

# Privatization, Free Trade and the Erosion of Government Authority



Mildred Warner

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## *Overview*

*Privatization Trends in Local Government*

*Democratic Deficit in Free Trade Agreements*

*Challenges for Extension*

Based on research with Amir Hefetz and Jennifer Gerbasi

<http://government.cce.cornell.edu>

# Theoretical Propositions: The New Public Management

## ⌘ Problem:

- Oversupply of public goods, budget maximizing bureaucrats, inflexible, unresponsive government, lack of choice

## ⌘ Solution:

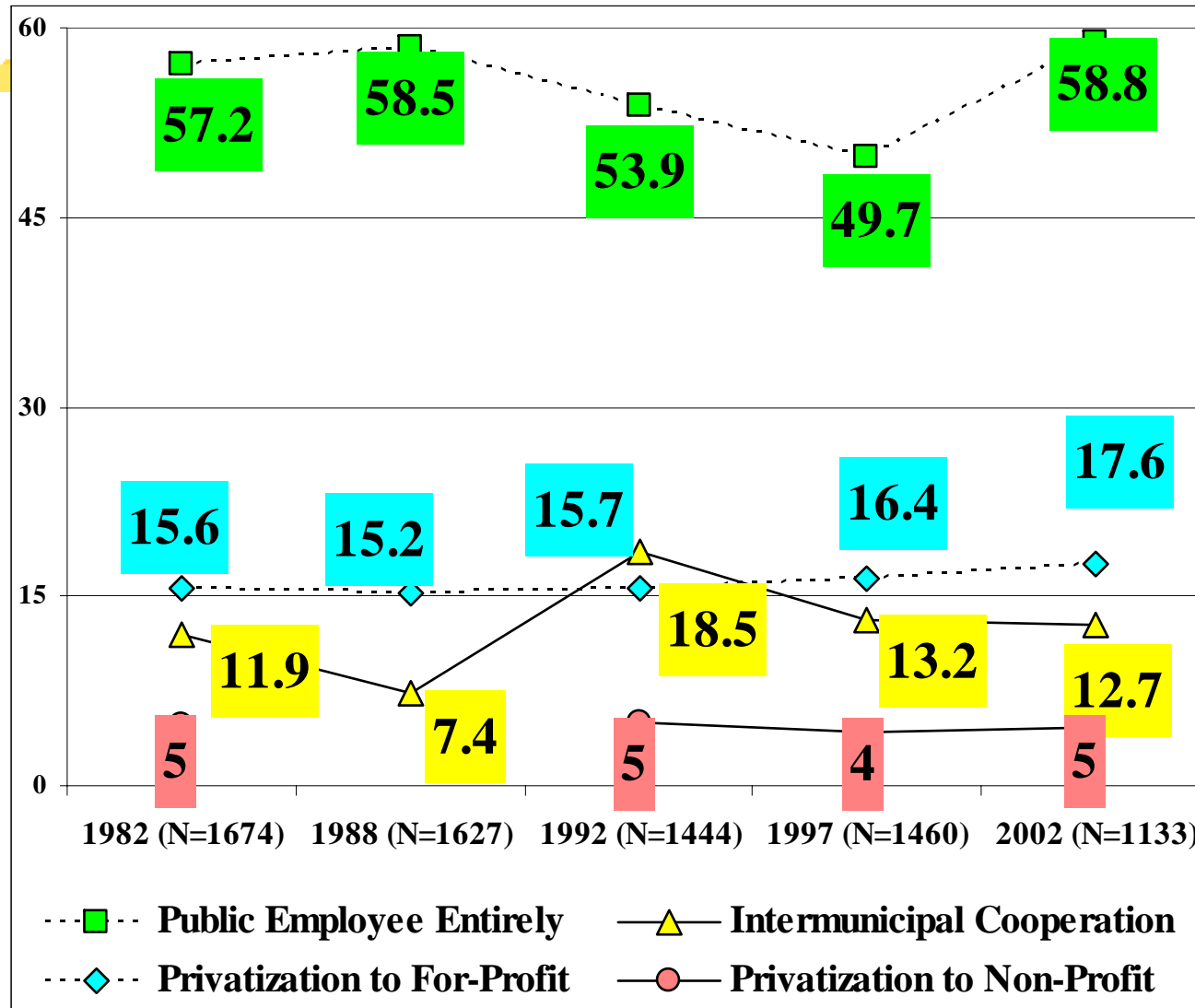
- Markets Can Provide Public Goods
- Competition (Privatization) Promotes Efficiency
- Market Provision Enhances Consumer Choice/Voice
- Private Sector Management can be applied to the public sector

# Theoretical Challenges: The New Public Service



- ⌘ Public goods result from market failures
  - There are limits to market solutions for public goods
- ⌘ Competition is costly
  - Government must structure the market, ensure stability and security
- ⌘ Citizens are more than customers
  - Collective needs are not the simple summation of individual desires. Deliberation changes preferences
- ⌘ Democracy ≠ Markets
  - Privatization raises challenges of accountability and blurs the line between public and private

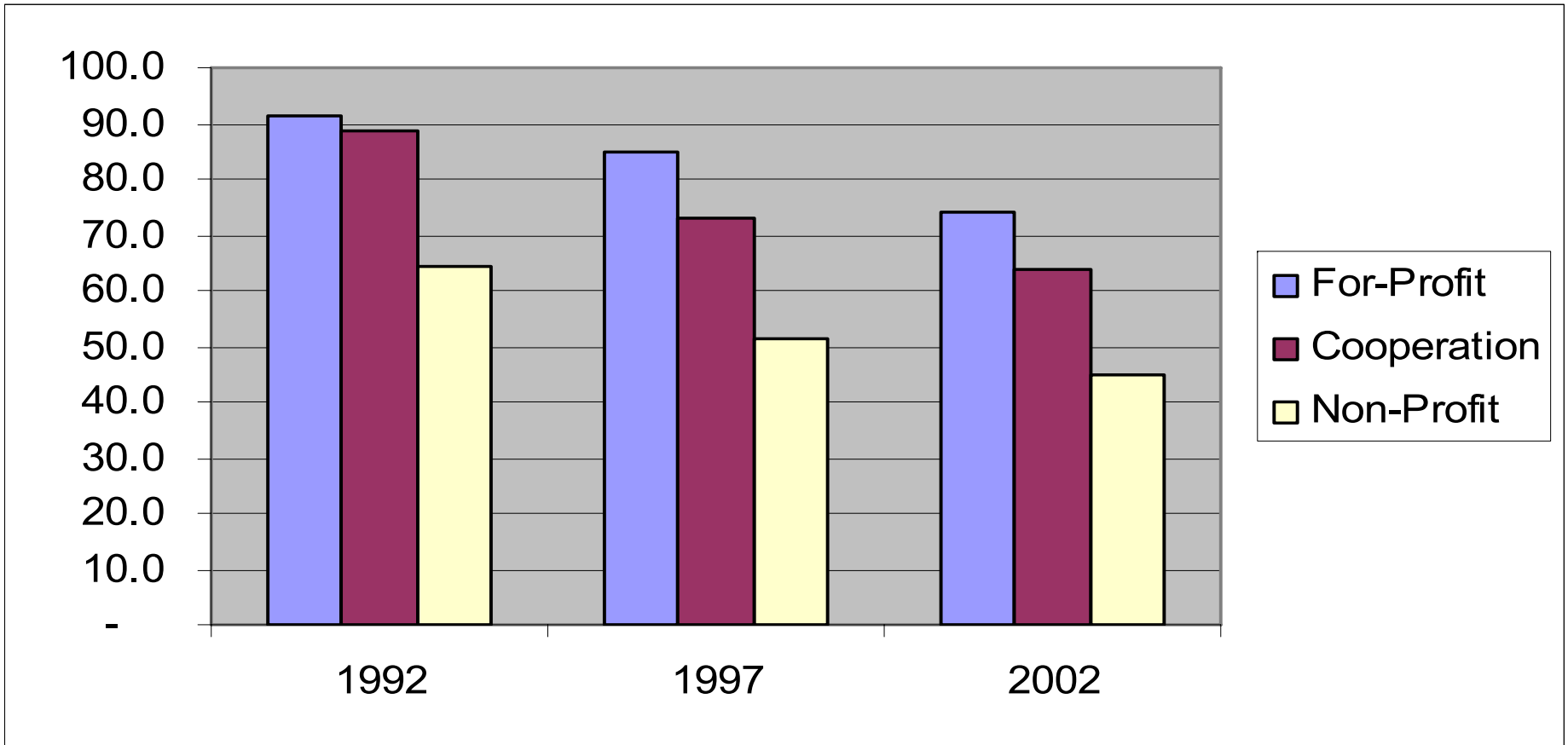
# Local Government Privatization Trends are Relatively Flat



Average provision as % of total provision

Source: International City/ County Management Association, Profile of Alternative Service Delivery Approaches, Survey Data, 1982, 1988, 1992, 1997, 2002

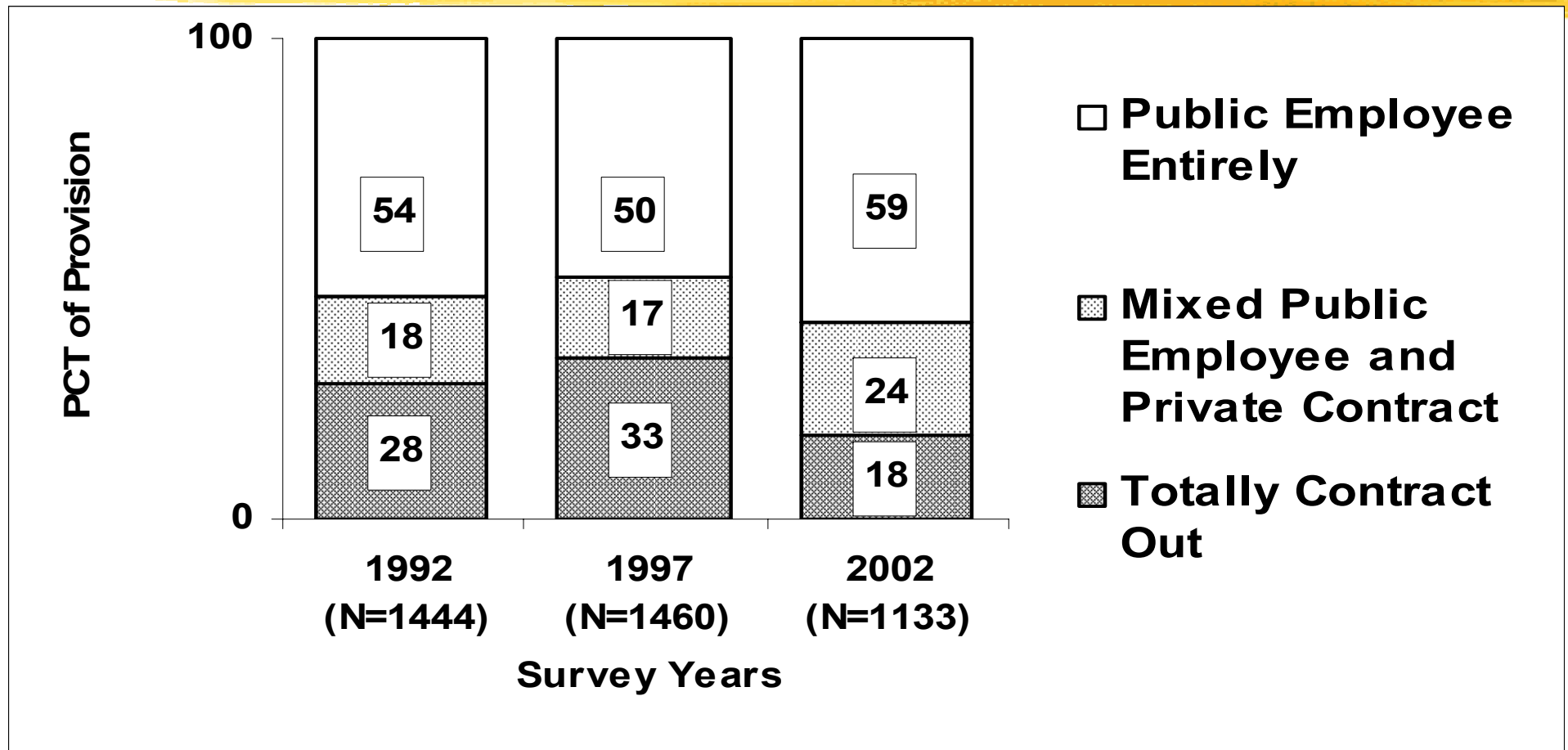
# Percent of Governments Using Alternative Delivery is Dropping



**% using at least once**

Source: International City/ County Management Association, Profile of Alternative Service Delivery Approaches, US Municipalities, 1992, 1997, 2002, Washington DC

# Public Delivery Rising Mixed Provision Rising the Most

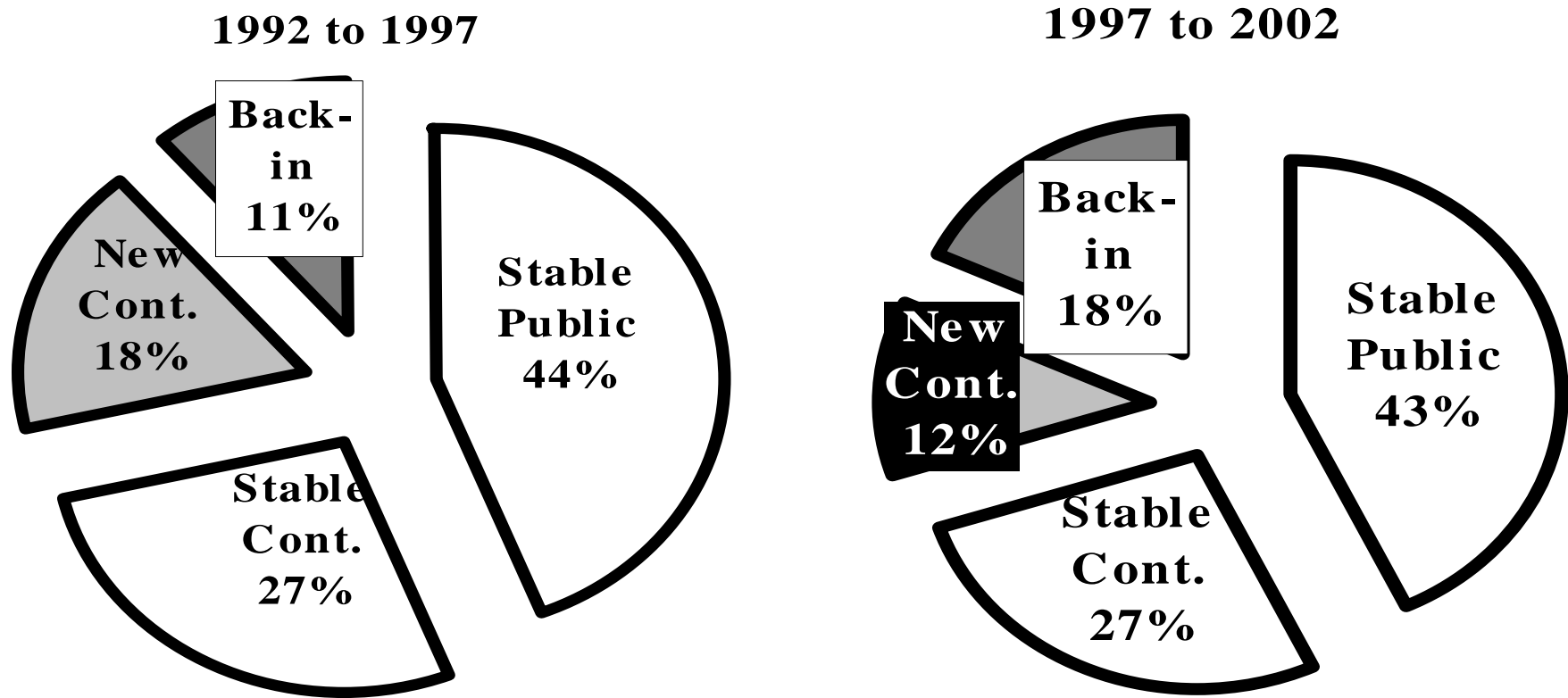


**Provision Rates: 66%, 61%, 53% for 1992, 1997, 2002 Respectively**

Source: International City/ County Management Association, Profile of Alternative Service Delivery Approaches, US Municipalities, 1992, 1997, 2002, Washington DC.

# Service Delivery is Dynamic

## Shift: Contracting Back In > New Contracting



Average percent of total provision across all places.

Source: International City/ County Management Association, Profile of Alternative Service Delivery Approaches, Survey Data, 1992, 1997, 2002, Washington DC. Paired sample size: 1992-1997: 628, 1997-2002: 480.

# Theoretical Myths – Empirical Realities



⌘ *Theory: Market Solutions for Public Goods*

Reality: Market Solutions Have Market Failures

- Lack of competition
  - Uneven distribution of market solutions
- Lack of full information and high transactions costs
  - Problems with monitoring and citizen voice
  - Loss of social benefits not specified in contract



# Theoretical Myths - Empirical Realities



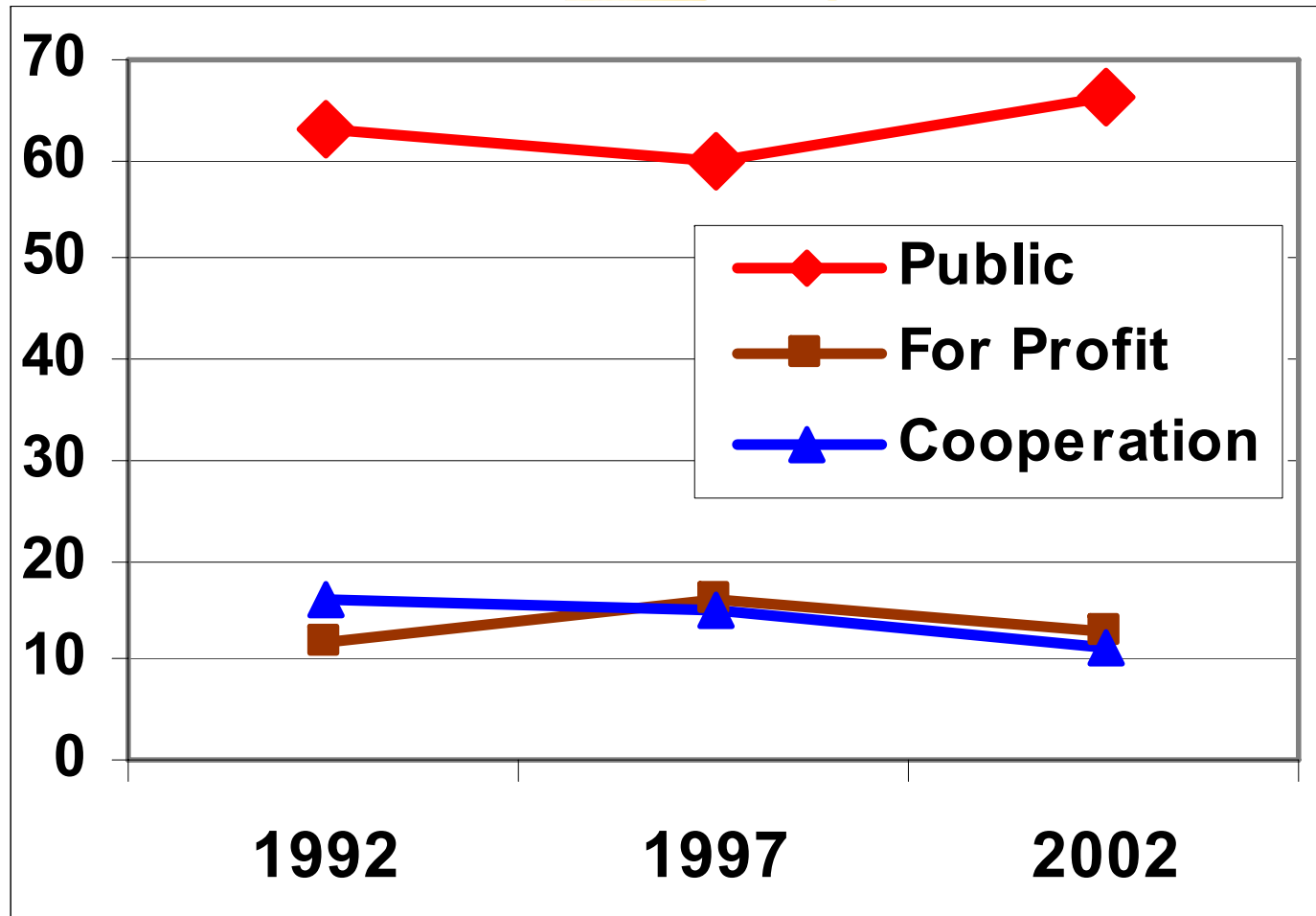
⌘ *Theory: Competition among local governments increases efficiency*

Reality: Competition increases inequality, promotes a privatized view of the city

⌘ *Theory: Differences in services reflect citizen preference*

Reality: Inequalities reflect market structure

# Rural places don't compete well in a market based government system



**Average provision as % of total provision**

Source: International City/ County Management Association, Profile of Alternative Service Delivery Approaches, Survey Data, 1982, 1988, 1992, 1997, 2002

# Theoretical Myths – Empirical Realities



⌘ *Theory: Market solutions enhance democratic expression*

Reality: Private markets reduce citizen to a consumer

⌘ *Theory: Citizen and consumer voice are similar*

Reality: Consumer choice exacerbates externalities that divide the metro region, can undermine the broader public good

# Managerial and Political Priorities are Shifting

Based on factors checked by city managers  
ICMA surveys 1992, 1997, 2002


|                        |   |   |
|------------------------|---|---|
| <b>Politics</b>        | → | <b>Pragmatism</b>                                 |
| <b>Opposition</b>      | → | <b>Monitoring</b>                                 |
| <b>Experimentation</b> | → | <b>Careful Contracting</b>                        |
| <b>Fiscal Stress</b>   | → | <b>Efficiency</b>                                 |
| <b>Cost Focus</b>      | → | <b>Concern with Quality<br/>and Citizen Voice</b> |

# Markets and Government



- ⌘ To use markets, government must play a market structuring role
  - Competition is not secured, contracts and monitoring important
- ⌘ Government is about more than efficiency
  - Equity and voice may be more important
- ⌘ Public management must secure public value
  - Service, community identity, human dignity, sustainability

# Free Trade Agreements Erode State and Local Government Authority

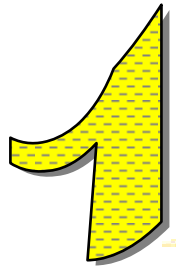


1. Foreign Investors on par with Nations
2. Redefinition of takings to include regulatory takings and provide compensation for loss of potential profits and market share.
3. Substitution of private tribunals for public courts
4. Preemption of sub-national legislative authority

⌘ Template from Chapter 11 of NAFTA

# Recent Treaties

- ⌘ North American Free Trade Agreement (1994)
  - New Investor Rights
- ⌘ World Trade Organization (1995)
  - Binding/Financial Penalties
- ⌘ General Agreement on Trade in Services (1996)
  - Liberalizes services
- ⌘ Free Trade Area of the Americas
  - Extends the above to all 31 north, central and south American countries excluding Cuba.



# Investor Rights

Foreign Investors are on par with nations

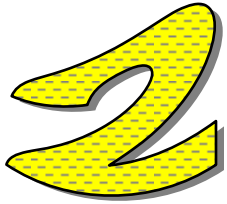
## ⌘ Defined:

- An investor is any person or entity with a financial interest in the property including individual shareholders and lenders

## ⌘ Investors

- Do not need the approval of their home nation





# Investor Property Rights

- ⌘ Under free trade agreements property includes:
  - market share
  - market access
  - future profits
- ⌘ Not considered “property” in the U.S.
- ⌘ Compensation could be awarded when a regulation interferes substantially with the enjoyment of property

# Partial Takings



US companies would **not** get compensation if:

- ⌘ All owners equally impacted
- ⌘ There were other uses of the property
- ⌘ The law is rationally related to a legitimate public purpose

Compensated only for:

- ⌘ physical occupation or
- ⌘ Close to 100% of the property value was lost



# US Laws/Courts Irrelevant

Foreign investors can challenge US laws in private international arbitration

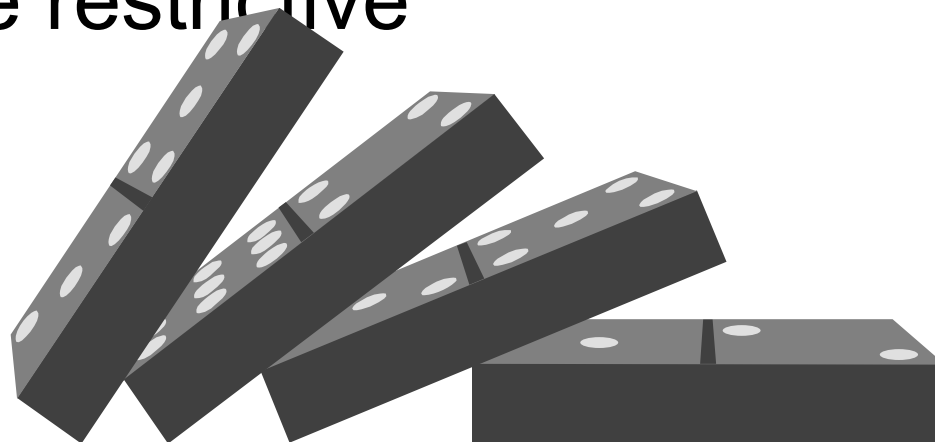
- ⌘ The federal government is a party
- ⌘ The state or locality is not privy
- ⌘ The deliberations are secret
- ⌘ The investor and country choose the law (usually international)
- ⌘ No deference is given to pre-national courts or previous tribunals



# 4

## Preemption of Legislative Authority

- ⌘ Harmonization
- ⌘ Precautionary Principle
- ⌘ Foreign Investor Comment in Legislative Process
- ⌘ The choice of mechanism or law must be the “least trade restrictive”





# Democratic Deficit

- ⌘ No effective mechanism for citizen input/debate
- ⌘ Citizen voice shared by foreign investors
- ⌘ Government action can be interpreted as a 'barrier to trade'
- ⌘ Investor needs placed above public values and accountability
- ⌘ Tribunals preempt legislation and court system

# Example 1

## Metalclad v. Mexico

### *Facts:*

- ⌘ Metalclad got Federal and Regional government approvals to build a toxic waste processing plant
- ⌘ The EIS said the ground water would be affected

### *Government response:*

- ⌘ The local government denied permit
- ⌘ The area was designated a nature preserve



# Resulting Challenge



⌘ Metalclad claimed:

- Expropriation of investment
- Unfair treatment

⌘ Award: The full cost of the completed building \$16.8 million US

⌘ Mexican Government is requiring local and state governments to pay

# Example 2

## UPS v. Canada

### Facts:

- ⌘ The Canadian Royal Post delivers parcels on letter routes
- ⌘ The government owned corporation parallels the US Postal Service

### Government Action:

- ⌘ No new action. Traditional role.





# Resulting Challenge



UPS, a United States corporation, claims:

- ⌘ This constitutes an unfair cross-subsidy
- ⌘ Public is competing unfairly with the private firm

Damages Requested:

- ⌘ Equal access to letter carriers or
- ⌘ Cash awards equal in value to the subsidy

# Example 3

## Methanex v. US

### *Facts:*

- ⌘ California well water was contaminated (smell, bad taste)
- ⌘ Studies showed it was MTBE
- ⌘ It is used to make gas burn clean
- ⌘ MTBE is carcinogenic
- ⌘ There are substitutes



### *Government Reaction:*

- ⌘ Courts award: \$50 million to municipalities for ground water contamination
- ⌘ California banned its use as of 2003

# Resulting NAFTA Challenge

## ⌘ Canadian manufacturer claims:

- Loss of Profit/Market Share
- Discrimination in favor of domestic products
- Other countries find no leakages
- California should enforce LUST laws more stringently rather than ban MTBE

## ⌘ Damages requested: \$970 million US

## ⌘ Case Failed, but CA was not allowed to be part of the proceedings



# Impact on Privatization



⌘ Traditional government services liberalized by GATS

⌘ Business

⌘ Health

⌘ Construction

⌘ Tourism

⌘ Distribution

⌘ Recreational

⌘ Education

⌘ Cultural

⌘ Environmental

⌘ Transport

Market structuring role threatened

⌘ Investor rights not balanced with public values

# Market Structuring Role Threatened



- ⌘ Subsidies to government services must be extended to foreign investors
- ⌘ Zoning may be challenged
- ⌘ Licensing may be harmonized
- ⌘ No residency requirements
- ⌘ No performance requirements
- ⌘ Bonds may be prohibited
- ⌘ Tax revenues may be affected
  
- ⌘ Investor rights not balanced with public values

# State and Local Governments Request Changes



- ⌘ National Council of State Legislatures
- ⌘ National League of Cities
- ⌘ National Association of Counties
- ⌘ Texas, Oregon, California, Oklahoma have made resolutions
- ⌘ Want transparency, disclosure, legal standards (traditional definitions of takings) and local government rights to subsidies and procurement preferences.
- ⌘ Request Chapter 11 of NAFTA not be repeated in new agreements

# Why not a stronger reaction?



- ⌘ State and local government are pro free trade
  - Need economic development to bolster their tax base
- ⌘ Democratic deficits first seen in Mexican and Canadian cases (since only investors to have rights are foreign and most firms are US-based)
- ⌘ Congress has never debated Chapter 11 Governance Provisions – Fast Track Approval

# Challenges for Extension



- ⌘ Need a public conversation about what we value in government.
- ⌘ Need a balance between governance and economic development goals.
- ⌘ Market solutions to public goods require government intervention
- ⌘ Citizen voice needs a place in the system
- ⌘ How do we create space for state and local diversity that respects our federal system?



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