Privatisation and Public–Private Partnerships

Unit 1 Defining Public–Private Relationships

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Unit Overview

As noted in the Module Introduction, the focus of this module is on the relationship between the public and the private sectors of the economy, and in this introductory unit you will be exposed to a broad overview of the different forms with which the two sectors can interact for the provision of goods and services to the state's citizens. Throughout this unit the term 'good' takes a broad connotation, including infrastructures such as highways, bridges *etc*.

However, for a better understanding of such public–private forms of relationships it is important to ask the following preliminary questions.

- What are the role and the duties of a state, which goods and services should be guaranteed to the population when employing financial resources raised through taxation?
- Moreover, which provisions should be made directly by the state, or instead outsourced to the private sector operating on its behalf?

Learning outcomes

After studying this unit you will be able to:

- outline how state functions have evolved over time
- discuss how the public sector typically relates to the private sector for the provision of public goods
- explain and assess the main features of alternative public–private relationships.

Reading for Unit 1

Vito Tanzi (1997) *The Changing Role of the State in the Economy: A Historical Perspective*. International Monetary Fund Working Paper No 114.

Nicola Dimitri, Gustavo Piga & Giancarlo Spagnolo (2006) 'Introduction'. In: *Handbook of Procurement*. Cambridge UK: Cambridge University Press.

1.1 Introduction

Unlike private goods, public goods can be beneficial to several people at the same time: they are defined as *non-excludable* and *non-rivalrous* – that is, goods that cannot be excluded from any citizen's use, and where any individual's consumption cannot prevent other people from consuming them too. These goods include such things as clean air, street lights, drinkable water and many others. It is important to point out, however, that what represents a public good depends very much on the culture of the state, and rights for a citizen in one country may not be considered as such in a different nation. In any case, whatever the rights, the state should take care of their provision through the available financial and human resources and, if needed, a legitimate use of violence.

In the rest of this unit you will be introduced to the different ways in which the public sector can relate to the private sphere for the provision of public goods. We structured this presentation to range from the *mildest* type of relationship – the public procurement of goods and services from the business sector to perform in-house its core activities delivering public goods directly – up to the *extreme* type where the state completely divests its ownership of some public assets and sells them to private entities.

In between these two extreme types of relationship, we shall consider two main intermediate forms: concessions and public–private partnerships (PPP). These are intermediate in the sense that, most often, ownership of the underlying public assets upon which provision of goods and services is based is not indefinitely, and/or completely, transferred to private entities. You will see that typically, in concessions, the state authorises a private partner to operate an infrastructure which, however, remains publicly owned; while in PPP, the private sector may supply financial resources to build and operate an infrastructure that, at the end of the contract, would be transferred, returned, to the state. Except for public procurement, in the other three forms of public–private relations the provision of public goods is outsourced to the private sector.

However, when provision is outsourced there is a delicate balance to strike between the goal of the public sector and that of the private sector. Indeed, while the state would care about social welfare the private sector, being business oriented, would be more interested in making a profit. For this reason, goals are rarely aligned, since pursuance of profit margins may often be at the expense of end-users and of their welfare. You must always keep in mind the possibility of such misalignment in order to understand, and possibly foresee, the outcomes of public–private relationships.

Prior to introducing the different forms of relations, the next section will give you a short overview of the state presence and functions and how they have changed with time.

1.2 The Role of the State

This section aims to give you an historical perspective on how the state has interpreted and changed its role in time. This will help you to better frame the following sections and assess the different forms of public–private relations critically – in particular, whether the chosen form of relation is the right one for the provision of a specific public good. The presentation of this section is largely based on the paper by Tanzi (1997), which will be set as your first reading below.

As suggested above, there are two possible perspectives on the role of the state: what the state *should* do (normative) and what it actually *does* (positive). Both perspectives are country- and culture-specific, although most western countries, where democratic and economic, capitalist, orientations go hand in hand, share similarities. For these societies a fundamental organisational principle is based on the idea of individual, human, rights and that the universal vote is the best means for selecting governments and rule. In some other countries voting is not an important means of choosing a government, and rule may be determined by alternative mechanisms.

Differences between what a state should do and what it effectively does may be due to a variety of reasons – including corruption, a lack of appropriate skills by public officers and a shortage of resources. In such cases, economic policy may be ineffective and its results different from what was expected. More-over, decisions taken by previous governments may superimpose and interfere with the policies undertaken by the current government, which could then turn out to be less effective than it was hoped they would be. This, as Tanzi notes, has led some economists to observe that authoritarian governments, by their very nature, somewhat paradoxically can have more degrees of freedom in pursuing the results expected by their policies, because they are less connected than democratic governments with decisions taken before their rule.

In developing countries, the state would be expected to play a fundamental role in fostering growth, but frequently because the private sector has not yet taken off, this would require a particularly efficient public sector for successful implementation of the policies. Unfortunately, however, it seldom proves capable of doing so.

1.2.1 The changing boundary between the public and private sectors

State activity increased from the early 1900s, partly as a result of world wars but also because of the advent of socialist societies and their underlying equalitarian principles, the great economic depression and other market failures, such as market externalities. Externalities include costs or benefits not directly planned for, and thus can be good or bad for individuals. Notable examples of undesirable externalities are traffic congestion, waste, smoke, pollution in general and noise, while positive externalities could include the general health benefits arising from childhood vaccination or increased market values in a neighbourhood because of individual house or garden improvements. In the case of negative externalities, the state may attempt to lessen them by, for instance, imposing a tax on waste or traffic congestion – that is, by charging a price to discourage or limit an activity that results in damaging other parties.

In the 1950s and 1960s a view prevailed that the state was in a better position than the market to address national industrial policy and, in general, to select which goods were considered essential to be provided for the country. The underlying assumption was that the internal working of the various state components and officers was fully consistent with commonly set goals. This did not take into account the possibility that rent seeking, lobbying activities and corruption within the public sector were an issue, a perspective which meaningfully changed around the 1980s.

Even without resorting to corruption or lack of skills, economists recognised that since public officers and employees might have individual goals different from publicly set goals, the appropriate delivery of public functions could be hindered. Ideas informing this view arose from the emerging concepts of asymmetric information and incentives, which argued that opportunistic behaviour within public institutions could be a main component of the inefficient delivery of public goods. As a consequence, public institutions and bureaucracies were no longer conceived as monolithic bodies, and the importance of understanding their internal working and motivations was stressed. Hence, as was already common in the private sector, it was increasingly understood that appropriately designed incentives and contracts should also be provided to public officers to enable them to perform efficiently (Salanié, 2005).

Indeed, alleged inefficiencies of the public sector partially explain the arguments stressing the eminence of the market as a more suitable institution than the state for efficient resource allocation. As a consequence, the role of the state gradually became more and more focused on supporting the market, rather than competing with the market. Thus, since the early 1980s, most governments had begun to divest ownership of public enterprises to the private sector, as well as outsourcing to businesses a variety of activities which until then had been performed directly by the state.

This applies mainly to the privatisation of natural monopolies, such as utilities and transportation industries. Because of the importance of these to the populace, it has been necessary to set up regulatory bodies – independent institutions – to ensure that private firms now running former state industries do not obtain excess advantage from their position at the expense of end users by charging exceedingly high prices and/or delivering low quality products (Laffont & Tirole, 1993).

This trend towards outsourcing public activities has continued until recently and it is occurring under a variety of forms, as you will see in studying this module.

Tanzi (1997) *The Changing Role of the State in the Economy: A Historical Perspective.*

Reading 1.1

Please study the Tanzi paper on the changing economic role of the state. This provides you with an overview on how the presence and the role of the state evolved over time.

After reading Tanzi's paper, write a few paragraphs summarising its content, and express your views on the role of the state in an economy.

Optional Reading 1.1

For a more comprehensive treatment of public policy and its relation to the market, you might consult the textbook by Hillman (2009),

Hillman AL (2009) *Public Finance and Public Policy*. 2nd Edition. Cambridge UK, Cambridge University Press.

However, this is an optional reading, only if you have time and interest.

1.3 Public Procurement

As noted in the Introduction, most of the functions and activities performed by the state for direct provision of public goods – such as security, health care, rule of law and administration – require procurement of goods, services and works from suppliers, most often business companies operating in the market. For this reason, public procurement could be considered as the *mildest* type of the public–private relationship, where the relevant public goods are provided directly by the state and business companies supply components of what is needed to do so.

Since despite the recent trend towards outsourcing the provision of public goods to the private sector, public procurement remains a meaningful share of countries' GDP (in the EU about 18%), it is clearly important that such a large volume of transactions should be performed effectively, delivering *best value for money*. Because of its importance, procurement is a highly regulated activity by states, and in Unit 2 of this module it will be discussed from an institutional point of view. More specifically, you will see that besides state regulations there may be other, supranational, organisations, such as the World Bank and other continental development banks, imposing their own procurement rules on borrowers when the loans are employed to purchase goods, services and infrastructures. These rules are meant to make sure that money is spent effectively and not wasted, either because of corruption or low skills and competence by the officials. Therefore, as you will see in more detail in Unit 3, public procurement takes place within superimposing legal frameworks, whose main underlying principles need to be harmonised for consistency to be achieved.

Dimitri *et al* (2006) 'Introduction' in *Handbook of Procurement*. pp. 3–13.

Reading 1.2

Now study the 'Introduction' of the textbook by Dimitri and colleagues. This will provide you with a broad view of the main themes to consider for effective procurement design.

When you have finished this reading, write a few paragraphs summarising the main issues for delivering effective procurement design.

1.4 Concessions

Proceeding further, with the business sector becoming more involved in public–private relationships, we briefly discuss here concession contracts, which you will study further in Unit 4. As the literature can be somewhat ambiguous and confusing on this kind of public–private relationship, we will consider concession contracts that are based mainly on an already existing public asset which the state allows a private partner to rent and operate, thus running a business to provide a public good on behalf of the public sector.

The distinguishing feature of this definition is that the asset – such as a highway, a bridge, a utility – would have been already available as a state-run asset, with no need to create it before the private partner can start operating it. Concessions to operate have a time length after which the asset is returned to the state, which could then decide whether to outsource its operation again, manage it in-house, sell the asset or keep it idle. Ambiguities in the literature may arise when concessions are referred to as situations where the private partner also needs to finance, build, and perhaps even design, the underlying asset. Consistent with much of the existing literature, we would refer to such situations as Public–Private Partnerships, PPP.

Concessions would be used to ensure provision of goods and services that otherwise might be judged as too expensive for the public sector, or no longer considered as part of its main core activities. These will often require a supervisory, regulatory, state role, to prevent possible rent-seeking activities on the end users by the private partner. For example, highway tolls charged by a private operator would need to satisfy an upper limit imposed by the relevant public authority.

1.5 Public–Private Partnerships

As we mentioned in the previous section, steps towards an even higher involvement of the private sector in the provision of public goods cover a wide range of initiatives that fall under the heading of Public–Private Partnerships (PPPs). These can exhibit different features, but they share some common traits (Engel *et al*, 2014).

Indeed, they often cover the construction and operation of infrastructural projects that the public sector does not have the resources to build. Funds would typically be provided by the private partners who, in turn, would expect to recoup their investments either by operating the asset or by receiving back from the public sector the amount invested, typically in instalments spread over time.

The main justification for PPP initiatives is that public goods can be provided when state finances are tight, as well as when the private sector is claimed to be more efficient in doing so. A further trait common across alternative PPPs is that they can bundle the different phases needed to implement the initiative into the hands of a single private provider, which does not need to be a single firm but could be a consortium of companies. Therefore, the D(esign) B(uild) F(inance) O(perate) is a diffused model, where the private partner is in charge of four phases, including financial sponsorship. As you will see in the module, other PPP models could include fewer, more, or different phases than DBFO. However, despite possible differences, a further common feature of such bundled projects is the shift of operational risk from the public to the private sector. Evidence from practice suggests that there are successful stories as well as less successful ones, and in Units 5 and 6 you'll be exposed to the advantages and limitations of PPP.

1.6 Privatisation

The strongest form of private sector involvement in the provision of public goods is when the state completely divests ownership of public assets to private buyers, such as when public utilities and other state-owned enterprises are sold outright. This has happened massively in Eastern Europe, in nations that have changed from socialist, centrally planned, economies to market, decentralised, capitalist economies. But it also happens in many OECD and non-OECD countries, where states have decided to take a step back and exit partly, or completely, from entrepreneurial activity. So, in our discussion of privatisation, we shall cover the sale of public assets, not only operated but also owned by private subjects. When this occurs, and unlike previous modalities of public–private relationships, it is natural to ask whether the relevant goods and services provided after the sale should still be considered of public relevance, since exit from government control or radically reduced ownership could be interpreted as a change in policy and priorities by the state.

A case in point is the utility industries, such as energy, telephone communication, transportation, which have been extensively privatised in many countries. However, a main reason for doing so has often resulted from tightness of public finances rather than a change of perspective by the state on whether those goods and services should still be guaranteed to the whole population on affordable conditions. A main reason why public ownership of such important industries has been divested is because control of utilities can be very attractive for the private sector, and its business sufficiently lucrative.

Privatisation will be discussed in detail in the final two units of the module, Units 7 and 8.

1.7 Conclusion

The role of the state is under ever-increasing scrutiny, as a result of rapidly-changing global contexts and pressures. As a consequence, greater consideration is being given to the means to improve the efficiency and effectiveness of public procurement, together with the potential for the adoption of concessions, public–private partnerships, and privatisation, as alternative strategies to the direct delivery of key activities and services.

In the rest of the module, we will consider these important issues in more detail. To end this introductory unit, though, it is useful to reflect upon any such recent changes in your own country.

Exercise 1.1

Consider and make brief notes on the following:

- In what ways has the role of the state been questioned in your own country?
- What contextual conditions or changes have led to this questioning?
- In general terms, have there been any resulting moves towards the adoption of concessions and/or public–private partnerships, or the privatisation of state assets / activities?
- In which sectors have these changes occurred? In such sectors, have there been improvements in price and quality?

Finally, to summarise, in this unit you have considered:

- the role of the state and the notion of public goods/services
- how the role of the state has changed / is changing, and the potential blurring of distinctions and boundaries between the public and the private sectors
- the significant role of the private sector in servicing public procurement
- how the private sector can become more directly involved in public service provision, through the adoption of concessions, public–private partnerships, and privatisation (as forms of increasing levels of private sector involvement).

References

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Hillman AL (2009) *Public Finance and Public Policy*. 2nd Edition. Cambridge UK, Cambridge University Press.

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Salanié B (2005) *The Economics of Contracts: A Primer*. 2nd Edition. Cambridge MA, MIT Press.

Tanzi V (1997) *The Changing Role of the State in the Economy: A Historical Perspective.* Washington DC, International Monetary Fund. Working Paper No 97/114.