Public–Private Partnerships

THE USE OF CONTRACT BY GOVERNMENT AND ITS AGENTS

Martin Ricketts

Given that the provision of a service is being controlled by the state, the decision whether to contract out that service provision to the private sector is essentially a business decision. A number of economic advantages and disadvantages need to be offset against each other. Governments are poorly placed to make such decisions and it is no surprise that PPPs are often inefficient and steered by political objectives.

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Introduction

The question of what activities to undertake internally and what activities to contract out to others is at the heart of the study of economic organisation. At the microeconomic end of the spectrum the question relates simply to individual choice over what to do oneself and what to purchase in the market. At a more collective level it relates to the strategic choice of the 'scope of the firm' – should it be vertically integrated or should it concentrate on a particular part of the supply chain and rely on other firms to supply it with inputs and purchase its output; should it serve many different markets or should it specialise in one or a few closely related ones? At the widest political level it relates to the question of what the government should produce through its own (public sector) organisation and what it should purchase from outside (private sector) suppliers.

Economists are specialists in the study of trade and the gains to trade. The 'everyday business of life' (as Alfred Marshall expressed it) involves engaging 'the co-operation and assistance of great multitudes' (as Adam Smith expressed it) and the impossibility of achieving this wide co-ordination of effort through central direction and administration has always been an important underlying theme of liberal post-Enlightenment political economy. Intellectual fashions have varied over time, of course, and confidence in the ability of government agencies to direct economic activity grew during the first part of the twentieth century – just as confidence in the technological efficiency of 'big business' was widely expressed and predictions of ever expanding corporate structures were commonplace. The nationalisation of the 'commanding heights' of the economy was supported (or reluctantly accepted) by a generation of economists after World War II, and the general expansion of government supply in the fields of health and education continued throughout the century.

The reasons for this somewhat uncritical attitude to government ownership and production in the middle of the twentieth century are debatable. Revulsion at the apparent failure of markets during the depression years no doubt played a part, as did a false, though difficult to resist, notion that the power of state organisation to mobilise millions of people for war might easily be transferred to the benign purposes of peaceful development. A tendency to see the technological developments of the time as favourable to huge enterprises and almost unlimited 'economies of scale' was also important, as was the view (associated with Schumpeter, 1943) that technological progress was becoming an automatic by-product of large-scale enterprise.

Nevertheless, there always remained a group of economists who regarded the economy as a continually evolving pattern of exchange relations where the main problems were the discovery and use of information, rather than as a giant factory for producing every type of output where the main

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constraints were purely technological. There is a sense in which the study of exchange and the mutual gains to trade imparts a 'natural' bias in favour of contract, and it is therefore not surprising that over the years 'market-orientated' economists have preferred public policy to be effected by means of contract than by the exercise of authority and widespread state ownership. Much of Smith's attack on the mercantilist system of the eighteenth century with its hostility to all forms of monopoly power can be interpreted in this light. In the mid nineteenth century the limitations of government organisation and the potential for gains through contracting out were well appreciated by J. S. Mill (1898, p. 581): 'The state', he notes, 'may be the proprietor of canals or railways without itself working them; and . . . they will almost always be better worked by means of a company, renting the railway or canal for a limited period from the state'. Marshall (1907) is quoted approvingly by Shleifer (1998): 'every new extension of Governmental work in branches of production which need ceaseless creation and initiative is to be regarded as prima facie anti-social because it retards the growth of that knowledge and those ideas which are incomparably the most important form of collective wealth'. Shleifer (1998, p. 135) himself argues forcefully against public ownership of assets and in favour of contract: 'When the opportunities for government contracting are exploited, the benefits of outright state ownership become elusive, even when social goals are taken into account'.

As dissatisfaction with the performance of state enterprises grew in the later part of the twentieth century a wave of privatisation occurred across the world.[1] Although this has been widely interpreted as a 'retreat of the state' it is not clear that the general size of government – in terms of its expenditure or its regulatory intervention – has declined. It is more accurate to characterise the change as a widespread recognition in political circles that state ownership was no longer advantageous. The existence of 'state-owned' assets conferred power on many interest groups – most notably the trade unions in the West and the bureaucratic 'nomenklatura' in the East – that was ultimately subverted by the rise of competing interests. The purposes of the state, it began to be recognised, could be achieved without state ownership of assets by the restructuring of industries, the use of contract and the introduction of a more extensive regulatory system.[2]

By the first decade of the twenty-first century the results of this worldwide trend away from state ownership towards state contracting and state regulation have been met with disappointment in many quarters. On the one side those who hoped for a more competitive free-market system as a result of large-scale privatisation have been dismayed by the extent to which government regulation has grown. While conversely, those on the other side who hoped for a more effective achievement of government objectives by means of contract with the new 'private sector' suppliers have been forced to confront the limitations of the contracting process. Neither side should really have been surprised. The public choice pressures leading to government regulation may mutate and evolve but they do not go away, while the problems of government contracting have been recognised for centuries. Samuel Pepys, Clerk of the Acts to the Navy Board during the reign of Charles II, observed dryly that, 'The King cannot have things done as cheap as other men'.

The location of ownership rights

The reason why 'ownership' rights are not generally thought to be efficiently allocated to state agencies is that they are best held by the parties that would otherwise face the highest cost of transacting (Hansmann, 1996). Owners hold 'residual control rights'. Rights in an asset that have not specifically been contracted to others are 'residual' rights and remain with the owner – just as a landlord continues to 'own' a house or piece of land and retains all those rights not assigned to his or her tenant in a lease. Clearly, in a world of perfect certainty and full information, organisational issues fall away and it does not matter who holds rights of 'ownership'. Whether, for example, a person 'lends' money to a 'homeowner' and then receives a flow of 'interest' or alternatively assigns use rights in a property to a tenant and receives a flow of 'rent' is, in a world of full information and certainty, of no consequence. The cost of transacting is very low and there is no action or contingency that cannot be covered contractually. Where information is imperfect, however, where it has to be discovered and where it is asymmetrically distributed between contractors – it begins to matter where property rights are located.

If, for example, the state holds ownership rights in physical assets, the people who actually use the assets have little incentive to think of ways of using them more cost effectively or to introduce innovations. They also are less likely to make complementary investments in specific skills and human capital if they lack control over the associated physical assets (Hart and Moore, 1990). The owner of a resource does not have to negotiate with another party to take advantage of a good idea, whereas an innovator without residual control rights will have to persuade the owner to agree to his or her novel plan of action. In the process there will be a danger that much of the benefit of the innovation will be lost or will leak away to the owner as contractual terms are revised. This reasoning suggests, for example, that owner-farmers are likely to be more cost efficient and innovative than tenant farmers. It also suggests that a government wishing to secure access to supplies of grain should not own a great deal of farmland and directly employ people to work it, but should instead contract with owner-farmers in the grain market to supply the food.

If the state is not a very efficient 'owner' of assets, Pepys's comment reminds us that, relative to the private sector, it might not be a very efficient contractor either. This observation needs to be interpreted with some caution however. On the one hand, substantial contractual problems attached to locating economic activity in the public relative to the private sector will tend to argue in favour of limiting the size of government activity. In essence, whatever the hoped-for benefits of additional state activity, they will be rendered unachievable or more costly by the contractual difficulties encountered. On the other hand, in some areas the only alternative to government action may be no action. Traditionally these areas have included the provision of public goods (the 'classical' function of the state) and the regulation of 'natural monopoly'. State action is required because the transactions costs of securing private agreement are high or even completely prohibitive.[3] To paraphrase Churchill's defence of democracy, the provision of public goods through the activities of state agencies seems a very inefficient mechanism until it is realised that it is better

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than all the available alternatives. The question then reverts to the opening organisational one of whether the production of public goods should be contracted out or undertaken 'in-house', i.e. within the state bureaucracy. As we have seen, writers such as Shleifer argue that contract will in most cases be preferred. However, recent experience suggests that this view requires elaboration even if the general presumption in favour of contract survives.

The cost of transacting

The classical liberal preference for a 'transacting' state rather than a 'producing' state (briefly sketched above) runs across the grain of another, more recent, but very important economic proposition – 'it would seem to be that there is a cost of using the price mechanism' (Coase, 1937). When Coase made this observation he began a revolution in our understanding of economic organisation. His aim was to cast light on the question of why some transactions were carried out within firms and others were carried out by the use of contract with outsiders, i.e. by 'the use of the price mechanism'. In other words, his aim was to produce an adequate theoretical explanation of the structure of firms – for example, to explain why some were vertically integrated and others not – a task that was impossible without some recognition that transacting is costly. Indeed in the absence of transactions costs there seemed to be no reason why firms should exist at all.

Coase's now celebrated insight led naturally to the idea that transactions were assigned 'within' an organisation when this was less costly than the use of outside suppliers (including the costs of the actual process of transacting with them). The 'boundary' of the firm was to be found where the cost of locating activities within an organisation was equal to that of locating them outside. From the perspective of this paper the importance of Coase's conceptual framework is evident. A general presumption in favour of contract for government activities implies that the costs of transacting can usually be expected to be lower than the costs of 'internal' state administration. Shleifer advances several plausible arguments in defence of this proposition but he does not actually investigate the contractual difficulties that the state faces (even when assumed to be benevolent) or indeed the distortions to the transacting process that might be anticipated (when more realistic assumptions are made about the motivations of its actors). In the end, comparative institutional analysis requires us to investigate realistic predictions of outcomes under a 'contractual' regime compared with an alternative state 'production-orientated' regime.

It should be recognised that these regimes are not as distinct (even in theory) as the above language seems to imply. There is an important sense (already mentioned in the introduction to this paper) in which *all* economic activity is ultimately about 'contract' and 'exchange' rather than 'technology' and 'production'. The firm itself is for Coase merely a set of contracts between co-operating inputs. The distinction between contracting *within* the firm and contracting with agents *outside* the firm therefore concerns the nature of these contractual bonds. Firm-like contracts are durable, 'relational', relatively loosely specified and will usually imply somewhat 'lower-powered' incentives than more 'arm's-length' and 'market-like' contracts. In Coase's original conception, labour within the firm, for example, agreed in a contract of employment simply to carry out lawful instructions and to be monitored in exchange for a wage or time rate. 'Outside' contractors and suppliers would be those who contracted period by period and who were not 'managed' or 'monitored' but received an agreed payment when specific contractual commitments had been satisfactorily achieved. Outside suppliers would therefore bear more risk and generally face 'higher-powered' incentives. Bargaining costs would tend to be higher and the importance of specifying clearly in the contract the specific measures of performance required of suppliers would be of central concern.

The same issues arise when we are considering contractual arrangements in the case of state agencies. The great difference is that, whereas Coase concludes that the firm must (up to some point) be transactionally efficient because it avoids the costs of outside transacting, Shleifer concludes that state agencies are generally transactionally inefficient because they overlook the potential advantages of outside contracting. There are some good reasons for these different conclusions. Coase looked at the structure of business as it existed in the mid-1930s and tried to explain this structure as the outcome of competitive adaptation. Firms, in their pursuit of survival and profit, adopted the contractual arrangements that were transactionally most efficient. Shleifer looked at the structure of state activity as it existed in the 1990s and saw it, not as the outcome of efficient adaptation to competitive forces, but as the inefficient expression of state monopoly power and public choice pressure.

In the late 1970s and 1980s the evidence of organisational inefficiency in the state sector in the UK and elsewhere was substantial. This suggests that the move towards a much greater use of contract was well founded. Nevertheless, the business of contracting is business – not engineering or simple administration. Good strategic judgment as well as sound detailed knowledge of local and particular circumstances will determine the ideal contractual arrangements to adopt. Asking state agencies to use contracts is to ask state officials to engage in business and to take on the skills and attributes of entrepreneurs and business managers. Government officials, however, do not face the same competitive pressures as business decision-makers, their own incentive structures are different, and 'politicisation' of the contracting process is likely.

Circumstances favourable to state contracting

Moving from state ownership to contracting with private sector suppliers will clearly be most advantageous where the costs of contracting turn out to be relatively low and the dangers of political interference are small. Where, for example, contract terms are easy to specify; information about contract performance is cheaply and reliably ascertained; the contractual environment is not very risky – so that the outcome is closely related to the contractor's actual effort and skill; where the contract does not involve assessments of conditions stretching into the distant future; and where performance does not involve the commitment of large amounts of highly specific

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capital (either physical or human) on the part of the supplier, the use of a competitive tender to assign a public sector contract would seem to be recommended. Why put up with the 'low-powered incentives' generally accompanying state provision when a fairly simple contract with a private supplier can be drawn up and enforced at low cost?

In the circumstances listed above, a competitive tender might be expected to produce good results because the hazards of contracting have been assumed to be negligible. Competing firms would all understand what was expected. The small amounts of general capital required would mean that large numbers of firms could enter the competition. Compliance would be easy to assess and unlikely to lead to complex and costly legal wrangles. Risk would be small and its distribution between the parties therefore not a problem. No party would feel unduly 'dependent' on the other and vulnerable to 'strategic' behaviour – promising more than could be delivered or reneging on contract terms after the event in the hope of renegotiating a more favourable deal. Frequent auctions would keep firms from becoming complacent, and incumbents would not be greatly advantaged at contract renewal because of the simplicity of the task and the lack of 'first-mover advantages'. Political interference would be discouraged because the contracting process could be so 'rule governed' and open. Protracted and confidential negotiations would be quite unnecessary, and an agency at 'arm's length' from the government would be well able to run the contracting process to meet standards laid down openly by the responsible politicians.

Of course, it is not just government contracting but contract in general that is favoured when costs of transacting are low. It makes sense for any organisation to contract out activities in such conditions. As Williamson (1985) might express it, the contractual situation described would not require the adoption of a sophisticated 'governance structure'. At least some proportion of government expenditure is no doubt of this type and is therefore not contentious. No one is surprised that the state contracts out its office supplies or the decoration and basic maintenance of its buildings. Many areas of state activity, however, involve contracting in circumstances far removed from this 'ideal' scenario. In particular, very long periods of time, very large amounts of very specific and durable capital, and very uncertain and changing conditions make provision of '*ex-post*' governance of a continuing contractual relationship extremely important. It is obvious that the contractors must anticipate that a process of contract revision as information accumulates and events unfold will be required. Here the usual 'popular' distinctions – between 'plan' and 'market'; 'internal administration' and 'outside contract'; use of 'the firm' or use of the 'price system' – begin to break down. The question is not so much about whether or not 'contract' should be used but rather what the nature of the contractual relationship should be between the various interested parties.

The London Underground Public–Private Partnership (PPP)

These difficult issues of long-term governance are well illustrated by the fate of the London Underground PPP. As originally conceived the upgrade of London's underground system would be achieved by agreeing a long-term (15-year) investment programme to be undertaken by private sector 'infrastructure companies'. The investment programme amounted to £9,700 million in the first 7.5 years and was estimated at a present value of £15,700 million[4] over the 30-year time horizon envisaged for the contracts. London Underground Limited (a state-owned company) reporting to an agency (Transport for London), a conduit for public money from the Department of Transport, invited private sector companies to bid to upgrade and maintain track, tunnels, signals, lifts, escalators and so forth. They would be rewarded by being paid an 'Infrastructure Service Charge' (ISC), a charge that was in turn related to achieving satisfactory levels of performance. 'Periodic reviews' of service contracts were to occur every 7.5 years mediated by a PPP 'Arbiter'. This enabled the scope of the PPP to be re-assessed and permitted 're-pricing' of the deals to take place. In order to encourage competing bids for the work London Underground agreed to reimburse bidders' costs. In total the 'transactions costs' incurred by both private and public sectors were £455 million.[5]

The PPP came into operation in 2003 with two infrastructure companies – Tube Lines and Metronet. After that date further investment requirements were identified and the original 15-year programme was extended to 22 years. In July 2007, however, the whole structure of the PPP was changed when Metronet was taken into administration. Running out of cash to undertake its commitments, Metronet requested an increase in payments totalling £992 million for the first 7.5 years of the contract. The Arbiter agreed to some increase in 'stage payments' but also 'reached the view that if Metronet had delivered in an efficient and economic way, its costs would have been lower than the baseline in the first four years of the contract'.[6] The administrator failed to secure a replacement private sector contractor to take over and deliver on Metronet's responsibilities, and these were subsequently returned to the public sector in the form of Transport for London. The PPP continues but the 'private' partner now comprises Tube Lines alone.

This case illustrates how severe the transactions costs underlying the outsourcing of government contracts can be and throws into relief some basic organisational issues. As can be seen from the quotation from J. S. Mill, the traditional assumption about organisational structure in the context of 'natural monopoly' is that the government would 'own' or regulate the network asset (the canal) and lease it to the private sector operators who would 'work' it. This is the 'concessions contract' approach to infrastructure.[7] It is a mechanism associated with the names of Edwin Chadwick (1859) and Harold Demsetz (1968) with competing network operators tendering prices at which they are prepared to work the system. The London Underground PPP reversed this arrangement. The train operator continued as a monopoly public sector organisation employing 13,500 drivers and other staff while the infrastructure was leased from 'private sector' investors. It is far from clear that this structure was based on considerations of transactional efficiency. The model used for the railways at the time of privatisation was nearer to Mill's conception with a regulated (later non-profit) provider of track infrastructure contracting at intervals with private sector train

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operating companies. The justifications for the London Underground PPP revolved around providing 'stable' funding for infrastructure improvements, the shifting of risk to the private sector, and the provision of incentives for timely delivery of upgrades.

Each of these objectives has a political as much as a transactional dimension. By contracting to pay 'infrastructure service charges' to private suppliers the government could be seen as 'tying its hands' and committing to a long-term programme that might otherwise be pushed off course by changing political pressures as annual budgets were formulated. The problem of enabling governments to give credible commitments when they transact with the private sector is an important one. But this potential gain in the case of the PPP was offset by the substantial problems of long-term transacting discussed above.[8] The government was, in addition, signalling its commitment to other important macroeconomic rules such as limiting the amount of annual public sector borrowing and the stock of outstanding debt relative to national income. By classifying borrowing for infrastructure upgrades as 'private' sector debt it could be kept off the government's balance sheet. There was, in other words, another political force leading to the chosen structure for the PPP that was not related to the transactional efficiency of the arrangements alone. The recent decision of the ONS to re-classify Metronet debt as a liability of the 'public sector'[9] marks a clear change and an implicit recognition that the PPP did not transfer the risk to the contractors and away from taxpayers as fully as had originally been envisaged.

As for the timely delivery of upgrades, the use of private sector contractors that were subject to the monitoring of shareholders and bondholders and faced the constraint of bankruptcy would be expected to imply very high-powered incentives in the case of a fixed-price contract. But, as has been argued above, the complexity and long time horizon of the PPP and the provisions for renegotiation as time advanced inevitably undermined the 'high-powered' nature of the incentives. The contractual link was supposed to be co-operative and 'relational' rather than 'arm's length' – and for good reasons. High-powered incentives are only possible where the desired outcomes can be clearly specified and verified. They can even be counter-productive where important dimensions of output are non-contractible. Thus the difference between 'relational' arrangements with 'private' contractors and the delivery of infrastructure improvements 'internally' by a state agency is less pronounced than it at first appears. Differences still exist however. Where bankruptcy is not possible and where the taxpayer underwrites losses, the power of trades unions is greatly strengthened, and the desire to contract with outside infrastructure companies was partially designed to sidestep these management problems of internal provision. It is revealing, however, that no attempt was made to contract with private sector suppliers of underground train services. This would have involved a head-on clash with a powerful union.

Conclusion

The age of large-scale state ownership has, for now, slipped into the past. An age of large-scale state contracting has replaced it. As a result, politicians and state officials are required to exercise business judgment about the governance of these contractual relations. They do so, not usually in a position of competition with other suppliers but still as monopoly providers of services to the public and dispensing considerable amounts of tax-financed support. Boycko *et al*. (1996) argue that depoliticisation is a major (perhaps *the* major) advantage attached to privatisation. This is based on the supposed higher costs of exercising political influence when it cannot be so easily hidden within the operation of state enterprises and when tax-financed support to special interests has to be more open. This paper has drawn attention to the possibility that the governance of complex contractual relations is also capable of obscuring the exercise of political and other special interests, and is unlikely to reflect purely commercial considerations. The nature of the inefficiencies induced through state action mutate as organisational structures change.

1. See Parker and Saal (2003).
2. For a review see Kessides (2005).
3. It is not true that all categories of 'public good' or all kinds of public utility will remain unsupplied without state action. Local public goods (such as street lighting, for example) might plausibly be provided by private action and monopoly exploitation by private utility companies has historically been partially addressed by the formation of user co-operatives. Such spontaneous 'solutions' require suitable environments to make the costs of agreement non-prohibitive – in particular geographically concentrated non-mobile user groups with non-trivial and fairly homogeneous interests. It is also worth remembering that technical progress and legal–institutional developments can sometimes make it possible to achieve such solutions to public goods problems (see for example Ostrom, 2008).
4. Evaluated using a discount rate of 6%.
5. NAO Report (2004, p. 5).
6. Office of the PPP Arbiter, Press Notice 03/07, 16 July 2007.
7. See, for example, Kessides (2005, pp. 104–108).
8. Similar problems have occurred across the world. Kessides (2005, p. 107) reports 'mixed results' of concessions contracts. 'There have been serious doubts about their efficacy, acrimonious disputes over contract compliance, numerous bankruptcy claims by concessionaires . . . Excluding telecommunications, more than 40 per cent of concessions have been renegotiated – and 60 per cent of those were renegotiated within their first 3 years, despite contract periods of 15–20 years.'
9. See Kellaway and Shanks (2007).

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