The Effect of Privatization on Public Transit Costs

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Abstract
In an effort to reduce operating deficits, increase productivity, and improve the quality of services, the public transit sector has been moving away from public ownership and operation and towards a franchising arrangement whereby a local government authorizes a private firm to manage and operate the city's public transit system. Profit maximization considerations imply that private managers have stronger incentives for cost efficiency. One such example is the city of Indianapolis which began privatization efforts in its transit operations in 1996. Based upon monthly data from January 1991 through March 1997, this study examines the effect of privatization on the city's cost of providing mass transit. The primary implication of the study is that Indianapolis has experienced an annual 2.6% reduction in operating costs since privatizing the management of its public transit system.

1. Introduction
Prior to 1960, privately owned and operated firms provided most urban mass transportation services in the United States. During this period, transit firms typically operated under an exclusive franchise agreement and received little or no government financial assistance, although they were subject to state and local regulations (Orski 1985). Beginning in the early 1960s, however, private enterprise gave way to public ownership and operation as private firms increasingly experienced financial problems in meeting the transport needs of the community. Among the most important factors contributing to the financial woes of private firms and the transition from private to public ownership were higher incomes which

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increased the demand for automobile ownership, state and federal government efforts substantially to increase highway capacity, and rising suburbanization of the population (Smerk 1974, 1979; Saltzman 1979). Moreover, rather than allowing private firms to solve their financial problems by reducing the extent and frequency of service, policy makers supported public ownership and operation. Losses were to be covered through subsidization: scale economy arguments were used to justify capital cost subsidies, while operating cost subsidies enabled cities to use mass transit to meet various social concerns. It was expected, for example, that public transit would play an important role in preserving and revitalizing cities, satisfying the transport needs of the less privileged, creating a better urban environment, and providing a more energy efficient form of transport (Altschuler 1981).

Unfortunately, the performance and quality of service of our nation's publicly owned and operated systems have been poor. The total operating subsidy from all levels of government (local, state, and Federal), for example, rose from $318 million in 1970 to $9.27 billion in 1990, a 30-fold increase in twenty years (Pucher 1995, 211-227). Various authors contend that subsidies have encouraged productivity declines, lack of innovation and initiative, and financial mismanagement of transit properties. Many studies, using a wide variety of data and methodologies, have examined the effects of government financial assistance on the performance of transit systems (Pucher et al. 1983, 155-176; Carver 1984, 407-413; Pickrell 1985, 281-298; Bly and Oldfield 1986, 415-427; Obeng et al. 1994, 127-149; Karlaftis and McCarthy 1997, 253-270). While the specific results vary among the studies, the conclusions overwhelmingly support the notion that there are clear links between increases in subsidies and reductions in performance and productivity. To deal with the reality of the degrading effects of subsidies on transit system performance, several authors have suggested three possible solutions: alter the federal and state subsidy programs to reward those systems that raise productivity, increase ridership, or enhance the quality of their services (Fielding 1987); shift subsidy responsibility from federal to more decentralized state and local governments which have stronger incentives for monitoring public transit operations and, accordingly, greater potential for generating efficiency gains in transit systems (Shughart and Kimenyi 1991, 251-276; Pucher 1995, 211-227); and re-examine the private alternatives to public ownership (Gwilliam et al. 1985a, 105-132; Gwilliam et al. 1985b, 215-222; Beesley and Glaister 1985a, 133-142; Beesley and Glaister 1985b, 223-224).

This paper contributes to the existing literature by investigating the impact that privatization has had upon a medium-sized public transit system. The Indianapolis Public Transportation Corporation (METRO) was created in 1972 to meet the growing transportation needs of the Indianapolis urban area and to promote travel to and from the Central Business District. While the Indianapolis area continued to grow steadily, bus services remained virtually unchanged and there were no plans to expand services to the rapidly developing communities in the surrounding areas. In recent years, METRO's ridership has been declining while at the same time subsidies have been increasing. A total of $1.2 million of local tax funds were used to subsidize METRO in 1982, growing to $6.4 million in 1992. Moreover, while the

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2 The Indianapolis transit system, operated as a public enterprise since 1972 and for the period under study, served an average population of 950,000. Although the Indianapolis Public Transportation Corporation primarily provides fixed route-fixed schedule services, the data also reflect some demand responsive services that the city offers. Since demand responsive services account for less than 3% of the total, their inclusion is not expected to significantly affect the results.