Centre for Market and
Public Organisation

Risks and opportunities of participation schemes in public services

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1. Some Background

Private involvement in public services:

- Private involvement in its various forms of delivery of public services is now vast.
- $3.24 trillion of assets had been transferred to the private from the public sector in the preceding 25 years (significant proportion of which consists of public services).
- 18 % of the global stock market value
- 39% of the non-U.S. total value

Studies of public sector transport projects*

- Nine out of ten transport infrastructure projects fell victim to cost escalation.
- Rail: the average cost escalation was 45%;
- Fixed links (bridges and tunnels): the average cost escalation was 34%
- Roads: the average cost escalation was 20%.
- Cost escalation is global phenomenon,
- Not decreased over the past 70 years,
- Average cost escalation for private fixed link roads is 34% compared with 110% for public

*Flyvbjerg, Bruzelius and Rothengatter, 2003, and Flyvbjerg, Holm and Buhl, 2002, 2003, 2004, 2005.

If this is general for other public services ten what does this evidence tell us?

- The evidence suggests things are going to be a long way from perfect whichever sector delivers.
- Small scale case studies can help elucidate problems and help learning from the past, but they are unlikely to be much use in informing which mechanism is best.
- If the history is bad enough then even minor improvements may bring huge benefits. So an apparently really poor private or public project might still represent good value for money.

Formality:

- Public sector comprises the economic activities controlled by the government.

- Public services are the set of services provided for large numbers of citizens in which there are potentially significant market failures (broadly interpreted to include equity as well as efficiency) that potentially justify some government involvement.

(Grout and Stevens (2003))

2. Private sector involvement in the delivery of public services : Why might sector matter?

At least four reasons:

- Contracts and motivation
- Competition
- Intrinsic motivation
- Finance

Inability to contract perfectly

- Contract quality is critical - if a private company owns the assets and delivers the service then the company may seek to reduce costs as much as feasible within the contract without regard to consequences for quality
- If contrast, the public sector agency should care about quality as well as cost reductions.
- However, a public supplier is harder to motivate

- The net effect is that the private sector is likely to provide lower costs but lower quality.

- So whether private ownership and delivery is better depends on the relative benefit of cost reduction relative to quality decline.

- The ability to regulate to make the private company do what is right is critical and can be difficult, particularly if private company is poorly funded.

Competition

- An alternative view as to why sector matters is competition
- Here the view is that what really makes the public sector expensive is the absence of competition
- In this case the benefit of private sector comes through an indirect role
- The private sector matters because it is the enabler of competition (but after it may not really matter which sector does the delivery)

- The evidence suggests competition matters but it is hard to ensure it is present

- For competition to be real there has to be a genuine fear of termination of contract for the incumbent – so less good for infrastructure (unless big players playing a repeated game with the government.

Intrinsic motivation

- The idea is that the non-profit sector encourages more intrinsic motivation from employees, thought to be big issue in ‘caring’ public services.
- My view is that this is not as strong as suggested
- Our research shows that, although non-profit sector employees are more than 40 per cent more likely to do unpaid overtime than individuals in the for-profit sector, there is no evidence that individuals change their ‘donated labour’ when they switch sector.
- Intrinsic motivated people choose sector but sector does not make people display more intrinsic motivation.

Finance

- Private sector can provide and purchase assets (privatisation).
- Private funding is ‘ring-fenced’ (notably PPPs) whereas public borrowing is not
- However, low equity base relative to replacement cost of assets can be a major problem.

3. How is the private sector involved?

At a high level useful to think of three models:

Full privatisation: Sale to private sector – role of government is to regulate (often independent regulatory agency).

Short term PPPs: This is often a basic outsourcing model

PPPs (e.g., PFI model). There are many variants

Advantages and disadvantages of the full privatisation model are well known.

- Has been successful in many countries
- Some common themes across countries
- Even in UK where the model has been successful there have been some interesting problems with broad implications – I mention two here ((i) equity base relative to replacement cost, (ii) licence v. price regulation).

- Low equity base relative to replacement cost can cause problems

  e.g., Railtrack bankruptcy

- Non-price regulation. e.g., supply of energy to domestic and micro businesses not price regulated
  - 6 companies (have 99.5% share, vertically integrated).
  - Regional concentration problem (70%+)
  - Strategy of contractual complexity - 188 contracts in market in 2007, grown to 311 in 2010
  - Low switching, despite scope for large switching gains ($200-$500) for many customers

Short term PPPs (outsourcing):

Evidence globally suggests this is relatively successful – waste management, hospital services, etc.

Evidence suggests competition is the critical element.

Some evidence that the benefits have spilt over to public delivery without competition.

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4. What are the benefits of Public Private Partnerships model?

- The PPP solution is for government to buy the service not the physical assets.
- Private sector usually owns the assets initially and makes all relevant investments - the public sector buys the flow of services
- A big problem is that the single supplier has some post-investment monopoly power. This is ‘removed’ by a competitive bidding process.

There are lots of variants around this theme

Economic benefits for PPPs fall loosely into two boxes:

- Economic efficiency arguments
- Political economy/Finance arguments

Economic efficiency argument

Traditional procurement:

- Builders are paid for the building and they then move on to build another.
- If the building turns out to be poor quality after many years then the government faces a complex legal battle

PPP models:

- Government pays for the service it gets. If a road/school, etc. is poor quality and needs expensive repairs then the builder pays and also suffers loss of income if cars use other routes while the road is repaired, school closed, etc..
- So if the contractor fails to deliver the service then the private contractor receives no payment.

So a PPP focuses on minimising whole life costing whereas traditional procurement does not.

The idea with PPP is that the contractor has a strong incentive to:

- deliver on time (to start the money flowing) and
- ensure good quality design and build to avoid costly repairs and failures later on.

Political economy/Finance argument.

- A mechanism to modernise and obtain infrastructure/services without having to find or borrow money today
- It is often argued that the government' legal duty to pay in the future may not be different from borrowing today.
- But signing a PPP may be different from borrowing , e.g., if the final destination of 'state' borrowed funds is more fungible, if the source of money affects commitment and quality of service for citizens.

The political economy/finance justification is frequently criticised

- Criticisms of this justification typically assume that the alternative is the public sector borrowing and doing the project.
- But this is not the relevant test
- Politicians are usually deemed to be too short term
- The poor state of global public sector infrastructure (hospitals, schools, etc.) in many countries is well documented
- So a mechanism that allows politicians to improve the infrastructure of the country while passing on the cost to those future generations who pay as they benefit is a plausible way of correcting the distortion.

Good evidence that PPPs work around the world but also plenty of horror stories

- Some common themes:
  - Overall delivery more likely to be on time
  - Overall better quality but more expensive
  - Transport infrastructure tends to work quite well
  - More mixed results:

    - where services are complex and need flexibility (some health services, IT - frequently specification/contracting is problem) but the traditional procurement is also a problem here

    - where financing/take up an issue (renegotiation problems), e.g., provision of water in poorer countries

Need for private funding unlikely to go away

- Needs for roads, schools, hospitals, energy networks, are growing and infrastructure is globally relatively fashionable
- Provision for old age is being transferred from public to private sector in developed countries (January 2011: assets in the 13 largest pension markets hit a record high of $26.5 trillion)
- Ever increasing use of pension funds for provision of infrastructure because time scales match well.
- Twelve dedicated infrastructure funds worth a combined $5.2bn reached final close during 2010 (more than double that of 2009 in terms of both size and number). Many of those funds were oversubscribed.
- PPP secondary market growing globally

Generic problems in really identifying whether PPPs are better

- Comparable information on true costs of public delivery is missing. The efficiency argument implies that whole life costing is better in a PPP but this requires comparison with whole life of public delivery. Governments do not have this data.
- Typically build costs are compared but this biases the comparison in favour of public provision
- Discounting processes within a finance ministry (using same discount rate for the ministry cost of public and private provision) also overestimate the cost of private delivery relative to public delivery

- ‘Value for money tests’ typically do not value the benefit of earlier delivery
- ‘Value for money tests’ typically compare private provision to hypothetical alternative
- Political economy of regulation not factored in [although renegotiation/re-nationalisation costs and ring-fencing (a response to the problem of political economy of regulation) may not be valued correctly either].
- Lock-in value (or cost) not assessed.

US example

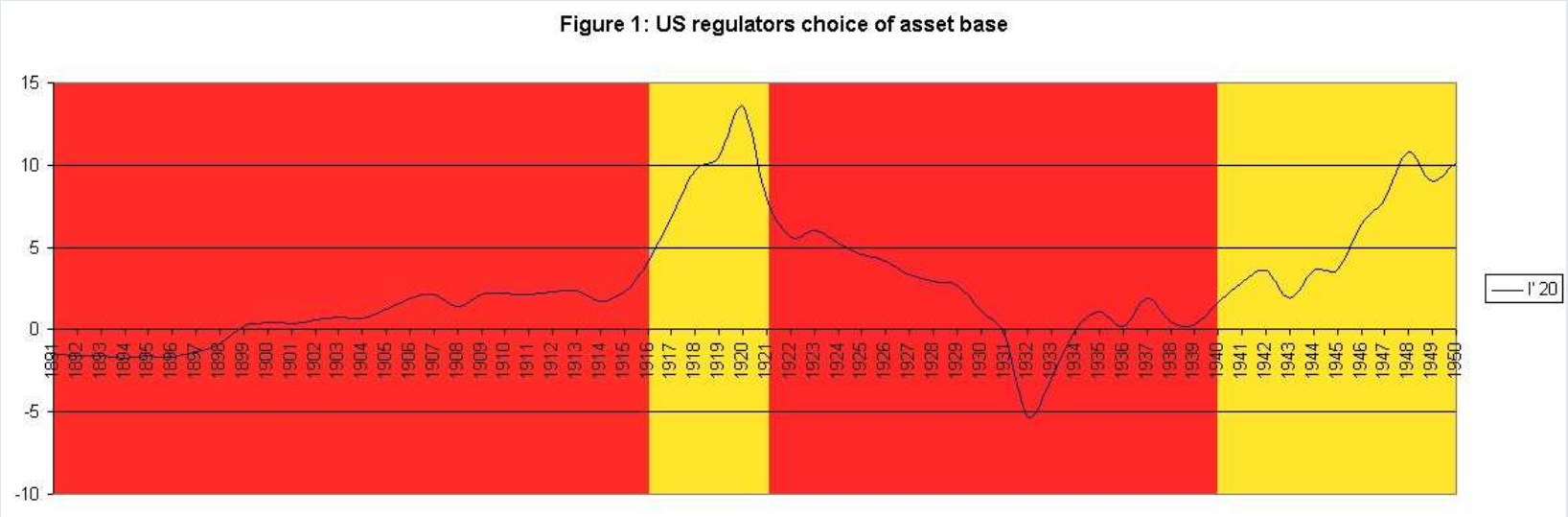
Figure 1: US regulators choice of asset base
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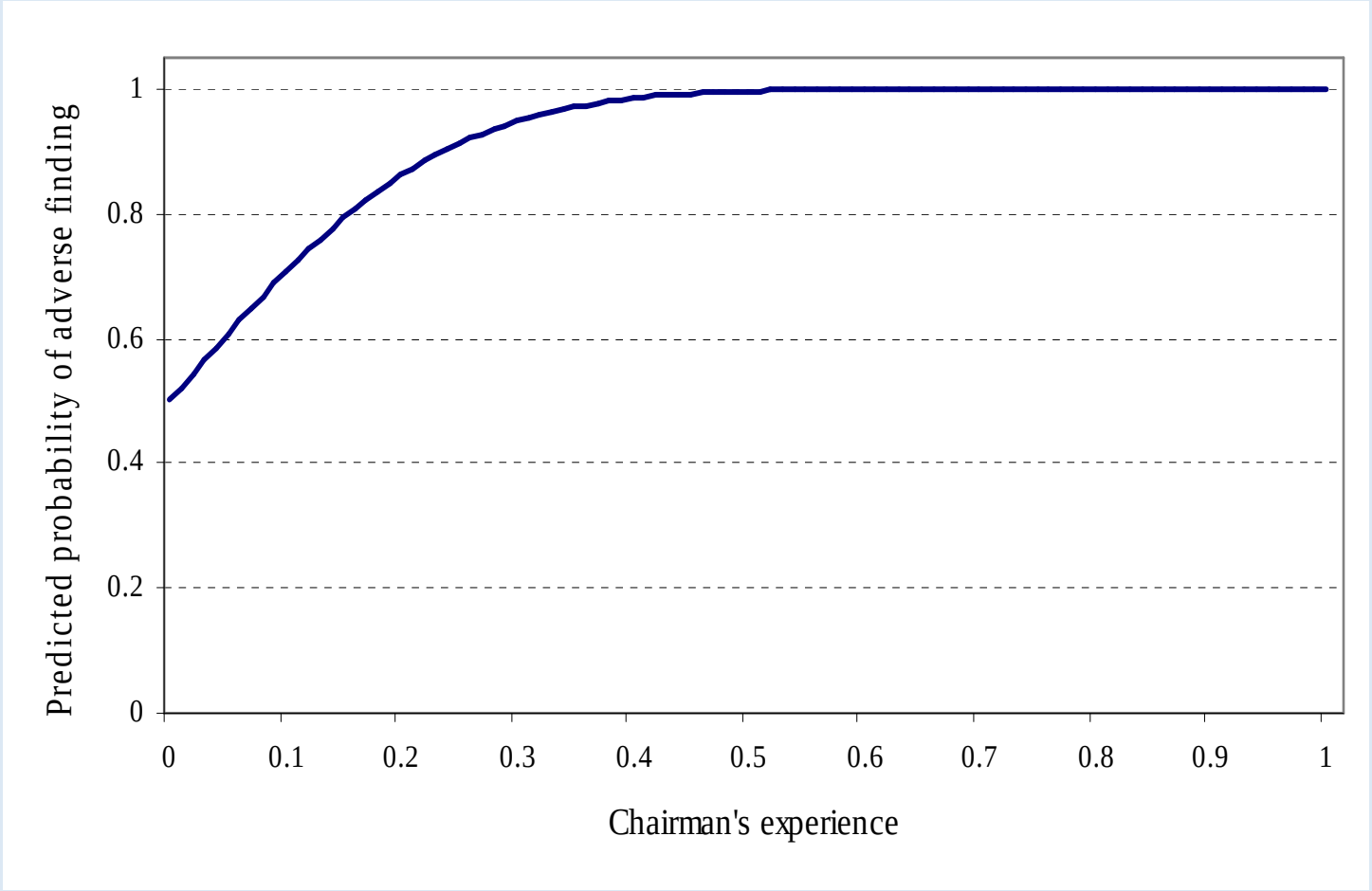
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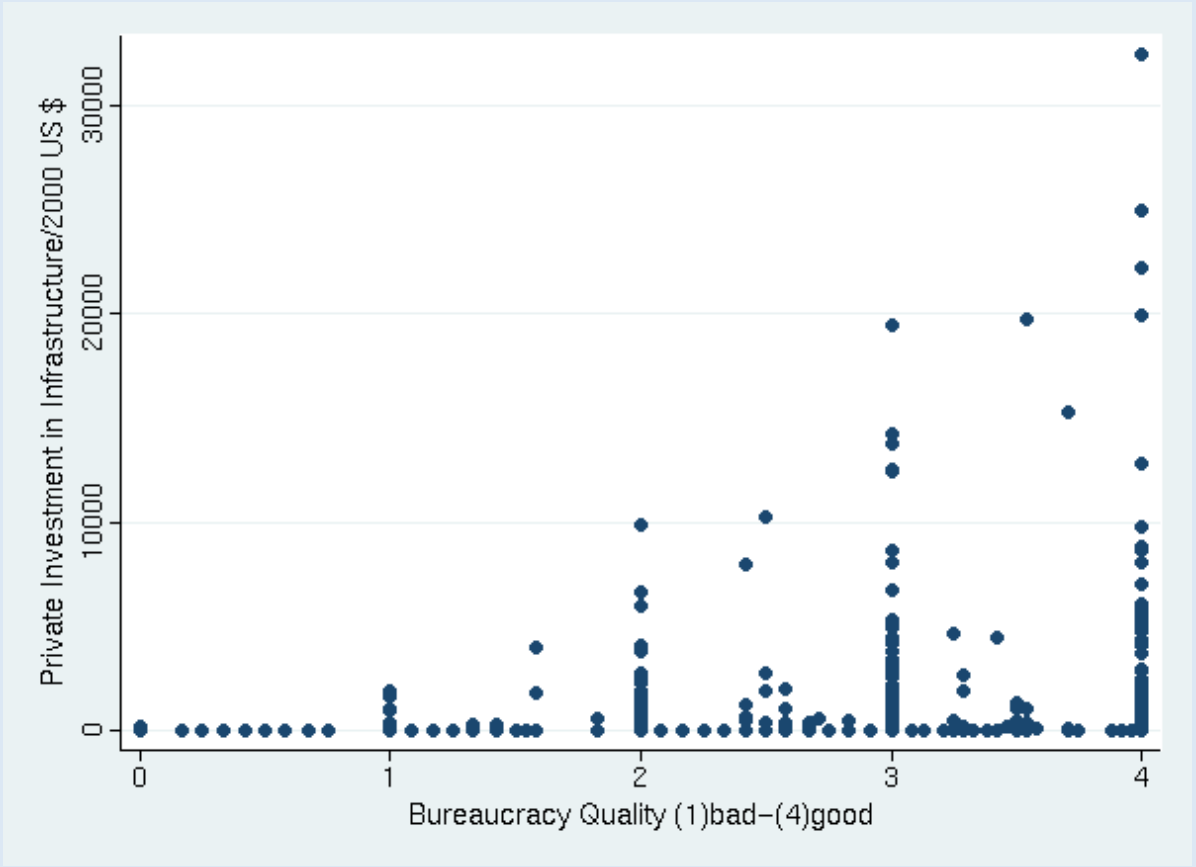
Chairman's experience

Investment against Bureaucracy Quality (PW database)



Generic problems with PPPs

- Renegotiation/re-nationalisation (changed requirements/funding issues/corruption)
- Lack of innovation
- Lack of up-front competition
- Procurement competence in public sector
- Risk transfer commonly an issue
- Political unpopularity of private sector provision of public services