

*A case study in
"nationalization," US-style.*

SEIZING ASSETS SLOW AND SUBTLE

by *Steve H. Hanke*

Nationalization sounds foreign to Amer-

icans. Governments only take over business enterprises in *other* countries. Mexican oil, British coal, Spanish steel, French banks—the list goes on and on. Either private assets are forcibly seized, sometimes violently and usually during wartime (as recently occurred in Vietnam and Nicaragua). Or a private enterprise is taken by condemnation, with the owners ordered to sell their assets to the government at a “just” price. (This was the method used several years ago by the socialist government of François Mitterrand to nationalize the banks in France.)

It's true that nationalization by these methods has been comparatively rare in the United States. Governments here do, though, take over private assets—the practice just takes a more subtle form. Price controls, confiscatory taxes, and burdensome regulations first force private companies into bankruptcy. Then government ends up the owner by default or by apparent beneficence. Either the bankrupt enterprises abandon their assets to the government as an owner of last resort—as is increasingly happening, for example, with rent-

controlled rental housing in New York City. Or the government offers to “bail out” troubled firms and thereby takes control of their assets—as in the federal takeover (“rescue”) of Penn Central Railroad in 1976.

An actual case can show how government takeover, US-style, works. Unfortunately, there is no dearth of actual cases. The one we'll look at here illustrates just how slowly and subtly it happens—and, consequently, how insidious it really is.

in 1936, the Blue Ridge Water Company set up service in Washington County, in northwest Maryland, to supply water through a central system to some 300 customers in the rural community of Highfield. Although Blue Ridge was a private company, Maryland law placed it under the regulatory authority of the state's public

service commission (PSC). The commission's ostensible purpose, then as now, was "to protect the public interest"—meaning, among other things, that the company's prices, the rates it charged customers for water, would have to be approved by the commission.

As a governmental, bureaucratic institution, the PSC—like all politicized institutions—had a constituency to satisfy. In this case, that constituency was water users. And water users, of course, like low water rates. So the PSC tended to keep water prices at levels that, it turned out, didn't cover Blue Ridge's real cost of supplying water—its operating expenses plus amortization of equipment and interest charges on the firm's debt.

This gap between controlled rates and real costs widened for all water companies during the 1970s, when inflation rates accelerated. Moreover, federal regulations had mandated many new costs, primarily via the Safe Drinking Water Act of 1974. Congress passed the act in response to reports of chemical contamination of drinking water in New Orleans and to the alleged need to set uniform nationwide drinking-water standards to protect public health.

Under the act, the federal Environmental Protection Agency (EPA) regulates the acceptable levels of inorganic contaminants, bacteria, and so on in drinking water. Where it is not practical to actually monitor these substances, the EPA may require water-system operators to implement specific—and often costly—treatment technologies to protect against the possibility of contaminants. The EPA has conservatively estimated that the total cost of meeting these mandated standards by the end of this year will be between \$1 billion and \$1.5 billion.

Back at the Blue Ridge Water Company, the PSC-controlled, artificially low water rates were causing two problems. Both, of course, were unforeseen by the commission, which, after all, thought it was acting in the public interest.

First, customers were not given the proper incentives to conserve water. As with any commodity, more of it tends to be consumed at lower prices than at higher prices. As the community grew, so did demand for water, unrestrained by prices reflecting the relative scarcity of water. This growth in demand taxed the

water system's capacity, particularly during the summer months. But without the PSC's approval to raise rates, Blue Ridge could neither control demand nor afford to expand its capacity. So it periodically resorted to water-use restrictions—which the PSC, local politicians, and customers took as evidence of inadequate service and poor management.

A second problem with price controls began to appear in the 1970s. By this time, original components of Blue Ridge's water system were beginning to show the sign of wear and decay—leakage. In 1977, the water company, its name now changed to Highfield Water Company, realized that in order to assure adequate service it would have to make \$500,000 of capital improvements, which it planned to make in three stages.

In 1977, however, Highfield's receipts were \$30,000, which were not even adequate to cover the company's real costs. So it could not finance the improvements internally; nor, with its dismal financial situation, could it raise the funds from a bond issue. Highfield applied to the Maryland PSC for a rate increase, seeking to up its yearly receipts to \$60,000. The PSC denied Highfield's request, even though the company's rates hadn't changed since 1968.

Next, the Public Service Commission held hearings to determine the adequacy of the existing system and the need for improvements. And who should show up at the hearings but the Washington County Sanitary District, claiming that it could get a federal grant to purchase Highfield Water Company's assets, make the necessary capital improvements, and provide water at an annual cost of only \$15,000.

If it sounded too good to be true, the commission didn't notice that. It revoked Highfield's license to operate and ordered the county sanitary district to assume operation of the system and apply for the federal grant.

After running the system for only several months, however, the district discovered that it could not even meet the system's out-of-pocket operating expenses with the existing receipts of \$30,000 a year. Because the district, as an independent government agency, was not under PSC regulation, it could raise its rates, which it did—to yield \$60,000 a

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The district also soon discovered that the federal funds it was counting on could not be used to purchase an existing water-supply system—they could be used only to make capital investments. The district then correctly concluded that the least costly option, from its point of view, would be to use the federal funds—which would cover 75 percent of any new capital project—to construct an entirely new, duplicate water system. So the district went ahead and built a new, \$1.2-million system, financed by a \$900,000 federal grant, with the district picking up the remaining \$300,000.

That's the story of the life and death of the Blue Ridge Water Company. A private enterprise was asphyxiated by government regulation. And resources were wasted: the nation's taxpayers had to cough up \$1.2 million, whereas a private company could have provided the service for only \$500,000, with the users of the service paying for it.

the case of Highfield (née Blue Ridge) is by no means an isolated one. Most of the nation's 64,000 water systems—15,000 of which are privately owned—operate with price controls of one form or another. And while both private and government-owned systems have faced cost increases that, since passage of the Safe Drinking Water Act of 1974, have exceeded the general rate of inflation, the politicians and regulators who set and administer water rates have not allowed prices to increase as rapidly as costs.

The results have been all too predictable:

- Water systems are in urgent need of repair and renovation, particularly in older cities. New York City's, for example, which is the largest publicly owned water system in the United States, has suffered from irresponsible maintenance and replacement policies. Much of the system is now literally falling apart. The annual number of water-main breaks per

mile—one basic measure of a system's integrity—has increased more than 60 percent in the last three decades; with improvements in materials and technology, this figure should have *declined*.

- The stock prices of most publicly traded private water companies are close to their book values, which are based on historical costs. Hence, the total value of the companies' stock is actually worth less than the replacement cost of the companies' physical assets.

- Demands for government subsidies and bailouts—to fill the gap between a system's revenues from its controlled rates and its real costs—are increasing in both the public and the private sectors.

And the demands for subsidies have not gone unheard. The federal Farmers Home Administration, for example, has been authorized to grant loans, at below-market rates of interest, for the purpose of improving *publicly* owned water systems. This, after having already granted \$1.1 billion in loans (again, to *public* systems) to help meet the mandated costs of the Safe Drinking Water Act.

In addition to these subsidized loans, there are construction grants from the Environmental Protection Agency for system improvements to government-owned water-wastewater systems. In 1985 alone, these amount to \$2.5 billion—*60 percent of the agency's total outlays*.

The fate of a small private water company in rural Maryland may at first seem an isolated case of little consequence. But seen in light of this larger pattern of events, it serves as an apt illustration of this moral: politicizing a problem may at first seem an attractive, sensible solution, but in the end the cost of nationalizing—or municipalizing—private assets may well be much greater than ever anticipated. And as a corollary: if you wish to provide the same or improved services at half the cost, privatize public assets and rely on competitive forces, rather than politicians and bureaucrats, to determine the prices and production that will best serve consumers. □

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DOING GOOD MAKES CENTS

Social problems can be solved – but only when they are turned into profitable business opportunities.

By Peter F. Drucker

In the early years of this century, two Americans—independently and, in all probability, without knowing of each other—were among the first businessmen in the world's history to initiate major community reforms. Andrew Carnegie preached and financed the free public library. Julius Rosenwald fathered the county farm-agent system and adopted the infant 4-H Clubs. Carnegie was already retired from business and one of the world's richest men. Rosenwald, who had recently bought a near-bankrupt mail-order firm called Sears, Roebuck & Co., was only beginning to build both his business and his fortune.

Both men were radical innovators. Successful businessmen up to their time, beginning with the Florentine Medicis in

the 15th century, had aimed at becoming aristocrats. Carnegie and Rosenwald became social reformers. The monuments that earlier businessmen had erected for themselves were cultural: museums, opera houses, universities. In Carnegie's and Rosenwald's own time the leading businessmen—A. Leland Stanford, Henry E. Huntington, J. P. Morgan, Henry C. Frick, and, a little later, Andrew Mellon—still followed this tradition. Carnegie and Rosenwald instead built communities and citizens—their performance, capacity, and productivity.

But there the similarity ends. The two held basically different philosophies. Carnegie, whose philosophy is well presented in Burton J. Hendrick's *The*