1982

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Foreword: Symposium on Governance of Public Enterprises

Neil Hamilton*

There is a growing awareness of both the importance of government enterprise in the American economy and the limited scholarship on this phenomenon in this country. The term government enterprise includes all production processes providing goods or services that are effectively controlled, directly or indirectly, by a branch of the government or by a body established by the government to conduct the undertaking in the public interest.

Throughout this century, federal, state, and local governments in the United States have created a variety of government enterprises in the form of government corporations, agencies, authorities, departments and districts to produce diverse goods and services. Although the growth in the use of these entities has been gradual, their cumulative role in the economy is now substantial. For example, the federal government created seventeen new government corporations or government-sponsored enterprises under varying degrees of government control in the period from 1960 to 1973. There are at least six thousand local and regional authorities and one thousand state and interstate authorities.¹

Given the significance of government enterprise in the economy, policymakers must have an understanding of several basic questions. The first question relates to why certain types of firms are government owned or controlled and how such firms behave. There are also normative questions of how such firms

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firms should behave and how to design organizational law applicable to government enterprise so that these enterprises will achieve their goals.

In contrast to the outpouring of literature on private corporate governance,2 and the growing literature on governance of nonprofit corporations,3 government enterprises in the United States have received little scholarly attention. Surprisingly, there is no established positive theory to explain why government enterprises came to exist, nor why their numbers have steadily expanded.4 Similarly, the great diversity of organizational law in government enterprises, even within a single industry such as urban mass transit, suggests that there is no agreement on the normative issue of the appropriate institutional design for these entities.5

The articles in this Symposium contribute significantly to filling these lacunae in the scholarly literature. The economist, De Alessi, writing On the Nature and Consequences of Private and Public Enterprises, undertakes a review of the positive economic literature attempting to explain why government enterprises exist and how they behave. The two lawyers, Murphy and Abrams, focus on normative issues of how government enterprise should be governed. Murphy also analyzes the more specific question of whether the government should produce investment services for public employee retirement systems. A summary of the most significant points of each article will provide a useful overview of the entire Symposium. Since opportunities for disagreement are abundant in a field with so few professionally established methodologies with which to test hypotheses and results, this Foreword also discusses a few points of contention with the respective authors' conclusions.


4. See Rossant, Foreword to A. WALSH, supra note 1, at xi; Hansmann, The Role of Nonprofit Enterprise, supra note 3, at 866.

The article by De Alessi undertakes the important work of summarizing the literature on the positive economics of government enterprise. As De Alessi points out, an analysis of both the structure of property rights and the implications of transaction costs resulting in the problem of shirking helps to structure the inquiry into the reasons for government ownership of certain types of firms and the behavior of such firms.

One persuasive explanation noted by De Alessi for the existence of government provision of some goods or services follows from the costs of establishing and enforcing private property rights. For public goods, which have the characteristics of nonappropriability and nonrivalry in consumption, the costs of excluding nonpayers may be high enough so that "some public goods will not be privately produced, or will not be produced in sufficient quantities, even though consumers would be willing to pay for them." This observation supports government provision of such goods.

Because, as De Alessi points out, government can contract with private enterprises for the production of such goods, the existence of public goods does not fully explain their production by government. More work on this issue is needed. Of the explanations proffered by De Alessi, the most intuitively satisfying is that for some goods the cost of defining and monitoring outputs relative to inputs is very high. Even if contracts with private enterprise could be drawn for the provision of these goods, as for example the level of defense, it would be extremely expensive to monitor compliance with contract specifications. Under these conditions, the private enterprise has substantial opportunities for shirking and opportunistc behav-

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7. For a definition of transaction costs and shirking, see id. at 193-95.

8. Nonappropriability means that such goods once made available are equally available to all individuals. Nonrivalry in consumption indicates that for a given output, additional consumption by one person does not imply reduced consumption for another. A classic public good is the lighthouse, wherein if one ship receives the benefit of a warning signal, it in no way deprives others from doing so. J. DUE & A. FRIEDLANDER, GOVERNMENT FINANCE: ECONOMICS OF THE PUBLIC SECTOR 22 (1977).

9. De Alessi, supra note 6, at 200.

ior. Government may seek to avoid this by producing the good itself.

Casual empirical observation of the shift from private to public ownership in the urban mass transit industry supports De Alessi's hypothesis. In the 1960's and 1970's, transit subsidies arose to increase the mobility of persons prevented by economic or physical disablement (the transportation disadvantaged) from moving about the metropolitan area. These subsidies resulted in part from the altruistic nature of the public, many of whom did not use mass transit but nevertheless wished to see equity in the distribution of wealth. The provision of transit services to the transportation disadvantaged is a public good since it clearly satisfies the preferences of an additional member of the public without a concomitant decrease in the consumption of other members of the public—i.e., there is both nonappropriability and nonrivalry in consumption.

It is difficult and costly to define and monitor outputs that will satisfy these altruistic preferences. A survey of transit systems observed severe shortcomings in the definition of policy and in the supervision of management. Without policy guidelines or supervision of management, the decisions of a private enterprise regarding the allocation of transit subsidies would be almost unchecked in a monopolistic or oligopolistic market—the most common forms of the local transit market. Policymakers are better able to prevent simple diversion of public funds if such goods are publicly produced. Civil service systems, requirements for competitive bidding, separate resource constraints for personnel, money and certain classes of supplies, and budgetary and accounting procedures can be mobilized for this purpose.

De Alessi then turns to the positive task of describing and predicting how government enterprises behave. The key notion, which Murphy and Abrams assume in their normative analyses of organizational law, is that "[t]he systems of property rights, or constraints, embedded in alternative organiza-

11. See N. HAMILTON & P. HAMILTON, supra note 5, at 64-65. The discussion in note 32 on page 65 questions the importance of this wealth redistribution hypothesis offered by De Alessi. See infra text accompanying note 25. De Alessi's argument is based on Pashigian's study. See supra note 10.

12. N. HAMILTON & P. HAMILTON, supra note 5, at 64-65.

13. Id. at 98-99.

14. Id. at 18, 29, 31.

15. Seidman, supra note 1, at 84.
tional forms thus determines, through actual or imputed prices, how the benefits and harms resulting from a decision will be allocated between the decisionmaker and everyone else. The resulting cost-reward structure will affect choices systematically."

It is in the application of this notion that opinion may differ. De Alessi explains that because property rights in the specialized assets of government enterprises are effectively nontransferable and the options of moving to other jurisdictions or influencing policy as a voter are costly, the owners of government enterprises see less direct benefit to themselves from efforts to monitor managers than do the owners of private enterprises. Thus, De Alessi hypothesizes that decisionmakers within government enterprises “will have weaker constraints on their choices than the managers of regulated comparable private enterprises.” This follows because the latter are subject to the discipline of the market while the former are “less constrained by market considerations.”

There are several problems with this reasoning. In some markets where government enterprise exists, such as local transit, the relationship of minimum optimal scale of a firm to the size of the market may call for monopoly or duopoly. Under such conditions, what is the “discipline of the market”? In addition, as discussed earlier, if government is unable to define policy or to supervise effectively a private enterprise, then the private enterprise will use all possible opportunistic behaviors to maximize profits in ways that may be totally unrelated to the public good. The bureaucratic constraints of government enterprise, however, may check this possibility.

Evaluating the studies of the economic consequences of government enterprise, De Alessi concludes that there is a good deal of evidence that government “enterprises typically will incur higher production costs and will be less efficient by market standards.” All of these studies, however, are seriously flawed. De Alessi points out earlier in his article that alternative organizational forms will have a significant impact on the choices of decisionmakers. It follows that unless the institutional structure of the government enterprise is first speci-

16. De Alessi, supra note 6, at 204.
17. Id. at 205.
18. Id. at 205-06.
20. De Alessi, supra note 6, at 207.
21. Id. at 204.
fied, comparisons between private and government enterprises are not meaningful. Unlike private enterprise, which has adopted a relatively standard company model of corporate governance even in regulated industries, government enterprise demonstrates a tremendous variety of organizational law, even within an industry.\(^{22}\)

The studies that De Alessi cites do not distinguish among types of government enterprise, some of which may be more efficient than others. Schmalensee is on firmer ground in concluding that the studies “provide some evidence consistent with the hypothesis of greater managerial discretion under public ownership,” but, at least in the electric utility industry, “the literature does not support assertions of dramatic efficiency differences between municipally owned and private electric utilities.”\(^{23}\)

Both the Murphy and Abrams articles assume the importance of the incentives and constraints embedded in organizational law posited by De Alessi,\(^{24}\) and seek to analyze how organizational law of government enterprises should be designed. Murphy’s article, *Regulating Public Employee Retirement Systems for Portfolio Efficiency*, applies the positive theory of how government enterprises in fact behave in analyzing how organizational law for public employee retirement systems should be designed. A key contribution of the Murphy article is the assertion that we must first ask what is the good to be produced by public employee retirement systems, or, equivalently, what is their purpose, in order to design organizational law that will best achieve the goal. This is the same problem that Hansmann identifies in the literature concerning nonprofit corporations. As Hansmann notes, “Much of the confusion in this area evidently originates from the lack of any coherent conception of the basic purposes served by the nonprofit form of organization.”\(^{25}\)

Murphy concludes that the principal product provided by public employee retirement systems should be, “within an appropriate risk level, the maximization of return on investments in order that the fund might realize the financial purposes of the pension system.”\(^{26}\) Murphy refers to this as portfolio selec-

\(^{22}\) N. HAMILTON & P. HAMILTON, *supra* note 5, at 11-16.


\(^{24}\) De Alessi, *supra* note 6, at 202.


The reasoning underlying this conclusion emphasizes the themes developed in the positive economic theories discussed by De Alessi. Attacking social welfare improvement as a control objective of pension investment, Murphy argues that, even if the social welfare investment is financially comparable to alternative investments, there are major problems both in defining social goals for a public employee pension fund and in implementing them through some system of weights to make the pursuit of inconsistent social goals operational. It is too costly to collect the data needed to identify investments that satisfy established financial and social criteria and needed to evaluate management performance to make social welfare improvement a feasible control objective of pension fund investment.

Similar reasoning applies to collateral return investment. The investment manager "must determine what collateral benefits derive from various investments and trace these benefits to individual plan participants of the particular pension fund. In addition, the fund manager needs a system for quantifying collateral benefits [to determine] the values each plan participant places on the collateral benefits, and [to reconcile] the differences among values." Murphy concludes that the transaction costs of making, reviewing, and modifying such determinations for both social welfare investment and collateral benefit investment are administratively prohibitive.

In essence, Murphy is applying the general predictions that De Alessi made about government enterprise behavior to this specific industry. Because it is more difficult to define and supervise the execution of goals, shirking and opportunistic behavior in De Alessi's terms increase. Murphy should have pointed out that the avoidance of these losses through the adoption of the portfolio efficiency objective must be weighed against the gains, if any, from the alternative investment objectives. For example, the broader purposes of social welfare improvement investment or collateral benefit investment may comport more closely with the preferences of at least some benefit recipients and taxpayers. Murphy should have been

27. Id.
28. See id. at 224-26.
29. Id. at 222.
30. Id.
more cautious in her conclusions given the weak empirical evidence cited on these issues.

Murphy then undertakes to outline the organizational law that will encourage the parties in fund management to strive for and achieve portfolio efficiency.\(^{31}\) This is a difficult task given the state of the positive theoretical literature, but Murphy offers sensible suggestions for improving governance of the funds. Particularly meritorious is the suggestion to use multiple funds managed by private investment management firms,\(^{32}\) which introduces competitive pressures toward lowest cost production.

The simplification of purpose leads Murphy to suggest that public production of investment management services may not be necessary. With a well defined purpose, problems of contract formation and performance evaluation are sufficiently manageable so that production of the service can be entrusted to private enterprise without unreasonable shirking or opportunist behavior. This conclusion is consistent with De Alessi's discussion of the predictions of the positive theory.

With clearly defined portfolio efficiency objectives to be met by private investment management firms, Murphy may err in calling for too much review by the investment board. Are "periodic face to face meetings"\(^{33}\) necessary? Would it not be sufficient to have only one review at the end of a contract unless performance measures reveal a serious problem? Similarly, the call for "a thorough evaluation of management performance"\(^{34}\) implies the possibility of the board remaking management decisions in the review. It is virtually impossible to reconstruct accurately the economic conditions at the time a decision was made. This sort of review will lead to interference in management and introduce the possibility of the board and management denying responsibility by blaming each other. During the contract period, unless a serious problem arises, it should be sufficient for the board occasionally to check the process of management decisionmaking on an issue to determine if it is within a zone of reasonableness.

The article by Abrams, *The Power Issue in Public Sector Grievance Arbitration*, focuses on grievance arbitration systems in the public sector. Since many government enterprises

\(^{31}\) *Id.* at 237-58.

\(^{32}\) *Id.* at 247.

\(^{33}\) *Id.* at 249.

\(^{34}\) *Id.* at 250.
such as investment management and mass transit are labor intensive, labor relations and labor costs are of major concern. In mass transit for example, wages and fringe benefits represent 70 to 80 percent of all operating costs.35

Abrams undertakes a normative analysis of how arbitrators should approach the issue of the authority and capacity of the public sector arbitrator. He refers to this as the "power" issue.36

Abrams seeks initially to explain the high incidence of the power issue in public sector grievance arbitration. He concludes that the principal explanation for the prevalence of management attacks on the capacity of the public sector arbitral institution is simply that the employer is "an elected governmental body, rather than a private entrepreneur."37 Because the employer is a governmental body, Abrams reasons that public sector collective bargaining is essentially a political process.38 In this process, public officials must adequately accommodate the political demands of taxpayers and public service users and providers at the risk of not being reelected.39

On the other hand, Abrams notes that labor arbitration decisionmaking is an adjudicative process based on established principles of contract interpretation, not an accommodation of political interests.40 Abrams concludes that while the resolution of grievance disputes does have an unavoidable political impact, the adjudicatory practices of arbitration render the arbitrator incapable of assessing the political implications of his or her actions.41 The implication, later developed more fully, is that this may be a serious weakness in public sector arbitration.42

To address these political issues, Abrams cautions arbitrators against assuming any direct political role in resolving disputes.43 He argues that public sector arbitrators can preserve the neutrality of grievance arbitration while recognizing that the collective bargaining agreement was negotiated, and that

37. Id. at 272-73.
38. Id. at 282.
39. See id. at 282-83.
40. Id. at 283.
41. Id. at 282-83.
42. Id.
43. Id. at 282-83.
the arbitrators must operate within a distinctive political context.\textsuperscript{44} Thus, principles of grievance arbitration developed in the private sector must not be "imported wholesale," but rather must be tailored to the distinctive context of the public sector.\textsuperscript{45}

A key insight by Abrams is the observation that those in charge of governmental bodies will seek to maximize votes among constituent groups rather than simply to pursue lowest cost production. Trebilcock and Hartle provide additional support for Abrams' thesis, pointing out that "both the determination of policy objectives . . . and the means by which those objectives are to be pursued, will be weighed against the calculus of how they serve the end of enhancing the prospects of election . . . by the political decision makers. Technical efficiency, per se, will not be a relevant criterion of interest choice; only if in some way it advances this end of politicians will it enter the calculus of decision."\textsuperscript{46}

There is room for disagreement on what this observation implies about labor arbitration. Because an arbitrator's decision in the public sector involves both vote maximizing politicians and an impact on governmental resources, the issue is whether grievance resolution in the public sector necessarily has a political facet, and whether this facet must be accounted for in arbitration.\textsuperscript{47}

The article by De Alessi provides a useful framework for addressing this issue. The initial question for a government enterprise is whether the government should provide the good or service. Whether to subsidize its provision is a political decision made by public officials. The actual production of the good or service involves essentially economic, not political, decisions.\textsuperscript{48} Production of the good or service at the lowest cost will best serve the public. That vote maximizing public officials may demonstrate opportunistic behavior because of the pub-

\textsuperscript{44} Id. at 283.

\textsuperscript{45} Id.


\textsuperscript{47} See Abrams, \textit{supra} note 36, at 274-77.

\textsuperscript{48} The mere fact of public production does not make every decision regarding it a political decision as implied by Abrams. \textit{See id.} at 277-78. \textit{But see id.} at 276 n.62. Simply because all labor decisions involving both private and public producers have a wider impact than only on the employer or on an employee does not make every labor decision a political decision. This politicization of what are essentially production decisions is a key problem leading to higher costs in mass transit. \textit{See N. HAMILTON & P. HAMILTON, supra} note 5, at 24-25, 109-111.
lic's lack of information on lowest cost production argues for structural mechanisms that minimize such opportunities and encourage lowest cost production. From this point of view, the public sector arbitrator should refrain from introducing political considerations except insofar as necessary to derive the economic result of lowest cost production. It is not the public provision or production of a good or service per se or the impact on public resources that introduces the political considerations, but rather the constraints introduced by political realities.