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Private-Public Partnership

Under the increasing pressure of shrinking budget resources and the requirement to improve the quality of public services, national governments have been applying a wide range of innovative approaches to enhance the wealth of the population through more efficient, economical and citizen-centered models of public sector administration.[1] Furthermore, a rapid evolution of public administration concepts and management techniques have drastically restructured the role of the state and forced the governments to introduce new methods of public service delivery to meet the call for the maximum value for public money. The New Public Management (NPM) doctrine[2] as a synthesis of these best practices of public sector management is gaining tremendous popularity in the OECD member states and is opening a wide range of opportunities for the developing countries on their way to more efficient public administration. Although the worldwide progress with NPM reforms is mixed, its major promise is to strengthen public administration in the increasingly competitive and global World by taking the best inputs from all stakeholders – both in private and public sectors.

Private-public partnership and cooperation belongs to a broad set of market-type mechanisms of public service provision that attempt to introduce key characteristics of market into the activities traditionally performed by the government. The driving force behind the growing application of this type of arrangements within public administration is their potential impact on the costs and quality of the provision of public services. If properly designed, market-type mechanisms can guarantee substantial efficiency gains either through lower costs or better quality and can considerably contribute to the economical utilization of public funds. Prior to the discussion of the application of market-type mechanisms by the government it is worthwhile to describe general mechanisms applied by in the international arena.

Outsourcing or contracting is one of the common market-type mechanisms applied by the governments to engage private sector into the provision of services, which are currently performed by in-house civil servants, either to state agencies and institutions or directly to citizens on behalf of the government. The verity of services contracted out to private sector may include both ancillary services to the key functions of various departments of the government, and, in some cases, core state function.[3] A set of non-core activities outsourced by the

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[1] USA, Canada, New Zealand, Australia, UK, Chile, Brazil, Finland, Poland, South Korea can serve as an example of such changes.
[2] The NPM doctrine was first introduced by ________
[3] The most typical example of core state function is a privately run prison.

government usually exceeds maintenance and support services (for example, catering, building cleaning and repairs) and frequently includes many services, which are important for the overall operation of the state agencies (for example, information technology, and human resources and logistics management).

The principle goal of outsourcing is to improve the efficiency of funds utilization by introducing market competition into the provision of public services. The crux of this method is enclosed in the incorporation of operational practices that closely reflect conventional business models into the public sector. The resulting benefits are derived through lower costs of services as well as better quality and reliability of services provided by the private sector. These costs and quality considerations form a set of strong preconditions that make outsourcing an attractive alternative to in-house services provision:

- Outsourcing must be a viable option – there are no regulatory restrictions on contracting a specific state function to the private sector;
- The private sector has the capacity to supply similar services or products in the required amount and under the established quality standards;
- The function to be outsourced is not an inherently governmental in its nature;
- Existing market conditions allow for the competitive outsourcing of the public services;
- The private sector may provide similar services at lower costs;
- The government has a capacity to enforce adequate monitoring of the quality of services outsourced to the private sector;
- The government consistently achieved unsatisfactory performance in the provision of some services;
- The private sector has a better expertise than in-house civil servants.
- In the long-run, the private sector is more flexible to adjust the quality and mix of services supplied;

Services, outsourced by the governments can be divided into three broad categories. The first group includes a wide set of blue-color support and maintenance services such as cleaning and management of buildings, waste utilization, laundry, catering and the provision of guard services. These services are relatively labor-intensive and usually do not represent critical importance to the functioning of the state agencies. Since this type of non-core operations is common for many business activities, they are provided in the competitive environment and under the clearly defined quality standards. Furthermore, monitoring and control over the provision of these services is relatively inexpensive which makes them the first-best candidate for the outsourcing. OECD member countries have already contracted out either all or majority of these services to the private sector. Outsourcing of this type of services in developing and transition countries is more problematic due to the large number of low-skilled people employed in the public sector, especially in the state-owned education, health and social security networks. The state might be willing to secure the employment of low skilled labor by maintaining labor-intensive operations within public sector as outsourcing these services to private sector may result in lower employment and wages for unskilled workers.[4]

[4] United Nations (2005), "Unlocking the Human Potential for Public Sector Performance." World Public Sector Report 2005

The second group of outsourced services includes activities that are ancillary to core functions of the state institutions. These are mostly professional back-office operations such as information technology, research, legal and audit services, financial and banking services, and human resource management. These operations are generally complex and intensive in skilled labor. For this reason, the provision of such services must comply with high quality standards. In addition, since the conditions under which these services are provided are particularly sensitive to the changes in the policy priorities of the government, a private provider must ensure sufficient flexibility to be able to adjust service delivery to the changing regulations of the government agencies that purchase these services. However, the risk of long-term erosion of human resources in the public sector may significantly restrict the potential benefits of contracting out professional services to private contractors. Since the supply of some of the services outsourced by the government may heavily rely on the skills possessed by in-house civil servants, the private sector will compete for such civil servants by offering higher compensations. As a result, in the long-run the government's capacity to resume the provision of such services may drastically deteriorate due to the scarcity of skilled civil servants. This risk is even more severe in the developing and transition economies, where the growing private sector aggressively competes with the government for skilled labor.

Finally, the third group of outsourced services is less common and represents services that are core functions of the state. Although, this type of outsourcing is quite rare in developed countries, it still dominates certain segments of the public sector in some countries. The outsourcing of prisons (Australia, Canada, United Kingdom and United States), emergency rescue and fire services (Denmark) and food inspection services (Iceland) are some of the example.[5]

Essentially, the magnitude of economic benefits of outsourcing in-house activities to the private sector is based on the ability of the government to establish functioning mechanisms of competitive contracting with the private suppliers. Unless such mechanisms are properly designed, outsourcing is unlikely to generate significant savings through lower costs of service delivery and may even worsen the quality of services supplied. Therefore, the existence of competitive markets for services outsourced by the public sector is a key precondition. Although, the capacity to contract private suppliers in a competitive environment depends on the types and complexity of public services outsourced, the government may actually contribute to the creation of competitive markets for these services due to the large size and quantity of contracts that require many private contractors.

The issue of private contractors' accountability is a principle concern of contracting out government activities, especially if these activities represent public services supplied directly to citizens. The government is responsible for the stable provision of outsourced services while the specific components of service delivery routine may be executed both by the private contractor and the public agency. As a result, it may be difficult to establish a clear responsibility for the delivery of services. Furthermore, in cases when public services are provided exclusively by the government, final consumers have more options for redress procedures that include a wide set of

[5] OECD (2005), "Modernizing Government: The Way Forward."

non-judiciary instruments. However, if services are supplied by private contractors, the range of administrative measures to enforce adequate provision of services may notably shrink.

The accountability of public sector is a key component of the good public governance. Although, the governments of developed countries have designed effective procedures to ensure transparency and accountability of their operations, outsourcing of public services to the private sector does not guarantee that the same degree of accountability will be preserved. This conclusion comes from the inherent differences of the corporate and public governance mechanisms. The private sector tends to focus on the accountability of results, while the public sector devotes close attention to process-related values such as equality and ethics. Since outsourcing implies contracts with parties that have divergent economic interests, operate in a competitive environment and typically attempt to maximize their own profits, contracting out public services to private suppliers assumes that the provision of these services will be performed under the corporate ethics rules, which usually represent a narrower set of values than ethics rules applied by the government. Furthermore, in the environment of weak corporate governance, which is typical for the developing economies, it is unreasonable to assume that existing corporate practices can replace public service standards. Therefore, outsourcing contracts extend beyond conventional commercial contracts and usually require private suppliers to comply with certain public service standards. This compliance may be strengthened by requiring private parties to adhere to the formal code of ethics designed for the public servants. A specific procedure to incorporate public service values into the outsourcing contracts depends on the overall development of the good governance practices in the country and may range from the formal requirement to accept approved code of ethics to a more flexible agreement between the parties on the process-related issues of service delivery. For example, in Australia, some state agencies require private contractors to follow general ethical rules common for private and public sector, while other agencies may enforce stricter regulations that stipulate specific components of public service ethical code private parties are obliged to comply with.[6] Another important aspect of public services delivery by private contractors is their capacity to maintain confidentiality of records on service users. It is clear, that in cases when complex public services are outsourced, to deliver services efficiently a private contractor may acquire information to which the access of general public is restricted. However, such information may unfairly improve the competitive advantages of specific providers or even jeopardize national security. Although, confidentiality of customers is a central value of good corporate practices, outsourcing may open access to the wider set of information on service users which may be used for commercial purposes unrelated to service delivery. For this reason, it is important to establish accurate boundaries on the information that can be obtained by private contractors as well as on the ways of how this information can be used.

In addition, contracting out public services to private suppliers has an important implication for the transparency of service delivery. Unlike public agencies, private sector has a right not to disclose information if it represents commercial confidentiality. As a result, the capacity to monitor service delivery, for example, the control over fairness of established service tariffs, may be limited due to the large amount of undisclosed private information. Obviously, there is a trade-off between the necessity to increase competitiveness of the service delivery and

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[6] Mulgan, Richard (2005). "Outsourcing and public service values: the Australian experience." International Review of Administrative Science, Vol 71(1): pp. 55–70.

enforce the disclosure of commercial information, which may deteriorate the competitive advantages of private contractors. Therefore, the ability of the government to maintain adequate accountability of the private contractors is a very important policy issue, solutions to which vary with the degree of complexity and political sensitivity of the public services outsourced. Since a private contractor is more flexible in the means to achieve targeted outcomes, this flexibility is one of the sources of lower costs of service provision. Furthermore, the ability of the private sector to supply public services at lower costs is driven by its higher proclivity to bear commercial risks that cannot be acceptable for the public sector. Although, the private sector may be better equipped to diversify these risks, their impact on the stable delivery of public services should be adequately assessed, especially in cases when vital public services are outsourced. Therefore, public-private sector contracts should represent a good balance between the necessity to achieve economic benefits from the outsourcing and the attempt to establish adequate degree of accountability, transparency and reliability of service delivery.

Public-private partnership (PPP) is a widespread market-type public service delivery mechanism that improves public sector efficiency trough private financing of public infrastructure assets (construction of highways is a typical example) and the transfer of commercial risks to private parties. A typical PPP agreement relies on the long-term sharing of risk and returns and assumes private business's involvement into the financing, designing, constructing, owning or operating of public facilities or services. A distinguishing feature of PPP is its potential to redistribute various risks between the participating parties in the way that each party is best equipped to manage assigned risks.

There are many categories of commercial risks that are endemic for large scale infrastructure projects. The common consequence of these risks is the undeveloped capacity of undertaken infrastructure projects to deliver public services in the required amount and under established quality standards. For example, construction risks may result from the underestimated costs of the projects and delayed completion of the facilities. A poorly designed infrastructure project places a considerable burden on the government due to the requirement to inject additional public funds into the construction. Once construction is completed, the adequate delivery of services is at risk as well. The government may be required to make regular payments to its partners even if service delivery is not performed in the agreed amount or its quality does not correspond to the relevant regulations and rules. Finally, the government may bear the major portion of the risk of demand for services fluctuations that may result from business cycles and other exogenous factors. If government's payments to the private partners are not adjusted with the level of demand, considerable demand instability creates serious financial pressure on the public sector.

The involvement of private sector in PPP schemes allows managing these risks more effectively at all stages of the project, including designing, constructing, maintaining and operating the facility. Essentially, the capacity to transfer risks relies on the long-term financial benefits of the participating parties. If the involvement of the private partner is adequately structured, this partner will contribute to the long-term success of the project at every stage of its execution.

The financing of the project by the private partner is a key component of any PPP contract that creates a strong long-term commitment and efficient allocation of risks. As a result, a private partner has a direct stake in ensuring proper maintenance and operation of public facilities since poor performance will unavoidably result in financial losses. Although, the financing of public projects by private sector is a good mechanism to improve the efficiency of public infrastructure, the essence of PPP is enclosed in the pattern of risk distribution between the parties. The costs of capital for the private sector is usually higher than the same costs for the government and always include a premium for all risks built into the project financed by this capital. Thus, if too much risk is shifted to the private parties, the increase in efficiency of public projects might not compensate for the higher private costs of capital to finance these projects. It is central to PPP contracts to avoid transferring risks (for example, a risk of unstable regulations of infrastructure assets) that are not project-related and cannot be effectively hedged by the private sector. At the same time, the government should not bear most of the project's risks since retaining these risks with the government will undermine the principle source of efficiency gains from PPP.

Noteworthy, the benefits of properly designed and executed PPP projects frequently extend beyond straightforward budget costs savings on public infrastructure investments and include design and technical innovations, timely delivery and costs certainty, higher quality and sustainability of provision of public services.[7] The performance of PPP projects in terms of on time and on budget completion is considerably better than the performance of conventional government procurement schemes.

Prior to implementing a specific PPP project it is necessary to answer two principle questions: whether the involvement of the government is justified (public interest test) and whether the private sector can best add value to the project under consideration. The answer to the first question is in the realm of the overall functional review of the government. The answer to the second question depends on the capacity of the private sector to allocate sufficient technical and financial resources for the timely and prudent fulfillment of the projects. This capacity, in turn, is defined by the long-term strategic nature of any private-public partnership. Several issues have to be considered to determine whether such a relationship is feasible:

- The complexity and size of the public infrastructure project;
- Private sector's technical expertise to execute the project and implement required innovations;
- The costs of the project to the private sector and the government;
- The capacity of the government to manage PPP project;
- The potential of the private sector to increase the value of infrastructure assets;
- The impact of PPP on the quality of services delivered;
- Potential conflicts with other stakeholders that may limit the scope of involvement of the private sector;
- The capacity of the private party to manage and operate the facility in the long-term.

Having answered these questions, the government should follow a list of policy recommendations designed to generate most of the efficiency gains from private-public partnership contracts:

[7] Fitzgerald, Peter (2004). "Review of Partnerships Victoria Provided Infrastructure." Final Report to the Treasurer, Growth Solutions Group, Melbourne.

- Public vs. private provision of infrastructure facilities must be considered and the private sector should be allowed to manage infrastructure components where it best creates value;
- Due to economies of scale, the government should encourage PPP in the projects with a large investment potential to extract the maximum efficiency gains;
- Adequate assessment of risks of the projects must be undertaken and the proper assignment of risks between all stakeholders should be performed;
- The government should encourage PPP projects, which efficiency heavily relies on the design and technical innovations (for example, energy saving projects). One of the key benefits of PPP projects is better access by private sector to new technologies that can considerably boost productivity and efficiency of outmoded public infrastructure;
- The government must be equipped with necessary managerial skills and instruments to conduct effective PPP project management;
- It is crucial to ensure maximum transparency and publicity of PPP projects;
- Any PPP contract should represent a clear and structured system of distribution of risks and returns between all stakeholders;
- The impact of PPP on the provision, maintenance and sustainability of the economy-wide stock of public infrastructure must be accurately assessed.

Vouchers are another instrument to deliver public services in the market environment and assume that service provision is separated from its financing. The government issues vouchers to citizens who are able to exchange these vouchers for services choosing among the different suppliers. There are various types of vouchers that allow a voucher-holder either to exchange them for a specific range of services or to pay for a fraction of costs of the services consumed. In addition, the suppliers of services may include both private and public agencies or may consist of private providers only. The efficiency gain from this mechanism is yielded through the competitive provision of specific public services which leads to the better quality of service delivery.

One of the key priorities of the vouchers programs is to facilitate access to high quality public services by socially unprotected groups of population - food stamps program in the United States is a good example. For this reason, sectors, covered by such programs, typically supply basic public services, including housing, education and health care; while in order to participate in the voucher programs an individual should pass certain eligibility criteria (for example, various criteria based on income, age, health conditions, family size and composition). As a result, this mechanism allows specific groups of population to consume basic public services by purchasing them in the competitive market. The ability to organize competitive provision of such public services is a major determinant of quality improvement of service delivery. Since vouchers usually create a heavy financial burden on the governments' budgets, the introduction of these programs should be strongly justified by higher quality and more options of service delivery.

The call for more efficient management of public resources has pushed the governments to introduce many innovative approaches in public sector. The involvement of private sector in the public service delivery is one of the central advancements and aims to improve competitiveness of provision of services with a direct impact on quality and costs of services as well as on the social inclusion. In developing countries, the potential for cooperation between the private and public sector in service delivery is rapidly growing. However, the capacity to initiate and manage such cooperation heavily depends on the ability to establish good governance within the public sector. Governments trying to improve efficiency through private sector involvement in the provision of public services are required to undertake thorough functional reviews of their operations, reform civil service and drastically rethink the philosophy of their relationships with the private sector. Apparently, within the weak public governance environment the decision to allow intensive participation of private sector in service delivery may seriously aggravate problems that arise when public is served by the private contractors. In particular, the accountability and transparency of service delivery as well as access to services by population may considerably suffer. Furthermore, potential efficiency gains might not be captured since in many developing countries the legal institutions to enforce market competition are especially weak. Due to limited budget resources and insufficient number local suppliers, sub-national governments may face even tighter restrictions on their efforts to engage private partners into the provision of public services. As a result, inappropriate design of public-private partnership mechanisms may result in mere replacement of public monopolies of service delivery with private monopolies. Therefore, private sector involvement in service delivery should logically fit into the overall concept of public administration reform and should be based on accurate assessment of the efficiency gains from the transfer of functions from public to private sector.