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# **The Emperor's New Clothes: Transit Privatization and Public Policy**

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## Executive Summary

This paper examines the impact of the five-year-old effort by the Urban Mass Transportation Administration (UMTA) to force state and local transportation authorities to convert a significant proportion of their systems from public to private operation.

It is derived from a larger Economic Policy Institute study (Sclar 1989).

Five major findings emerge from this investigation:

1. Privatization establishes the wrong priority for urban transportation systems.

The primary goal of urban transportation policy should be to improve the speed, safety, and convenience of metropolitan travel. The primary goal of privatization policy is to reduce the tax money that publicly operated systems receive to transport transit-dependent people, regardless of the effect on congestion, pollution, and the economic efficiency of the city. Thus privatization is a significant break with past bipartisan federal policy that viewed urban public transportation expenditures as investments in the nation's productive capacity.

Choosing the wrong primary transportation goal will exact costs. It means retarding progress on containing environmental pollution and forcing an inefficient overinvestment in automobile-related infrastructure. The larger national productivity losses from this course far outweigh any possible gains from cost containment.

2. Privatization confuses the efficiency and effectiveness of transportation systems with lowering cost on individual *routes*.

Privatization policy assumes that urban transportation networks are merely a collection of separable routes rather than complete systems. But, in fact, the measure of the success or failure of urban transportation lies in its ability to move travelers between any two points in the metropolitan area, not just between two points on a given route. One result is that privatization advocates typically omit from their competitive cost analysis the necessary cost of increased supervision and coordination which a privatized, route-focused approach requires.

3. Studies financed by UMTA and used by that agency to prove cost savings from privatization are methodologically flawed and their conclusions unjustified by the underlying data. Typically, the UMTA studies:

- Compare the "fully allocated" public cost for a given route, which includes a share of the cost of planning, programming, financing, marketing, monitoring, and coordinating an entire transportation network, with the private bid for a route, which does not.

- Compare the *allocated cost* of running a public system to the initial bid by a private contractor. Since it is a common practice to deliberately underbid in order to get the first contract and capture the market, bids cannot be assumed to represent the actual cost of private operation, which ultimately will be passed on the public.

- Ignore the furnishing to private contractors of public equipment and services in the calculation of private costs.

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*Studies financed by UMTA ... are methodologically flawed and their conclusions unjustified by the underlying data.*

■ Do not measure any differences in quality of service such as travel time, reliability, comfort—that may result from privatization. Inasmuch as the cost of a service can be lowered by reducing the quality of the service, ignoring such changes makes cost comparisons meaningless.

Available evidence indicates that true cost comparisons would show that privatization has not been successful as a general strategy to contain costs, and may actually force increased cost onto the public.

4. The *hope* for savings from privatization rests upon an inaccurate conception of how public contracting operates in practice.

UMTA's policy is based on simplistic textbook theories of competitive markets. It does not take into account the real-world market strategies of public contracting in which establishing monopolies, influencing public officials, and obtaining hidden subsidies are commonly used to enrich private investors at public expense. When contracting is examined against these real world constraints, the evidence indicates that the market for contracted services operates less like textbook competition and more like textbook monopoly or oligopoly, in which prices are driven as much by relative bargaining power and political considerations as by underlying production cost. Contrary to the claim that privatization will lessen the political factor in operating urban transportation systems, developing experience suggests the opposite is true.

Private sector involvement in transit remains a viable option in some instances. These findings do not mean that contracting for private operation of portions of an urban mass transportation system is never appropriate. They do, however, strongly suggest that such decisions should be made on a case-by-case basis after a thorough analysis of the relative costs and benefits involved. Federally ordered privatization, initiated in Washington and forced on local and state governments, as in UMTA's present policy, is not in the best interests of either the nation's commuters or its taxpayers.

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## **Introduction: Privatization Policy in Context**

### **Privatization: A Flawed Policy**

In October 1984, the Urban Mass Transportation Administration (UMTA) of the U.S. Department of Transportation (DOT) announced an official “policy regarding private enterprise participation in the development of plans and programs to be funded under the Urban Mass Transportation Act of 1964 (UMT Act), as amended. ...” (Federal Register, 1984:41310). That Federal Register notice marked the formal beginning of UMTA’s policy of promoting “privatization.” In the announcement, UMTA’s stated goal appeared innocuous enough: “to insure that local decisionmakers fully and fairly consider the private sector’s capacity to provide needed transportation services.” (Federal Register, 1984:41310.) But in the ensuing five years, it has become clear that the announcement was the beginning of a far-reaching policy change: a deliberate attempt to use the power of the federal purse to force the balance of direct transport service provision away from local public agencies and towards private, for-profit operators.

Today, UMTA still claims that its policy initiative is merely an attempt to insure that Congressional intentions with respect to private sector participation are met. However, as implemented in federal regulations, the agency’s privatization policy has gone far beyond congressional intent and represents a radical break with historic federal transportation policies which undergirded America’s economic development for over one hundred years.

The conceptual rationalization for privatization policy is essentially the view that “the fundamental problem in transit is *insufficient cost control*” (Cox, 1989, pg. 2. Emphasis added.). If runaway costs are the problem, UMTA’s reasoning goes, privatization can solve it by forcing a system of competitive bidding for service on what UMTA views as its reluctant grantees, the managers of local urban transit systems. As this paper will show, however, this reasoning reflects a misunderstanding of how the process of public contracting works in practice. We also argue that privatization is likely to prove disappointing to UMTA as a money saving scheme. In fact, it will most likely increase costs by instituting a less efficient use of transit resources.

UMTA’s privatization policy represents a clear break with past policies. From the founding of the Republic until the arrival of the Reagan Administration in 1981, our national approach to matters of transportation had been primarily infrastructural. That is, transportation policy has historically been an integral part of economic development policy. Policy makers viewed public costs for capital improvements and operating subsidies—for barge canals, highways, railroads, harbors, airports, and mass transit—as investments in the overall productivity of the American economy: investments that would not be made except by the public sector. UMTA’s present detour from this wise and proven policy will impose large costs on our national economic productivity.

At the outset, the Reagan Administration explicitly stated its intention to change public transportation priorities. Its first major budget proposal stated that “*there is no reason* for someone in Sioux Falls to pay

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federal taxes so that someone in Los Angeles can get to work on time by public transportation.” (America’s *New Beginning*, 1981:4-28. Emphasis added).

Efficient expenditure of public money should always be an important policy objective, but such considerations should not be allowed to distort our focus from the *purpose* of the expenditures. During political debates, opponents of a program typically attempt to change the terms of the debate from considerations of program outcomes to considerations of cost. It is politically easier to oppose inefficient spending than to openly oppose a program with widespread public benefits, such as support for urban transit. That dynamic appears to have occurred with privatization. Privatization is a policy built primarily around an ideological desire to either decrease or eliminate public funding for public transit; failing that, it aims to insure that as much of the public money for transit passes to private firms as possible. This ideological component is so strong that UMTA opts for private contracting even when it is *prima facie* more expensive than public provision.

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### **Urban Transportation Policy: What Should We Be About?**

The policy goal of urban transportation should be to ensure the quick, safe, and efficient movement of people and goods around metropolitan areas. Such movement is vital to the well-being of urban society. Indeed the quicker, safer, and more efficient the movement, the better off is the national economy.

To accomplish this policy goal, policy makers today must address five vital concerns: traffic congestion, environmental quality, energy conservation, savings on infrastructure investment, and equal access to all members of society. When we consider all these factors, the general conclusion is this: *urban transportation policy must aim to increase the extent to which we move people by mass transit and decrease our dependence on the automobile.* To understand this conclusion consider the following facts:

(All of the following items come from *Transit 2000*, 1988.)

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#### **Traffic Congestion:**

■ Congestion is now a common feature of urban and suburban travel. It will increase more than 400 percent on the nation’s freeways, over 200 percent on non-freeways and over 1,000 percent in areas with less than one million in population over the next 20 years.

■ The most conservative estimates indicate that total travel will increase one to two percent per year. Over the next three decades that would add the same amount of traffic as has been added in the last three decades.

■ In the next 20 years, auto trip delays will increase by 5.6 billion hours per year, excess fuel consumption will increase by 7.3 billion gallons per year, total costs to travelers will rise by \$41 billion per year.

#### **Environmental Quality:**

■ Sixty-eight cities are too polluted to meet ozone standards; 59 cities

fail to meet standards for carbon monoxide pollution; over 100 suburban areas exceed current pollution standards.

■ Motor vehicles are a major cause of carbon dioxide, the pollutant that contributes to global warming through the greenhouse effect. Motor vehicles also contribute 60 percent of the hydrocarbons that produce ozone and smog problems.

■ Persistent, worsening air pollution is now known to adversely affect everyone, not just those with respiratory problems. Over 100 million Americans now live in areas where air quality is below acceptable standards. The national health care bill for air pollution illness is \$40 billion per year.

■ Ozone accumulation at ground level threatens the long-term viability of entire industries. Crop losses due to ozone, smog, and other air pollutants in the U.S. each year equal \$1.3 billion.

■ The U.S. Environmental Protection Agency is beginning to apply sanctions and limit development in non-attainment areas (areas not in conformance with clean air standards). Former EPA Administrator Lee M. Thomas has repeatedly stated that "solving the urban ozone and carbon monoxide problem will require us to change our driving habits".

#### **Energy Conservation:**

■ Transportation accounts for 65 percent of petroleum use today.

■ Petroleum imports have risen to 35 percent of total supply and may go up as high as 60 percent by the year 2000.

■ The U.S. Department of Energy has characterized the current dependence on foreign oil, likely to continue in the future, a threat to national security.

■ Despite today's abundant supply and low prices, some forecasters project as much as an eight-fold increase in petroleum prices after the beginning of the twenty-first century.

■ Gasoline prices in North America, and in the U.S. particularly, remain well below world levels. These low prices act as an incentive for consumption rather than conservation. In the U.S. in 1987, the average price per gallon was 82 cents including an average of 25 cents in total taxes; in five western industrial nations, the 1987 average price was \$2.78 per gallon, including \$1.84 in taxes.

#### **Infrastructure Investment:**

■ In the absence of aggressive development of public transportation, there will be a need for 102,000 new lane miles to handle the traffic by the year 2010. Yet few experts believe it will be possible to construct these facilities.

■ If as little as 20 percent of these new traffic lanes remain unbuilt, the need and demand for public transportation will double.

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***There will be a need for 102,000 new lane miles to handle the traffic by the year 2010. Yet few experts believe it will be possible to construct these facilities.***

### **Equal Transportation Access for All Citizens:**

Population groups with limited access to automobiles are expected to increase rapidly over the next two decades:

- The number of persons over 65 will grow from 25.7 million in 1980 to over 65 million in 2030. The very elderly population over 75 will grow even more rapidly.

- Observers project a disproportionate growth in the size of the population with incomes below the poverty line. Access to transit will be especially important to the creation of economic opportunities for this group.

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*Access to transit will be especially important to the creation of economic opportunities for [the low-income population].*

# **A Sharp Break with Past Policies**

## **The Evolution of Federal Urban Transportation Policy**

From the early 1900s through the end of the 1950s, the federal government created policies aimed at helping the nation's rural and urban areas accommodate the demands of automobile and truck travel. Initially such travel was viewed as primarily a rural phenomenon. Indeed the Federal-Aid Highway Act of 1916 specifically prohibited roads and bridges funding to any area that could be remotely considered urban.

The 1944 Highway Act remedied that situation. Looking forward to the needs for improved traffic circulation in the post-World War II era, this act explicitly designated aid for urban roads. In the decades between 1916 and 1944, the automobile and truck moved from a primarily rural to an urban, and more important, suburban travel mode (Schaeffer and Sclar, 1980). The 1944 act permitted the federal government to pay 50 percent of the cost of designated urban roads in recognition of the new importance which this mode of travel now enjoyed in metropolitan areas.

The policy of accommodation to the infrastructural needs of automobile travel culminated in the passage of the Federal-Aid Highway Act of 1956. This act established the Highway Trust Fund. Through this fund, states were reimbursed for 90 percent of the cost of the interstate highway system, initially called for in the 1944 act. In addition, Veterans Administration and Federal Housing Administration mortgage guarantee programs, along with federal income tax deductions for mortgage interest and property taxes on owner-occupied homes, encouraged the post-war migration of the nation's urban residents to the auto dependent suburbs.

Beginning in the 1960s, the federal government reoriented its approach to transportation policy in the face of the complex realities of metropolitan circulation. It had become evident that the solution was no longer a matter of increasing the capacity of roads to accommodate more cars. It was now a problem of choosing the most effective mix of transportation modes: cars, buses, and rail.

The value of cities rests on their ability to sustain a high population density in a comparatively small amount of space. Cities thus require a far different mix of transport modes than do the less dense suburbs that evolved after World War II. Improved automobile and truck mobility were vital to that suburban growth, but cities need modes that can carry more people using less land. Moreover, the nation began to see its metropolitan areas as complex, integrated systems in which goods and people shifted about in continuous circulation. To serve these systems efficiently, the underlying transportation network of cars, buses, and trains had to fit together. This fit could only come about through comprehensive transportation planning, design, and operation.

In the early 1960s, the federal government began to address the issue of making choices between the degree of reliance on private vehicles versus common carriers such as buses and subways. These choices

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were difficult, since any course of action has its benefits and its costs. Each is better for some groups of people and worse for others. Because of these considerations, urban transportation policy emerged as a legitimate and explicit focus of political debate and regional planning.

The Highway Act of 1962 reflected this new approach. That act mandated that highway plans must be

properly coordinated with plans for improvements in other affected forms of transportation the Secretary shall not approve any program for [highway] projects in any urban area of more than fifty thousand population unless he finds that such projects are based on a continuing comprehensive transportation planning process carried on .. in conformance with the objectives stated in this section. (Highway Act of 1962, Public Law 87-866, section 134.)

Two years later, the Urban Mass Transportation Act of 1964 (UMT Act) was signed. That act legislated as a national goal that cities maintain, rebuild, and expand their transit systems as part of a balanced system of urban transportation.

By the time the UMT Act became law, it was clear that most of the nation's privately operated urban transport systems were in serious trouble. Badly undercapitalized, they were barely able to remain in business, let alone serve as the organizational vehicle for the transit expansion that was urgently needed. Based on the long history of local public operating subsidy that these systems began receiving as early as the second decade of the present century, it was anticipated that this new public mandate would by and large be carried forward through direct public provision of service. It was not that private operation was opposed. Indeed, where feasible, the act expressly encouraged it. It was simply acknowledged that private operators could not develop the complex area-wide systems needed by the expanding metropolitan areas of post-World War II America.

Between 1965 and 1981, the UMT Act and a series of subsequent amendments changed the urban transit maps of America's metropolitan areas. These acts mandated comprehensive transport planning and coordination through the establishment of Metropolitan Planning Organizations (MPOs). They led to the creation of public metropolitan transportation authorities across the nation. They provided funding for specific projects and demonstrations, planning grants, and also matching grants for capital improvements. The major goal of the UMT Act was to address the general *capital* needs of American urban transportation in a planned deliberative manner.

In the early years, much of the federal money was used to take over the aged and failing operations of local private providers-to put urban transit back on a firm footing under the control of public authorities. In later years, municipalities used the funding to make capital investments in new buses, rail vehicles, tracks, and rights-of-way. During the first ten years, the federal government paid two-thirds of these costs. After the 1973 oil crisis, the government increased its share to 80 percent.

The 1970s were marked by two extremely severe petroleum short-

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ages. Over the decade, the price of oil went from under \$10 to over **\$30** per barrel. These events tended to focus even more emphasis on encouraging the use of mass transport systems. The National Mass Transportation Act of 1974 authorized federal funds for *operating* assistance to local transit authorities. By 1984 a total of \$5.3 billion in public operating assistance was provided to local transit systems. Of this, the federal government contributed about \$900 million or almost 17 percent. The remaining 83 percent came from state and local governments. The states contributed about one-third and the local governments about one-half of the total.

The 1978 Surface Transportation Assistance Act expanded allocations for both capital and operating assistance and divided the funding available for new construction and equipment into categories. Additional funds were authorized for new bus projects, commuter rails, intercity bus services, and joint development projects. New approaches tapped into the Highway Trust Fund for transit operating subsidies and authorized joint transit development block grants.

The programs of the 1960s and 1970s remain fundamental supports for the nation's transit systems. They provide capital grants (on approval of requests), offer direct operating subsidies, and make funds available for special transit programs. These are essentially the programs that most local transit agencies regard as crucial if current service levels are to continue. They are also, however, the programs that privatization policy seeks to undermine.

### **Urban Transportation Policy Since 1980**

When the Reagan Administration took office in 1981, it was hostile to the idea of any active federal policy to help localities balance travel modes. If Americans by and large choose to travel by automobile, then so be it. It was also ideologically hostile to the public provision of service, even at the local level. As a result, two new goals were placed at the top of the nation's urban transportation policy agenda:

- to reduce federal spending on transit programs, and
- to establish a more central role in public transport for the private sector.

To sell this new approach politically, the Administration advanced the theoretical argument that if localities would substitute competition among private providers of transit for the present system of public provision, sufficient savings from increased operating efficiencies would more than offset any loss from decreased federal funding. The validity of that theory is now a central issue for the future of urban transportation policy.

In 1984, UMTA announced its new policy regarding private participation, which it dubbed "privatization." The new policy charged localities with the responsibility of demonstrating that they were *actively* encouraging private firms to participate in the provision of new and restructured local services. Unless UMTA was satisfied on this score localities would not be able to obtain or retain matching funds for these services. Still, in seeming to maintain the policy of community responsibility, the

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federal government nominally left the choice of actions to local decisionmakers,

In 1986 the Administration again proposed to entirely eliminate transit operating assistance and to reduce transit subsidies by 75 percent. Congress, however, did not agree, and in September of that year passed a bill to continue the mass transportation program, including a \$13 billion, four year extension of the federal program. In addition, in the 1987 appropriations bill, Congress took the opportunity to express its view that UMTA had not been respectful of local decision making and to clarify Congressional intent as regards transit privatization. In the conference report which fashioned the final appropriations bill the conferees reiterated that

■ the extent of private sector involvement in the provision of public transit is best decided at the local level, there should be no quotas affecting local programs, and conditioning funding on a certain level of {private sector} involvement is not consistent with the Urban Mass Transportation Act of 1964, as amended. ...

■ any UMTA policy statements on private sector participation, such as those of October 1984 and January 1986, should not exceed UMTA statutory responsibilities under sections 3(e), B(e), and 9(f) of the UMT Act of 1964, as amended. ...

■ UMTA's Office of Private Sector Initiatives should be primarily a source of information to facilitate private sector involvement in urban mass transit. The conferees do not believe that this office should be regulating the local transit planning or decision-making process or giving priority to or otherwise basing the release or allocation of Federal assistance on the nature of the local planning or decisionmaking process, or the decisions made at the local level as to the provision of mass transit services or functions, and has included a general provision to that effect.

■ The conferees firmly believe that the final decision regarding provision of service rests with the grantee. .. in an effort to respond to concerns that UMTA has overstepped its legal authority by explicitly conditioning section 9 grants on private sector involvement, it is the intent of the conferees to make clear that such a conditioning of formula grants cannot occur. The conferees want to be certain that UMTA does not exceed its current statutory authority as it implements its private sector initiatives.

(Conference Report, "Making Appropriations for the Department of Transportation and Related Agencies", to accompany H.R. 5205, pp. 28-29.)

In a circular released in December 1986, in response to the congressional conference report, UMTA denied that it was overstepping its legislated bounds in pursuing privatization. It argued that it was merely following its interpretation of the existing requirements of the UMT Act of 1964, as amended. (UMTA C 7005.1)

The present situation with regard to urban transportation policy can be characterized as a stalemate. On one side sits the executive branch of government which is defining the urban transportation problem as a

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*On the other side sits the Congress ... calling for a more active and innovative stance to ensure that our urban transportation systems are up to the challenges that international economic competition and environmental concerns have forced upon the nation.*

local problem of cost containment to be solved with privatization. On the other side sits the Congress, including members on both sides of the aisle, calling for a more active and innovative stance to ensure that our urban transportation systems are up to the challenges that international economic competition and environmental concerns have forced upon the nation.

The deadlock between Congress and the Administration must be resolved. The present policy emphasis on privatization is distinctly counterproductive. As this paper attempts to demonstrate, if fully implemented, privatization would create minimal systems of metropolitan mass transit. Where it has been tried, privatization does not save costs; it shifts costs from the general public to the transit-using public in the form of an inferior product and to transit employees through lower wages. Given that non-transit riders in the general public also receive benefits from mass transit (such as reduced congestion and pollution) the policy is likely to increase inequities as well as reduce the resources available for mass travel in this country.

That is a particular tragedy at the present time. Today, it is no longer possible for us to expand our automobile based travel systems. The financial and environmental costs are simply beyond our means. *If we are to keep our metropolitan areas and hence our nation economically viable as we move into the next century, it is important that a legislative/executive consensus be forged around a thoughtful and comprehensive program of public transport investment and complementary land use planning.* Given the distribution of fiscal resources, only the federal government can provide leadership in this undertaking. The present policy stalemate must be resolved in favor of strengthening the initiatives begun in the previous two decades under both Republican and Democratic administrations.

### **Transportation Subsidy**

Much of the debate about privatization hinges on the question of how efficient a publicly provided transportation service can be. Implicit in the pro-privatization case is the idea that if private enterprise undertook the public transport task, the endeavor not only would be less costly, but might even prove profitable. As we consider the evidence on this point in the sections that follow, it is important to bear in mind that transportation systems, regardless of public or private operation, have never maintained themselves without some form of subsidy. Every **system**, regardless of mode, is susceptible to this problem. That statement does not preclude the possibility that certain *routes* may be profitable at certain times.

When in 1802 it was decided to establish the U.S. Military Academy at West Point, New York, this decision was motivated in no small part by the need to subsidize the training of civil engineers who would then be available to construct canals and dredge rivers and harbors so that travel across the new nation might be easier and less expensive. After the Civil War, the federal government engaged in a massive give-away of public lands to underwrite the cost of railroad construction.

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*Transportation systems, regardless of public or private operation, have never maintained themselves without some form of subsidy.*

In the late nineteenth and early twentieth centuries, the creation and private operation of electric street railway (trolley) companies was initially stimulated and subsidized by real estate developers who built new suburbs along the trolley lines. Once the new houses were sold and this potential for private gain evaporated, so too did the private subsidy from real estate development that had supported trolleys. The problems caused by this withdrawal of private subsidy were so great that in 1919 President Wilson established a national commission to look into the difficulties of that vital, but “virtually bankrupt,” urban transportation industry (Smerk 1968).

Among the recommendations that the commission made were the following:

(All quotes from the Report of the Federal Electric Railway Commission are found in Smerk 1968.)

- It is of the highest importance that both the total cost of the service and the cost to the individuals who use it be kept as low as possible without injustice to those who take part in producing it. .

- The full cooperation of labor is essential to the highest prosperity and the usefulness of the industry. The employees in this occupation should have a living wage and humane hours of labor and working conditions. They should have the right to deal collectively with their employers, through committees or representatives of their own selection. All labor disputes should be settled voluntarily or by binding arbitration, and the award of such a board should be final and binding upon both parties.

After discussing several ways in which it might be possible to financially strengthen the electric trolley lines and leave them in private hands, the commissioners conclude by saying:

If the reforms incident to public regulation which we suggest in this report should not result in making private ownership satisfactory to the public, such reform should at least enable public ownership to be established upon a just and equitable basis.

Two points from the Report of the Federal Electric Railway Commission are important for our present discussion of privatization. The first is that public versus private operation was not originally an ideological issue. It was simply the case that mass transit was important but not profitable at the fare box. Consequently, the question then, as it should be now, was the pragmatic one of how to ensure that the service be efficiently provided. Second, unlike the present situation, in which UMTA seeks to shift the cost from the public purse to the riding public with poor service and to the transport workers through lower compensation, the federal commissioners of 1919 sought to establish procedures which would forthrightly ensure that the transit system’s legitimate bills were equitably paid.

It is important to remember, as noted earlier, that the issue of subsidy does not disappear when we examine automobile travel as an element of urban mass transportation. In addition to the subsidies provided by the federal government since the beginning of the present century, there have also been large state and local subsidies to automobile travel.

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***Consequently, the question then, as it should be now, was the pragmatic one of how to ensure that the service be efficiently provided.***

While segregated self-sustaining highway trust funds at the federal and state level were developed after much of the primary highway infrastructure was in place, the level of subsidy continues to exceed the revenues from these funds. Most of the local street infrastructure is supported not by highway taxes but by state and local general revenues. Free parking is the rule in suburban shopping centers. Without these massive capital and operating subsidies, auto travel would not prove to be economical for the vast majority of those who currently depend on the car for their mobility. In the larger scheme, the costs that individuals bear through ownership of their own vehicles are small compared to the overall public costs of making that transport system viable.

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## Competitive Bidding in Theory and Practice

UMTA's privatization strategy is rooted in the theory that sellers compete permanently in an unceasing struggle to wrest market share from one another. These competitive pressures, the theory goes, will force service prices down to the level of actual production costs under conditions of efficient operation.

UMTA implicitly assumes that competitive bidding for transport service will work very much like this abstract model of a competitive market. As with any broad generalization, its relevance must be carefully tempered by an analysis of the facts.

Given the comparative newness of UMTA's privatization policy, the evidence is not yet at hand to render a final judgement on this experiment. However a review of UMTA's own studies on privatization, our analysis of the historical record, and our independent examination of actual experiences with "privatization" to date in different municipalities point to a disturbing conclusion. The experiment with privatization is likely to cost, not save, taxpayers money. Furthermore, enforcing a policy of privatization will likely cause the service to the riding public to deteriorate.

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### UMTA's Best Case

In order to make the practical case for privatization, UMTA has financed at least 20 empirical studies with the goal of demonstrating that privatization saves money. The studies, however, fail to evaluate service quality.

All the studies we have seen are, not surprisingly, favorably inclined towards providing transit by multiple private providers. Those that directly deal with the relative cost of public-and-private-sector-operated transit invariably claim that with the use of private sector transit 'considerable cost savings are possible.'

The most detailed, widely quoted, and important UMTA-financed study on this subject is *Public Transit Service Contracting*, by Teal, Giuliano, and Morlok (1986). The study includes a nationwide survey of transportation contracting by public agencies.

Teal and his co-authors used three approaches to estimate the savings from the use of private contractors. By the first method, they estimate savings of 42 percent; by the second, "about 30 percent;" and by the third method, the savings are "10 to 50 percent." None of these estimates, however, can stand up to careful analysis.

The first estimate (42 percent) is based on the result of the author's own mail survey. This survey (Teal, *et al.* 1986 Appendix B) yielded, as the authors explicitly acknowledged, *the* revenue vehicle mile (RVM) and revenue vehicle hour (RVH) costs of public transit *system* operations and private transit *route* operations. These were then tabulated by the number of vehicles in the operation. Table 1 reproduces the numerical results of this so-called "cost comparison" in their entirety.

Two points immediately confront the reader perusing this table. The first is that there appears to be a direct correlation between size of

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**TABLE 1**  
**UMTA's Teal Study:**  
**Public Agency versus Private Contractor**  
**Operating Costs for Fixed Route Transit by Size of System**

	Cost/RVM	Cost/RVH	Sample Size
<u>25 or fewer Vehicles</u>			
Private Contractor	\$1.90	\$27.05	51
Public Agency	1.91	<b>26.98</b>	159
<u>26 to 50 Vehicles</u>			
Private Contractor	2.21	30.62	<b>9</b>
Public Agency	2.33	30.12	66
<u>51 to 250 Vehicles</u>			
Private Contractor	2.38	33.75	6
Public Agency	2.67	36.95	79
<u>251 to 500 Vehicles</u>			
Private Contractor	2.05	<b>29.09</b>	4
Public Agency	3.26	48.87	10
<u>More Than 500 Vehicles</u>			
Private Contractor	N/A	N/A	N/A
Public Agency	4.11	53.09	23

Source: Teal, et al., 1986, p. 24

*In the only category with sufficient numbers of cases to yield generalizable results ... private contractors show no cost savings over public agencies.*

operation and cost: the larger the operation the higher the cost. The second is only in the category of 251 to 500 vehicles is there an appreciable difference between the costs of private route operations and public system operations. That finding by itself does not demonstrate that the larger public systems are less efficient than private operations of comparable size. It may only reflect the fact that larger public transit systems have a more complex mission to fulfill.

It should also be noted that the extremely small number of cases in the 251 to 500 vehicle category—only four private contractors—made this particular calculation highly suspect for purposes of generalization. In the only category with sufficient numbers of cases to yield generalizable results—25 or fewer vehicles—private contractors show no cost savings over public agencies.

Another major problem implicit in these data is that they essentially compare public “system” costs with private “route” costs. The former include the planning and coordination function, the latter does not. As will be discussed further, private contractor costs also exclude the significant costs of oversight and control activities that public transit agencies are required to perform when they privatize operations. UMTA's analysis also never considers the cost savings that accrue to the contractors from equipment furnished by the public agency sponsors. Neither does it consider the agencies' extra maintenance costs—especially at the end of the contract period when contractors may skimp on maintenance.

To arrive at their conclusion of 42 percent savings, Teal and his co-

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authors compare the cost of public agencies with over 250 or more vehicles against those of private contractors operating 26 to 50 vehicles. They justify this highly suspect cross-size-category-comparison by arguing that the large public agency would normally contract with smaller private contractors!

There is significant overhead cost associated with the planning and control of larger transit systems, but to break these systems into numerous smaller operations also imposes costs. Either the metropolitan community must suffer with the chaos of uncoordinated services, or create a new and probably more costly bureaucracy to coordinate the diverse operations.

That the Teal study found only slight or no cost differences between public agencies and private contractors for systems with less than 250 vehicles should make readers leery of the assumption that it is the type of operator (private versus public) that generates the extra unit costs and not other factors, such as system size.

The Teal study's second method of estimating "savings" is based on a literature review of studies that compared the cost of private and public service provision. The authors compiled data from 12 studies, nine of which deal with solid waste disposal, and one each with custodial service, public works maintenance, and fire protection. According to the authors, these studies show savings of 15 to 50 percent. But since none of the studies cited deal with public transit route service, their relevance to the problem at hand is not readily apparent. The lack of public transit cases is especially significant in light of the finding, implicit in their own study, that size and not public versus private provision is the key cost variable.

The third cost saving assertion made in the Teal study is that competitive contracting saves up to 50 percent with a mean of 29 percent. These percentages come from a special survey of 31 fixed-route transit services that are competitively contracted. Agencies were asked to estimate their savings due to competitive contracting. But as the authors themselves note:

Cost savings, as estimated by service sponsor, varied considerably.

In some cases, reported cost savings appeared to be the result of detailed estimates, while in others they were *judgmental based estimates*. (Emphasis added.)

Despite this poor quality data, the researchers then present a mean savings estimate, complete with a standard deviation of 18 percent! The addition of such statistical gloss, however, cannot strengthen the argument if the underlying data is questionable.

Typical of UMTA's willingness to allow unsubstantiated claims of cost "savings" are statements made in the executive summary of a study by Mundle and Associates, Inc. (1987). The executive summary reports findings of 29 to **60** percent, but the text more honestly states: "A detailed comparison of all operating and capital costs associated with providing services under these programs ...*has not yet been completed.*" (Emphasis added.)

Although many details in the UMTA studies are factually accurate, in

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the aggregate, the forest is not the sum of the trees. Rather the agency uses the research selectively to justify its privatization programs. Complex conceptual and measurement problems are swept aside. Such issues should be integral to such an important decision-making process. Instead they are ignored in the interests of a narrow ideological political goal.

### **The Fallout of UMTA's Research: Denver**

UMTA's narrow advocacy approach has already led some decision makers to make major and costly policy changes on a shaky basis. The recently enacted "privatization" law in Colorado is an excellent case in point.

In May 1988, the State of Colorado passed a law requiring the Denver Regional Transportation District (RTD) to privatize at least 20 percent of its bus service as of March 31, 1989. This is the first time in which an attempt is being made to go beyond privatization of new or revamped service, to apply the policy to existing service.

The law's preamble makes quite clear that the legislators relied on UMTA's research. It states that "public transportation service should be provide at the lowest possible cost [and] private transportation providers have been effectively used under competitive contracts to provide transportation services at lower cost and with lower annual cost increases (Senate Bill No. 164, Section 1)." The ultimate objective of the legislation is to transform RTD into a contract management agency overseeing private service operators. ("Bill," 1988.) Highlights of the Colorado law:

- RTD to convert 20 percent of total bus service to operation by private firms under contract to the district. Firms are chosen on lowest cost basis among qualified bidders.
- Competition must be consistently maintained. No provider can receive more than 50 percent of the vehicle hours on any RFP.
- Any qualified bidder can provide bus service in the District if the firm requires no subsidy.
- RTD fully allocated *costs* are to be compared with that of private operator's *bids*.
- There are to be no layoffs of RTD employees because of privatization.
- RTD is to perform a management study to determined if management functions could also be privatized.

In addition to a narrow cost containment approach to transport: policy, the bill also moves away from the broader view of the potential of mass transportation to serve as a tool of economic policy. Rather it narrowly defines the prime purpose of public transportation as serving the "transit dependent."

Given the fact that the legislation prohibits layoffs, it is difficult to see how costs to the agency can do anything but rise during the initial period. To the extent that any "savings" materialize, they can only occur far in the future and will likely be absorbed by other problems of implementing this legislation, resulting in no net benefit to the tax-

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payer. Furthermore, given the complexity of the entire system, it would appear that any savings that do occur will come at the expense of service quality.

**The** RTD privatization approach raises a number important service performance issues:

*1. More Bureaucracy with No New Resources*

Given the vision of the agency as having large contract supervision functions, which is implicit in this legislation, RTD will have to significantly increase its contract supervision and auditing capability. With no additional funding provided, that change can only come at the expense of existing operations. Although contractors will have their own street level supervisors, RTD street level supervisors will also be responsible for the performance of the contractors vis-a-vis the riding public.

*2. Interlining and System Efficiency*

In a unified system, buses and operators can be moved from one route to another as the situation demands. This increases the system's efficiency, especially under emergency conditions. The Colorado law limits this capability. Public transport users do not generally take a single bus. They usually take two or more buses to get from point A to point B. With multiple operators, the time loss that accompanies transferring can only become worse, not better. If transferring requires too much time, riders who can will opt to leave the system. The result will be increased auto ridership with all its attendant infrastructure and environmental problems.

If the performance of a transit system has to hinge on the coordination of multiple independent private contractors, each under its own pressures from breakdowns, and other problems, absenteeism, etc., it seems inevitable that the efficiency of the entire system must diminish.

The irony of this situation is this: given their individual constraints, even if each operator was working as efficiently as possible, the lack of a shared system goal would mean that the overall system would still be less efficient.

*3. Work Force Competence*

To the extent that private contractors can provide service at lower cost, they will do so at lower wage levels. Lower driver and mechanic wages, however, have an implicit cost in greater turnover and increased absenteeism, higher training costs, and less system reliability and safety. That, in turn, means that transit riders no longer receive the same product. Decreased reliability at the time that we are trying to increase ridership appears to be a wrong-headed policy.

*4. Jitneys and Balkanization*

The biggest enigma created by the law is the provision that allows qualified firms not in need of subsidy to operate anywhere in the district, exempted from taxes and public utility regulations. The impact of this provision is unknown, but havoc and destructive competition is more likely to result than an effective metropolitan wide transit service.

The basic problem with the Colorado law is its heavy-handed ideological approach to a complex public policy issue. Some purchasing of transportation from private providers by the larger public agencies has

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always made sense, and has occurred in most larger agencies. But the agency should have the right to exercise a responsible make/buy decision. Agencies should not have an important economic decision dictated by arbitrary ideological and political considerations. Contracting might be thought of as we think of aspirins: two can cure a headache, but the whole bottle will kill you.

### **The Practical Problems of Contracting**

UMTA and privatization advocates would no doubt argue that while the initial data may be weak and speculative, time is on their side because the idea is fundamentally sound. Careful analysis suggests otherwise. Let us consider some of the questions which must be answered in attempting to implement a nationwide program of transit privatization.

#### *Is Competition Stable Over the Long Run?*

Privatization assumes that competing suppliers in an arms-length relationship with one another and the public agency will attempt to win the agency's *ongoing* business by providing the best product at the lowest price.

The problem with this view is that it overlooks the fact that the virtues of the competitive market are more appealing to *buyers* than to sellers. Sellers seek to find as many ways as possible to undermine competition. One way to do this is by finding "market niches" they can dominate. From these positions, sellers can exact some type of stable monopolistic advantage. These specialized markets have higher and more stable prices than would occur under competition. In practice, this market situation is so typical that expert observers tend to regard occasional episodes of competitive price cutting and product innovation in any field as evidence of temporary market instability.

For drastic policy changes, such as transit privatization, it is therefore important to consider longer-term market dynamics. Even if initially some competition occurs, the important question for policy analysts is this: Will competition persist? Or will there be negative second- and third-order effects as sellers attempt to strengthen their individual positions at the expense of buyers and one another? UMTA and other proponents of privatization have not considered this longer-term situation. They satisfied themselves with a simple recitation of the static textbook model of the idealized competitive market. As a result, we are moving forward with a policy favored for its ideological purity, rather than its practical content and realism.

The dynamics of the second- and third-order impacts can drastically alter the anticipated policy change. This process was forcefully demonstrated in the experience of Westchester County, New York, where all transit service has been contracted since 1975. When privatization began, there were 16 private companies in the program, none with more than a third of the system's passengers. By 1985, there were eight companies, with the largest carrying 93 percent of the passengers (D'Adamo, 1985:16). According to the former Transportation Commissioner of Westchester County:

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. . . the fact that one company grows larger and larger it is probably inevitable that other companies will either grow smaller or disappear altogether, in either of which events they will no longer be in a position to provide services for the public sector. In other words, there will be no other game left in town and the one surviving, large company will have assured itself that even if transit contracts are put out to competitive bidding by the public authority that company would not face any competition and could charge the public sector whatever it wanted as though there had not been any competitive bidding at all. (D'Adamo,1985:19).

UMTA's latest Section 15 Reports (U.S. Department of Transportation, 1988) bear out D'Adamo's fear. Westchester County's largest contractor lists per vehicle operating expenses per revenue hour which are only about five percent less than those of the very large and very complex New York City Transportation Authority (\$66.20 and \$69.90 respectively).

In the real world, the idea that a steady supply of small efficient competitors will be continually available just does not accord with the facts of life for small firms. The more likely outcome in a market such as public transit is that one or two large firms will come to dominate each market area with only token competition. Any undercapitalized upstart who attempted to underbid would eventually be undermined by the deeper pockets of the larger operators. The net effect of these marketplace realities, is that we must seriously question the casual assertion that competitive bidding is easy to implement, manage, and maintain.

#### *Does Politics Play a Role in Contracting?*

Suppliers do not sit idly by and allow competition to threaten their economic position. They actively engage in both political and economic "marketing," which tends to undermine the competitive environment.

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***Politics and economics are not separate domains.***

This situation is clearly illustrated in the experience of Sonoma County Transit (SCT). Using competitive bidding, SCT had previously contracted with Laidlaw Transit to provide area service. At the expiration of the contract in December 1988, the county sought to award a new three-year contract to a public provider, the Golden Gate Bridge and Transit District (GGBTD). GGBTD offered to provide the three-year service for a cost of \$5.5 million. This bid favorably compared to Laidlaw's \$6.1 million and the lowest private bidder, American Transit Corporation's (ATC) bid of \$5.9 million. Nevertheless, in response to a protest from the California Bus Association, a lobbying and political arm of the private operators, UMTA forced SCT to award the new contract to ATC, and not to the public operator. The formal decision in this case was clearly not based on saving public money, but on bureaucratic technicalities in the service of privatization policy. From the point of view of the private operators, they were not going to sit by idly while a new market was lost to them. As is usually the case, politics and economics are not separate domains. Arguments that contracting for bus service in a world of political actors is the same thing as choosing a

brand of soap powder in a supermarket, fly in the face of reality.

### *Can Little Fish Ever Eat Big Fish?*

The case for privatization, as with the Teal study previously discussed, is usually put in idealized terms: small, efficient, entrepreneurial, operators are pitted against large, inflexible, and inefficient bureaucratic public systems. Reality, however, shows that most of the successful players in the new game of transit privatization are large national multi-product firms or their subsidiaries, not smaller local competitors. In one UMTA-financed project it was found that of 1.2 cases of either peak hour service on regular route service contracting, ten of the awards went to large national firms and only two to local operators.<sup>2</sup>

Either the picture of the local, small, “lean and mean” efficient competitor is inaccurate, or the larger firms are willing to use their capital to shift costs internally to underbid the first contract in order to achieve market power. The latter analysis appears more likely. If not monopolistic, the larger firms are oligopolistic—they are able to override to a degree the cost-control mechanism of the competitive market place through power and political considerations. They have the resources and are willing to use them strategically in order to gain the all-important positional advantage that accrues to the first entrants into any new market.

This result is contrary to the ostensible intent of the privatizers, who call for small competitive firms to share the market and drive down costs. The implication of our analysis is that the prices charged by bidders will have less to do with costs of operation and more to do with relative economic and political power. In such a situation, long-run costs will be higher than those anticipated by the competitive model, and—in all likelihood—higher than those of the present public sector as well.

### *Is the Customer Always Right?*

The promise of service improvement through competitive contracting is based upon the notion that entrepreneurial sellers will be more responsive to buyers than public agencies, because of the implied threat of losing the route to rivals. However, the contractor’s customer is the agency, not the riders. Vendors do not necessarily see their long-term interests tied to the rider’s well-being as much as public transit agencies do. Capital investments in rider satisfaction make no sense to contractors who are concerned that they may lose the service to a lower bidder in the next round of negotiations. As a result, privatization as envisioned by UMTA is not a strategy for ridership expansion, but for market stagnation around a low quality product.

Once again consider the experience in Westchester County, New York, as reported by the former head of the County’s transportation agency R. Raleigh D’Adamo:

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***Such need for oversight will make the relationship between agency and contractor increasingly adversarial. The more service the agency contracts out, ... the more this power struggle will favor the major contractor or contractors.***

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activities—you do the marketing, you put out the time tables, it is your logo on the buses--the complaints focus on that public authority and you are held ultimately responsible, not only by UMTA for the wise use of UMTA funds, but to the public for the provision of services. Unfortunately, we found frequently that the private operator felt insulated from that direct contact and not directly responsive to the day-to-day going on. Our remedy for that was unfortunately costly, but it required us to log in each of the complaints and then forward them to the operator for investigation and then preparation of a response back to the public. We also felt that we had to spot check the nature of the responses that we were getting from the operator to make sure that they were indeed, honest and that the situation that caused the complaint in the first place was not going to be repeated. So that is part of the problem in having outsiders do some of the work (APTA Tape, 1788).

#### *Is a Contract in Theory the Same as a Contract in Practice?*

According to the theory of privatization, after an agency selects a contractor, a contract is drawn up that specifies services, costs, penalties for non-performance, and procedures for handling unforeseen contingencies. Theoretically, the agency then needs only to monitor street-level performance to decide if it is getting its money's worth. However, as we detail this scenario problems emerge.

For example, a typical contingency may suddenly require more service than the contractor is furnishing. The agency must decide if the situation requires more vehicles and drivers, or just more efficient use of existing ones. In order to make this determination, the agency must conduct a detailed review of the contractor's internal operations. In other words, the public agency will have to judge and, at times, question the decisions made by the contractor's managers. Over time, such need for oversight will make the relationship between agency and contractor increasingly adversarial. The more service the agency contracts out, and the less equipment and drivers it has under its direct control, the more this power struggle will favor the major contractor or contractors. The result will be that price will be the outcome—not of actual costs—but of relative negotiating strength.

To avoid the dangers of such situations, public agencies can let out management contracts to private firm using agency equipment. While such arrangements are attractive because of their convenience, there is little evidence that they are less costly. A recent feasibility study for the Denver RTD concluded that such contracting out for management service would increase costs by 25 to 30 percent to the RTD (Deloitte, Haskins & Sells, 1989:v).

#### *Summary*

There are two fundamental problems with the model of competitive bidding as a cost-containment strategy: it ignores political and economic realities, and it takes a myopic view of efficiency.

The textbook model of competition is devoid of politics and social constraints; the real world is crammed with them. In the world of textbook economics, prices and quality are the outcome of non-coercive, competitive market forces. In the world of real actors, competitors do not simply win or lose on the basis of product and price. They use any and every social and political advantage at their command to maintain market share. All of these factors must be considered in any thorough policy analysis of the pros and cons of such a radical change as transit privatization.

The second problem with the approach is its failure to think about the implications of bidding *routes* in terms of the goal of maximizing *system* efficiency. The issue of the trade-off between the purported savings benefits and increased costs has never been competently addressed by UMTA.

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## The Measurement of Cost

### Cost Curves Bend with the Wind

Although the entire justification for privatization is that it will save public money, UMTA has been forced to go to heroic lengths to make even that portion of its case. Although the meaning of *cost* might at first glance appear self-evident, it is only when one begins to measure it that the crucial role of value judgments become apparent. In the final analysis, the classification and evaluation of cost is a highly subjective matter. As the UMTA-sponsored studies make clear, deciding which cost items to consider and which to ignore depends upon the goals and interests of those seeking the data.

The crucial question for privatization is whether or not private operators can in fact provide comparable service at lower cost than the public agency. Therefore it follows that it is necessary to develop some generally agreed-upon definition of costs.

UMTA takes the position that the proper way to evaluate a public or nonprofit transit agency's service cost is on a fully allocated basis. Such an estimate should include not just the direct ("out-of-pocket") costs of the service in question, but an allocation of that service's share of all overhead costs for administration, facilities, and the like. In addition, UMTA wants to be sure that "subsidies provided to public carriers, including operating subsidies, capital grants and the use of public facilities" are also "reflected in the cost comparisons" (Federal Register, 1984:41312). UMTA has different rules for the private side, however. Any legitimate bid is taken as a fair basis for comparison. In UMTA's words:

Only the bids [sic] of public agencies and non-profit agencies must reflect fully allocated costs. UMTA does not intend that a private operator fully allocate its costs or bid this figure in a procurement.

The price bid by the private operator is the figure against which a recipient's or a non-profit agency's fully allocated cost is compared (Federal Register, 1989: 1563 5).

This dual basis for cost comparison clearly reflects UMTA's priority of actively expanding the role of private operators in public transport. The unstated presumption here is that private operators do *not* price their products strategically to generate better long-term market position. As mentioned earlier, however, such a presumption is a misunderstanding of the strategic behavior of most private firms, especially the national multi-product firms which are moving into the new contracting market.

If we assume that private operators intend to win market share to obtain long-term profits, there is no reason to think that they would not bid on the basis of less-than-full-service costs and carry the loss through the cash flow produced by their other operations. Over the long-term, private operators would intend to more than make up the short-term loss through the oligopolistic power over the newly created market, they would exert as winners of the initial contract.

Indeed Greyhound Lines, Inc., (GLI) was quite explicit on this point in a recent contract negotiation with the Regional Transit Authority

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(RTA) of New Orleans. Greyhound, the successful bidder, was asked the following question by the RTA:

Considering that RTA is facing difficult financial times and that UMTA has directed RTA to utilize privatization, how much can GLI reduce their bid price? (Excerpted from "Greyhound," 1987.)

Greyhound's response:

The existence of significant capacity and capabilities in the current GLI and ART [its partner in this venture] facilities has permitted this bid to be submitted with only *incremental costs*. There is no opportunity to reduce the bid. (Excerpted from "Greyhound," 1987. Emphasis added.)

We can only assume that the "incremental costs" mentioned by Greyhound do not include any company-wide overhead involved in taking on the RTA contract. It will be interesting to re-examine this situation when the present self-admitted "low ball"<sup>3</sup> contract expires, to see what happens to price under the reconfigured political game with the contractors as major new players.

The larger problem is that, despite professions to the contrary, UMTA's rules place a higher priority on increasing private operation than on efficiently using public money. At the most recent Annual American Public Transit Association meeting Gary Gleason, General Manager of the Santa Barbara MTD, reported the following experience:

We had a private sector bid a year ago They bid about \$980,000 on this 20 percent segment of our service and our fully allocated costs are within the neighborhood of \$1,000,000 so that there was about a \$20,000 savings over a year's period to operate this part of Santa Barbara's service. However, in looking at our incremental costs and being able to identify what people in the shop would be laid off, we were able to identify very precisely where a cost reduction would be and as we found out, our cost reduction would, in fact, only be about \$380,000 per year. So in order to take advantage of this so-called private sector situation, it was actually going to cost us an additional \$600,000 to participate with the private sector. And right now we are in the process where the sole bidder that we had on the project has protested both to the Washington headquarters of UMTA and the regional headquarters and they have won their protest as the general manager, I'm the one that's responsible every year for writing the checks, and I know, in fact, that if I accepted the bid, that I would have an additional \$600,000 cost (APTA tape, 1988)

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red outcome, not the best public policy. UMTA's rules allow private firms to exploit their existing capital and cash flow to obtain market power but does not allow public operators similar opportunities.

**Heads, I Win; Tails, You Lose: New Orleans Experience**

Even if we grant that cost estimation involves complex value judgments, it is still shocking that the UMTA-sponsored studies report only those costs favorable to privatization and ignore costs that would tilt the equation in the other direction. This selective use of evidence can be seen clearly in the process UMTA followed to achieve a privatization contract in New Orleans.

In early February 1988, the Regional Transit Authority (RTA) of New Orleans awarded a three-year contract to a consortium of Greyhound Lines, Inc. (of Texas), and Airport Rhodes, Inc. (of Louisiana), for \$3,922,364 to provide **56,045** hours of service along five of its routes in and around New Orleans. RTA made the decision to pursue this course of action in order to conform to UMTA's policy of privatization.

Consistent with UMTA policy, the decision was made on the basis of comparing RTA's fully allocated costs with the bid prices of the various proposers. Even though the Greyhound consortium bid on the basis of only its incremental cost, our analysis indicates that in fact the Greyhound price was higher than the fully allocated costs of the former service. The only savings to Louisiana taxpayers in this UMTA demonstration comes at higher cost to U.S. taxpayers, who end up footing the bill for the UMTA grants that subsidize the project and make it appear as a "savings." Table 2 summarizes data from the grant application from the RTA to UMTA and letters between UMTA and the RTA.

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*Even though the Greyhound consortium bid on the basis of only its incremental cost, our analysis indicates that in fact the Greyhound price was higher than the fully allocated costs of the [public] service.*

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TABLE 2

**Cost Increases Under Privatization: New Orleans**

Greyhound Average Annual Cost(\$3,922,000/3) .....	\$1,307,333
Annual Bus Leasing Costs (\$4,400,000/3) .....	1,466,666
Annual Maintenance 5 Contractor Supplied Vehicles .....	240,000
Loss of CBD Shuttle Subsidy from Business Community .....	100,000
Monitoring, Contract Administration, Evaluation, Evaluation and Coordination .....	150,000
<b>Total Annual Contract Cost to RTA . . . . .</b>	<b>\$3,263,999</b>
Fully Allocated RTA Cost (56,045 x \$48.85 per hour) .....	\$2,737,798
Additional Annual Cost of Contracting .....	\$ 526,201
Additional Cost over 3-Year Contract .....	<b>\$1,578,603</b>

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From the point of view of the RTA, "savings" occur only because, for the three-year life of the demonstration, UMTA is picking up bus leasing and other costs through grants. Indeed the RTA, mindful that the UMTA demonstration would end in three years, wrote UMTA requesting that the necessary additional buses be purchased rather than leased as that would be less expensive in the long run, even though it would make the

short term results appear less favorable. UMTA initially denied the request.

It should be noted that a year later UMTA relented and agreed to RTA's request to purchase the buses. However, as of June 1989-a year and a half into the demonstration-the buses have not yet been bought.

From the point of view of the public sector more generally, this "demonstration" will cost \$58.24 per hour or an additional \$9.39 per demonstration hour to help further a goal far removed from the requirements of good urban transportation policy.

### **The Case of New Jersey Transit**

As the New Orleans and Santa Barbara tales illustrate, the UMTA policy seems more likely to raise rather than lower the actual costs for local agencies. In order to defend against this outcome, many operating authorities may attempt to ignore UMTA's proscriptions as much as possible. That is exactly what is happening at New Jersey Transit (NJT).

Established in 1979, NJT is one of the youngest public transit authorities in the nation. The decision to take over the largest of many competing private systems in New Jersey came only as a reluctant last resort. The issue that tipped the balance towards public takeover was the realization that, with the private system (Transport of New Jersey) receiving some \$50 million a year in public operating subsidies, there had to be greater public accountability (Premo, 1988). In enacting the New Jersey Public Transportation Act of 1977, the Senate and General Assembly of the State of New Jersey found that: "In the provision of public transportation services, it is desirable to encourage to the maximum extent feasible the participation of private enterprise and *to avoid destructive competition.*" (Emphasis added.) This quotation indicates that, unlike the Colorado legislature, which relied on UMTA research.. the New Jersey legislature understands that too much route competition can destroy system viability.

Consistent with that legislative mandate, the NJT Board adopted a policy statement on privatization which says in part:

Because of this major involvement by government a rational and coordinated system of routes is mandated. *A rational coordinated public transportation system without destructive competition is a prerequisite for the efficient application of tax dollars.* (NJT Board, April 29, 1986. Emphasis added.)

With this pragmatic rather than ideological approach to delivering, transit service, which is cost effective "from a taxpayer and a customer perspective," NJT encourages

private carrier proposals for operation of service when such a proposal improves the financial position of NJ Transit by a substantial amount as it relates to the service to be bid (NJT Board, 1986).

This policy, although ostensibly implementing UMTA's privatization

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*The New Jersey legislature understands that too much route competition can destroy system viability.*

policy, is clearly at odds with UMTA's insistence on the use of fully allocated costs. NJT, in accordance with its legislative mandate, consistently uses "avoidable costs" rather than fully allocated costs in comparing private contract services to public in-house services. While perhaps inconsistent with UMTA's desires, the policy is consistent with NJT's own wish to avoid financial suicide. Also inconsistent with UMTA, but consistent with reality, NJT acknowledges that not all forms of competition are socially desirable. Consequently it seeks to avoid those forms which are destructive of systems and supports those which contribute to more efficient system operation.

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*Not all forms of  
competition are  
socially desirable.*

## Privatization and Labor Costs

Labor is the major cost item in every transportation operating budget. To the extent that privatization advocates think there is fat to be cut from transit systems, they believe that it lies in labor costs. They view drivers and mechanics as overpaid, a result of the fact that public operators do not have to compete to keep their franchise (Cox, 1989). They reason that if people are willing to flip hamburgers at McDonald's for \$3.35 per hour with no fringe benefits, why should transit authorities pay drivers \$10 or more per hour plus fringe benefits. Surely people will and do drive vehicles for less.

What this reasoning overlooks, is that the work of transit drivers is more complex than the simple task of moving a vehicle down a street. If one accepts the proposition that a well-functioning urban transportation system requires carrying out complex tasks of coordination, then it follows that the reliability of the work force is integral to the success of the operation.

The work behaviors of drivers and mechanics have a larger impact than those of fast-food workers. If a hamburger flipper fails to show up for work, the line at McDonald's gets just a little longer that day. Some patrons will go to Wendy's and life goes on.

On the other hand, if bus runs are cancelled or delayed because of erratic work patterns by drivers and/or mechanics, the economy suffers because there is no alternative vendor for transit. The cost of doing business increases. New automobile infrastructure can be built and maintained only at exceedingly high cost, if it is indeed still possible for localities to go that route. More likely, economic activity begins to stagnate. Where possible, firms will migrate to those locations where they can still find sufficient numbers of workers who can get to work on time. That is scarcely a recipe for a viable national economy in the new era of international competition.

Another important issue is the safe movement of people on buses and the safety of those who share the streets with these buses. It is worth remembering that, earlier in this century, one of the important impetuses for public takeovers of trolley lines and bus lines was public reaction to the high accident rates among private operators.

In New Orleans, where an UMTA-financed privatization experiment is now underway, preliminary data reported at the most recent APTA Annual Meeting by the system's general manager indicates that in the first quarter of operation, Greyhound's "passenger and traffic accidents doubled what they had been under the RTA operation." Similarly; Greyhound was experiencing "an average of 1,101 vehicle miles per mechanical road call for the five lines (they operated). For the same period, the RTA system experienced an average of 6,254 miles per mechanical road call" (APTA tape, 1988). To a great extent, the ability of private operators to get their safety and reliability records under good control will depend on the degree to which they can retain operators and mechanics on a long-term basis.

A reliable work force, as with any other high-quality input into a

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production process, is more costly than a lower-quality input. There is a high correlation between the reliability and professionalism of the workforce and the rate of worker remuneration (Peterson, *et al.*, 1986:30-31). The lower the wage level and the smaller the fringe package, the higher is absenteeism and job turnover and, hence, the more difficult is the problem of running a complex system at a steady level of acceptable performance.

Unlike transit operations, food franchises are designed to accommodate the vagaries of an unstable work force. Those franchises make a trade-off between losing some business during periods of longer lines and paying all workers higher wages. That is not the case with a vital public service such as transportation. Between the costs of lost work time for the economy and the additional operating costs generated by higher accident and breakdown rates, the public costs of unreliable operation can run into billions of dollars.

At the heart of the privatization argument lies the assumption that because public transit tends to be a public monopoly, service costs are not disciplined by competitive forces. As evidence, privatization proponents cite data that suggests that the rate of transit cost increase has exceeded the general level of inflation (Cox, 1989; Cox and Love, 1988).

Since labor is the major cost item in every transportation budget, the argument usually devolves into the claim that public sector employees are being paid above prevailing competitive standards. Hence, it is high cost labor proponents propose to trim through privatization.

As with most complex issues, simple answers, however appealing, are wrong answers. Proponents of privatization fail to go beyond simple correlational reasoning: they reason that if the cost of public operation and labor costs are both going up, one must cause the other. However, correlation is not causation.

Let us consider some complexities that an adequate transportation cost policy must address.

One study (Pickrell, 1983) of the increase in transit deficits between 1970 and 1980 concluded that five factors accounted for the rise:

- Decrease in real fares (when adjusted for inflation) were responsible for 28 percent of the deficit,
- Wage increases accounted for 25 percent of the deficit,
- Decrease in labor productivity accounted for 18 percent,
- Increased transit mileage accounted for 16 percent, and
- Increases in energy costs caused 12 percent of the increased deficit.

The two issues most often cited in arguments against public operation are wage increases and declining productivity. According to Pickrell, however, the two account for less than one-half (43 percent) of the total increase in cost from 1970 to 1980. To illustrate the complexity of these issues and hence why the privatization answers are likely to be the wrong answers, consider the following observations.

First, labor productivity is a complex issue. A high-quality work force is a stable work force. In the case of transit, the technology employed has not changed much since at least the 1920s. As a result, there are no technological offsets to the higher wages which employees

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***There are no technological offsets [in transit] to the higher wages which employees need to keep pace with living costs as they perform essentially the same job.***

need to keep pace with living costs as they perform essentially the same job.

A second reason for the decrease in measured labor productivity has been the fact that peak hour ridership has increased. As a result, the number of transit workers increased by more than did the number of transit miles causing productivity per worker to fall. The reason this happens is that expansion in peak period service necessitates an expansion in the work force, which is not the case for off-peak travel. Increased peak hour travel, however, is a desirable public objective, since it brings reductions in congestion, pollution, and other benefits. Ironically, then, a decrease in labor productivity as conventionally measured is the inevitable result of sensible transportation policy.

In light of the complex set of factors which contribute to transit deficits, a far more sophisticated policy approach is called for than the one UMTA has adopted to date if the agency is truly concerned with cost containment.

Finally, it is also important to remind ourselves that the cost-savings UMTA hopes would materialize from privatization may be entirely an artifact of the way UMTA calculates such comparisons. On this point, it is worth quoting at length from the conclusions to a detailed study which UMTA financed to demonstrate that public transport workers are more costly. In the conclusion, the authors frankly state that:

One motivation for a study of comparative compensation is to determine whether cost savings can be realized by enlarging the role of private firms in the delivery of transit services. The findings are consistent with the view that private firms operate at lower labor costs than public agencies. ... (Peterson, *et al.*, 1986:43-44.)

In the very next paragraph, they then qualify their finding:

It needs to be emphasized, however, that the cost differentials reported here stem from a transit environment in which private transit firms are small, have much greater route flexibility, and . operate in a highly competitive environment. The compensation advantages of private operators might be expected to continue to hold true in the face of moderate expansion in the number or size of such competitive firms. *Whether privately-owned transit firms of a much larger scale, enjoying franchise monopolies, and under public regulation, would also enjoy labor cost advantages is an entirely different question, and one not addressed in this study.* Compensation comparisons with the large, investor-owned electrical utilities in our sample revealed much smaller public sector compensation premiums than did comparisons with the smaller competitive private transit firms (Peterson, *et al.* 1986:44. Emphasis added.)

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***Ironically, then, a decrease in labor productivity as conventionally measured is the inevitable result of sensible transportation policy.***

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***It is also important to remind ourselves that the cost-savings UMTA hopes would materialize from privatization may be entirely an artifact of the way UMTA calculates such comparisons.***

## Towards a Sound Basis for Transport Policy

In conclusion, let us again emphasize that privatization may shift costs but will create no new resources, Privatization is therefore not a formula for improving transit efficiency. It is a recipe for stagnation. Private operators, once contracts are signed, have no incentive to do more than comply with contract terms. regardless of changing demographics or other circumstances. Their market is not an economic one built around ridership, but a political one, based on winning a new contract. Such contractors also lack the tradition of public service that can motivate public systems to provide good quality service and respond to the changing needs of transit users. The experience to date indicates that riders will receive short shrift in this situation.

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***Privatization may shift costs but will create no new resources. Privatization is therefore not a formula for improving transit efficiency. It is a recipe for stagnation.***

It is also a recipe for stagnation in a broader sense. Privatization policy will strangle not just public transit, but all urban transportation. If we do not invest new resources in transit, we implicitly accept the *status quo* of ever-increasing automobile congestion and environmental degradation as the natural state of urban affairs. Yet experience from around the world shows that well-designed transit as part of thoughtful land use and urban design efforts can challenge the economically and environmentally stagnant *status quo*. Well-planned transit can get people to switch their travel and living patterns to ones that are far more accommodating to the mass travel modes required of the increasingly urban world of the next century.

An urban transport policy with the goal of fast, safe, and efficient movement of people and goods around metropolitan areas must incorporate three elements: the importance of local option in contracting, the need for subsidy, and the breadth of proper transportation policy goals.

1. Recognize the imperfect nature of public contracting and allow for local options.

Competitive contracting is appealing in theory but less so in practice. Our actual experience with such arrangements from defense procurement to scandals in school bus contracts must make us aware that this approach to goods and services procurement is imperfect at best. We have no fool proof scheme for such ventures. As a result, *it is far better to allow those charged with providing the transport service to make their own decisions and hold them accountable for the outcomes, not the inputs.*

2. Understand that transportation always needs subsidy.

Transportation differs from many other goods and services sold in private markets because many of its most important benefits are external to the consumer. Contrary to the Reagan Administration's early pronouncement, even people who never leave Sioux Falls, have an economic interest in people in Los Angeles getting to work on time. The complex and interdependent economy of which we are all a part requires that everyone else must get their individual jobs done, for you and I to perform ours well. The public policy question is how we distribute the burden for this essential public service. *Cost shifting*

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***If we do not invest new resources in transit, we implicitly accept the status quo of ever-increasing automobile congestion and environmental degradation as the natural state of urban affairs.***

*within the transportation system through privatization is a poor substitute for a thorough-going process of creating a fair and efficient system of public finance to pay for a vital public service.*

3. The issue is not public service versus private service but maximization of broader public policy goals.

This distinction was recognized in 1919, by President Wilson's Federal Electric Railway Commission. Even though it preferred the private provision of transportation, it was prepared to make the pragmatic choice for public provision if it was needed. In 1964 the U.S. Congress passed the Urban Mass Transportation Act. In that act, it recognized the public versus private provision question as a pragmatic issue. Each day school districts around the country make the same pragmatic public versus private choice in their provision of school bus service. So too we must recognize that the public versus private question should not be decided on the basis of ideology but according to what works best for broader public policy goals of safe, efficient, cost-effective, and convenient movement of people in the service of enhanced economic productivity. *Local officials, accountable to their voters and riders are in the best position to decide what works best. They should be permitted to make that decision and then be accountable to their constituents for the result.*

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***The issue is not public service versus private service but maximization of broader public policy goals.***

## Endnotes

As will be explained below, the validity of that assumption is not borne out by the experience to date.

The estimate is derived from the “Private Sector Briefs” produced for UMTA’s Office of Private Sector Initiatives by the Rice Center. The “Briefs” contain a total of 17 Peak Hour Transit Service and Regular Route Transit Service privatization cases. However two are foreign examples and three represent special circumstances such as emergency service during a strike.

The term “low ball” is a description of a contract strategy in which a seller offers an initial price below what they would have to charge in the long run to be profitable.

“Avoidable costs” are *actual* cost savings which an agency experiences by *not* supplying in-house the service which the contract now provides. It is the net difference between the incremental costs saved by not directly supplying the service and the incremental costs incurred by administering the contract. If this net difference is greater than the price of the contract, then an actual saving is gained. If it is less, then a financial loss is imposed on the public agency.

To illustrate, assume the case of a route whose incremental costs (i.e. out of pocket costs) to a public agency is \$10,000. A private contractor bids \$9,000. However, it costs another \$2,000 for the public agency to monitor and service the private contractor. Under the “avoidable cost” rule, the agency would not make the contract, since its total cost would be \$11,000. However, as illustrated in the Santa Barbara case, when the public agency is forced to use “fully allocated” costs, it must add to its calculation of savings from contracting out a proportional share of the agency’s total overhead even if that overhead cost would *not* be saved. If, in the hypothetical case, that fictitious savings came to \$2,000, the contract would have to be let (public savings ostensibly becomes \$11,000 compared with contracting of \$10,000). But in real terms it would cost the public and extra \$1,000 to operate the route.



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