percent -- use private building maintenance workers.

The cost savings in efficiencies that accompany privatization are the primary reason for its growing popularity throughout the United States.

But, despite the growing popularity of use of privatization, Federal policies are often barriers to local and state governments who can take full advantage of this privatization.

Before I comment on the Federal barriers to infrastructure privatization, I want to note one glaring Federal obstacle to introducing competition between the public and private sectors in the delivery of transportation services.

There have been several studies and real examples of dramatic decreases in operating costs of bus operations when public monopolies are challenged by the private sector.

A 1991 study prepared for the U.S. Department of Transportation Administration concluded that privatization of New York's bus system would yield $600 million in annual savings.

Because of Federal law, the report recommends phasing in this policy over a 10-year period. The fact is that local government could not expedite this privatization because federal law is biased against transportation privatization.

Section 13(c) of the Urban Mass Transit Act requires that an employee whose job is eliminated due to privatization receive up to 6 years of severance pay.

Can anyone imagine a private severance package that is as lucrative as this one? The cost of this federal mandate makes transportation privatization almost impossible.

This Federal policy should be eliminated because it is unnecessarily preventing local governments from reducing taxpayers' costs.

Before I discuss the impact of federal policies on infrastructure privatization, let me share with you some relevant personal experiences.

During the last decade, I have been eyewitness to the benefits of privatization. As many of you may be aware, I am very active in private sector activities in the newly free countries of Central Europe. I have witnessed and participated in many privatization projects and I can testify that those countries which have embraced privatization -- for example, the Czech Republic, Hungary and Poland -- are prospering, while others, like the Ukraine, are foundering, as they look to state-sponsored economic development to bring their economies and infrastructure into the 20th century.

For years, I have maintained that once the United States was the teacher, and now we stand to learn valuable economic lessons from our former students.

We have to implement public policies which promote private enterprise. We must recognize that neither federal, state, or local governments have the resources to meet our nation's massive infrastructure needs. Roads, bridges, and airports must be upgraded and expanded, while water and wastewater facilities must be modernized.

The Congressional Budget Office has estimated that the cost of these projects will be between $600 billion and $1 trillion.

Judging from the rhetoric and economic realities, the days of Washington footing the bill are largely over.

Those that seriously analyze the benefits of privatization quickly learn that the private sector has the resources and the ability to help modernize the nation's aging infrastructure. They also begin to appreciate that their government assets, such as airports, roads, and water systems, are worth an estimated $226 billion, assets which the private sector is anxious to invest in if Federal policies change to allow them to do so.

Permit me to give you one specific example of a challenge and problem facing local governments in every corner of the nation.

To comply with the new water standards set forth in the Clean Water Act, local governments must come up with $136 billion to invest in these infrastructure projects.

Is Washington going to finance the implementation of these Federal mandates? Is Washington going to raise taxes to come up with the financing? Is Washington prepared to subsidize the modernization of water, wastewater, and waste energy plants?

I do not believe I would find too many members of your Committee, of the Senate, of the House, who would answer those questions in the affirmative. Nor do I advocate doing so.

Given Washington's inability to pay the steep bill to comply with its mandates in the Nation's day-to-day infrastructure needs, local governments are facing a mammoth financing problem. While the task is formidable, it is not an impossible one to accomplish.

All that is needed is for Congress and the Executive Branch to lift the Federal barriers which are preventing local governments from making full use of the financial and professional resources of the private sector.

Around the world, the private sector is investing in infrastructure. Last year, the Bank of International Settlements reports that world-wide private investment rose to $240 billion. But opportunities for private infrastructure investment are not available in the U.S. Here, Federal laws and regulations are preventing and dissuading American companies from investing in their own country.

It is estimated that American firms invested $15 billion in 1995 in other parts of the world. But in the United States, we can point to only a few infrastructural projects -- two highways and one wastewater treatment project.

This has got to change.

Later today, you'll hear from the experts on what specifically has to be done.

Let me leave you with a businessman's perspective on what your guiding principles should be in addressing privatization.

First and foremost, we must appreciate the giant task facing state and local government officials. In issuing Executive Order 12803, which began the process of allowing state and local governments to privatize assets that receive Federal grants, President Bush clearly stated that the need to adjust Federal policy because, and I quote, "States and localities face a growing need to modernize and expand their vital infrastructure assets. They seek innovative means to take advantage of the value of existing assets and to obtain private sector financial assistance."

Second, we have major infrastructure needs which only the private sector is in a position to fulfill.

Third, we must change all laws and regulations that discriminate against the private sector participating in the finance and ownership of public infrastructure. We must streamline the privatization approval process.

It should not take two years to gain Federal approval of a $6.8 million wastewater privatization. As it did in Franklin, Ohio.

As an American concerned about the future of my Nation, I find myself in the unusual position of promoting privatization in the land of free enterprise.

At times it's been a lonely experience. I felt like a single voice in a dense forest.

We seem to need to be reminded that private enterprise created jobs and opportunity that welcomed the world. It built the bridges, dug the subways, and sculpted a skyline known around the globe.

A few years ago, *The Wall Street Journal* was prompted to write, and I quote: "For all this, one Nation is still standing on the platform watching the global privatization train depart -- the United States."

Today, I am more optimistic. I see the light at the end of the tunnel. Mayors and governors have become advocates of privatization and this hearing is a sign that there is a serious movement to change Federal policy.

I applaud all your efforts and stand ready to assist you in dismantling Federal obstacles to state and local privatization.

Thank you.

[The prepared statement of Mr. Lauder appears in the Submissions for the Record.]

Senator Mack. Again, thank you for your presentation. On a personal note, for those of us who have an interest in the issue of privatization, I want to say to both of you, we appreciate deeply the work that the two of you have done. You have not only invested money into this project, but you have made a commitment personally from a time and energy source, and we greatly appreciate that.

I am going to ask a very broad, general question, which, frankly, both of you have addressed in your statements, both written and oral. But I think that sometimes it helps, in a sense, through dialogue. I think people can get to the heart of the matter a little bit quicker.

And I would suspect that people who are listening to this on the outside, the taxpayer, let's say, is probably saying, what, again? What's the motivation for our doing this? Why do we really want this to come about? What benefits will we derive?

Either one of you can hop in and just express -- Mr. Poole, you want to start?

Mr. Poole. I'll be happy to start.

I think there are two or three main reasons why this is a change that needs to be made.

First of all, we have a growing amount of evidence now that government enterprises that provide things like airports and water supply and basic infrastructure needs are not very efficient at doing the job and they're not very innovative.

We are seeing, for example, in California's first private toll road, the first use anywhere in the United States of time-of-day pricing to try to manage congestion.

Governments have been talking about this for 20 years, but it took the private sector to have the courage to actually go out there and do it and make it successful.

Senator Mack. Let me just stop you right there. Again, for the average person listening, they might not understand what you meant by that phrase -- what was it?

Mr. Poole. Okay. Time-of-day pricing, sometimes called congestion pricing.

It means charging a higher price, a higher toll at rush hour and a lower toll at other hours, and it's designed to keep traffic flowing smoothly by matching supply and demand.

And it's working like a charm.

The Riverside Freeway in Orange County, California, where that's now in place for the last month is running smoother and faster and more efficiently than it ever has before because there are now these private express lanes that cost as much as $2.50 to use during rush hour that people are willingly choosing to use because it saves them a half-hour of time.

The public sector has talked about doing this for 20 years, but the private sector has the motivation to bring that kind of innovation and put it into place.

So that's one, is to get rid of, to replace inefficiency and stagnation with innovation and greater efficiency.

Second is the sheer financing challenge of coming up with the capital that we need to rebuild and modernize much of America's infrastructure.

You know, the interstate highway system, most of it is about 30 years old and it's almost all going to need to be rebuilt in a major way, just to replace what's there as well as in many cases to add lanes and new capacity.

The cost today to do that is far more than what's coming in from the Federal gasoline taxes. It's almost inevitable -- it certainly would be wise to shift a lot of that over to toll-based finance and the innovations, again, of the private sector with this user-friendly electronic toll collection.

I don't see any realistic alternative on the horizon for doing this kind of modernization and rebuilding without tapping into private capital. And private capital is there. There's $5 trillion in U.S. pension fund assets, for example, as one possible source that could be mobilized to invest in rebuilding America's infrastructure. Not with somebody's economically targeted coercion from government, but on a voluntary basis because it could make good commercial sense to do so.

Senator Mack. And why don't they invest now?

Mr. Poole. They don't invest now because all infrastructure today when it's owned by government is funded with tax-exempt bonds or direct tax money. Pension funds don't have any reason to buy tax-exempt bonds because they don't pay taxes.

So if we shifted to a financing system based on taxable investments, then it would be an economically attractive proposition for pension funds to invest in this kind of infrastructure.

Senator Mack. Well, so far, again, to the average person who might be for the first time focusing in on the term, privatization, innovation and efficiency, what you're saying, that, in essence, the private sector will provide greater efficiencies, and I assume that there is data to support that.

Mr. Poole. There is ample data to support that.

Senator Mack. And with respect to innovation, you refer to what is happening in California and the toll road that you referred to, that, in the private sector, there would be greater freedom to pursue various policies, but also with the risk if the wrong policies are chosen. There would be loss or there would be a quick reaction to that failed policy to change it, as opposed to through some multi-year, multi-agency, multi-step, multi-bureaucracy effort to try to change a policy that in fact didn't work.

Mr. Poole. Exactly. That's one of the reasons, incidentally, that the World Bank today, which has done a remarkable shift on policy in the last five years, the World Bank today is aggressively promoting infrastructure privatization all over the world, in part, because of the need to finance infrastructure modernization, but also in part to much greatly reduce the risk of costly white elephants produced by government and to shift the risk of developing new projects to the shoulders of private investors who can willingly assume that risk and will therefore make wiser decisions about where to invest scarce capital.

Not building a five billion dollar dam if only a billion dollar dam is really economically justified, for example.

Senator Mack. Let me let Mr. Lauder get in here.

Mr. Lauder. Thank you. I think Mr. Poole can give numerous examples of how privatization can be more efficient.

But in answer to your question, the average person, or for that matter, any person out there in the United States would realize that the government running most institutions, most businesses, cannot run it as well as a private individual can.

And whenever the government has stepped in and tried to run something that a private individual or a company can run, they've always done it less efficiently.

And I think that if you'd ask any person, who can best deliver newspapers to you in the morning, a private company or the government, I think the unanimous feeling would be private individuals.

And what we've seen over and over again is that private companies have come to state and local governments and, for that matter, the Federal Government saying, if we can do it better, cheaper for the people, why can't we? And they've been told over and over again about the laws that stop them.

I think the purpose of this hearing is to say, what laws have to be changed and let's have competition.

Our country was built on competition.

Too often, we hear about what the government can do. I live in New York City and I look at the skyline of New York. That was built by private individuals with a dream, a dream of what can be done.

I believe that had there been the laws that we have today stopping people from doing things, you would have seen a much different United States.

Thank you.

Senator Mack. So far, we've identified a couple of things -- innovation, efficiencies being one, the capital needs.

And what both of you said in your statements, in essence, was that over -- I don't know what period of time you were covering, but over, and you might want to clarify that, over a certain period of time, there is estimated a tremendous capital need for infrastructure in the country.

And neither of you see the politicians willing to step forward and say, in order to finance that, we've either got to cut entitlement programs, or, as I would be quickly reminded by others, to reduce the rate of growth in entitlement programs.

If we're not willing to do that or to raise taxes, then what we're saying, in a very quiet way, but the people in the country are going to feel in the future is a deterioration in the infrastructure of the Nation, whether that's water or sewer or whether that's airports or roads or major highways or bridges.

And tell me why, then -- tell me what is going to draw the private sector into filling this void if we, in essence, create a neutral or balanced or even playing field?

Mr. Poole. Well, simply the opportunity to earn a profit by providing services that people want and need.

It's not just a matter of theory. We already know that in the United States, we have the best electricity system in the world. And that's largely because that is mostly a private enterprise, investor-owned industry.

The desire to earn a profit by delivering good service is precisely what will attract people into the water supply business, the airport business, the highway business.

And that is going to have the benefit not only of preventing deterioration, but of making services better and more user-friendly.

A good example, Senator Mack, is if you have flown in or out of London in the last five or six years. Most people who use Heathrow and Gatwick airports don't realize that those are now investor-owned, 100 percent privately-owned airports.

And one of the reasons that they are more friendly places to be than they used to be 10 or 15 years ago is that the company that owns and operates those airports has essentially created shopping malls within those airports. And it turns out that those shopping malls are now covering more than half of the total cost of operating those airports.

And this is not being done by tax money. It's not being done by any kind of mandatory charges on the users. It's simply that when you create good shopping environments for a group of people that are trapped in an airport for a certain amount of time, they voluntarily spend money on goods and services at the airport that they otherwise would have spent somewhere else.

And this has turned out to be a way of helping finance the privately-owned airports that no one had really thought of before as a significant revenue source. And yet, it makes the whole experience of using the airport a lot more pleasant for the passengers.

Mr. Lauder. I'd like to add to what Mr. Poole said.

The myth that privatization immediately means loss of jobs, in the case of Heathrow and Gatwick and the five other airports that are privatized in England, if you look, you'll see that over a period of time, more jobs were created. It became not only a very profitable venture for BAA (British

Airports Authority), but for the thousands of people who were employees of the airport who received stock in return for this, they profited by it and there were new jobs created.

It's had a very, very good effect on the whole area around there. And we've seen in privatization, when an airport is privatized, it has an effect on the area around the airport.

I had the good fortune last night to have dinner with Lady Thatcher, who is the ex-prime minister of the UK. We had discussion about Heathrow and Gatwick, as I knew I would be here today.

She said, look, we discussed this privatization for some time in the UK before they were privatized. As a matter of fact, we started discussing it right after World War II.

But it took a government -- and she was obviously referring to her government -- to say, we will do it. We will take the obstacles away. She said, when I started, there were many obstacles to privatization. There were many critics of privatization, as you have here in the United States.

But once the government decided to do it and make it work, it can work. And people have watched this and seen what can be done. We see it happening now. Australia has made the decision. I know Toronto has their second terminal that has been done by private money, and the potential here is enormous.

The major issue that has to be done is the government has to be able to say, okay. We believe in it. We've seen it work.

Let's do it.

Senator Mack. Let me just pick up on the point about airports. We're going to hear from Governor Pataki here shortly. I understand he wants to sell some airports.

What kind of Federal impediments are there to what he wants to accomplish?

Mr. Lauder. Well, you want to take that?

Mr. Poole. Yes. The most important one is that a provision of the basic Federal law that spells out airport grants, at least the way it's interpreted by the FAA, is said to mean that the proceeds from selling or leasing an airport cannot be used by the government that now owns the airport and wants to sell it.

The proceeds somehow would have to stay on the airport.

Now this is contrary to what everybody does all around the world in privatization. It's contrary to what Franklin, Ohio did when they sold their wastewater plant last year. It's contrary to what every government will normally do.

By selling an enterprise, they are shifting the taxpayers' investment from that commercial enterprise, which is not really inherently governmental, and reallocating those monies towards inherently governmental functions, such as public safety and social services, things that only government can do.

And yet, somehow, we have embedded in Federal law this idea that that cannot happen. That's not allowed to happen for airports.

Senator Mack. Let me just ask you a point of clarification.

Are you talking about future revenues derived from operations of the airport, or are you talking about the sales proceeds, or both?

Mr. Poole. I'm talking about both at this point because the language in the law, there's nothing in the legislative history of that provision that indicates that it would apply to the sale proceeds because that wasn't even contemplated at the time the 1982 Act was enacted.

But the FAA and many of the airlines today interpret that provision as also applying to sales proceeds in addition to operating revenues.

So this is a matter that is going to have to be addressed by Congress at some point to clarify the situation and to make it possible for cities and states to be able to realize any proceeds from selling these very valuable assets.

Senator Mack. Again, let me raise maybe a more general question.

I suspect that there will be those that we will hear a little bit later on that will raise an issue from the perspective of the user or the consumer or the taxpayer or the society in general that you're turning over a project, an asset, that is now run by government for the good of the people to the private sector.

What guarantees are there that the needs of society will be served? After all, aren't these folks interested in that word profit? And somehow, doesn't that mean that they couldn't possibly be interested in serving the public?

Mr. Lauder. I think any businessman, or woman, for that matter, will tell you that obviously is the way and the way you get a profit is by giving goods and services.

There will be alternatives. If you're not giving the goods and services, you can take a different airport.

In New York, for example, there are three airports and there's competition.

What we've seen over and over again is that when you have competition, you have better service. Right now you have no competition. You have a monopoly, and there is no reason why you should get better service in Kennedy.

So I would turn the question around the other way and say to those people who question this, today, there is a monopoly. There is no competition. When you have competition, you have better services and better prices.

So that same argument that is often given by people, anti-privatization really works against them.

Mr. Poole. Let me add to that, though, that there are going to be some situations where you have what's today a public-sector monopoly that will be replaced, for all practical purposes, with a private sector monopoly.

For example, a city's water system. It's unlikely that there is going to be a competitive water system to that. In some cities, there really is only one airport that's big enough in a reasonable period of time, at least, to serve air carriers. Let's say Kansas City or Wichita.

So what do you do in those cases?

There, I think it's important that we understand that government will retain and needs to retain some kind of a consumer protection regulatory role. But that's a very different role from being the owner and operator of the facility itself.

Just as we, for the most part, don't have government in the electricity business in the United States, we do have government where there's electricity monopoly service regulating that monopoly in the interest of protecting consumers.

And likewise, in those few cases where we do have investor-owned water companies, we have government playing a regulatory role.

There's lots of questions we can raise about whether the kind of regulation that we have in the United States is the most efficient and least costly. The British, I think, are doing a better job of regulating their newly privatized infrastructure than we are in this country.

They are using a relatively simple price cap regulation rather than the rate-of-return regulation that we use. But that's a detail.

The point is that where there is going to still be a monopoly, there needs to be a government supervisory role and that's the main way, besides just the self-interest of the company, in attracting customers and gaining a good reputation -- that's the other way in which consumers will be protected.

Senator Mack. So what we're in essence saying is that in areas like highways and bridges and airports, water plants --

Mr. Lauder. Bus systems.

Senator Mack. Pardon?

Mr. Lauder. Bus systems.

Senator Mack. Bus systems. We ought to look at them similar to how we have in the past looked at, I guess, telephones and electricity.

Mr. Poole. That's right. Exactly.

Senator Mack. That the interest of the public at large has been served through a combination of private investment, private operation, with a regulatory oversight.

Mr. Lauder. Yes.

Mr. Poole. Correct.

Senator Mack. Now let me just, again, just building on that, in the area of electricity, electrical utilities, why don't you lay out what you see the differences between the market that they operate in and, let's say -- let's say water and sewer.

Mr. Poole. Well, electricity is one of those areas that has traditionally in the United States been considered a total monopoly, all the way from generating electricity, transmitting it over long distances and then delivering it in the local retail system.

We're seeing now a huge ferment in electricity where we're at the early stages of deregulation that's going to lead to a much restructured and more competitive market.

California's Public Utilities Commission recently adopted a plan that by, I think, the year 2002, even individual residential consumers will be able to choose their ultimate electric supplier and that ultimate producer will send electricity over wires maybe owned by several different companies to the ultimate consumer's household.

I'm not sure if we're going to see that degree of deregulation ever come to the water industry, but it's possible that we will see wholesale competition in water in which we have different ultimate sources supplying what might become a common carrier network of water transmission lines to local water systems.

The local water distribution will probably remain a monopoly.

Senator Mack. Yes. Let me hop in. I was thinking in this area, and I really haven't had a chance to think this through, so I'm just going to be tossing it out now. It may not even make any sense.

But the tax-exempt issue that you raised earlier. Certainly we have, in this electricity, this utility market, we have both private sector and governments.

Mr. Poole. Yes.

Senator Mack. We have governments that use, I guess, tax-exempt bonds to fund their electrical-generating capabilities. And we have the nongovernment or the private sector that has to pay the taxable rate.

Mr. Poole. Yes.

Senator Mack. But yet, they're able to compete.

I guess the question comes, why hasn't that happened in the area, let's say, of water and sewer?

Mr. Poole. For the most part, it's because people have just assumed that only government can do this or only government should do this.

This was not prearranged. I'm glad you mentioned that, though, because I brought along a study that the Reason Foundation is releasing today that did an investigation of the underlying cost structure of a set of California municipal water utilities and investor-owned water utilities. We do have a few large ones in California. And we found that although these two sets of utilities charge essentially the same price to the consumer, the investor-owned ones are having to pay 17 percent higher cost because of all the taxes that they pay that the municipal ones don't.

And yet, there's so much greater efficiency in the private sector operators that they're able to overcome that obstacle, that artificially-imposed extra cost, and still deliver water at competitive prices.

Let me just give you one excerpt. I looked this up while we were talking.

Our study showed that per 1000 household accounts, the typical investor-owned water utility has 1.62 employees, compared to 3.49 for the municipal ones.

Senator Mack. Say that to me again.

Mr. Poole. The investor-owned water utility has 1.62 employees per thousand customers, 1.62 compared to 3.49 for the municipal ones.

So that's an illustration of the kinds of underlying efficiency differences that are out there waiting to be realized for the benefit of consumers if we can shift from largely municipal to largely private investor-owned infrastructure in the case of water.

There are probably similar gains to be had, although not necessarily that same magnitude, in airports, in highways, in other things that government is now owning and operating.

But people haven't been looking at that and they haven't realized how much of a price they're paying in decreased efficiency by having government as the provider of these things.

Senator Mack. Again, either one or both of you raised the issue about what happens to the flow of revenues either from the sale of a government-owned entity and the revenues from that government-owned entity.

What's happening in other countries? What kind of requirements do they have? Is it strictly one of saying, if you maintain the facility for the same public purpose, then what you do, in essence, is up to you?

What's happening in other countries?

Mr. Lauder. Well, I can talk in terms of Eastern Europe.

What they've done in the case of privatization there and obviously, you're starting from a communist system which was total state-owned, to a capitalistic system.

They have taken the point of view that whatever -- it's basically putting these things back on the tax rolls and they're saying that whatever profit you make, a portion of that obviously is taxable and the rest is for you to keep, as long as you fulfill certain regulations and certain requirements.

England, Mr. Poole knows more about this than I do, is somewhat similar, but there are other aspects of it.

Mr. Poole. We've only begun looking at the differential tax treatment around the world. But I've been fascinated to find just recently that major airports in Europe, and I'm talking about in countries like Germany and Denmark and Italy and France, government-owned airports pay taxes, as if they were private businesses, which is unthinkable to most people in the United States. But the governments in Europe recognize that these are essentially commercial enterprises and they should pay corporate income taxes when they make a profit, and many of them do.

Charles deGaulle Airport makes a profit. Frankfurt Airport makes a profit and pays corporate income taxes.

We've also found that it appears as if almost no other country in the world has anything like our tax-exempt municipal bonds.

Senator Mack. Right.

Mr. Poole. Italy seems to be about the only country where there's anything like that.

Generally speaking, the borrowing is done at commercial normal rates.

Senator Mack. Let me hop in here because this is the hot part of the issue.

Are you saying that we ought to eliminate tax-exempt borrowing on the part of states and municipalities?

Mr. Poole. I think we as a Nation really ought to look at whether this is an efficient subsidy or not. And there's already been some good academic work that says that there's a lot of friction in the system, so to speak. A lot of the benefits don't end up leading to lower costs or lower prices for consumers.

I would say certainly for user-fee-supported infrastructure that is essentially commercial and that could be provided very well by the private sector, like toll roads and airports and water delivery systems, that's really no good reason to subsidize the borrowing for those kinds of systems.

For general obligation bonds, that's another question and we haven't really looked into that. But I think for --

Senator Mack. But you're saying that, in essence, it's reasonable to expect that there is a private sector interest and capability.

Mr. Poole. Yes. Yes.

Senator Mack. That to establish an unequal set of regulations or tax laws, that, in essence, provides an incentive for that activity to take place in government as opposed to the private sector, that that ought to be eliminated.

Mr. Poole. I think that that's just foolish government policy.

Senator Mack. Because I assume the assumption is that the reason for the tax exemption in the first place was, without it, we would not be able to interest the investment to come into that area.

Mr. Lauder. Yes.

Mr. Poole. That's correct. That's exactly right. And that might have been true at one point in our history. I don't know.

But today, it's clearly -- you will hear from private sector people today who have access to capital. If the policies are such that people can earn a reasonable return on it, there's no question that the capital is here.

We have companies already -- British water companies in California are scouting the market wanting to buy municipal water systems.

There is definitely capital out there if we can create the environment in which it can earn a reasonable return.

Senator Mack. In some of our conversations in the past when we've gotten into this tax-exempt issue, another hot topic that's kind of out there these days has to do with the flat tax.

Mr. Poole. Right.

Senator Mack. I wonder if either of you wants to make a comment with respect to how the flat tax might -- what role it might play in this whole issue of privatization.

Mr. Poole. Well, certainly, if the pure flat tax, as it's been presented by Dick Armey and Steve Forbes, for example, were to be adopted, under which there's no longer taxation of earnings from things like bonds or stocks, then there would no longer be any reason for a distinction between taxable and tax-exempt bonds.

And so that would mean basically that this distinction would go away, and all financing would be on a level playing field.

So that would be one, I would say, of the side benefits of a pure flat tax, would be it would solve this financing of playing field issue.

Short of that, if that kind of a change doesn't take place, then I think we either have to figure out some way of taxing the financing of at least those commercial activities that government now does, or extending the tax exemption to the private sector people so that, one way or another, they're on an equal footing when it comes to issuing debt for these kinds of projects.

Senator Mack. I think I would raise one additional area and I think we have touched on it, but I don't think we've focused enough.

If you have a situation in which you allow state and local communities to take assets that have been funded by Federal grants and sell those and to retain the revenue derived from that sale, doesn't that encourage a system in which you just keep putting -- there's going to be more and more people wanting the Federal Government to put grants into their local communities and then turn around and use that as some kind of resource?

Is that a fair assessment?

Mr. Poole. That's a fair assessment of the concern that's been expressed.

My colleague at the White House calls that flipping, asset-flipping.

But I think the answer to that is to stop giving Federal grants. I think there would be a lot of benefits to be had if we no longer gave grants, at least to the larger commercial airports, and if we decentralized the highway program to the point where the states collect the highway taxes and spend them in their state, instead of having the Feds also tax gasoline and send the money to Washington, extract some overhead, and then reallocate it and send it back in accordance with Washington's priorities rather than with the individual state's priorities.

Senator Mack. I, by the way, have encouraged that. I think we ought to end that system.

Mr. Poole. Good.

Senator Mack. In fact, we're developing legislation to introduce later this year that would do exactly that.

Again, I'll just go back to one of the first questions I asked just to make sure we get it on the record as best we can.

The consumer, the taxpayer is listening to this for the first time. And what they have heard from us is that one of the reasons that the Federal Government ought to eliminate the barriers for the entrance of the private sector into many services infrastructure that is now being done by state and local governments is because, one, there's a tremendous capital need that you don't believe is going to be provided by governments.

Number two was the efficiency that comes from private operations versus public operations. And as part of that number two was also that you're going to get more innovation. I would add, I guess, innovation/flexibility, greater flexibility to deal with problems. Speed, I guess, also in responding to changes in the market and being able to correct decisions that appeared on the surface to be wise decisions, to be able to correct those in a timely manner.

Is there anything else that you all would want to add?

Mr. Poole. Well, implicit in some of those things is greater user-friendliness because you'd really change the mind set of the entity providing those functions to one of serving customers.

Even where there's a monopoly, if you look at the attitude that BAA takes towards the users of Heathrow and Gatwick, they're doing monthly customer surveys on, did they find a baggage cart? How was the quality of the food? Did the staff treat them well, and so forth? A real customer friendliness that we very seldom find in most of our government-run infrastructure in the United States.

And I think that's the kind of thing that we want to encourage -- responsiveness and accountability to those customers.

Senator Mack. Mr. Lauder, anything you want to add?

Mr. Lauder. I think Mr. Poole covered the various areas.

At the end of the day, I think the critical element for the taxpayer is, is he or she getting a service at the best possible price and is this service the best service that can be done?

And our country was built on a premise of competition and a premise of people believing in taking responsibility. And I think what we're saying is that give the individual a chance to compete, and I think that the taxpayer will be much better off.

Senator Mack. Well, again, I want to express my appreciation for both of your participation today, and again reiterate, at least from my perspective, my appreciation for the effort that you all have made over the years to raise this issue in the minds of the American people.

Thank you very much.

Mr. Lauder. Thank you.

Mr. Poole. Thank you.

Senator Mack. Governor Pataki?

Our second panel is made up of one individual, Governor Pataki of New York. Prior to his election, he served two terms as mayor of the City of Peekskill, New York. He has also served in the state legislature.

Governor Pataki brings a unique perspective to this afternoon's hearing as the Chairman of the Republican Governors' Association Committee on Privatization.

Since his election, Governor Pataki has developed an ambitious privatization agenda for New York, which has given him first-hand knowledge of Federal obstacles to state and local privatization efforts.

Again, Governor, thank you for your participation today and I look forward to your comments.

PANEL II

STATEMENT OF THE HONORABLE GEORGE PATAKI, GOVERNOR, THE STATE OF NEW YORK

Governor Pataki. Thank you very much, Senator, and thank you for hosting this hearing. And I'd like you to thank the members of the Joint Economic Committee for holding this hearing and inviting me to testify.

I've been asked by your staff to identify Federal barriers that stand between New York State and a successful privatization program.

Of course, doing this in five or ten minutes is like trying to explain the Federal tax code on a postcard. But given the time restraints, I'll skip all of the obvious pronouncements about the importance of privatization because I think we all agree that particularly now, as Washington seeks to finally achieve a balanced budget, governors, mayors, county executives must all be free to explore creative, more cost-effective methods of rebuilding infrastructure and delivering essential services.

And I'm sure we also agree that privatization is fast becoming one of the most effective ways to meet those objectives.

Several years ago, *The Wall Street Journal* noted that privatization is sweeping the world, but the United States, the father of capitalism, is standing at the station while the train moves out.

The reality is that we're not standing at the station by choice. Washington has handcuffed us to the platform.

All across the country, Federal bureaucrats have made it difficult and, in many cases, impossible, for the states to pursue areas of privatization with any real effectiveness. And all across the country, because of these Federal impediments, worthwhile privatization projects are turning into long, drawn-out nightmares.

While in New York we have successfully privatized assets within our jurisdiction, such as the sale of the Vista Hotel and the sale of a state-run bakery and a state-owned golf course, we're hamstrung when it comes to privatizing areas that require the blessing of the Federal Government.

The result is that we are delayed or, in fact, missing out on golden opportunities -- opportunities to harness the energy, expertise, and wealth of the private sector, and parlay it into improved services, cost savings, and expanded tax base and additional tax revenue for our people.

The barriers states face as we seek to harness the capital and expertise of the private sector occur at all levels of the Federal Government.

That is to say that this includes specific statutory obstacles, regulations and rules which limit state options, and too often, the hostile reaction of an entrenched Federal bureaucracy.

Let me give you some examples of each.

RCRA. As you know, RCRA deals with, among other things, the discharge of potentially hazardous effluent from various facilities. It differentiates between industrial plants which may discharge very hazardous materials, and ordinary sewage treatment plants. The latter are regulated by a less stringent and less costly set of standards.

RCRA did not contemplate the possibility that at some point, there could be private ownership of public wastewater systems.

Thus, those facilities subject to the less costly standards are defined as "publicly-owned treatment works." The Environmental Protection Agency has literally interpreted these words to mean that a publicly-owned sewage treatment plant, if it's sold to a private firm, would be subject to the more costly discharge standards applying to industrial plants, even though the discharges remain the same.

So, in other words, the standards will change based on whether it's publicly or privately owned, notwithstanding the goal to have one standard for appropriate treatment of wastewater facilities at sewage treatment plants.

Privatization would be greatly aided if Congress amended RCRA by substituting a new term, such as public purpose treatment plants, as opposed to publicly-owned treatment systems.

Another impediment, Revenue Procedure 93-13, is a product of the Tax Reform Act of 1986. It provides that contracts with the private sector entered into by states and localities to manage facilities, developed with tax-exempt bonds, are limited by a "3 to 5 rule."

That is, the contracts must provide for termination with cause after three years and terms of no more than five years.

Revenue Procedure 93-19 prohibits any form of manager compensation tied to net profits. By limiting the ability of firms to recoup capital invested and by discouraging productivity incentives, the effect of these rules is to seriously dampen the extent and scope of privatization agreements to manage public facilities.

These need to be revised.

Let me outline just one specific example of how Federal barriers impede state privatization efforts, in this case, in the sale of an airport.

Not long ago, New York began to seriously test the feasibility of privatizing state-owned airports. Despite millions of tax dollars that have been poured into these properties, they have not performed well as wards of the state and taxpayers, including the City of New York, have not gotten an adequate return on their investment.

But our exploration into this area started out on a very discouraging note. When our Empire State Development Corporation issued a request for financial advisors to handle the airport and other privatization projects, we were warned time and again that our biggest problem would be Federal regulations and the bureaucrats who enforce them.

In this case, unfortunately, the Federal Government lived up to this notorious reputation, just like it did when bureaucrats killed the efforts of Orange County in California to privatize John Wayne Airport.

Let me just run down some of the specific obstacles we're currently facing in New York with our airport privatization program.

The way it stands now, in addition to the impediments noted above, Washington bureaucrats can insist that states and localities pay back Federal grants to airports, wastewater facilities and other public properties if they are privatized.

This makes no sense. These weren't loans. These were grants.

Assuming the purpose of Federal grants is to improve the airports and keep them safe for the public -- and they have in fact been used for this purpose -- what difference does it make who ends up ultimately owning those facilities.

As long as the airport continues to function as an airport and serve the public, Federal grants should not need to be repaid. Penalizing states whose airports wind up in private hands discourages privatization.

Whatever Federal aid has been provided to a state-owned airport should remain to benefit the state and should apply equally to private as well as publicly-held assets, so long as the public interest is served.

Further, the Federal Government continues to limit what local governments can do with the proceeds from an airport sale. For instance, if an airport is sold to the private sector, there are severe restrictions on what can be done with the proceeds from the sale.

However, the Federal Government has granted exemptions to this rule for public authorities, which own airports in New York, New Jersey and in Massachusetts.

The Federal Government should have the same policy for all state governments if the private sector becomes the owner and allow us to use the proceeds of that sale as we deem most effective for the people we represent.

Federal tax policies also inadequately distinguish between public and private borrowing designed to meet airport capital improvement needs that will enhance public safety, such as improving runways.

If Washington is serious about promoting privatization, and I know, Senator, that you are, then it should level the playing field by allowing tax-exempt borrowing for private sector projects that serve a vital public need, such as the expansion of airports and the expansion of wastewater and water projects.

True privatization, the kind that generates additional revenue, expands the tax base, taps private sector sources of capital, and creates new private sector jobs, cannot happen until the Federal Government allows fair competition between the public and private sectors.

That's what we need, to implement privatization on the right scale, which, in my opinion, is a grand scale, and that's what we need to reap the cost benefits of privatization and pass those savings on to our taxpayers.

If this leveling process is to be successful, the Federal Government must establish an approval process for privatization projects that is simplified, less cumbersome and, above all, fair.

In that regard, the privatization of Franklin, Ohio's waste treatment facility is a good news/bad news story.

The good news is that the Franklin project survived a Federal approval process and successfully completed its privatization.

The bad news is that in addition to all the other complex negotiations and approvals needed, it took two full years just to get the nod of approval from the Federal Government for the sale. And this was not a giant billion-dollar deal. This was, I believe, a $6.5 million project.

And so, despite its eventual success, this Franklin model doesn't serve as much of an incentive for other governments to pursue privatization.

This is unfortunate because, in the long run, taxpayers are going to pay more if they must rely exclusively on the public sector for services.

In states and cities throughout the nation, the introduction of competition into the delivery of services has resulted in better, less expensive, public services.

The privatization of Indianapolis' wastewater treatment facility is going to save taxpayers $65 million and the privatization of Denver's bus system reduced operating expenditures by 27.5 percent.

The need for these types of private activities is further highlighted by the capital needs states and localities face in meeting their infrastructure needs.

Just as one example, Senator, it's estimated that to fulfill the mandates of the Federal Clean Water Act, states and local governments are going to need additional capital of almost $136 billion.

While public-sector financing is not readily available, the private sector can fill the void if federal laws and regulations do not discriminate against their participation in the process.

I'm confident that this issue has the bipartisan support of Democrat and Republican elected officials. State and local officials across the country must fill the vacuum created as Washington pulls back on its financing of infrastructure projects.

And they will be successful in doing this if Federal policies and bureaucrats don't stand in the way of allowing us to exercise the privatization option when we feel it's in the best interest of our constituents.

I urge you to follow through on the revolution of empowering the states to govern themselves by loosening the senseless rules and regulations that are preventing us from using the private sector to rebuild our crumbling infrastructure.

I think I speak for a lot of governors, perhaps all of them, when I say that privatization is too great an opportunity to go unrealized. In fact, I've

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taken a leading role in both the National Governors' Association and the Republican Governors' Association to address this issue.

We're not asking Washington for handouts for financial aid or anything that will cost the Federal taxpayer one cent. We're simply asking that the Federal Government do no harm, that is, to step out of the way so that we can move forward and progress.

Let me end, Senator, by saying that I know that with you, I'm preaching to the choir. Obviously, you realize that the Federal Government has a serious problem in this area and that recognition and commitment you have to overcoming these burdens is going to help us solve the problem together.

So I want to commend you and the panel for recognizing the seriousness of this issue and for taking the first step towards resolving it.

Thank you.

Senator, if you have any questions, I'd be pleased to try to answer them.

[The prepared statement of Governor Pataki appears in the Submissions for the Record.]

Senator Mack. Thank you. I appreciate your input here today. I do have several thoughts I want to pursue.

"Do no harm. Step out of the way." Tell me in simple terms how we can do that.

Governor Pataki. Well, let me give you an example.

With RCRA, change the law. If there is a municipally-owned sewage treatment plant and they have the ability to sell it to a private investor that will put it on the tax rolls, free up capital, allow them to make other infrastructure costs, and they've done an analysis that concludes that it's in the best interest of their constituents to do it, they can't because under the present law, they would have to upgrade that sewage treatment plant that is already meeting all the applicable Federal standards simply because of the change from public to private ownership.

That makes no sense.

And so, effectively, it precludes this type of project from going forward.

If that law were changed, it could happen.

The same thing with airports, the example I gave. The Federal Government has given grants to states and localities. They've used them for infrastructure improvements, runways, landing areas, terminals.

The Federal Government doesn't have that on its books any more. Those were grants given. And now, all of a sudden, though, if a local government makes the determination that they think it can be run better and more in their interest privately, they have to repay those grants.

Senator Mack. Let me focus on this question for a second because I think it is one that people have a little bit difficult time grasping.

I guess the thinking would go something like this.

Federal taxpayers give X-hundreds of millions of dollars to a local community for a specific purpose. I suspect that most people's initial reaction would be, let's not go to the transfer part or the sale part now. But Private Company X comes to the Federal Government for the purpose of providing an airport.

I think most people's reaction would be the Federal Government is not in the business of providing grants to private companies. What appears to be the next logical statement, therefore, they would be opposed to taking the funds that created that airport through a Federal grant to, say, a local community, selling that and then the local community keeping the resources.

I guess that is where --

Governor Pataki. Senator, I think there's a distinction there when you have the public ownership by a county or a state or a local government of a facility such as an airport.

If that airport, just using hypothetical numbers, and we have a number of very real situations in New York, with Kennedy, La Guardia, Republic and Stewart, all owned by either state authorities, multi-state authorities, or the state government.

In those cases, the Federal money has already been used by the government. It's not to benefit the private sector. And I totally understand that if someone was here saying, let's get Federal money to benefit a private company and allow them to avoid the need to raise capital or allow them to make more money, then it doesn't make any sense.

But these are funds that were used for runway improvements, as an example, that have gone into public service, gone into making the airports safer and having greater capacity, and served a municipal purpose.

Now that municipality makes the determination that it doesn't want to be in the airport business, for whatever reason. That value will have to be paid for by the private company. The airport is worth more because those public improvements have been made.

So the private company has to pay for them out of private assets to the State of New York, in the case of an airport that we would like to sell.

Obviously, we would have to use the proceeds of that sale for public purposes. We would have to use them for additional infrastructure, whether it's highways or improvements to sewage treatment plants or other transportation facilities.

So you don't run the risk of those Federal grants ever going to benefit the private sector directly. They go to benefit the public good through the sale.

But so long as they're tied up and if the airport is worth a billion dollars, but you have to give back a large chunk of that to the Federal Government, the incentive for the local government to make the sale disappears.

Senator Mack. Let me move on to the tax issue here for a second.

In your comments, I concluded that basically, we would end up with a situation that says, to give the private investor the same ability to sell tax-exempt bonds as the public entity if they were going to be pursuing some kind of project that was for the public good.

Governor Pataki. Right. It would have to be something that serves the public interest, such as safety improvement at an airport.

And the example that I would think of is something like a ground control system. That is something where you don't want people's lives to be jeopardized.

Senator Mack. What about a reverse situation, that we said, no tax exemption for either?

Governor Pataki. That would work as well so long as it's a fair system.

The problem, the only problem I have with that is that governments are facing the need to raise billions of dollars for infrastructure improvements. And to the extent that they might lose the tax-exempt ability to finance those improvements because of the existence of a private-sector operator, then it could make it far more difficult for the public sector to continue to raise that capital.

So that's an option that would provide, if, on a limited basis, a fair, competitive situation. But if it extended well beyond that, it could jeopardize the ability of local governments to raise the capital for infrastructure improvements that they need.

Senator Mack. The reason I raise that because, again, the theory here is that there is an interest in the private sector to invest in infrastructure.

And if that theory is correct, then given the opportunity to participate under an equal set of regulations, there should be capital flowing in there. And then it would be just a question of which is more efficient? Is it more efficient for the government to do it? Is it more efficient for the private sector to do it? And therefore, you don't need the incentive of the tax-exempt status in order to draw that capital there.

Governor Pataki. Well, Senator, what you just said I think is right and the important thing is that you just have to be able to make the determination as to what's in the greater public interest.

Can it be done more effectively and efficiently by the public sector or more effectively and efficiently by the private sector and allow the local officials to make that determination?

Right now, we can make a determination that it could be done better by the private sector, but not be allowed to carry that forward because of the Federal impediments.

And it's those impediments that we would like to see removed so that we would have the flexibility to determine and act on what we believe is in the best interest of the people we represent.

Senator Mack. Again, there's this thing that I raised just at the end of the last panel where the concept of grants flowing to states and local communities, either after very short periods of time or after some extended period of time, those grant funds, in essence, find their ways for other purposes.

I can assure you that a number of my colleagues around here would be nervous about the fact that they don't get to control that money any longer. And the whole issue of whether there should be any Federal grants -- some would suggest, well, just don't give any Federal grants any more.

Governor Pataki. Well, we could still use some Federal grants, Senator. I wouldn't take that position.

(Laughter.)

Senator Mack. So what you are saying is as long as the funds that came -- as long as you got the Federal grant, you would be required that any benefits that derived from you as a result of that Federal grant would have to be still used for public purposes.

I don't know what the fear is. I'm trying to raise a question from those who would be in opposition to this, and I'm not sure I'm articulating it properly.

Governor Pataki. I don't know what the fear would be. But just if we used the hypothetical where you get $100 million grant to upgrade the safety standards and capacity of a public airport, you do that. You serve the public purpose. You have a safer, more effective airport.

You then make the determination that private company X can run it more effectively, cheaper, will give you a sound return on your investment and will put it on the tax rolls and create a better economic climate.

You make the sale. You are being paid back that $100 million. The local government would reap a return based on its investment that it made in that airport.

It would then be free to use that for other things, such as improving sewage treatment plants, for expanding highways and bridges, and lessen the need for other Federal grants and other programs because governments are required to use those proceeds for a public purpose.

And I would like not to see Congress keep in place this impediment where the local government that has achieved and received a benefit through the Federal grant loses that benefit simply because of the nature of the ownership of the facility.

Senator Mack. And I'm going to close with this last question, which was, I think, the first that I raised with the first panel.

Think about the person who might be listening to this discussion for the first time about the idea of allowing state and local governments to privatize, to sell off entities that they have been operating for years. Individuals are probably saying, well, what's the benefit from doing that?

Now what we heard so far, and I think you mentioned some of them, you've got the issue of capital. The State of New York is going to be faced with a tremendous capital need to provide either for new infrastructure or for updating current infrastructure. And you have concerns about where that capital is going to come from, given the environment that we find ourselves in today.

The second is the efficiency, the flexibility and so forth.

Are there other things that you would say to the person listening for the first time about what the benefits are of doing this?

Governor Pataki. Yes, there's a third as well. It's that, at least in New York, all these publicly-owned facilities are off the tax rolls.

So that, as one example, the Vista Hotel in New York City was owned by the Port Authority. Tax-exempt. It made some payment in lieu of taxes but it didn't pay based on its value.

It's just been sold for $141 million.

That does three things. The Vista Hotel is going to run better because it's going to be run by a private sector expert as opposed to a government entity.

The second is that the Port Authority now has those capital funds available for other purposes -- transportation, hopefully, purposes that meets its public-service objective and running a hotel does not.

And the third is that now that that hotel is in private sector ownership, it will be on the tax rolls, ultimately, so that the value of that property will be paying property taxes to the local government.

So it's something that I think is of significant benefit, not just to the state government, but very often to the local government as a result of putting properties that were publicly owned back on the tax rolls.

Senator Mack. Well, Governor, I really appreciate your taking time to participate in this discussion today. It is one that is important.

Again, not many in this country have really focused on the issue of privatization. And those who have been interested in this issue say we as a Nation, through the World Bank and others, encourage governments all around the world to be getting the private sector involved in infrastructure and so forth, and here in this country, we have not.

And I think that your testimony today certainly adds weight to why we should be moving forward on making the kinds of changes to reduce these impediments to privatization.

So I thank you very much for being here and for your input.

Governor Pataki. Thank you very much, Senator, and good luck with the continued hearings of the panel.

Senator Mack. Thank you.

Governor Pataki. Thank you.

Senator Mack. There's a slight hesitancy on my part. I'm just trying to determine whether all the panel members of the third panel are here.

So if you'd just bear with me for a second.

(Pause.)

I would invite the panelists for the third panel to come forward. I think we're missing one, but I understand that maybe he is on his way.

It looks like at this point we have three of the five panelists here.

I think we will go ahead and get started. I'm under the impression that the other panelists are on their way. I will introduce the three of you at this point.

Mr. John Dowd is senior vice president of Wheelabrator Clean Water Systems, Incorporated, whose company owns and operates trash to energy and independent facilities, supplies air quality control systems for a broad range of water and wastewater treatment products and services to municipal and industrial customers.

Al Bilik is president of the Public Employees Department of the AFL-CIO. He was elected to office in 1988. His career in the labor movement spans some 40 years. He also holds a master's degree from Columbia University.

And Al Shanker -- it's nice to see you -- is president of the American Federation of Teachers. He is also senior vice president of the AFL-CIO and chairman of the general board of its department of professional employees.

He's widely known as a leader in the education reform movement.

I welcome all three of you. Mr. Dowd, why don't we begin with you?

PANEL III

STATEMENT OF JOHN T. DOWD, SENIOR VICE PRESIDENT, WHEELABRATOR CLEAN WATER SYSTEMS, INC.

Mr. Dowd. Thank you, Mr. Chairman.

First, let me try and establish why Wheelabrator would be invited to testify this afternoon.

We are in the water and wastewater business and have been for more than two decades. We were the first company, the first private company to operate a wastewater treatment plant in this country. Specifically, the Burlingame, California plant, and we still operate it to this day, started in 1972.

And perhaps most important, today, we are the company that actually privatized the Franklin, Ohio, wastewater treatment plant that has already been mentioned more than once by previous speakers.

I might also add if it isn't already clear that water and wastewater is the area of privatization that we are interested in. I appreciate that it's a much broader subject than that.

The subject today is Federal barriers and what do we suggest. The detailed testimony that I already submitted is just that -- many pages long and detailed. Let me cover just the highlights.

Let me make several points.

You asked before, what would we want the Congress to do? I would say the first thing would be make the private solution the first order of business rather than as it is now, the last order of business.

Put the private solution first, not last. If and when municipalities come and say, we need some help to solve this infrastructure problem, the question should be, have you gone to the private sector? Can they help you?

Second, as you've already heard, eliminate the statutory and regulatory barriers, especially those in the tax code. And there's a number of them and they're all covered in my written submittal.

Let me just mention perhaps the main one. And that is to allow long-term contracts.

It is imperative that we be allowed contracts in the order of 20 years, and why? So we can invest in these facilities. So we can bring them up-to-date. That is how we will make them environmentally better. We'll make them operate better. But the 20 years will also allow us to amortize that investment over a long period of time.

You've heard a lot of discussion from Governor Pataki and others about the equal footing of the tax-exempt financing versus the normal taxable financing.

I would make two requests there. Delete the private activity bond cap.

Senator Mack. Say that again. I'm sorry.

Mr. Dowd. The private activity bond cap. As it exists now, each state has a limit of private activity bonds that is based on $50 per capita. There's a whole formula.

Just get rid of that cap, insofar as it pertains to the financing of these kinds of infrastructure projects.

And second, I would suggest allowing accelerated depreciation. That smacks of -- well, that's just going to be a bonanza for private companies.

The truth of the matter is it won't be at all because these transactions are going to be competitively bid in 99 percent of the cases. The kinds of savings that a private company would get from accelerated depreciation will in fact flow back into the bidding process because we're going to compete with a number of other companies and we're going to want to win, and you're not going to get that way by keeping it all in your pocket.

And fourth, we want total grant forgiveness. As Executive Order 12803 is written, there's a depreciation factor in there. What we would look for, as is now contained in Senator Roth's bill, total grant forgiveness, rather than partial.

So what will the results of all this be?

In the water wastewater area, we will free up $30 to $35 billion. That's the value of the plants that exist today in the ground. That can all be converted to cash and used by municipalities for infrastructure, for debt reduction, or for rate reduction.

Second, the service fees will be reduced. That was the case in Franklin. In fact, we acquired that plant for $6.8 million and the service fee is reduced by approximately 20 percent.

That is also the case in Wilmington, Delaware. Now that's not finalized yet, so we are just predicting the outcome there. But the results of that will be a reduction of more than 15 percent and an up-front payment of as much as $53 million.

The third thing that hasn't been commented on at all today and that is the industrial development that may follow this privatization.

I refer you to an article in Public Works Financing, and I'll make a copy available, Mr. Chairman, to you, the title of which is, "Franklin, Ohio's Privatization Bonanza."

And the whole discussion is about what this has meant to that city with new jobs, new industry coming in, because they chose to privatize their wastewater treatment plant and will privatize their water treatment plant, as is their plan.

I'll give you one quote from the Mayor, "The end result of this privatization is dollars for economic development," he says. "It's a bonanza."

What are the problems? What do we need to worry about? What should be our concerns?

First is the control issue. Will the town and city lose control of their facilities somehow?

I would argue that they'll have better control if they deal with qualified companies, financially and technically qualified. They'll have a legal and binding contract in place that they can enforce on us that's better than doing it themselves.

The second thing is the employees.

That should not be a controversial issue. Speaking as the head of one company's efforts in this, we should not do this on the backs of the employees. The point is we should take care of the employees.

In Wilmington, it was done by the RFP (Request for Proposals) that said there will be no lay-offs for two years. The benefits for the employees will be equal to or better than what they are today.

It would not be fair and it would not be right for us to do privatization and hurt people who really haven't caused the problem in the first place.

So I would submit, as one company in this business, we're not going to do that. We're going to make sure that the employees are taken care of.

So, in closing, Mr. Chairman, this is going to be a year of lots of controversy in Washington and other places. I'm from New Hampshire, so I already know all about that.

I would suggest that this need not be a controversial issue, that in fact this is something that both the Republicans and the Democrats can do in 1996 that will help our cities and towns.

And I would encourage prompt action, and I thank you.

[The prepared statement of Mr. Dowd appears in the Submissions for the Record.]

Senator Mack. Thank you very much.

Mr. Bilik, why don't we go to you next?

STATEMENT OF AL BILIK, PRESIDENT, PUBLIC EMPLOYEE DEPARTMENT, AFL-CIO

Mr. Bilik. Thank you. Good afternoon. I'm Al Bilik, president of the AFL-CIO Public Employee Department. The Department, Mr. Chairman, is composed of 35 national unions, all involved in public service.

One of our major affiliates is the American Federation of Teachers, which of course Mr. Shanker heads.

Our members provide public services on a daily basis. They know that privatization can serve as a panacea only for the financially near-sighted and is a disguise for poor management of our infrastructure's assets.

And that's the essential question. It is not public versus private. It's good and bad management. And you find examples of both in both.

We all have the same objective -- to improve the quality of our infrastructure and our public services, generally. But our citizens should be warned, in my view. Privatization promises a simple, compelling solution to the complex, multi-faceted, chronic fiscal crisis which now plagues American governments.

I urge the Committee to set aside ideology, look at the facts and seek alternative solutions.

Proponents argue that privatization can provide state and local government significant savings. As Richard Hebdon of Cornell notes in his review of the Lauder report, which we heard much of this afternoon, "Unfortunately, ideology still seems to be the guiding principle of privatization research."

Hebdon reviews the academic literature contained within the Lauder report, finds that the study's cost data is 20 to 30 years old. The report primarily relies upon one article from 1984, which fails to present the full results of that author's statistical analysis.

In addition, the article's intent is to simply promote privatization, not to provide objective analysis.

Now the Lauder report totally ignores the option of labor-management cooperation, which we have not heard anything about today. Cooperation is a very effective method for improving public services. Not only effective, but proven so.

John Koskinen, the OMB Deputy Director for Management, pointed out in his House testimony on December 12th of last year, "We believe that improved efficiency and service quality can best be achieved through increased competitiveness and through improved labor-management cooperation."

That statement confirms a similar earlier assessment by the major accounting firm, Peat Marwick (KPMG), following its study of management operations for the City of Indianapolis.

But estimates, nevertheless, of privatization savings range widely, anywhere from, among the figures we've seen, 16 to 77 percent. Local governments frequently target, for example, mass transit for privatization.

However, research by Columbia University Professor Elliott Sclar shows that while some initial incremental savings may be found after contracting out, by the second round of contracting, those savings disappear.

This was clearly shown in Denver, and there was a reference to Denver earlier. But you will see in Sclar's report that virtually no difference between public and private operating costs existed. The differences ranged from a high of 4 percent down to a low of seven-tenths of 1 percent.

But the auditor did not account for the fact that the private operators kept the fair revenue. And when that revenue loss is added to the operating cost, the Denver privatization is actually losing around $4.20 per revenue hour.

This was a statement by Sclar before an Illinois Senate Committee in January of this year.

Well, why worry about six-year provisions if privatizers guarantee continued employment?

Under the circumstances, we've heard comments that the privatizers are quite willing to give all the benefits possible in terms of job security. Mr. Dowd just talked about two years in Wilmington and we've heard other references earlier.

If that's the case, why be overly concerned about that six-year provision in the Mass Transit Act, which does provide for some security, not through the goodness of the heart of the new contractor, but by our government's own guarantee?

When President Bush issued his Executive Order 12803, urging states and local governments to privatize, there were responses from various sources. The AFL-CIO issued a statement that placed the 13 million member federation in strong opposition. We said that privatization of public assets is a recipe for disaster at a time when the Nation's infrastructure is in a state of severe decline.

It is bad policy for the government to turn over public facilities to private operators that place a top priority on making money, not serving the public.

The *Chicago Sun-Times* offered a similar comment at about the same time, alluding to the private contractor that drove the pilings that flooded the downtown of Chicago back in 1992.

It was private and not public.

Caution regarding privatization prevailed until the EPA began to encourage communities to give up control of their facilities.

On July 11 1995, new ground was broken, as Mr. Dowd suggested, when the Franklin, Ohio regional wastewater treatment plant was approved for transfer to the waste management subsidiary, Wheelabrator. About $6 million was involved.

The transaction did not involve competitive bidding. The price was established by a technique known as "the original cost less depreciation method," and none of the net proceeds was returned to the Federal Government, a very significant investor in that enterprise in Ohio.

Prior to the Bush order, Executive Branch policy on a management disposition was based on the so-called Grants Management Common Rule. That Rule applies to all Federal infrastructure grants to local governments to protect the Federal investment and to ensure that the purposes of the grants are achieved.

The common rule, however, presumes continued public ownership until the asset is no longer needed.

If an infrastructure asset sale takes place, the common rule requires the Federal Government to be treated as a shareholder.

The Wall Street Journal hailed the Franklin transaction, reporting that Wheelabrator and the others are hoping for similar deals elsewhere. It's established that there are more than $30 billion in wastewater treatment facilities currently in government hands. The others referred to are two giant French firms, Compagnie Generale des Eaux, which is called CGE, and Lyonnaise des Eaux, the latter having earlier negotiated the management contract with the City of Indianapolis.

The magazine, Public Works Financing, in its June '94 issue, reported that CGE and Lyonnaise were accused of causing, and I quote from the journal, "80 percent of the political corruption in France" through their funding of candidates in municipal elections.

Indeed, the French parliament in January of 1995 adopted a law that "prohibits businesses from contributing to any political campaigns in any way."

It's my view that we should prohibit contractors from contributing to politicians and parties with whom they do business.

I want to comment quickly on an ad that appeared in Governing magazine recently. It's an ad extolling the virtues of the mayor of Indianapolis, Steve Goldsmith, who has done remarkable work. It's an ad taken by, in part the French company, Lyonnaise, which holds the operating rights, along with some others, to the wastewater treatment plant in Indianapolis.

It's a very good ad. It's well done. And it says here, "We want to offer a well-deserved accolade. But if we know Steve Goldsmith, he's going to continue to make a splash in Indianapolis and beyond for years to come."

Now this is a paid ad, obviously, and it's no coincidence that Mr. Goldsmith, who has submitted testimony here today, is also today making his announcement that he's a candidate for governor of Indiana.

There's a serious question in my mind, and there should be, it seems to me, in the minds of the Committee, that when private enterprise, in inducing or attempting to induce the taking of a contract for public services, gets involved in local political -- I was going to use the word chicanery, and I'm sure that's not fair -- local political involvement, that there is the hint, the broad hint, of great trouble ahead, as witnessed by what happened in France.

The publication, The Economist, in 1995, added New York, Trenton, Orange County to the short list of local governments seeking quick-fix solutions, along with the City of Wilmington, currently negotiating with Wheelabrator. And according to the November issue of Public Works Financing, the 20-year deal will cost the company some $53 million.

That contradicts findings by a prominent consultant, Myron Oldstein, formerly of KPMG, that the lowest-cost option would be for the county to build and operate its own treatment plant.

Cities like Wilmington and Franklin still bear the ultimate risks. Wastewater treatment is absolutely critical to public health and public safety. Bacteria and viruses thrive in raw sewage. Acts of nature such as floods and storms can force industrial waste releases -- witness the disaster in Milwaukee when several people died a few years ago.

Furthermore, under many existing private operation management contracts, local governments continue to cover capital costs, debt retirement, property insurance and ownership and administration.

And when vital public services are at stake, the government is always ultimately liable for the health and well-being of its citizens, whether or not it technically owns the facility.

We should ask some questions.

Was the Franklin deal truly based on fair-market value? Was there a formal appraisal and accounting of the actual market value of the plant?

A recent report reveals that the 1990 sale by the British government, of which we've heard today, of 12 regional electric utilities for 5 billion pounds was in fact a steal for the companies.

The magazine, Euromoney, for November of 1995, now estimates the value of those plants at 20 billion pounds.

Simon Taylor, a utilities analyst with J.P. Morgan in London, said, "Only now is it becoming clear just how cheaply they were sold." It's late for the British, but are we adequately protecting ourselves against similar disasters?

Senator Mack. Mr. Bilik, let me ask you, if you would, to wrap up.

Mr. Bilik. All right. I will. I appreciate that I've taken more time than I was accorded. Thank you very much.

I just want to conclude with this suggestion. I think putting America's infrastructure on the auction block will only serve to harm ordinary Americans, businesses and communities. Low-income households would be particularly harmed. Although the privatizers say that the facilities should continue to be used for its original purpose, they don't specify who is to determine how long a facility will be needed.

Privatized facilities such as recycling centers, water treatment plants, hospitals, schools could be converted to other uses. And in the event that a private firm cannot make a profit, it may be forced into bankruptcy and under such circumstances, all of us, the taxpayers, will be liable. We could end up with a situation much like the savings and loan debacle.

The public employee department believes that the Federal Government should put a stop to any further efforts to privatize public facilities. We urge the Congress to reject legislation such as H.R. 1907 and S. 1063, which value private profit over public service.

We would ask President Clinton to rescind the Bush Executive Order 12803, and this action would be more in the public interest than enacting any legislation that would expand and codify the Bush Executive Order.

Thank you very much and I do apologize for running over.

[The prepared statement of Mr. Bilik appears in the Submissions for the Record.]

Senator Mack. Mr. Shanker?

STATEMENT OF ALBERT SHANKER, PRESIDENT, AMERICAN FEDERATION OF TEACHERS

Mr. Shanker. Thank you very much, Mr. Chairman.

I'm here to talk about our brief history with private management in the field of public education. I'd like to start by saying that I am not in principle opposed to the idea of private management of public schools or public school systems.

It may be that some day there will be firms with highly competent professionals who are able to come into school systems that are in disarray, help put them together, and show the local people how to do it.

That has not been the experience up to now.

There are several companies in the field and they have been given a red carpet treatment with the press and others proclaiming success before there was any. The most prominent of these companies is EAI -- Educational Alternatives Incorporated.

This outfit managed one school in Miami, Dade County, where they had a school for four or five years. The school system over a year ago withdrew the contract, saying that the students in that school, even though more money was being spent on them, were doing no better than students in control schools.

Baltimore signed a contract with EAI. Essentially, the contract was that EAI would run nine schools and make as a profit whatever money they could get from savings.

The savings came about by increasing class size, by dismissing teachers who have special qualifications to teach disabled youngsters, by putting severely disabled youngsters into regular classrooms, and by dismissing the regular paraprofessionals and school aides who live in the community and have been working with those students and their families for years.

The school aides were getting $12 an hour and health benefits. They were replaced with recent college graduates for seven dollars an hour and no benefits.

Of course, kids out of college getting seven dollars an hour didn't last very long. It was a job until they got a better job.

Now what were the results in Baltimore?

First let me say that EAI said that it would produce dramatic improvement in pupil achievement scores in one year and it would do it for the same money that the Baltimore public schools were spending on other students.

Well, the contract shows that EAI actually negotiated a very sweet deal for itself. It got about $500 more per student than was being spent on students in any other school in Baltimore.

So the first thing is they got more money.

The interesting thing is that, instead of raising achievement scores or even keeping them level, the nine schools managed by EAI had student score plummet dramatically. This was at a time when at all other schools in Baltimore, the scores went up.

This was true three years in a row.

EAI's contract has recently been cancelled by the City. But the scores of the students have not yet reached the level that they were at when EAI was brought into the school system.

While EAI was managing nine schools in Baltimore, the City of Hartford decided that they would hire EAI to manage their entire school system. Why anybody would go to them after that sort of record, I don't know, but this tells you something about the capacity of school boards to intelligently deal with private companies.

It is the equivalent of my going to the bald barber to ask advice about how to grow hair.

But the EAI went to Hartford and there, too, they were supposed to make their profit by -- they were supposed to get half the savings in the system.

What happened was that after a few weeks, they decided that they did not have the capacity to manage the whole school system. So they decided they would manage just about a dozen schools.

They spent most of their time from last September to the present negotiating with the school board about how much money they were supposed to get. They suggested the school board fire a large number of teachers and increase class size because, if they fired these teachers, millions of dollars would be saved and EAI would keep half the money.

The school board didn't want to save money that way, and so EAI did not get any profits. But they did pour millions of dollars into the schools with computers and other things.

So EAI has been asked to leave there, too.

There are a few other companies in this business.

One is an outfit called Edison, originally put into business by Chris Whittle. The chief executive officer is Benoit Schmidt, the former president of Yale University.

There, too, with Edison, the record is not great.

The Edison people came on the scene saying that they would, within a few years, start 1000 private schools in the country, that those private schools would charge tuition equal to the average per-pupil expenditure in the United States, and that 10 percent of the students in those schools would be on free scholarships. They would be public school students. And this would be a demonstration of the fact that private schools run by this company could do much better than public schools.

After two years, they gave up on the plan because their calculations were slightly off. While they might have been able to run schools at the same per-pupil expenditure as the public schools, they had forgotten to figure into their calculations the fact that they would have to either build, buy, or rent 1000 buildings. It is hardly something to inspire confidence when a major company forgets to figure into its calculations the cost of doing business.

So they are in business, but they are now managing six -- not 1000 private schools -- but six public schools.

Let me just conclude by saying this: the basic analogy that is used, or the basic speech that I once heard Benoit Schmidt give, and Chris Whittle as well, is that public schools are a monopoly. We know that monopolies don't have to shape up because they don't face any competition. If you had private management, there would be competition for that management, at least. That was the justification of it.

It's rather strange that Benoit Schmidt does not notice the fact that the schools that we look up to, the schools of Japan, of Germany, of France, of Sweden, of Switzerland, of Australia and of many other countries around the world, are not privately managed. Indeed, they are government monopolies and, if anything, are more monopolistic than ours because they are either national or state school systems. None of them have 15,000 local school boards.

I'd like to conclude where I began. It may be that some day there will be companies that are able to do this. Right now, we don't have companies, but worse than that, we don't have public management that's really capable of effectively dealing with private companies.

If I call in a contractor to fix up my kitchen, I will watch him pretty carefully. I will want to make sure that the cabinets I ordered are indeed the cabinets that are put in and not some other version, that the lighting system is the one that I contracted for.

I assume that the contractor may try to cut corners, unless I watch him very carefully.

That does not happen on the public school scene. The test scores plummet in Baltimore. By the way, they violated Federal laws with respect to how they handled these disabled youngsters, a horrible record.

And instead of the superintendent of schools saying, "Thank God we got rid of them, I made a mistake, and now we'll look for some other outfit, an outfit that can do a better job," in this morning's *USA Today*, the superintendent says: "In a perfect world, EAI and the City of Baltimore would be renewing a commitment to work together for years to come."

Well, why would you renew for years to come a contract in which the students' scores were going down and in which the service costs you more than the service you were providing in any other school?

There's only one reason and that is that the superintendent of the schools is a political figure. He's trying to save face. What he's telling the public is I did not make a mistake in the first place. I did the right thing.

And so we see that there is a tendency here, at least in public education, when they enter into some form of privatization. Instead of carefully monitoring the company to make sure that they're getting what they bought in the first place, there's a tendency to cover up for all the shortcomings because the shortcomings reflect on a poor political decision made in the first place.

Thank you.

[The prepared statement of Mr. Shanker appears in the Submissions for the Record.]

Senator Mack. Next we'll go to Mr. Bob Cranmer, who serves on the three-member Allegheny County Commission. I believe that's the Pittsburgh area.

Mr. Cranmer. Yes, it is, sir.

Senator Mack. He is the Commission's point man on privatization.

I welcome you and look forward to your testimony.

STATEMENT OF THE HONORABLE BOB CRANMER, COMMISSIONER, ALLEGHENY COUNTY, PENNSYLVANIA

Mr. Cranmer. Thank you very much. And I certainly thank you for giving me the honor and the opportunity to come and address the Committee today.

I was recently elected to the board of commissioners in Allegheny County, Pennsylvania, along with my running mate and incumbent, Commissioner Larry Dunn.

We were elected with a mandate from the electorate to systematically reduce the size of county government, which has grown unchecked in the county for the past 25 years.

My background includes nine years as an active-duty Army officer and as a manager with AT&T, working through the period when the corporation transformed itself from the largest public utility in the world to now one of the most competitive corporations.

Some background on the county.

Allegheny County is one of the most populated counties in Pennsylvania. It encompasses 130 municipalities, 727 square miles of territory, and has a population of 1.3 million.

The county has a budget currently at about $759 million.

I ran for the position of county commissioner because I believe that our county government was being mismanaged. This mismanagement resulted in an exorbitant tax burden for the citizens.

The voters thought so, too, obviously, and that's why we were the first Republican majority elected in the county since 1932. So, obviously, there was a problem that was recognized.

Recently, Money magazine ranked Pittsburgh with the third highest tax burden out of the top 100 cities in America, and last year, Allegheny County was ranked with the second highest property taxes in the United States.

As a result of this, the county has been experiencing a loss in residential and business investments, along with a massive loss in population to the surrounding counties.

The need for exorbitant taxes is fueled by a requirement to feed what has come to be a mini-state government in Allegheny County.

Now it's very clear that to have a competitive region, you must have a competitive government. As a result, on January the 1st, our first day in office, we cut property taxes by 20 percent and we froze a haphazard real estate assessment system as part of a plan to make our region more competitive again and, again, friendly for both residents and businesses.

To make our government more efficient, we plan in the coming year to implement a strategy of managed competition and also certain specific projects of privatization, which, again, has been used across the country in cities like Indianapolis, Milwaukee, and Philadelphia.

Allegheny County's managed competition strategy will be a comprehensive effort to let private sector companies compete with government workers to deliver the services. We expect the principal benefits of this strategy to be a lower cost of government, a subsequent lower tax burden, and an increased responsiveness of government to the citizens.

For Allegheny County to use this and other privatization approaches, we feel the Federal Government must adjust its regulatory position with state and local governments.

Currently, the county relies on significant Federal dollars to fund its mass transit, airports, children and youth services, nursing homes, juvenile programs, and community development block grant programs.

When we first examined the county budget earlier this month, we soon understood that, in some program areas, cuts could not be made because of the incentives set up by various Federal agencies. Some programs are matched by Federal grants ranging from a one-to-one match to a 29-to-one match of federal to local funds.

For example, in order to save one dollar in county money, we might have to give up from $10 to $30 in Federal matching money. So with a financial constraint, it's difficult to overcome that because we're more or less penalized by losing a large sum of money in making something more efficient and reducing the amount of money the county actually has to spend.

And that is particularly apparent in children and youth services.

If we contract out more of these programs, the county would not benefit from the bulk of the savings. Consequently, then, the pressure to continue to spend money in service delivery directly enhances the need for more government bureaus.

In the area of mass transit, Section 13(c) of the Federal Transit Act provides labor protection provisions for employees of public transportation systems and it is an extremely complex Federal requirement.

The Department of Labor generally requires an approval of an application for Federal Transit Assistance funds by labor unions before funds are released and, in effect, it gives labor unions control over when application for funds can be approved.

This actually gives powers to the unions in the ability to use the 13(c) certification process as a bargaining tool in other unrelated issues. Attempts to contract out unrelated services can thereby be held hostage by this bargaining process.

Currently, 13(c) is administered by the Department of Labor and not the Federal Transit Administration. This adds an unnecessary layer of bureaucracy to an already complex process.

The Federal Transit Administration, along with awarding grants funds, should assume administrative responsibilities for this certification.

Historically, the certification process has been delayed because of the time period given to the unions to raise objections and for the delay caused by the Department of Labor's slow response time.

While recent Labor Department regulations are intended to speed up the process, it is not known how effective they will be. The process creates needless delay and substantial uncertainties for transit agencies attempting to implement projects. This also boosts project costs to the taxpayers while stifling innovative services.

While the new regulations do streamline the process, they are inadequate because the Department of Labor still can opt out, i.e., the Department retains the right to withhold certification where circumstances inconsistent with the statute so warrant, until such circumstances can be resolved, i.e., problem with a labor union contract.

The current 13(c) agreement deters privatization because they inhibit the transit authority's basic management rights to contract out to implement more effective services.

Finally, 13(c) specifies that any transit worker who loses his or her job due to subcontracting in any form has the right to be paid six years of severance pay.

In short, no employees can be let go in a cost-effective manner to reduce costs in a privatization effort.

In the area of aviation, aviation savings do not benefit the county's budget because any cost savings must be maintained within the aviation budget.

If such cost savings were used to cut county taxes, this action would be considered a diversion of funds by the Federal Aviation Administration and be disallowed.

Full privatization of an airport is also heavily discouraged by current Federal policies. According to an analysis by the Reason Foundation, there are two types of grants specified under the Airport and Airways Improvement Act of 1982 -- discretionary grants and entitlement grants.

While the former may continued under a privatized airport, the latter may not.

One final point. Because government entities are entitled to issue tax-exempt bonds, they can entice investors to buy the bonds at lower interest rates.

On the other hand, if a private entity tries. And even if they cannot do this, such as sewer treatment or water treatment, they cannot take advantage of that same enticement for the government entity.

This means that government entities have a built-in advantage over private entities in capital cost.

So, in conclusion, I must say I thank you again for giving me the opportunity to represent our views here today, and on behalf of Allegheny County and other administrations across the country, I ask for your assistance in attempting to reduce the overall cost of local government because it's imperative that we seek and find ways to save money and to deliver services more effectively and efficiently.

Thank you.

[The prepared statement of Mr. Cranmer appears in the Submissions for the Record.]

Senator Mack. Thank you. Our last panelist this afternoon -- and we've been joined, by the way, by Senator Santorum from Pennsylvania.

Did you have any opening statement?

Senator Santorum. I'll wait. Thank you, Mr. Chairman.

Senator Mack. Okay. I'll turn now, then, to Mr. Bell, who is president of British Airports Authority USA, Incorporated.

His firm owns and operates seven airports in the United Kingdom. BAA also operates the Indianapolis International Airport, which is the largest U.S. airport to come under private management.

We welcome you and look forward to your statement.

STATEMENT OF MICHAEL E. BELL, PRESIDENT, BAA USA, INC.

Mr. Bell. Thank you, Mr. Chairman.

I've been employed by what was called the British Airports Authority, but now it's called BAA Plc for some 10 years now.

Senator Mack. Try to get that microphone a little bit closer to you.

Mr. Bell. Does that work?

Senator Mack. Yes, that's great.

Mr. Bell. Okay. But I'm not very good with microphones.

Right.

(Laughter.)

Okay. I've held my current post in the United States for five years. The privatization of airports in the United Kingdom is very interesting. It took place in 1987. The primary objective of that privatization and a lot of others was raise revenue as part of a program to mitigate the national government deficit, something of which, of course, has familiar tones here.

What was interesting is that since that privatization, BAA has maintained safety and security as its top priority. Its become far more customer-focused in the belief that profits flow from satisfied customers. It's increased productivity every single year. Passenger service has improved every single year. We've improved sources of nonaviation revenue, so that airlines don't have to foot the bill for everything that's done. And landing charges have been reduced every single year.

Also, we've created an environment where employees are both motivated and empowered to deliver their best work.

My company has two contracts in the United States. First, at Pittsburgh International Airport, where we set new standards for U.S. airports. For the very first time, customers at airports were faced with a unique blend of branded operations, a choice of places to go, a lot of competition between operators, and prices which were guaranteed to be not a cent more than those charged by the same outlets located away from the airport.

Just for an example, coffee typically at a U.S. airport is $1.05. At Pittsburgh, it not only cost just 49 cents, but you have a choice of over 30 different food and beverage outlets, all operated by different people, to buy that coffee at.

And that has been an amazing success, and it has now become the standard by which other U.S. airports are judged. It's the first U.S. airport to have had on-board tenants, such as TGI Fridays, Brookstone's, the Nature Company, the GAP, and many other internationally well known, recognized stores.

Second, we recently won a contract to manage Indianapolis Airport, and we won that contract because of our ability to reduce costs and increase nonairline-related revenue sources, like the retail program that I described and also property and cargo developments.

BAA actually guaranteed reductions in charges to airlines over the ten-year contract period and it also undertook to vastly improve the level of service to all airlines and passengers.

This is an airport which has a reputation in the U.S. for already being extremely efficiently run.

We also undertook to retain all the existing employees and to maintain their benefit levels.

Why did we do that?

Because the talent and knowledge to do jobs better and more efficiently actually lies with the people doing those jobs. And our role is not to profit at their expense, but to benefit by harnessing their talent and their expertise and creating a climate in which they can actually contribute to the future development of the business.

It's interesting to note that the City of Indianapolis will not receive direct financial reward by putting this contract to private management. This is because of the so-called closed-loop system, which ensures that all funds generated on the airport are required to stay on the airport. But the city believes it will gain in other ways because it will create smaller government. It will create better service to airlines and passengers, thereby enhancing the attraction of doing business in the City of Indianapolis. And it will also provide access to a much wider range of air service and marketing skills.

Now there are special problems that relate to airports in the United States.

First of all, many U.S. passenger facilities are well below the standards found at the world's best airports.

Secondly, billions of dollars are going to be required to develop the infrastructure for the next century. And as a result of conditions attached to airport improvement grants by the FAA, airport owners are not permitted to make a profit from their airport operation.

What this actually means is that they're just not motivated to reduce costs or to increase alternative sources of revenue. There is no reason why they should address that particular problem.

This, in turn, diminishes the quality of passenger services and it increases airline costs.

Capital that is available is often not being spent effectively, as the wrong things are being built or they are designed to satisfy civic or mayoral pride, rather than satisfying just the needs.

Airlines have a number of legitimate fears that must be addressed. What they sometimes don't realize is that successful private companies, like themselves, are customer-obsessed.

We only make a profit if we really satisfy our customers.

I suggest that some of the U.S. airlines are probably missing the point when they seek to maintain the status quo. What they should be seeking is to make sure that there is a situation created that gets them their best possible service at the lowest possible cost. They should be demanding lower charges for the use of better facilities.

I want to say a few things about employees.

Typically, it is not the fault of existing airport managers or employees that cause those problems that I described. It is much more likely to be the environment they work in, the procedures required by government bodies with regard to employment or procurement, just for example, and the gross interference that often takes place with regard to the appointment of contractors, the holders of senior posts, and in a case I recently heard of, even the color of the walls.

Privatization, on the other hand, gives the employee and management the opportunity to blossom and discover their real talents.

Privately managed airports in the U.S. are already resulting in reductions in costs, improvements in service, and the expansion of alternative source of income.

It can also provide a source of capital, provided that that capital is spent effectively.

Unfortunately, there are barriers to the introduction of private capital. There are three levels of subsidies relating to publicly-run airports in the U.S. They are the source of tax-exempt bonds for financing, the exemption of those airports from normal taxes, and the gift of Federal grants.

Those barriers to private capital will be a handicap. But it is possible to realize many of the benefits of management, even whilst those barriers remain. This is what has been done in Indianapolis, where the added value by the private sector is shared with the airport owner, and a portion of that added value is guaranteed.

Now I just want to share with you a personal perspective on this because, as I said before, I have worked for my company for over 20 years now. And in 1985 and '86, when privatization was being discussed, like most of the employees of my organization, I was opposed to it.

Philosophically, it seemed wrong. It seemed a threat to our security and our ability to do our jobs. And that may not seem either rational or logical now, with the benefit of hindsight, but that was the way we felt in 1985 and '86.

In 1987, it was almost as if a light came on. Procedures and paperwork went out the door and common sense and freedom to management came in.

The productivity and the job that we felt in going to work was something that we all shared and we all benefited from, and we were able to benefit not just in increased personal reward, but also in terms of security of our jobs and in much greater satisfaction in doing a job well.

And what I've described to you is a common experience of employees at all levels.

So I urge that we do everything possible to enjoy the benefits of private management techniques and style in U.S. airports at the earliest possible date.

Gentlemen, thank you very much for listening and I appreciate the opportunity to come here.

[The prepared statement of Mr. Bell appears in the Submissions for the Record.]

Senator Mack. Thank you, Mr. Bell, and again, I express my appreciation to all of you for your both being here today and for the testimony that you have provided.

I'm going to ask just a couple of questions and then I'm going to give Senator Santorum an opportunity to get involved here.

I think that the first area is to Mr. Dowd.

We've had this discussion about the tax-exempt status of financing. I've raised, I think in both panels, the question about -- the way it's been presented to me is that you kind of give the private sector the same incentive, if you will, with the tax-exempt bonds.

What about the opposite situation? If you were to eliminate the tax exemption, would there still be interest in the private sector in the moving into these infrastructure areas?

Mr. Dowd. Senator, do you mean to eliminate tax-exemption completely?

Senator Mack. Right. So, in other words, that both the municipality and the private sector would be competing for capital on the same basis.

Mr. Dowd. Yes, that would have the same effect. To tell you the truth, that seemed to us to be a fairly heavy lift, to use a little jargon, politically. But it would absolutely have the same effect as far as we're concerned to levelize the playing field.

Senator Mack. Mr. Bell, do you have a reaction to that?

Mr. Bell. Well, I think the essence is to level the playing field. And enable anybody to compete sensibly, yes. The same type of financing should be available to the private sector or the public sector if they're doing the same jobs.

I think the essence is to level the playing field. Either it should be removed from the public sector operation or it should be given to the private sector.

Senator Mack. Mr. Dowd, let me go back to you and let's talk about the Franklin case.

What most of the discussion today has been about is eliminating barriers. While it's fairly obvious to anyone who's been observing this discussion, I certainly favor the privatization concept. And so what we've been talking about is the elimination of barriers to allowing the private sector to participate.

If you made Franklin a success, given the present structure, why can't it be duplicated in other areas of the country?

In other words, some people might say, why are we going through all of this if you all proved that it was such a success in Franklin?

Mr. Dowd. It wasn't easy. It took a long time, as you've heard others describe up here. And what we had to do were really three things. We had to, in the end, file something called a Grant Deviation Request. That was finally approved by the EPA and by the OMB.

So those things which, were there in conflict with existing regulations, were taken care of through this deviation-type document.

Second, we became co-permittee on the NPDES permit.

Senator Mack. I'm sorry? What does that mean?

Mr. Dowd. We and the cities, Franklin and Germantown and Carlyle, are all listed on the NPDES permit.

Senator Mack. Which is what?

Mr. Dowd. The National Pollution Discharge Eliminate System permit, which is the comprehensive permit for any wastewater treatment plant.

And we did that -- actually, that makes a lot of sense in a number of cases. But we also did that to sort of work around some of the other language problems that exist in regulations in the EPA today.

And the third thing that we did was we took care of all those other nonstatutory things in our contract where we assigned the responsibilities of who would do what for 20 years so that there was no question as to what our responsibilities are and what the responsibilities of Franklin, Germantown and Carlyle are because, by the way, privatization is more correctly called a public/private partnership. There's still a role for those towns or for Wilmington or any other city that we would do business with.

Senator Mack. Are you aware, are there a number of municipalities that are looking for this opportunity to enter into privatization?

Mr. Dowd. Yes, there are. It's happening rather recently. It's starting to attract more attention.

Senator, if you don't mind, I'm not going to read you a list of them because it's a competitive business and I'm not going to tell anybody anything about who's looking.

Senator Mack. No, I understand.

(Laughter.)

Mr. Dowd. Other than I will say, Milwaukee, because that's one that's been in *The Wall Street Journal.* So we can talk about Milwaukee and others, too, by the way.

But, yes, and if I may just add something to that.

What I think we would hope for from the Congress is sort of the Congress taking the bully-pulpit role, speak out in favor of privatization as a real solution. I mean, there's real statutes to change and laws to change and tax laws to help you. But there's also that role of what you're doing right now, which is making this a visible, talked-about issue.

That hasn't happened, in all fairness, in Washington, and it needs to happen.

Senator Mack. Let me just ask one more question and then I'm going to turn to Senator Santorum.

Senator Mack. And it's directed to Mr. Bilik.

Let me make two comments. One is let's set aside, let's both of us set aside ideology. And let me raise the question having to do with capital.

I think one of the issues that at least has been expressed here today is, as we look into the future, there is a tremendous need for capital infusion, whether that's for an expansion of a present facility, whether that's refurbishing a present facility, or whether that's an absolute brand new facility -- new highways, new bridges, new water treatment, et cetera.

And the concern that's being brought to us is that, under present conditions, the difficulty of getting the capital necessary to carry out "public works," in your comments, and I may have failed to have picked it up when you were making your statement and I apologize if you did, but I don't believe you really addressed the issue of the capital formation requirements that we're going to be facing.

And I wonder if you'd --

Mr. Bilik. Mainly because I didn't.

That's obviously a basic problem, raising the money to be able to do something about the terrible need for improvement in our infrastructure. All the studies indicate we are in deep trouble.

But I'd like to reverse that slightly and point out that not only is that aspect of our community lives in deep trouble, but the very simple, everyday performance of local government is in deep trouble for the same reason -- lack of finances.

And that's what's driving the Wilmingtons and the Franklins and the rest of them to do business with private organizations -- to gain some cash now in order to be able to do the kinds of things that they're supposed to do on a continuing basis.

And it's that drive for immediate satisfaction, cash satisfaction, that is going to ultimately cause our communities throughout the country to face up to the inevitable -- there will be a cash flow problem that they will somehow never meet because all their infrastructure, ultimately, will be peddled off in the private market.

They have no continuing income. But back to your question.

It's a serious question as to how we raise enough money. Traditionally, governments have done this by floating bond issues, the Federal Government deeply involved through its portion of investment, the kind of thing that the Common Rule describes.

We're now saying to ourselves -- we just don't have it. The country is too poor nationally and at all levels to raise the money to be able to effectively deal with our national needs, our community needs.

Well, I think we ought to face that issue first. Are we so poor? We're still the richest nation in the world. The greatest gross domestic product of all countries. The highest individual income levels -- that is, on an average basis -- in the entire world.

And yet, we plead poverty and somehow are unable to face our direct, immediate needs and needs that will have to be met in the future.

Let's set that aside for the moment.

There have been suggestions and the speaker earlier, I think from the Reason Foundation, alluded to the enormous amounts of money in our pension plans, that may be a source of income or source of investment to do something about our public needs.

It's been suggested before. It's not new. Felix Rohatyn, for example, has developed what I thought was an interesting proposal. It needs some safeguards -- to reach out to the public pension funds. Forget about the private pension funds now, most of which are in the hands of corporate executives.

But the public pension funds are administered to a very great extent by boards of trustees, often many of which are appointed or elected by their fellow workers, and they have an interest in making pension funds available to worthwhile investment purposes.

These have been loosely called economically targeted investments, investments that go beyond the ordinary, but that, based on a description of a need, something that will be of help to the community and to the workers in that community, including the public employees.

Housing has been taken up in that way in many places, very effectively, and other kinds of infrastructure could easily be done that way, too.

But it would have to be done, obviously, on a voluntary basis for our pension funds where, in fact, there is a trillion dollars plus now.

It's there for investment. Large percentages are invested, most of which are in the routine corporate world or mutual funds and so on, but could be invested in a more directed, more useful way, in the area of our immediate concern.

Senator Mack. Well, let me ask you this question. It was raised earlier. I'll just focus on the narrow.

The problem with the type of investment that you're talking about is that that's tax-exempt investment and frankly, it doesn't enhance the return to the pension fund, so it's really not an incentive for those funds to go there.

So if we eliminated -- in fact, if there was some financial benefit, if we allowed, in essence, the market to determine what are the best investments, I would suspect we would see the pension funds starting to invest in those areas.

Mr. Bilik. That's entirely possible.

Senator Mack. Let me shift now. I appreciate your response to the question.

Mr. Shanker is here speaking primarily from an education standpoint. I'm, frankly, not prepared to get into that debate.

But I think it's important for all of us, when we are trying to analyze where we ought to be going in the future about some of our experiences in the past.

I can remember as a young man in a community called Cape Coral, and I think maybe you and I discussed this when we had an opportunity several years ago, of trying to encourage the people in my community to maintain a millage rate, not let it drop, but maintain a millage rate so that we could continue to construct more schools in an area that was growing very rapidly in our state.

It was rejected.

Now the usual thing that happens in that kind of a situation is that the salesman -- and this can be used across the board in any kind of a sale -- the salesman usually figures that the potential customer is just an idiot. They obviously have misunderstood the great benefits that I described, in presenting to them.

What we ought to really do it to analyze -- instead of saying that it's got to be something other than my fault that that didn't happen, we really ought to start understanding what is the message that we're getting back from this rejection of government.

And if people in the country are saying, we're really not willing to provide a tremendous increase in the funds necessary for infrastructure in the country, I think that those of us who have a public responsibility need to be asking ourselves -- are there other ways to encourage that investment in order to get the job done?

And so with that, I will turn to my colleague and welcome, and hop in.

OPENING STATEMENT OF SENATOR RICK SANTORUM

Senator Santorum. Thank you, Mr. Chairman.

If I can just pick up on what Senator Mack was questioning on with respect to capital investment. And just some thoughts from you, Mr. Dowd.

If you've taken over a sewage treatment facility, how do you deal with the issue of capital investment in those facilities to upgrade, et cetera?

How do you deal with that?

Mr. Dowd. We determine -- part of the whole bidding process, as you look at an existing plant, is what does it take to get it up to present-day standards?

That becomes part of the monies that we put into our bid, monies that we will spend as soon as we are in the plant and able to take responsibility for it. And it's monies that will, by upgrading it, allow us, in the case of wastewater treatment plants, to use fewer chemicals, to have a more automated plant, to use less power, to in fact cut our costs.

And then the 20-year contract period allows us to regain that investment that we spent on the first day, figuratively speaking, over a long period of time.

That's how it all works, to be honest with you, and why this makes sense. So you wind up with a better plant. What you need is a 20-year time frame to pay for it.

Senator Santorum. Thank you. Mr. Bell, you say, and having flown a couple of times out of the Pittsburgh airport, I'm sure there are people who are the security people who actually think I go to work there every day because I'm in and out of there so often. And I can attest to the quality of the retail establishment there.

My understanding is you manage the retail facilities there, but you do not run the airport in Pittsburgh.

Is that correct?

Mr. Bell. That's correct, Senator.

Senator Santorum. And in Indianapolis, you run the airport.

Mr. Bell. That's absolutely correct, yes.

Senator Santorum. Okay.

Senator Mack. And there's not ownership in either place.

Mr. Bell. There is not ownership in either place, no.

Senator Santorum. Can you explain to me, I guess, maybe, the differences in dealing with those things?

To what extent do you get involved in the airport management at all at Pittsburgh, or do you not?

Mr. Bell. It's interesting, but at Pittsburgh, we get involved in it quite a lot. There are a number of times -- and forgive me. I'm going back. I started out running that Pittsburgh operation, so my comments are probably now two years out of date because I've been living here since that time.

But we started off having a situation where our advice was asked a great deal, simply because a lot of those people that we had working there in Pittsburgh knew a lot about aviation world-wide.

This particularly happened when USAir went through some difficulties and we were actually asked to help them meet some people from British Airways. I wouldn't go so far as to say we brokered a deal or anything like that, but we certainly were in a position to make contacts and situations.

From time to time, we've been asked what our people do on snow-clearing and so on. We facilitate visitors from international boards simply because we have those contacts.

According to the contract, we have zero to do with the airport management. In practical cases, we're more than happy to give any advice, comment or, more likely, contacts.

We also take some initiatives where we see that they would help.

For example, when dealing with USAir and talking to them about their passenger processing methods and so on, it would be ridiculous not to tell them something that we had seen in another part of the world.

It's one of the benefits of a multi-airport system. But strictly speaking, we have no part in the management of the airport at Pittsburgh.

Senator Santorum. Thank you. Commissioner Cranmer, who is a good friend of mine, and I want to thank you for coming here today. And I congratulate you on your first 30 days in office, which I know, when coming into office and trying to take over from an old regime, you can barely see over the mountains of work that you have to do, and I appreciate you taking the time to come here and testify.

Just a comment and question.

You talked about your money for social service programs requiring a big match and that that is a disincentive for you to reduce funding because if you reduce county dollars a dollar, you said you'd lose $30 in Federal funds.

How do we get around that on the Federal level? What do we do on the Federal level to allow you to continue to spend adequate resources on obviously needs in the social service area without allowing you to do the efficiencies that you believe are necessary?

Mr. Cranmer. Surely I would be the first to recognize the great need that we have in Allegheny County for children and youth services and mental health programs and so on. And in no way do we want to detract from that.

We have just been overrun with concern by various special interest groups that we will reduce the budget in that area and therefore, decimate the program. And we've gone to great lengths to tell them that we can't do that, that because of this matching fund arrangement, our hands are bound, really, as far as how we can look for efficiencies.

You spend more, you get more.

The plan has basically incented people, as you just reviewed, to spend more money.

Now I would think that one of the ways the Federal Government could address this, one of the new ways they're dealing with the states, and that's in block grants.

If Federal funds are destined for Allegheny County, possibly either directly from the Federal Government or possibly through the state, we could receive some type of block grant that we could spend as we see fit and then we would have the flexibility, then, to incorporate various new procedures, new measures, privatization, what have you, to make that operation more efficient.

It's an area that requires tremendous expenditure. There's a vital need. But they're also the areas that really have the most significant opportunities available to save money because of the environment of just spend more money, and you'll get more money.

So a lot of money we feel has been wasted.

So you could possibly consider a block grant program for counties.

Senator Santorum. Well, I don't know whether we're going to do a block grant for counties. But obviously, with respect to the welfare area, we put forward, in fact, passed, legislation here in the Congress and sent to the President in the area of welfare reform, which he has, unfortunately, vetoed, which would provide a lot of block grants in the area of social service funding.

There is a provision in that legislation, even the one he vetoed, that requires a maintenance of effort for the first, I believe, four years, is the bill that the President just vetoed, that requires the state -- I assume that the state would pass on that requirement to the county to maintain a level of 75 percent of funding.

Would you see that as a great impediment to restructuring if you had to continue to spend 75 percent of the money that you had previously been spending in order to qualify for the block grant?

Mr. Cranmer. Well, surely. That would be acceptable because anything's better than what we have now because we don't do a thing. We can't touch those programs. We can't try to do anything with them because we're bound by the financial constraints.

So anything that would give us the ability to fluctuate the amount of money that we spend and we could reduce, and again, improve efficiencies, would be perfectly acceptable.

Senator Santorum. So 75 percent -- I've heard from some governors and other saying, that's still too high.

That doesn't cause you any heartburn to have to continue to spend that kind of money to get the matching funds?

Mr. Cranmer. Not at all, considering how much we have to spend now. Anything is better than the current situation.

Senator Santorum. Thank you.

Mr. Cranmer. Thank you.

Senator Mack. Mr. Bell, let me go back and raise a couple of questions.

How do Federal policies towards airport privatization in the U.S. compare to those other countries where BAA operates?

Mr. Bell. The U.S., although it accounts for nearly half of the world's civil aviation transport and passenger terms, is wholly exceptional in the way that its airports are managed and financed.

These days, it is becoming increasingly more unusual for national governments or federal governments to give grants to any of their airports.

Typically, regulation falls into two roles -- safety regulation and economic regulation.

Senator Mack. Safety and what? I'm sorry?

Mr. Bell. Safety regulation and economic regulation. The safety regulation that takes place in the U.S. is not much different from that that takes place elsewhere in the world.

In many cases, it's of a much higher standard.

And security regulation, which I ought to talk about on the same level as safety, is clearly different, and that is tailored around the world according to the threat that pertains at any particular airport.

So it's different, but for good reasons.

The economic regulation is different. In the United Kingdom, for example, the landing fees are regulated by a commission of the Civil Aviation Authority which meets once every five years, taking hearings from airlines and so on, and that sets the regime for the following five years, taking into account the capital expenditure program at the airports and so on.

Now that regime in the United Kingdom has resulted in a continuing reduction in landing fees every year since 1987 for the first five years, 1 percent in real terms every year, subsequent to that, 8 percent each year.

Now, to the extent that as we've increased the revenue from sources other than charges to airlines, our revenue from retail activities, for example, is now greater than that total level of income from aircraft charges, quite a remarkable situation, one our customers are very happy with.

Elsewhere in the world, there is much less economic regulation. Only in the United Kingdom are there large numbers of airports operated by private companies and it's coincident, or perhaps not coincident, that those charges are some of the lowest charges in the world.

Elsewhere, charges of airports are subject to some sort of monopoly antitrust regulation which enables a government to be called in for hearings any abuse of charges.

The really important thing about the United Kingdom experience is that regulation on aircraft charges is not based on a rate of return regulation.

Were it to be, that would provide us for a motivation to reduce costs and increase nonaviation sources of revenue up to a point, but then that motivation would disappear. And that is one of the most stultifying things that anybody could do to any privatized organization.

I think, to sum that up very briefly, the situation in the U.S. is quite different. The starting point is quite different. And perhaps the biggest single difference is the level of subsidy which a mature industry like the U.S. airport industry is still receiving -- tax-exempt bonds, exemption from taxation at all levels, and Federal grants.

Senator Mack. One additional question. One of the issues that came up in the earlier panels had to do with all the revenue generated from the airport must remain on the airport, or in the airport.

Do you run into those kinds of situations in other countries as well, or what is the situation there?

Mr. Bell. No. I'm not aware of that type of regulation existing in any other country.

Now, this is not a comprehensive survey, but we do have offices around the world. And I have never heard of that happening anywhere else, which is kind of interesting because it happens in half the world's aviation industry, namely, in the U.S., but only in one country.

Senator Mack. Okay. All right. One more question for Mr. Cranmer.

If you were not covered by Section 13(c) of the Federal Transit Act, how would you pursue privatization without placing an undue burden on public transit workers?

Mr. Cranmer. I think we would --

Senator Mack. The whole issue here, Mr. Bilik, I think, touched on it in his comments. The way I took it was, in essence, you got two years versus six years. Or five years, maybe.

But if you would address that area for me. I guess, again, most people that observe these discussions for the first time think of privatization efforts as a way of reducing costs at the expense of the employee and the employee only.

So I just would be interested in your thoughts there.

Mr. Cranmer. Our whole strategy, I would say before just out and out privatization of services, will first be aimed at managed competition. It will give those workers the opportunity to bid on continuing to provide that service.

And if in fact they win the bid, that then they in fact will keep that service or keep the services.

Also, we would look at privatizing in a piecemeal fashion. At this point, we have a large transit organization that's basically designed on a 1960s requirement to take everyone from the outlying communities in downtown Pittsburgh.

Well, the transportation requirements have changed over the years and everyone doesn't work downtown. We were looking at putting in smaller routes and looking for piecemeal services throughout the county that we could bid out in an independent fashion.

So with that, we're not looking for a wholesale replacement of the current transit workers, but, again, injecting competition to the point where they're required to become more competitive themselves.

And I might also say that that area of our budget faces the same constraints because of Federal matching funds and especially state matching funds. Our ability to reduce that area of the budget is greatly constrained.

It's similar to the human services.

So, again, we stress before privatization, managed competition, to give those workers the ability to maintain their jobs and the services.

Senator Santorum. I just have one follow-up to Mr. Bell, and that is, you were critical of the Federal Government providing funds for airports, which may be the justification for this closed-loop system if the Federal Government isn't going to provide funds. You have to keep those funds within the loop.

I suspect that's what's going on.

Why are you critical of us providing funds? Should we not? How do other countries do airport renovations, build new airports?

Mr. Bell. Yes. I hope I wasn't critical of the Federal Government providing funds. That's a matter for the Federal Government. It's not for me to judge.

I think what I really wanted to --

Senator Santorum. Maybe condescending. Maybe that's a better word.

(Laughter.)

Mr. Bell. Oh, forgive me. That wasn't my intent.

(Laughter.)

The point that I'm making is that it is not from a business point of view in a mature industry necessary to continue to subsidize that industry.

Now, in a sense, what's happening is if you make a Federal grant, you're distorting an industry. I'm not saying wrongly, but moving it away from free market pressures. It's not bearing its own costs.

This industry is mature and in other parts of the world, we've proved that it can bear its own charges and it can finance its own infrastructure expansion from its own way.

So please forgive me. I was not suggesting for one minute that it was wrong to do it. What I was pointing out was that there are other ways of using that money. You can use it for whatever other Federal purposes. And this industry can stand on its own two feet.

Now, I think what you might find will be a healthy debate from other people as to whether that will mean higher charges for the users of those facilities. My own experience proves that that is categorically not the case because, with motivation, profit-motivation, the ability to take money away from the airport, then the owners of that airport can address matters of cost and alternative sources of income.

And, if my own company's experience is anything to judge by, can actually continue to substantially reduce those charges.

So I wouldn't dream of criticizing the Federal Government. But I think that there are alternative ways of approaching the problem.

Senator Santorum. Do other countries have the extent -- you say that we account for half of the civil aviation. You're talking about commercial aviation, civil commercial aviation.

But I would assume that we also account for a large percentage of general aviation in the world, and a lot of those funds are obviously used to maintain general aviation boards as opposed to maybe other countries that don't use that.

Mr. Bell. Yes, you're absolutely right, sir. And my remarks are primarily addressed to major civil air transportation and not to general aviation.

General aviation is a different industry from the one that I was talking about. I think there is a good case to be made on a case-by-case basis for small air fields, social service air fields, and so on, from time to time will need the subsidy, and I think that that is a different matter.

Senator Santorum. Thank you.

Senator Mack. Well, again, I thank all of you for coming this afternoon and for your participation.

Thank you very much.

[Whereupon, at 3:45 p.m., the Committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF SENATOR CONNIE MACK, CHAIRMAN

During the past 20 years, privatization has emerged around the world as an important way to accomplish vital goals. Countries as diverse as Great Britain, France, Thailand, New Zealand, and even Albania have privatized airports, utilities, roads, bridges, water treatment plants, and countless other assets. Their experience clearly shows that privatization can cut costs and improve service. Indeed, in many cases, private capital is the only way to build or renew large-scale infrastructure.

Here in the United States, governments own plenty of these kinds of facilities. Yet, while America is known around the world as the home of free enterprise, there has been no large-scale move to privatization like in other countries. Why not?

One major reason can be found in federal policies that shackle privatization initiatives at the state and local levels. Federal grants for airports, highways, water treatment plants, and other assets come with strings attached, virtually ensuring these facilities remain government-owned forever. Federal regulatory requirements make the private ownership of some services economically impossible, leaving government as the only option. Federal tax policy subsidizes government ownership of infrastructure that could otherwise be operated as viable, private businesses. In all these ways, the federal government tilts the playing field against private enterprise and in favor of bloated bureaucracy.

These policies bring with them significant costs. On the local level, taxpayers pay higher costs for subpar service. And in some cases, public infrastructure simply deteriorates because Washington makes it hard for state and local governments to attract the private capital needed to fund repairs. On the national level, barriers to privatization increase the deficit by reducing federal tax revenues. In fact, corporate income tax revenues could be as much as $7.7 billion higher if states and localities privatized all of their assets that could be run as businesses, according to a study by this committee.

No one is saying that all government assets and services should be privatized, but Washington is keeping states and localities from realizing important opportunities. Current federal policies do not merely restrain recklessness; they crush even careful, well-crafted privatization plans.

Ideally, America should be simultaneously trying at least 50 different approaches to solving our most pressing problems. Yet many federal policies mandate one-size-fits-all answers. Sure, what may work in one place may not work in another, but we're far more likely to find real solutions if we unleash the creative potential of as many Americans as possible. What we can not afford to do is to let Washington's barriers stymie state and local governments in their efforts to meet the needs of their people.

The subject of this hearing is not the use of federal power to force privatization on other levels of government. Far from it. This hearing was motivated by complaints we have heard from numerous governors, mayors, private firms, and other citizens who are frustrated by federal policies.

The issues involved cut across the jurisdictions of many Congressional committees. So, we at the Joint Economic Committee decided to hold these hearings to draw attention to the problem. I hope we can begin building an information base that our colleagues in both Houses can draw upon as they work to dismantle federal barriers.

All across America, public officials want to privatize assets and services. A thriving industry of private entrepreneurs already exists, ready to step in when they can do a better job. Private capital often stands ready to foot the bill. Washington needs to be ready to get out of the way, and let government officials who want to privatize, privatize.

Joint Economic Committee

U.S. SENATOR
Connie Mack
CHAIRMAN

PRESS
RELEASE

FOR IMMEDIATE RELEASE
Monday, February 5, 1996

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MACK ISSUES NEW JEC REPORT ON FEDERAL BARRIERS TO PRIVATIZATION

Senator Connie Mack (R-FL), Chairman of the Joint Economic Committee, issued a new JEC report today entitled *"The $7.7 Billion Mistake: Federal Barriers to State & Local Privatization"* highlighting outdated federal policies that discourage states and localities from privatizing their assets.

Mack said: "All across America, public officials want to privatize assets and services. A thriving industry of private entrepreneurs already exists, ready to step in where they can do a better job. Washington needs to be ready to get out of the way, and provide opportunities for state and local governments who want to improve services to their citizens.

The JEC report outlines three main federal barriers which inhibit privatization of state and local enterprises:

Grant Requirements dictate that state and local governments return any underappreciated portions of their federal grants to the federal government. This makes privatization more expensive and encourages continued government control.

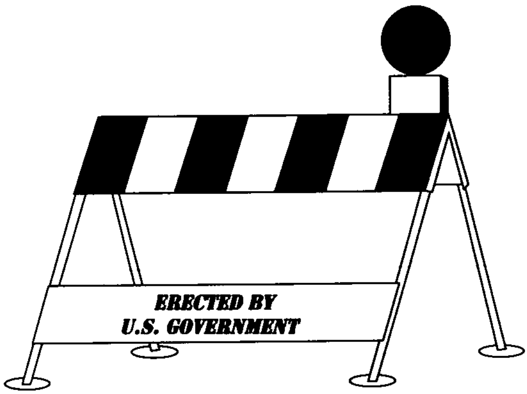
Regulatory Requirements inhibit private investment by making privatization impossible or uneconomical. These federal regulations differ by industry, but they include environment regulations, labor laws and prohibition on user fees.

Tax Policy subsidizes government-owned enterprises but not privately-owned businesses. As a result, competition does not take place on a level playing field, which makes state-owned enterprises appear more efficient than they are and discourages private competition.

Mack concluded: "State and local government officials want less government intervention from Washington and more freedom on the local level to do what's best for their citizens and communities."

Joint Economic Committee Staff Report

The $7.7 Billion Mistake:



Federal Barriers to State & Local Privatization

Senator Connie Mack, Chairman

Available on the Internet: http://www.senate.gov/~jec/privatiz.html

February 1996

EXECUTIVE SUMMARY

State and local governments own more than $227 billion worth of assets that could be privatized and run as viable commercial businesses, including highways, airports, water companies, and electric companies. By continuing to spend too much on enterprises that private investors fund elsewhere (either in this country or abroad), state and local governments needlessly drive up public sector costs and simultaneously sacrifice service.

Privatization cuts costs and improves service because of key differences between incentives and management in the public and private sectors. Government officials are accountable to the coalitions that elected them, which may or may not represent the broader interests of taxpayers. In contrast, private firms are directly accountable to their customers, who can reject a certain company's services if it fails to offer an attractive combination of price and quality.

Privatization can also generate significant savings and benefits for state and local taxpayers. When state and local governments contract out services, they save between 16 and 77 percent, depending on the service. When they sell assets, they receive a one-time cash windfall, new investments in infrastructure, cost savings for taxpayers, and a new stream of tax revenues. Federal policies inhibiting state and local privatization also cost the U.S. Treasury as much as **$7.7 billion** each year, since government-owned enterprises do not pay federal income taxes.

So given all of the benefits of privatization, why aren't more states and localities trying it? One significant problem is that many current federal policies make privatization difficult -- and sometimes impossible. Three main federal barriers inhibit privatization of state and local enterprises:

- <u>**Grant Requirements**</u> dictate that state and local governments return any undepreciated portions of their federal grants to the federal government. This makes privatization more expensive and encourages continued government control.

- <u>**Regulatory Requirements**</u> inhibit private investment. For example, tolls are prohibited on most interstate highways. Without tolls, private investors have no way to raise revenues and investment will not occur.

- <u>**Tax Policy**</u> subsidizes government-owned enterprises but not privately-owned businesses. As a result, competition does not take place on a level playing field, which makes state-owned enterprises appear more efficient than they are and discourages private competitors.

Rejection of more efficient, privately managed alternatives has both local and national consequences. On the state and local level, citizens pay higher taxes and receive subpar service. On the national level, forgone corporate tax revenues inflate both the deficit and the national debt.

Available on the Internet:

http://www.senate.gov/~jec/privatiz.html

THE $7.7 BILLION MISTAKE: FEDERAL BARRIERS TO STATE AND LOCAL PRIVATIZATION

WHY PRIVATIZE?

Across America, state and local governments are looking to privatization to improve service and lower costs. Privatization can accomplish both goals simultaneously, because it replaces the incentives and management methods of the public sector with the incentives and management methods of the private sector.

BENEFITS OF PROFIT-ORIENTED MANAGEMENT

"The profit motive" is often falsely blamed for all sorts of anti-social business behavior. Additionally, government provision of roads, electricity, and other services often gets justified with the superficial argument that, since government does not need to make a profit to stay in business, costs and charges can be lower. In reality, profit is the carrot that rewards private firms for reducing costs and enhancing quality. The motive for profit usually makes private businesses more responsive to their customers.

> ***"Privatization broadens the corporate tax base by turning tax-exempt public entities into private enterprises that pay corporate income taxes... Thus, current federal policies inhibiting state and local privatization cost the U.S. Treasury as much as $7.7 billion each year."***

Privatization is based on the principle that private ownership generates greater accountability than the political process. Private owners risk their own money instead of taxpayer dollars. Therefore, they have stronger incentives to provide quality service at attractive prices. If a firm fails to do so, the customers will stop buying or turn to competitors. (If the firm is a government contractor, it may still risk losing the government's business once the contract expires.)

Government administration, on the other hand, often fails to work as promised because of poor incentives and inadequate use of knowledge.

GOVERNMENT FAILURE: POOR INCENTIVES

In the public sector, employees are held accountable by elected officials for promoting the public's welfare. Not surprisingly, the "public's welfare" is usually defined by the campaign promises made by the winning politicians. The cost and quality of service thus depends on what type of electoral coalition elected the politicians.

> ***"Private owners risk their own money instead of taxpayer dollars. Therefore, they have stronger incentives to provide quality service at attractive prices."***

Unfortunately, special interest politics is not an aberration, but an integral part of public decisionmaking. To win elections, politicians face strong incentives to confer benefits on narrow constituencies -- like particular industries, companies, or even subgroups of public employees -- and spread the costs across all taxpayers. Concentrating benefits and dispersing costs is a tried and true formula for reelection. Beneficiaries have a strong motivation to get informed and turn out the vote, but the average taxpayer usually does not keep track of and reward politicians for the savings gained by eliminating individual projects or programs. George Washington and James Madison admonished Americans to avoid special-interest politics in their famous warnings against the spirit of "party" or "faction." Nevertheless, it usually takes a financial crisis or a taxpayer revolt to shake ruling coalitions out of business as usual.

GOVERNMENT FAILURE: POOR USE OF EMPLOYEE KNOWLEDGE

Even if special interest politics were not a factor, governments face significant managerial problems in mobilizing employee knowledge to serve taxpayers. A private firm can give its employees the chance to use their knowledge by allowing more discretion in serving customer needs, even as they are held accountable through profit-sharing, bonuses, and other types of rewards based on profitability. If customers stop buying, that affects the employees' wallets, and lets them know it's time to improve their job performance.

> ***"Government's ability to give employees discretion is much more limited, because individual taxpayers cannot choose to stop buying particular government services."***

Government's ability to give its employees discretion is much more limited, because individual taxpayers cannot choose to stop buying particular government services. There is little or no direct accountability to individual taxpayers. In government, rigid rules and procedures substitute for market feedback. For certain governmental functions, this makes sense; after all, no taxpayer wants a traffic cop to get a bonus based on the volume of traffic tickets he issues. The original intent of this "bureaucratic red tape" was to keep public employees accountable for their use of government power. However, in so many instances, governments have gotten too bogged down with bureaucratic procedure. Such rigidity not only inhibits incentives for employees, but also deters them from identifying and implementing cost-saving innovations and improvements.

REINVENTING GOVERNMENT THROUGH PRIVATIZATION

Current initiatives to "reinvent government" purport to overcome some of this bureaucratic inertia and borrow successful, quality-oriented management methods pioneered in the private sector. Because bureaucratic restrictions are meant to control abuses of power, reinvention will enjoy the most success in agencies that make little use of the government's sovereign power and thus can function much like private businesses. This begs the question – if a government enterprise can be run like a private business, why should it not *become* a private business, fully substituting the profit motive for the "vote motive"?

> ***"...if a government enterprise can be run like a private business, why should it not become a private business, fully substituting the profit motive for the 'vote motive'?"***

FORMS OF PRIVATIZATION

Privatization takes several forms. The most prominent are contracting out, vouchers, and sales of assets.

CONTRACTING OUT

Contracting out is the most common type of privatization at the state and local level. A Council of State Governments survey revealed that contracting out accounts for 78 percent of all privatization initiatives at the state level. One of the leaders, Massachusetts, saved $50 million in 1993 by contracting for management of state buildings, mental health services, prison health and food service, highway maintenance, and several other services. Massachusetts' state-run prison health services had failed to meet standards for national accreditation. In striking contrast, the contractors not only met accreditation standards, but they cut costs by 40 percent per inmate.[1] Massachusetts' experience is not unique. Privatization expert E.S. Savas estimates that New York's state and local governments could save $3 billion annually if they contracted out just 25 percent of their services.[2]

> ***"Privatization expert E.S. Savas estimates that New York's state and local governments could save $3 billion annually if they contracted out just 25 percent of their services."***

In recent years, cities have received more headlines for contracting out than states. In Indianapolis, Philadelphia, and Chicago, competitive contracting for city services has cut costs by between 16 and 77 percent, depending on the service. By simply forcing municipal governments to compete, savings occur even when city departments win bids to continue providing certain services. Contract services include printing, custodial service, nursing homes, sludge hauling, job training, and drug treatment. Indianapolis saves $28 million annually due to contracting; Philadelphia saves $21.5 million.[3] In Los Angeles, competitive contracting for 15 bus routes cut costs by 51 percent, increased service reliability, and cut accident rates by one-third.[4]

Despite the fears of public employee unions, the savings from contracting out do not usually entail lower wages. Private contractors generally operate more efficiently than government because they give employees the same amount of vacation that other private-sector workers get; have greater flexibility in hiring and assigning workers; use more modern equipment; and hire fewer supervisors to tell workers how to do their jobs. One expert notes, "Most taxpayers work in the private sector under these commonplace ground rules."[5]

Vouchers

Vouchers are less commonly used by state and local governments. The most prominent and controversial example is in the City of Milwaukee, where the parents of 1,000 inner-city youth can receive vouchers enabling them to choose private, nonsectarian schools instead of being locked into their neighborhood schools. The principal goal of this initiative was not to save money, but to expand the educational options of poor students. It is too early to tell how the program affects academic achievement, but reports suggest that most parents are quite satisfied with the program thus far.[6]

Asset Sales

Assets sales represent the most complete form of privatization. Private investors gain title to government-owned assets, and the newly-privatized enterprise pays for itself through user fees (or in some cases a contract with the government that sold the asset). Alternatively, state and local governments may simply opt to have the private sector build and operate new infrastructure, such as highways or sewage treatment plants, instead of spending taxpayer dollars to build the facilities in the first place.

> ***"Private investors gain title to government-owned assets, and the newly-privatized enterprise pays for itself with user fees."***

During the past decade, financial pressures have played a large part in persuading state and local officials to consider this form of privatization. State and local governments own approximately $227 billion worth of assets that could be run as free-standing, profitable businesses.[7] By holding these assets, governments tieup taxpayer dollars in enterprises that private investors fund elsewhere, either in this country or abroad. Private ownership of infrastructure offers four types of financial benefits to state and local governments:

- **New Infrastructure**
  Many states and municipalities opt for privatization simply because they cannot generate sufficient revenues on their own to repair, replace, or expand roads, airports, sewage treatment plants, and other facilities. Across the globe, governments are selling or leasing airports, highways, and bridges for precisely this reason.

> ***"Private firms can usually operate infrastructure at lower costs than the public sector..."***

- **Cash Windfalls**
  Privatization creates a one-time cash windfall that governments can use to reduce debt burdens or fund other long-term projects. Sale of New York's LaGuardia and Kennedy Airports, for example, would net the city of New York $2.3 billion, and sale of the New York Thruway would generate $1 billion, according to the New York State Senate Advisory Commission on Privatization.[8]

- **Lower Costs**
  Private firms can usually operate infrastructure at lower cost than the public sector, saving taxpayer dollars in cases where the government remains the principal customer of a private facility. For instance, the sale of a sewage treatment plant in Franklin, Ohio to Wheelabrator, Inc., cut three municipalities' annual sewage costs by 17 percent.[9]

- **Greater Revenues**
  Privatization also places formerly government-owned facilities on the local tax rolls, creating an ongoing stream of new income. A Reason Foundation study estimates that if all of the assets in the following table were privatized, they would generate more than $3 billion annually in property tax revenues for local governments.[10]

> ***"Privatization... places formerly government-owned facilities on the local tax rolls, creating an ongoing stream of new income."***

Asset sales may be the most complete form of privatization, but they are also the form of state and local privatization that federal policies do the most to discourage -- much to the nation's financial detriment. As federal lawmakers scramble to reduce the budget deficit, few realize that widespread state and local asset sales would significantly broaden the federal tax base.

Privatizing State and Local Assets: The U.S. Lags

State/Local Assets and Est. Value	*Comparable US Businesses*	*Comparable Overseas Privatizations*
Highways/bridges *$102.4 billion*	Dulles Greenway (Dulles-Leesburg, VA)	Channel Tunnel (Britain/France) Franchised toll roads (France, Spain, Argentina, Mexico, Thailand, ect.)
Wastewater facilities *$30.8 billion*	Franklin, OH plant sold to Wheelabrator (1995)	Britain (privatized water utilities in 1989) Thailand (1993)
Commercial airports *$29.0 billion*	None	BAA (Britain, 1987)
Water systems *$23.9 billion*	15% of US population served by private cos.	France -- 75% privately-owned Britain -- 100% (since 1989)
Electric utilities *$16.7 billion*	PEPCO	Nova Scotia Power (Canada, 1992) British electric industry (1980s)
Ports *$11.4 billion*	Ceres Marine Terminal (Baltimore, lease)	Associated British Ports (1983)
Parking structures *$6.6 billion*	Colonial Parking	N.A.
Waste-to-energy plants *$4.0 billion*	44% privately owned	N.A.
Gas utilities *$2.0 billion*	Washington Gas	British Gas (1986)

Sources: *Robert W. Poole Jr., David Haarmeyer, and Lynn Scarlett, "Mining the Government Balance Sheet," Reason Foundation Policy Insight No. 139 (April 1992) and "World Business" special section, The Wall Street Journal (October 2, 1995).*
N.A. = information not available.

Local Privatization Reduces Federal Deficits

Privatization broadens the corporate tax base by turning tax-exempt public entities into private enterprises that pay corporate income taxes. Rothschild Inc. estimates that publicly-owned water, sewer, and electric utilities would pay approximately $1 billion in federal corporate income taxes if they were private companies.[11] If all $227 billion worth of assets in the table were privatized, a conservative estimate suggests that federal corporate income tax revenues would be $4-7.7 billion higher annually.[12] *Thus, current federal policies inhibiting state and local privatization cost the U.S. Treasury as much as $7.7 billion each year.*

These financial benefits for governments bear striking testimony to the power of private-sector incentives and management. Private investors are often willing to buy or build infrastructure, pay taxes on it, and offer customers a better deal than they currently get from the government. This occurs because private firms believe they can operate infrastructure more efficiently than government. Governments betray the public interest when they fail to take firms up on the offer.

Barriers to Privatization in the U.S.

> ***"Countries as diverse as Iran, India, Thailand, France, and Italy have or plan to have private firms owning and operating... enterprises that governments run in the U.S."***

Privatization is a worldwide trend. Britain and New Zealand have well-deserved reputations as leaders, but others are far ahead of the United States in selected areas. Albania, formerly the last bastion of Stalinism in Europe, rivals the U.S. in airport privatization: a private firm will build and operate a $44 million expansion of the Tirana airport.[13] Countries as diverse as Iran, India, Thailand, France, and Italy have or plan to have private firms owning and operating airports, highways, wastewater treatment facilities, power plants, and many other enterprises that state and local governments run in the U.S.

If governments worldwide are scrambling to capture the benefits of privatization, why does America lag? Many state and local governments are eager to privatize assets, but current federal policies place barriers in the way. Federal policies inhibiting state and local privatization take three forms: grant requirements, regulatory requirements, and tax policy.

Grant Requirements

Federal grants often come with strings attached that inhibit privatization of whichever government entity is receiving the grant. Current policy, embodied in Executive Order 12803, permits the state or local governments to sell assets in order to recover its original investment, but then it must pay back the undepreciated portion of all federal grants.

In some cases, this policy prevents privatization because the undepreciated grants may exceed the market value of the asset. This occurs because states and localities have relatively poor incentives to spend "free" federal grant money carefully. All grant dollars have to be used for the project for which they were intended, so lower levels of government receive little reward for managing federal tax dollars carefully.

In other cases, a sale would generate enough money to pay back the undepreciated portion of grants, but the state or local government would get little of the sale proceeds. Here, privatization is theoretically possible, but state and local officials have little incentive to pursue it. They get a better political payoff from trying to attract industry with subsidies or lobbying the federal government for more grants.

They're Grants, Not Loans!

Federal grant repayment policy is especially illogical given the simple fact that these are grants, not loans. The purpose of grants is to supposedly encourage the upgrading or construction of highways, airports, wastewater plants, and other infrastructure. In most cases, private buyers want to continue using the assets for the purpose for which they were built; thus, facilities built with grant money still serve their intended purpose after privatization. If anything, privatization gives the federal government more "bang for the buck" on past grant dollars, because a private owner will operate the facility more efficiently. Nevertheless, federal policy discourages the change of ownership.

> ***"In most cases, private buyers want to continue using the assets for the purpose for which they were built; thus, facilities built with grant money still serve their intended purpose after privatization."***

Airport Grants: Special Strings Attached

Virtually all airports have an additional restriction that inhibits privatization. If an airport receives a federal grant, the owner must plough all revenues back into the airport; states and localities never use airport profits to fund tax cuts or other public services.[14] Similarly, a private buyer of a publicly-owned airport might be required to put all profits back into the airport, since virtually all significant airports have received federal grants in the past. This requirement severely limits an airport's attractiveness as an investment.[15]

Several localities have found that federal policies create insurmountable barriers to privatization. Albany County, NY had to scrap a plan to lease out its airport in 1991 when the Federal Aviation Administration decided that a $30 million lease payment could not go into the county's general fund, even though the county had invested more than $30 million in the airport.[16] Bankrupt Orange County, California could sell John Wayne Airport to help alleviate its fiscal crisis, but a county task force concluded that federal grant repayment policies make a sale impractical.[17] The mayor of Syracuse, NY, which established its own commission to study airport privatization, likewise concluded, "If the federal government is truly interested in promoting and assisting local government in bettering service and lowering taxpayer exposure, then this barrier must be removed."[18]

REGULATORY REQUIREMENTS

Many facilities owned by state and local governments enjoy preferential treatment under federal regulation, or have other strings attached that effectively prevent privatization.

Wastewater: RCRA

A prominent example is the Resource Conservation and Recovery Act's treatment of effluent discharges. A privately-owned wastewater plant is subject to the same costly standards as an industrial plant. But the same wastewater plant owned by a municipality is subject to less costly standards, because the standards for private facilities were really intended to cover industrial plants that discharge chemicals and other hazardous wastes.

> ***"Many facilities owned by state and local governments enjoy preferential treatment under federal regulation, or have other strings attached that effectively prevent privatization."***

Highways: Toll Restrictions

Federal highway policies also inhibit privatization of roads and bridges. The Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA) lifted the federal ban on tolls for all but interstate highways, and let states use private funding to match federal grants. However, many of the most significant benefits from highway privatization would come on congested urban interstates, where tolls are still prohibited (with the exception of up to three pilot projects). Without toll revenues, it's hard to attract private investors for highways.

Transit: Labor Laws

Labor laws make it more difficult to privatize mass transit. No significant bus or subway lines in the United States support themselves, but some local governments have cut costs 30-60 percent by contracting bus routes to private firms. Section 13(c) of the Urban Mass Transportation Act limits these savings by requiring up to six years' severance pay for employees who lose their jobs due to increased efficiency. In effect, this provision gives public transit agencies a choice of offering huge severance payments or limiting contracting to the rate of attrition in the workforce, unless the labor agreement or state law provide otherwise.[19]

TAX POLICY

Two aspects of federal tax policy make state and local privatization less attractive: differential treatment of interest on debt, and the tax-exempt status of municipal utilities.

Taxable vs. Tax-Exempt Interest

When a state or local government borrows money to build infrastructure, the interest it pays is tax-free to its investors. When a private company issues debt to buy or builds an identical facility, the interest is taxable, due to changes in the Tax Reform Act of 1986. Since states and local governments pay lower interest rates than private corporations, public ownership often looks more efficient than it really is. Because the federal tax code provides a hidden subsidy, cities and states opt to own assets that could actually be operated more efficiently and effectively by private businesses.

Outstanding Bonds: Another Twist

Additional tax issues emerge when a private firm wants to acquire a facility built with tax-exempt bonds that are still outstanding. Theoretically, it is possible for the bonds to remain tax-exempt if the facility has been used for five years and the sale proceeds are used for other projects that would qualify for tax-exempt financing. In practice, the process of getting federal approval generates significant uncertainty and delays. The city of Franklin, Ohio spent a year getting IRS and OMB approval for the sale of its wastewater treatment plant to Wheelabrator, which has operated the plant under contract for several years.

> ***"When a state or local government borrows money to build infrastructure, the interest it pays is tax-free to the investors. When a private company issues debt to buy or builds an identical facility, the interest is taxable, due to changes made by the Tax Reform Act of 1986."***

The IRS is in Charge

The current tax code also gives the IRS an excuse to dictate contract terms when a government decides to contract out management and operation of a facility. A facility's bonds could lose their tax-exempt status if the management contract rewards the managers based on net profits. This provision clearly removes one of the major incentives states and municipalities can use to enhance the contractor's productivity. Without such an incentive, it is harder to achieve the benefits that private management could potentially deliver.

A single federal policy creates all these problems: the differential taxation of interest paid on corporate versus state and local debt. A fundamental tax reform like the flat tax would level the playing field by taxing all interest income in the same way.

Municipal Tax Exemptions

Municipal utilities, as government-owned entities, are generally exempt from corporate income taxes and local property taxes. The tax-exempt status of municipal utilities creates a barrier to privatization, because the local special interests that benefit from waste have a strong incentive to resist privatization.

"Federal grant, regulatory, and tax policies discourage state and local governments from privatizing infrastructure..."

Subjecting municipal utilities to federal taxes or exempting investor-owned utilities are both politically unthinkable. A more limited debate, however, revolves around payments referred to as "contributions in aid of construction." New customers of utilities sometimes make up-front payments to cover the costs of initiating service. A new subdivision, for example, might pay a substantial fee to get hooked up to a larger community's water and sewer system. Under the Tax Reform Act of 1986, investor-owned utilities must count these contributions as taxable income. Municipal utilities, as tax-exempt entities, face no such constraint, and so the tax code artificially subsidizes municipal operation of water, electric, and gas companies. In New York, contributions in aid of construction to an investor-owned utility must be 70 percent higher than those to a publicly-owned utility, just to cover the extra taxes.[20]

CONCLUSION

Governments the world over make substantial use of private capital to fund infrastructure that can be fully supported by user fees. Unfortunately, the United States lags behind the rest of the world. Federal grant, regulatory, and tax policies discourage state and local governments from privatizing infrastructure assets.

State and local governments as well as private investors are eager to promote such privatization. However, states and municipalities have run up against federal grant and regulatory obstacles when they have tried to pursue privatization. Private investors are pouring money into highways, bridges, airports, utilities, and other infrastructure all around the world, and they would do so here if the federal government would simply get out of the way so states and localities can manage their assets.

In addition to stifling infrastructure investment, current policies have other, more measurable costs. Taxpayers and users of facilities pay more to make up for government waste and inefficiency. State and local governments forego about $3 billion in property tax revenues by keeping infrastructure out of the private sector. The federal government, meanwhile, loses $4-7.7 billion annually in corporate income tax receipts because of its own policies impeding state and local privatization.

Prepared by Senior Economist Dr. Jerry Ellig

ENDNOTES

1. John O'Leary (ed.), *Privatization 1994* (Los Angeles, CA: Reason Foundation, 1994), p. 8; *Privatization in Massachusetts: Getting Results* (Commonwealth of Massachusetts, Nov. 1993).

2. E.S. Savas (ed.), *Privatization for New York: Competing for a Better Future*, Report of the New York State Senate Advisory Commission on Privatization (January 1992), p. 11.

3. John O'Leary (ed.), *Privatization 1994* (Los Angeles, CA: Reason Foundation, 1994), pp. 10-11.

4. Wendell Cox and Jean Love, "Bus Service," in E.S. Savas (ed.), *Privatization for New York: Competing for a Better Future*, Report of the New York State Senate Advisory Commission on Privatization (January 1992), p. 161.

5. E.S. Savas (ed.), *Privatization for New York: Competing for a Better Future*, Report of the New York State Senate Advisory Commission on Privatization (January 1992), p. 2.

6. John O'Leary (ed.), *Privatization 1994* (Los Angeles, CA: Reason Foundation, 1994), pp. 10-11.

7. Robert W. Poole Jr., David Haarmeyer, and Lynn Scarlett, "Mining the Government Balance Sheet," Reason Foundation Policy Insight No. 139 (April 1992).

8. E.S. Savas (ed.), *Privatization for New York: Competing for a Better Future*, Report of the New York State Senate Advisory Commission on Privatization (January 1992).

9. "First US Wastewater Privatization Nears Completion," *Environmental Business Journal* (Nov./Dec. 1994), p. 7.

10. Robert W. Poole, Jr., "Privatizing State and Local Infrastructure: Empowering Cities and States to Tap Private Capital and Rebuild America," Reason Foundation Policy Study No. 190 (May 1995), p. 3.

11. Wilbur L. Ross, Jr., "How an Internal Revenue Service Rule is Standing in the Way of Privatization," *The Bond Buyer* (April 3, 1995).

12. If private investors are to buy the assets, they will need to earn a before-tax rate of return at least equal to that on a riskless long-term investment, such as Treasury bonds. Treasuries currently pay in the neighborhood of 6.5 percent. A 6.5 percent return on assets worth $227 billion is $14.775 billion in taxable profits. A corporate income tax rate of 34 percent generates revenues of $5.02 billion. If the privatized company invests heavily, so that it is

subject to the alternative minimum tax, it might pay at the lower, 26 percent rate, with tax revenues of $3.84 billion. Of course, infrastructure is a riskier investment than Treasury bonds, and the rate of return will have to reflect this risk, so profits and tax revenues would likely be much higher than $5 billion. A 10 percent rate of return, more in line with returns available on common stocks, would generate between $5.9 billion and $7.7 billion in revenues, depending on the corporate tax rate.

13. John O'Leary (ed.), *Privatization 1994* (Los Angeles, CA: Reason Foundation, 1994), p. 34.

14. This provision is in Section 511 of the Airport and Airway Improvement Act of 1982. About 10 major airports can divert some revenues under the Act's grandfather provisions.

15. William G. Laffer III, "How to Improve Air Travel in America," in E. Hudgins and R. Utt, *How Privatization Can Solve America's infrastructure Crisis* (Heritage Foundation, 1982), pp. 72-73.

16. E.S. Savas (ed.), *Privatization for New York: Competing for a Better Future*, Report of the New York State Senate Advisory Commission on Privatization (January 1992), p. 89; "John Wayne Airport Revenue/Sale Task Force (June 1995), p. 5.

17. Report of the John Wayne Airport Revenue/Sale Task Force (June 1995).

18. "Prepared Testimony of Roy A. Bernardi, Mayor of the City of Syracuse, before the House Subcommittee on Government Management, Information, and Technology," (March 14, 1995).

19. Wendell Cox and Jean Love, "Bus Service," in E.S. Savas (ed.), *Privatization for New York: Competing for a Better Future*, Report of the New York State Senate Advisory Commission on Privatization (January 1992), pp. 159-65.

20. Robert W. Poole, Jr., "Privatizing State and Local Infrastructure: Empowering Cities and States to Tap Private Capital and Rebuild America," Reason Foundation Policy Study No. 190 (May 1995), p. 14.

My name is Robert W. Poole, Jr. I am president of the Reason Foundation, a nonprofit public policy research institute based in Los Angeles. For more than 17 years we have been researching privatization on a worldwide basis. I have done research on this subject under the auspices of the U.S. Agency for International Development and the World Bank, and I have advised, among others, the President's Commission on Privatization, the White House Office of Policy Development, the U.S. Department of Transportation, and in the current Administration, both the National Economic Council and the National Performance Review.

My testimony today focuses on the privatization of infrastructure facilities at the state and local level: facilities such as airports, bridges and highways, electric and gas utilities, seaports, and water and wastewater systems. The bad news is that funding for such vital infrastructure is not keeping pace with recognized needs. The growth of our population and economy require expansion of the infrastructure used for energy, environmental, and transportation purposes. The deterioration of major highways and environmental infrastructure requires substantial investments in reconstruction and modernization. And increasingly stringent environmental standards will require additional investments in water quality and waste disposal.

While the need is evident, federal funding is becoming less and less available, due to the overriding need to balance the federal budget. Moreover, there is a growing recognition, from OMB Director Alice Rivlin and numerous members of Congress, that with few exceptions, infrastructure is and should be a state and local, rather than a federal, responsibility.

Other countries face similar infrastructure problems. Increasingly, their response is to turn to the private sector and private capital to meet these needs for new and modernized infrastructure. The latest global survey of major privatized infrastructure projects was released last fall by the newsletter *Public Works Financing*. It reports that 356 privatized infrastructure projects worth $146 billion have been financed and put under construction in 42 countries during the past decade. They include:

- 58 water/wastewater facilities worth nearly $11 billion
- 124 toll roads, bridges, and tunnels worth almost $70 billion
- 18 rail projects worth $7 billion
- 10 airport terminal and runway projects worth $21 billion
- 18 seaport projects worth $2.1 billion
- 57 (non-U.S.) power projects worth $29 billion.

Overall, including both financed and planned projects, some 980 specific projects with an aggregate value of almost $700 billion are in some stage of active consideration by governments in 95 countries.

Unfortunately, only a handful of these projects--and only a small fraction of this massive investment--is taking place in the United States. While the World Bank and USAID are telling governments worldwide why they should privatize major infrastructure, the United States itself relies primarily on government finance, ownership, and operation for airports, highways, seaports, water supply, and waste disposal facilities.

Based on our 17 years of researching privatization, I believe there is a very powerful case that private ownership of major infrastructure will generally lead to greater efficiency, wiser investment decisions, and greater customer-friendliness. Those types of infrastructure where the United States *has* relied primarily on the private sector--electricity and telecommunications--are the world-standard in their field. But the same *cannot* be said about the quality of our airports, our highways, our seaports, our water supply, or our waste disposal facilities. The most-advanced infrastructure in these fields is in countries such as Britain, France, Italy, Japan, and Hong Kong, where long-term private franchises or outright private ownership are becoming standard practice.

There are several reasons why the United States lags well behind other developed countries in making use of the private sector for infrastructure. The Reason Foundation published a policy study last May explaining the many ways in which federal law is biased against private capital and private ownership in infrastructure.[1] There are tax-code barriers, regulatory barriers, and grant-related barriers.

The most important of these barriers is the federal tax code. Consider two otherwise identical infrastructure facilities that serve the public--an airport, a toll bridge, or a water system. If the facility is owned by investors, it must pay federal corporate income taxes and in most cases it can finance its operations only with taxable debt. The identical facility, if owned by a government agency, pays no taxes and can borrow at tax-exempt rates. The net effect of these policies is that the federal government tells investors, governors, and mayors: "We prefer that these vital facilities be provided via municipal socialism, rather than via the marketplace." Is that really the message Congress wants to send in 1996?

As we all know, if you tax something, you get less of it. If we want more private-sector investment in America's infrastructure, Congress should provide consistent tax treatment to those who invest in these vital facilities, *regardless of ownership*. That could mean either removing tax exemptions from state and municipal facilities that are essentially businesses or extending tax exemption to infrastructure facilities owned and operated by the private sector.

The second type of barrier is regulatory. Here again, many federal rules and regulations were written without taking into account the possibility that investor-owned firms could finance, build, own, and operate basic infrastructure. Thus, for example, the Resource Conservation & Recovery Act seeks to provide less-costly effluent standards for facilities that treat municipal wastewater, as compared with industrial wastewater. But the way RCRA implements this is to exempt "Publicly Owned Treatment Works." This ignores the fact that the private sector can and

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[1] Robert W. Poole, Jr., "Revitalizing State and Local Infrastructure: Empowering Cities and States to Tap Private Capital and Rebuild America," Policy Study No. 190, Los Angeles: Reason Foundation, May 1995.

does own and operate municipal treatment plants. But RCRA subjects them to the more costly regulations that apply to industrial facilities.

There are many other federal regulations that stand as obstacles to privatization of infrastructure. In transportation, the Intermodal Surface Transportation Efficiency Act permits the private redevelopment of certain categories of federally aided highways and bridges--a welcome step forward. But it specifically exempts the most important and commercially attractive portions of the nation's highway system--the Interstates. It's no wonder, then, that hardly any states have taken advantage of these provisions.

When it comes to airports, the Airport & Airway Improvement Act, at least as interpreted by the Federal Aviation Administration, requires that not only must any operating profits of an airport be reinvested in the airport but also that any proceeds from selling or leasing an airport be reinvested in that airport or airport system. This removes one of the principal motivations for a city or state to sell an airport--the desire to shift its resources into core functions, letting the private sector take over commercial functions.

The third type of barrier is entanglements imposed by federal grant agreements. President Bush attempted to deal with these constraints by issuing Executive Order 12803 in 1992. It was intended to gain the cooperation of federal grant-making agencies (principally the EPA, the FAA, and the FHWA) and to eliminate the requirement that grants be repaid if a city or state privatized an infrastructure facility. But the Office of Management & Budget objected, resulting in a compromise that calls for repayment of an amount based on the undepreciated portion of the facilities financed with the grant. Congressman McIntosh has sponsored legislation to remove this repayment requirement and to codify EO 12803's principles into law.

In previous congressional testimony I have made the point that any grant-payback requirement amounts to a transfer tax on privatization transactions. This is hardly the way to encourage such transactions to take place. If Congress finds privatization to be sound public policy, it should at worst be neutral about the decision of state and local governments to adopt it. It should not impose a tax on their decision, which is what any amount of grant repayment amounts to.

OMB and Treasury concerns about federal revenue losses from privatization are very short-sighted, because the federal government will benefit handsomely if privatizations occur, but will reap no fical benefits if they do not occur. Let me give you a brief quantitative example.

At the request of the Bush White House, in 1992 the Reason Foundation put together an estimate of what dollar volume of privatizations might take place if there were a more level playing field, and cities and states took full advantage of it to sell user-fee-funded infrastructure facilities to investors. Our widely quoted estimate was that cities and states, over a period of years, might sell some $227 billion worth of enterprises and facilities.[2] A summary of those assets and enterprises is included here as Table 1.

What OMB and Treasury tend to forget is the enormous fiscal benefits of this kind of privatization--to all three levels of government. First of all, there would be a one-time infusion of capital for the local and state governments selling these facilities--about $114 billion to cities and counties and $113 to states. In other words, without having to spend a single dollar of federal funds, Congress could open the door to this major infusion of capital into state and local governments.

In addition, every level of government would begin receiving new streams of annual tax revenues as the privatized facilities became ordinary investor-owned businesses. Local governments would benefit to the tune of about $3.4 billion per year (making the conservative assumption that property taxes would average 1.5 percent of market value; in many places it would be more than that).

Federal and state governments would get three new streams of tax revenue. First, they would collect ordinary corporate income taxes from these newly privatized businesses. Second, they would tax the dividends earned by investors in the stock of these businesses. Third, they would tax the interest paid to investors in the bonds of these businesses (assuming that tax-exemption is not extended to the bonds of privatized facilities). Table 2 lays out these projected fiscal impacts, assuming the entire $227 billion worth of infrastructure in Table 1 were to be sold. You will note that the federal government would receive over $8 billion *per year* in net new tax revenue.

In conclusion, I want to point out that these concepts of private investment in infrastructure are becoming increasingly bipartisan. For the past two and a half years we have been discussing these issues of public-private partnerships in infrastructure with people at DOT, at EPA, at the National Performance Review, and at the National Economic Council--as well as with members of Congress from both parties. What has impressed me in all this is how much agreement there is in principle on these issues. All of these players now agree that:

- We cannot modernize America's infrastructure via business-as-usual; it is going to require significant amounts of private capital.

- Shifting to direct user fees produces many benefits, among them congestion-relief and conservation of resources, thanks to the incentives provided by pricing.

- For inherently monopolistic infrastructure, users must be protected from

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[2] Robert W. Poole, Jr., David Haarmeyer, and Lynn Scarlett, "Mining the Government Balance Sheet: What Cities and States Have to Sell," Policy Study No. 139, Los Angeles: Reason Foundation, April 1992.

exploitation.

There is far more common ground than there is disagreement. To be sure, we can haggle a bit over the details--exactly what conditions should be put on privatization transactions, to protect the public interest. But let us not get bogged down in those details. Rather, let us seize the opportunity to remove federal barriers to private investment in this country's infrastructure, giving cities and states the option to use this important new tool.

I would be pleased to answer any questions you may have.

Table 1: Salable State and Local Infrastructure
($ Billions)

	Local	State
Airports*	25.0	4.0
Electric Utilities*	13.0	3.7
Gas Utilities	2.0	---
Highways/Bridges	---	95.0
Parking Structures	6.6	---
Ports*	9.0	2.4
Turnpikes	---	7.4
Water	23.9	---
Wastewater	30.5	---
Waste-to-Energy	4.0	---
	$114.3	$112.5

* Local/state breakdown estimate

Table 2: Fiscal Benefits of Infrastructure Sales
($ Billions)

	Local	State	Federal
One-Time Proceeds	$114.3	$112.5	---
New Annual Revenues			
• Property Taxes	3.40	---	---
• Corp. Income Taxes	---	0.681	2.30
• Dividend Taxation	---	0.340	1.02
• Bond Interest Taxation	---	1.600	4.80
Total Annual	$3.40	$2.621	$8.12

Assumptions:
1. Sale price equals 5 times gross annual revenue.
2. Net taxable income equals 15 percent of gross revenue.
3. Federal corporate tax rate equals 34 percent of net taxable income.
4. State corporate tax rate equals 10 percent of net taxable income.
5. Local property tax equals 1.5 percent of market value.
6. Dividends equal 50 percent of net taxable income.
7. Dividends taxed at 30 percent federal, 10 percent state.
8. Fifty percent of purchase price financed with taxable bonds.
9. Modernization investment equals 1/3 of market value, financed with taxable bonds.
10. Taxable bond interest rate equals 8.5 percent.
11. Interest earnings taxed at 30 percent federal, 10 percent state.

MAY 1995 POLICY STUDY NO. 190

REVITALIZING STATE AND LOCAL INFRASTRUCTURE:

EMPOWERING CITIES AND STATES TO TAP PRIVATE CAPITAL AND REBUILD AMERICA

by Robert W. Poole, Jr.

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Policy Study No. 190
May 1995

REVITALIZING STATE AND LOCAL INFRASTRUCTURE
Empowering Cities and States to Tap Private Capital and Rebuild America

by

Robert W. Poole, Jr.

EXECUTIVE SUMMARY

America has large unmet infrastructure needs, but governments at all levels are strapped for funds and under voter pressure to downsize. State and local governments have begun to experiment with infrastructure privatization—both selling or leasing existing facilities to the private sector for expansion and modernization and issuing long-term franchises under which the private sector finances, designs, builds, and operates wholly new infrastructure projects (airports, toll roads, wastewater plants). Federal policy has been inconsistent toward this privatization trend, and in many cases poses significant barriers to it.

A number of government policies direct states and cities to favor government ownership of infrastructure enterprises. The identical airport terminal, toll bridge, water utility, or wastewater plant is treated in one way by federal law if it is government owned and in a radically different way if it is owned by investors. Tax laws exempt from taxation the interest on bonds issued by government enterprises—which translates into higher debt-service costs for investor-owned infrastructure (as well as reduced revenue for the federal government). Further, government-owned enterprises are generally exempt from local property taxes and both federal and state income taxes. Federal grant and regulatory policies also discriminate against a facility owned by investors, as compared with the identical facility owned by a state or city government.

These policies, many of them unique to the United States, are preventing this country from realizing the full benefits of the worldwide movement toward privatizing airports, highways, energy and environmental infrastructure. These benefits include the ability of cities and states to "mine their balance sheets" by selling or leasing infrastructure facilities to private operators, the potential of faster development of needed facilities thanks to streamlined private-sector methods, potential cost savings and efficiency gains from bottom-line-oriented management of infrastructure, and the benefits of introducing market pricing where it is now lacking.(Market pricing would provide incentives to conserve scarce resources like water supply and landfill capacity, and incentives to shift usage away from congested peak-use periods).

A number of short-term reforms would give cities and states greater freedom to privatize. These include modest tax-law changes, codifying the provisions of a 1992 Executive Order on infrastructure privatization, permitting tolls on Interstate highways, and changing the definition (in environmental regulations) of municipal wastewater plants to include those which are privately owned.

Longer-term reform would level the playing field for infrastructure finance, either by extending tax-exempt status to infrastructure revenue bonds regardless of the ownership status of the facility or by ending tax-exempt status for all *new issues* of revenue bonds for user-fee supported infrastructure. The former proposal might be found to be revenue-neutral to the Treasury, depending on the assumptions used. The latter would ultimately produce some $24 billion per year in net new federal revenue, once fully phased in.

An added benefit of encouraging investor-owned infrastructure would be the development of world-class U.S. infrastructure firms. Thanks to the experienced gained in the large U.S. home market, these firms would be more likely to succeed in capturing a share of the huge world market for privately owned and operated infrastructure.

TABLE OF CONTENTS

I. INTRODUCTION

America's public infrastructure—facilities provided by state and local governments for energy supply, transportation, water supply, and waste disposal—is in trouble. As documented in 1988 by the National Council for Public Works Improvement,[1] these vital systems increasingly suffer from deferred maintenance, obsolescent technology, and inadequate capacity. NCPWI's findings are equally valid today.

Traditionally, diagnosis of such a problem would have brought forth efforts by Congress to solve the problem via new or expanded federal programs. Indeed, the NCPWI report helped generate support for the Intermodal Surface Transportation Efficiency Act of 1991, which was intended to increase federal investment in transportation infrastructure. Likewise, the Clinton Administration came into office in 1993 pledged to "rebuild America" via new spending programs. Continued federal fiscal pressures, however, ensured that neither of these initiatives significantly expanded the federal role.

Now the voters have signaled a major change in course, echoed by mayors and governors across the country. More than ever before, the task of Congress is now viewed as downsizing the federal government, balancing the federal budget, getting rid of unfunded federal mandates, and devolving authority and responsibility to states and municipalities. In this new policy environment, how best can the nation's infrastructure challenge be met?

During the past five years a number of cities and states have begun to expand the role of the private sector in public-purpose infrastructure. Increasingly, they are turning to private firms to manage such facilities as airports, highway maintenance and toll collection, and water and wastewater facilities and systems. Some have sought to sell such enterprises to private firms, turning these facilities into investor-owned rather than municipal utilities (and freeing up their capital for other pressing needs). Other cities and states have entered into long-term franchise agreements with private consortia to design, finance, build, and operate new or expanded infrastructure, such as airport terminals, toll roads, and wastewater plants (thereby making their limited public infrastructure funds go further).[2]

States and municipalities, in partnership with the private sector, are best equipped to address America's infrastructure problems. User fees, privatization, and public-private partnerships are the tools needed for this task. However, significant barriers to making this transition are posed by certain provisions of the federal tax code, by current federal infrastructure grant programs, and by various regulatory provisions. Congress could empower cities and states to work with the private sector to address their infrastructure problems by reforming these aspects of federal law.

II. GOVERNMENT OWNERSHIP OF INFRASTRUCTURE

A. The Surprisingly Large Role of Government Ownership

Before delving into solutions to America's infrastructure problems, we need to understand the uniqueness of this country's approach to funding and managing such facilities. The past decade has seen a worldwide movement to privatize government enterprises, encompassing nearly 100 countries. In developed countries like Britain and France and developing countries such as Argentina, Malaysia, and Mexico, responsibility for such facilities as airports, highways, electricity, water supply, and waste disposal is being turned over to investor-owned companies. Existing infrastructure is being sold or long-term leased to such firms, and new infrastructure is being developed and operated by private consortia under long-term franchises. The United States lags significantly behind this worldwide trend.

There are a few exceptions. In telecommunications, the United States has always had nearly 100 percent investor-owned companies, in contrast to the rest of the world, where—until the past decade—most countries had state-

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1 Fragile Foundations; National Council for Public Works Improvements.

2 John O'Leary, ed., *Privatiztion 1994*, Los Angeles: Reason Foundation, April 1994, pp. 27–42.

owned post and telecom monopolies. In electricity, the United States has also had predominantly investor-owned utilities, although there are still 2,010 state and municipal electric utility systems in this country, serving 16.3 million customer accounts. Worldwide, the sale of government-owned electric utilities topped $10.5 billion in 1994, second only to the sales of telecom utilities.[3]

The United States also has 800 municipal natural gas utilities, serving 3.6 million customer accounts. Britain was the first country to privatize its gas industry, in 1986. Since then, Argentina, Malaysia, and several other countries have begun to privatize their gas utilities.

When it comes to water and wastewater utilities, the United States is a bastion of "municipal socialism." In contrast to Britain, where 100 percent of this industry is in the private sector, and France, where the figure is 75 percent, only 15 percent of the U.S. water supply is provided by private firms, and virtually none of wastewater treatment capacity is in the private sector. With a handful of exceptions (such as Indianapolis and San Jose), investor-owned water utilities tend to be in small communities, typically under 3,500 population, with municipal water works predominating in all other sizes of towns and cities.[4]

The contrast is even more stark when we turn to transportation infrastructure. Essentially 100 percent of the U.S. highway and commercial airport systems are government-owned, and all but a handful of airports are government-operated. By contrast, Britain has privatized its major airports, and a number of other countries (including Australia, Austria, Argentina, Denmark, Germany, Italy, and Malaysia) are in the process of doing likewise.[5] Similarly, the major motorway systems of France, Italy, and Spain (the equivalent of our Interstate highway system) were developed and are operated by private firms under long-term franchise agreements known as build-operate-transfer (BOT) arrangements.[6] Britain and Germany are planning to privatize their motorway systems within the next decade. And the World Bank and other development agencies are encouraging developing countries to adopt the BOT model for highways and other major infrastructure—as Argentina, Mexico, Malaysia, Hungary, Poland, and many others are now doing.[7]

B. Problems with Government Ownership

1. Costs

The debate over public-sector versus private-sector ownership of utilities and infrastructure is a long-standing one. Besides populist ideological arguments about ownership "by the people," advocates of public ownership tend to focus on the claim that government-owned utilities are to be preferred because they have inherently lower costs. As factors leading to lower costs, they cite: 1) lower-cost financing because of the availability of tax-exempt debt; 2) lower operating expenses because the enterprise is exempt from paying most or all taxes; and 3) lower overall costs because there is no requirement to earn a profit.

While widely believed to be true, these alleged lower costs are not necessarily the case. Many factors affect the overall cost of an infrastructure enterprise; what counts is the *overall net cost to the users*, not the level of individual components of total cost.

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3 *The International Privatization Update*, vol. 3, no. 12, December 1994, p. 3.

4 David Haarmeyer, "Privatizing Infrastructure: Options for Municipal Water-Supply Systems," Policy Study No. 151, Los Angeles: Reason Foundation, October 1992.

5 Robert W. Poole, Jr., "Guidelines for Airport Privatization," How-to Guide No. 13, Los Angeles: Reason Foundation, October 1994.

6 The word "transfer" refers to the fact that the long-term franchise agreement is typically for a period of 25 to 50 years, at which point title is to revert free and clear to the government, which may either seek a new franchisee or begin operating the facility itself.

7 World Bank, *World Development Report 1994: Infrastructure for Development*, Washington, D.C.: World Bank, June 1994.

What can lead to lower overall costs in a privately owned firm? One important factor is economies of scale. Private purchasers of existing infrastructure facilities or developers of new ones frequently operate many such facilities in a number of communities. They can take advantage of centralized accounting, administration, billing, engineering, insurance, and professional services, spreading these overhead costs over many facilities instead of just one.

Second, private firms are typically more efficient in their use of labor than are government-run enterprises. They may organize the work differently, using one supervisor for a larger number of workers, using a mix of full-time and part-time workers, and investing more heavily in equipment to make the work less labor-intensive. For example, when Indianapolis contracted out the operation and maintenance of its two advanced wastewater treatment plants in 1994, the winning firm was able to reduce operating costs by more than 40 percent, primarily by redesigning the workforce.

Economies of scale and workforce redesign can in some cases reduce operating costs enough to make it *possible* for a private firm to pay taxes and net a profit while still offering competitive prices to users. Nevertheless, the existence of significant tax advantages for municipal enterprises is a major hurdle to overcome in producing privatization transactions that benefit all parties.

Another major difference is often found in *capital* costs—i.e., paying for major investments in expanding and modernizing the enterprise. Municipal utilities typically pre-finance improvements in large blocks, issuing tax-exempt bonds well in advance of the need for all of the new facilities. Private firms are more likely to use "just-in-time" construction, funding only the increment of new capacity needed at the time. In addition, municipal utilities must often borrow several years worth of capitalized interest, provide bond insurance to attract buyers, provide additional reserves for future principal and interest payments, and pay significant costs of issuance uniquely associated with municipal bonds. Another factor that affects the amount financed is the time spent in design and construction. The shorter time period typical of privatized projects means fewer years that must be financed prior to the beginning of the revenue stream from user fees.

To be sure, the interest *rate* paid by a municipality is lower because of the tax-exempt status of the bonds, but the *total amount financed* can be significantly larger than a private firm would require (for the reasons noted above). Thus, the net annual debt service costs can sometimes end up being comparable to that of an investor-owned firm, even with the higher (taxable) interest rate the firm must pay.

2. Loss of Tax Base

Municipal infrastructure enterprises (airports, bridges, water systems, etc.) typically do not pay normal property taxes, nor do they pay state or federal income taxes. Yet the identical service business, if owned by investors, would pay all of these taxes. There is no question that these taxes are costs to the investor-owned firm, which must ultimately be paid for by the users. But they are also important potential sources of revenue to local, state, and federal governments. It seems odd that a city or county's property tax base is diminished by the rather arbitrary exemption of some utilities, but not others, from the tax rolls. If the estimated $227 billion[1] in marketable state and municipal infrastructure were restored to the local tax base, they would produce over $3 billion per year in property tax revenues (assuming an average tax assessment of 1.5 percent of market value).

3. Mis-Pricing

There are also significant problems in the way government-owned infrastructure enterprises charge for their services. Generally, due to various political pressures, these enterprises do not charge market prices. The Congressional Budget Office, among others, has found that "while both public and private [water] utilities usually set prices that are more than enough to cover operating costs, only private utilities routinely charge

[1] This figure is derived in Robert W. Poole, David Haarmeyer, and Lynn Scarlett, "Mining the Government Balance Sheet: What Cities and States Have to Sell," Policy Study No. 139, Los Angeles: Reason Foundation, April 1992.

enough to cover fully not only operating costs but also the depreciation of capital facilities."[9] (Many government enterprises do not record depreciation charges at all.) Thus, while the rates they charge to users may appear to be attractive, these below-cost rates mask an unsound fiscal condition which will lead to much larger rate hikes in the future, to catch up with the need to rebuild and modernize.

Below-market pricing misleads consumers about the true cost of the resource they are using. If users believe that water or electricity is cheap, they will tend to use more of it. But if prices reflect the actual, higher cost of these resources, users will be motivated to conserve. A good illustration is the use of electricity in the Pacific Northwest. Thanks to below-market pricing by government-owned utilities, electricity consumption per capita in the Pacific Northwest is 20 years higher than the national average.[10] Likewise, cities without water meters (like Sacramento, California) show much higher household water use than cities with meters and realistic pricing. When Denver switched to prefered water sevice in 1987, water use per household dropped by 27 percent.[11] Also, consumers who pay for solid-waste disposal by the can or by the pound have a strong economic incentive to conserve on their use of the waste-disposal system. Residents of cities whose garbage companies have implemented "pay-as-you-throw" pricing are much more likely to compost yard wastes and to recycle newspapers and other recyclables than residents of cities where garbage is either paid for via property taxes or charged for on a flat-rate monthly basis regardless of the amount collected.[12]

A similar effect is found in transportation infrastructure. Most government-run highways do not charge users at all, and those that do charge flat-rate tolls, regardless of the level of demand. Private toll-road developers in California and Washington State are planning to charge "congestion prices" which will be high at rush hour and low at off-peak hours. Nearly all (government-run) commercial airports charge landing fees based on the weight of the aircraft, ignoring the fact that the cost of tying up runway and taxiway space may be equally large for a private plane and a large airliner, and the fact that demand is very high at busy hours and quite low at off-hours. By contrast, privately owned Heathrow and Gatwick airports in London charge prices which are not based on weight, and which vary by time of day and season of the year.

4. The Public Authorities Alternative

Many observers acknowledge the limitations of government agencies as owner/operators of infrastructure, but contend that America has invented an alternative that combines the best of both the public sector and the private sector: the public authority. It is argued that the public authority has the freedom to operate like a business, but because it is retained in the public sector, inherently safeguards the public interest.

Other scholars disagree, contending that in some respects the public authority combines the worst of both worlds: it is exempt from many of the constraints that an investor-owned firm would have to comply with (e.g., local zoning laws, building codes) but is not disciplined by having to be accountable to share owners. Investor-owned firms are likely to be more efficient than public authorities, because the former are subject to much stronger economic incentives for productivity.

Legal scholar Clayton Gillette laid out this case in some detail in a recent policy study comparing public authorities with investor-owned firms.[13] Table 1, reproduced from that study, summarizes the principal differences between the two types of enterprise. Gillette concludes that these differences are significant enough

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9 Congressional Budget Office, "Financing the Municipal Water Supply," Washington, D.C.: May 1987.

10 Data obtained from Energy Information Administration of the U.S. Department of Energy.

11 Memo from Eddie Hernandez, Denver Water, April 5, 1995.

12 Lisa A. Skumatz, "Variable Rates for Municipal Solid Waste: Implementation, Experience, Economics, and Legislation," Policy Study No. 160, Los Angeles: Reason Foundation, June 1993.

13 Clayton P. Gillette, "Public Authorities and Private Firms as Providers of Public Goods," Policy Study No. 180, Los Angeles: Reason Foundation, September 1994.

that "the decision to have public authorities provide major infrastructure should be reconsidered, since private firms can often perform these same public functions while not suffering from the institutional disadvantages of public authorities."

Table 1

Comparison of Performance Constraints

Factor	Public Authority	Private Firm
Accessible to Voters	No	No
Subject to Public-interest Regulations	Sometimes	Yes
Clear Performance Measures	Sometimes	Yes
Customer Monitoring	Low	Low
Rating-agency Monitoring	Medium-high	High
SEC Disclosure Requirements	No	Yes
Managers' Financial Incentives	Low	High
Owners' Financial Incentives	No	Yes
Implicit State Guarantee	Yes	No
Bondholder Monitoring	Yes	Yes
Shareholders' Monitoring	No	Yes
Incentive to Overexpand	Medium	Low
Procurement Regulations	Sometimes	N/a
Managerial Performance Controls	Low-medium	High
Corruption Incentives	Sometimes	Low

C. Why the Persistence of Government Ownership?

Despite the serious problems with government-operated infrastructure enterprises, the United States has seen only a handful of efforts to either sell municipal utilities or to make use of the private sector to develop and operate new infrastructure. What accounts for the persistence of the governmental approach in the land of free enterprise, while the rest of the world is busily converting infrastructure to private enterprise?

The short answer is that a variety of long-established government policies favor governmental over private ownership of these vital facilities. Among the most important are tax policies. First of all, both federal and state law exempt from taxation the interest on bonds issued by state and local governments—even when those bonds are used to develop business enterprises paid for by customers (such as utilities and airports). By contrast, the interest on bonds issued by private firms is fully taxable. This tax discrimination results in interest rates on taxable debt that are at least two full percentage points (200 basis points) higher than for comparable tax-exempt bonds. This difference in interest rates translates into higher debt-service costs for the equivalent amount of capital investment, if developed privately.

The United States is virtually alone in exempting infrastructure bonds from taxation. Cross the border into Canada, or cross the Atlantic to Europe (except for Italy) and there is no such thing as a tax-exempt infrastructure bond. Only the United States subjects private infrastructure developer/operators to this kind of tax discrimination.

In addition, infrastructure enterprises owned and operated by government are generally exempt from both local property taxes and state and federal corporate income taxes. Once again, government policy biases the choice between private and government ownership of these vital facilities, increasing the cost of choosing the former mode.

Another disincentive to private ownership of infrastructure is federal grant programs. The current federal Airport Improvement Program provides "entitlement" grants to airports based on the number of annual passengers enplaned—except that privately owned airports are not eligible.[14] Similarly, the Federal Aviation Administration

[14] The AIP law was modified in 1978 to permit "discretionary" grants to be made to privately owned airports, but the annual entitlement grants are still available only to publicly owned airports.

has claimed that a municipality that sold or leased its airport could not legally make use of the proceeds for general governmental purposes but must retain them solely for airport purposes. While several legal observers have disputed that claim[15], the threat of costly litigation has served to discourage serious efforts to privatize airports. Requirements that previous federal grants be repaid in the event of the sale of an infrastructure facility have likewise discouraged the sale of such facilities.[16]

Various other provisions of federal law have also served as barriers to privatization of infrastructure. For example, waste-discharge provisions of the Resource Conservation & Recovery Act (RCRA) intend to differentiate between municipal wastewater treatment plants and industrial facilities that may discharge waste water, subjecting the latter to more detailed regulation because of their potentially more hazardous nature. Because the law specifies "publicly *owned* treatment works" [emphasis added], it inadvertently subjects a privatized municipal plant to a more costly regulatory regime, even though the plant carries out the identical municipal function regardless of ownership status.

Clearly, federal tax, grant, and regulatory law were not *intended* to bias the choice of ownership of infrastructure in this way. These laws simply did not contemplate the possibility that, by the dawn of the 21st century, the private sector worldwide would be able and willing to take responsibility for basic infrastructure functions. What policymakers need to do is to remove these biases from the law. This will permit city and state officials to choose between private and public ownership on their merits, rather than because the cost comparison between these alternatives has been distorted.

III. THE POTENTIAL OF INFRASTRUCTURE PRIVATIZATION

A. Asset Sales and Public-Private Partnerships

Before going further we need to be clear on definitions. The word "privatization" means different things to different people. It is often associated with the outsourcing of service delivery by a government agency, via competitive contracting. That is *not* the sense of the term that is relevant here. The focus of this paper is on two other types of privatization: asset sales and public-private partnerships (long-term development franchises). Both are ways in which responsibility for financing, owning, and operating infrastructure (rather than just operations and maintenance) can be shifted to the private sector.

Divestiture (asset sales) is the most common form of privatization worldwide. Typically, government either organizes an initial public offering of stock (as the federal government did in 1987 with Conrail) or it holds a competition in which firms submit bids to purchase the enterprise. Combinations of these methods are also possible, in which a government offers a majority stake to the winning firm but sells off the rest of the shares to large numbers of investors. A common feature of this type of privatization is for government to reserve a portion of the shares (typically 10 percent) for workers and managers; they may be given a certain number of shares and permitted to buy additional shares at a large discount. The purpose is to give these employees a tangible stake in the enterprise's success as a private firm, helping to overcome both their natural fear of change and the organized opposition of their union leaders.

When a government needs a new infrastructure facility but is unable or unwilling to finance and develop it itself, a public-private partnership based on a long-term franchise is often employed. The government agency defines

[15] See the following legal analyses: Jim Burnley, Jim Pitts, and Karen Grubber, "Legal Analysis and Policy Review Pertaining to Public/Private Partnership for Commercial Airports," Washington, DC: Winston & Strawn, March 24, 1993; E. Tazewell Ellett, "FAA's Privatization Policy: Past, Present, and Future," *Public Works Financing*, October 1992; and Karen J. Hedlund and John P. Giraudo, "A Legal Memorandum to John F. Brown Company Inc. Regarding Federal Restrictions on Transfer of Airport Revenues and Sale or Lease of Airport Property," Los Angeles: Skadden, Arps, Slate, Meagher & Flom, June 12, 1992.

[16] John P. Giraudo, "Breaking Free of Federal Grant Restrictions: Making Infrastructure Privatization a Real Option," Policy Study No. 127, Los Angeles: Reason Foundation, February 1991.

a set of requirements in a Request for Proposals (RFP) and engages in a competitive process to select the firm or consortium which presents the best proposal, as judged against a set of quantitative selection criteria. The winner receives a franchise for a period of years long enough to recover its investment in the project. If properly structured, this franchise is "bankable," i.e., the firm or consortium can use it to raise the capital (both debt and equity) to finance, build, and operate the facility. This process is often termed Build-Operate-Transfer (BOT), since the most common form of franchise agreement calls for the ultimate transfer of the facility back to the government at the end of the franchise period. In the United States this form of privatization is often called a public-private partnership (PPP).

Asset sales and PPP are often considered two separate issues, with the latter considered less controversial than the former. But these two forms of privatization are actually closely related. A mature facility (e.g., an airport or a water system) has a well-established history of usage by customers, known operating and maintenance costs, etc. It is relatively low-risk for a private firm to take over. By contrast, developing a totally new facility—a new toll road, a new airport, a new wastewater plant—carries considerable risk. Not only are there the normal risks of development and construction (changing interest rates, construction delays, etc.) but there is also great uncertainty in the forecasts of future usage of the facility.

To the extent that policy makers wish to see a healthy infrastructure industry develop in the United States, able to meet the needs for new and modernized infrastructure, it is unwise to expect firms (either financiers or developers) to take on *only* the high-risk new-development projects. In many cases, being able to take over an existing facility and expand or modernize it is far less risky—and therefore far more likely to attract firms and capital into the infrastructure field. Hence, asset sales and public-private partnerships must go hand in hand.

B. The Case for Asset Sales

The most common argument against asset sales is that it is "selling the family silver"—i.e., a short-sighted policy that may generate one-time cash benefits but is unwise in the long run. (This argument has been raised in virtually every one of the 100 countries which now have active and successful privatization programs.) There are several problems with this argument.

First, selling a state or municipal infrastructure asset does not result in the *loss* of asset value for the government. It is simply changing its form, from a physical asset to a financial asset. On the government's balance sheet, only the location of the asset has been changed. Presuming the government uses the proceeds from the sale wisely, the change is, at worst, neutral in financial terms. Except in emergencies (e.g., a municipal bankruptcy), proceeds from asset sales should not be used to pay for ongoing government operating expenses. Rather, they should be used for other capital transactions—e.g., to pay off outstanding debt (thereby reducing future interest costs) or to pay for other needed infrastructure that does not lend itself to private provision.

Second, to the extent that privatization succeeds in changing management incentives, the performance of the facility under private ownership should be superior to what was experienced under government ownership. Since they were privatized in the mid-1980s, Britain's airports, seaports, electricity, water and wastewater, gas, and telecom enterprises have become more entrepreneurial, more efficient, and more customer-friendly than in their days as state-owned enterprises.[17] France's large private water companies are considered the world's most technologically advanced firms in the industry.[18]

Third, the financial benefits of asset sales to the selling government go well beyond the one-time windfall of the sales proceeds. Many (though not all) state or municipal utilities receive operating subsidies which represent a drain on the taxpayers. Privatization usually eliminates such subsidies and any claim on future subsidies.

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[17] Matthew Bishop and Mike Green, "Privatisation and Recession," London: Centre for the Study of Regulated Industries, March 10, 1995. See also M. E. Beesley, ed., *Regulating Utilities: The Way Forward*, London: Institute of Economic Affairs (in association with the London Business School), July 1994.

[18] David Haarmeyer, "Privatizing Infrastructure: Options for Municipal Water-Supply Systems," Policy Study No. 151, Los Angeles: Reason Foundation, October 1992.

Moreover, as noted previously, privatized utilities become part of the local property tax base, and become subject to state and federal income taxes. Thus, all three levels of government will reap ongoing revenue benefits thanks to this type of asset sale.

C. What States and Cities Have to Sell

In 1992, when the Bush Administration was considering an executive order to ease federal barriers to state and local infrastructure privatization, the Reason Foundation compiled an inventory of state and local enterprises which might be candidates for divestiture.[19] The results are summarized in Table 2, which is extracted from that report. Included in the inventory are only those types of infrastructure that can be expected to be financially self-supporting via payments by users. Excluded, therefore, are jails and prisons, mass-transit systems, public housing projects, and other types of facilities which do have privatization potential but would be harder to turn into into free-standing businesses.

Included are the following:

- **Airports**: The largest 87 airports, which enplane 90 percent of all passengers on scheduled airline service. Valuation is based on prices paid for overseas airports which have been sold to investors.
- **Electric Utilities**: The 2,010 state and municipally owned utilities (excluding cooperatives and federal power agencies). Valuation is based on the British electricity privatization.
- **Gas Utilities**: The 800 municipal gas utilities (data from American Gas Association). Valuation is based on the British gas privatization.
- **Highways and Bridges**: These figures derive from a Reason Foundation study of how states might leverage their highway funds with private capital, which estimated that full 50-state implementation of this approach might lead to $19 billion per year in private investment in highways and bridges, primarily involving upgrading and modernization of existing facilities which would be sold or long-term leased to the private sector.[20]
- **Parking Structures**: Between 35,000 and 40,000 of the nation's 100,000 parking structures are owned by governments. Valuation is based on standard industry formulas, assuming an average of 525 spaces per facility.
- **Ports**: The 45 largest U.S. ports, which handle 1.2 billion tons of cargo per year. Valuation is based on the privatization of British ports.
- **Turnpikes**: Eight eastern toll roads, ranging in length from the New Jersey Turnpike (80 miles)

Table 2

Salable State and Municipal Enterprises

Enterprise Type	Estimated Number	Estimated Market Value ($ Billions)
Airport (Commercial)	87	$29.0
Electric Utilities	2,010	16.7
Gas Utilities	800	2.0
Highways and Bridges	n/a	95.0
Parking Structures	37,500	6.6
Ports	45	11.4
Turnpikes	8	7.4
Water Systems	34,461	23.9
Wastewater Facilities	15,300	30.8
Waste-to-Energy Plants	77	4.0
Total Estimated Value		$226.8

Source: Robert W. Poole, Jr., et al., "Mining the Government Balance Sheet: What Cities and States Have to Sell," Policy Study No. 139, Los Angeles: Reason Foundation, April 1992.

[19] Poole, et al., "Mining the Government Balance Sheet."

[20] Robert W. Poole, Jr., "Private Tollways: How States Can Leverage Federal Highway Funds," Policy Study No. 136, Los Angeles: Reason Foundation, February 1992.

to the New York Thruway (512 miles). Valuation is based on estimates from investment bankers in the early 1990s.

- **Water and Wastewater**: The 34,461 municipal waterworks, which serve 85 percent of the population, plus the wastewater systems which serve 100 percent of the population. Valuation is based on the privatization of British water authorities.
- **Waste-to-Energy Plants**: Seventy-seven municipally owned solid waste plants. Valuation is based on depreciated value of the municipalities' investment in these facilities.

Overall, as noted previously, U.S. state and local governments own some $227 billion worth of enterprises which would readily lend themselves to privatization via asset sales

D. The Case for Public-Private Partnerships

Around the world, governments are increasingly turning to private capital and private consortia to finance, design, build, and operate major infrastructure under long-term BOT franchises. There are a number of reasons for this phenomenon.

1. New Source of Capital

Governments everywhere are short of funds to invest in new infrastructrure projects. Public-private partnerships (PPPs) tap into commercial debt and equity capital that is not currently being invested in infrastructure.

In Australia, pension funds have begun to invest in privatized infrastructure projects. Virtually none of the huge pool of U.S. pension fund capital (some $4.6 trillion) is invested in public infrastructure, since nearly all bonds for such projects are tax-exempt. Since pension funds are not subject to taxation, they can get higher yields by investing in taxable debt.

Insurance companies in this country have begun to invest in the taxable bonds of PPP projects, such as the California and Virginia private toll roads and several recent sports-arena projects. Insurance company portfolios represent another huge pool of capital which could be tapped to a greater degree for infrastructure needs.

In addition, a PPP project's financing typically includes an equity component, constituting between 10 percent and 40 percent of the total capital. This, too, is an entirely new source of funding for infrastructure.

2. Time Savings

Both domestic and foreign experience indicates that privately developed projects can be completed and put into service in significantly less elapsed time than traditional public works projects. The private sector typically assembles a consortium of firms which use a technique known as "design/build." In this method, the design and construction phases are integrated, rather than being carried out as separate steps by separate parties. This type of process can reduce development time by one-third to one-half. For example, the privately developed Terminal 3 project at the Toronto airport took only 3.5 years from start to finish, compared with Transport Canada's estimate of 7 years via traditional methods.

3. Cost Savings

In construction, time is money. Reducing the time period during which capital is tied up translates directly into capital-cost savings on the project. The design/build process also leads to the designers and contractors working more closely together, reducing the number of costly change-orders during construction. Moreover, a private consortium that will end up *owning and operating* the facility has much stronger incentives to design it for low-cost operation than does an outside architect or engineer.

4. Risk Reduction

One of the factors that has led major development banks to promote PPPs is the degree to which this form of infrastructure development shifts risks away from government and onto the private consortium. Numerous white-elephant infrastructure projects have been produced in the past two decades, and not merely in the Third World.

Grandiose, overbuilt airports and highways to nowhere are hardly unknown in the United States. Taxpayers and municipal bondholders generally get stuck paying for these consequences of political factors overruling economic factors. PPPs provide much stronger market discipline. By shifting much or all of the development risk and revenue risk to the private consortium, a government can set in motion powerful forces that reduce costs and identify "bankable" revenue streams. And if these forces still prove to be inadequate, the taxpayers will be insulated from any subsequent losses.

5. *New Tax Revenues*

In contrast to state or municipal infrastructure enterprises, those developed as PPPs (unless specifically exempted) will be taxpaying businesses. Hence, they will pay local property taxes, state income taxes, and federal income taxes. Price Waterhouse has estimated that the $250 million private tollroad in Loudon County, Virginia, will pay some $96 million in local property taxes and some $450 million in state and federal taxes over the life of its 40-year franchise.[21] That is more than $2 in tax revenues for every $1 of initial capital invested.

E. What States Have Done Thus Far

Since 1988, a number of states have enacted specific legislative measures to permit PPPs in surface transportation. These states include Arizona, California, Florida, Minnesota, Missouri, Texas, Washington, and Virginia, as well as the Commonwealth of Puerto Rico. Other states that have authorized PPPs under existing law include Colorado and South Carolina. Tollway projects have been financed and put under construction, as of 1994, in California, Virginia, and Puerto Rico, while Arizona and Washington have issued RFPs and selected projects. Several other states, including Massachusetts and New Jersey, have considered making use of PPPs as well.

Several states, including California, enacted PPP measures during the 1980s aimed at environmental infrastructure such as wastewater treatment plants. For the most part, these measures have led to very few projects, primarily due to the tax discrimination against private financing discussed previously. Although the same negative factors apply to tollway PPP projects, where the latter are succeeding is primarily in locations where the potential demand is so high that the project can still be financed, despite the higher financing costs of taxable bonds.

F. Previous Federal Efforts

The federal government has acknowledged the interest of cities and states in using the private sector to a greater extent as the provider of infrastructure. Congress included provisions for this kind of public-private partnership in the Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA), and both President Bush and President Clinton issued executive orders intended to support private ownership and private capital investment in the nation's infrastructure. These federal initiatives have borne little fruit at the state and local level thus far.

1. *ISTEA's Public-Private Partnerships Provisions*

ISTEA partially reversed the federal government's long-standing prohibition of tolls on federally aided highway facilities. States may now impose tolls on all but Interstate highways, and ISTEA also calls for up to five pilot projects on congestion pricing in urban areas, up to three of which may include urban Interstate facilities. ISTEA also permits states to match some of their federal highway funding with private, rather than state funds, thereby making total government dollars go farther. States entering into such partnerships with the private sector may sell or lease existing facilities to private consortia for upgrading and modernization, and may grant long-term franchises for new highway and bridge projects.

The response by state governments has been modest. Since enactment of ISTEA, three more states (Minnesota, South Carolina, and Washington) have authorized highway privatization projects. Only Washington State explicitly referenced the ISTEA provisions in its legislation. And when the Washington Department of

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[21] Price Waterhouse, *Legislative Initiatives for Public-Private Partnerships in Transportation*, Washington, DC: The Privatization Council, 1991.

Transportation held a major competition for project proposals in 1994, none of the six finalists proposed to make more than token use of these provisions.

2. *Executive Order 12803*

Many types of infrastructure—and, in particular, airports, highways, and wastewater systems—have been developed in part with federal grants during the past 30 years. Much confusion has accompanied a handful of attempts to privatize such facilities (e.g., the abortive effort of Albany, New York, first to sell and then to lease its airport in 1989-90. The OMB common rule on grants to state and local governments permits their termination by the recipients, but—since it did not contemplate the privatization of the enterprise, but rather its abandonment or conversion to other use—requires that the awarding agency receive its percentage share of the proceeds from the sale of the asset.[22]

Would-be privatizers pointed out to the Bush White House that this provision could prevent many asset sale transactions, by raising their cost to the point where the deal would not be attractive. In response, President Bush in 1992 issued Executive Order 12803 on Infrastructure Privatization. While the original intent of its drafters was to eliminate the payback requirement altogether, OMB strongly resisted, and the result was a compromise. E.O. 12803 states that if the agency requires grant repayment, what a city or state must repay is the undepreciated portion of the grant (i.e., the remaining value of the assets purchased with the grant funds, after depreciation has been calculated using IRS accelerated depreciation schedules). It also provides that the *first* claim on the proceeds of a sale or lease of an infrastructure asset (before any funds are used for grant payback) is for the state or municipality to recover its original investment in the facility.

As with the ISTEA provisions, the response to E.O. 12803 has been minimal. Since ISTEA already dealt with the area of highways, the principal infrastructure fields affected by the order are airports and wastewater systems. The relevant agencies took opposite approaches to implementing the order. The EPA set up a pilot program, under which municipalities were invited to propose privatization transactions making use of the order. Three jurisdictions were selected, only one of which (Franklin, Ohio) has proceeded with an actual sale transaction. As of January 1995, that proposed sale of a wastewater treatment plant was still awaiting OMB and IRS approval, more than six months after all the parties to the transaction had finalized all other aspects of the deal.

The Federal Aviation Administration, despite much internal work since the Albany episode to develop a written policy on airport privatization, adopted the public stance that no action by it was required. It would wait until a proposed airport sale or lease was presented to it and make policy on a case-by-case basis. This uncertainty deters serious investment proposals.

3. *Executive Order No. 12893*

President Clinton entered office pledging to "rebuild America" but also promising to reduce the deficit. He was also under pressure from public employee unions to rescind E.O. 12803, which the unions opposed because it favored privatization. The conflicting pressures of deficit reduction and expanding public works led to the issuance of a new executive order on infrastructure, No. 12893, issued in January 1994. Contrary to some expectations, it did not rescind E.O. 12803 but rather, to some extent endorsed its general principles. Specifically, it called for uniform principles for federal infrastructure programs in transportation, water resources, energy, and environmental protection—including cost-benefit analysis, market-based mechnisms, and "private sector participation in the ownership, financing, construction, and operation of the infrastructure programs." Federal agencies were directed to take action to implement these principles and to "minimize regulatory and legal barriers to private sector participation."

As of the end of 1994, however, 11 months after the order was issued, little real change had occurred. DOT Secretary Federico Pena established an Infrastructure Financing Task Force to explore innovative financing and public-private partnerships, and the modal agencies in DOT sought ideas on innovative financing. But no policy

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22 John P. Giraudo, "Breaking Free of Federal Grant Restrictions: Making Infrastructure Privatization a Real Option," Policy Study No. 127, Los Angeles: Reason Foundation, February 1991.

on airport privatization emerged, nor did specific new proposals for highway privatization. And EPA's lone wastewater privatization pilot project continued to await approval or rejection from OMB and the IRS.

IV. NEAR-TERM REFORM AGENDA

It should be clear from the foregoing that state and local governments have the potential to dramatically reshape the way in which infrastructure is provided and financed in this country. It should also be clear that federal tax, grant, and regulatory policies at present serve as significant impediments to the full implementation of this new infrastructure paradigm by those states and cities which might wish to do so. Congress has an opportunity to modify or remove these impediments, thereby giving significant new opportunities to state and local governments and to the private sector. Removing these barriers would not mandate that cities and states privatize anything. It would simply permit them to take those actions, should they decide that asset sale· and/or infrastructure franchises represent sound public policy.

This section sets forth relatively modest changes which could be made relatively quickly. The subsequent section then presents a more sweeping, longer-term recommendation to fully implement the new infrastructure paradigm.

A. Tax-Code Changes

In response to the Tax Reform Act of 1986, the Internal Revenue Service has provided in Revenue Procedure 93-13 that contracts with the private sector entered into by state and local governments to manage facilities developed with tax-exempt bonds are limited by a "3-5" rule. Such contracts must provide for termination without cause after three years and terms of no more than five years. Rev. Proc. 93-19 prohibits any form of manager compensation tied to net profits, which serves to discourage productivity-enhancing incentive structures. Not complying with these rules results in the loss of tax-exempt status for the bonds.

The practical effect of these rules is to seriously curtail the extent and scope of privatization agreements to manage and (especially) modernize facilities. A five-year term is too short to recover most capital investments which a private firm might make in upgrading or modernizing a facility. Hence, most facility privatization has been limited to short-term operating and maintenance (O&M) contracts, in which the municipality makes all the investments and bears all the risks. Much of the real potential of infrastructure privatization is thereby precluded. These restrictive rules should be done away with.

Revenue Procedure 93-17 was a response to the growing interest in infrastructure privatization via sale or lease. Its intent was to permit existing tax-exempt bonds to remain tax-exempt in the event of privatization of the infrastructure facility, if several conditions are met. The proceeds must be expended for a purpose that would qualify for tax-exempt financing, and the facility must continue to be used for its original purpose for at least five years. (Of course, if the bond covenants themselves require that the bonds be paid off in the event of a change of ownership, IRS flexibility is irrelevant.)

The first test case of this rule was the 1994 attempt by Franklin, Ohio to privatize its wastewater treatment plant by selling it to a private firm. As of early 1995 the IRS had not yet been able to decide whether or not to permit the facilities' bonds to remain tax-exempt.

This kind of discretion should not be left in the hands of the IRS, creating needless uncertainty and delays which can decrease the likelihood of transactions being able to proceed. Congress could codify this procedure, removing the need for the IRS to approve each transaction prospectively—and its apparent discretion to disapprove such transactions.

On December 30, 1994 the IRS published a proposed revision of these rules in the *Federal Register*. Management contracts could extend up to 15 years, but incentive compensation would still be largely ruled out. Tax-exempt status of existing bonds could be preserved in the event of sale to private owners, but the proceeds would have to be spent by the municipality to defease public debt or to buy some other exempt infrastructure facility. These provisions represent a step in the right direction, but a better solution would be clear direction from Congress that it is in the public interest to bring private capital and ownership into infrastructure, and that existing IRS procedural obstacles should be abolished.

For those cases where bond covenants preclude leaving the original bonds in place, with continued tax-exempt status, Congress could amend the tax law to permit a one-time refinancing by the new private owner on a tax-exempt basis. The benefits to the Treasury would be the new corporate income tax revenue generated by a for-profit firm which would replace a non-taxpaying municipal entity. In many cases, as noted in an article in *The Bond Buyer*, the privatization transaction would not take place at all if the facility would have to be refinanced at the outset with taxable debt.[23] The cost of servicing the new (taxable) debt would have to be borne immediately, while the cost savings brought about by privatization would take a number of years to phase in. The Treasury would be better off with the new corporate tax revenues it would obtain via privatization transactions that come about than with no revenues (the current situation) if such transactions do not come about.

B. Executive Order Codification

The original intent of President Bush's E.O. 12803 was to obviate the need for paying back federal grants in the event of privatization, on grounds that the OMB common rule had never contemplated privatization as the occasion for grant termination. As long as the facility remains in service to the public for its original purpose, its changed ownership status should be of no concern to the federal agency which made the grant(s) to assist with its construction or modernization. Moreover, the intent of E.O. 12803 was to direct the relevant federal agencies to respond positively to requests by grantees to privatize infrastructure facilities.

These principles should be codified, rather than remaining in the precarious form of an executive order that could be rescinded at any time. Thus, Congress could enact a measure that asserts as federal policy that states and cities are free to privatize their federally aided infrastructure, by sale or lease, so long as those facilities are kept in their original use of serving the public. Repayment of previous grant amounts would be prohibited. Proceeds from the sale or lease would be available to the seller or lessor for any public investment purpose, including the repayment of outstanding debt or an endowment fund whose earnings would be used for specified public purposes. The relevant grant-making federal agencies would be directed to cooperate with privatization requests from grantees. And Congress would expect to exercise oversight of these agencies to ensure that they were complying with both the letter and the spirit of this measure.

C. Sector-Specific Reforms

The short-term measures outlined above apply to all types of infrastructure. Current federal law also contains provisions that apply more narrowly, inhibiting privatization within specific sectors. Congress could also remove these barriers.

1. Airport Entitlement Grants

As noted previously, the current Airport Improvement Program permits privately owned airports to receive discretionary grants for specific projects, but explicitly prohibits them from receiving the entitlement grants received by all passenger airports based on their number of annual enplanements. This provision clearly discriminates against the private sector, adding yet another factor that artificially creates a cost disparity between government and private ownership. Removing it would be another step toward a more level playing field.

2. Tolls on Interstate Highways

As contemplated in the ISTEA legislation, now that the nation's major highway system is largely complete, the main priority is to modernize it and keep it in good repair. Accordingly, the largest potential market for the private sector is not the creation of entirely new highways and bridges but the modernization and upgrading of existing facilities. Among the highest-traffic facilities in the highway system are Interstates, especially urban Interstates. And as Congress recognized in creating the congestion pricing pilot project section of ISTEA, it is

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23 Wilbur L. Ross, Jr., "How an Internal Revenue Service Rule Is Standing in the Way of Privatization," *The Bond Buyer*, April 3, 1995.

urban areas where the introduction of direct pricing would have the greatest benefit in controlling congestion. Public agencies are very reluctant to put prices on currently "free" highways, but the private sector is eager to have the opportunity to do so (as Washington State has recently demonstrated). Hence, removing the current ban on tolling Interstates would be a very significant reform in the highway field.

3. Investor-Owned Utilities: CIAC

Privately owned water and electric utilities were put at a further disadvantage compared with municipal utilities by the Tax Reform Act of 1986. The issue concerns the tax status of contributions made by would-be customers to facilitate the extension of service to that customer. Under the 1986 Act, Contributions in Aid of Construction (CIAC), when made to an investor-owned utility, are to be included as taxable income of the utility. Thus, depending on the combined rate of federal and state corporate income taxes, an investor-owned utility must charge the customer an amount sufficient to make up for the amount by which the contribution is decreased by these taxes. In high-tax states such as New York, the total "gross-up" required is as much as 70 percent. Thus, while a municipal utility must collect $1,000 to pay for a $1,000 connection, an investor-owned utility must collect as much as $1,700 for the same $1,000 connection.

The practical result of this exaggerated cost for connecting, say, a new subdivision to an existing system, is the creation of many small new water districts to avoid the impact of the tax. It also serves as a disincentive for consolidation of non-viable water systems into economically more viable units. The tax on CIAC is yet another legally created disparity between government-owned and privately owned utilities. Repeal of this tax has been supported by the National Association of Homebuilders and the National Association of Regulatory Utility Commissioners.

4. Wastewater Systems: POTW

The Resource Conservation & Recovery Act (RCRA) deals, among other things, with the discharge of potentially hazardous effluent from various facilities. It properly seeks to differentiate between industrial plants, which may utilize and possibly discharge very hazardous materials in their effluent, and ordinary municipal sewage treatment plants. The latter are regulated by a less-costly set of standards.

The authors of RCRA did not contemplate the private ownership of municipal wastewater systems. Thus, in choosing the wording to specify what type of facility would be subject to the less-costly standards, they used the term "publicly owned treatment works." In implementing RCRA's discharge standards, the EPA has interpreted these words literally to mean that only those facilities 100 percent owned by a public-sector entity are regulated by the POTW standards. Thus, if a wastewater plant were sold to a private firm, it would be regulated by the far more costly discharge standards applying to industrial plants. Since the EPA has not felt justified in liberally interpreting the language of RCRA, Congress could substitute a new term such as "public-purpose treatment works," which would be neutral between government and private ownership.

5. Solid Waste Disposal: Unfunded Mandates

Congress is considering legislation to protect state and local governments from additional unfunded federal mandates. This worthy goal could inadvertently impose further competitive disadvantages on private providers of infrastructure facilities. For example, if a waste-to-energy facility owned by a city or county were exempted from a costly federal mandate to install scrubbers, but the same exemption were not granted to identical facilities owned by private firms, the latter would be placed at a severe economic disadvantage. Once again, the danger is that Congress will enact legislation that fails to recognize that public-purpose infrastructure is increasingly being provided by private firms. Federal law needs to move toward a level playing field between public and private ownership, rather than further tilting the field in favor of government ownership. The same environmental regulations should apply to all infrastructure that serves the public, regardless of who owns and operates it.

V. LEVELING THE PLAYING FIELD FOR INFRASTRUCTURE FINANCE

The single most significant barrier to infrastructure privatization is the tax code's discrimination against private capital. Permitting the public sector's bonds to be tax exempt but taxing those of the private sector creates a non-level playing field, biasing the choice between the two forms of ownership. That some asset sales can still pencil out as viable transactions despite the large disparity in interest-rate costs indicates the potentially large efficiency gains to be had from private ownership. But there is no good reason for the U.S. government to continue to tilt the scales in favor of government ownership.

There are two alternative ways to level the playing field. One is to extend tax-exempt status to bonds for public-purpose infrastructure, regardless of ownership status. The other is to end the availability of tax-exemption for revenue bonds for those types of infrastructure which are inherently self-supporting business enterprises.

A. Public Benefit Bonds

A proposal to create, in the tax law, a new category of infrastructure bonds was made in 1994 by Lehman Brothers[24] and introduced in Congress as part of the Infrastructure Development Act of 1994 (H.R.5120) by Reps. Rosa DeLauro and Richard Gephardt. Public Benefit Bonds would consist of two categories: "Type A" bonds for transportation and environmental infrastructure that are currently tax-exempt, and "Type B" bonds that are not currently tax-exempt but that fund infrastructure facilities which benefit the public at large, whether privately or publicly owned. Eligible Pension Fund Investors would be permitted to treat the interest earned on such bonds as part of the Participant's tax cost basis, which would render the interest income tax-free upon distribution. Hence, the bonds would have an interest rate comparable to those of current tax-exempt municipal bonds.

Lehman Brothers carried out an analysis to estimate the budgetary impact to the Treasury, based on assumptions about the budget scoring process used by the Treasury and the Joint Committee on Taxation. In the base case, taxable investors purchase tax-exempt municipal bonds and pension funds invest in taxable corporate bonds of similar creditworthiness. In the Public Benefit Bond case, the pension funds shift to a given dollar amount of the new Public Benefit Bonds, while taxable investors purchase an equal amount of (taxable) corporate bonds no longer held by the pension funds. The net result of these transactions is increased net tax revenues to the Treasury, both short-term (over the five-year time frame used by the Treasury and JCT) and longer-term.

Substituting tax-exempt bonds for taxable bonds on privately owned projects would be a significant stimulus to increased private-sector activity, both in purchasing and modernizing existing infrastructure facilities and in developing totally new infrastructure. Other things being equal, financing a facility with tax-exempt debt would mean lower debt-service costs and hence lower charges to users.

But a significant question remains as to whether the proposal would actually be revenue-positive to the Treasury. The analysis hinges on the zero-sum assumption that investors who now purchase tax-exempt municipals will shift to purchasing taxable corporate bonds. This assumption is not defended, but simply asserted. Yet there is no reason to expect that the demand for tax-exempt bonds by high-bracket investors will go down, simply because pension funds (in which some of those investors may also be participants) can now purchase infrastructure bonds.

B. Taxable Bonds for Infrastructure Enterprises

The alternative way to level the playing field is to remove the tax-exemption for those infrastructure enterprises that are essentially businesses, whether or not their owner is a government or a private firm. (Current law generally distinguishes between "governmental" services such as fire, police, welfare, and education and "proprietary" services such as electricity, gas, water, telephone, and garbage service.) The tax code could simply

[24] Lehman Brothers, "Estimating the Federal Budgetary Impact of Public Benefit bonds," Philadelphia: Lehman Brothers, June 10, 1994.

spell out the types of infrastructure enterprises which will be assumed to be business-like and fully supportable by user charges. Such a list could be the following[25]:

- Airports
- Energy Facilities
- Electric Utilities
- Gas Utilities
- Environmental Facilities
- Highways, Bridges, and Tunnels
- Ports
- Solid Waste Facilities
- Transportation Facilities
- Wastewater Treatment Facilities
- Water Facilities

It would be unfair to those who have purchased existing bonds for such facilities to remove their current tax exemptions. Hence, the proposal would apply only to *new issues* of revenue bonds in the designated categories. There would be a gradual transition to the new approach, over a period of 15 to 20 years, at the end of which nearly all bond financing of these types of infrastructure would be on a taxable basis. As with the previous approach, there would be a level playing field for all new facilities and for all expansions and modernizations of existing facilities. This should lead to significant private-sector participation, via both purchase of existing facilities and long-term franchises for new ones.

What would be the revenue impact to the U.S. Treasury as this approach is phased in? Table 3 assembles figures on the average annual issuance of municipal revenue bonds in each of the above categories over the five years 1990 through 1994. In the typical year of this decade, thus far, some $51 billion of infrastructure revenue bonds were issued. This represents 26.3 percent of the total municipal bond market. Their average coupon was 5.43 percent.

Assuming that this annual volume is typical, we can project a similar volume of new issues into the future. Assuming that the average coupon on these now-taxable bonds is 200 basis points higher than their tax-exempt predecessors, the annual interest on $50.852 billion worth of bonds would be $3.778 billion. At a tax rate of 36 percent, this would produce $1.36 billion in year one. Each subsequent year there ·ould be an additional $50.852 billion in new issues, adding another $1.36 billion in tax revenue. Since the average maturity of the infrastructure revenue bonds in Table 2 is 18.23 years, by year 18 federal tax revenues from this new source would peak at $24.5 billion, remaining at this level in future years, as shown in Figure 1. Hence, this change would produce substantial, ongoing deficit reduction, while dramatically increasing privatization of infrastructure.

Table 3

Average Annual Volume of Infrastructure Revenue Bonds 1990 1994

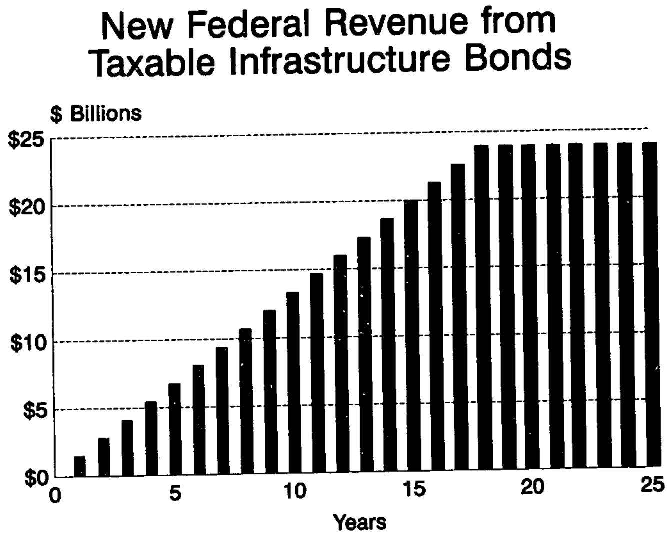
	$ Billions	Number	Maturity
Energy			
Electricity	12.693	162	19.6
Gas	.375	20	21.2
Subtotal	13.068	182	
Environmental			
Solid Waste	3.382	182	17.1
Water & Wastewater	19.695	1,464	16.7
Subtotal	23.077	1,646	
Transportation			
Airports	5.250	102	19.7
Highways	8.465	242	13.6
Ports	.992	38	19.7
Subtotal	14.707	382	
Total Infrastructure	$50.852	2,210	18.23
Other Municipal Revenue Bonds	77.460		
General Obligation Bonds	64.919		
Total Municipal	$193.231		

Source: Securities Data Corp.

[25] Purposely omitted are non-commercial enterprises such as urban rail systems, which could still be funded by general-obligation bonds or other tax revenues.

What would be the possible negative effects of such a change? Investment banking firms would be no worse off from this change, assuming the total volume of infrastructure bonds remained at least the same (if not larger). They would simply be doing a larger fraction of their bond volume on the commercial rather than the municipal side of their business. And since margins on municipal issues have been thin in recent years, investment banks might welcome the change.

Figure 1



Bond buyers would have a smaller (by about one-fourth) pool of new issues to choose from each year, about which they would probably be unhappy. Yet they would still have the remaining three-fourths of new issues and the entire existing pool of outstanding bonds in which they could still invest on a tax-exempt basis. Even after the change was fully implemented (after year 18), there would remain a large tax-exempt market of general-obligation bonds and non-infrastructure revenue bonds. And no current bond-holder would be taxed on any existing bond-holding.

City and state governments might object to this change, on grounds that it would increase the interest rates on a portion of their new issues, thereby leading to higher user fees for their constituents. As noted previously in Section II, there would be a number of offsetting factors working toward *lower* costs for privatized infrastructure, but this might be dismissed in advance of the change as unproved and purely theoretical.

On the other hand, for the remaining three-fourths of new issues of municipal bonds—those that would remain tax exempt—there would likely be some reduction in interest rates. This would occur for the following reason. The same number of high-bracket investors would create the same amount of demand for tax-exempt munis, but the supply would be one-fourth less. This increased demand (in relation to supply) would bid up the price for the tax-exempt munis, causing their yield to fall. In other words, cities and states could sell their remaining munis at a lower interest rate. Thus, on balance, cities and states would receive an offsetting benefit of somewhat lower interest charges on the majority of their new issues of municipal bonds.

VI. AN ADDED BENEFIT: NEW EXPORT MARKETS

This paper has recommended that federal policy remove all barriers to infrastructure privatization, leveling the playing field between government and private ownership of infrastructure. If this were done, in addition to the benefits flowing from increased investment, better pricing, and better management of our infrastructure there would be the added benefit of stimulating the growth of an important export industry.

The world is moving more rapidly than we are to this new infrastructure paradigm. Worldwide, in 1994 alone, some $23 billion in new infrastructure projects were privately financed, bringing the total of such projects to nearly $83 billion. According to a detailed tally by *Public Works Financing*, another 416 projects valued at $431 billion are in the planning stages.[26] Latin America, Asia, and the former Communist world, in particular, are developing modern infrastructure via asset sales and public-private partnerships.

But the fact is that U.S. firms are doing poorly in the international competitions to finance, develop, own, and operate this infrastructure. British, French, Italian, and Japanese firms are among the leaders in winning competitions for airports, toll roads, water systems, and waste disposal facilities around the world. The world's largest and most sophisticated water/wastewater firms are the large French and British water companies. The world's largest private, for-profit airport developer/owner/operator is the privatized British Airports Authority. The leading firms experienced in building and operating tollways at a profit are French, Italian, and Spanish companies which have been doing this for several decades in their home markets.

The United States has no real home market where American firms can hone their skills and expertise as owner/operators of transportation and environmental infrastructure. The persistence of municipal socialism in this country—in contrast to our international competitors—has stunted the development of world-class capabilities in our firms. To be sure, U.S. firms are still among the leaders at engineering, design, and construction. But our firms are far less experienced at *financing* and *operating* large-scale infrastructure facilities as business enterprises.

It is ironic that the land of free enterprise has thus far largely missed out on the opportunity to develop the modern infrastructure needed in the former Communist world and the rapidly growing Third World. Creating a home market for privatized infrastructure would give U.S. firms the kind of experience that would increase their competitive edge in the huge worldwide infrastructure market of the 21st century.

ABOUT THE AUTHOR

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[26] William Reinhardt, "1994 International Major Projects Survey," *Public Works Financing*, October 1994.

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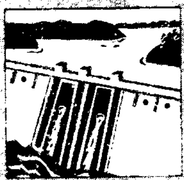

Restructuring America's Water Industry:

Comparing Investor-Owned and Government-Owned Water Systems

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RESTRUCTURING AMERICA'S WATER INDUSTRY:
COMPARING INVESTOR-OWNED AND GOVERNMENT WATER SYSTEMS

by
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EXECUTIVE SUMMARY

Who should supply consumers with water? This study compares the performance of investor-owned water companies with government-owned water companies in California to gauge the potential benefits of restructuring the industry, focusing on tax subsidization, the cost of capital, water charges, operating costs, investment income, and capital expenditures. It also discusses the related issues of regulation and employment. Analysis of the data yields the following results:

- Investor-owned water companies provide comparable water services to consumers at the same price as government-owned water companies even though they pay taxes and do not receive extra nonoperating income.
- Government-owned water companies receive generous tax subsidies that otherwise could be used to lower taxes or fund other government projects with higher priorities.
- The net cost of capital is higher for government-owned water companies than for investor-owned water companies.
- The real water bill is higher for government-owned water companies than for investor-owned water companies.
- Investor-owned companies are substantially more efficient in their operation of water services than government-owned water companies.
- Government-owned water companies receive a substantial amount of nonoperating income from excess cash balances and investments.
- It is likely that government-owned water companies spend more on facilities than investor-owned water companies, although the data on this issue are not entirely conclusive.

- Water service is highly regulated whether it is operated by an investor-owned company or a government-owned company.
- Government can better regulate an investor-owned water company than a government-owned water company.

These results suggest that the decision to have government entities provide water to consumers should be reconsidered, since investor-owned companies can provide this same function at the same cost without subsidies or tax-exemptions. California and other states should adopt policies which encourage the termination of government provision. Such policies would have minimal impact on consumers, since the price of water is approximately the same for the two types of provider. Moreover, the revenues generated by terminating the government water companies could be used to reduce taxes or to fund other, higher-priority government programs.

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I. INTRODUCTION

A. The Importance of Restructuring

A growing number of countries have restructured all or part of their water-delivery systems to realize private-sector efficiencies. Most notable among these are England and France, where nearly 100 percent and 75 percent of the population, respectively, is served by investor-owned water companies. Evidence from England, which privatized its entire water and sewer system in 1989, suggests that investor ownership has resulted in dramatic overall improvements, especially in capital investment, operating efficiencies, and water quality.[1] In addition, British and French companies now compete worldwide in a rapidly growing market for the design, building, and operation of water and sewer systems.

The United States, and California in particular, would benefit from similar restructuring. Currently, investor-owned water companies serve approximately 15 percent of the U.S. population, and just 12 percent of California's. The remaining population receives its water from government-owned water companies. The government-owned water companies receive generous tax subsidies at the local, state, and federal level and are not subject to market pressures such as the threat of acquisition, the interests of shareholders, or the risk of bankruptcy. Operating in a highly insulated environment, the government-owned water companies are not subject to the same incentive systems which promote efficient delivery of the same services in the investor-owned sector. The question of whether water should be delivered by investor-owned firms or government-owned firms is at the heart of the controversy over the role of government with respect to a natural monopoly in a free-market economy. Arguably the most efficient delivery of water services in a given geographical area is accomplished with a single provider. The question is, therefore, whether public services with these characteristics, can be more efficiently financed and operated by investor-owned firms or by government-owned firms.

An examination of a portion of the California water industry containing both investor-owned and government-owned water companies provides empirical data needed to answer this fundamental question. Many of the theoretical issues relevant to this debate have been amply covered in scholarly and professional journals, but empirical studies comparing the performance of investor-owned water companies with government-owned water companies are decidedly lacking. This situation has occurred for a variety of reasons, both methodological and political. Methodologically, there are a number of barriers, including the absence of common accounting standards and the subtle effects of subsidization, that make comparisons using traditional methods difficult. Important participants in the government-owned water industry, including employees, investment bankers, lawyers, brokers, accountants, engineers, consultants, and elected board members, have differing views as to whether or not the government-owned industry should be liquidated. Most likely, this subject has in part been ignored for a number of personally important reasons, including but not limited to, the fear of job loss, reduction of service provider and consultant income, and loss of political contributions, power, and elective positions.[2] These are the same types of fears which participants in all private and government industries face when the status quo is challenged.[3]

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1 *The Economist*, March 11, 1995, pp. 55–56.

2 The governmental-owned water companies are fully aware their *raison d'etre* is being questioned. An example of this can be found in Monterey County where its Water Agency recently employed a consultant "to identify the organization structure which will best enable the Agency to perform most effectively in the near-term and to position itself strategically for long-term success in the emerging competitive utility services environment." The consultant contract with the Agency also states the consultant will be the Agency's "champion of public ownership and operation of local utilities." It is as though government-owned water companies are adopting defensive strategies reminiscent of the defensive strategies of the 1980s adopted by corporate management to stop takeovers from occurring and to protect jobs of entrenched management.

3 See the case titled Blunt v. Securities and Exchange Commission (CCH 98,822) United States Court of Appeals for the District of Columbia. No. 94-1336 (1995) for discussions of the SEC's regulation of the relationships between the tax-exempt Issuer and the Underwriting Community and the need for such regulation.

B. Methodology

This study compares the operations of the three largest investor-owned water companies in California with that of the large government-owned water companies servicing Contra Costa and Alameda Counties. The figures for the three investor-owned water utilities used for this study— California Water Service Company, San Jose Water Company, and Southern California Water Company—yield an approximation of the whole investor-owned water market in California since together they service about 60 percent of all customers served by investor-owned companies or approximately 12 percent of California's total water customers. All information not directly cited in the text regarding these investor-owned companies is taken from the 1992, 1993, and 1994 Class A Water Utility Annual Reports filed by these companies with the California Public Utilities Commission (CPUC).

The sample of government-owned water companies includes special districts with service areas in multiple counties, special districts with service areas in multiple cities within a single county, and municipal agencies with service areas in only one city. The following government-owned companies were included: Alameda County Water District; Contra Costa Water District; Diablo Water District; Dublin San Ramon Services District; East Bay Municipal Utility District (water operations only); and Water Enterprise Funds from the Cities of Antioch, Hayward, Livermore, Pittsburgh, and Pleasanton.[4] Combined, these government-owned companies are approximately the same size as the three investor-owned water utilities: they both have total revenue streams ranging from $325 million to $350 million per year. For the government-owned companies, all information not directly cited in the text is taken from their audited financial reports for fiscal years 1993 and 1994 (which together cover the period from July 1, 1992 to June 30, 1994) and from bond offering circulars issued during this time period.[5] For those agencies delivering both water and sewer services, this study used the combined financial reports to include only the water division of each entity.

The most significant barrier to making comparisons between investor-owned firms and government-owned water companies is not only the variation in accounting methods used by the government and investor-owned sectors, but also the lack of a universal accounting standard within the government sector itself. While the annual reports filed with the CPUC generally conform to a common accounting standard, the government sector has no such requirement. Government-owned companies' financial reports are audited, and are reliable, but the lack of standardization makes comparisons across companies, each of which employs its own method of accounting, quite challenging. Some government-owned companies include investment income in their operating revenue, while others account for it as nonoperating revenue; some government-owned companies report expenditures on contractual services, while others include that number within administrative and general costs. Moreover, variations in accounting practices result in a number of revenue streams, such as developer contributions and connection fees, that are sometimes accounted for in such a way that they cannot be differentiated from other items.

A number of steps were taken to transform the different accounting methods used by the government-owned and investor-owned sectors into a universal method for comparison. First, much of the analysis focuses on the statement of income, which itself controls for a great number of differences between companies, such as one-time capital expenditures and credit periods. Second, many numbers are converted into figures per connection. By dividing income and expenditures by the number of actual physical water connections, a common denominator is created, and more useful comparisons can be made. Since each connection serves a definite number of customers, figures per connection relate to the impact per customer, for which the number of connections is a useful proxy. In addition, water rates are too easily manipulated by shifting the burden to new customers with

4 Zone 7, an agency of the County of Alameda, is not included in the sample because it is primarily a wholesaler to California Water Service Company, Dublin San Ramon Services District, and the cities of Livermore and Pleasanton.

5 The Annual Reports on Financial Transactions Concerning Special Districts of California released by the Office of the Controller as well as the Summaries of California Public Debt by the California Debt Advisory Commission were also examined. However, due to different reporting requirements, the figures in these reports were not always consistent with those of the audited financial statements, to which this paper defers.

high connection fees or to various geographical areas with differential rates to be useful for this type of analysis. Third, the accounting methods used by the government-owned companies themselves were retained whenever possible, on the theory that their aggregate figures include the useful data, even if some of the particular numbers are accounted for in different ways. Fourth, communication with financial officers of surveyed agencies clarified their published financial statements when necessary.

Aside from disparities in accounting practices, a comparison must take account of other differences in operating conditions faced by water utilities. Over-sensitivity to factors such as difficulty in developing and managing water resources, the timing of the last debt offering or the deferral of maintenance, however, is dramatically reduced by clustering the utilities into two groups, investor-owned and government-owned. Since each group contains a cluster of water utilities, each operating in slightly different conditions, individual differences are theoretically evened out and general trends highlighted. In addition, a weighted average system is used to properly control for differences in each utility's size. The figures in this study are therefore averages for the entire industry. While these results may not have the statistical rigor of a regression analysis based on a large sample of water entities, they are certainly acceptable for discerning broad differences between the two types of water company.

II. COMPARING INVESTOR-OWNED AND GOVERNMENT-OWNED WATER COMPANIES

A. Summary of Operations

Table 1: Summary of Water Company Operations (Per Connection)

	Investor Owned	Government Owned
Total Operating Revenue	$426	$425
Total Operating Expense	($273)	($330)
Depreciation	($29)	($75)
Operating Earnings	$124	$20
Property Taxes Received	$0	$30
Connection Fees	$0	$18
Investment Income	$0	$27
Other Revenue	$6	$60
Taxes Paid	($41)	$0
Cost of Capital: Interest on Debt	($31)	($92)
Cost of Capital: Dividends	($35)	$0
Other Expenses	($11)	$0
Total Nonoperating Income	($112)	$43
Net Income	**$12**	**$63**

Table 1 summarizes the average annual income and expense per connection for the investor-owned companies and government-owned companies in this study. The most striking, but not altogether unexpected, result is that investor-owned companies rely primarily on operating earnings to pay taxes (property and income) and the costs of capital (interest on their debt and dividends to stockholders), whereas government-owned companies rely completely on nonoperating sources of income, such as property tax allocations and investment income, to pay their costs of capital (interest on debt). Further, government-owned companies have low operating earnings due to their significantly higher operating expenses and depreciation costs. It is not surprising that managers of government-owned companies do not focus on streamlining operations, since they are guaranteed a constant supply of income from local property taxes, from the interest on accumulated cash reserves, and from connection fees. Furthermore, since government-owned companies are exempt from local, state, and federal taxes, and do not have to pay dividends, managers need only worry about covering the interest payments on their debt. Managers of investor-owned companies, on the other hand, facing high levels of taxes, interest payments, and stockholders desiring a competitive level of dividends, must reduce costs wherever possible to generate the revenue to pay for these expenses.

Government-owned companies make a substantial amount of income in the Other Revenue category. However, the $60 per connection of other revenue in Table 1 results from the sale of raw water by only one agency, Contra Costa Water District (CCWD). CCWD earns from $25 million to $30 million per year on wholesale water sales to surrounding water purveyors, apart from and independent of their usual services to individual, commercial, and industrial customers. The wholesale sale of this water has nothing to do with the operation and finance of water services by government-owned companies, which is the topic of this study.[6] Furthermore, since the raw water is sold to surrounding cities and districts, including the cities of Pittsburgh and Antioch and the Diablo Water District, each of which accounts for the purchase of this water as an operating expense, including the revenue realized by Contra Costa Water District as in Table 1 results in double counting. Therefore, since this Other Revenue number is above and beyond the typical water service provided the water industry, adjusting for this outlay changes the industry average in the Other Revenue category to $11 per connection, only $5 per connection higher than that for investor-owned companies. Table 2 removes this extra income to show how it affects the other figures.

Table 2: Revised Summary of Water Company Operations (Per Connection)

	Investor Owned	Government Owned
Total Operating Revenue	$426	$425
Total Operating Expense	($273)	($330)
Depreciation	($29)	($75)
Operating Earnings	$124	$20
Property Taxes Received	$0	$30
Connection Fees	$0	$18
Investment Income	$0	$27
Other Revenue	$6	$11
Taxes Paid	($41)	$0
Cost of Capital: Interest on Debt	($31)	($92)
Cost of Capital: Dividends	($35)	$0
Other Expenses	($11)	$0
Total Nonoperating Income	($112)	($6)
Net Income	$12	$14

Table 2 brings into full view the decoupling of operating earnings and nonoperating income that occurs in government companies. Table 2 also allows for an overall assessment of the potential results of restructuring California's government water entities from the consumer's point of view. Since both investor-owned and government-owned water companies have almost identical streams of operating revenue, converting government-owned to investor-owned utilities would yield efficiencies in operation of ($124 minus $20) $104 per connection. Although the loss of the non-operating income sources that government companies enjoy, and the payment of taxes by the investor-owned companies, would result in a loss of ($112 minus $6) $106 per connection, investor-owned companies would still be able to offset the loss. With restructuring, this would be $104 per connection in efficiency gains,

[6] This study is principally directed towards the retail sale of water to residential customers by government-owned water companies. There are additional issues involved in the wholesale sale of water including but not limited to pricing, conservation practices, and transfer of water and the power of government-owned water companies to interpret the state and the federal government water policies.

less $106 per connection in loss of tax and other revenues—essentially a wash. Thus private-sector efficiencies are substantial enough to allow investor-owned companies to service California's water customers without increasing water rates, while still paying $41 per connection annually in taxes and freeing up scarce public resources for alternative investments. The following sections examine the effects of selected parts of the trade-off involved in restructuring in more detail, using the adjusted summary of operations as a point of departure.

B. Tax Subsidization

Tax policy creates a nonlevel playing field between government-owned and investor-owned water purveyors in the United States. As already indicated in Table 2, investor-owned water companies must pay $41 per connection in local property taxes, franchise fees, state income taxes, and federal income taxes. On the other hand, government-owned companies, exempt from each of these taxes, receive in additional revenues an allocation of local property taxes worth $30 per connection. Table 3 provides further data on the tax treatment of investor-owned and government-owned companies in California.

As Table 3 demonstrates, investor-owned water companies in California pay a yearly average of 2.85 percent of their total operating revenue toward local property taxes and franchise fees as well as 6.82 percent of their total operating revenue in state and federal corporate income taxes. Government-owned water companies, on the other hand, *receive* a portion of local property tax revenue equal to 7.05 percent of their total operating revenue each year. This means that state and national tax practices give government-owned water companies an advantage over their investor-owned sector counterparts equal to approximately 17 percent of total operating revenue.[7]

Table 3: Taxation of Investor-Owned and Government Water Utilities

	Investor Owned	Government Owned
Tax Income (Expenditures)		
Total Local Taxes	($9,725,357)	$17,424,800
• % of Operating Revenue	2.85%	7.05%
Total Income Taxes	($23,236,911)	
• % of Operating Revenue	6.82%	
Total Taxes	($32,962,268)	
• % of Operating Revenue	9.67%	
• Per Connection	($41)	$30
Tax Relief to Public Water Agencies		
Estimated Local Taxes		$7,045,527
Estimated Income Taxes/Business		$16,859,823
Estimated Income Taxes/Individuals		$19,112,339
Property Tax Allocation		$17,424,800
Total Tax Relief		$60,442,489

The tax benefits enjoyed by the government-owned water companies are intended to maintain low water rates for consumers. Government-owned water companies suggest that restructuring would increase the prices customers pay for water because investor-owned companies would pass on the cost of taxes to the consumer. However, as discussed above, the efficiencies gained from investor-owned management are sufficient to cover taxes while maintaining comparable rates. Furthermore, today's consumer is, in effect, paying to keep water rates low by foregoing government services that would have been funded by revenues generated by the payment of taxes by government-owned water companies. An exemption from taxes can be considered a "tax expenditure," equivalent in its impact on the government budget to a direct subsidy.

7 While it is not theoretically valid to add these two percentages because they are derived from different operating revenues, the fact that the operating revenue is relatively similar for the two groups in this study makes the addition in the very least a useful figure.

In the case of water purveying, the sheer size of the combined subsidy and tax relief received by government-owned water companies justifies a closer analysis. In just the two counties examined in this study, taxpayers subsidize government-owned water companies in the amount of $17.4 million in local property tax allocations every year. Were these government-owned companies not tax-exempt, they would also be paying out yearly an estimated $7 million in local property and franchise taxes as well as an estimated $17 million in state and federal income taxes. In addition, government-owned companies have access to the tax-exempt bond market, allowing them to float bonds the interest on which is tax exempt. (While investor-owned companies can issue a small amount of tax-exempt debt, their access to this market is extremely limited.) Were government-owned companies forced to offer taxable debt and pay dividends, like the investor-owned water companies, investors would pay an estimated $19 million in individual income taxes per year.[8]

The $60 million lost in tax revenue in the two counties examined in this study (the total tax subsidy) is $60 million that could be used to lower tax rates, balance budgets, improve inner city infrastructure, increase crime prevention efforts, or provide any other service deemed desirable by the public.[9] Because California's general fund resources are limited, and voters are increasingly denying requests for bond funding, water projects at the state and local level will be increasingly threatened in coming years.[10] Regardless of one's own spending priorities, the issue is whether public funds should be used to subsidize government-owned water companies when there may be higher priorities for these same public funds, and when the service can be provided by the investor-owned sector at no additional cost to the consumer. Although $60 million collected in tax revenue would not produce $60 million in direct benefits, since no government is that efficient, it would produce a tangible benefit to the community the loss of which is the cost of tax subsidization.

Furthermore, as Table 2 indicates, this tax relief appears to relieve pressure on managers to reduce costs, encouraging inefficiency in the very service whose cost it is designed to reduce. When investor-owned water utilities can provide the same service more efficiently, one wonders why the taxpayer is forced to subsidize the less efficient provider.

C. Cost of Capital

The United States is virtually alone in exempting municipal bonds from taxation. The tax-exempt bond concept is justified with the argument that the market does not allocate sufficient capital to fund the water plant improvements the public needs. While this may once have been the case, there is currently no shortage of capital for funding water projects. The size of investor-owned companies in other countries, such as England and France, as well as in the United States, suggests that there is a ready capital market for building and maintaining water infrastructure. Nonetheless, the cost of capital for government-owned and investor-owned water companies has become a central issue in debates over restructuring the industry.

Government-owned water companies contend that the tax-exempt bond market allows them to save about 30 percent on debt costs. This savings is said to result in lower rates for consumers, who do not have to pay for the higher interest rates charged on taxable debt, and also to encourage capital investment. The 30-percent figure comes from dividing total outstanding debt in a given year by total interest payments that year. As Table 4 shows, this study found the cost of debt to be 6.10 percent for public agencies and 8.09 percent for

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8 The estimates for local and corporate income taxes are based on the percentage of total operating revenue that investor-owned water utilities pay. The estimate for individual income taxes assumes a combined state and federal marginal tax rate of 42 percent. There are additional tax subsidies that vary depending on the locality that have not been included in this analysis. For example, an argument used against the privatization of the Santa Margarita Water District was that its water bill was part of the property tax, which can be deducted from taxable income for federal income tax purposes.

9 See John Giraudo, "Is Privatization a Solution to the Urban Crisis?" Carnegie Council\DRT International Privatization Project (New York: Carnegie Council on Ethics and International Affairs, May 8, 1992), p. 5.

10 Richard Rosenberg, "A New Era in California Water: The Business Perspective," Remarks Delivered to the Water Education Foundation (Sacramento: Bank of America Corporation, March 30, 1995), pp. 3–4.

investor-owned companies, consistent with this reasoning.[11] This 30-percent differential, however, does not characterize the entire situation. The reason government-owned companies have lower interest payments is their access to tax-exempt financing. Investors are willing to buy tax-exempt bonds with lower interest rates because the real yield on a tax-exempt debt instrument, if the investor's marginal tax rate is high enough, is still higher than the real yield on a taxable debt instrument.[12] The lower rates public agencies pay are therefore purchased at a cost, namely the amount of lost income tax revenue that investors would be paying to states and the federal government were the interest on their bonds not tax-exempt. As discussed above, tax exemptions result in quantifiable costs.

Theoretically, a competitive bond market should reduce the interest rates on tax-exempt bonds until their effective yield is approximately equal (once the tax benefits are taken into account) to the yield on taxable bonds. This means the loss in taxes would equal the gain realized by the public agencies through lower interest rates on debt. In practice, however, public agencies must pay slightly higher rates to attract investors to municipal bonds. The estimated amount of income taxes lost to pay for lower rates on tax-exempt municipal water bonds is about $19 million per year for just these agencies. The estimated amount of money saved by the agencies due to the lower rates—the differential in rates, 1.99 percent, times the total amount of debt outstanding—is approximately $17.5 million. As Table 4 illustrates, the extra $1.5 million is the amount holders of tax-exempt bonds make above the amount they would have made were their funds invested in the taxable bond market. In other words, about 8.5 percent of the $19-million income tax subsidy does not even reach the water agencies at all, but is channeled instead to investors.[13] This effect can also be seen by adding the amount of lost taxes which would have been paid to the State and Federal governments to the cost of capital public agencies pay, generating a cost of capital of 8.27 percent, as opposed to the 8.09 percent paid by investor-owned companies. Thus, the questions are: first, whether the Treasury should be subsidizing government-owned water companies' borrowing costs when investor-owned companies can raise the same level of funds in taxable markets; and second, whether the subsidy is efficient when 8.5 percent of it does not even reach the government-owned water companies it is intended to help.

Table 4: Cost of Capital for Investor-Owned and Government-Owned Water Agencies

	Investor Owned	Government Owned
Cost of Debt	8.09%	6.10%
Cost of Debt Including Lost Taxes	8.09%	8.27%
Estimated Cost of Tax Exemption		$19,112,339
$ Saved By Tax Exemption		$17,482,478
Subsidy to Bond Investors		$1,629,861
Cost of Debt per Connection	$31	$92
Cost of Equity per Connection	$35	$0
Total Cost of Capital per Connection	$67	$92

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11 Although any year's interest payments include the "embedded cost" of the interest rate at the time the debt was issued, and thus depend on historical factors, since all utilities finance periodically, the aggregate of interest payments on numerous bond issues is a useful number for comparison.

12 Table 4 shows the high income tax investor of tax-exempt bonds receives a tax subsidy of approximately 15 percent by purchasing tax exempt bonds. By purchasing tax-exempt bonds, the high income investor increases his yield on his capital by approximately 8.5 percent. The fundamental policy issue is whether or not this subsidy should be made available to people with large amounts of capital.

13 This effect is typical for tax-exempt bonds. See Robert S. Amdursky and Clayton P. Gillette, *Municipal Debt Finance Law: Theory and Practice* (Boston: Little, Brown & Co., 1992), pp. 428–35.

There are two additional problems with the 30-percent debt-savings calculation. First, it does not take into account the total capitalization of an investor-owned firm, which finances its activities with both debt and equity. That is, the true cost of capital for an investor-owned firm must include interest payments to bondholders, or the cost of debt, and dividend payments to stockholders, or the cost of equity. Second, the true cost of capital must take into account the projects that capital is financing. Doing so requires that the cost of capital be determined from the point of view of the customer. For example, a utility that is 50 percent less efficient than its competitor in its construction of a new water treatment facility must borrow twice as much money to complete the project. If the rate on its bonds is 50 percent lower than its competitor's, the percentage of the customer's bill going to pay the cost of capital is identical for the two utilities.

Table 4 shows the cost of capital per connection for the investor-owned and government utilities in our sample. Investor-owned water utilities pay $31 per connection in interest payments and $35 per connection in dividends, for a total cost of capital per connection of $67, or 16 percent of the water bill. Government-owned water companies, whose only source of finance is debt, pay a total cost of capital of $92 per connection, or 22 percent of the water bill. This means that public agencies pay approximately $25 per connection more for capital than investor-owned companies.[14]

This extra 6 percent of the water bill is in part caused by various inefficiencies associated with the use of capital by the government-owned water companies. In the first place, government-owned water companies often finance projects in advance of their actual construction because their financing comes in large blocks. They have to borrow a larger amount to cover the interest on the borrowed funds due before the funds are even put to use. Conversely, investor-owned companies, which fund only projects that are about to be undertaken, save significant amounts on interest payments.[15] In addition, it is likely that for various institutional reasons, such as regulations applicable to public-sector contracting, it is more expensive for government-owned water companies to design, construct, and operate facilities. Investor-owned projects are often completed in one-third to one-half less time than public projects because investor-owned companies can use a consortium of firms to integrate the design and construction phases, something government-owned companies rarely do.[16]

Another factor increasing the cost of capital for government-owned water companies is the higher issuance costs associated with tax-exempt financing. Government-owned water companies often must purchase bond insurance, need larger reserves for interest and principal payments, and pay higher finance charges.[17] Issuance fees to lawyers and investment bankers, for example, are higher for government-owned water companies than for investor-owned water companies. The financial structure of government-owned water companies forced them to refinance much of their debt in the early 1990s, incurring more of these same fees. Since investor-owned companies finance their operations with both debt and equity, high debt payments caused by the unusually high interest rates of the late 1970s and early 1980s had less of an effect on them. The government-owned water companies in this study paid $10.7 million in finance fees each year.

From an accounting perspective, this amount does not show up in full in the cost of capital for any given year because such charges are amortized over the life of the bonds to which they apply. Nevertheless, such charges

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14 Some agencies expense losses on the defeasance of debt, while others amortize this cost over the life of their new bonds. Rather than attempt to approximate amortization schedules for a complicated set of bonds, the choice made by the agency, to expense or depreciate, was retained. Removing nonamortized costs associated with new debt, which overcompensates for the differences in accounting, decreases the public agency cost of capital to $78, still higher than the cost of capital for investor-owned companies.

15 Robert W. Poole, Jr., "Revitalizing State and Local Infrastructure: Empowering Cities and States to Tap Private Capital and Rebuild America," Policy Study No. 190 (Los Angeles: Reason Foundation, May, 1995), p. 6.

16 *Ibid*, p. 17.

17 *Ibid*, p. 6. Investor-owned companies pay these charges only to the extent that they issue tax-exempt debt. As stated before, though, their use of tax-exempt financing is extremely limited.

do slightly increase the amortized debt costs, and thus the overall cost of capital per year for government-owned water companies.

D. The Water Bill

The generous tax treatment of government-owned water companies is often justified on the grounds that such tax exemption lowers the price of an essential public service. It has generally been assumed that government-owned water companies charge less for the same level of service than their investor-owned competitors. The idea of a lower water bill has become a crucial political weapon against those who would restructure the water industry in California.[18] One reason for this continued belief is the data collected by the Environmental Protection Agency for its 1986 study of water systems and the Congressional Budget Office report that is based on those data.[19] While the survey data do show government-owned water companies charge lower prices, the data also reveal that the price differential between government-owned and investor-owned utilities decreases as the number of customers increases. Since the average government-owned water system today is much larger than the average investor-owned system, much of the aggregate data show lower prices for the government-owned water system only because they are taking advantage of economies of scale that most investor-owned companies do not currently enjoy.[20]

As Table 5 indicates, this study shows that total operating revenue per connection is virtually identical for investor-owned companies ($426 per connection) and public agencies ($425 per connection). Since total operating revenue is the income generated from service charges, or water bills, the benefits of tax exemption are not passed on to the consumer through lower water charges. Of course, individual water bills vary according to geographic characteristics, but the average water bill for both government-owned and investor-owned water companies is virtually identical.

Table 5: Water Cost to Consumer for Investor-Owned and Government Water Agencies (per connection)

	Investor Owned	Government Owned
Total Operating Revenues	$426	$425
Property Taxes	$0	$30
Connection Fees	$0	$18
Local and Income Tax Subsidy	$0	$74
Total Revenues	$426	$547

In fact, government-owned water companies derive *more* income from consumers than investor-owned water companies when other "hidden" charges are taken into account. The allocation of $30 in property taxes per connection, for example, is another charge that transfers funds from consumers to government-owned water companies. In addition, only government-owned water companies receive connection fees and Service Connection Charges (SCC charges) from new customers. These are typically used to pay for capital upkeep, but in some cases are accounted for as operating income. The $18 per connection collected in these fees is thus a second hidden charge. Last, the taxes avoided by government-owned companies is $74 per connection. This represents the amount of government services that the customers forego to have their water provided by a government-owned water companies in Alameda and Contra Costa Counties rather than by investor-owned

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18 A pamphlet distributed at the hearing on California-American Water Company's bid to privatize the Santa Margarita Water District titled, "Deny the Cal-Am Proposal Tonight," gives a number of reasons why "there will be no rate decrease, despite Cal-Am's promise." Regarding this issue, see the letters page in the Los Angeles Times, Orange County Edition, July 2, 1995, p. 6.

19 Frederick W. Immerman, *Final Descriptive Summary: 1986 Survey of Community Water Systems* (Washington, D.C.: Office of Drinking Water, U.S. Environmental Protection Agency, 1987); Congressional Budget Office, Financing Municipal Water Supply Systems (May 1987), p. 4.

20 Patrick C. Mann, "Water Utility Regulation: Rates and Cost Recovery," Policy Study No. 155 (Los Angeles: Reason Foundation, March 1993), p. 6.

companies. The real cost to the consumer when these hidden charges are taken into account is actually $121 higher per connection for government-owned water utilities.

E. Operating Expenses

Part of the reason the tax exemption does not benefit the consumer in the form of lower service charges is the higher operating expenses of government-owned water companies. This study finds that government-owned water companies have significantly higher operating costs. As Table 6 shows, they spend $330 per connection while investor-owned companies spend only $273 per connection. Since there are no obvious differences in the quality of service being provided by large investor-owned and government-owned water companies, the difference of $57 per connection is the amount of operating efficiency lost due to government ownership.

Table 6: Selected Operating Expenses for Investor-Owned and Government Water Agencies

	Investor Owned	Government Owned
Total Operating Expense per Connection	$273	$330
Employees per 1,000 Connections	1.62	3.49
Salaries as % of Operating Revenue	13.40%	37.13%
Maintenance as % of Operating Revenue	5.29%	9.13%

One reason for the large discrepancy in operating costs is the level of employment: investor-owned firms hire 1.62 workers for every one thousand connections while government-owned firms hire over twice that amount at 3.49 employees per one-thousand connections. The measure of the number of employees hired by government-owned water companies may also be artificially low because government-owned water companies hire significantly more outside contractors and consultants than investor-owned companies. As Table 6 shows, the result is a much higher percentage of operating revenue that must be allocated to employee compensation. A second reason for the discrepancy is the amount of resources channeled to maintenance. Investor-owned water companies spend about five percent of their operating revenue on maintenance while government-owned water companies spend almost nine percent of their operating revenue maintaining their water facilities.[21] There may be many more areas where differences in operating expenditures can be located, and more reasons for the discrepancy.

F. Investment Income

Aside from their tax exemptions, generous allocations of property taxes, and the ability to charge connection fees, government-owned water companies have an often-ignored source of nonoperating revenue investment income. As Tables 1 and 2 showed, this income allows government-owned water companies to keep service rates artificially lower than they would actually be by helping to pay for the cost of capital. Public agencies collect an average of $27 per connection while investor-owned companies collect virtually nothing from investment income.

As Table 7 shows, the reason government-owned water companies collect such high levels of investment income is their substantial current asset balances. Water utilities, because the industry is capital intensive, require a certain amount of current assets as a reserve fund in case of unforeseen events such as system failure, unusual weather conditions, or natural disaster. However, the difference in current account balances for public agencies, who hold $663 per connection, and investor-owned utilities, who hold only $94 per connection, is enormous. Once disaggregated, the numbers are even more telling. Both investor-owned and government-owned water

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21 Part of this difference may be caused by one or two years of deferred maintenance by investor-owned water companies for cash-flow purposes during years of unusually low revenue.

Table 7: Investment Income Data for Investor-Owned and Government Water Agencies (per connection)

	Investor Owned	Government Owned
Investment Income	$0	$27
Cash and Investments	$9	$560
Total Current Assets	$94	$663

companies have similar levels of receivables and prepaid expenses, meaning that the real difference in the current asset balances is caused by cash and investments, the main sources of non-operating income. While investor-owned companies maintain an average of $9 per connection, government-owned water companies in the study have a $560 per connection in cash and investments.

The CPUC, which regulates the investor-owned water companies in California, has apparently determined that large cash reserves are not necessary for the operation of (investor-owned) water companies. The government-owned water companies' extra $551 per connection in cash and investments, producing a constant revenue stream, effects a serious competitive disadvantage for investor-owned water companies, above and beyond that caused by the tax code.

From a public-policy perspective, these reserve funds represent a misapplication of California's financial resources. An investor-owned business would never accumulate enormous amounts of cash and investments, but would instead use the funds to diversify, upgrade facilities, and acquire related companies—or be taken over by some third party who could put the funds to better use. The government-owned Irvine Ranch Water District, on the other hand, invested $32.5 million in an apartment complex, Sycamore Canyon Apartments, and has an additional $12 million invested in two other real estate developments, Lewis Homes and Wood Canyon Villas.[22] The district is thus using funds generated from water services, taxes, and charges to compete with investor-owned apartment complexes. In the two counties examined in this study, public water agencies hold about $326 million in cash and investments each year. They are theoretically optimizing the returns from these investments each year. This investment activity has nothing to do with the purveying of water. When government-owned water companies are using the public's funds to speculate on interest spreads, the loss the public experienced in Orange County might happen again.

The fact that tens of millions of dollars in cash and investments are held by government-owned water companies, many of which still have large amounts of outstanding debt, indicates a serious flaw in the framework within which these companies operate. It is not clear to what extent arbitrage is still occurring, but many government-owned water companies have both significant levels of outstanding debt and huge cash reserves. Furthermore, government-owned water companies do not appear to pay tax on the income they earn on their investments. Theoretically, the market allocates capital to its most productive uses by offering higher rates of return on those investments. Unless one believes that government-owned water companies have better judgment than other investors, subsidizing their investments allows them to direct capital to less productive areas. Public policy should surely not subsidize the investments made by government-owned water companies, merely because they are government-owned, especially when they represent capital inefficiencies.

G. Capital Expenditures

Since plant and equipment provide benefits for many years, actual capital expenditures are amortized. One measure of capital investment is therefore the amount of capital depreciated per year. Based on this measure, it appears that government-owned water companies spend a larger amount on capital than investor-owned companies. As Tables 1 and 2 showed, they charge about three times more to depreciation per year than investor-owned companies ($75 per connection versus $29 per connection). Depreciation, however, depends

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[22] Note 7 of the Independent Auditor's Report on the Irvine Ranch Water District for the year ended June 30, 1994, page 32.

heavily on accounting procedures, which differ substantially from the investor-owned to the government-owned water companies. While both investor-owned and public agencies have an interest in depreciating capital expenditures as quickly as possible, the former to reduce their tax liability and the latter to justify higher rates, investor-owned companies have less freedom with their depreciation schedules than government-owned water companies because the CPUC mandates that they use straight-line depreciation. Some municipalities use accelerated depreciation, which provides far more generous annual write-offs. Therefore, comparisons between the depreciation of investor-owned and government-owed property, plant, and equipment are not as precise as comparisons for other forms of income and expense. At least some of the difference is caused by the faster depreciation schedules used by government-owned water companies.

It is also possible to compare actual capital expenditures, measured as the value of all additions to property, plant, and equipment per year. Doing so reveals that these government-owned water companies have actual capital expenditures equivalent to about 58 percent of their operating revenue while investor-owned companies have expenditures equal to about 21 percent of their operating revenue. One problem with this type of comparison is its sensitivity to the time period used for study. For example, the East Bay Municipal Utility District may have incurred its $60-million office building expense during the years this study covers. Since this project is so large, removing its cost reduces the aggregate value of capital expenditures to only 27 percent of operating revenue. A second problem with this comparison is its inability to gauge the usefulness to the consumer of a given level of capital expenditures. Nor is it clear from aggregate spending whether companies are buying the same array of capital facilities or not. Is a new office building as valuable as upgrading water treatment facilities? If, as suggested above, it costs more for a government-owned water company to construct new facilities, does a higher expenditure indicate better long-term planning or merely higher costs?

It is probably safe to assume that government-owned water companies in California spend more on capital expenditures than investor-owned companies, but the degree to which this is the case is unclear. It is also unclear how much of the greater expenditures reflect inefficiencies in public-sector construction or better long-term planning. However, assuming that the three-times higher expenditures for both depreciation and actual capital expenditures for government-owned water companies reflect generally higher capital expenditures, and further assuming that government-owned water companies are about 20 percent less efficient, which is the efficiency difference associated with their operations (see Table 6), then it would seem that they more than compensate for any inefficiencies. This finding is not consistent with the conventional wisdom that public agencies tend to neglect or delay capital replacement.[23] California may be unique in this regard for a number of reasons.

First, because California is a high-tax state, it has a well-developed and sophisticated tax-exempt market, allowing government-owned water companies easy access to financing. Although the use of general obligation bonds has declined in recent years, water revenue bonds have taken their place.

Second, economic growth in California provides a constant stream of funds to government-owned water companies specifically earmarked for capital expenditures. These funds include both connection fees and contributions from real estate developers. When new customers are connected to a water system, water utilities typically charge various fees to cover the costs associated with the connection, such as installing meters and building service lines. Increasingly, government-owned water companies are also charging a one-time fee for new customers designed to fund the capital investment oriented to servicing new customers. These fees are often called system development charges, system capacity charges, connection charges, or facilities charges.[24] The idea is to charge new customers for the capital investments, such as a new reservoir, that their connection necessitates rather than increasing the rates on old customers and thus forcing them to pay for the addition of new customers.

[23] See, for example, David Haarmeyer, "Privatizing Infrastructure: Options for Municipal Water Supply Systems," Policy Study No. 151 (Los Angeles: Reason Foundation, October 1992), pp. 14–15.

[24] Mann, pp. 21–22.

The difficulty, of course, lies in properly allocating the benefits of capital expenditures among various categories of customer, from new customers to old customers, and from one geographic area to the next.[25]

These connection fees have made adding new water services extremely expensive in Alameda and Contra Costa Counties. The Contra Costa Water District adds a facility reserve charge to its usual service, meter, valve, and installation fees according to meter size, ranging from $7,140 for a meter of five-eighths of an inch to $57,120 for a two-inch meter.[26] The East Bay Municipal Utility District charges a similar fee, which it calls the system capacity charge (SCC), for each of the nine regions served by the district. Prices vary by region, but single-family, residential account SCC charges range from $1,390 to $8,210 for a meter of five-eighths of an inch to $12,500 to $33,600 for a 1.5-inch meter. Commercial and industrial SCC charges are relatively similar, but they allow for much larger meter sizes, and hence much higher costs, ranging from $27,300 for a two-inch meter in the lowest-cost region to a high of $294,000 for a four-inch meter in the highest-cost region.[27] These charges raise the cost of residential and commercial development and make urban redevelopment considerably more expensive.[28]

The larger investor-owned water companies (Class A and B) are not allowed to charge fees to connect to their systems. The CPUC has ruled that the most appropriate way to pay for capital expenditures associated with system growth is through additional capital, either debt or equity, rather than through connection charges. Only smaller companies, those serving under 2,000 customers, are allowed to charge connection fees on the assumption that they are limited in their ability to raise capital. Not allowing connection fees would force them to shift the burden of paying for additional customers to their older rate payers.[29] Water companies also receive funds earmarked for capital improvement from developers in the form of Contributions in Aid of Construction and Advances for Construction. Real estate developers pay their local water utility to build the infrastructure necessary to provide water service to their developments. For investor-owned water companies, if the new infrastructure is deemed economic (i.e. if user charges from the new service will over time pay for the initial capital investment), the money given by the developer is considered an Advance, and must be refunded over a period of 40 years. If the new infrastructure is noneconomic (i.e. if user charges from the new service will never be sufficient to pay for the initial investment), then the money given by the developer is considered a Contribution and is not refundable. The Tax Reform Act of 1986 mandated that contributions be accounted for as taxable income, increasing the costs associated with connecting to investor-owned companies' water services, which now require more money in contributions to cover their taxes.

All money received from developers by government-owned water companies is considered a contribution, regardless of the profitability of the project it funds. All funds are thus nonrefundable. In addition, public agencies do *not* pay income tax on these contributions. Funding capital expenditures through connection fees and contributions from developers means that capital upkeep is contingent upon growth in the real estate industry. If real estate development slows, the funds will no longer be available, and rates would have to be increased to pay for system depreciation and maintenance. Government-owned water companies have thus developed a political interest in fostering new growth to maintain their connection-fee income stream.

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25 See CH2M Hill, Water Rate Structure Study (Oakland: East Bay Municipal Utility District, April 1995), Section 5.

26 Charges effective March 1, 1995.

27 East Bay Municipal Utilities District pamphlet, "Applying for Water Service When Your Property Fronts on an Existing Main," p. 3.

28 Environmentalists wanted to eliminate growth by banning all future connections to the East Bay Municipal Utility District. Developers worked out a compromise with the district's board to allow high connection fees instead, which they were willing to pay. Some worry that the removal of water provision from local government control would prevent them from controlling growth. However, should cities wish to control their growth, they should do so without creating inefficiencies in water purveying, endangering a scarce resource.

29 California Public Utilities Commission, "Revision of General Order 103 and Water Tariff Rules 15 and 16," Decision 91-04-068 (April 24, 1991).

The third reason government-owned water companies have comparatively higher capital expenditures in California is the high dividend payout ratio of California's investor-owned water companies. Net income before dividends is $46 per connection, yet the average dividend payout is $35 per connection, about 75 percent of net income. Such high dividends mean that little cash is left for capital improvements. It appears that California's investor-owned water sector has become addicted to ever-increasing dividends to maintain the value of their stock.[30] While increasing dividends was not difficult in the inflationary environment of the 1970s and 1980s, lower levels of inflation have made it more and more difficult to increase dividends each year in the 1990s.

The requirements of an investor-owned water company do not inherently demand such high dividends and thus lower capital expenditures. As Table 8 shows, dividends per share paid in 1994 by two large British water companies, Yorkshire Water and Thames Water, are significantly lower as a percentage of earnings per share than those paid in 1994 by two California water companies in this study, Southern California Water Company and California Water Service Company.[31]

Table 8: Dividends for British and Californian Water Companies (in p and $)

	Yorkshire	Thames	S. Cal.	Cal. Water
Earnings per Share	68.00	56.80	1.43	2.44
Dividends per Share	22.80	22.50	1.20	1.98
Dividends as % of Earnings	**34%**	**40%**	**84%**	**81%**

It is likely that the British water companies do not have to pay such high dividends because they are growth companies. Investors buy stock in these companies expecting earnings per share to increase as the global water and sewer market expands and the British companies take advantage of new opportunities. California's investor-owned water companies offer widows and orphans stock, designed to pay stable, high dividends, but not to offer significant growth opportunities.

III. ISSUES IN THE RESTRUCTURING PROCESS

A. The Case for Restructuring

A close examination and comparison of the operations of a representative sample of investor-owned and government-owned water purveyors in California has yielded the following results:

- Investor-owned water companies provide comparable water services to consumers at the same price as government water companies even though they pay taxes and do not receive extra nonoperating income.

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30 From the Letter To Shareowners in the Southern California Water Company Annual Report 1994: "We are pleased to report that calendar year 1994s dividend of $1.20 per common share marked the company's 41st consecutive year in which dividend pay outs were increased." From the Letter To Our Shareholders in the California Water Service Company Annual Report 1994: "At its January 1995 meeting, the Board of Directors voted to raise the annual dividend on common stock from $1.98 to $2.04 per share, making this the 28th consecutive annual increase."

31 Yorkshire Water, Annual Report and Accounts 1995, 2; Thames Water, Annual Report and Accounts 1994, 1; Southern California Water Company, Annual Report 1994, 1; California Water Service Company, Annual Report 1994, ii.

- Government water companies receive generous tax subsidies that could be used to fund other government projects and higher priorities.
- The cost of capital is higher for government water companies than for investor-owned water companies.
- Investor-owned companies are significantly more efficient in their operation of water services than government water companies.
- Government water companies receive a substantial amount of income from high levels of cash and investments.
- It is likely that government water companies have higher capital expenditures than investor-owned water companies, although the data on this issue are not entirely clear.

These results suggest that a restructuring of the U.S. water industry, to take advantage of the beneficial effects of investor-owned market pressures, is in the interest of the general public. Since investor-owned water companies are more efficient than their government-owned counterparts, they can deliver comparable services at a lower cost. This means they can supply water for the same prices charged by government-owned companies even while they pay a substantial amount of taxes to local, state, and federal authorities. This tax money, in turn, rather than being lost to inefficient water services, can be passed onto consumers or used to fund other governmental activities. The delivery of comparable water services by investor-owned companies even with higher nonoperating costs is possible because the finance and operation of water services by the investor-owned sector creates stronger incentive systems for cost reduction and efficient resource allocation. The institutional environment of an investor-owned company provides incentives for managers that are in the best interest of the general public.

While this study demonstrates that the investor-owned sector operates and finances water utilities more efficiently than the public sector, it remains unclear whether investor-owned companies, given the current regulatory environment, invest a sufficient amount in capital improvements to meet projected long-term needs. The results of this study suggest government-owned companies spend more on infrastructure in terms of dollars spent. It is unclear how much of the difference can be explained in terms of the differences in efficiencies between the public-sector and investor-owned spending. Theoretically, investor-owned companies determine infrastructure based on demonstrated need, subject to cost-benefit analysis and return-on-investment criteria. It is unclear what factors determine the expenditure of money by the government-owned companies.

While the results of this study have direct implications for the operation and financing of water systems, they do not necessarily mean that California's water assets should be sold.[32] There are a number of models on which restructuring could be based, including the French franchise model, in which investor-owned water companies do not own the plant and equipment, but only own the right to operate it for a specified amount of time. The most appropriate model for restructuring should be a topic for future research. The focus of this paper has been on the empirical results of the different incentive systems faced by management in the government-owned and investor-owned water sectors.

B. Regulatory Issues

While this study has attempted to highlight public-sector capital and operating inefficiencies by using investor-owned companies as a point of comparison, the investor-owned sector could be even more efficient if rate-of-return regulation, now favored by the CPUC, were replaced with a system of price caps similar to the

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[32] Project valuation has become a central difficulty with asset sales. Richard Rosenberg, Chairman and CEO of Bank of America, in a letter to Senator Dianne Feinstein dated July 18, 1995, expressed his concern over a proposed sale of the Central Valley Project due to the questionable valuation performed by the purchasing party. Although hailed as a model for future sales, the sale of an Ohio sewage treatment plant to a private company raised tricky issues, such as the application of depreciation against the federal government's investment in the project. See *The Economist*, August 19, 1995, pp. 25–26.

ones adopted in England and France and beginning to be adopted by local governments in the regulation of the waste industry.[33] Rate-of-return regulation was proposed by the business community in the Progressive Era in response to the Populist tendency to fix price levels for the regulated utilities at such unreasonably low levels as to make it impossible to earn any return on investment. Rate of return regulation was designed to introduce rationality into the price-setting process. However, the current problem is that all money generated from efficiency gains is forced back to the consumer, rather than being properly apportioned among shareholders, reinvestment, and consumers. Perhaps the best evidence of the failure of the current regulatory framework is the inability of the U.S. water industry to compete internationally. While U.S. computer and biotechnology industries compete worldwide, the French and the British dominate the world market in the development of new water and sewer systems; international American companies are virtually nonexistent. This juxtaposition has occurred because the United States has developed a totally subsidized public sector and an investor-owned sector, regulated on a rate-of-return basis, that is dominated by cost-plus type thinking. The regulatory environment does not foster the creation of large, efficient water companies structurally designed to compete in international markets.

Regulation has thus become a double-edged sword for proponents of restructuring the water industry. On the one hand, the current regulatory framework does not encourage restructuring because investor-owned companies are not allowed to fully benefit from increased efficiencies that can be created from private-sector finance and operation of formerly public water systems. There is little incentive for further restructuring of the industry in this type of environment. On the other hand, a central regulatory mechanism is already in place for administering a fully restructured industry.[34] The CPUC has been regulating the investor-owned water sector for years, and is now overseeing the full restructuring of the electric, gas, transportation, and communications industries to take full advantage of market pressures.

Aside from economic regulation, restructuring brings environmental and health regulations to the forefront. In California, environmental regulations on water use imposed by the California Environmental Protection Agency's State Water Resources Control Board, and subsidiary Regional Water Quality Control Boards, already apply to both investor-owned *and* government-owned water companies.[35] The statutory authority is in place for these boards to fully administer the water industry; the only question is whether they decide to exercise this authority. So far, they have been pushing only for the integration of water and sewer agencies. State regulatory bodies have required, as a condition of certain permits, that the government-owned entities work together on issues of water use such as the appropriate use of treated versus fresh water.[36] The British water companies provide both water and sewer services, both of which are regulated by the same regulatory authority. In California, even though the regulatory framework for water and sewer systems has already been consolidated, the two functions are still in most cases provided by separate government-owned water and sewer companies. This balkanization of authority came into existence in California because of the state's growth practices and patterns. Now, the state government is prodding government-owned water companies to perform as integrated units. In essence you have three sets of governments bureaucrats trying to determine public policy and implement it for water and sewer in Alameda and Contra Costa County. Similar balkanization of authority was one of the motivators of the changes in the British water systems.

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33 The City of Oakland has adopted an inflation-based price regulatory system for the waste management industry. The discussion surrounding the adoption centered on how do you get capital invested in up grading the waste collection system and how do you give the consumer stable rates. This system is used in over 50 percent of the waste systems in the country. See draft of Franchise Agreement for Solid Waste and Yard Waste Collection and Disposal Services between the City of Oakland and Waste Management of Alameda County, Inc., July 18, 1995.

34 Public Utilities Code Sections 200 et seq.

35 Water Code Sections 13,000 et seq. and Water Code Sections 100 et seq.

36 State of California, California Environmental Protection Agency, State Water Resources Control Board, Division of Water Rights, "Permit for Diversion and Use of Water, No. 20749," Application 20245 of the Contra Costa Water District, Filed June 5, 1961, Sections 12–14, pp. 19–21.

Health standards for public drinking water were introduced by the federal Safe Drinking Water Act in 1974, and further amended in 1986. The U.S. Environmental Protection Agency and the California Department of Health Services have set quality standards which require suppliers to monitor and treat for potentially harmful contaminants in drinking water.[37] Both investor-owned and government water companies publish annual water quality reports showing the maximum contaminant levels allowed by law and the amount of such contaminants state-certified laboratories found in their drinking water. Both the investor and government water companies must meet the *same* federal and state standards.

Critics of investor-owned water companies often argue that, even if they face the same standards as government-owned companies, the profit motive inherent in investor-ownership gives managers an incentive to cut corners on health regulations. This argument is both theoretically flawed and empirically incorrect. Theoretically, there is no economic incentive to ignore such regulations because the regulatory framework itself allows for cost recovery on expenses incurred in complying with water standards. Empirically, although no comprehensive study has been completed comparing government-versus investor-owned sector compliance with water quality standards in California, there does not seem to be a difference in water quality between the larger investor-owned water companies and government-owned water companies.[38] Indeed, the historical record indicates that government-owned companies have been less likely to comply with environmental and health standards than the investor-owned sector in a whole range of policy areas.[39] Government-owned water companies are more likely to use their political leverage to fight stringent standards on whatever service they provide. In addition, the regulating agency has a more difficult time forcing government-owned companies to adopt the costly policies necessary to meet their standards. While the government can tell investor-owned companies to cut their dividends or operate with less profit, government-owned companies often demand increased subsidization, and thus increased taxes, to support any improvements. Since it is politically unpopular to raise taxes, the politicians have been known to look the other way on enforcement issues.

Margaret Thatcher, in discussing why privatization of the water and sewer industry was pursued as a governmental policy, explained the situation as follows:

> The privatization of the water industry was a more politically sensitive issue. Much emotive nonsense was talked along the line of, "look, she's even privatizing the rain which falls from the heavens." I used to retort that the rain may come from the Almighty but he did not send the pipes, plumbing and engineering to go with it. The Opposition's case was even weaker than this, for about a quarter of the water industry in England and Wales had long been in the private sector. Of more significance was the fact that the water authorities did not just supply water: they also safeguarded the quality of rivers, controlled water pollution and had important responsibilities for fisheries, conservation, recreation and navigation. It was Nick Ridley—a countryman with a natural feel for environmental issues—who, when he became Environmental Secretary, grasped that what was wrong was that the water authorities combined both regulatory and supply functions. It made no sense that those who were responsible for the treatment and disposal, for example, should also be responsible for regulating pollution. So the bill which Nick introduced also established a new National Rivers Authority. Privatization also meant that

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37 Health/Safety Code Sections 4000 et seq.

38 East Bay Municipal Utilities District, "Annual Water Quality Report"; Southern California Water Company, Yorba Linda System, "1994 Water Quality Report." These represent two comparable systems.

39 James Q. Wilson, "Can Government Regulate Itself," The Public Interest (1977); Bruce A. Ackerman, et al. The Uncertain Search for Environmental Quality (The Free Press, 1973); Michael R. Fitzgerald, et al. Intra-Governmental Regulation and Public Interests: Air Pollution Control and the Tennessee Valley (University of Tennessee Bureau of Public Administration, 1983); C. S. Russell, "Monitoring and Enforcement," in Public Policies for Environmental Protection, ed. Paul Portney (Resources for the Future, 1983); Holly June Stiefel, "Municipal Wastewater Treatment: Privatization and Compliance," Policy Study No. 175, Los Angeles: Reason Foundation, February 1994.

the companies would be able to raise money from capital markets for the investment needed to improve water quality.[40]

The United States has the worst of both worlds: a government-controlled regulatory structure in place with limited regulatory authority over other governmental agencies. Therefore, if a public policy is not properly pursued by one governmental agency to the satisfaction of another government agency, and the public perceives it is not being well served, the government blames the government for its inadequacies.[41] This avoids accountability. In Alameda and Contra Costa Counties, the level of absurdity has been reached where government-owned companies are suing county governments over who has jurisdiction over new developments. California has developed a new system of checks and balances where governmental businesses and agencies sue each other and then the government has its courts referee the disputes.

C. Public Accessibility

It is important the public perceive a forum exists for input on public policy issues involving water. Argument can and will be made that elected and appointed boards of the government-owned water companies give the public such access. The authors suggest there are alternatives for public access such as the CPUC and the State Water Resources Control Board and its subsidiary boards. Additionally, these government agencies might possibly be funded by a surcharge on the consumer's water bill so their ability to regulate and provide for public input is not frustrated by the general budget constraints of the state government. In the Integrated Waste Management Act, Public Resources Code Sections 40,000 *et seq.*, California developed such an agency and funding mechanisms. Possibly the state could use this act as a model for similar legislation to modify the powers of the State Water Resources Control Board and the Public Utilities Commission to accomplish greater public access, to address potential public concern about limited public accessibility resulting from restructuring of the water industry.

D. Employment Issues

One area of inefficiency this study has highlighted in the government-owned water companies is the problem of overstaffing. As with many private-sector industries that have undergone streamlining, part of the efficiency gains involved in restructuring would be gained through reducing employment. Thus, plans must be implemented to address the resulting dislocation of government employees.[42] A number of lessons can be learned from the British experience, where employees of the government-owned water companies were given special stock options in the privatized successor companies. In addition, the massive upgrading of facilities which occurred in Britain since privatization has prevented net job loss by shifting jobs from the office to the construction site. Most important, though, is the fact that the British companies have used their expertise to become competitors in the global water and sewer business in only a few years. Since highly competitive industries generate many well-compensated, productive jobs as well as increased support staff in the export/consultancy part of their operations, short-term employment losses may be more than compensated for by long-term employment gains as the industry becomes competitive across the United States and in international markets.

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40 Margaret Thatcher, *The Downing Street Years: 1979–1990*, New York: Harper Collins, 1993, p. 682.

41 There have been recent articles in the *Wall Street Journal* attacking the British privatization experience. See for example the October 2, 1995 articles on English privatization. In order to thoroughly understand the British Privatization and the current rates, one has to understand the extent of the capital expenditures over the last six years and what would the cost have been to the consumer if the same capital expenditures had been undertaken by the traditional public sector. The *Journal* also criticizes the wage level of some of the senior managers of the water utilities in England. The *Journal* articles did not mention how many senior managers of the British water companies have been terminated because they failed to perform as the capital markets expected them to perform. What is a reasonable compensation for performance in the investor-owned sector is beyond the scope of this paper.

42 See John O'Leary and William D. Eggers, "Privatization and Public Employees: Guidelines for Fair Treatment," How-to Guide No. 9, Los Angeles: Reason Foundation, September 1993.

Future research should also investigate the level of minority employment in the government-owned sector vis a vis the investor-owned sector. Government has traditionally been a major provider of equal employment rights for well-educated African-Americans, 75 percent of whom are employed by some level of government. This has created an ethnic group that could be hostile to the idea of restructuring. However, since the investor-owned water companies sell water to the federal government, and are thus considered federal contractors, they must also comply with Title 7 and federal employment requirements. None of the three investor-owned companies in this study has had a major employment discrimination suit brought against it, whereas the East Bay Municipal Utility District, in a 1985 decision, lost a Title 7 suit.[43] Preliminary analysis seems to indicate that, in the water sector, the government and investor-owned sectors employ relatively equal percentages of minorities, in both overall employment and in specific types of jobs.

Table 9: Ethnic Employment Data for Investor-Owned and Government Water Companies

Position	White		Black		Hispanic		Asian		Other	
	SCWC	EBMUD	SCWC	EBMUD	SCWC	EBMUD	SCWC	EBMUD	SCWC	EBMUD
Managerial	77%	70%	7%	16%	9%	7%	7%	5%	0%	2%
Professional	62%	67%	8%	8%	8%	4%	23%	22%	0%	0%
Technical	58%	69%	0%	7%	5%	7%	32%	18%	5%	0%
Clerical	56%	49%	13%	28%	23%	9%	9%	14%	0%	0%
Craft	76%	64%	8%	13%	11%	11%	3%	5%	3%	1%
Maintenance	59%	53%	11%	29%	28%	10%	3%	7%	0%	1%
Company-wide	63%	62%	10%	15%	18%	11%	8%	12%	4%	1%

Table 9 shows the percentages of different ethnic groups employed by the East Bay Municipal Utility District and the Southern California Water Company.[44] Non-whites constitute approximately the same percentage of the total number of employees for both utilities, although the distribution of this 37 and 38 percent varies due to geographic differences. Whereas the East Bay Municipal Utility District employs more African-Americans and Asians, the Southern California Water Company employs more Hispanics and members of other ethnic groups (most prominently American Indians). This relationship generally holds across employee categories, from the highest-level officials to members of the maintenance staff. While ethnic minorities are somewhat concentrated in lower-paying jobs in both industries, it does not appear that there is a greater concentration in either sector. Of course, a larger sample, and an investigation of the effect of other factors, such as contracting regulations, on minority employment would be needed before any conclusive results could be obtained. Future research should address these issues in greater depth.[45]

[43] A former Vice President of the East Bay Municipal Utility District board said that they would not deal with the discrimination issues in the suit until after the federal judge made the finding. This is consistent with the argument that public agencies are less willing to comply with regulatory standards.

[44] East Bay Municipal Utilities District, EEO-4 Occupational Categories, Current Utilization, September 23, 1994; Barrington-Wellesley Group, Inc., "Trends in EEO Employment," in Management Audit of the Southern California Water Company for the California Public Utilities Commission, Final Draft Report, January 1994, VIII-24.

[45] The paper has not tried to analyze the impact on housing patterns that may develop because of restriction on water connections and high costs connection or SCC fees. In the public agencies discussed in this report the area least ethnically diverse is the San Ramon Valley served by East Bay MUD. This is also the area where there has been the most money spent arguing about the unavailability of water and the need for high connection fees and SCC charges. If there had been unlimited amounts of water available to the San Ramon valley, more affordable housing might have been built in the area and this had the potential for changing the ethnic make-up of the region. One wonders if the real issue was water or the fear of ethnic diversity.

The authors have been told the water system in California is dominated by white males. Any change in the system's current structure will present opportunities for participation by nonparticipants in the industry. So to the extent people of color and women are currently nonparticipants in the management of the California water industry, change represents an opportunity. The restructuring of the waste industry over the last 10 years in California has presented major opportunities for women and people of color. For example, until 10 years ago, the vast portion of Alameda County was serviced by a small independently owned traditional waste collection company. The company was totally dominated by white males. The waste collection services in Alameda County are now provided by Waste Management of Alameda County, a division of WMX. Since WMX acquired the company, there have been substantial opportunities in the company for women and persons of color. In fact, the current manager is a man of color. This never happened under the previous ownership. Women and persons of color should not be fearful of a change in the status quo because it will lead to many more opportunities.

IV. CONCLUSION

Any discussion about reforming the structure of the water industry must include options for the restructuring of the industry using the taxable market for capital and the performance accountability of the investor-owned sector. Tax exemption for government-owned water companies benefits only a small group of lawyers, bankers, investors, and politicians at the expense of water consumers and the general taxpayer, who are forced to subsidize the inefficient provision of water services. Investor-owned water companies can supply water for the same prices charged by government-owned companies even while they pay a substantial amount of taxes to local, state, and federal authorities. Water marketing, a suggested solution to California's water problems, will not work so long as there is a strong government-subsidized water industry not subject to market pressures. When a subsidized industry does not have to respond to market pressures, there is little motivation to efficiently allocate resources.

This study sheds light on an area that has not received adequate attention relative to its importance in terms of public policy. Perhaps more sophisticated ways of comparing government and investor-owned companies can be developed by CPAs so the two sectors may be compared more accurately. One significant barrier to such comparisons could be overcome if government-owned water companies were forced to use the same accounting standard (such as GAAP), much as the investor-owned water companies have been required to do under CPUC and SEC regulations. While the findings of this study are based on a small sample, the trends should be further substantiated and quantified by more sophisticated, broad-based analysis in the future. It is important to ask several questions about any institutional framework for the delivery of water services:

- How does it affect water quality?
- How does it affect environmental goals?
- How efficient is it in financing water infrastructure?
- How efficient is it in operating water systems?
- What is the optimum method to regulate the delivery of water service?

The answers to these questions will change over time as environmental, financial, and political conditions change. Institutions that were once the most efficient mechanism for solving a particular problem often persist, embodying the ideas, power relations, and political compromises of the time of their creation. The provision of water services by the numerous quasi-autonomous government-owned companies, each with its own engineers, lawyers, and governing boards, may once have been the best solution to the perennial problem of water distribution in California. If they have now become anachronisms, progressive public policy must facilitate the creation of a new institutional framework for the provision of water services.

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PREPARED STATEMENT OF RONALD LAUDER

I want to thank Chairman Mack and members of the Joint Economic Committee for sponsoring this hearing.

I am testifying as Chairman of the New York State Privatization Commission and a concerned citizen.

I believe the Federal Government's policies toward State and local privatization is one of the most important issues facing this nation.

Six years ago, when I became the first public figure to advocate privatization in New York City, I was publicly accused of being in bed with the mob. Undeterred by this less than enthusiastic reception, I set out to promote the value of privatization. The result was the publication of Privatization for New York: Competing For a Better Future. Today, New York's Mayor and Governor are articulate proponents of privatizing a wide range of government services and assets. Many of which were introduced in Privatization for New York.

In addition to my modest efforts in New York, political and economic realities across the nation caused America's Mayors, Governors and County Executives to explore and adopt the privatization option in the delivery of services.

Faced with severe budgetary constraints, elected officials are discovering that privatization can reduce public expenditures while providing necessary services and infrastructure needs.

Later today, you will hear from elected officials and expert witnesses on how privatization has brought the benefits of competition to taxpayers in Indianapolis, Milwaukee, and Massachusetts. Democrats, such as Mayors Norquist and Rendell and Republicans like Mayor Goldsmith & Governor Weld have employed the privatization option very successfully.

A recent Mercer Group study concluded that there has been a substantial increase in the use of privatization on the local level.

In the decade from 1985 to 1995, there has been a significant increase in the use of privatization for a wide range of services: 70% of local governments have privatized janitorial services, 50% employ private waste collection, and 42% -- up 10% -- use private building maintenance workers. The cost savings and efficiencies that accompany privatization are the primary reason for its growing popularity throughout the United States.

Before I comment on the Federal barriers to infrastructure privatization, I want to note one glaring obstacle to introducing competition between the public and private sectors in the delivery of transportation services.

There have been several studies and real examples of dramatic decreases in operating costs of bus operations, when public monopolies are challenged by the private sector. A 1991 study prepared for the U.S. Department of Transportation Administration concluded that privatization of New York's bus system would yield $600 million in annual savings. Because of Federal law, the report recommends phasing-in this policy over a ten year period. The fact is that local government could not expedite this privatization because federal law is biased against transportation privatization.

Section 13(c) of the Urban Mass Transit Act requires that an employee whose job is eliminated due to privatization, receive up to six years of severance pay. Can anyone imagine a private severance package that is as lucrative as this one? The cost of this federal mandate makes transportation privatization more difficult. This federal policy should be eliminated because it is unnecessarily preventing local governments from reducing taxpayer costs.

Before I discuss the impact of federal policies on infrastructure privatization, let me share with you some relevant personal experiences.

During the last decade, I have been eyewitness to the benefits of privatization. As you may be aware, I am very active in private sector activities in the newly free countries of Central Europe.

I have witnessed and participated in many privatization projects and I can testify that those countries which have embraced privatization -- for example, the Czech Republic, Hungary and Poland -- are prospering, while others, like Ukraine, are foundering as they look to state sponsored economic development to bring their economies and infrastructure into the 20th Century.

For years, I have maintained that once the United States was the teacher -- now we stand to learn valuable economic lessons from our former students. We have to implement public policies which promote private enterprise.

We must recognize that neither federal, state, or local governments have the resources to meet our nation's massive infrastructure needs. Roads and bridges need rebuilding, airports must be upgraded and expanded, while water and wastewater facilities must be modernized.

Judging from the rhetoric and economic realities, the days of Washington footing this bill are largely over. State and local governments are saddled with the problem of financing infrastructure needs that are estimated to cost hundreds of billions of dollars.

With Washington pulling back and their own treasuries strapped to the bone, state and local officials are exploring the privatization option. Those that seriously analyze the benefits of privatization quickly learn that the private sector has the resources and the ability to help modernize the nation's aging infrastructure.

They also begin to appreciate that their government assets -- such as airports, ports, roads, and water systems -- are worth an estimated $226 billion. Assets which the private sector is anxious to invest in if federal policies change to allow them to do so.

Permit me to give one specific example of the challenge and problem facing local governments in every corner of the nation. To comply with the new water standards set forth in the Clean Water Act, local governments must come up with $136 billion to invest in these infrastructure projects.

- Is Washington going to finance the implementation of these federal mandates?
- Is Washington going to raise taxes to come up with the financing?
- Is Washington prepared to subsidize the modernization of water, wastewater and waste-to-energy plants?

I do not believe that I would find too many members of the Senate or the House who would answer these questions in the affirmative. Nor do I advocate doing so. Given Washington's inability to pay the steep bill to comply with its mandates and the nation's day-to-day infrastructure needs, local governments are facing a mammoth financing problem. While this task is formidable, it is not an impossible one to accomplish. All that is needed is for Congress and the Executive Branch to lift the Federal barriers which are preventing local governments from making full use of the financial and professional resources of the private sector.

Around the world, the private sector is investing in infrastructure. Last year, the Bank of International Settlements reports that world-wide private investment rose to $240 billion. But opportunities for private infrastructure investment are not available in the U.S. Here, federal laws and regulations are preventing and dissuading American companies from investing in their own country. It is estimated that American firms invested $15 billion in 1995 in other parts of the world, but in the United States we can point to only a few infrastructure projects -- two highways and one wastewater treatment project.

This has got to change. Later today, you will hear from the experts on what specifically has to be done. Let me leave you with a businessman's perspective on what your guiding principles should be in addressing privatization:

- First, and foremost, you must appreciate the giant task facing state and local government officials. In issuing Executive Order 12803, which began the process of allowing state and local governments to privatize assets that received Federal grants, President Bush clearly stated the need to adjust Federal policy because "states and localities face a growing need to modernize and expand their vital infrastructure assets... they seek innovative means to take advantage of the value of existing assets and to obtain private sector financial assistance."
- Second, we have major infrastructure needs which only the private sector is in position to fulfill.
- Third, we must change all laws and regulations that discriminate against the private sector participating in the financing and ownership of public infrastructure. We must streamline the privatization approval process.

  It should not take two years to gain Federal approval of a $6.8 million wastewater privatization -- as it did in Franklin, Ohio.

As an American concerned about the future of my nation, I find myself in the unusual position of promoting privatization in the land of free enterprise. At times, it has been a lonely experience -- I've felt like a single voice in a dense forest.

We seem to need to be reminded that private enterprise created jobs and opportunity that welcomed the world. It built the bridges, dug the subways, and sculpted a skyline known around the globe.

A few years ago, the Wall Street Journal was prompted to write, "For all this, one nation is still standing on the platform watching the global-privatization depart: the United States."

Today, I am more optimistic. I see light at the end of the tunnel. Mayors and Governors have become advocates of privatization and this hearing is a sign that there is a serious movement to change federal policy.

I applaud all your efforts and stand ready to assist you in dismantling federal obstacles to state and local privatization.

PREPARED STATEMENT OF GOVERNOR GEORGE PATAKI

I want to thank Senator Mack and members of the Joint Economic Committee for holding this hearing and inviting me to testify.

I've been asked by your staff to identify the federal barriers that stand between New York State and a successful privatization program. Of course, doing this in five or ten minutes is like trying to explain the federal tax code on a postcard.

Given the time constraints, I'll skip all of the obvious pronouncements about the importance of privatization, because I think we all agree that, particularly now, as Washington seeks to finally achieve a balanced budget, governors, mayors, and county executives must be free to explore creative, more cost-effective methods of rebuilding infrastructure and delivering essential services.

And I'm sure we also agree that privatization is fast becoming one of the most effective ways to meet those objectives.

Several years ago, the Wall Street Journal noted that privatization is sweeping the world, but the United States -- the father of capitalism -- is standing at the station while the train moves out.

The reality is that we're not standing at the station by choice -- Washington has us handcuffed to the platform.

All across the country, federal bureaucrats have made it difficult -- and in many cases impossible -- for the states to pursue areas of privatization with any real effectiveness. And all across the country, because of federal impediments, worthwhile privatization projects are turning into long, drawn-out nightmares.

While in New York we have successfully privatized assets that are within our jurisdiction- such as sale of the Vista Hotel, of a state-run bakery, and a golf course- we are hamstrung when it comes to privatizing areas that require the blessing of the federal government.

The result is that we are delayed, or in fact missing out on golden opportunities -- opportunities to harness the energy, expertise and wealth of the private sector, and parlay it into improved services, cost savings, an expanded tax base, and additional tax revenue for our people.

The barriers states face as we seek to harness the capital and expertise of the private sector occur at all levels of the federal government; that is to say this includes specific statutory obstacles, regulations and rules which limit state options, and too often the hostile reaction of an entrenched federal bureaucracy.

which limit state options, and too often the hostile reaction of an entrenched federal bureaucracy.

Let me give you examples of each.

The Resource Conservation and Recovery Act ("RCRA")

RCRA deals with, among other things, the discharge of potentially hazardous effluent from various facilities. It differentiates between industrial plants, which may discharge very hazardous materials, and ordinary sewage treatment plants. The latter are regulated by a less-stringent, and less-costly, set of standards.

RCRA did not contemplate private ownership of public wastewater systems. Thus, those facilities subject to the less-costly standards are defined as "publicly-owned treatment works" ("POTW"). The Environmental Protection Agency's literal interpretation of these words means that a publicly-owned sewage treatment plant sold to a private firm would be subject to the more costly discharge standards applying to industrial plants, even though the discharges remain the same.

Privatization would be greatly aided if Congress amended RCRA by substituting a new term such as "public-purpose treatment works," for POTW.

Another impediment, Revenue Procedure 93-13, is a product of the Tax Reform Act of 1986. It provides that contracts with the private sector entered into by states and localities to manage facilities developed with tax-exempt bonds are limited by a "3-5" rule. That is the contracts must provide for termination without cause after three years and terms of no more than five years.

Revenue Procedure 93-19 prohibits any form of manager compensation tied to net profits. By limiting the ability of firms to recoup capital invested and discouraging productivity incentives, the effect of these rules is to seriously dampen the extent and scope of privatization agreements to manage public facilities. These need to be revised.

Let me outline one specific example of how federal barriers impede state privatization efforts -- the sale of an airport.

Not long ago, New York began to seriously test the feasibility of privatizing state-owned airports. Despite the millions of tax dollars that have been poured into these properties, they have not performed well as wards of the state, and taxpayers, including the City of New York, have not gotten an adequate return on their investment.

But our exploration into this area started out on a discouraging note. When our Empire State Development Corporation issued a request for financial advisors to handle the airport and other privatization projects, we were warned time and again that our biggest problem would be federal regulations, and the bureaucrats who enforce them.

In this case, unfortunately, the federal government lived up to this notorious reputation -- just like it did when bureaucrats killed the efforts of Orange County California to privatize the John Wayne Airport.

Let me just run down some of the specific obstacles we're currently facing in New York.

The way it stands now, in addition to the impediments noted before, Washington bureaucrats can insist that states and localities pay back federal grants to airports, waste-water facilities and other public properties if they are privatized.

This makes no sense. These are not loans, but grants. Assuming the purpose of federal grants is to improve airports and keep them safe for the public, and they have in fact been used for this purpose, what difference does it make who owns them? As long as the airport continues to function as an airport, federal grants should not need to be repaid.

Penalizing states whose airports wind up in private hands discourages privatization. Whatever federal aid has been provided to a state-owned airport should remain to benefit the state, and should apply equally to private as well as publicly held assets, so long as the public interest is served.

Further, the federal government continues to limit what local governments can do with the proceeds from an airport sale. For instance, if an airport is sold to the private sector, there are severe restrictions on what can be done with the proceeds from the sale. However, the feds have granted exemptions to this rule for public authorities which own airports in New York, New Jersey, and Massachusetts. The federal government should have the same policy for all state governments if the private sector becomes the owner.

Federal tax policies also inadequately distinguish between public and private borrowing designed to meet airport capital improvement needs that will enhance public safety, such as improving runways.

If Washington is serious about promoting privatization, then it should level the playing field by allowing tax exempt borrowing for private sector projects that serve a vital public need -- such as the expansion of airports, and the expansion of wastewater and water projects.

True privatization -- the kind that generates additional revenue, expands the tax base, taps private sector sources of capital, and creates new private sector jobs -- cannot happen until the federal government allows fair competition between the public and private sectors. That's what we need to implement privatization on the right scale- that is, on a grand scale- and that's what we need to reap the cost benefits of privatization and pass those savings on to our taxpayers.

If this leveling process is to be successful, the federal government must establish an approval process for privatization projects that's simplified, less cumbersome and, above all, fair.

In that regard, the privatization of Franklin, Ohio's waste treatment facility is a good news, bad news story. The good news is that Franklin survived the federal approval process and successfully completed a privatization project. The bad news is that in addition to all of the other complex negotiations and approvals needed, it took two full years just to get the nod of approval from the federal government for the sale. And so, despite its eventual success, the Franklin model doesn't serve as much of an incentive for other governments to pursue privatization.

This is unfortunate, because in the long run taxpayers are going to pay more if they must rely exclusively on the public sector for services. In states and cities throughout this nation, the introduction of competition into the delivery of services has resulted in better, less expensive public services. The privatization of Indianapolis's wastewater treatment facility will save taxpayers $65 million. And the privatization of Denver's buses reduced operating expenditures by 27.5%.

The need for these types of private activities is further highlighted by the capital needs states and localities face in meeting their infrastructure needs. For example, it is estimated that to fulfill the mandates of the Clean Water Act, states and local government will need almost $136 billion. While public sector financing is not readily available, the private sector would fill the void if federal laws and regulations did not discriminate against their participation in the process.

I'm confident that this issue has the bipartisan support of Democrat and Republican elected officials. State and local officials across this country must fill the vacuum created as Washington pulls back on its financing of infrastructure projects.

And they will be successful in doing this if federal policies and bureaucrats do not stand in the way of allowing us to exercise the privatization option when we feel it's in the best interest of our constituents.

I urge you to follow through on the revolution of empowering the states to govern themselves by loosening the senseless rules and regulations that are preventing us from using the private sector to rebuild our crumbling infrastructure.

I think I speak for a lot of Governors -- perhaps all of them -- when I say that privatization is too great an opportunity to go unrealized. In fact, I have taken a leading role in both the National Governors' Association and the Republican Governors Association to address this issue.

We're not asking Washington for handouts, financial aid, or anything that will cost the federal taxpayer one cent. We're simply asking that the federal government do no harm -- that is, step out of our way to progress.

Let me end by saying that I realize I'm preaching to the choir here. Obviously, you realize that the federal government has a serious problem in this area -- and that recognition will help us to solve the problem together. So I want to commend your panel for recognizing the seriousness of this issue and for taking the first step toward resolving it.

Thank you.

Mr. Chairman and Members of the Committee, I appreciate the opportunity to testify on behalf of Wheelabrator Clean Water Systems Inc. and to share my thoughts on Wheelabrator's experience with privatization, which we prefer to call public/private partnerships, and what we see as the Federal barriers encountered by private companies willing to buy or build public assets or infrastructure. I will start by telling you who Wheelabrator Clean Water Systems Inc. is, then explain Wheelabrator's views on public/private partnerships and our experience with the Franklin Area Wastewater Treatment Plant and the Wilmington Wastewater Treatment Plant. I will then turn to some of the impediments to privatization and our recommendations on how Congress can stimulate public/private partnerships.

I have also included two attachments to my written testimony. The first one contains our suggestions for legislation on wastewater treatment privatization. I believe you will find that it can easily be broadened to cover many other types of infrastructure assets but we have confined our suggestions to wastewater facilities because that is what we know best. The second provides suggested changes to Senator Roth's Federal-Aid Facility Privatization Act, S.1063. Because he is on the committee, and the legislation is germane to your hearing I thought the Committee would find our comments useful. In both instances the Committee will find examples of how we suggest various barriers to privatization might be removed.

Now I'll tell you about my company.

WHEELABRATOR CLEAN WATER SYSTEMS INC.

Wheelabrator Clean Water Systems is a wholly owned subsidiary of Wheelabrator Technologies Inc., an American Fortune 500 company traded publicly on the New York Stock Exchange. One of the world's largest multifaceted environmental services companies, Wheelabrator Technologies owns and operates trash-to-energy and independent power facilities, supplies air quality control systems for a broad range of industrial and utility applications, and provides a comprehensive range of water and wastewater treatment products and services to municipal and industrial customers.

Our commitment to the water and wastewater industry spans more than two decades. Wheelabrator Clean Water Systems pioneered the contract operation and maintenance of water and wastewater treatment facilities in 1972; this contract with the City of Burlingame, California was recently renewed into the 21st century. Today we're pioneering a new form of public/private partnership as the first private firm to purchase a municipal wastewater treatment plant under Executive Order 12803.

We're very proud of our successful track record. Our goal is to ensure that the facilities we operate go unnoticed in the communities we serve, quietly providing safe, efficient, and economical services. But our performance has not gone unnoticed by the U.S. EPA and other agencies and associations. We have earned more awards for safety and performance excellence than any other contractor in the field. A list of the communities we serve as well as a list some of our awards is attached.

Wheelabrator has international experience as well. Our Mexican subsidiary, Wheelabrator Mexicana S.A. de C.V., has partnered with Companie Mexicana de Aguas to rehabilitate and operate wastewater treatment plants. This watershed collaboration is one of the first launched since the introduction of the North American Free Trade Agreement (NAFTA). Wheelabrator Clean Water Systems is eager to contribute vital environmental technologies and services to support Mexico's need for infrastructure development and environmental restoration, and to help Canada meet its commitment to environmental protection. We support the environmental goals endorsed by NAFTA, and will continue to seek international investment opportunities in the spirit of free trade and to contribute to economic growth in Mexico, Canada and the United States.

Mr. Chairman, We think this says a lot about our ability to keep up with changing times and the changing needs of our clients. Now I would like to give you Wheelabrator's view of privatization which, as I mentioned, we prefer to call public/private partnerships, and our experiences in Franklin, Ohio and Wilmington, Delaware.

PUBLIC /PRIVATE PARTNERSHIPS

Throughout the United States, municipalities are faced with the problem of balancing community needs with available funding. There is increasing pressure to provide quality municipal services while holding the line on operating costs and complying with changing government regulations. This challenge becomes increasingly difficult as funding sources from the state and federal governments dwindle. Many communities have partnered with the private sector to help address these unique challenges.

In the past, barriers in federal regulations and the Tax Reform Act of 1986 have combined to slow private investment in municipal wastewater treatment facilities. When President Bush signed E.O. 12803 in 1992, it increased the interest in public/private partnership options. The Executive Order states that infrastructure is critical to economic growth. It goes on to acknowledge that state and local governments understand their own needs and how to satisfy them. The order protects the public investment. It requires the privatized facilities to remain committed to a long-term partnership and continue to operate within environmental compliance and budget. As outlined in E.O. 12803, proceeds from a sale or lease of a publicly-owned wastewater treatment facility must first repay state and local government investments in the project. Thus, after the facility debt is defeased, the municipalities will have funds left over to invest in other infrastructure or to reduce taxes or other debt. Proceeds attributable to the federal grant less depreciation are returned to the federal government.

Public/private partnerships are an important financial opportunity for a community to explore. The U.S. EPA estimates that publicly owned treatment works (POTW) will need $127 billion in capital investment over the next 20 years to meet Clean Water Act regulations. A wastewater treatment plant can be a hidden source of cash that can be used for needed services through public/private partnerships. The amount of money that could be freed up if the private sector were to acquire current wastewater infrastructure is estimated at more than $30 billion from some 15,000 facilities.

Public/private partnerships should be tailored to meet the community's specific needs. There are various arrangements that allow a municipality to free up badly needed funds that are tied up in it's wastewater treatment works. Property and income tax rolls would be expanded as tax-exempt public properties become tax paying properties. Privately owned facilities may even cost less to operate, as communities in Ohio and Delaware are finding out.

One of the biggest issues with public/private partnerships comes from a concern about what will happen to employees when a publicly owned facility is transferred to a private sector owner. In Wheelabrator's case we want to be very specific about what it means. It make no sense to us to approach a fundamental change in public policy, such as public/private partnerships, and then go about making that change in such a way as to hurt people and alienate them to that change in the process. Wheelabrator intends to find jobs for all employees in any facility we privatize. Let me emphasize that: <u>all employees!</u> Wheelabrator intends to operate the facilities it owns with the number of people it takes to operate that facility safely, efficiently, and in an environmentally responsible manner. If all the people at facility are not needed at that facility we will find them a job at one of our other facilities, retrain them or work with the municipality to employ them elsewhere.

Since Executive Order 12803, public/private partnerships have become an economically attractive and sound alternative for municipalities. Two case studies are highlighted below.

<u>CASE STUDY ONE: FRANKLIN, OHIO</u>

History
Located 25 miles south of Dayton, Ohio, the Franklin Area Wastewater Treatment Plant is a 4.5 million-gallon-per-day regional facility serving 25,000 residents. Wheelabrator EOS, a subsidiary of Wheelabrator Clean Water Systems Inc., has operated the Franklin Area Wastewater Treatment Plant under a contract with the Miami Conservancy District (MCD) since 1987. The plant serves the municipalities of Franklin, Germantown, and Carlisle. In August of this year, Wheelabrator, MCD, and the municipalities completed the historic first wastewater treatment plant public/private partnership, which includes a 20-year service agreement. It was the culmination of a two year effort by MCD, the communities and Wheelabrator, ultimately requiring approvals from the U.S. EPA and the Office of Management and Budget. The following highlights the major points of the transaction:

Purchase Price and Rates
The $6.8 million purchase price for the facility exceeded the outstanding debt on the facility. Thus, after the facility debt was defeased, the municipalities had funds left over to invest in infrastructure or to reduce taxes or other debt. The annual service fee to be paid by the municipalities for wastewater service was agreed to in conjunction with the purchase price and was approximately 20 percent lower than the fee paid to MCD.

Ownership Structure
The ownership structure is designed to allow private ownership under municipal control. The plant is owned by Wheelabrator, who will be responsible for operations and maintenance (O&M)

and replacement of capital equipment at the facility. The collection system and interceptors are owned by the municipalities who continue to be responsible for rate setting and new connections to the system as well as enforcement of the industrial pretreatment program. The plant site is owned by the municipalities and leased to Wheelabrator.

Expansions
Plant expansions will be determined by the municipalities since Wheelabrator does not have the ability to add new customers to the system. Wheelabrator will manage and finance the expansion and be responsible for its implementation. Wheelabrator will design the expansion and provide a fixed price to the municipalities based upon bids solicited from qualified bidders. Any necessary increase in the service fee for the expansion will not occur until the expansion comes on line.

Environmental Regulation
During the approval process, Wheelabrator pioneered a new concept for National Pollutant Discharge Elimination System (NPDES) permitting. The NPDES permit is jointly held by Wheelabrator and the municipalities. Wheelabrator will be responsible for plant operations; for monitoring and sampling services for industrial pretreatment programs; and for proper regulatory reporting. The municipalities will be responsible for enforcing the industrial pretreatment program. The Service Agreement details the components of the industrial pretreatment program along with specific procedures for enforcement. The joint responsibility for the NPDES permit gives all parties the incentive to ensure compliance for both plant influent and effluent.

Purchase Option/Extension
The municipalities have the option to purchase the facility or extend the Service Agreement at the end of the 20-year term. The option price in year 20 will be the fair market value.

CASE STUDY TWO: WILMINGTON, DELAWARE

History
Wheelabrator EOS has operated the City of Wilmington's biosolids dewatering facility since 1985. In May of 1995, the City issued a Request for Proposal for professional services for the purchase, management, operation and maintenance of the Wilmington Wastewater Treatment Plant (WWTP). The City's 90-million gallon per day advanced wastewater treatment facility serves 400,000 residents in the City and New Castle County. In August of 1995, the City selected Wheelabrator for the project and entered into negotiations which are still in progress.

Purchase Price and Rates
Wilmington predetermined the price for the facility in it's request for proposal at $53 million. The City will be paid their purchase price after receiving state and federal approvals. The service fee bid by Wheelabrator is less than the City's current operating cost.

Ownership Structure
The City of Wilmington will retain significant control through the structure of the purchase. The facility will be owned or leased by Wheelabrator, which will be responsible for management; operations and maintenance (O&M) and replacement of capital equipment at the facility. The

City will retain ownership of the collection and interceptor systems. The City will also be responsible for all rate structures and the enforcement of the industrial pretreatment program. The WWTP site will also be owned by the City and leased to Wheelabrator under a ground lease.

Expansions
Plant expansion needs will be determined by the City. Wheelabrator will manage, design and finance the scheduled expansions, provide the City with fixed cost for the expansion and be responsible for on schedule completion and start-up. Any necessary service fee increase will not occur until the expansion has been completed and operational.

Environmental Regulations
As noted above, Wheelabrator pioneered the implementation of a new arrangement for NPDES permitting. The arrangement identifies both the private owner and municipal service client as joint holders of the permits. This relationship satisfies the U.S. EPA and will be the recommended approach for the WWTP transaction. The City will remain the enforcement agency for the industrial pretreatment program. The service agreement will detail the components of the industrial pretreatment program along with specific procedures for compliance and enforcement. The joint permit responsibility provides incentives for both parties to ensure influent and effluent compliance.

Mr. Chairman, let me now turn to what Wheelabrator sees as some of the impediments to privatization and what Congress can do to stimulate public/private partnerships for wastewater treatment infrastructure.

PROMOTING WASTEWATER TREATMENT INFRASTRUCTURE REVITALIZATION

As discussed earlier, in order to maintain, expand and build new wastewater treatment infrastructure, local and state governments are dependent on their ability to finance such projects. Federal funding of wastewater treatment infrastructure assets in the form of grants, loans or tax exempt treatment of municipal financing has reached the limit of effectiveness in supporting these activities. In many ways it serves as a barrier to the achievement of economic efficiencies and new construction. Private enterprise provides economic efficiencies via competitively driven improvements, but these efficiencies are inaccessible to local and state government because existing laws, regulations and policies prevent or severely limit their application where federal financing has been the traditional option.

To allow for the building, revitalization and maintenance of our wastewater treatment infrastructure with minimal impact on the federal budget, Congress should turn to the economic efficiencies that can be achieved by encouraging public/private partnerships. This can be accomplished by facilitating financing for, and eliminating barriers to private ownership and operation. Private sector investment can provide the necessary equity for capital improvements, expansions and upgrades which are desperately needed by local government to meet public health and environmental standards. The traditional model of federal financing and public ownership and operation of infrastructure must be subjected to the competitive practices of the private sector if we are to provide for economic growth.

If Congress is to achieve the most cost effective revitalization of the Nation's wastewater treatment infrastructure, federal policy must provide:

1. The encouragement for the public sector to first consider the private sector to finance, construct, own and operate wastewater treatment infrastructure assets before making use of federally assisted financing.

Providing federally assisted financing to the public sector without requiring a cost comparison with the private sector's ability to provide the service at the same or lower total net cost is inconsistent with a fully competitive market. If the private sector can finance, construct, own and operate wastewater treatment infrastructure assets while assuming the same, if not higher, level of service and environmental protections, on a cost effective basis, then the private sector should be given the opportunity to do so. Anything less leads to inefficiencies and further dependence on old solutions which have proven, over time, to be inadequate.

2. The elimination of statutory and regulatory barriers to privatization, especially in the tax code.

Most POTWs have been funded in part by the proceeds of tax-exempt bonds. However, current and proposed Treasury Regulations relating to tax-exempt bonds will impede POTW privatization in those transactions involving a transfer, lease or long term operating contract by requiring the public entity to follow prescribed, burdensome remedial procedures, and imposing on the public entity a large up front cash toll charge to preserve the tax exemption of bonds that financed the POTW, and in any public ownership structures by arbitrarily limiting the term of contracts under which a private sector entity may operate a POTW and still preserve the tax exempt bonds.

The rule changes below are enhancements of ideas reflected in existing or proposed Treasury rules.

A. Adoption of the currently proposed Treasury rule change to the "alternative use of facility" safe harbor rule that allows any tax exempt bonds that financed a POTW to remain outstanding after privatization of the POTW with the following modifications:

1. Permit this remedial procedure to be used even if there was an advance refunding of any governmental bonds used to originally finance the POTW.

2. Provide that bondholder interest proceeds will not be subject to the alternative minimum tax.

3. Eliminate the requirement that the public entity obtain retroactive volume cap.

4. Permit this remedial procedure to be used if the private entity finances the acquisition of the POTW with tax exempt bonds.

B. Adopt in substantially its present form the currently proposed Treasury rule change to the "alternative use of proceeds" safe harbor rule that allows tax exempt bonds that financed a POTW to remain outstanding after privatization of the POTW.

C. Permit contracts for private operation of POTWs to have a term of at least 20 years without requiring any remedial action in order to preserve tax exempt bonds that financed the facility.

D. Modify the effective dates of rule changes to provide that these revised rules pertain to the privatization of existing POTWs.

These enhancements are appropriate for wastewater treatment infrastructure privatization because these transactions will not alter the original public purposes served by POTWs — providing wastewater services to communities. Moreover, the encouragement of privatization allows public entities to better achieve the public purposes of POTWs by gaining access to capital for federally mandated upgrades and to more sophisticated technology, cost effective design, construction, and operation; reduced overall operating costs; and superior environmental compliance.

3. The opportunity for the private sector to compete on an equal footing with subsidized public financing.

Providing the private sector with an opportunity to compete with subsidized public financing will require that Congress create parity between public financing and private financing. Federal policy should, in order to encourage public/private partnerships, remove unintended impediments in the existing tax code, raise the tax-exempt bond cap allocation or allow access to tax exemptions, deductions, credits or accelerated depreciation for private sector investments in wastewater treatment infrastructure construction, ownership, and operation. This will allow the public sector to harness the financial strength of the private sector, and offer alternative financing options that are currently ignored by the public sector because of the availability of federally assisted subsidies.

As a direct result of these changes in federal policy, an increasingly significant portion of the Nation's wastewater treatment infrastructure will be financed, built, owned and operated by the private sector. This, in turn, will break the gridlock of waiting for federal grants and other loan programs, and accelerate investment in infrastructure. Such investment will create jobs and promote economic growth. I want to make the point that we are not asking for an advantage over public financing only that we be treated in the same fashion.

As explained in the attachments to this statement, legislation addressing the issues described above would be a tremendous assistance to local communities and the private sector's efforts to pursue public/private partnerships.

Mr. Chairman, that concludes my statement. I will be happy to answer any questions.

SUGGESTED ELEMENTS FOR WASTEWATER TREATMENT PRIVATIZATION LEGISLATION

I. Local and state government should be encouraged to evaluate privatizing the wastewater treatment infrastructure, generally referred to as Publicly Owned Treatment Works (POTW), to pay for construction and improvements before utilizing federally assisted financing for such projects.

Revitalizing the Nation's wastewater treatment infrastructure will require increased private sector involvement. Local and state government can either finance projects themselves, or seek to privatize the infrastructure, before utilizing federally assisted financing for such projects. The public/private partnership approach allows the public sector to take advantage of the equity that is in existing infrastructure assets and work with the private sector to use that equity and other private financing to pay for new construction and upgrades. In order to encourage and promote a transition to public/private partnerships, before a local or state government seeks federally assisted financing for infrastructure projects, they should determine (using the least burdensome process practicable) whether:

A. There is a private sector entity willing and able to undertake the project; and

B. The total net cost of allowing a public/private partnerships to undertake the project would be as cost-effective or more cost effective than public sector financing, ownership and operation of the project.

II. The requirement for repayment of federal construction grants for wastewater treatment infrastructure should be forgiven.

There is a substantial need for new and refurbished wastewater treatment infrastructure in the Nation. There is also a substantial amount of equity in existing infrastructure that can be tapped in addition to private sector investment, to help pay for new construction, expansion and system upgrades. The opportunities to achieve real cost efficiencies should also be made available to communities with existing wastewater infrastructure projects that do not require, at the present time, financing for new construction or upgrades but would like to free up capital for reduction of debt, taxes or use in other infrastructure projects.

A. Legislation should allow public sector wastewater treatment infrastructure assets to be transferred to the private sector by sale, and the requirement for repayment of federal construction grant or grants used for that project should be forgiven. All proceeds from the sale of such assets should go to the local and state governments; and

B. In order to ensure that such activities do not adversely impact the local or state government and users of the infrastructure system or facility, the principles guiding asset utilization and transfer embodied in E. O. 12803 should be followed;

C. The process followed by local and state government to transfer wastewater treatment infrastructure assets to the private sector should consider total net cost, and allow processes such as competitive bidding, direct contract negotiation, or whatever is required by state law.

III. Appropriate qualifications criteria for private sector participation should be established.

Private sector entities who intend to participate in the privatization of wastewater treatment infrastructure assets must be "qualified" to undertake the responsibilities accompanying the public/private partnership arrangements so as not to jeopardize the performance of the infrastructure facilities and to ensure uninterrupted service. To this end, legislation should require that the following "qualifications" be demonstrated by the private entity in order to be eligible to participate in an asset transfer arrangement, or to be eligible for preferred federal tax treatment:

A. Private sector entities must demonstrate sufficient experience and financial strength to address problems associated with the ownership and long-term operation of wastewater treatment infrastructure assets, and the ability to satisfy requirements to meet any guarantees agreed to as the result of a transfer of assets;

B. Private sector entities must demonstrate the ability to assure protection against insolvency and interruption of services through appropriate contractual and financial guarantees; and

C. Private sector entities that intend to enter into public/private partnerships by taking ownership of a transferred public infrastructure asset, to the extent consistent with GATT and NAFTA, must be majority owned and controlled by citizens of the United States, and does not receive foreign government subsidies since the fate of the service provided by that transferred asset may be influenced by foreign government decisions.

IV. Federal statutory, regulatory and policy barriers to privatization should be removed.

The House has already taken steps to address some of the barriers. For example H.R. 961 The Clean Water Act Amendments of 1995, passed by the House on May 16, 1995, includes provisions in sections 504 and 603 that redefine Publicly Owned Treatment Works (POTW) and allows states or other relevant agencies to transfer POTWs to qualified private sector entities, and generally codifies E.O. 12803. S.1063 the Federal-Aid Facility Privatization Act builds on a key element of the Sale of Treatment Works provision in Section 603 of H.R. 961, by allowing total forgiveness of federal grants.

To full achieve the benefits of privatization the following statutory changes to the Internal Revenue Code should be made.

A. Modification of the fair market value facility repurchase requirements.

When a private entity purchases a POTW and wishes to be treated as the owner of the facility for tax purposes and not subject to the adverse tax-exempt property rules, current law requires that any local government repurchase option at the end of the operating contract be at fair market value determined at the end of the contract. Since local government needs certainty to plan for its repurchase of the facility, tax law should be modified to allow a fixed repurchase price to be agreed upon when the contract is signed.

B. Elimination of limitations on the acquisition of existing property when Private Activity Bonds are used to purchase a POTW.

In the event private activity bonds are used to finance the acquisition of an existing POTW, current tax code rules that limit the financing of existing property purchases require that qualifying rehabilitation expenditures (excluding, among other things, tax-exempt use property under Section 168(h)) be made in an amount equal to at least 15% of the financed portion of the purchase price of buildings and 100% of the financed portion of the purchase price of other structures within 2 years of the later of the acquisition date or the bond issue date. These requirements should be eliminated as they are not only ambiguous but are arbitrary in both the percentage and time requirements, and do not represent the capital investment cycle or needs of a POTW. The limitations on the acquisition of existing property should be eliminated for private activity bonds used to finance the purchase of an existing POTW.

V. Create parity between public and private investment in public purpose wastewater treatment infrastructure

The Internal Revenue Code currently recognizes that certain private sector capital projects contribute to the public good, and so provides a special method for extending the availability of tax exempt financing to qualifying projects. This access, however, requires that projects compete for limited financing under a bond cap in each state, which is usually awarded on a first-come, first-served basis. While certain projects may qualify, the granting of tax-exempt bond cap allocations is often subject to rationing or a lottery system designed to allocate limited funds among competing public sector demands that far exceed the cap.

It is essential to create parity between public and private sector investment in public purpose infrastructure. Federal policy intended to subsidize public financing of wastewater treatment infrastructure should be extended to private sector investment in the same types of capital projects by providing changes in the tax code.

Statutory changes to the Internal Revenue Code include:

A. Allowing 5 year accelerated depreciation on privatized POTWs.

Current Tax Code Section 168 provides for a 20 year class life for POTWs and 15 year 150% declining balance depreciation schedule. To encourage private sector ownership and investment in POTWs and lower ratepayer costs, Section 168 should be modified to provide for a 5 year depreciation schedule.

B. Remove the Volume Cap Requirement on Tax Exempt Private Activity Bond Financing of POTWs.

Current revenue code requires tax exempt bond cap allocation for private activity bonds used to finance POTWs. Competition for bond cap allocation severely restricts private activity bond financing of POTWs and, therefore, the bond cap should be removed.

COMMENTS ON THE FEDERAL-AID FACILITY PRIVATIZATION ACT

Wheelabrator supports the concept behind the Federal-Aid Facility Privatization Act. First, it will put into law what is today only an executive order. That Executive Order, 12803, was signed by President Bush in 1992. Today the current Administration supports the executive order and has seen first hand that positive impact it can have. Future administrations, however, may not feel compelled to support it. Wheelabrator would like to see privatization a matter of law as well as policy.

More importantly, S. 1063 improves on Executive Order 12803 (E.O. 12803) by freeing up additional capital for states and local governments to use by forgiving rather than depreciating the federal grant. The local governments are really the best ones to decide how to recycle the money the federal government has given them. The original purpose of the wastewater construction grants was to build needed public purpose infrastructure. Today the private sector can provide that assistance and service. It only seems logical that those funds remain in the hands of the local government instead of being returned to the federal government.

Wheelabrator believes that E.O. 12803 provides a basis upon which S. 1063, and other legislative initiatives, can substantially improve. Our experience in this area suggest that S. 1063 provides greater incentives for public and private sector entities to make decisions about public/private partnerships. It also, however, raises the level of uncertainty about how beneficial it may or may not be based on its linkage to federally imposed grant assurances.

We have looked carefully at this legislation from the point of view of wastewater treatment facility public/private partnerships and offer the following observations.

1. The use of proceeds from a privatization effort (i.e., asset sale proceeds) are limited in Section 6 of the legislation to uses consistent with applicable grant assurances and provisions. This essentially extends federal oversight onto subsequent use of proceeds, even though the executive agency or department would no longer be involved with providing grants for such assets. Moreover, compliance with many of the grant assurances will not and should not be appropriate for public/private partnerships. Local government and private partners will continue to be regulated for environmental purposes, but such regulations are generally outside the grant assurances requirements.

2. There appears to be a conflict between two provisions concerning consistency with grant assurances and provisions. In Section 3(b), the text states that executive agencies and departments can waive or modify any grant assurance consistent with Section 4. Section 4, however, indicates that <u>private parties</u> purchasing or leasing the infrastructure asset will comply with all applicable grant assurances, although such assurances were originally intended for the <u>public sector</u>. On the face of it, it is not clear where federal grant assurances end or if they could even be modified. We believe, and think that local government will concur, that when an infrastructure asset is sold, and the federal repayment requirement is waived, the asset should not have all grant assurances and provisions tied to it. The important assurances such as those contemplated by E.O. 12803 should be covered in the service agreement between the parties.

This, in particular, is an example of why the unique conditions surrounding a wastewater public/private partnership project need to be carefully reviewed, in light of how grant assurances will or will not apply after the asset transfer. Wastewater treatment infrastructure and related federal construction grant assurances are unique compared to the plethora of grant assurances attached to other types of infrastructure. The provision, as it currently stands in S. 1063, masks such distinctions and is perhaps too broad and all encompassing.

3. The bill does not address the need to set a threshold of "competency" for private sector entities who are allowed to participate in partnership arrangements. For example, it is important to ensure that private entities have a proven track record for efficient service delivery, have operating expertise, can provide financial assurance to guarantee that services and operations would not be disrupted if the entity encountered financial or technical difficulties, and has a successful record of compliance with federal and state regulatory programs, especially environmental regulations.

4. Section 6 of the proposed legislation, provides for state and local government recovery of its capital investment in the affected asset. The provision also specifies the ability to recovery "unreimbursed operating expenses", and "a reasonable rate of return". These two items are not defined. It is important to define what is meant by these items so that any public/private partnership projects following the principles set forth by the legislation does not become unduly complicated and impossible to complete.

5. Finally, it might be advantageous to include a finding in the legislation which accurately reflects the current economic reality facing the Congress and the ability of the Federal government to finance infrastructure development and maintenance. The finding should encourage the public sector to first consider private sector financing, operation and ownership of infrastructure assets, and consider the federal government the lender of last resort. Scarce federal funds could then go where they would have the most impact.

WHEELABRATOR EOS AWARDS

▪1995

Environmental Protection Agency, Region IV - Best Tasting Water in Georgia
Atlanta-Fulton County Water Treatment Plant, Alpharetta, Georgia

Arizona Water & Pollution Control Association - Safety Award - Treatment and Collections
Colorado River Joint Venture/Wheelabrator EOS Inc., Parker, Arizona

National Council for Public-Private Partnerships - Project Award
Franklin Area Wastewater Treatment Plant, Franklin, Ohio

Ohio Water Environment Association - Safety Award
Springboro Wastewater Treatment Plant, Springboro, Ohio

Pacific Northwest Pollution Control Association - Safety Award - Division B Lost-time Free Accidents and Five Years of Lost-time Free Accidents
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1994

Georgia Water Pollution Control Association - George W. Burke Safety Award
Albany Wastewater Treatment Plant, Albany, Georgia

Environmental Protection Agency, Region VI - Regional Administrator's Environmental Excellence State Award
Beneficial Use of Biosolids Operating Project Greater Than 5 MGD
Chickasaw Wastewater Treatment Plant, Bartlesville, Oklahoma

California Water Pollution Control Association - Safety Award
Burlingame Wastewater Treatment Plant, Burlingame, California

Ohio Water Environment Association - Safety Award
MCD Dayton Wastewater Treatment Plant, Dayton, Ohio

Pacific Northwest Pollution Control Association - Safety Award, Division B, Zero Lost-time Accident Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1993

Georgia Water Pollution Control Association - Plant of the Year Award/Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

Environmental Protection Agency, Region IV - Award of Excellence for Beneficial Sewage Sludge Utilization
Albany Wastewater Treatment Plant, Albany, Georgia

Environmental Protection Agency, Region IV - Operations & Maintenance Excellence Award, Second Place
Albany Wastewater Treatment Plant, Albany, Georgia

Environmental Protection Agency, Region III - Operations & Maintenance Excellence Award
Oaks Wastewater Treatment Plant, Oaks, Pennsylvania

Ohio Water Environment Association - Safety Award - Plant Operations
Springboro Wastewater Treatment Plant, Springboro, Ohio

Ohio Water Environment Association - Safety Award - Collections Systems
Springboro Wastewater Treatment Plant, Springboro, Ohio

Environmental Protection Agency, Region VI - Operations & Maintenance Excellence Award Finalist
Vancouver Wastewater Treatment Plant, Vancouver, Washington

Pacific Northwest Pollution Control Association - Safety Award - Division B, Zero Lost-time Accidents
Vancouver Wastewater Treatment Plant, Vancouver, Washington

Pacific Northwest Pollution Control Association - Operations Challenge - First Place Overall
Vancouver Wastewater Treatment Plant Team, Vancouver, Washington

▪1992

Georgia Water Pollution Control Association - Plant of the Year Award/Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

Environmental Protection Agency, Region IV - Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

Georgia Water Pollution Control Association - Best Operated Plant in Georgia - Greater than 15 MGD
Atlanta-Fulton County Water Treatment Plant, Alpharetta, Georgia

Chrysler Corporation - Quality Excellence Award
Chrysler Canada LTD, Wastewater Treatment Plant, Bramalea, Ontario, Canada

Ohio Water Pollution Control Association - State Safety Award
MCD North Regional Wastewater Treatment Plant, Dayton, Ohio

Ohio Water Pollution Control Association - State Safety Certificate
MCD North Regional Wastewater Treatment Plant, Dayton, Ohio

Montana Water Pollution Control Association - George W. Burke Safety Award
Great Falls Wastewater Treatment Plant, Great Falls, Montana

▪1991

Environmental Protection Agency, Region IV - Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

Georgia Water Pollution Control Association - Plant of the Year Award/Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

Environmental Protection Agency, Region VIII - Operations & Maintenance Excellence Award
Great Falls Wastewater Treatment Plant, Great Falls, Montana

Environmental Protection Agency, Region VIII - National Operations & Maintenance Excellence Award
Great Falls Wastewater Treatment Plant, Great Falls, Montana

Ohio Water Pollution Control Association - Safety Award
Springboro Wastewater Treatment Plant, Springboro, Ohio

Pacific Northwest Pollution Control Association - Division B, Zero Lost-time Accident Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1990

Georgia Water Pollution Control Association - Plant of the Year Award
Albany Wastewater Treatment Plant, Albany, Georgia

Environmental Protection Agency, Region VI - Award for Environmental Excellence - Pretreatment Programs
Chickasaw Wastewater Treatment Plant, Bartlesville, Oklahoma

Ohio Water Pollution Control Association - George W. Burke Safety Award
Franklin Area Wastewater Treatment Plant, Franklin, Ohio

Zimpro/Passavant Company - Plant of the Year Award
Great Falls Wastewater Treatment Plant, Great Falls, Montana

Pacific Northwest Pollution Control Association - Division B, Zero Lost-time Accident Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1989

Georgia Water Pollution Control Association - Plant of the Year Award/Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

Environmental Protection Agency, Region IV - Award of Excellence for Beneficial Sewage Sludge Utilization
Albany Wastewater Treatment Plant, Albany, Georgia

Ohio Water Pollution Control Association - George W. Burke Safety Award
MCD North Regional Wastewater Treatment Plant, Dayton, Ohio

Massachusetts Water Pollution Control Association - Operations & Maintenance Excellence Award - Honorable Mention
Leominster Wastewater Treatment Plant, Leominster, Massachusetts

Department of Ecology - Washington State - Operations & Maintenance Excellence Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1988

Environmental Protection Agency, Region IV - Operations & Maintenance Excellence Award Finalist
Albany Wastewater Treatment Plant, Albany, Georgia

Ohio Water Pollution Control Association - Safety Certificate
MCD North Regional Wastewater Treatment Plant, Dayton, Ohio

Ohio Water Pollution Control Association - State Safety Award
MCD North Regional Wastewater Treatment Plant, Dayton, Ohio

Ohio Water Pollution Control Association - State Safety Award
Franklin Area Wastewater Treatment Plant, Franklin, Ohio

Ohio Water Pollution Control Association - Safety Certificate
Franklin Area Wastewater Treatment Plant, Franklin, Ohio

Environmental Protection Agency, Region I - Operations & Maintenance Excellence Award
Leominster Wastewater Treatment Plant, Leominster, Massachusetts

Pacific Northwest Pollution Control Association - Division B, Safety Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

Pacific Northwest Pollution Control Association - Division B, Zero Lost-time Accident Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1987

Environmental Protection Agency, Region IV - Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

Georgia Water Pollution Control Association - Plant of the Year Award/Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

Georgia Water Pollution Control Association - George W. Burke Safety Award
Albany Wastewater Treatment Plant, Albany, Georgia

Ohio Water Pollution Control Association - Safety Certificate
MCD North Regional Wastewater Treatment Plant, Dayton, Ohio

Ohio Water Pollution Control Association - Safety Certificate
Franklin Area Wastewater Treatment Plant, Franklin, Ohio

Massachusetts Department of Environmental Quality Engineering - Operations & Maintenance Excellence Award
Leominster Wastewater Treatment Plant, Leominster, Massachusetts

Pacific Northwest Pollution Control Association - Division B, Zero Lost-time Accident Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1986

Georgia Water Pollution Control Association - Plant of the Year Award/Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

San Francisco/San Mateo County Safety Council - Award of Merit, Program for the Achievement of Outstanding Ratio of Hours Worked to Lost-time Accidents
Burlingame Wastewater Treatment Plant, Burlingame, California

New York Water Pollution Control Association - Safety Award
Poughkeepsie Wastewater Treatment Plant, Poughkeepsie, New York

Pacific Northwest Pollution Control Association - Division B, Zero Lost-time Accident Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1985

Georgia Water Pollution Control Association - Plant of the Year Award/Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

San Francisco/San Mateo County - Safety Council Award of Honor
Burlingame Wastewater Treatment Plant, Burlingame, California

San Francisco/San Mateo County - Safety Council Award of Merit, Program for the Achievement of Outstanding Ratio of Hours Worked to Lost-time Accidents
Burlingame Wastewater Treatment Plant, Burlingame, California

New York Water Pollution Control Association - Regional Safety Award
Poughkeepsie Wastewater Treatment Plant, Poughkeepsie, New York

Pacific Northwest Pollution Control Association - Division B, Zero Lost-time Accident Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1984

San Francisco/San Mateo County - Safety Council Award of Merit, Program for the Achievement of Outstanding Ratio of Hours Worked to Lost-time Accidents
Burlingame Wastewater Treatment Plant, Burlingame, California

Pacific Northwest Pollution Control Association - Division B, Zero Lost-time Accident Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1983

Pacific Northwest Pollution Control Association - Safety Award
Eastside Wastewater Treatment Plant, Vancouver, Washington

Pacific Northwest Pollution Control Association - Safety Award
Westside Wastewater Treatment Plant, Vancouver, Washington

▪1982

Georgia Water Pollution Control Association - Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

California Water Pollution Control Association - Safety Award
Burlingame Wastewater Treatment Plant, Burlingame, California

Pacific Northwest Pollution Control Association - Regional Safety Award
Westside Wastewater Treatment Plant, Vancouver, Washington

Pacific Northwest Pollution Control Association - Division B. Zero Lost-time Accident Award
Vancouver Wastewater Treatment Plant, Vancouver, Washington

▪1981

California Water Pollution Control Association - Safety Award - First Place Program
California Wastewater Treatment Plants

Pacific Northwest Pollution Control Association - Safety Award
Eastside Wastewater Treatment Plant, Vancouver, Washington

▪1978

Georgia Water Pollution Control Association - Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

▪1977

Georgia Water Pollution Control Association - Operations & Maintenance Excellence Award
Albany Wastewater Treatment Plant, Albany, Georgia

WHEELABRATOR EOS WATER AND WASTEWATER FACILITIES

Facility	Client Name & Address	Phone No.	MGD	Facility Type	Start Date	Project Type
Albany, GA	Robert Merton Director for Public Works City of Albany, City Hall P.O. Box 447 Albany, GA 31703	(912) 883-6950	20	WWTP Secondary	1985	Mainte-nance
Atlanta-Fulton County Water Resources Commission, Atlanta, GA	Michael Leonard, General Manager Atlanta/Fulton County WRC 9750 Spruill Road Alpharetta, GA 30201	(404) 664-7455	56	Water	1991	Full O&M
Bartlesville, OK	John H. Miller, City Engineer City of Bartlesville P.O. Box 699 Bartlesville, OK 74005	(918) 337-5235	7	WWTP Secondary	1986	Full O&M
Bedford Hills Correctional Facility, Bedford Hills, NY	David Viola, Contract Manager Hueber-Breuer and Viola P. O. Box 159 Bedford Hills, NY 10507	(914) 244-3428	0 50	Trickling Filter	1994	Full O&M
Burlingame, CA	Ralph Kirkup, P.E. Public Works Director City of Burlingame, City Hall 501 Primrose Road Burlingame, CA 94010	(415) 696-7230	5	WWTP Secondary	1972	Full O&M
Colorado River Sewage System Joint Venture Parker, AZ	Lawanda Laffoon, Chairman Colorado River Sewage System Joint Venture P. O. Box 628 Parker, AZ 85344	(520) 669-9821	1.2	WWTP	1994	Full O&M
East Aurora, NY	Jerry Hiller, Village Manager Village of East Aurora 571 Main Street East Aurora, NY 14052	(716) 652-6000	3.5	WWTP	1995	Full O&M
Fort Devens, MA	Phyllis M. Loiselle Contracting Officer Directorate of Contracting Building 227 Fort Devens, MA 01433-5340	(508) 796-2025	5.18	Water	1995	Full O&M
Fort Dix, NJ	Monica Heltz, Contract Administrator Department of the Army AFTZ-DOC (Building 5418) Fort Dix, NJ 08640-6150	(609) 562-5271	4 6	WWTP Secondary	1995	Full O&M
Franklin, OH	James L. Rozelle General Manager & Chief Engineer Miami Conservancy District 38 East Monument Avenue Dayton, OH 45402	(513) 223-1271	4.5	WWTP	1987	Own and Operate

WHEELABRATOR EOS WATER AND WASTEWATER FACILITIES (Continued)

Facility	Client Name & Address	Phone No.	MGD	Facility Type	Start Date	Project Type
Great Falls, MT	John Lawton, City Manager City of Great Falls, Civic Center P.O Box 5021 Great Falls, MT 59403	(406) 771-1180	10	WWTP (AWT)	1977	Full O&M
Lecheria, MX	Ing. Jorge Molina Riquelme General Director Compañia Mexicaña de Aguas Montes Urales No 760 Piso 1 Lomas de Chapultepec, MX, D F 11000	(011) 525-886-1632	9.13	WWTP Water Reclamation	1994	Own and Operate
Leominster, MA	The Honorable Dean J Mazzarella Mayor of the City of Leominster City Hall, 25 West Street Leominster, MA 01453	(508) 534-7500	9.3	WWTP (AWT)	1983	Full O&M
Lynn, MA	Robert Tina Contract Administrator Lynn Water & Sewer Commission 400 Parkland Avenue Lynn, MA 01905	(617) 592-7048	26	WWTP Secondary	1985	Full O&M
Massachusetts Water Resources Authority (MWRA) Deer Island, MA	Dave Ferguson, Project Manager Healy/Modern Continental 190 Taft Avenue Winthrop, MA 02152	(617) 539-0150	10.8	Water	1995	Full O&M
MCD - Dayton, OH	James L. Rozelle General Manager & Chief Engineer Miami Conservancy District 38 East Monument Avenue Dayton, OH 45402	(513) 223-1271	11.2	WWTP	1985	Full O&M
North Haven, CT	Richard Branigan Director of Public Works Town Hall, 18 Church Street North Haven, CT 06473	(203) 239-5321	4.5	WWTP (AWT)	1991	Full O&M
Oaks, PA	Fred Walker, Chairman LPVRSA, 5 River Road Oaks, PA 19456	(610) 666-0623	8.7	WWTP (AWT)	1994	Full O&M
Petaluma, CA	Tom Hargis, P E Director of Engineering City Hall, 11 English Street P.O. Box 61 Petaluma, CA 94953	(707) 778-4345	5.2	WWTP Secondary	1979	Full O&M
Poughkeepsie, NY	Richard Marino, City Engineer City of Poughkeepsie Department of Public Works Civic Center Plaza Poughkeepsie, NY 12601	(914) 451-4109	10	WWTP Secondary	1980	Full O&M

WHEELABRATOR EOS WATER AND WASTEWATER FACILITIES (Continued)

Facility	Client Name & Address	Phone No.	MGD	Facility Type	Start Date	Project Type
Powder Mill, MA	Irene Gruber, Property Manager Atlantic Management Corp. 40 Speen Street Framingham, MA 01701	(508) 626-0025	0.01	Water	1990	Full O&M
Sioux City, IA	Paul Nolan, Utilities Director City of Sioux City P.O. Box 447 Sioux City, IA 51102	(712) 279-6222	30	WWTP	1995	Full O&M
Springboro, OH	Brad Townsend Assistant City Manager City of Springboro 320 West Central Avenue Springboro, OH 45066	(513) 748-1041	2.16	Water	1990	Full O&M
Springboro, OH	Brad Townsend Assistant City Manager City of Springboro 320 West Central Avenue Springboro, OH 45066	(513) 748-1041	2	WWTP	1990	Full O&M
Sturbridge, MA	James Malloy, Town Administrator Town of Sturbridge P.O. Box 227 308 Main Street, Route 131 Sturbridge, MA 01566	(508) 347-2500	0.5	WWTP Secondary	1989	Full O&M
Sturbridge, MA	James Malloy, Town Administrator Town of Sturbridge P..O. Box 227 308 Main Street, Route 131 Sturbridge, MA 01566	(508) 347-2500	1.6	Water	1989	Full O&M
Tupelo, MS	Denise Farrar Contract Administrator Northeast Mississippi Regional Water Supply District P.O. Box 7118 Tupelo, MS 38802	(601) 844-0807	12	Water	1991	Full O&M
Vancouver, WA	Victor Ehrlich, P.E., City Engineer Vancouver City Hall, P.O. Box 1995 Vancouver, WA 98660	(206) 696-8008	15.2	WWTP (AWT)	1978	Full O&M
Westborough, MA	Raymond E. Welsh Chairman, Westborough Treatment Plant Board 238 Turnpike Road Westborough, MA 01581	(508) 366-7615	7.7	WWTP (AWT)	1990	Full O&M
Wilmington, DE	James C. Holloway, Jr., Commissioner Department of Public Works City of Wilmington 800 French Street Wilmington, DE 19801	(302) 571-4220	90	WWTP Secondary	1985	Solids Handling, Mainte-nance

WHEELABRATOR EOS WATER AND WASTEWATER FACILITIES (Continued)

Facility	Client Name & Address	Phone No.	MGD	Facility Type	Start Date	Project Type
Woodmere, OH	Randy Kertesz, President Woodbran Realty, Inc. 3439 West Brainard Street Suite 260 Woodmere, OH 44122	(216) 831-9110	0.5	WWTP (AWT)	1989	Full O&M

WHEELABRATOR EOS INDUSTRIAL FACILITIES

Facility	Client Name & Address	Phone No.	MGD	Facility Type	Start Date	Project Type
Caterpillar, Inc. Mossville, IL	Jack Hippen, Purchasing Caterpillar, Inc. Mossville, IL 61552-0600	(309) 578-8313	0.80	WWTF	1995	O&M
Chrysler Canada, LTD, Bramalea, Ontario, Canada	Doug Casselman Environmental Coordinator Chrysler Canada, LTD. 2000 Williams Parkway East P.O. Box 2500, Bramalea, Ontario CANADA L6T 4Y6	(905) 458-2770	0.80	Metals Removal Plant	1987	Full O&M
General Motors Corporation, Oshawa, Ontario, Canada	Jerry Kehoe, Manager Wastewater Environmental Affairs General Motors Corporation 1908 Colonel Sam Drive Oshawa, Ontario CANADA L1H 8P7	(905) 644-5497	2.00	Metals Removal Plant	1992	Full O&M
IBM Southbury, CT	Susan Callaghan AXIOM Real Estate Management 150 Kettletown Road Southbury, CT 06488	(203) 262-3596	0.08	Tertiary WWTP	1988	Full O&M
Pepsi-Cola Somers, NY	Cesare Corte Facility Services Manager Pepsi Cola Company Routes 35 & 100 Somers, NY 10589	(914) 767-7331	0.08	Tertiary WWTP	1988	O&M
Rocky Glen Mill, Newtown, CT	Sandra Wright The Glen Mill Corp. 75 Glen Road Sandy Hook, CT 06482	(203) 674-5639	0.01	Tertiary WWTP	1986	Full O&M
United Airlines, San Francisco Airport, CA	Bobby Vance Engineering Staff Representative United Airlines MOC, Bldg. 49 San Francisco Airport, CA 94128	(415) 634-4551	0.70	Metals Removal Plant	1991	Full O&M
Vancouver, WA	Victor Ehrlich, P.E. City Engineer Vancouver City Hall P.O. Box 1995 Vancouver, WA 98660	(206) 696-8008	3.20	IPP	1978	Full O&M

WHEELABRATOR EOS GROUNDWATER TREATMENT FACILITIES

Facility	Client Name & Address	Phone No.	GPM	Facility Type	Start Date	Project Type
Industrial Wastes, Inc., Darlington, PA	Randolph Harper Manor Care, Inc. 10770 Columbia Pike Silver Springs, MD 20901	(301) 593-9600	300	Leachate Treatment	1982	Full O&M
Kin-Buc Landfill, Edison, NJ	Richard Karr Waste Management, Inc. Three Greenwood Square 3329 Street Road Ben Salem, PA 19020	(215) 244-9514	300	Groundwater Treatment	1995	Full O&M
Mill Creek Superfund Site, Erie, PA	Gary Lang, P.E. U.S. Army Corps of Engineers Baltimore District Greater Pittsburgh Int'l Airport 316 Defense Avenue Coraopolis, PA 15108-4403	(412) 474-8134	100	Groundwater Remediation	1991	Full O&M
Pinney Dock & Transport Company, Ashtabula, OH	Joseph DelPriore Pinney Dock & Transport Company 1149 E. Fifth Street Ashtabula, OH 44004	(216) 964-7186	30	Leachate Treatment	1990	Full O&M
Sawyer AFB, MI	Ray Lane, P.E. U.S. Army Corps of Engineers Badger Area Office Schroeder Madison, WI 49843	(608) 269-7491	1500	Groundwater Remediation	1994	Full O&M
Shaw AFB, SC	Michael Sydow, P.E. U.S. Army Corps of Engineers Savannah District P.O. Box 889 Savannah, GA 31402	(912) 652-5658	70	Groundwater Remediation	1992	Full O&M
U.S. Steel, Tabernacle Drum Dump Site, Tabernacle, NJ	Tony Nuzzo U.S. Steel Company 600 Grant Street Pittsburgh, PA 15219	(412) 433-6336	180	Groundwater Treatment	1993	Full O&M

PREPARED STATEMENT OF AL BILIK

Good afternoon. I am Al Bilik, President of the AFL-CIO Public Employee Department. Thank you for this opportunity to present my views on privatization.

PED comprises 35 international unions representing 4.5 million members in the public sector, providing diverse services such as transportation and waste water treatment. Our members provide public services on a daily basis. They know that privatization can serve as a panacea only for the financially near-sighted and as a disguise for poor management of our infrastructure's assets.

Conservatives encourage accelerated privatization, including the sale of our public assets to corporations. However, the Public Employee Department urges this Congress to conduct due diligence as it evaluates privatization. Our citizens should be warned : privatization promises a simple and compelling solution to the complex, multi-faceted and chronic fiscal crisis which now plagues American government. Privatization promises salvation through enhanced workplace efficiency in the production and delivery of services. Conservatives argue that private corporations can provide less expensive alternatives to the costs of public service. The incentives supposedly induced by private ownership -- cost minimization and risk taking -- must be examined closely. I urge the committee to set aside ideology, look at the facts and seek alternative solutions.

Proponents argue that privatization can provide state and local governments significant savings. As Richard Hebdon of Cornell University notes in his review of the Lauder Report (the New York State Senate Advisory Commission), “unfortunately ideology still seems to be the guiding principle of privatization research” (*Labor Studies Journal*, Spring 1995). While alternatives such as labor-management cooperation can improve public services, the Lauder Report ignores that option. Hebdon reviews the academic literature contained within the 1992 Lauder Report and finds that the studies' cost data is 20 to 30 years old. The Lauder Report primarily relies upon one article from 1984, which fails to present the full results of the author's statistical analysis. The author's analysis contains potential statistical biases regarding sample size and selectivity. In addition, the article's intent is to promote privatization, not provide objective analysis.

Estimates of privatization savings range from 16 to 77 percent. Local governments frequently target mass transit for privatization in search of those savings. However, research by Columbia University professor Elliot Sclar shows that while some initial incremental savings may be found after contracting-out, by the second round of contracting those savings disappear. This was clearly shown in Denver where he found:

> virtually no cost difference between public and private operating costs. The differences ranged from a high of 4 percent down to a low of seven-tenths of one percent ... (but) the Auditor did not account for the fact that .. the private operators kept the fare revenue. When that revenue loss is added to the operating cost, the Denver privatization is actually losing around $4.25 per revenue hour. (Elliot Sclar Statement before the Illinois Senate Transportation Committee, January 18, 1996.)

While privatization proponents argue that regulations, such as UMTA Section 13(c), inhibit privatization, cities such as Denver, Dallas, New York, San Diego and counties such as San Mateo, California and Sonomish, Washington have both private and public entities operating within each system.

Privatizing public infrastructure poses the greatest risk to taxpayers. When President Bush issued Executive Order 12803 in April 1992 urging states and local governments to privatize infrastructure assets such as tunnels, bridges and water treatment facilities, there were responses from various sources. The AFL-CIO issued a statement that placed the 13-million member federation in strong opposition: "Privatization of public assets is a recipe for disaster at a time when the nation's infrastructure is in a state of severe decline.... It is proven bad policy for government to turn over public facilities to private operators that place a top priority on making money, not serving the public." The *Chicago Sun Times* in an April 30, 1992 editorial cautioned the city: "Don't rush to make public works private. It was a private contractor that drove the pilings that flooded downtown. Rushing into privatization before understanding everything involved ... is an overreaction." That was generally the response from local governments and states to the Bush Order.

Caution regarding privatization prevailed until the Environmental Protection Agency began to encourage communities to give up control of their water treatment facilities. In 1991, waste water specialist Randall Holcombe found that most municipalities which contract with private firms passed both the cost of production and much of the risk of operating the business onto the local government *(Public Budgeting and*

Finance, Fall 1991). On July 11, 1995, new ground was broken when the Franklin, Ohio Regional Waste Water Treatment Plant was approved by EPA and OMB for transfer to the Waste Management, Inc. subsidiary, Wheelabrator, Inc., for $5,984,704. An added $840,293 was paid to lease the site for 20 years. The transaction did not involve competitive bidding, and the price was established by a technique known as the "original cost less depreciation" method. None of the net proceeds was returned to the federal government. The entire payment was retained by the local government involved. The Bush Executive Order allows proceeds to be used to reduce taxes and debt at the local level.

The Wall Street Journal hailed the Franklin transaction on October 2, 1995, reporting that "Wheelabrator and the others are hoping... for similar deals elsewhere... it is established that there are more than $30 billion in waste water treatment facilities currently in government hands." The others referred to are two giant French firms, Compagnie Génerále des Eaux (CGE) and Lyonnaise des Eaux, the latter having earlier negotiated a management contract with the City of Indianapolis. While those firms provide 75 percent of France's municipal population with drinking water and 40 percent with sewage services, they have been charged with generally corrupting municipal elections in France. *Public Works Financing,* in its June 1994 issue, reported that CGE and Lyonnaise were accused of causing "80 percent of the political corruption in France" through their funding of candidates in municipal elections. The French parliament in January 1995 adopted a law that "prohibits businesses from contributing to any political campaigns in any way."

The Economist on August 19, 1995 added New York, Trenton and Orange County to the short list of local governments seeking quick-fix budget solutions. The city of Wilmington, Delaware, desperately trying to get out of debt, is currently negotiating with Wheelebrator to operate and maintain their waste water treatment plant. According to the November issue of *Public Works Financing,* the 20-year deal will cost the company $53 million. Wilmington has apparently decided to cede the direction of replacement capital to the private firm.

However, cities like Wilmington and Franklin still bear the ultimate risks. Waste water treatment is absolutely critical to public health and environmental safety. Bacteria and viruses thrive in raw sewage. Acts of nature such as floods and storms can force industrial waste releases. Furthermore, under many existing private operations and management contracts, local governments continue to cover capital costs, debt retirement, property insurance and ownership and administration. When vital public services are at stake, the government is always ultimately liable for the health and well being of its citizens whether or not it technically owns the facility.

It's necessary to ask some questions about the players and the transactions. We know about the communities, but what about the transactions? Was the Franklin deal truly based on fair market value? Was there a formal appraisal and accounting of the actual market value of the plant? A recent report reveals that the 1990 sale by the British government of twelve regional electric utilities for £5 billion was in fact a steal for the companies. *Euromoney* for November 1995 now estimates the value at £20 billion. Serious questions are being asked. Simon Taylor, a utilities analyst with J P Morgan in London, commented: "Only now is it becoming clear just how cheaply they were sold." It's late for the British, but are we adequately protecting ourselves against similar disasters? We should request a review by the General Accounting Office, an objective source of critical analysis.

Will the federal government, which has contributed so heavily in the past to our infrastructure development, be adequately compensated by the projected sales? The Franklin experience sends a clear signal that it is relatively easy to forego federal claims by administrative leap-frog. Now we see legislation being considered that would not only exclude the federal government as a recipient of any of the profits of such sales; it would explicitly **prohibit the federal government from setting standards for the operation and maintenance of public infrastructure.**

In recent years, the United States has witnessed an unprecedented erosion of our physical infrastructure. Our highways and sewer systems are crumbling, bridges are collapsing, airports are overcrowded, and rail rights-of-way are in a state of disrepair. During the 1980's the U.S. was spending 1.6 percent of GDP on infrastructure, Germany was spending 4.7 percent and Japan 6.3 percent. To equal Germany's investment would require that we now spend $175 billion annually. But the solution to this decline is not to hand over federal responsibility for financing and operating of infrastructure to the private sector. We believe that the situation will only worsen if states and localities sell off major public facilities to private companies in exchange for quick cash to settle debts or pay for other public services.

Proponents of privatization argue that public infrastructure needs massive investment. The federal government won't be forthcoming with the funds, so states and localities must turn to the private sector. Private firms will put up the capital as long as they can operate the enterprise and obtain a market rate of return. But in order to assure a market rate of return, the private sector will be inclined to raise user fees. In Indianapolis, the Airport Authority has signed a 10-year comprehensive management contract with BAA USA. *Public Works Financing* reported in June 1995 that while the company will be "fully at risk for its guaranteed savings" the contract does not require a large capital commitment from the company. Indianapolis' Mayor Steve Goldsmith agreed to "take the city's share of any winnings [cost savings] in the form of customer goodwill and long-term economic efficiency gains." If public employees in other city departments can work with management to maintain efficient, quality public services, why does the Authority have to contract-out management of the airport ? In fact, BAA is required only to share 25 percent of its savings with the Airport Authority once it successfully generates savings of $6 million a year. To do so, the company will have to establish the lowest cost base in the country and produce exceptional revenues from ancillary services, such as retail sales.

Putting America's infrastructure on the auction block will only serve to harm ordinary Americans, businesses and communities by making public facilities more expensive and less accessible. Low-income households would be particularly harmed by the ensuing higher user fees. Although the privatizers say that the facility should continue to be used for its original purpose after it has been turned over to the private sector, they don't specify who is to determine how long a facility will be needed for its original purpose. Once privatized, facilities such as recycling centers, water treatment plants, hospitals, and schools could be converted to other uses whenever the new owners determined that they are no longer needed for their original purpose. In the event that a private firm cannot make a profit with a public facility, it may be forced into bankruptcy. Under such a circumstance, the government -- and, ultimately, the taxpayers -- will be held liable. We could end up with a situation much like the savings and loan debacle, with the taxpayers forced to bail out the private firm.

Another downside to asset privatization is that states and localities will be tempted to sell off assets as a quick fix to their financial woes -- without addressing the underlying causes of their fiscal problems. After years of selling off assets to balance their budgets, states and localities eventually could be faced with severe revenue shortfalls. A fiscal crisis could ensue after these stop-gap gimmicks of selling off assets run their course.

The Public Employee Department believes that the federal government should put a stop to any further efforts to privatize public facilities. We urge the Congress to reject legislation such as H.R. 1907 and S. 1063, which value private profit over public service. We also urge President Clinton to rescind the Bush Executive Order 12803 and to instruct the federal departments to grant no waivers regarding federal rights. This action would be more in the public interest than enacting any legislation that would expand and codify the Bush Executive Order.

PREPARED STATEMENT OF ALBERT SHANKER

Mr. Chairman and Members of the Committee:

I am Albert Shanker, president of the American Federation of Teachers, AFL-CIO, which represents 885,000 teachers and school staff at all levels of the education system, as well as state and local government employees and healthcare professionals. I appreciate the chance to speak to you today about privatization in education.

What's the Real Problem with Schools?

Privatization is not a new idea for fixing public schools. It's been around for a long time. Proponents of privatization see public schools as a monopoly, and it's always easy to get applause by knocking monopolies. The theory is that monopolies don't produce good results because there's no competition, and without competition, the monopoly has no incentive to strive for quality or efficiency. The obvious conclusion, then, is to inject some good, old-fashioned private-sector competition into the public school system.

There's only one problem with this theory, and that is that there is no evidence that it works. So I think it's important to start by taking a look at why people are dissatisfied with our public schools. Are parents and the public saying get rid of the public school monopoly? No. Are they clamoring for vouchers or private managers? No. In fact, the public -- when given a chance to vote on it in California, Oregon, Colorado, and DC -- has emphatically rejected vouchers.

What do parents and the public say they want? Two things: discipline and academic standards. They've been saying this for at least ten years, but politicians and would-be reformers haven't been listening. They're still not listening.

What parents and the public want are schools that are safe and orderly enough for learning to take place and that set high academic standards for all students. Recent polls, particularly two very interesting studies by the nonpartisan research group Public Agenda, show overwhelming support for greater discipline and higher standards, including among minority parents and those who consider themselves "traditional Christians." Here are a few figures from "First Things First," the first Public Agenda study:

- Sixty-one percent of Americans said that academic standards are too low in their schools, with 70 percent of African-American parents with children in public schools agreeing.
- Eighty-two percent supported setting up "very clear guidelines on what students should learn and teachers should teach in every major subject," with 92 percent of African-American parents and 91 percent of traditional Christian parents agreeing.
- Seventy percent want to raise standards of promotion from grade school to junior high, letting students move ahead only when they pass a test showing they have met the standards.

Other polls show that these views are also widely supported by teachers and the business community. In a second study, called "Assignment Incomplete," Public Agenda further probed the public's views on school reform, asking a number of questions comparing public and private schools. What they found people liked about private schools was not competition or freedom from monopoly. They believe that private schools are more orderly and disciplined than public schools, and that they have higher academic standards.

When Public Agenda offered a series of proposed solutions for failing public schools, 48 percent of respondents said they wanted to "overhaul the public schools" and "increase the money public schools get," versus 10 percent who favored private management and 28 percent who wanted vouchers. A 1995 Gallup poll on education found that 65 percent of respondents opposed allowing students to attend private schools at public expense.

How should we respond? By giving the public what it doesn't want -- vouchers and private management? Or by making the common-sense changes parents and the public are asking for in public schools: order, discipline, and high standards? Public schools can do these things. It's public policies that made them stop, and so it's public policies -- not privatization -- that can restore discipline and standards.

The Crucial Role of Standards

If I were a businessman and I saw someone else in the same business putting out a better product than mine, I'd sure want to know what the other guy was doing and maybe try to steal some of his ideas. So let's look at the school systems of OECD countries that do a better job with their students. What do we see? Monopolies. And, moreover, the most reviled sort of monopolies -- government monopolies!

Other countries whose students routinely outperform ours all have education systems that are monopolies, centrally directed or coordinated by their national governments. Not a single one of these countries uses competition or private management or vouchers as an instrument of educational improvement. And not a single one has considered dismantling or selling off their public school systems, which is what some are advocating here.

What all of these countries have in common are a system of clear, common, and rigorous academic standards for all students, at least through their equivalent of our ninth or tenth grades, a set of national or nationally coordinated tests to see if students are meeting the standards, and incentives for students to work hard in school. In these other countries, unlike here, good advanced training or apprenticeships, good jobs, and university admission all depend on doing well in school. Students -- and their parents and teachers -- know what's expected of them in school, and they know that there will be serious consequences in their lives if they fail to meet the standards. Moreover, since the primary mission of schooling in these countries is academic, students who constantly disrupt classes are suspended or put in alternative placements, so that those who want to learn can do so.

A few of these other countries do subsidize private and religious schools. But the important point is that the state requires private and religious schools to operate according to the same standards as public schools. They must use the same curriculum and the same tests. They get roughly the same level of funding and pay the same teacher salaries as public schools. They are highly regulated within highly centralized education systems. To do that here would breach the wall of separation between church and state; destroy the independence of independent schools; and add to government regulation and costs. It's unthinkable here, given our traditions. Yet without doing these things to ensure accountability, quality and equity, we will further fragment a system that is already dangerously fragmented.

The main exception to these basic operating principles of OECD systems is England, which is actually trying some of the choice and competition experiments proposed here and finding mixed results.

Well, why am I beating the drum for standards again, when your topic is privatization? Because I believe that the effort to privatize schools is completely misguided and destructive. It will erode, not improve, the quality of education and student achievement. I'm arguing that discipline and a system of standards, assessments, and incentives for students are the most essential reforms our schools need right now, and they're standard operating procedure in other successful school systems.

We know that such standards-based systems work in other countries. And standards and discipline are what characterize good schools in this country, public and private. I believe that it is irresponsible and immoral for us to continue ignoring what works while pressing for unproved fads. It's time to stop fooling the public by promising them that privatization panaceas with no evidence of success behind them are the answer to the problems in our public schools. Let's do for all students what we now do only for some students, usually those in more affluent communities, and what other countries do for all their students.

The Promise of Privatization

A leading assumption behind privatization efforts is that competition and private-sector know-how will make public schools more efficient. But there is a large body of literature showing that the assumption is baseless. Here are a few examples.

One recent study found "only weak and inconsistent evidence" for the proposition that competition among schools increased efficiency and concluded that "reforms aimed solely at increasing competition among schools could be ineffectual " ("On Competition and School Efficiency," by S. Grosskopf, K. Hayes, L. Taylor, and W. Weber, Research Dept., Working Paper 95-06, Federal Reserve Bank of Dallas, August, 1995). Others demonstrate that a voucher system would dramatically increase education costs and shift these costs from the private to the public sector (e.g., "Estimating the Costs of an Educational Voucher System," by H. Levin and C. Driver, National Center for Education Statistics, March, 1994). Yet another argues that "markets are not always more efficient than internal production, especially when the product in question -- public benefits in one area or another -- is hard to measure and control. The transaction costs involved in regulating private producers may well exceed any of the supposed gains in efficiency from a reduced public sector" ("Why Educational Vouchers May Be Bad Economics," by M. Krashinsky, *Teachers College Record*, Vol. 88, No. 2, Winter, 1986).

This last point about transaction costs is especially important because it is so often overlooked. Privatization and voucher schemes are more complex transactions than the market analogy suggests. There is a voluminous literature demonstrating that there are huge public costs involved in monitoring and evaluating the performance of private contractors and in running third-party payment systems, which is what a voucher system is. And rather than reducing bureaucracy, they increase it. These transaction costs are rarely discussed with the public until a crisis, like healthcare or the Department of Defense contractor scandals, brings them to light.

A Case Study in Private Management: Education Alternatives, Inc.

Let's look briefly at the track record of the only private company that has tried to manage public schools, Education Alternatives, Inc. (EAI). In Baltimore, they promised a dramatic improvement in student achievement in the first year, and they promised to do it for less money. What happened? Test scores went down in EAI schools, while they went up in other Baltimore schools. What did the superintendent and school board do? Nothing, in part because the superintendent was busy running around the country proselytizing for EAI.

What about the second year? EAI schools' test scores were still down. EAI came under investigation for violations of special education laws, and information from the school system showed that EAI increased class size, cut special education services, and took money away from classrooms to pay for corporate overhead. We learned that, not only was EAI failing to cut costs, it was getting about $500 more per student than other schools -- money that was drained from other Baltimore schools and is a big part of their current budget shortfall. Meanwhile, the company took home $2.6 million in profits.

In the third year, some test scores in EAI schools started to inch back up, but students are still behind where they were before EAI arrived. An independent evaluation by the University of Maryland/Baltimore County showed that EAI failed to deliver on most of its promises. When they couldn't raise test scores, the company touted its success in cleaning up the schools and supplying computers. But the UMBC evaluation showed that they didn't even do a very good job at that. The evaluation found few differences between EAI schools and other Baltimore schools -- and those schools didn't get any extra money.

EAI lied repeatedly about test scores and attendance figures, and when they were caught in their lies, claimed that they were simply "errors." They withheld financial information to the point that the Baltimore city council was forced to subpoena the company for its financial records. In Hartford, they booked the entire Hartford school district budget as revenue, even though they were managing only five schools and did not control the funds. This made the company look more successful on Wall Street than it really was, and city officials criticized the accounting maneuver as misleading and unethical. With no sense of irony, EAI is now claiming that the reason they failed in Hartford was that they didn't control the money they earlier claimed they controlled!

After three-and-a-half years, the Baltimore school board finally pulled the plug on EAI. Who gets to keep the computers is now the subject of a dispute, but there's no disputing the fact that Baltimore got less for more from EAI, not the reverse. The person who benefited most was EAI's executive, John Golle, who made lavish profits by taking public dollars out of Baltimore and trading his EAI stock in timely fashion.

EAI was recently kicked out of Hartford, as well, largely over a financial dispute. EAI is claiming millions of dollars in reimbursement, but the city says EAI agreed that they would only be paid if they could find savings in the school budget. Hartford taxpayers were outraged when EAI billed the city for thousands in first-class travel for EAI staff, public relations fees, and condominium rent. John Golle recently announced that he's now setting his sights on more affluent suburban districts.

The record of EAI demonstrates that private contractors can engineer profit through stock manipulation, inflated claims, and pocketing public funds taken from other schools -- all before a single student has shown improvement. The record also shows that EAI knew no more -- in fact, a lot less -- than public schools about how to improve student achievement.

Behind the zeal to privatize public schools is the assumption that there's a lot of fat to cut out of school budgets. We hear repeatedly that public education costs have gone up, while achievement has remained flat. But as EAI learned, there isn't a lot of fat. Most of the increase in education expenditures over the last twenty years has gone to special education and other hard-to-educate youngsters. In Baltimore, EAI made its profits not from bureaucratic excess -- in fact, no central office functions or staff were cut -- but by cutting special education and remedial services to disadvantaged students and by increasing class size, that is, by taking money out of classrooms. In Hartford, they didn't get paid because they couldn't identify any savings.

In sum, the case for privatization in education rests only on theory or ideology, not on facts. The facts, with respect to EAI, earlier privatization experiments called "performance contracting," and the Milwaukee voucher program, show that privatization is, at worst, a scandal and a disaster, and, at best, no improvement over the status quo. It has produced no improvement in student achievement, and, in some cases, has depressed it. And student achievement, after all, is our main problem in education. Privatization is a hope and a prayer, when what we need are reliable answers to our problem.

The Role of Public Education In a Democracy

Privatization arguments rest on the argument that education is primarily a private benefit and so best left to parent and private discretion. But in a democracy, education is, first and foremost, a public good. All taxpayers support education, not just the small number of families (somewhere around 27 percent) who actually have children in public schools. Why? Because in a democracy, all citizens have a stake in a well-educated populace and suffer from one that is ill educated. In a diverse and pluralistic country like ours, public schools are the glue that helps hold society together. If we privatize our education system, we would become the only nation on earth to abdicate our responsibility for socializing our young into the common values of our society and the shared duties of citizenship. The Founding Fathers had it right. Only with public education can you have both the unfettered pursuit of individual private interests and a free society.

Despite their dissatisfaction, Americans remain fiercely attached to their public schools. All the polls tell us they want them fixed, not abandoned. In a democracy, when you think the public is wrong, you need to make the case for why they're wrong. If you think they're right, you should give them what they want. The American Federation of Teachers believes that parents and the public are right, and that they should get what they want and what we know works, standards of conduct and achievement, not radical proposals for dismantling our public schools.

PREPARED STATEMENT OF COMMISSIONER BOB CRANMER

I. Introduction

A. Personal Background

- Good afternoon. I first would like to thank you for the honor and opportunity to address this committee today. I was recently elected to the board of commissioners in Allegheny County, Pennsylvania along with my running-mate, and incumbent commissioner, Larry Dunn. We were elected with a mandate from the electorate to systematically reduce the size of a county government which has grown unchecked for the past 25 years.
- My background includes nine years as an active-duty Army officer and as a manager with AT&T working through the period when the corporation transformed itself from the largest public utility in the world to now one of the most competitive and efficient.

B. County Background

- Allegheny County is one of the most populated counties in Pennsylvania. It covers 727 square miles and has a population of 1.3 million. The County has a budget of approximately $750 million.
- I ran for the position of County Commissioner because I believed that our county government was being mismanaged. This mismanagement resulted in an exorbitant tax burden. The voters thought so too for my election represented the first Republican led courthouse in Allegheny County since 1932.
- Recently, *Money Magazine* ranked Pittsburgh with the 3rd highest tax burden out of 100 cities. Last year Allegheny County was ranked with the 2nd highest property taxes in the United States.
- As a result the county has been experiencing a loss in residential and business investment, along with a massive loss in population to the surrounding counties. This need for exorbitant taxes is fueled by a requirement to feed what amounts to a mini state government.

II. Governing Allegheny County; Ideas for Redesigning Government

A. Running an Efficient Government

- It is very clear that to have a competitive region you must have competitive governments. As a result, on January 1, our first day in office, we cut property taxes by 20% and froze a haphazard real estate assessment system as part of a plan to make our region competitive again.

- To make our government more efficient we plan to implement the strategy of "managed competition" which has been used across the country in cities like Indianapolis and Milwaukee. Allegheny County's "managed competition" strategy will be a comprehensive effort to let private sector companies compete with government workers to deliver services. We expect the principal benefits of this strategy to be a lower cost of government, a lower tax burden and increased responsiveness of government to the citizens.
- For Allegheny County to use this and other privatization approaches, the federal government must adjust its regulatory position with state and local governments.

III. Federal Barriers to Privatization

A. Overview

- The County relies on significant federal dollars to fund its mass transit, airports, children & youth services, nursing homes, juvenile programs, and Community Development Block Grant programs.
- When we first examined the County budget we soon understood that, in some program areas, cuts could be made because of the incentives set up by various federal agencies.
- Some programs are matched by federal grants - ranging from 1 to 1 match, to 29 to 1 match - of federal to local funds. For example, in order to save $1 in County money, we might have to give up $10 in federal money - a financial constraint that is difficult to convey to the tax payers. This system rewards high spending while ignoring efficiency and performance.
- Children & Youth Service programs are a prime example. If we contracted out more of these programs the county would not benefit from the bulk of the savings. Consequently, the pressure to continue the service delivery directly by various government bureaus is great.

B. Mass Transit System - The Allegheny County Port Authority

- As you know, Section 13(c) or the Federal Transit Act provides labor protection provisions for employees of public transportation systems and it is an extremely complex federal requirement. It is currently administered by the U.S. Dept. of Labor.

- The Department of Labor generally requires an approval of an application for federal public transit assistance funds by labor unions before funds are released, in effect giving labor unions control over when applications for funds are approved. This power gives unions the ability to use the 13(c) certification process as a bargaining tool for other unrelated labor issues. Attempts to contract out unrelated services can thereby be held hostage.
- Currently, 13(c) is administered by the Department of Labor and not the Federal Transit Administration. This adds an unnecessary layer of bureaucracy to an already complex process. The Federal Transit Administration, along with awarding grant funds, should assume administrative responsibilities for the 13(c) certifications.
- Historically the certification process has been delayed because of the time period given to unions to raise objections and for the delay caused by the Department of Labor's slow response time. While recent labor department regulations are intended to speed up the process it is not know how effective they will be. This process creates needless delay and substantial uncertainties for transit agencies attempting to implement projects. This also boosts project cost to taxpayers while stifling innovative services.
- While the new regulations do streamline the process they are inadequate because the Department of Labor can still opt out, i.e. "the department retains the right to withhold certification, where circumstances inconsistent with the statute so warrant, until such circumstances have been resolved."
- Current 13(c) agreements deter privatization because they inhibit a transit authority's basic management rights to contract out to implement more efficient services.
- Finally, 13(c) specifies that any transit worker who loses his or her job due to subcontracting of any form has to be paid 6 years of severance pay. In short no employees can be let go in a cost effective manner due to any privatization effort.

C. Aviation - Constraints to Efficiencies

- Aviation savings do not benefit the County's budget because any cost savings must be maintained as aviation funds. If such cost savings were used to cut county taxes this action would be considered a diversion of funds by the Federal Aviation Administration, and thereby be disallowed.

- Full privatization of an airport is also heavily discouraged by current federal policies. According to an analysis by the Reason Foundation, there are two types of grants specified under the Airport & Airway Improvement Act of 1982: *"discretionary"* grants and *"entitlement"* grants. While the former may continue under a privatized airport, the latter will not.

D. Other Issues that Deter Privatization

- Because government entities are entitled to issue tax exempt bonds, they can entice investors to buy them at a lower interest rate. On the other hand, private entities cannot do this even if they perform the same functions, such as sewage treatment and are generally unable to offer tax exempt debt. This means that government entities have an built-in advantage over private entities in capital costs.

E. Conclusion

In closing, I thank you very much for granting me this opportunity to represent my views today and ask that you consider my testimony. On behalf of Allegheny County and other administrations I ask for your assistance in our attempt to reduce the cost of local government while we seek to increase efficiency and service overall delivery.

PREPARED STATEMENT OF MICHAEL BELL

My name is Michael E. Bell. I am President of BAA USA Incorporated which is headquartered in Sterling, Virginia. We are a subsidiary of London based BAA Plc. The parent company was originally called British Airports Authority when it was owned by the British Government from 1966 until it's privatization in 1987.

I have been employed by the British Airports Authority, BAA Plc. and BAA USA Inc. for over 21 years. I have held my current post in BAA USA for the past 5 years. I have extensive experience in training airline managers and in airline sales, economics and marketing.

THE AIRPORT PRIVATIZATION EXPERIENCE - BAA PLC.

Since privatization by a flotation on the London Stock Exchange in July, 1987, BAA Plc. has:

1) maintained safety and security as its top priority,
2) become extremely customer focused in the belief that profits flow from satisfied customers,
3) increased productivity every single year,
4) improved passenger service,
5) increased alternative sources of non-aviation revenue so that they now exceed landing fees,
6) reduced landing charges every single year as required by government regulation.
7) increased capital expenditures so that BAA owned airports will serve as the benchmark for all airports in the 21st Century. To achieve that goal, BAA is making capital improvements costing an average of $1.5 million per day.
8) learned to deal with airlines on a business to business basis, and
9) created an environment where employees are motivated and empowered to deliver their best work.

BAA Plc.'s stock is traded in the U.S. through A.D.R.'s and is quoted on the London, Sydney and Toronto stock exchanges.

BAA USA INC.

My company has two contracts in the United States.

1. Pittsburgh: BAA Pittsburgh Inc., a subsidiary of BAA USA Inc., has a contract as the master developer for the retail areas. Effectively this contract has privatized the management of the retail function and space within the airport facility. By applying the same customer satisfaction principles developed in the United Kingdom, we introduced to the U.S. a unique blend of branding, choice, competition and prices, which are guaranteed not to be even a penny more than that char-ed by the same outlets located off the airport. The result is per passenger spending at Pittsburgh continues to set new records for U.S. airports.

The retail program at Pittsburgh Airport has now become the qualitative standard by which other American airports are judged. Pittsburgh is very proud of the fact that it has the first airport in the U.S. to have such tenants as T.G.I. Fridays, Brookstones, The Nature Company, The Gap and many other internationally recognized brand name stores. The total number of tenants now exceeds 70 which includes 30 food outlets, three shoe stores and three rival news stores.

2. Indianapolis: BAA USA Inc. won a ten year contract that started October 1, 1995 to manage the Indianapolis Airport and five smaller airports. Because of our ability to reduce costs and increase non-airline related revenue sources, BAA was able to guarantee significant reductions in charges to the airlines over the ten year contract period. In additional, BAA will vastly improve the level of service to the airlines and their passengers.

The Indianapolis contract brings many benefits of full privatization which can be replicated by other cities and counties across the country. However, it is impossible for us or any private company to provide sufficient capital for comprehensive infrastructure development because of the limited duration of the contract.

It is important to note that the City of Indianapolis will not receive any direct financial reward by awarding the contract to BAA. However, the city will gain in other ways as it will cause:

1) smaller government,
2) better service to airlines and passengers thereby enhancing the attraction of doing business in the city, and
3) access to BAA's air service marketing skills.

PROBLEMS UNIQUE TO THE UNITED STATES

Many U.S. airport passenger facilities fall well below the standards found at the world's best airports.

Billions of dollars will be required to meet airport infrastructure financing requirements for the 21st Century. It is unlikely that either the government and/or the airlines will be able to provide all of the needed capital.

As a result of conditions attached to Airport Improvement Grants by the FAA, airport owners are not permitted to make a profit nor are they motivated to reduce costs or increase alternative revenue sources. This diminishes the quality of airport passenger services and increases airline costs.

Capital that is available is not being spent effectively as often the wrong things are built, or they become too expensive because they are designed to satisfy civic or mayoral pride rather than satisfying customer needs.

AIRLINE VIEWS

Airlines have a number of legitimate fears that must be addressed by the Congress and private sector providers. Successful private companies, including BAA, are customer obsessed - we profit only by satisfying our customers. It is with some deference therefore that I venture to suggest that some U.S. airlines are probably missing the point when they seek to maintain the status quo, i.e., retain existing grant conditions that prevent airport owners from making a profit. This condition is sometimes called "no revenue diversion" or the "closed loop system."

What airlines should really be demanding is better facilities, lower charges for the use of such facilities, and lower landing fees. All can be and are provided by the private sector worldwide. Undoubtedly landing fee charges will probably have to be regulated or controlled in some manner, but such oversight should under no circumstances be based on rate of return as such a standard will only stultify any incentive for management improvement.

EMPLOYEES

Typically it is not the fault of existing airport managers or employees that causes the problems I describe. Rather it is the environment that they work in and the procedures required by government bodies with regard to employment and procurement for example and the lack of direction and motivation referred to. In addition, it is not unusual for there to be political interference with regard to the appointment of contractors, the holders of senior posts and in a case I learned of recently even the color of the walls. The political process is often slow to make decisions and the aviation industry is a fast moving business.

Privatization on the other hand gives employees and management the opportunity to blossom and to discover their real talents.

CONCLUSION

Privately managed U.S. airports will result in reductions in costs, improvements in service and the expansion of alternative sources of income. It will also provide a source of capital and ensure that capital is spent effectively.

There are currently barriers to the introduction of private capital to U.S. airports, but it is possible to realize many of the benefits of private management even whilst those barriers remain. This is what has been done in Indianapolis where the added value brought by the private sector is shared with the airport owner. A proportion of that added value is guaranteed, and under the residual funding agreement that affectively ensures reducing costs to airlines as well as improved service.

PREPARED STATEMENT OF GOVERNOR PETE WILSON

To open, let me first thank the distinguished members of the Joint Economic Committee, and in particular, Chairman Mack for the opportunity to submit testimony for this hearing. In addition, I would like to recognize the efforts of Congressman McIntosh and Congressman Horn.

In my 1996 State of the State address I reiterated one of the main goals for my administration in this coming year -- to make California government more efficient and cost-effective, and to improve the quality of the service it delivers to taxpayers.

During my first term, I made a variety of changes to remake California's government. California's economy has rebounded due to the entrepreneurial spirit and creative enterprise of companies that compete and win in the world market. California's businesses must stand the rigorous test of competitive market forces, and so too must California's government.

For instance, rather than award all state employees with pay increases year after year, I instituted a program that rewards employees based upon merit, and on-the-job performance. In 1993, I furthered this effort by instituting "performance budgeting" for state agencies, beginning on a pilot basis with four state departments. Under this plan, no longer will state programs automatically receive additional funding year after year. Instead, it must be demonstrated that state programs are succeeding in their core functions: at tasks that matter.

These actions, however, are only the first steps. In many cases, it may not be enough to make government more efficient in doing what it has always done. We need to ask ourselves whether a government program is really the best way to solve a problem. Sometimes a government program, no matter how well run, is ineffective at best, and counterproductive at worst. I intend to make state government not just more efficient but also more effective. My Cabinet agencies and departments are now developing proposals to accomplish this goal.

Identifying possible state functions to open is a two step process. First, state agencies and departments must identify their core functions -- the irreducible and essential services that citizens demand, and must be performed by government to achieve the most effective result. And second, how best to accomplish the peripheral tasks that they are now obliged to perform.

There are several ideas that are the basis for our effort in California:

- All state government agencies and programs should be evaluated. We need to make state government compete. We must ask ourselves whether a state program or agency is really making a net contribution to the lives of people. If not, we should get rid of the program or agency. When dealing with taxpayers' money we should have no sacred cows. In the past, privatization efforts have focused primarily on the management of public assets and infrastructure. Indeed, while the private sector can many times measurably improve the management of these facilities, our efforts should not be limited, for instance, to the private management of state office buildings. In my 1996 State of the State address, I announced the creation of "Opportunity Scholarships," a pilot project to introduce competition to the worst performing of California's schools. In this program, children attending the bottom 5% of California's schools will be given a voucher that can be used to purchase education on a competitive basis, from the public sector or the private sector.

- Governments should not merely replace public monopolies with private monopolies. In general, old monopolies that are facing real competition are losing the battle. Performance improves whether the monopoly that is opened to competition is private or governmental. The objective is healthy competition, not privatization for its own sake.

- Privatization should be based on lasting efficiencies and improvements in quality. It is important to understand that privatization succeeds only when market forces are allowed to operate. My goal is to develop a competitive environment that ensures the high quality, cost effective and efficient allocation of resources, rather than a one-time boost to state and local tax rolls. The proceeds from privatization of state assets are a beneficial side-effect, but it should not be considered the foundation for the effort.

My Cabinet agencies and departments will report their findings to me next month. By the time tax returns are due, I will deliver a plan to make sure that Californians get the best value for their hard-earned dollars.

As you know, I have joined with Governor Pataki and other Republican governors as part of the Republican Governors' Association's Task Force on Privatization to identify specific federal barriers to state privatization efforts. As we work to improve government in our respective states, it is important that the federal government not act as an unnecessary impediment to state initiative. Governors should not be required to seek permission and waivers from Washington in order to improve the quality of their state service. I look forward to sharing with you our findings for California, as well as the final results from the RGA initiative.

Mr. Chairman, members of the committee, let me again thank you for this opportunity.

PREPARED STATEMENT OF REPRESENTATIVE SCOTT KLUG

When I was appointed to head the House Privatization Task Force earlier this year, I was asked to develop a list of options at the federal level. In my search for these opportunities to reduce the deficit and increase the quality of government services, I came across a number of privatization barriers imposed by the federal government itself. One of these obstacles that stands in the way for state and local governments to privatize their own infrastructure is the federal grant repayment requirement.

Because of this requirement, our state and local governments back home have not been able to use private sector resources to improve roads, water treatment centers or airports. In addition, our movement to balance the budget has had a direct effect on the state and local governments' revenue. If privatizing infrastructure benefits the local economy, who are we in Congress to deny them this opportunity?

Franklin, Ohio has already enjoyed the success from privatizing their own wastewater treatment facility. The Federal-aid Facility Privatization Act of 1995, H.R. 1907, was introduced on the House side. This important legislation would lift this barrier and open up more investment opportunities, not only for state and local government, but for local economies as well. I'm pleased, Mr. Chairman, to explore the potential benefits of lifting this barrier for state and local governments.

• The Issue at Hand

One of the largest barriers to state and local privatization is Executive Order 12803. It was issued by President Bush in 1992 and changed the previous 100% federal grant repayment requirement. Under current law, state and local governments must repay the depreciated amount of the federal grant if any federal-aid infrastructure is privatized. In addition, the proceeds from the sale may only be used for investment in additional public assets, debt reduction or tax relief. Because of these limits, privatizing infrastructure has not been an option for state and local governments. They would gain little or no benefit after the federal grant repayment.

With any privatization initiative, of course, there are concerns of how to deal with possible increased fees, which in this case, are infrastructure users. H.R. 1907 does not directly address this issue. State and local governments, however, would not be prevented from attaching an agreement to the transaction. In the bid, for example, a local entity could attach in the bid a required limit on the rate of increase in fees over a certain period of time. Though such a provision may decrease the value of the infrastructure asset, all privatization transactions must be sensitive to the current users.

The most popular example of privatization at the local level which was sensitive to these issues was the first and only privatized wastewater treatment plant in Franklin, Ohio. Earlier this year, three counties and two cities sold the Franklin Area Wastewater Treatment Plant. Because Executive Order 12803 requires the repayment of the depreciated value of the federal grants, Franklin did not have to pay any portion of the fully amortized investment to the federal government. The sale price was approximately $1.2 million and the proceeds are being used for sewer utility-related expenditures. Franklin is now preparing to privatize their water utilities plant.

The intention of H.R. 1907 is to provide state and local governments with the option to draw from the resources of the private sector. The benefits would range from an increased tax base for local, state, and federal governments to increased efficiency and quality of our infrastructure back home. In addition, H.R. 1907 would save the federal government money by reducing the state and local government need for federal aid. I look forward to working with state and local government officials on lifting this and other privatization barriers.

PREPARED STATEMENT OF REPRESENTATIVE DAVID MCINTOSH

Thank you, Mr. Chairman and other Members of the Joint Economic Committee, for the opportunity to present this statement regarding federal barriers to state and local privatization. I commend you for your attention to the important issue of infrastructure privatization.

One of the issues driving the 104th Congress, and particularly my colleagues in the freshman class, is the need to revive the principles of the 10th Amendment to the Constitution by reordering the relationship between the federal government and state and local governments. For decades the federal government has accumulated power, depriving states and localities of their constitutional authority over matters not explicitly reserved for federal oversight. As a result, the people most capable of efficiently providing government services -- dedicated local government officials -- often have their hands tied by overbearing federal directives.

In this Republican-controlled Congress, we have aggressively fought to reverse the concentration of power in Washington. From ending unfunded mandates and reforming the welfare system to our efforts to save the Medicare and Medicaid programs, Congress has steadfastly sought to return authority and discretion to the states and local governments. The push to reform federal policies which prevent state and local governments from employing innovative infrastructure management practices, such as privatization, is another step forward in this continuing effort.

To address one of the steepest federal barriers to the privatization of a wide variety of infrastructure assets, I joined with Rep. Steve Horn (R-CA) to introduce The Federal-Aid Facility Privatization Act of 1995 (H.R. 1907).

Prior to 1992, a federal regulation -- known as the "Common Rule"-- required state and local governments to fully reimburse the federal government for all grants received for any federal-aid infrastructure facility upon the transfer of such facilities to the private sector. This 100 percent repayment requirement was a prohibitive economic disincentive to privatization transactions, preventing local officials from realistically considering public-private partnerships as a means for improving infrastructure services.

As Executive Director of President Bush's Competitiveness Council, I fought to give states and localities the freedom to consider a full range of infrastructure development and management arrangements by eliminating this barrier to public-private partnerships. As a result, President Bush issued Executive Order 12803, which asserted that "State and local governments shall have greater freedom to privatize infrastructure assets." The Executive Order eased the repayment requirement by permitting the repayment of the depreciated value of federal grants received.

Unfortunately, the intervening years have shown that Executive Order 12803 did not go far enough. The modified repayment requirement continues to prevent state and local governments from implementing innovative infrastructure management arrangements. Despite the enthusiasm of many governors and mayors for privatizing infrastructure assets, only one transaction -- a small wastewater facility in Franklin, Ohio -- has been formally completed. And it was only completed after months and months of delay caused by federal scrutiny of the transaction.

H.R. 1907 removes this unnecessary burden on community control of infrastructure assets. Specifically, the bill allows a state or local government owner to transfer an infrastructure asset to a private party, either by sale or long-term lease, with no repayment of federal grants, so long as the asset continues to be used for its original purpose. This needed reform returns decision making power to state and local governments while preserving the federal interest by requiring that the asset continue to meet the needs for which it was intended.

Defenders of the status quo in Washington will continue to try to stand in the way of legislation, like H.R. 1907, which returns authority and discretion to state and municipal governments. They will claim that these proposals are too complex or have unanticipated consequences in order to delay action. But these claims are often motivated by a paternalistic belief that the federal government must protect local governments from themselves.

I also understand that some groups within the aviation industry have concerns about the impact of H.R. 1907 as it pertains to airport privatization. I welcome the input of these groups, and look forward to working with them to explore ways to address their concerns, preserve and enhance our vital national aviation system and move forward with a consensus bill.

Local governments should have the freedom to employ innovative infrastructure management arrangements, including public-private partnerships, without interference from Washington. H.R. 1907 is narrowly crafted to remove the primary federal policy restricting such privatization transactions, without otherwise altering federal oversight of these facilities.

H.R. 1907 is an important first step in this Congress' privatization efforts. If we can remove existing barriers to privatization through enacting this legislation, we will untie the hands of state and local governments and encourage private investment in infrastructure. This privatization will generate revenue and improve state and local facilities across the nation.

I applaud Governor Pataki and the other members of the Republican Governors Association Privatization Task Force for their commitment to promoting public-private partnerships, and look forward to working with these Governors to enact H.R. 1907.

Thank you, again, Mr. Chairman and members of the Committee for considering infrastructure privatization issues, including H.R. 1907.

PREPARED STATEMENT OF MAYOR STEPHEN GOLDSMITH

Mr. Chairman:

Thank you for inviting me to comment on barriers that the federal government creates for privatization at the local level. This issue is vital to me and, indeed, to all mayors because the absence of local control over solutions to urban problems cripples our ability to deal with uniquely local problems in uniquely local ways.

C.S. Lewis reminds us, "We all want progress, but if you're on the wrong road, progress means doing an about-turn and walking back to the right road."

It's time for Washington to do an "about-turn" on its urban policy. Congress should return to the spirit of the 10th amendment and restore a sensible balance between the federal government and the rest of America.

The question you ask today is whether the federal government stands in the way of our ability to privatize or take other action to streamline local government. The answer is a definite yes.

Congress should recognize that the marketplace in which cities operate has changed. No longer do major cities compete against each other for businesses and home owners. We compete against our suburbs, and we start out at a substantial disadvantage. Suburbs have lower taxes, less crime, and better schools. As a result, wealth and jobs are rapidly flowing out of our cities, leaving pockets of poverty behind. Not only has the federal government failed to address this fundamental imbalance, but it has actively increased the forces pushing wealth out of the cities.

Cities are surviving, and some of us are even thriving. In my city, Indianapolis, we have added created or retained 87,000 jobs in our economy over the last four years. The most recent unemployment figures show us at 3.2% -- almost as close to full employment as a major city can get.

Yet our cities are surviving not because of the federal government, but in spite of it. Federal programs, regulations, and taxes distort the way that we give attention to and even think about our problems. Simply put, they inhibit the free marketplace in cities.

Don't misunderstand. Ultimately, cities cannot succeed without your help. But, frankly, Washington has been our problem much more often than it has been our partner in attacking urban problems.

Let me give you some examples of how federal regulations and tax policy have impeded our ability to make city government more competitive.

Indianapolis has achieved a reputation for efficiency in government. In the past four years non-public-safety city employment has fallen by over 40% while city services have improved. Part of these sweeping changes resulted from the city's decision to enlist the private sector in the provision of municipal services.

But federal regulations often make it difficult for us to streamline city government and force us, in contrast, to be inefficient.

Indianapolis, like most large cities, has a publicly-owned bus system. In the past decade our ridership has fallen by 40%, our costs have risen, and the quality of our bus services has deteriorated. I thought that a reasonable solution to address these problems would be to open up our mass transit system to competition.

That was before we learned about section 13(c) the Urban Mass Transit Act. That section requires cities using federal transportation subsidies to pay six years of full salaries and benefits to all employees who undergo a "worsening of their positions with respect to their employment" as a result of such competition.

We eventually did compete out our bus services in Indianapolis, but we had to do it by using state and local money rather than federal money. The outcome will be more bus routes for our customers, cleaner buses, and more punctual service. Indianapolis used its state and local dollars to compete against the federally-funded monopoly. Yet Congress continues to force local governments to waste federal tax dollars and reduce transit services to those who are economically and physically dependent. Removing this barrier would enhance urban services.

The Fair Labor Standards Act is another obstacle to local governments. Even though the following example is not about privatization, it is representative of the harmful effects of this law.

In the 1980s I headed the Governor's Task Force to Reduce Drunk Driving. One of our recommendations was to have police officers volunteer to work overtime patrolling Indiana highways. They would get their normal rate of pay for the hours they worked. Our proposal, however, ran afoul of the Fair Labor Standards Act. It is illegal for a state to pay its officers at their normal rate of pay for overtime. Instead, the federal government requires us to pay time and a half for overtime.

The outcome was obvious. We did add officers to the highways, but far fewer than we had envisioned due to the Fair Labor Standards Act.

Such regulations can be burdensome, but our biggest roadblock has been federal income tax laws. The Internal Revenue Code, we have discovered, favors socialism over capitalism.

Indianapolis, like most other cities, has issued bonds to help finance municipal facilities. Because interest on the bonds is tax-exempt, cities can borrow funds at a lower rate. But the Internal Revenue Code effectively precludes many privatization initiatives since the bonds become taxable if a so-called "private business use" occurs.

Here is an example to show how this tax provision works. The City of Indianapolis owns twelve golf courses. When I came into office, the courses were in poor shape and the city got angry calls from golfers about their quality. We thought that we could address these problems best by opening up the management of our golf courses to competition. But the tax code got in the way.

We believed that since we owned the golf courses, we should get a percentage of the gross receipts from private vendors who might be interested in managing them. Local golf professionals responded enthusiastically to the prospect. Many of our courses, however, had been built with tax-exempt funding. We discovered that because of that tax-exempt financing, all of the bonds would become taxable under federal tax law if we used performance-based contracts. Performance-based contracts are the surest way to minimize the our liability and to make a contractor accountable for quality operations. But if the bonds had become taxable through using performance-based contracts, investor confidence in our bonds would have plummeted and bondholder suits would have been inevitable.

Because federal tax laws favor socialism over capitalism, our city was forced to guarantee revenues to the golf managers (golf professionals) because curiously the tax exemption of the bonds precluded contracts that were exclusively contingent; i.e. exclusive a percentage of revenues. We could not protect our taxpayers by having the private managers (the pros) work on an incentive-only basis in which they would get only a percentage of the net earnings.

Federal tax laws also prevent long-term contracts, forcing winning vendors to limit the amount of the capital investment they might otherwise make. Without the tax laws, the golf pros would have invested more in the courses and the city's savings would have been greater. My city was forced into a series of confusing contractual relationships because of these provisions.

Another example concerns our advanced wastewater treatment plants. Our two wastewater treatment plants are among the finest in the nation, but we thought that we could save our taxpayers money by selling them and having private industry operate them. Our citizens would not care who owned the assets as long as it cleaned our waste water. But because the plants had been built with federal funds, we would have had to repay the federal government if we had privatized the plants. Federal law encourages socialism rather than capitalism since it provides a strong disincentive for privatizing government assets. Taxpayers are punished, for the federal government favors government-owned enterprises.

We then considered having a private party lease the facilities. But tax-exempt bonds had provided part of the financing, and they would have been taxable if the plants had been leased even if the city continued to own them.

After we realized that privatization and leasing were out of the question, we thought that we could still gain efficiencies and cost savings by opening up the management of our wastewater treatment plants to competition. Again we ran up against a federal roadblock. If a private manager takes over a facility that was paid for with government-financed bonds, federal law prohibits contracts for the management of those facilities for lasting more than five years. We were interested in a contract of ten or fifteen years because a long-term contract would give the private company managing the facility the incentive to make substantial capital investments to enhance efficiency that it would be unlikely to make with a short-term contract.

Eventually we did contract out the management, at savings to our taxpayers of 44%. The contract is for five years. But federal restrictions impeded us from doing what we wanted.

A bill currently before Congress would solve part of this problem. H.R. 1907, sponsored by Rep. David McIntosh, would end the need for cities and states to repay a portion of their federal grants if an infrastructure facility is sold or leased to a private party. I endorse this bill as an important first step in lowering federal barriers to private ownership.

There are other things that Congress can do to eliminate discrimination against private ownership. For instance, interest on municipal revenue bonds that support infrastructure are nontaxable. But bonds for the same purpose to support private ownership or construction of similar assets is fully taxable. The effect is monopolize ownership of large assets like airports and wastewater plants in the government. In 1994 Reps. Gephardt and DeLauro introduced legislation that would end this discriminatory treatment and provide a level playing field. The bill went nowhere, but the idea is sound.

Regulations also often differentiate between the government and private industry in a way that imposes great burdens on industry and makes private ownership problematic. For instance, the Resource Conservation & Recovery Act provides more stringent regulations for industrial waste than it does for municipal waste. The consequence is to make privatizations of facilities that create waste harder than they should be.

In conclusion, I urge Congress to remember that every time it adds a new regulation, it inhibits the ability of states, counties, and cities to solve local problems. From our point of view, it would be far more productive for Congress to engage in extensive deregulation than spend its time creating new hurdles for us to overcome.

Thank you.

PREPARED STATEMENT OF ROBERT ZAUNER

Mister Chairman, my name is Robert Zauner. I am a registered professional engineer, vice-president of Hughes Transportation Management Systems (HTMS) and the chairman of the Minnesota Transportation Group (MTG). I have been involved in the transportation industry for twenty-five years. During the past six years I have been involved in the development of privatized toll highways. I have served as a member of the Board of Directors and as Vice President of the Highway Division of the Associated General Contractors of Minnesota. I also chaired its bridge committee. I currently serve on the Boards of Directors of the Minnesota Transportation Alliance, a transportation advocacy group, and the Intelligent Transportation Society of Minnesota, as well as the Advisory Council of the University of Minnesota's Center for Transportation Studies.

The MTG is a team of technology, construction, engineering, and financial companies that personifies the private sector's capability, desire and interest in the privatization of highway infrastructure. For the past six years we have worked with state legislators, local officials, and state departments of transportation in the development of enabling legislation, privatization programs, and privatized highways. Our team members have been involved in privatization efforts in California, Washington, Arizona, Virginia, South Carolina, and Minnesota where we recently submitted proposals to develop three highway projects totaling over $700 million.

In my testimony today I would like to share several issues I have encountered in my efforts to privatize highways. Some are institutional barriers others are perceptions or prejudices created by the present funding system that are as difficult to overcome as institutional barriers themselves. They include:

1. Reconstruction and improvements to the interstate system are exempt from tolling.
2. State and local government see little benefit to privatizing or implementing toll financing due to their perception that they are receiving no additional funding for doing so.
3. The disparity between taxable and tax exempt financing
4. Privately financed highways are at a disadvantage when competing for investor dollars.
5. Tolling represents double taxation

6. Unrealistic expectations for low cost roads
   - "Roads are free"
   - "Roads are paid for"
   - "My road is the most dangerous road in the state it should be fixed now!"
   - "Its not fair, I paid for everyone else's road they should pay for mine."
   - "Toll roads mean toll booths and having to carry a jar of quarters in my car."
   - "Toll roads create safety problems at toll plazas"
   - "We have waited long enough its our turn"

The Interstate Highway System is a critical link in the nation's transportation network. It is truly one of the greatest and most expensive public works projects ever undertaken. While the interstate system includes only 2.5% of our highway lane-miles more than 22% of our travel is on it. It will also require nearly a third of our annual capital expenditures to improve it in the future. Yet reconstruction or capacity expansions on the interstate system cannot be toll financed. The privatization and tolling provisions of ISTEA and the NHS Act should be expanded to allow the use of tolls on the Interstate System if a road, bridge, or tunnel, is reconstructed, substantially improved, or its capacity is expanded. This will attract the investment and expertise of the private sector to complete needed, major reconstruction projects, improvements, and expansions to the system faster and at less cost. It will also relieve the large financial burdens these projects place on many State Departments of Transportation.

State and local governments have not yet accepted private equity as additional money to meet their transportation needs. I believe Congress could create a better environment for the private sector by requiring that alternative financing, including but not limited to tolls, congestion pricing, mileage pricing, and public-private partnerships, be considered on a project, or a series of projects on a single highway, when the cost exceeds $10,000,000. Such a provision would make it more likely for government entities to pursue alternative financing.

The private sector is at a disadvantage to government in financing infrastructure due to the disparity in rates between taxable and tax exempt financing. The federal government also loses tax revenue when tax exempt bonds are used to finance improvements. Eliminating this disparity would make taxable financing more competitive and the federal government would increase its tax revenues.

Unlike the power and telecommunications industries there is no clear track record of private involvement in the delivery of transportation infrastructure. As a result, the financing of such investments can be difficult to close. By making the unobligated balance in the Highway Trust Fund available as a guarantee for transportation infrastructure loans, financing would be more easily obtained and investment of private equity in transportation projects would increase. Regarding this provision the Office and Management and Budget has advised the Federal Highway Administration that portions of the unobligated balance in the trust fund actually committed as a debt reserve would be scored at ten cents on the dollar for budget purposes. Such use of the unobligated balance would have a minimal effect on the deficit.

The payment of tolls to finance specific projects does not constitute double taxation. The situation is similar to a homeowner who needs or desires to make repairs or improvements to his, or her, home. A homeowner's monthly mortgage payment allows him, or her, to live in a home while it is being paid for. Similarly, the gas tax is being used to maintain and make limited improvements to our existing road system. If a homeowner desires to make repairs or improvements additional funds outside his monthly payments are needed. Similar to the homeowner, if we want to make specific improvements to our road system we must find an additional source of funds. By using tolls, the revenue raised is targeted to a specific need. A need created by a specific demand and the investment made is tailored to meet that need. This is an efficient and equitable way of making investments. It introduces market forces into transportation infrastructure investments. The improvements made are also paid by those who benefit most from the improvement. This is a fair and equitable means of paying for improvements.

The public's unrealistic expectation that traditional transportation funding can meet their needs is evidenced by the statements listed above. The current system is unable to meet those expectations due to major changes in automobiles and our travel patterns. Increased fuel efficiency and life-span of vehicles coupled with increases in the number of trips and trip length has contributed greatly to our current funding situation. Neither the gas tax nor license fees is increasing. Moving away from these funding mechanisms to charging for the space used on a road would help change these expectations. Charging for highway travel by the mile, would make us more aware of the cost of travel and would assess costs to the largest users. This would result in more prudent use of highway capacity. Such a move would also permit the introduction of congestion pricing to highway travel. Most commodities are paid for in this fashion. Introducing it into highway travel would improve utilization of the existing system and lessen demand for additional capacity.

Drivers have not liked paying tolls because they do not like fumbling for quarters, stopping and paying the tolls. This is no longer necessary. My company, Hughes Transportation Management Systems, has adapted defense-related technology to collect tolls at freeway speeds on the open road without toll plazas. Eliminating toll booths and stopping to pay tolls eliminates most driver's objection to toll financing.

In closing, I would like to state that I am very positive on the opportunities and benefits of highway infrastructure privatization. This optimism is buoyed continued bi-partisan support of the Minnesota legislature, business, and labor. We are continuing our efforts despite the fact that we are charging a fee for a service that our competition, government, is giving away "free." We would like to participate more fully. Addressing the issues I have outlined today would improve the competitive disadvantage we now face. I would be happy to answer your questions.

PREPARED STATEMENT OF PETER COOK

The National Association of Water Companies (NAWC) is the trade association representing the nation's investor-owned water utilities. Our 360 members in 41 states provide safe, reliable drinking water to more than 22 million Americans every day. We employ a combined workforce of more than 15,000. Eighteen of our companies have shares which are publicly traded. Ten of our companies also provide wastewater to a combined 350,000 persons nationwide.

Approximately 80% of the population in the United States receives its drinking water service from various governmental agencies and authorities. For wastewater services, the percentage of governmental ownership is greater than 95%. Many of these municipal water and wastewater systems have aging infrastructure and are now facing the daunting task of complying with the mandates of both the Safe Drinking Water Act and the Clean Water Act. All of these factors are placing enormous strains on the funding and technical capabilities of many systems. The Environmental Protection Agency's (EPA) 1992 needs survey estimates that the Clean Water Act will cost federal, state and local governments $137 **billion** over the next 20 years. This was $57 **billion** more than the 1990 estimate. Further, an estimated $49 **billion** will be required to meet the requirements of the Safe Drinking Water Act through the year 2000. To address these growing financial responsibilities, government systems across the country are exploring various privatization alternatives, often with NAWC companies. However, while exploring privatization, localities regularly encounter legislative and administrative obstacles which should be removed.

The members of the NAWC have the experience and resources to professionally operate first class water and wastewater facilities The private sector has proven that it is capable of providing safe, reliable drinking water to the public in an efficient manner. For these reasons, the NAWC applauds this committee's efforts to investigate the issues affecting privatization and is pleased to offer this statement.

Summary of Issues

Contributions in Aid of Construction (CIAC). Investor-owned water utilities are taxed on capital contributions from developers for system expansion. This tax creates competitive advantages for government systems and indirectly discourages privatization efforts.

Furthermore, it encourages the proliferation of small water systems, which are often unable to keep pace with new regulatory requirements.

The NAWC has sought relief of this provision since 1986 and supports the companion bills H.R. 957 and S. 448, sponsored by Congresswoman Nancy Johnson and Senator Charles Grassley, respectively, which would repeal this tax.

The Joint Tax Committee (JCT) has determined that these bills would do no damage to the current efforts to balance the budget. JCT has determined that the bills would raise $43 million over the next seven years through a change in depreciation of water utility property which is included in the bill. Furthermore the Treasury Department has said they do oppose the change.

We are pleased to report that the language of these bills was included in the Budget Reconciliation legislation. Though that bill was vetoed and its fate is now uncertain, we feel confident that more opportunities to pass this legislation will present themselves before the end of 104th Congress.

Publicly Owned Treatment Works (POTW). Because of how POTWs are defined, the regulatory requirements for municipally-owned treatment facilities are different than industrial dischargers. Because of this there is often confusion when a private company assumes ownership of a municipal facility or POTW. This confusion has existed since enactment of the Clean Water Act in 1972. The NAWC supports a uniform definition of a POTW based on purpose rather than ownership to facilitate private sector investment in wastewater treatment facilities.

NAWC supported language alleviating this discrepancy was included in H.R. 961, the House passed amendments to the Federal Water Pollution Control Act (The Clean Water Act). In the Senate, Senator Lautenberg has introduced S. 1436 which would also correct this problem. The NAWC is pleased to endorse and support Sen. Lautenberg's efforts to pass this legislation either by itself, or as part of a larger vehicle such as a Clean Water Act rewrite.

Rev. Proc. 93-19. This Internal Revenue Service ruling severely limits the ability of governmental bodies to contract with private operators for water and wastewater management services. It limits the term of the management contract to periods of three years if tax-exempt debt of the government entity is outstanding. This time limit precludes significant investment by private contractors to attain operating efficiencies or to make system improvements. The NAWC is currently working with both the Administration to address this concern and pursuing a possible legislative remedy. Congressional attention to timely resolution of this matter would expedite privatization activities.

Codification of Executive Order 12803. This Order issued by President Bush in 1992 was designed to facilitate the sale of government facilities that had received funding through federal grants.

Many municipal drinking water systems and most wastewater systems were financed during the last several decades in whole or in part with federal grant money. Grant repayment conditions are imposed by the Office of Management and Budget (OMB) if the facility is sold or leased. The presumption by OMB is that the asset's use would change with private ownership. However, unlike housing and other general purpose structures, water and wastewater facilities are almost never converted to some alternate use.

Executive Order 12803 requires the local government to repay the undepreciated portion of the grant. The local government, however, is allowed to recover its costs before any funds are used for grant payback. The Executive Order also places restrictions on the use of proceeds received by the city as a result of the sale or lease. The Executive Order directs federal agencies to adopt rules to carry out its requirements. To date, implementation has been very disappointing and clearly not achieved the order's intent of streamlining privatization efforts.

The NAWC supports companion bills which have been introduced to codify the order and improve it. These bills are, H.R. 1907 sponsored by Congressman McIntosh and S. 1603 sponsored by Senator Roth. Under the bills:

1) A city would not be obligated to repay federal grants provided the grant-funded facility continues to be used for its original purpose. Long-lived investments in water and wastewater facilities that continue to be used as such should not require repayment.

2) Local Governments could use the proceeds it received as a result of the transfer without the restrictions found in Executive Order 12803.

A codification of the Executive Order was contained in the House passed Clean Water Act reauthorization, H.R. 961. It is a direct codification, however, which is to say like the Executive Order, much of the grant repayment would still be required. Requiring this grant repayment would severally limit the local government's ability to sell their assets if they so choose. This would, therefore, do little to achieve the Order's goal of increased privatization.

Also, the language in H.R. 961 is limited only to wastewater facilities. There are many privatization opportunities (bridges, roads, airports, etc.) potentially available to local governments if a codification of the order is passed beyond H.R. 961's narrow reach. Finally, the NAWC has concerns with some of the language in the codification of the order in H.R. 961. Specifically, starting on page 253 line 17:

"(C) with respect to subsection (k), to the extent consistent with the North American Free Trade Agreement and the General Agreements on Tariffs and Trade --

> "(i) is a majority-owned and controlled by citizens of the United States; and
>
> "(ii) does not receive subsidies from a foreign government."

This language on the surface seems a rather benevolent clause, however, it would have no positive practical effect. It would only serve to cause confusion and uncertainty to localities which are pursuing the privatization of an infrastructure asset. Though all NAWC members would pass the test this clause puts in place, in our growing global economy many do conduct business with foreign companies. A locality could easily choose to err on the side of caution, and not privatize simply to comply with a provision, which is has no practical effect. The language should not be included in a codification of Executive Order 12803.

Drinking Water State Revolving Loan Fund (SRF). The President has advocated the creation of a State Revolving Loan Fund to assist localities in funding drinking water infrastructure improvements. The fund would likely be modeled after the Clean Water SRF. The NAWC supports the creation of a fund, but believes that eligibility for loans should be extended to investor owned drinking water facilities.

In this regard, we are particularly pleased that the Senate's recently passed S. 1316 extends eligibility of SRF loans to private and investor-owned water utilities. We encourage the House of Representatives to support the same eligibility.

NAWC members are federal tax paying businesses, which clearly supports their eligibility for SRF loans. Furthermore, ultimately the customers of investor-owned water utilities would end up being penalized through higher water rates. In this era of increased interest in privatization by Federal, state, and local governments, to not extend eligibility of SRF loans to investor-owned water companies would place the option of privatizing a facility or consolidating it with an investor owned company at a severe economic disadvantage to the status quo or municipal options. Given the desperate need for more efficient and effective public services, we need to be considering more options not fewer.

Conclusion

The water service business is perhaps the most basic of enterprises. That is why it is often taken tor granted. But continued economic growth may be jeopardized if aging government infrastructure is not replaced. Given the magnitude of the problem, support for private sector participation in the solution is vital.

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