



Legislative Research Council

Issue Memorandum 06-01

Competition between Government and Private Enterprise

Academic Perspective

Every academic discipline attempts to explain the origins and operations of society. No single field of thought can fully explain everything, but certain perspectives may clarify specific features. Many legislative debates may be reduced to asking the questions of, "Who it affects? What it concerns? When does it apply? How much does it cost? and "Who pays?" Part of this discussion is couched in political terms, but these questions also have significant economic aspects. This section explains the economic role of government in a free market using the subfield of public finance theory. Government usually becomes involved when markets fail. Market failure can be caused by several reasons including monopoly, the lack of markets, costly information, externalities, and public goods. Each of these failures will be discussed and examples provided for each.

A monopoly occurs when a single supplier or seller has the ability to set the price for a good or service and there is no or little competition. An example of a monopoly could be a utility company. Utility companies are more apt to have little or no competition when prices are set and charged to consumers. As a result, government often regulates those price-setting industries more than the type of industries that compete with each other.

Markets are not always present. Occasionally people are willing to purchase a good or service that is not readily available. While insurance products allow for the recovery due to certain losses, no insurance policy provides protection from all losses. Property can be insured against damage due to fire, storms, and vandalism, but insurance generally does not provide coverage of loss due to war, foreign invasion, or occupation. It is difficult, if not impossible, to calculate the

probability and cost of such destruction. There can be a role for government to interact with the market. As an example, shortly after the terrorist attacks of September 11, 2001, Congress passed the Terrorism Risk Insurance Act of 2002. Under the Act, which Congress renewed in 2005, the U.S. Treasury Department will subsidize insurance companies for certain losses due to acts of terrorism. This allows the insurance industry to more fully cover policy holders who can then operate more confidently in the economy.

All economic theory is based upon rational behavior. People will behave in such a way so as to enhance or maintain their overall well-being. In order to be rational, a person needs information to make the best possible decisions. The less information that a person has available, the greater the possibility that a poor and inefficient decision will be made. However, the acquisition of that information can be costly because it takes time to shop and compare. People will generally collect comparative information so long as it is relatively easy to acquire. The more important that an economic decision is, the more willing people become to shop around. An obstacle to collecting comparative information, is knowing where to find it. Recently, the Legislature encouraged the posting of information. In 2005, Senate Bill 169 was passed which required hospitals to report the median price of the most common inpatient treatments. Using this information, consumers may be better able to decide which health care providers will be the most affordable within their financial constraints. This also encourages competition between hospitals which could dampen the growth of health care costs.

People's actions often affect the welfare of other people that are nearby. An externality is said to exist if the market does not take this effect into account, and an inefficient amount is produced or consumed. An externality can be either negative or positive in nature. A classic example of a negative externality is environmental pollution. In these instances governmental regulation may be merited in an attempt to internalize the cost of polluting. One is able to pollute so long as they are able to pay the price, either in the form of cleanup costs or regulation compliance. These costs then become a factor in considering how much polluting activity to engage in. An example of a positive externality is inoculation against communicable diseases. The individual benefits from the vaccine as do those people nearby who are less likely to contract disease. As a result, the economy is able to operate more efficiently.

Some goods or services are so unique that only government can provide the good or service. An example of a public good is a road. It would be exceedingly inefficient for a person to build a road to get from point A to destination B. While an individual would benefit from the road, the cost would most likely be prohibitive. Even if one could afford its construction, it would be difficult to prevent others from using the road. They would become free-riders. Granted, a toll system could be established, but that would be problematic at best for an individual to administer and exclude nonpayers.

A public good is defined as a product or service that is inexhaustible, non-

excludable, and the marginal cost to provide an additional unit of the public good is \$0. Unlike a private good that can be consumed and depleted, a public good cannot be exhausted. For example, a light house warns ships of dangerous waters. Any passing ship will be able to utilize the warning without diminishing the warning received by others. The goods available in retail stores are excludable; only one person at a time can consume and benefit from a private good. People cannot be excluded from using public goods. There are no ports of entry on public sidewalks. Once money has been spent to provide for a public good, there is no extra cost (also known as the marginal cost) when an additional person uses the good. For instance, according to the Congressional Budget Office, the proposed budget for national defense for federal fiscal year 2005 was approximately \$460 billion. This budget would not increase due to growth in the nation's population.

These classifications are a good way to distinguish economic phenomena, but they do have their limits. While municipal parks are considered public goods that are open to all, state parks can exclude nonpayers. Unlike K-12 education, colleges and universities compete with each other for students. If the users of a public library increase from one to two, the utility for both is not diminished. However, if the number of library patrons increases from one to one thousand, then congestion will increase, and the quality of usage will decrease. The public nature of goods can be seen as a matter of degree. That degree of "publicness" can only be determined by examining the level of market competition.

In Practice

During the 2006 Legislative Session, Senate Joint Resolution 1 was introduced and Senate Bill 188 was amended for the purpose of prohibiting governmental entities from selling certain goods, commodities, and services to the general public. This was not the first time the Legislature debated this matter. In 1984, the Legislature passed SB 3 creating the Private Enterprise Review Commission to determine the extent of government competition with private enterprise. The Commission consisted of twelve members representing the Legislature, private enterprise, the state, and local governments. The Commission only existed for one year as additional funding was not provided to continue operations. The Commission reported its findings and recommendations to the Executive Board in June 1985, which included a recommendation that the Legislative Research Council (LRC) establish a track record of complaints regarding government competition with private enterprise. The LRC would then forward the complaints to the Executive Board for referral to the appropriate committee for study and recommendation.

Even though the LRC did not receive complaints regarding government competition with private enterprise, complaints were being made to the South Dakota Retailers Association and other associations. Examples, include the operation of campgrounds, lodging, construction of homes, embroidery, golf courses, water slides, recreational facilities, gift stores, concessions, liquor stores, restaurants, convention centers, garbage collection, trenching,

ambulance transfers, telecommunications, electricity, infrastructure construction and maintenance by government employees, sale of CD's and DVD's, audits, insurance, etc.

Local governments and the state offer various degrees of goods and services that compete with private enterprise, which may be a result of the size and location of the government, precedent, public demand, local leadership, etc. Many local governments have limited financial resources, including property tax limitations, while the public requests more and improved services. Government enterprises, for example, those involving recreational facilities in larger communities and retail liquor/restaurant facilities in smaller communities may be in direct competition with private enterprise. Instead of evaluating how these facilities may be competing with a private enterprise, local officials may be looking at these facilities in ways to determine how additional proceeds may be obtained or how the services could be improved or expanded for the public benefit or purpose. The decision to offer a service or build a facility that provides a public benefit or purpose is a legislative decision and is subject to the referral process.

The Department of Legislative Audit has received a few complaints from the public concerning the activities of local governments that infringe on private enterprise. Legislative Audit has contacted these local governments to discuss the nature of the activity and whether the activity is permissible under state law. The Department of Legislative Audit audits all the counties and a handful of school districts and municipalities. It is difficult for any auditor to discover whether a local government is competing illegally with private enterprise unless an individual files a complaint. If a local government is conducting an illegal enterprise, a primary concern for that local government besides conducting an illegal enterprise should be the liability exposure if an accident occurs and how it may impact their insurance. For instance, a municipality may not clean snow off the parking lot of a private enterprise. Publicly owned equipment and public employees cannot be used to construct, repair, or maintain private property. However, a municipality may work on its water and wastewater infrastructure lines that cross the same private property.

Certain municipalities, pursuant to state law, may own and operate facilities that provide telecommunication services, electricity, solid waste pickup, or sale of alcoholic beverages. In many other municipalities these same services are provided by private enterprise. Municipalities are not mandated by law to provide many services and infrastructure needs that are commonly provided, but municipal governments chose to do so as normal operations of a community. Some municipalities do not own and operate their own source of their drinking water which may be provided by a nonprofit rural water system. These enterprises would have been grandfathered in by SB 188, but a new community, such as Summerset, may have to adopt ordinances before offering any services they may choose to provide to their citizens. If SB 188 would have passed 30 years ago, would the innovations that occurred since that time, such as the development and use of computers and computer programs, have required the

passage of ordinances or resolutions? Would the copying of material and the printing of forms have required the passage of ordinances or resolutions by governmental entities? In addition, environmental mandates have been and are being passed down to local governments concerning drinking water, wastewater, and solid wastes requiring new levels of service to be provided. In meeting these new environmental requirements or the needs of a growing population, could the phrase "new or expanded services" be interpreted in a manner requiring the enactment of ordinances or resolutions to comply with the provisions SB 188?

Defining new or expanded sales of goods, commodities, or services is open to interpretation and legal challenges. Some decisions to provide goods and services may be made without consideration of the consequences for private enterprise. For example, if a municipality changes its source of water from a well field that has relatively hard water to a rural water system that offers a soft source of water, does this meet the threshold of new or expanded service? This change in the source of water may eliminate the need for water softeners or at the very least decrease the sale of water softener salt. If the new water supply is an affordable, reliable, and safe drinking water source, that municipality may pursue that source of water. Notices, publications, hearings, and other procedures can be complied with, but would the governing body necessarily contemplate the decreased sales of water softeners, softener salt, and possibly hot water heaters in making the decision?

In some instances, local officials believe they need to retain certain capabilities, like street resurfacing equipment, because they believe it provides more flexibility and good service to their citizens. But is it more economical and does it save tax payer dollars? The business community should challenge local officials to pencil out the cost of certain goods and services and prove that government can conduct the activity more economically than private enterprise. If it is not more economical, the entity should at least weigh the additional costs against the social benefits of providing timely and necessary services to citizens. Recognizing that it may be more important for the entity to have the capability to react to a need in a timely fashion and that it may be difficult to do so under the bidding and procurement requirements imposed by state law, the entity may decide to retain such capability.

In other cases, a governing body may have ties with local quasi-governmental organizations like the chamber of commerce or economic development corporation which could be receiving tax dollars from the governing body to operate. In lieu of tax dollars, a governing body may offer in-kind services like bookkeeping, printing, and computer programming. This takes business away from private enterprise, but is it more efficient and reasonable? The governing body must consider the impacts of its decision in providing these in-kind services in lieu of additional tax dollars. They should also evaluate whether tax dollars are actually being saved or is it a matter of trying to internalize the operations. The governing body should consider the best use of limited tax dollars and the potential negative impact on private enterprise when making these decisions. The governing body should further evaluate how essential it is for them to

retain that capability and make a determination based on facts. Every governing body needs to be cognizant of the decisions they make and how it impacts its taxpayers and tax collectors that own private enterprises. If the private enterprise owner believes an incorrect decision has been made, their options are limited. They may accept the loss of the client and the income or go to the governmental body and ask for relief. However, there is concern whether asking for relief or reconsideration may jeopardize certain relationships that particular private enterprise has with the governmental entity and the community. In either case there is no guarantee that the business will return. If there is open and unfettered communication between private enterprise and government, then issues may be resolved with less fear of the consequences.

The next few paragraphs describe other examples of government competition with private enterprise that involve state government, the universities, school districts, and the prisons.

The state through its procurement system allows certain nonprofits to purchase items through the state bid. If agreed to by the vendor, state employees, for example, may be able to purchase computers from the vendor at the same price as awarded under the state bid system; which may be providing an indirect benefit to the employees purchasing computers. The vendor, who was awarded the bid for an item, may have further lowered the price realizing that additional sales may be made to nonprofits and employees. However, this also precludes local businesses that may be able to satisfy local purchases, but are not capable of bidding on the item on a statewide basis, from competing. The balance between the possibility of receiving a lower state bid and providing a benefit to nonprofits and employees versus creating a barrier or hurdle to the local competition must be evaluated.

Then there are circumstances, especially in the university systems, where the universities are allowed, and may even be encouraged to find, soft money to partially fund salaries and facilities. The Legislature may be unable or unwilling to provide the money to fully fund these positions or programs. These partially funded positions or programs could be competing against consultants, engineers, scientists, and biologists.

One example of how schools districts are competing with private enterprise is that some schools are now providing after-school day care. The schools have facilities such as playgrounds, gyms, lunch rooms, and class rooms that are suitable for after-school day care. In addition, there are grants available for school districts to enter this type of care. This scenario obviously financially impacts private after-school day care providers in the area. One school district realizing this potential impact, worked with the local providers in developing a plan to allow the private providers the opportunity to be employed at the school and removing the burden of providing this business in a private home.

Another visible example of goods and services that are provided by a governmental entity is found in Prison Industries (See Addendum A). Prisons

provide a readily available, inexpensive workforce. Public officials want to improve the prisoners' work habits and skills and provide a positive work experience. Prison industries provide a product for which there is a demand and which is expected to have a minimal impact on the local market. However, the end result is that no matter what work activity is pursued for the inmates, it will most likely compete with one or more private enterprises. The inmate population has been growing and the market for traditional inmate industries is limited, causing the Legislature to pass legislation in 1989 permitting private sector involvement in prison industries. Each private sector enterprise involved in this process must also be approved by the federal government.

The examples of public involvement in private enterprises that could be conducted privately are never ending. Drawing a bright yellow line defining what goods and services can be offered by government or which goods and services are prohibited will be complicated. Drafting legislation with procedural methods for permitting certain government action that fit general purpose governments such as counties and municipalities versus schools and special purpose districts may also be challenging. Some entities meet on a weekly basis, others meet once a month, or once or twice a year. Some entities offer many services, while other entities may only offer one or two services. Some entities use ordinances, while others use resolutions. Furthermore, as technology improves and innovations occur, any system that is enacted would have to be flexible and responsive to accommodate changing times.

The Guidelines

Senate Bill 188 evolved through the 2006 legislative process and certain features of each proposal were more or less favorable to the proponents and opponents. The basic concept of the bill was to grandfather the activities and enterprises currently being conducted by government and require certain procedures to be completed before pursuing new activities and enterprises. Concerns were raised regarding how the provisions of the bill would be interpreted and applied. Also, there was a concern that the bill added additional burden and expense for local governments to conduct matters that they are already empowered to do by state law. What is the penalty if a government fails to comply with the provision? If service is found to be in violation, does the service have to be suspended until the governmental body completes the implementation process? If a legislative process is enacted, there needs to be latitude in the process for goods and services that are offered by government to keep pace with changing conditions.

There are a number of complaints about campgrounds, municipal liquor stores, municipal golf courses, prison labor, and access to items on state bid. Realistically, the public parks and campgrounds will continue to exist; municipal liquor stores and establishments will most likely remain in the communities where they currently exist; municipal golf courses and recreational facilities will be maintained and expanded as demanded by the public; state prisoners will be occupied by one or more activities that will compete with some sort of private enterprise; and the universities will conduct research and pursue contracts with

the private sector. However, the use of publicly owned equipment on private property, in most instances, is illegal and an effort should be made to create public awareness stopping this type of activity. Governing bodies also need to be cognizant of competition with private enterprise. Each governing body needs to examine the functions they currently perform and determine whether an activity is better suited for private enterprise. Is an activity a revenue generator without consequence? Is it being conducted in a manner that saves tax dollars? The statement that this is the way it has been done for the last fifty years is no longer a solid argument given today's economic model and innovations. It is good government to reexamine how business is being conducted, and challenges to the system should be welcomed from the private enterprise.

The Legislature offers an opportunity for private enterprise to obtain information and provide public comment on rules that are being promulgated that may directly or indirectly impact their enterprises. When agencies or boards file proposed rules with the LRC, they have to file a small business impact statement pursuant to SDCL 1-26-2.1. In many instances, the rules do not impact small businesses; however, it does provide a means for the Rules Review Committee members and the public to become aware of a possible impact. The agency or board proposing the rules files a statement briefly describing the impact of the rules including financial impacts. The filing of the statement provides the committee and the public with the opportunity and information to further discuss the issue. In a few instances, business and industry has used the small business impact statement as a means to bring further debate regarding the conclusions made concerning the cost, imposition, or infringement the proposed rules may have on business and industry. The rules review committee has also raised concerns and questions with the agencies and boards promulgating rules concerning the conclusions made by the agencies and boards. However, since the inception of this process in 2004, the promulgation of rules has not been stopped because of a small business impact statement.

One alternative for private enterprise to voice its concerns could be the Government Operations and Audit Committee (GOAC) committee, which was created pursuant to SDCL 2-6-2 for the purpose of inquiry and review of any phase of the operation and fiscal affairs of the state. This committee does provide a means for the business sector to question decisions made by state government that may impact their businesses. However, depending on the interpretation of the term, state, there is no authority given to this committee to provide for inquiry and review of the political subdivisions of the state. If the business sector believes that this committee is a suitable means to examine government competition with private enterprise, then it would be prudent to further define what issues the committee may hear concerning the political subdivisions of this state. Another option would be to create another committee for purpose of inquiry and review of any phase of the operation and fiscal affairs of the political subdivisions of this state.

In 2000, The Maine Legislature created the Advisory Committee on Fair Competition with Private Enterprise to review complaints where competition with

private enterprise is potentially unfair. The advisory committee consists of members from government agencies, the university, the public and private sector, and a state employee who meet to review complaints on government competition with private enterprise. The committee developed a process for interaction with persons or businesses, who have perceived unfair competition by state government. Since the committee's inception, the committee has reviewed a number of complaints of unfair competition by state government with private enterprise in a variety of areas such as: water testing, printing, and textbook sales. The committee reports, by January 15th each year, to the Governor and to a Legislative committee and recommends changes in policies and practices concerning unfair competition practices by state government.

A less formal means of improving communication between government and business is to invite the various business associations to the annual meetings of the Municipal League and Association of County Commissioners to discuss issues concerning competition with private enterprise. Officials from the local governing bodies and their associations could also be invited to the annual meetings of the business associations.

Conclusion

It is the objective for issue memorandums to analyze issues and specifically answer policy questions. Regrettably, this memorandum cannot explicitly identify instances when South Dakota government, or its local units, are unnecessarily competing with the private sector. That requires significant amounts of subjective consideration that only the people's duly elected lawmakers can provide. However, this memorandum can assist by providing a series of questions that should be asked whenever a proposal is being considered by the Legislature or another governing body within this state.

- 1 Why, and to what extent, has the market become inefficient?
- 2 How "public" is a good or service that is to be provided by government?
- 3 Is the public good or service available to all or only those who would otherwise be denied access?
- 4 Will the public good or service be diminished through use?
- 5 Has technology changed the landscape?
- 6 Will there be an added cost to the state if the population of users increases?
- 7 Can certain people be excluded from benefiting from a public good or service?
- 8 If it is proposed that the government provide a private good (such as housing or medical services), is there a significant benefit (a positive externality) that will be bestowed upon the general public?

When answering these questions, it is wise to take a moment to scrutinize the assumptions that are the basis of the answers. Assumptions will color the answers and lead to certain conclusions while precluding others. Reasonable minds can disagree, but this framework will encourage the Legislature to flesh

out differences of opinion and make the best possible decisions for the future of the state.

This issue memorandum was written by Fred Baatz, Principal Research Analyst, and Reed Holwegner, Chief Fiscal Analyst for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council. The information contained in the memorandum is accurate as of the date of publication.

Addendum A:

Prison Industries Annual Report

Our Mission:

To produce high quality goods and services to a customer base that includes agencies of the State of South Dakota, agencies of the U. S. Government, city and county governments and nonprofit organizations. We hire inmates to work in our shops located at the South Dakota State Penitentiary, Mike Durfee State Prison, and the South Dakota State Women's Prison. We are committed to providing job skills and a positive work experience that will prepare inmates for a successful return to their communities. The skills they learn and the work ethic they develop will enable them to provide for themselves and their families.

Private Industry Enhancement:

As the inmate population of adult corrections system grows, so does the need to provide more work opportunities for inmates. Traditional industries also have a very limited market in which to sell its goods. These two facts prompted the decision to explore private sector industry possibilities. In June of 1989, the Department of Corrections applied for certification in the Private Sector/Prison Industries Enhancement Program. This application was forwarded to the United States Bureau of Justice Assistance after the South Dakota Legislature passed legislation permitting private sector involvement in prison industries. South Dakota was granted certification in 1990. In addition to the State's certification, each private sector enterprise must be approved by the federal government. The application for each enterprise must include the enterprise market, the number of inmates to be employed, the wages to be paid, and verification that the venture will not impact the local market.

FY 2005 Activities:

Inmate wages paid in the private sector for FY 2005 were 477,237. Inmates employed in these industries paid \$28,634 to the South Dakota Crime Victims' Compensation fund, \$143,172 for incarceration costs, \$28,634 in family support obligation, \$43,576 in federal taxes, and \$36,532 in social security. Private sector businesses operating during FY2005 included Metalcraft Industries which has welding and machine tool operations at the Jameson Annex. Because Metalcraft Industries is a Prison Industries Enhanced Program they must pay the inmates wages that are comparable to local industry. In turn, minimum wages were paid to inmates that prelaced window components for Sioux Vocational and Balance Systems Incorporated. This work was previously outsourced to China.

