

## *Privatization as State Transformation*

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### *Introduction*

Privatization is an ambiguous term covering many loosely related phenomena.<sup>1</sup> In this essay, I focus on one specific aspect of privatization - the privatization of governance. This sidesteps arguments about the presumed efficiency gains of e.g. turning state-owned entities into for-profit corporations, and highlights the *political* consequences of privatization - how it takes decisions which had once been within the remit of democratic politics and hands them over to regulated private actors. Considered in this light, privatizing governance surely includes privatization in its narrow economic sense, especially given that the current trend towards privatized governance had its beginnings in economic privatization.

Yet it also involves broader transformations. The key point, and key argument of this essay is that privatization does not so much involve the shrinking of the state as its transformation. State control exercised through direct ownership (with associated relations of influence) is replaced by state control exercised through regulation (with associated relations of influence). In a very important sense, privatized entities typically remain imbricated with, and embedded within the state. They are not abandoned to the vagaries of competitive markets. However, the politics of the state is transformed from one of ownership relations, to one of politics mediated through regulators which in

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<sup>1</sup> I am grateful to Joe Heath, Jack Knight, Nancy Rosenblum, Melissa Schwartzberg and the participants in the 2011 Nomos workshop for their comments, which have greatly improved this text.

part seek to turn privatized entities' activities towards the purposes of the state, and in part look to protect these entities against external pressures.

The privatization of state owned entities helped transform the state's relationship with the economy, so that it sought to shape economic outcomes externally through regulation rather than ownership while internally shifting its mode of operation to more closely resemble contractual relations. The turn to regulation has had international consequences, as national regulations clashed with each other, sometimes leading to some regulators winning, but often leading states that could not reach agreement among themselves, either to limit the scope of regulation (through treaties intended to protect private actors) or to turn to private actors as governors themselves. Finally, the serpent is beginning to bite its own tail as private actors have sought to take advantage of international regimes to reshape the domestic reach of the state, defining inconvenient regulations as a kind of 'taking' of their property and demanding compensation for them.

In short then, the privatization of governance involves three different aspects - national privatization strategies, the conversion of state structures, and international responses to regulatory clashes that sometimes allow private actors to reach down and further re-engineer the form of the state. I deliberately present a stylized schema here, emphasizing the ways in which these different levels reinforce each other, rather than the frictions that often arise between them. This has the obvious disadvantage of over-simplifying a very complex set of relationships, but the advantage of isolating plausibly important causal interconnections, which are typically obscured in political science accounts that tend to focus on national or international politics rather than the complicated interactions between them. When I look at specific national experiences, I focus primarily on the US and UK for ease of exposition. These are not typical cases, but they do illustrate the possible consequences of privatization in especially pungent ways.

This account helps explain not only why key parts of the state have become privatized or semi-privatized, being put out to private operators, but why states

are increasingly relying on private systems of ordering. It shows how the privatization of governance spans the international sphere as well as domestic politics, since international and cross-national forms of regulation have sometimes been partly privatized, and sometimes structured so as to provide private entities with new opportunities to challenge government decisions. Finally, it provides the basis for a specific normative critique of privatization. Here, I do not try to evaluate whether the economy works worse, or better, after privatization than it did in an era when the state exercised control through ownership rather than regulation. Instead, more simply, I show that privatization did not work as its enthusiasts argued and believed that it would, looking to evaluate it in terms of its own promises. Rather than pushing back the state, and replacing political inefficiency with the competitive disciplines of the market, it has replaced one form of political control with another.

First I examine the origins of the most recent wave of privatization, in simple or 'economic' privatization, the processes through which aspects of the economy that used to be under state control have been privatized, either being transformed into, or bought by, profit-oriented market entities. This wave of privatization has lasted from the 1980s to today (e.g. the UK government's recent privatization of the Royal Mail and current proposals to privatize the land registry) and has profoundly changed politics. Today, states seek to avoid direct ownership of large firms, and even when states have taken over businesses (as when the UK government took over the Royal Bank of Scotland to prevent its collapse), they have usually sought to return these businesses to profit and the private sector as quickly as possible. Functions that were previously seen as core to the state - such as education and healthcare in the UK, and intelligence and military operations in the US - have increasingly been put out to private industry.

Next, I examine how states have renounced ownership stakes in business, they have moved from a paradigm of direct control, to one in which their instruments consist primarily of independent regulatory agencies (for businesses with which the state has an arms-length relationship) or contracts (for businesses that the state relies on directly). However, it has often turned out to be difficult to regulate businesses effectively or to craft contracts that provide

real accountability, especially when the businesses have much greater expertise or resources than the regulators. This means that states are increasingly reliant on private actors with their own pecuniary interests for resources and information, replacing traditional forms of public influence such as political parties with intimate patterns of exchange between political and economic elites which often engage in elaborate forms of *pantouflage* in which private sector personnel move into government for a period or vice versa. Not only have states privatized state owned companies, but they have put out many of their own internal operations to the market, becoming increasingly reliant on private actors to understand how best to regulate, and sometimes to implement their regulations.

Third, I address the question of cross national and international forms of regulation. As privatization has led to a renewed focus on regulation, it has led both to greater opportunities for private actors to escape the reach of regulators by shifting jurisdiction, and to greater potential for conflict as regulators seek to limit international exit opportunities so as to retain their control. This creates a new arena for politics, in which the increased prominence of national regulators makes clashes between countries with different regulatory approaches more likely, empowering actors who can influence the processes through which these disputes are resolved, and weakening actors who do not have such influence (Farrell and Newman 2014). It also strengthens the hand of multinational firms vis-a-vis regulators, since they now have greater opportunity to move their activities to locations with friendly regulators, as well as multiple access points for influence on international policy discussions.

This has led to a *partial privatization* of international regulatory processes (Buthe and Mattli 2011), as states increasingly turn to private standards or private regulators to resolve conflicts, or alternatively find themselves subject to international dispute resolution mechanisms that have allowed private actors to challenge and seek redress for regulatory actions that they believe impinge upon their rights. These new cross national arrangements help private actors to reach down into domestic political systems, making it much more difficult for regulators to impose costly regulations, and hence expanding the space for purely privatized governance. For example, ISDS (Investor State Dispute

Settlement) resolution mechanisms, incorporated in bilateral and multilateral investment and trade treaties, effectively provide businesses with an opportunity to challenge public regulations that is not available to ordinary members of the public, and to win substantial damages when private arbitrators find in the interests of the plaintiffs.

These different aspects of privatization often tend to reinforce each other. As more aspects of the economy are privatized, it becomes easier for actors who might benefit from privatization to press the state to make further concessions. As states become more reliant on the private sector for information and resources, they become more inclined to acquiesce to the demands of private actors who see potential profits from privatization. As international regulatory processes are privatized, or opened up to the influence of private actors it becomes easier for private actors with access to the relevant international forums to press for concessions and limits in regulatory powers that advantage them and further reshape the role of the state. By keeping the state at the heart of analysis, one can see how the kinds of feedback loops between interest groups and state entities identified by historical institutionalists (Pierson 1993) can thrive in an environment of privatization.

They also have important consequences for power relations. As noted, advocates of privatization tend to stress the economic advantages of liberalization. They tend not to focus very much on the ensuing politics. There is evidence that the privatization of governance tends to benefit particular interests rather than the general public. Many traditional privatizations were carried out on favorable terms for buyers or managers, who sometimes went from poorly paid government servants to very well paid executive officers, often with significant stakes in the new profit-making enterprise.

Hence, as privatization has advanced towards the core competences of the state, rather than creating free markets, it makes and reproduces patterns of diffused and complex chains of authority, and semi-invisible forms of interchange and mutual advantage between economic and political elites. The privatization of core state functions makes it hard for specialists - let alone members of the public to keep track of who is responsible for what, as chains of authority and obligation become ever longer, and ever more tangled with each

other. Finally, international private regulatory processes are usually heavily skewed in favor of specialist actors and against members of the general public.

The account of privatization that I present is at heart a story of changing power relations, building on both skeptical rationalist (Knight 1992) and historical institutionalist (Hacker and Pierson 2016, Hall and Thelen 2009) accounts. It thus is at odds with e.g. some public choice accounts (e.g. Heath 2011) that see privatization as, essentially, a set of managerial innovations and improvements aimed at remedying deficiencies in the state-managed economy, and hence tend to present a narrative of privatization as a series of ever-continuing improvements brought through by benignly intentioned bureaucrats and policy makers. As per Knight's arguments (1996), self-interested actors are only likely to seek Pareto improving institutional changes under relatively unusual circumstances. This skepticism may be overstated (actors are not always simply self-seeking), but provides a clearer and more consistent account than alternatives. It does, however, underestimate the role of ideas, which also plausibly played an important role in the relevant transformations.

### *Economic Privatization*

The current wave of economic privatization began in the late 1970s and early 1980s. The word itself was popularized in Margaret Thatcher's Britain, and used to refer to processes that had previously been dubbed 'denationalization.' However, there is disagreement about *where* the turn towards privatization came from.

Some scholarship highlights the collapse of Keynesian patterns of demand management, and points towards partisanship and government composition as key factors (Boix 1997, Bortolini, Fantini and Siniscalco 2004, Zohlnhöfer, Obinger, and Wolf 2008). For example, Carles Boix (1997) argues that the wretched economic conditions of the 1970s led different governments to behave in different ways. All governments faced difficult economic conditions, and the need to generate new economic revenues without raising taxes. Right wing governments, which had previously gingerly embraced Keynesianism abandoned it, in favor of economic reform programs that were aimed at promoting the

market and raising money through sales of state companies, while left wingers continued to favor the state.

Others point to public opinion (and the personal experiences of individuals) (Battaglio and Legge 2009), pointing out that public service employees are less likely to favor privatization than other citizens. Others still highlight the power of ideas (Bartle 2002, Fourcade-Gourinchas and Babb 2002, Kogut and Macpherson 2008), pointing how variation in ideas held by governing elites, as well as variation in the ability of the state to shape policy debate, led to sharp variation in outcomes. Finally, a EU-centric literature examines privatization as one manifestation of “Europeanization” - the replacement of national markets with protections for incumbents by a more liberalized ‘Single Market’ under pressure from the European Commission and the European Court of Justice (Knill and Lehmkuhl 1999, Eising and Jabko 2001, Schneider and Häge 2008). The International Monetary Fund and other international actors similarly pressed for privatization in countries under their tutelage (Babb and Buira 2005, Henisz, Zelner and Guillen 2005).

Over time, privatization has escaped its conditions of origin. Schneider, Fink and Tenbucken (2005, p.720) find that there was a statistical relationship between right wing rule and privatization in the 1980s, but that the relationship disappeared in the 1990s, when, in their pithy description, “the motto became ‘Everyone privatizes’.” While right wing parties were more enthusiastic to privatize than parties on the left (Zohlnhöfer, Obinger, and Wolf 2008), privatization had become part of the accepted policy repertoire, shaping both public opinion and the scope of politically acceptable ideas, while also helping international bodies such as the European Commission and International Monetary Fund to press for further privatization in states under their sway.

Privatization escaped via diffusion processes. Once it had become sufficiently established in a number of core states, it spread to other states that wanted to imitate and emulate them (Henisz, Zelner and Guillen 2005). Diffusion of privatization policies was more likely to occur between countries that were geographically close to each other (Schmitt 2011). It also snowballed over time - as more countries adopted privatization policies in areas such as

telecommunications, the perceived legitimacy of the policy (and hence the likelihood that other countries would adopt it) increased too (Fink 2011).

The diffusion of privatization policy has had sweeping - and varied - consequences. It has not led states to converge in any simple and straightforward way on a single model of economic policy making. Instead, it has been taken up in different ways by different national states (Vogel 1996). States were quicker to take up privatization in some sectors than in others, often looking to pick low hanging fruit in the privatization of telecommunications, before moving to more difficult and less lucrative targets such as electricity (Levi-Faur 2003). While ideas have spread, they have been taken up in different ways in different national contexts. Marion Fourcade and Sarah Babb (Fourcade-Gourinchas and Babb 2002) find that perceived economic failures and sharp social conflicts led dissident coalitions in the UK and Chile to take up liberalization and privatization policies in a struggle to take over control of the state. In contrast, liberalization and privatization had a far less dramatic immediate import in countries such as Mexico and France, where they were integrated into more long-lasting state projects of modernization.

This has led to variegated outcomes across (at least) three dimensions. First, there is variation across sectors. Some sectors have been much more likely to be privatized than others. Second, there is variation across countries. Some countries have gone further in privatizing certain sectors than others. Finally, there is variation in the form of privatization. Very often, economists think of privatization as a simple process in which economic activities that were under the direct control of the government are given over to profit maximizing actors who vigorously compete with each other in a minimally regulated market. This is rarely (and perhaps almost never) the case. Privatization typically comes with strings attached, and the kinds of string vary across countries. Privatization has not meant that the state has become uninvolved in the economy (a point to which I return below), or that the retreat of the state has led to corresponding advances for free markets. Rather, the involvement of the state now takes different forms.

### *Privatization and Regulation*



Privatization has not led to a retreat of the state so much as its transformation. First, advanced industrialized states typically no longer own large swathes of the economy. Instead, they have adopted the US model - they seek to control outcomes through regulation rather than ownership. This goes far beyond privatized industries; states now regularly resort to regulation across a wide variety of topics and issue areas, delegating regulation to specialized agencies, or even self-regulatory bodies. Second, states have transformed themselves internally too. States have not only privatized state owned firms, but have 'privatized' essential aspects of their own internal operation. Some parts of the functions of states, which were traditionally managed with internal resources, are now subcontracted out to for-profit entities. Others are handled within the state, but through mechanisms that seek to simulate some of the aspects of free markets (e.g. through putting different units of the state in direct competition with each other).

Very often, people see privatization and deregulation as two sides of the same coin. There is a strong scholarly consensus that this generalization is wrong. As privatization has proceeded, states have often tended to increase rather than decrease their reliance on regulation. In Christopher Hood and Colin Scott's (2000, p.2) description, "[the] privatization of utilities has meant government has shifted from owner regulator to ... regulator alone for many key industries." Giandomenico Majone (2007) documents how privatization meant both that the government often had to regulate the prices of the newly profit-oriented firms and to prevent some of these firms from abusing their dominant position to deter competitors. Steven Vogel (1996) finds that privatization has been associated with re-regulation rather than de-regulation. Levi-Faur (2005, p.12) claims that "a new division of labor between state and society (e.g., privatization) is accompanied by an increase in delegation, proliferation of new technologies of regulation, formalization of interinstitutional and intrainstitutional relations, and the proliferation of mechanisms of self-regulation in the shadow of the state."

European states now rely far more on regulation than in the past (Majone 1994, 1997). In the UK, even while the numbers of traditional civil servants fell sharply, the numbers of employees working for regulators rose quite

dramatically. As Hood and Scott (2000) note, the state used to be able to exercise authority by means of direct ownership. Now, it uses a different toolkit. Regulators typically have the authority to make and interpret rules within a broader legislative mandate, and to interpret these rules in ways that bind private actors. In the US, for example, law courts are usually quite deferential to regulators' interpretation of their own rules, under the *Chevron* standard. Some regulators - such as the Security and Exchanges Commission - even have their own internal administrative judges, who both work for the regulator and issue binding rulings on how the regulator's rules should be understood and enforced. Sometimes, state regulators may work at one remove, effectively outsourcing much of the implementation of regulations to self-regulatory bodies, and acting only as a final backstop.

However, there are important differences in the level of regulation across economic sectors. Braithwaite and Drahos (2000, p. 5) find that "regulation of the environment, safety and financial security have ratcheted up more than they have been driven down by globalization," and that ratcheting up is in general more common than a regulatory race to the bottom, but that there has been a ratcheting down of economic regulation of issues such as bank capital adequacy.

Why has privatization been so often associated with an increase rather than a decrease in regulation? There are two main theories. One sees regulation or re-regulation as a reassertion of the public interest (Levi-Faur 2009). Here, regulations are designed by states to restrain private actors in ways that conduct towards the general interest, perhaps in response to public pressure. As important economic activities have moved from the public to the private sector, the public sector has needed to keep new private interests in check and, ideally, to harness them for public benefit. Regulation provides one way to achieve this. A second approach sees regulation as an assertion of state interest, without necessarily assuming that it is normatively attractive. Vogel (1996) sees both privatization and re-regulation as state led processes, and examines how different states with different interests end up with very different combinations of regulation and private sector activity. Braithwaite and Drahos (2000) and Mattli and Woods (2009) show how power relations (and in particular the role

of the US, as most powerful state in the international system) shape regulation at the global level.

As an extensive literature discusses (Laffont and Tirole 1991; see Dal Bó 2006 for an overview), the intimate relationship between the regulators and regulated is often likely to lead to regulatory capture, in which the regulator identifies the interests of the regulated sector (or its biggest firms) with its own institutional interest, and seeks to protect these interests. Public choice accounts (e.g. Stigler 1971) tend to claim that independent firms identify how they can harness the regulatory power of government to their benefit, to control entry to their market and hence limit competition. The problem, according to this analysis, is that government has the power to coerce and that some businesses are politically influential enough to bend government to their will.

In actuality, as economic sociologists (Fligstein and MacAdam 2012) have observed, the relationship between the state and domestic markets is actually rather more intimate than Stigler suggests, especially in sectors that have been privatized. It is not so much that the state is interfering with markets that otherwise would be naturally inclined to gravitate towards competitive relations, as that state rules originally constituted the market and continue to constitute it and remake it, creating an intimate - but two way - relationship between the state and market actors.

This highlights aspects of privatization that are obscured by standard economic theory. The change from control-via-ownership to control-via-regulation is not a retreat of the state and encroachment of the market, but a reshaping of the relationship between them so that they blur together in different ways, creating new hybrid political relations that are neither traditional state hierarchy, nor state ownership of partially independent firms, nor yet market competition.

Indeed, privatization has consequences too for the inner workings of the state. Hood and Scott (1996, p.322) document how the external regulation of firms has gone in lockstep with increased internal reliance on internal contracts (rather than bureaucratic hierarchy) within the British state, rightly predicting in the 1990s that “bureaucratic regulation [the ways in which some parts of the state oversee and regulate the operation of others] is likely to become more

similar to business regulation in style and operation.” Civil service units are now more like service providers than traditionally secure and specialized bureaucratic institutions. These changes mean that government becomes a kind of ersatz market in which units compete (or, sometimes, pretend to compete) with each other, and with external service providers for contracts. The government both tries to become more like a market in how its own units deal with each other, and to put out as many of its activities as it can to external providers.

As Colin Crouch (2004, 2011) has documented in a pair of important books building on the experience of the United Kingdom, states have not only sold off their stakes in key economic sectors, but have begun increasingly to rely on market like arrangements for their own core functions. On the one hand, they directly integrate subcontracting relations with private entities within the core functions of the state. On the other, state or state-funded entities seek to compete with each other internally in designed schemes that ape the logic of markets with greater or lesser verisimilitude.

Most obviously, states now subcontract out many aspects of their core functioning to private subcontractors. In a series of publications, Deborah Avant and her colleagues (Avant 2006, Avant and De Nevers, 2011) have documented how key aspects of the US military have been privatized, in a process that accelerated dramatically during the Iraq war. Many traditional security functions are now performed by private subcontractors. The same is true of intelligence, where e.g. Edward Snowden concluded that he would be more easily able to get access to government secrets as an employee of the private firm Booz Allen Hamilton than as an employee of the NSA. This reflects both a more general trend of putting out key intelligence technical and research tasks to private enterprise, and the specific dynamics of the cybersecurity sector, where the US state has been particularly dependent on specialized help.

The United Kingdom too has seen a sharp increase in privatization of government services, both under Labour and Conservative administrations. While the National Health Service remains heavily regulated, the UK government has tried to encourage the development of national chains of hospitals to achieve efficiencies, with mixed results. It has also sought to move

schools from the state sector into the non-profit sector, allowing a variety of experimental governance arrangements, which again have led to significant controversy (Foster 2015). None of these subcontracting arrangements are properly competitive, either because they require compliance with complex mandates (which makes it hard for many potential providers of the service to compete for them, or because they require specific and unusual technical knowledge, or knowledge of how government processes work, or because they are mediated through close personal or political connections with key decision makers. Hence, they are more pseudo-market than market.

Other pseudo-markets can be seen in those aspects of government that have not been put out to sale. Units in the UK government compete with each other as though they were independent entities in a market, rather than bureaucratic entities linked in a common hierarchy (Crouch 2004). Common metrics such as the Research Assessment Framework for higher education in the UK (Smith, Ward and House 2011) and the testing provisions associated with the No Child Left Behind Act in the US (Ryan 2004) are intended to provide many of the benefits of markets through obliging units to compete for resources in a transparent framework.

The evidence on the overall success of these efforts to build pseudo-markets within the state is murky enough that both their enthusiasts and detractors can claim that the facts support them. What *is* clear is that like all schemes that seek to substitute metric-based incentives for actual market efficiencies (see e.g. Miller 2004), they can be, and are gamed by sufficiently ingenious actors, who may look to maximize benefits in perverse ways. For example, universities looking to do well in the Research Assessment Exercise can pay foreign academics to affiliate themselves in more or less nominal ways, so that their work is 'counted' as part of the university's research output. Schools looking to do well under No Child Left Behind, have incentives to 'teach to the test' (even when this does not help the child learn) or even to encourage systematic cheating.

The efficiency benefits of putting government services out to for-profit contractors are difficult to measure. Many of the goods provided by the state are difficult to price. State services are furthermore typically bound up with

complex bureaucratic practices that are difficult for outsiders to understand, let alone adapt their own practices to. Either state authorities seek to impose their own practices on external market providers, not creating markets so much as pseudo-markets with little real competition, or they embrace the logic of markets with possible damage to their own legitimacy.

Crouch discusses the negative consequences of the first path - pseudo-markets for external contracting- arguing that they have created new kinds of firms, which specialize not in providing any particular service, but rather in leveraging their knowledge of how government works and their privileged relations with government employees. Such firms interface with government across a wide set of contracting activities. Such firms need very high levels of resources, expertise and contacts to operate, limiting the number of market players, and hence limiting the benefits of competitive bidding.

Katzenstein and Waller (2015) document some of the dangers associated with the other path. US states increasingly contract out major aspects of running prisons and probation services to the private sector. Often, this is done on the basis of contracts which effectively turn private sector businesses into tax farmers, providing them with a monopoly e.g. on phone calls, financial transfers, commissary sales or similar services that prisoners and their families need, in return for a kickback. The state of Florida, for example, mandates that financial transfers to prisoners be subcontracted to “the responsive, responsible bidder submitting the highest percentage commission” [to the state]. In such contracting arrangements, government and the private sector join forces to extract the highest rates possible from what is, quite literally, a captive market, combining the coercive power of the state (without any obvious mechanisms of legitimacy) with the extractive power of business monopoly.

Notably, this can create a self-reinforcing cycle of the kind identified by Paul Pierson (1993) for interest groups. The state generates a policy, which in turn creates an interest among those actors whom the policy benefits. These actors then have an incentive to organize themselves, so as to protect the interest that they have, and to demand an expansion of the policy, with more benefits. The bureaucrats or other officials charged with administering this policy benefit from the support of an outside interest group in their own struggles over resources.

Hence, a tacit alliance forms between interest group and officials, and moreover a feedback loop, in which the growth of a policy area benefits those (whether outside interest groups or officials) who are involved in it, and have greater resources to press for still more growth.

Just such a mechanism appears to have underpinned the privatization of much of the US incarceration system. Initially, privatization was driven by the belief that private industry could incarcerate prisoners more cheaply and efficiently than the state. Rapid privatization led to a rapidly growing private correctional industry, with firms like the Corrections Corporation of America (CCA), which is currently the largest firm in the sector in the US, running 61 facilities with approximately 90,000 beds and \$1.7 billion revenue in 2011.<sup>2</sup> This firm enjoyed strong political connections. A co-founder is former chairman of the Tennessee State Republican Party and many senior officials held stock in the company (Chang and Thompkins 2002). It was also well connected to the public prison system. A senior official at the company was former head of the American Correctional Association and Commissioner of Corrections departments in Virginia and Arkansas (ibid). As the industry has burgeoned, large firms like CCA and their senior management have donated large amounts of money to the Republican Party and to individual legislators, while lobbying for more privatization of prisons. More recently, these corporations have pressed quietly for an enforcement heavy approach to immigration reform, which provides much of their profits (nearly half of undocumented immigrants in custody are held in privately owned facilities).<sup>3</sup> Hence, the policy of prison privatization has generated new interests, which are using their resources to press for privatization, which is likely to benefit them given their political clout and contacts.

Privatization is not then generating free market competition so much as it is changing the nature of the state. The state often (and likely typically) needs to remain involved in managing these economic activities, either through regulation or through contract. The creation of a zone of specialized intersection between

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<sup>2</sup> Suevon Lee, "Here's What You Need to Know About the Two Companies Dominating the Private Prison Industry," *Business Insider*, June 22, 2013.

<sup>3</sup> Lee Fang, "How Private Prisons Game the Immigration System," *The Nation*, February 27, 2013.

the public and private sector plausibly corrodes both. Profit making entities are typically able to pay much better than the government. This, at a minimum, results in a continual drainage of expertise from the public into the private sector. At its worst, it encourages corrupt relations between the two, ranging from implicit cosy arrangements, in which government officials overseeing contracts know that complaisant behavior will likely eventually be rewarded with a well paid private sector job, to more direct forms of exchange and speculation. For many managers, the status of government employee and government contractors are different phases in the same life cycle.

Furthermore, visibility and accountability are occluded by a dense cobweb of relationships. It is difficult for anyone who is not directly involved to be certain what is going on in complex webs of contractual arrangements between the government and private sector. It is even more difficult to establish who should take the blame when things go wrong. When a contractor fails to deliver the promised benefits, it is often not clear whether it, or the government which employed it, should be held accountable.

Finally, as the state hives off core competences, it begins to lose the capacity to make independent judgments about how to regulate, or even which goals to pursue, again making it more dependent on intimate and long term relationships with private interests, whether they be regulated firms, telling the state how it should craft its regulatory policies to achieve appropriate goals, sub-contractors, telling the state how it should manage its relations, or businesses lobbying under-resourced legislators. Over the last few decades, the analytic capacity of the US state has withered away, as, for example Congress has lost the Office of Technology Assessment, and seen the starvation of legislative staff and institutions such as the Congressional Research Service that are intended to provide it with independent capacity to analyze policies. This has made it ever more dependent on lobbyists, to provide information and often even to draft bills. The situation is replicated in statehouse legislatures, which often rely on business-dominated organizations such as ALEC, the American Legislative Exchange Council, for model legislation.

All this leads to a new kind of semi-privatized state, most eloquently described by Crouch (2004, p. 100), who sees the state as having been



transformed from an independent and authoritative actor in society to a nexus in a web of contracting and regulatory relationships. He argues that the capacity of the state to recognize and act upon a clear sense of the public interest has radically diminished:

As government contracts out an increasing range of its activities, its employees really do lose competence in the areas being covered by the contractors, areas within which public servants have until now had unrivaled expertise. As they become mere brokers between public principals and private agents, so professional and technical knowledge pass to the latter. ... In the process of trying to make themselves as similar as possible to private firms, public authorities also have to divest themselves of an intrinsic aspect of their role: the fact that they are authorities. It should be noted that this loss does not extend to the political center of national government itself. In fact, far from achieving the disappearance of state power dreamed of by libertarians, the privatizing state concentrates political power into ... a tight central nucleus, which deals predominantly with its peer elites in private business.

Crouch's remarks are aimed at the UK (and to a lesser extent the mainland European and US) experience, and draw a strong general conclusion that some may contest. Even so, they describe a very important tendency in the privatization of the state. His arguments are bolstered by those of Peter Mair (2013), who finds that traditional democratic relations, in which parties play a key mediating role between public and elites, are being replaced by intense intra-elite relationships of resource exchange

### *Privatization of Rule-Making on the World Stage*

Privatization is remaking the state in different ways in different countries. This has important consequences for global politics too. Privatization and regulation are not creating a more homogenous world, but one in which different

styles of regulating are more likely to lead to disputes than before. Clashes between different regulators from different countries provide new opportunities for private actors to influence or implement policy, and even to reach down again into domestic politics.

If states are more prone to governance-by-regulation than in the past, they also face new difficulties in regulating in a complex international system (Mattli and Woods 2009). The more willing states are to regulate, the greater the risk of rule clash between different regulatory jurisdictions, each with their own regulators and rules. If privatization and regulation are two legs of the stool, globalization is the third. National markets are no longer separate from each other, to the extent that they ever were. They interpenetrate each other. We have moved from a world where markets for many commodities (especially network commodities) were national, and were governed by state owned entities, to one in which markets are not limited by national borders, and are governed by different regulators, who often disagree with each other. In the description of Abraham Newman and Elliot Posner (2011), there is very often a 'mismatch' between the jurisdiction of regulators and the extent of the market. The state has been transformed from a hierarchical actor at the 'commanding heights' of the economy to a regulator of market actors, who increasingly work on a regional or global, rather than a national scale.

This has important implications for the privatization of governance. Most obviously, it often provides firms with increased bargaining opportunity vis-a-vis the state. Many businesses are relatively mobile, and hence capable of relocating their assets from one jurisdiction to another. This provides them with 'structural power' vis-a-vis state regulators, which have to pay attention to their interests, lest they decide to relocate (Lindblom 1982). Some businesses can often pick and choose across different regulatory regimes. The structural power of business may vary by sector or country, so that some firms, in some states, are more influential than others (Culpepper and Reinke 2014, Culpepper 2015). Yet in many situations, we may expect that businesses will be able to use their bargaining power to re-tilt their relationship with regulators in their favor, so that they favor firms more and the other actors to whom governments are responsive less.

It also sometimes allows businesses to replace formal state regulation with what might be described as a tacit privatization of rules. For example, for a significant period of time, US rules banning online gambling and the rules of other states that sought to regulate gambling were effectively undermined by the activities of a small group of gambling businesses, which set up offshore on the island of Antigua, a country which imposed no very strenuous limits on these businesses' activities. It is difficult to retain the force of national regulations when businesses can systematically evade them. Under such circumstances, the relevant rules will be those set by the businesses themselves to try to ensure customer confidence (e.g. by persuading potential customers that the gambling companies will not create a secret house advantage, and will pay up on winnings).

States may, of course, respond to this by seeking to extend their jurisdictional reach so as better to grasp slippery firms that are seeking to evade it (or that might be in a better bargaining position if they were credibly able to threaten to evade this) (Farrell and Newman 2015a). Regulators are increasingly willing to work extraterritorially, either by cooperating with other regulators in other states, or by using other businesses as proxies, or by coercing other regulators to change local standards, or by simply barring firms from relocating sensitive activities overseas. For example, the US managed to cripple the Antiguan gambling industry by pressing the financial industry into service as its enforcers, obliging them to block payments that appeared to be directed to or from offshore gambling concerns. The European Union (EU) has sought to prevent private actors from escaping EU privacy rules, by barring them from exporting the personal data of Europeans overseas, unless the receiving country has an "adequate" privacy system (*ibid*). This has strengthened the EU against demands from large firms that it weaken their privacy rules, while allowing EU regulators to shape the privacy laws of other countries to better reflect EU standards.

Yet efforts by regulators to apply their rules extraterritorially are likely to result in renewed clashes with the regulators of other states, which may have different rules or no rules. This provides a new set of opportunities for well

situated private actors to propose or influence solutions to regulatory disputes, very often in ways that involve a greater privatization of governance.

For example, when the EU sought to get the US to change its rules on privacy, the US balked, first proposing that the EU should accept US self-regulatory schemes as providing adequate privacy protection, and then, in consultation with major US firms, coming up with an arrangement in which self-regulation would be embedded in a system with minimal government oversight (Farrell 2003). Large businesses in the pharmaceutical, software and entertainment industries created an ad-hoc Intellectual Property Committee that succeeded in setting the agenda for divisive inter-state negotiations over WTO intellectual property rules where the US had previously engaged in extraterritorial pressure against countries that it believed had insufficient intellectual property protections (Sell 2003), providing businesses with new abilities to take action against governments that were perceived as recalcitrant. Private creditors played a key role in shaping contentious cross-national discussions over sovereign debt, opposing proposals for a far reaching mechanism for restructuring sovereign debt, and acting as “private entrepreneurs” to promote their own model international code of conduct, backed by a body of senior financial sector executives and government officials, in which the former have majority representation on the board (Helleiner 2009).

Such opportunities have arguably transformed the relationship between private and state-led governance in the international arena. Arguably, private governance arrangements no longer fall under ‘the shadow of the state,’ (Knill and Lehmkuhl 2002) or consist primarily of self regulatory arrangements intended to forestall more far reaching government rules. As different regulatory approaches have come into conflict with each other, generating the need for solutions, the private actors who dominate various cross-national self-regulatory arrangements have been able to take advantage of new opportunities. Some specific examples illustrate a much more general trend.

First, alliances of cross-national actors have often been able to *influence* proposed solutions to regulatory clash, by, for example, proposing standards that benefit themselves, perhaps at the cost of others. In particular, private sector entities that are easily able to cooperate across the borders of the relevant

jurisdictions are likely to be better capable of affecting standards, since they can mobilize across both or many jurisdictions, offering cross-jurisdictional support for the solutions that they favor. In general, this has tended to favor businesses vis-a-vis other social actors that are less easily able to work across borders, and has favored some businesses (those involved in the relevant cross national networks) over others (Farrell and Newman 2015a). For example EU and US clashes over accounting standards led both to accord a crucial role to standards created by the International Accounting Standards Board, a private organization set up by a variety of cross national accounting and financial firms to influence European debates (Farrell and Newman 2015b). Businesses have, however, found their cross-national influence substantially limited in situations of significant public controversy (Culpepper 2010, Newman and Kalanpur unpublished).

Second, they have sometimes been able to *implement* solutions that have the formal or informal blessing of the states in question, being delegated by states individually or collectively to solve a problem that states lack the resources or expertise to solve themselves. For example, Buthe and Mattli (2011) show how producer groups have come together in international standard setting bodies to play a key role in shaping national rules e.g. about product standards. Organizations such as the International Organization for Standardization (ISO) and the International Electrotechnical Commission (IEC) specifically exclude states and governments from membership. They provide specifications for products that are implemented in the national regulations of WTO. The WTO agreement requires all member states to “use international standards as the technical basis of domestic laws and regulations *unless* international standards are ‘inefficient or inappropriate’ for achieving the specified public policy objective.” (Buthe and Mattli 2011, p.6). Non-conforming standards can be treated as violations of international trade law.

Third, they have sometimes *substituted* for more traditional means of regulation, regulating some area that states have been either unwilling or incapable of regulating themselves. For example, there are several international self-regulatory bodies that certify forest management. States were themselves incapable of agreeing to sign a convention on forestry at the Earth Summit in

1993 (Cashore 2002, Bartley 2007), leading the World Wildlife Fund and other organizations with a strong cross national presence to set up the Forestry Stewardship Council in order to create and certify standards for timber producers. This Council is purely voluntary and depends on consumer willingness to accept its certification as a sign of better production practices. However, it has been incapable of preventing industry led groups from creating their own competing standards, generating confusion among consumers who are unlikely to understand the differences between groups.

These efforts are primarily international in scope, although they may have domestic consequences. More recently, however, private actors have begun to use cross-national or international arrangements in order to reshape domestic regulation. Most simply, actors with privileged access can use the transposition of international agreements into domestic law either to strengthen or weaken rules. Sell (2003) documents how businesses used the transposition of an international treaty on intellectual property into US law to impose rules that they might have had difficulty in introducing otherwise. Here, businesses were able both to organize internationally as private interests to shape international rules, and then use these rules to reshape domestic institutions. Similarly, firms from both the US and European financial industries have a privileged voice in negotiations between the US and EU over trade and standards. US firms would like to weaken domestic financial regulations by introducing common and watered down rules.<sup>4</sup>

Such efforts resemble traditional lobbying, albeit through the back door provided by the international system. However, international processes sometimes give businesses more direct means of private action. For example, international businesses have begun to use the international investment regime to try to push back domestic regulations that are not in their interest. Over the last half-century, there has been an extraordinary proliferation of Bilateral Investment Treaties (BITs) world-wide (Elkins, Guzman and Simmons 2006). These treaties allow investors from one signatory state to take state authorities in the other to international arbitration for measures or policies that affect their

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<sup>4</sup> See Christian Oliver and Shawn Donnan, "Brussels Wants Finance Rules Back in US Trade Pact," *The Financial Times*, January 27, 2014.

investments. These treaties both reinforce the regime of privatization and extend it.

They reinforce the regime by making it highly expensive for states to reverse course on privatization by renationalizing businesses that have been sold in full or in part to investors from countries with relevant treaties. BITs treaties are designed precisely to make state expropriation expensive, and thus to discourage it. Only countries such as Venezuela, Bolivia and Ecuador that are strongly disaffected from the existing international economic system have sought systematically to renationalize aspects of energy or infrastructure. Unsurprisingly, such countries have found themselves being sued in arbitral tribunals.

Second, the regime of privatization is being extended, as relevant 'investments' under BITs are redefined in increasingly broad ways (Edwards forthcoming). For example, an energy company is currently suing India for making a retrospective tax assessment, which it claims substantially hurt its share price, thus causing it substantial economic damage. Notoriously, the US tobacco giant Philip Morris is suing Uruguay, Norway and Australia for introducing legislation requiring that cigarettes be sold in plain packages or packages graphically depicting the consequences of smoking, claiming that this represents a regulatory expropriation of Philip Morris's intellectual property. The prominent New York law firm Skadden, noting the "novel" ways in which BITs clauses are being reinterpreted, has effectively invited potential clients to consider suing e.g. European governments that have forcibly bailed out financial entities during the global economic crisis. As Haley Edwards notes:

In July 2014, a group of 120 professors of law and legal theory wrote a letter to the USTR making the case that under existing, fluid definitions of what is "fair" or what constitutes an "indirect expropriation," tribunals could feasibly interpret a whole host of legitimate regulatory actions as a violation of an international investment treaty.

Julia Gray (2015) further argues that BITs allow multinationals to forum shop across states, so as to find the treaty with the clauses most likely to support

an action; for example, the Philip Morris case against Australia was filed by Philip Morris's Hong Kong subsidiary to take advantage of an especially lax treaty. She finds evidence that businesses have actually set up paper subsidiaries in countries such as the Netherlands so as to be able to sue particular jurisdictions.

Thus, BITs complete the circuit from the national to the international and back to the national, providing an internationally based means of private action that can then be used to reshape the state's domestic regulatory capacity. Their consequences off the equilibrium path are likely more important than their direct deployment. Investment professionals believe that a previous threat of action under NAFTA's investor dispute resolution mechanism restrained Canada from introducing anti-smoking legislation, while the action against Uruguay is widely perceived as a shot across the bows of other states that might be contemplating similar action. States that are considering regulations are likely to be nervous if they fear these regulations might see them hauled before arbitral tribunals (Edwards 2016). In part as a result of privatization, states have turned towards regulation, but they are finding that their capacity to regulate is being significantly constrained.

### *The Three Aspects of Privatization*

In this essay, I have tried show how the wave of privatizations that began in the late 1970s or early 1980s has had profound political consequences. Specifically, it has reshaped the state, so that it increasingly relates to the economy as a regulator, and to increasingly use market-like mechanisms in its own workings. The move towards regulation at the domestic level had international consequences, as globalization created a mismatch between cross-national markets and national regulatory systems. This helped private actors to evade regulatory power, leading some jurisdictions to seek to extend their grasp extraterritorially. This in turn led to greater clashes between regulators over whose rules, if any, should prevail, providing new opportunities to private actors that had organized cross-nationally to propose, influence or shape solutions to regulatory clash. Most recently, we have seen private actors use international



agreements to reach back within the state, using ISDS provisions to undermine state regulations that are not in their economic self-interest.

The purpose of this essay is to disentangle a complex skein of causation between markets, states, international regulatory processes and back again, rather than to provide a complete account of how privatization works nationally and on the global level. The latter would be an Augean labor. Thus, the account presented here is necessarily simplified. Specifically, it emphasizes the ways in which these different levels of activity reinforce each other rather than (as they sometimes do) rubbing against each other. It presents the impression of a seamless totality, rather than the complex, ambiguous and ever-shifting network of relationships that is present in actuality. One could emphasize different causal chains between the national and global, and by so doing arrive at quite different stories.

Nonetheless, even partial accounts like this one are potentially valuable. Political science has great difficulty in thinking clearly about the political relationship between national and global processes of regulation and privatization. The same is true of cognate disciplines such as economics (to the extent that it concerns itself with politics) and economic sociology. The scholarly literature tends to focus either on purely national patterns, or on international patterns of regulation, or, to the extent that it is interested in the relationship between the two, to focus on processes such as diffusion, that tend to discount or pass over the political relations through which one set of ideas diffuses, while another withers on the vine. Equally, those who are practically concerned with regulation and privatization tend to neglect such relationships, exactly because they are complicated, and involve interactions that usually extend far past the issues and relations that any individual or organization can easily concern themselves with.

Mapping out these relationships is a crucially important task for the social sciences, together with legal scholarship (which has begun to think more explicitly about these relationships but could surely do more) and political theory and philosophy (which has e.g. important accounts of responsibility at both the global and national levels, but relatively little about the interaction between them). This essay should be read as one - partial and imperfect - effort

to start mapping out one key chain of causation as a step towards this broader agenda.

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