

PRIVATE DELIVERY OF PUBLIC SERVICES

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Contents

3	Summary
5	1. Introduction
6	2. Some definitions and taxonomy
8	3. A brief history
10	4. Some conceptual points
14	5. Full privatisation
16	6. Public-private partnerships
20	7. Not for profit
23	8. Conclusions
24	References

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Summary

The private sector is playing an ever-growing and diversified role in the delivery of public services around the world. Indeed, the scale of private involvement in its various forms is now vast. For example, by 2003, \$3.24 trillion of assets had been transferred to the private from the public sector in the preceding 20 years, a significant proportion of which consists of public services. This is about 18% of the global stock market value and 39% of the total non-US value.

Within developed economies, privatised companies account for a significant fraction of the stock markets: more than 13% in Germany and nearly 12% in Australia, most of which are public services. Over 1,000 ‘public-private partnerships’ (PPPs) projects – again mostly public services – had reached financial closure in the European Union alone by 2007 with a total capital investment of around €200 billion.

The landscape has not always been like this. By the 1970s, the public sector dominated the delivery of public services to such an extent that in many western, developing and communist countries the terms ‘public services’ and ‘public sector’ had begun to appear almost synonymous (with the obvious exception of the United States). Globally, it now appears that this was the highpoint of the public sector’s colonisation of public services and the intervening period has witnessed a dramatic swing away from this position.

This ‘new’ private involvement in the delivery of public services is the focus of this report. The report identifies three models of private delivery: full privatisation; public private partnerships (encompassing outsourcing and PFI-type partnerships); and not-for-profit organisations.

¹ This report is based on Professor Grout’s keynote address at the European Commission’s Eurosocial Taxation Conference, Mexico, 24th – 28th November 2008.

1. Introduction

The private sector is playing a growing and increasingly diversified role in the delivery of public services around the world. This report explains why this is happening and how history has affected the current landscape of private delivery of public services. It identifies the major models of private delivery and their conceptual underpinning. Finally, it assesses the role of the private sector in public services.

The scale of private involvement (in its various forms) in public services is now vast. For example, it is estimated that by 2003, \$3.24 trillion of assets had been transferred from the public sector to the private sector in the preceding 20 years, a significant proportion of which consists of public services. This was about 18% of the global stock market value and 39% of the non-US total value (Megginson, 2005).

Within developed economies, privatised companies account for a significant fraction of the stock markets: more than 13% in Germany and nearly 12% in Australia (Megginson and Netter, 2001), most of which are public services. Over 1,000 'public-private partnership' (PPP) projects – again mostly public services – had reached financial closure in the European Union alone by 2007, with a total capital investment of around €200 billion (Blanc-Brude et al, 2007).

The landscape of public service delivery has not always been like this. In the 1970s, the public sector dominated the delivery of public services. Indeed, in many developing, communist and western countries (with the exception of the United States), the terms 'public services' and 'public sector' had begun to seem almost synonymous.

Globally, it now appears that this was the highpoint of the public sector's colonisation of public services. The intervening period has witnessed a dramatic swing away from this position and towards the private delivery of public services.

2. Some definitions and taxonomy

2.1 The public sector, public services and public organisation

To map out the sphere of private involvement in public services, it is important to distinguish between the 'public sector', 'public services' and 'public organisation' (though it is difficult to provide watertight definitions).

The public sector comprises the economic activities controlled by the government. A legitimate concern is that the public sector is not subject to the discipline of the competitive market and may lack incentives to control costs, provide good quality service and respond to customers' needs. Hence, what is the appropriate sphere of the public sector and which sector should deliver which public services is a critical question.

As a working definition, this report takes public services to be 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 justify government involvement, whether in production, finance or regulation (Grout and Stevens (2003)).

What's in and what's out is a little blurred at the edges, but this definition of public services clearly includes utilities, transport infrastructure, most education and health services, street cleaning and rubbish collection, and national defence.

The terms 'public sector' and 'public services' are not fully aligned. Not everything that the public sector does is a public service – for example, helping to promote the efficiency and exports of private sector industry is not a public service in the sense used here. What's more, many services supplied in some countries by the private sector are unambiguously public services – for example, water supply and electricity distribution.

The term 'public organisation' describes the analysis of the appropriate structures for delivery of public services. Given the definition of public services, it is clear that public organisation is not simply about the organisation of the public sector.

2.2 Models of private delivery of public services

Although the role of the private sector is diverse and there are numerous delivery 'mechanisms', most non-public delivery can be loosely categorised into one of three (overlapping) models:

- Full privatisation – the focus of section 5 of this report.
- Partnerships between the private and public sectors – the focus of section 6.
- Heavily restricted legal forms of organisation, which in practice mostly boil down to non-profit organisations – which are discussed in section 7.

Full privatisation. The defining characteristic of full privatisation is that the government's role is 'arm's-length'. Ownership is fully transferred to the private sector. The newly created private company recovers most if not all of its revenues from the general public and private sector customers. And the government's involvement is, at least in theory, thereafter limited to setting up regulatory agencies and keeping a watching brief on the objectives to which the regulator is to be held accountable.

This model has been very common around the world for big utilities such as telecoms and energy and, to a lesser extent, water and transport. Of course, in many cases, the transfer of ownership is more apparent than real, since companies often operate under a licence from a regulator. Although a company may legally have full ownership of its assets, the assets are of limited use if the company does not have a licence to sell the service.

So the full privatisation model still allows scope for political pressure and corruption. It is not surprising therefore that the independence of the regulator and the general level of corruption in an economy have turned out to be important elements in determining the success of the approach.

Furthermore, because of the scale of the infrastructure involved,

these companies tend to be placed on stock markets or put out to the world's capital markets. So the full privatisation model has become forever intertwined with political sensitivities about stock markets, global capital markets and, particularly in developing countries, the development of their own financial markets (see, for example, Grout (1987, 1994)).

Public-Private Partnerships. For other services governments have chosen to maintain a more direct relationship with the private sector or to continue to provide many public services themselves. There are many reasons why they might do this:

- The nature of the services may make the full privatisation model impractical – for example, an integrated urban road network.
- Poverty may make it impossible to charge economic tariffs.
- Sometimes the only purchaser is the government itself – for example, defence or, in many economies, healthcare and primary education services.
- The government may face anti-privatisation political pressures from workers or the electorate.

In any of these circumstances, the government may end up having a far more intimate, complex, continuing and subtle relationship with private providers. These partnerships tend to be either *outsourcing-type partnerships* – where services are provided on short- or medium-term contracts – or longer-run *private finance initiative (PFI)-type partnerships*.

PPPs are not partnerships in the way that lawyers, professional service providers or private companies understand the term – all exchanges take place under a clear contractual relationship and there is clear ownership of all assets.

There is an element of truth in the idea that the global public was sold privatisation by governments as if it was a panacea for all public sector sins, and the public have since found that this could

never be the case. As a result, the word privatisation is now met with more scepticism. For politicians and non-governmental organisations, it carries a tarnished feel that the word partnership nimbly sidesteps since it suggests more of a closely balanced relationship than is really present.

The evidence on outsourcing partnerships is well documented. In contrast, there is far less evidence on PFI partnerships and they remain highly controversial. Nevertheless, there has been a large global shift towards their use. The International Monetary Fund (IMF) has described PPPs as 'a wave that is sweeping the world' (IMF, 2004). This may be slightly overly enthusiastic but indicates the scale of what is happening.

Not-for-profit. While the profit motive and its consequences are generally considered a central plank of what the private sector has to offer, they are not essential. Private legal forms can be set up with all sorts of restrictions on what they can and cannot do. Setting up an organisation in a way that prevents the distribution of profit to shareholders is relatively common. It is then a moot point whether a not-for-profit organisation is really part of the private sector or a sector in its own right (often referred to as the third sector).

There is a vast theoretical literature on the potential benefits of such structures though it is yet not matched by empirical research. Not-for-profit organisations play a major role in delivery of public services in the United States, and there is a clear sense that governments elsewhere will increasingly be turning to this model.

3. A brief history

3.1 The shift from public to private

Over the last 30 years, the sequencing of the development of the models outlined in section 2 roughly follows the order in which they are presented. The full privatisation model has led the way with outsourcing partnerships not far behind. Then PFI partnerships followed, and the proposed growth in not-for-profit activity outside the United States is only just starting.

This sequencing was almost inevitable given how the renewed interest in private involvement in public services arose. The trend to more private involvement in public services has not happened in isolation. Its roots lie in the broader privatisation strategy pursued by conservative governments in the 1980s (initially in Chile and the UK), which then spread rapidly around the globe.

Indeed, much of the activity that was shifted out of the public sector in this global wave of privatisation had no 'public' features at all other than being owned by the public sector, often because of historical accident or left-wing doctrine. The formerly communist transition countries provide the extreme example. Here the majority of the assets sold or given away by governments cannot be considered public services in any useful sense.

The total value of assets transferred from the public sector to the private sector since the 1980s has been vast. The rationale for the privatisation wave was part economic and part political:

- On the economic side, the ambition was to reduce costs and improve efficiency by replacing 'soft' public budget constraints with hard market constraints while simultaneously bolstering government coffers.
- On the political side, reducing the size of the state and its workforce offered the prospect of making voters more conservative and rapidly ushering in market mechanisms, particularly in transition economies, rendering a return to the old ways less probable.

When looking at the patchwork of car manufacturers, airlines, metal shops and banks that were sitting in the public sector all around the world by the 1970s, the private sector was an obvious and politically expedient home.

Much of the evidence suggests that the privatisation programme achieved many of its economic and political objectives. Privatisation is generally, although not universally, associated with improved efficiency indicators (Megginson et al, 1994, Megginson and Netter, 2001). It is also positively associated with higher sovereign debt (Bortolotti et al, 2004).

The situation with public services was and remains more complex. But the general drive to raise funds and move activities rapidly to the private sector meant that those public services with good market value that could be shifted fully into the private sector were first up. This basically meant big utilities and among these the services with strong demand and market power.

Telecoms were the prime target everywhere, and the vast majority of telecoms networks in the world now sit in the private sector. Energy networks followed and, in some countries, including the UK, water and rail networks were also privatised.

The growth in partnerships came later, in part as a way of dealing with services that cannot easily be fully privatised, but also as a response to public concerns about some of the financial and distributional consequences of the privatisation programmes.

The current growing interest in not-for-profit delivery mechanisms is also driven in part by a desire to harness 'pro-social motivation' – the desire that people have, to a greater or lesser degree, to help others when doing their jobs and not simply get paid (Benabou and Tirole, 2006). But it has also arisen in part as a political response to disquiet about how far it is possible to go in harnessing the profit motive to deliver public services.

3.2 Historical evidence on infrastructure projects

Of course, even when the public sector was almost the sole direct supplier of public services, the private sector still played a role in many countries, contributing to building the physical infrastructure necessary for public service delivery. This section looks briefly at the evidence on these public projects, as it helps to understand where the drive for privatisation came from and provides some lessons in what is achievable.

A series of studies by Flyvbjerg and colleagues of the financial performance of major public infrastructure projects throughout the twentieth century is of particular interest (Flyvbjerg, Bruzelius and Rothengatter, 2003, and Flyvbjerg, Holm and Buhl, 2002, 2003, 2004, 2005).

These studies show that nine out of ten transport infrastructure projects fell victim to cost escalation. For rail, the average cost escalation was 45%; for fixed links (bridges and tunnels), the average cost escalation was 34%; and for roads, the average cost escalation was 20%.

There are examples of cost escalation across five continents, and so the researchers conclude that it appears to be a global phenomenon. They note that cost escalation depends on the length of the implementation phase, with every additional year escalating costs by 4.64%. A central point is that cost escalation has not decreased over the past 70 years, suggesting that lessons are not being learned.

Finally, these studies find that the average cost escalation for private fixed link roads is 34% compared with 110% for public, providing weak evidence that private may be cheaper. But almost all of the projects in the studies are public sector projects so this comparison needs to be treated with caution.

Other studies confirm this gloomy picture. For example, in the UK, the National Audit Office (NAO, 1988) finds average cost overruns

of around 28% on a sample of 42 road construction projects. This kind of evidence helps to explain the attitudes to public procurement and public delivery that influenced the proponents of privatisation. It makes for sorry reading but some important points follow.

It is not uncommon to see advocates of public (or private) provision use individual case studies of failure to castigate private (or public) delivery mechanisms. But given the evidence, it makes little sense to expect that any change in delivery mechanism would be able to move from such poor performance to first class delivery. The evidence suggests things are going to be a long way from perfect whichever sector delivers.

So while small scale case studies can help elucidate problems and help learning from the past, they are unlikely to be much use in informing which mechanism is best since everything is likely to look poor relative to some textbook ideal.

Furthermore, if the history is bad enough and the projects large enough, then even minor improvements may bring huge benefits. So, for example, an apparently really poor private or public project might still represent good value for money.

4. Some conceptual points

4.1 Why should sector matter?

Why should it matter which sector delivers services? Why can't the public sector replicate the most beneficial aspects of the private sector and vice versa? The underlying reason stems from two interrelated problems:

- Asymmetry of information.
- Incomplete contracts.

'Agents' that implement public services projects – think of public or private sector employees, private companies, etc. – tend to have more information than the 'principal' – the government. This asymmetry of information imposes restrictions on what can be achieved and the agent, by dint of better information, may obtain an information 'rent'.

There are many examples why asymmetries may create differences between sectors. For example, if one sector lends itself more easily to certain mechanisms (for example, competition) than another then it may be easier to offset the consequences of asymmetries in particular sectors. Also if asymmetry of information is a real concern then it may matter whether workers in different sectors have different preferences, since the problems of asymmetry of information may be less pronounced when the principal's and agent's preferences display similar missions.

It is well known that incomplete contracts can have real effects (e.g., Grout, 1984, Hart and Moore, 1988). Contracts tend to be incomplete for all sorts of reasons. For example, some activities may be important but too nebulous to specify in a contract. Even though the parties involved may be able to identify accurately what is happening it may not be possible for a third party (e.g., a judge) to accurately observe or for other reasons it be too difficult to define in a watertight legal way. The potential outcomes may also be too numerous to categorise.

If contracts are incomplete, then it will not be possible to describe fully what actions the owner of an asset should make in every possible situation. So the owner of an asset is likely to have some flexibility over outcomes when the other party would prefer this not to be the case. This will be a more significant issue the harder it is to cover critical issues within a legal contract.

Incompleteness of contracts may be a particular problem with public services since the service is often difficult to define completely. For example, it is difficult to define the quality of care that should be administered in particular situations and hard to prove legally that

someone is not doing enough in different situations.

Where contractual incompleteness is a significant issue and cost reduction reduces quality, then how much cost reduction there will be may depend on the sector that is doing the delivery – that is, which sector owns the assets and the 'production' process:

- If a profit-maximising private company owns the assets, then the company may choose to reduce costs regardless of the consequences for (non-contractible) quality reductions.
- In contrast, the public sector will care about quality as well as cost, taking account of any effect of quality reduction when reducing costs – so quality should be higher and cost reductions lower. But the public agent is harder to motivate to reduce costs even when it has limited effect on quality.

The net effect is that the private sector should provide lower costs but lower quality. This suggests that:

- Where the social cost of non-contractible quality reduction is large relative to potential cost savings – for example, brain surgery – then public provision may be optimal.
- Where the social cost of non-contractible quality reduction relative to potential cost savings is less of a problem – for example, telecoms – then private provision is likely to bring benefits (e.g., Hart et al, 1997, Shleifer, 1998).

4.2 Profit and competition: why they matter and when they are beneficial

The value of involving the private sector may not be because delivery by one sector is innately better than another. It is possible that what really makes the public sector expensive is the absence of competition, and hence introducing competition will lead to lower costs.

The private sector then has a role to play but it is indirect. The private sector matters because it is the enabler of competition, but once there is sufficient competition it does not really matter which sector does the delivery.

There is considerable evidence that competition has a cost-reducing effect, but there are limitations to the services to which it can be applied. For competition to be real, there has to be a genuine fear of termination of contract for the incumbent. So the process is only suitable where changing supplier is practical. If

there are significant costs of transfer, then the incumbent is in a strong position and the competitive framework can unravel.

If a government threatens to replace a supplier but the costs of replacement are high, then, when it comes to it, the government may not follow through their threat – the threat of replacement is said to be ‘time inconsistent’. This consequence of the problem that threats may not be time consistent is well understood in economics and is the focus of a substantial literature (for example, Kreps and Wilson (1982)).

Competition may have a big impact on some services, such as refuse collection, since if things go wrong during transfer, then bins may be emptied haphazardly for a short while but this is an inconvenience not a major problem. But this is not true for many public services.

For example, with gas or electricity transmission or railways, there may be real dangers with transfer of contracts. In hospitals (with the exception of cleaning and laundry), there are clear risks to the public of intermittent delivery. Similarly, where there are big investments upfront, then relationships need to be more long-lived. All of this suggests that delivery will have to be characterised by longer lasting partnerships for many public services.

Of course, the for-profit organisational form is not the only private sector model. There are many private sector organisations that adopt a legal form that explicitly blocks the profit motive by making it illegal to distribute profits to shareholders.

The owners of for-profit private sector firms receive the residual income of an activity once all costs are met. If, in a simple example, revenues are 100 and costs are 95, then the owners receive a residual profit of 5. A small reduction in costs of 5% (that is, costs fall to just over 90) is extremely valuable to the owners since it almost doubles the value of the company.

The for-profit private sector organisational form creates powerful incentives to reduce and control costs. This has value where cost control is an issue. But the organisational form is poor at fostering and harnessing ‘pro-social behaviour’.

4.3 Pro-social motivation: when the profit motive may hurt

It is useful to distinguish between preferences and behaviour. Individuals may care about the activities in which they are involved beyond the financial rewards that they receive. In the

context of public services, this is sometimes called public service motivation – the desire to work in public services to contribute to output and quality.

More generally, this can be thought of as pro-social motivation (Francois and Vlassopoulos, 2007). Pro-social motivation can lead to pro-social behaviour such as ‘donated labour’ – labour donated beyond what is explicitly or implicitly contractually required – but this may depend on the type of organisation that employs the motivated individual.

The idea that not-for-profits may be better at encouraging employees and management to display pro-social behaviour than for-profit organisation stems from the work of Arrow (1963), Hansmann (1980), Easley and O’Hara (1983) and Rose-Ackerman (1996). In this literature, not-for-profits generate a trust signal – that is, not-for-profit suppliers will not reduce quality even though they are not contractually bound to a specific standard.

The idea that not-for-profit organisations elicit pro-social behaviour has been formalised in a series of papers by Francois (2000, 2001, 2003 and 2007). The analysis rests on the inability to contract fully over all outcomes.

Consider a hospital where all employees have pro-social motivation and, by way of example, decide that they will never leave a shift if there is no-one else at hand to take over. The commitment of the staff to stay if needed protects a for-profit employer from bad outcomes, including potential legal redress, if there is a staff shortage, and so a for-profit company will find it hard to pre-commit not to take advantage of this by hiring fewer employees than before.

Of course, the employees will realise this and so will not ‘go the extra mile’ because their donated labour does not improve the quality of patient care. So the for-profit form is unable to deliver the preferred outcome – it cannot prevent itself from diverting donated labour if it arose and so any desire to offer any is diluted or destroyed completely.

In contrast, in a non-profit organisation, the non-distribution constraint prevents this expropriation and so the donated labour does indeed improve the outcome of the business. Employees who are motivated therefore have an incentive to donate labour.

This literature suggests that donated labour will be positively associated with not-for-profit and government organisations, and absent or limited in for-profit organisations. The Francois approach depends on the inability to contract completely.

Hansmann's original paper also discusses contractual failure. However, Ghatak and Mueller (2009) point out that the Francois studies focus on contractual failure between employees and manager, and this failure is different from the explicit or implicit contractual failure in studies such as Hansmann (1980), Easley and O'Hara (1983) and Glaeser and Shleifer (2001). But all these approaches have common features and it makes sense to think of them collectively as 'organisational form' approaches since the pro-social behaviour depends on the presence of a not-for-profit structure.

The 'mission-matching' approach (most clearly formalised by Besley and Ghatak, 2005) also identifies when the profit motive may be inappropriate. In this model, individuals have particular missions, which motivate them to engage in pro-social behaviour. The mission – and the associated behaviour – is a fixed individual characteristic, but people will be attracted to like-minded organisations, so that mission-oriented organisations that favour high quality public service provision will attract employees whose personal mission matches this. The core distinction is between mission-oriented and profit-oriented organisations, and the approach suggests that, in some circumstances, profit-oriented organisations may perform less well than mission-oriented ones because they will not attract mission-oriented individuals. So the profit motive may be less effective where individuals have strong pro-social missions.

4.4 Can a long-term relationship help?

The central feature of PFI-type partnerships is that the government signs a long-term contract with a private supplier and pays for the delivery of the public service throughout the life of the contract. Thus the government pays for the service as it gets it rather than paying upfront, which is the traditional procurement model.

The private contractor typically owns the physical 'asset' and makes money from the payments for the service that it generates. Essentially, the building of an asset and the delivery of services over a long period are bundled together.

A road contract is good example:

- The traditional public provision arrangement involves the government signing an agreement with a contractor to build a road: the government pays the contractor for the road when it is built, after which the government owns the road, maintains it and makes it freely available to the public.
- With a PPP, a private contractor builds and owns the road: the government pays the contractor a fixed fee for every vehicle that uses the road over, say, a 25-year contract period.

Upfront expenditure by the private sector followed by long-term payments by the public sector for the service are the key themes of PFI partnerships. Besides roads, other activities where this type

of PPP has been used in the UK include building hospitals, schools, prisons, the Channel Tunnel, government offices and embassies, developing computer systems, and updating the London underground.

The argument for bundling in this way is clear in the following example. In the traditional public provision model, builders are paid for the building and they then move on to build another. If the building turns out to be rather poor quality after many years, then the government faces a complex legal battle to prove that poor building rather than poor specification or incorrect maintenance is at fault.

In contrast, in the PPP model, the government pays for the service it gets. If a road is poor quality and needs expensive repairs, then the builder pays this and also suffers loss of income if cars use other routes while the road is repaired. So if the private contractor fails to deliver the service, then it receives no payment. The idea is that the contractor has a strong incentive to deliver on time (to start the money flowing) and to ensure good quality design and build to avoid costly repairs and failures later on.

There is a large and diverse literature on the efficiency arguments for PPPs, for example, Bentz et al, 2003, Dewatripont and Legros, 2005, Hart, 2003, Martimort and Pouyet, 2008, and Iossa and Martimort, 2008. But in its various forms, the key benefits arise from the bundling of building and service delivery.

4.5 Political economy issues and getting the benchmark right

It is not uncommon to see discussions of private versus public delivery completely ignoring the 'political economy' issues around the incentives of public officials. For example, criticisms of private delivery tend to focus on the failure of private delivery and somehow implicitly assume that public agencies, although possibly inefficient, will at least be trying to do the 'right' thing. But it makes more sense to assume that all delivery processes will be implemented by individuals who are intent on achieving their own objectives.

A good example relates to the time structure of PPP financing. The previous section provides a logical economic argument for partnership models based on the incentive effects of bundling. But there is no doubt that PPPs have also proved very attractive to governments around the world for a completely different reason.

This is because governments can use PFI partnerships to provide new infrastructure today without having to pay upfront. A new hospital or school agreement signed today will only start to cost the government money once it is up and running, and the cost is spread over the next 25, sometimes 40, years. PPPs provide a mechanism for governments to modernise infrastructure without having to find or borrow money today to meet the cost. Of course, in terms of commitment, a legal duty to pay in the future may not be different from borrowing today. This depends

on the risk that the private sector is bearing. If the government only pays for the service it gets, then this is clearly different from entering a commitment to pay a fixed debt repayment every year regardless of the outcome (Engel et al, 2007).

Signing a PPP may also be different from borrowing if the final destination of borrowed funds is more obscure and fungible than signing a PPP. So again borrowing and investing may not be viewed as identical by a government or the population.

This is only one of many political economy arguments for PPPs. An example of another is one made by Maskin and Tirole (2008), who show that PPPs can be optimal when public officials have an incentive to favour high cost projects when they benefit their constituencies.

It is extremely common to hear criticism of these justifications for PPPs. The criticisms typically assume (implicitly rather than explicitly) that this justification for private sector delivery is bad because the public sector could borrow and do the project. But this is not the relevant test. What matters is the realistic alternative not a hypothetical alternative.

Politicians are not commonly thought of as angels so it does not make much sense to assume that they are in this context. Politicians are usually deemed to be too short-term and this affects their choices. The poor state of public sector infrastructure (hospitals, schools, etc.) in many countries (including the UK) is well documented and it is caused in no small part by reluctance to commit expenditure and increase debt for something that does not bring immediate benefits to voters.

So a mechanism that allows politicians to improve the infrastructure of the country while not raising debt yet still passing on the cost to future generations seems a plausible way of correcting the distortion. It may not be perfect but this is not a perfect world.

As an aside, it is worth pointing out that this discussion of PPPs shows how diverse the consequences of delivery mechanisms can be and so how hard it is to make really accurate comparisons.

PPPs enabled the Labour government to survive while issuing very little public debt in the decade after 1994. But the

combination of this lack of government debt and changes in pension laws (which now require pension funds to hold larger quantities of long-term government bonds) created a shortage of government debt in the market. The price of the scarce debt was bid up and as a result real interest rates were pushed to their lowest for a century. An unwelcome side effect of this cheap money was to help fuel the UK property boom, making it one of the most vulnerable markets now that property prices are falling.

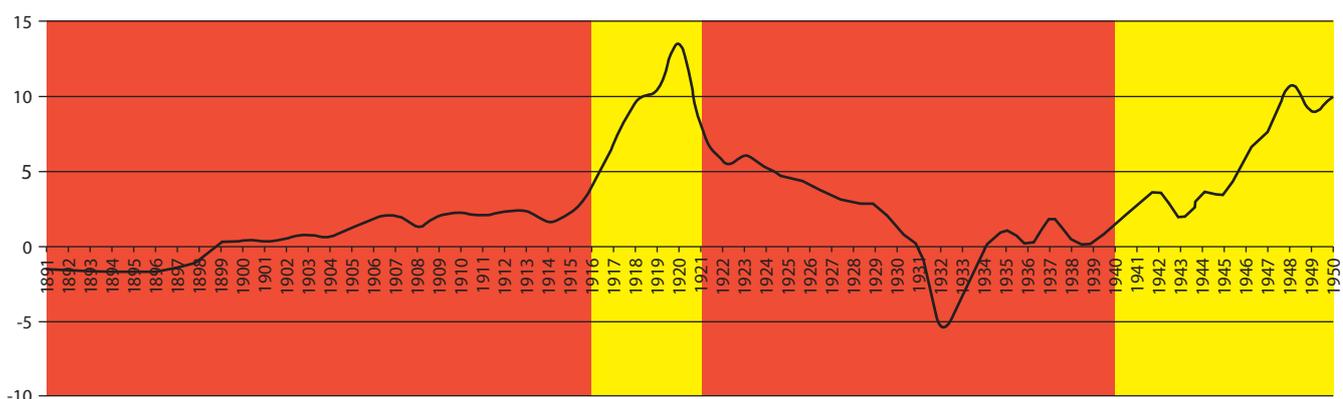
The key point in this subsection is that when assessing a private delivery mechanism, it is essential to compare it with the set of realistic public alternatives. The example of PPPs is not unique. Analysis of the behaviour of regulators in the United States during the period when utility regulation was developed shows that the political economy aspects of delivery are ubiquitous.

The utility model that dominated the second half of the twentieth century (historical cost rate of return regulation) was developed in the US between 1890 and 1950. During this period, there was uncertainty about which regulatory asset base (historical cost or replacement cost) was appropriate. Regulators opted for different approaches at different times: Figure 1 provides a rough summary of which approach was most likely at any particular time based on cases of regulatory and company disagreement that went to the Supreme Court for resolution.

The red region denotes periods when replacement cost was the regulatory dominant choice, and the yellow region denotes periods when historical cost was the regulatory dominant choice. The solid line denotes the relationship between replacement cost and historical cost for assets aged up to 20 years. If the number is high, then assets cost far more to replace than their historical purchase price. If the ratio is low, then replacing assets is much cheaper relative to their historical cost.

Figure 1 shows very clearly that the choice of replacement cost and historical cost is not random. Regulators are much more likely to opt for historical cost when the historical cost of assets is abnormally low (that is, when the solid line is high) and opt for replacement cost when the solid line is low. In other words, the regulators choose the definition of asset value they will apply according to what will give the lowest prices to the customer at the time, not what is consistent or optimal economic policy.

Figure 1: US regulators choice of asset base



5. Full privatisation

The global privatisation programme has a well-established history and much has been written over the last 25 years. For this reason, it receives less attention in this report than partnerships and not-for-profit organisations. The following provides some high-level evidence.

There is now a significant amount of evidence showing that, on average, privatisation in telecoms, gas, electricity distribution and water is beneficial, sometimes enormously so. Megginson and Netter (2001) provide the most comprehensive international survey of studies of privatisation. They conclude, 'we know that privatisation "works", in the sense that divested firms always become more efficient, more profitable, and financially healthier, and increase their capital investment spending'.

In the UK, Martin and Parker (1997) find that in the 1990s, telecoms firm BT achieved annual labour productivity growth of 15% and British Gas achieved 6%. Parker (1999a,b) documents a long list of improvements in service measures in UK telecoms, gas and electricity and water since privatisation. Indeed, Pollitt and Smith (2002) show that there were major efficiencies achieved in the early years after privatisation even in the rail industry in the UK, which is generally regarded as a difficult case.

Newbery and Pollitt (1997) document significant welfare gains following privatisation in electricity in the UK – mainly caused by greater investment, lower prices and improved productivity. These effects are also apparent in other developed economies, for example, Galal et al (1994).

Privatisation is also generally beneficial in developing countries though the picture here is more mixed. Davies et al (2005) identify productivity gains in most developing countries and document far more positive than negative effects for consumers, governments and investors. Campos et al (2003) show gains of 2% per year in productivity in Argentina's water industry from privatisation, and Estache and Kouassi (2002) find clear benefits from having private operators in Africa. But Estache and Rossi (2002) find no clear difference between public and privatised provision in Asia.

A clear message from many studies is that privatisation alone does not deliver anything like the same benefits if it is not

accompanied by liberalisation (that is, increased competition) or independent regulation:

- Newbery (1997) argues that liberalisation is critical in obtaining the full benefits of privatisation: 'privatisation is necessary but not sufficient'.
- Zhang et al (2002) study privatisation in 24 developing countries and find that privatisation is most successful when combined with competition or regulation.
- Bortolotti et al (2001) conclude that the financial and operating performance of telecoms companies improves significantly after privatisation, but that a sizable fraction of the observed improvement results from regulatory changes – alone or in combination with ownership changes rather than from privatisation alone.
- Alesina et al (2005) use data on regulation in several sectors of many OECD countries to provide evidence that regulatory reform of product markets is associated with increased investment, with entry liberalisation playing an important role. They find that regulatory reforms have had a significant positive impact on capital accumulation in transport (airlines, road freight and railways) communication (telecoms and postal) and utilities (electricity and gas) sectors.

In general, price cap regulation has better overall impact on cost than rate of return regulation but quality is sometimes affected:

- Abel (2000) shows that the US telecoms industry as a whole has responded favourably to the incentives created by price cap regulation but results for service quality are mixed.
- Ai and Sappington (2002) find evidence of greater network modernisation and lower costs under price cap regulation.
- Majumdar (1997) evaluates the effect of incentive regulation on the productivity of US local exchange carriers between 1988 and 1993 and concludes that introducing pure price cap schemes has a strong and positive, but lagged, effect on technical efficiency.

An obvious question is how far the privatisation model can be pushed in the delivery of public services. The privatisation of the UK railways is informative here, having culminated in the first bankruptcy in the UK of a privatised utility.

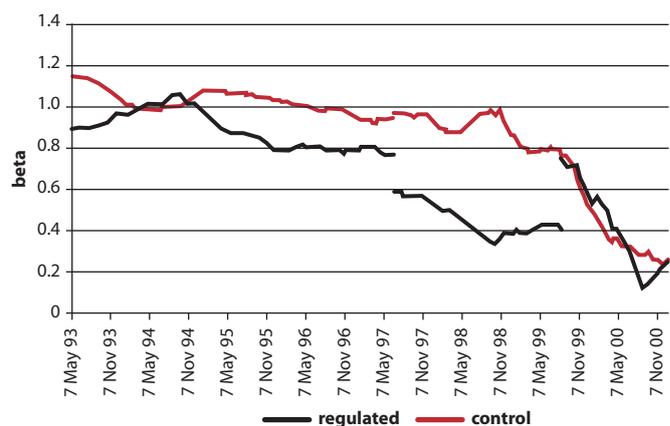
To some extent, the blurred incentives and responsibilities (on the side of both the regulator and the companies) were the result of the original privatisation structure and have been much improved subsequently. But the problem is deeper since it was the government that decided the future of the business and the returns to shareholders, not the independent regulatory body, and the government decided that it would no longer contribute enough to keep the company afloat.

If companies cannot cover all their costs from customers, then the model suffers from being too close to government and the benefits of having an independent regulator are hard to achieve. This is the extreme version of a problem that arises commonly when revenues at the time of privatisation do not cover the replacement cost of assets (Grout and Zalewska, 2004).

Keeping government at arm's length is clearly beneficial but is a common concern. This is notable in developing countries, where corrupt administrations can seek to dictate the behaviour of privatised companies. But even in the UK, government actions have had a significant impact on privatised companies even in the presence of independent regulators.

Figure 2 (Grout and Zalewska, 2006) shows the risk levels over time of regulated companies (the black line) in the UK between mid 1993 and early 2001. An obvious question is whether the risk of regulated companies is directly affected by political changes. One possibility is that the shift from Conservative to New Labour government had no impact. Another is that the shift towards a potentially more interventionist New Labour government affected the companies (one argument being that under an interventionist government regulation would be more similar to rate of return regulation, i.e., lower but more regulated profit). A third possibility is that any effect is limited to the period of the political discussion concerning profit sharing, i.e., during the discussions that took place within the new Labour Government as to whether it was appropriate to replace price cap regulation with profit sharing between companies and consumers.

Figure 2: Regulated and control portfolios' beta coefficients estimated for sub-periods



In this figure the regulated companies display a downward jump in risk soon after the 1997 election and from this point on the risk figure is almost always below the values under the Conservative government. This shows that political changes do matter and a quick analysis could suggest that there was a permanent change under New Labour. However, the figure also shows the risk of a control sample of traditional companies (the red line). It is clear that the drop in risk from late 1999 onwards is common to both sets of companies. The cause of this fall is the e-commerce 'bubble' and is not unique to regulated companies. So the evidence suggests that the political impact on the companies is limited to the period when discussions took place within the New Labour government with regard to changing the regulatory structure. This research shows that governments can have a large and focussed effect on independently regulated companies, because of the rates of return that these companies earn relative to other large market share companies (Grout and Zalewska (2007, 2008), and emphasises that regulated privatised companies are never really free of government politics.

6. Public-private partnerships

There is no accepted definition of what constitutes a PPP. In some countries almost any involvement of the private sector in the provision of public services is described as a PPP. At the other extreme economists tend to think of PPPs purely in terms of the PFI model, which as described in Section 4 is essentially a model of upfront expenditure by the private sector followed by long-term payments by the public sector for the service. Here we first discuss outsourcing-type partnerships and then consider PFI-type partnerships.

6.1 Outsourcing partnerships

The evidence on the impact of outsourcing on costs is very clear. For example, Domberger et al (1986) look at refuse collection in 305 local authorities and find that in where the service was put up for tender and given to a private operator, there were average cost savings of 22% (after allowing for differences in service factors that would have affected cost).

It is possible that this could have been due to sample selection effects – notably that the authorities that put their waste collection up for tender were those that thought they were paying too much for the services. Szymanski and Wilkins (1993) show this is not the case: they find savings of approximately 20% after the introduction of compulsory competitive tendering in local government.

Using data from 3,000 hospitals in the UK, Domberger et al (1987) find savings of 34% from competitive tendering for hospital domestic services. The Australian Industry Commission (1996) brings together the results from 203 international studies of competitive tendering. No attempt was made to align the results of the surveys (for example, by adjusting the evidence to make the results more directly comparable) but a clear message emerges: most savings were between 10% and 30%.

So the private sector effect is present but is this effect direct or indirect? Several studies address the question of whether the price falls are greater if a private sector company wins a bid compared with the situation where the public sector incumbent wins.

Most studies find no direct sector effect –for example, Domberger et al (1986, 1987), Dijkgraaf and Gradus (2003) and Milne and McGee (1992). But Szymanski (1996) reports that if a local authority awards the tender to their in-house team, then costs are

reduced by about 10% compared with a 20% cost reduction with private contractors. Using Italian procurement cases, Bandiera et al (2008) also find a sector effect.

Other studies using different approaches also suggest that competition is a key driver. Coviello and Mariniello (2008) look at Italian procurement and the effect of publicity laws. Using evidence from over 40,000 procurement auctions, they show that increasing publicity from local to regional increases bidders by 50% and reduces the price paid by 5%. Increasing publicity to the European level has no effect on the number of bidders but reduces the price paid by an additional 10%.

Gupta (2002) examines the highway construction industry in Florida in the period 1981-86 and shows that as the number of bidders increases, then the cost decreases. This research suggests that once somewhere between six and eight bidders enter the auction, then the winning bid is unaffected by further bidders. But Hong and Shum (2002), looking at the state of New Jersey's procurement auctions, show that too much competition can reduce bids because of the problem of the winner's curse.

Bel and Costas (2006) suggest that the benefits of contracting out may decline over time, and Ohlsson (2003) finds that public production is only 6% cheaper than private production.

There are insufficient recent studies to know if there is a time effect but it is not implausible. As outsourcing develops, then more public sector suppliers realise that they may become exposed to these competitive forces. The probability that this will happen will itself be sensitive to the performance of the public supplier since the worse it is, the more probable a government will turn to outsourcing. So it would not be surprising to find public delivery improving over time even for services where outsourcing is not formally present.

Of course, this does not mean that the benefits from having outsourcing, relative to a situation where outsourcing could never arise, are reduced. It is simply that the growing threat of outsourcing is enough to bring about some of the benefit through better public delivery. So when the sector actually is changed, the net effect is less since part of the gain is already in the public cost figures.

Turning to quality, there is little evidence showing that quality

falls if the private sector takes over an activity. Domberger et al (1995) undertake a careful analysis of 61 cleaning contracts and find that cleaning performance was either maintained or improved.

The Australian Industry Commission (1996) summarises more than ten studies and interviewed contractors to assess the impact on quality. It claims there is little evidence of lower quality. Indeed, evidence of quality increases, which is attributed to 'a much clearer focus on what is required in the service, improved performance monitoring and the ability to choose among alternative providers'.

But it appears that much of this effect operates through competition rather than there being something unique about the private sector that makes it inherently cheaper. There is some evidence that the sector effect is present but it is not the biggest part of the story.

So a clear message arises from the outsourcing model. The private sector helps to reduce costs and does not appear to reduce quality to any measurable degree.

6.2 PFI partnerships

There are essentially two aspects that define a PFI partnership:

- **Technical structure:** the production process involves activities that differ over time, and the quality at one stage affects the quality and cost of subsequent stages. An example is that the first stage may be to design, build or renovate an asset and the second stage may be to maintain or use the asset to deliver a service.
- **Incentive structure:** the government adopts an incentive scheme that bundles these stages together with one operator, that is, the same private supplier may design, build, finance and operate the process. This creates a long-term relationship between the government and the supplier.

PPP projects of this type are found all over the world and are growing rapidly. Virtually every OECD country has such partnerships. But they also arise in countries as diverse as Argentina, Brazil, Chile, Kenya, Mozambique, Nigeria, Peru, Tanzania and Uzbekistan.

PPPs in public services are not new. Examples where a private provider designed, constructed and operated a service within a complex contractual relationship with the government could be found in almost every continent during the nineteenth century.

In the UK, PPPs were a natural extension of the privatisation policies of the Conservative government of the 1980s, bringing private incentives and money into services that were not suitable for full privatisation. There was a desire to modernise infrastructure without directly raising government borrowing. And any replacement of public sector jobs (traditionally the strongest base of trade union power) with private sector non-unionised activity was seen as an extra bonus (Grout, 1997).

When New Labour came to power in May 1997, there was a political problem. The policy of 'rolling back the state' was not something the New Labour leaders could promote directly. Their real target was 'incentivisation' of the delivery of public services.

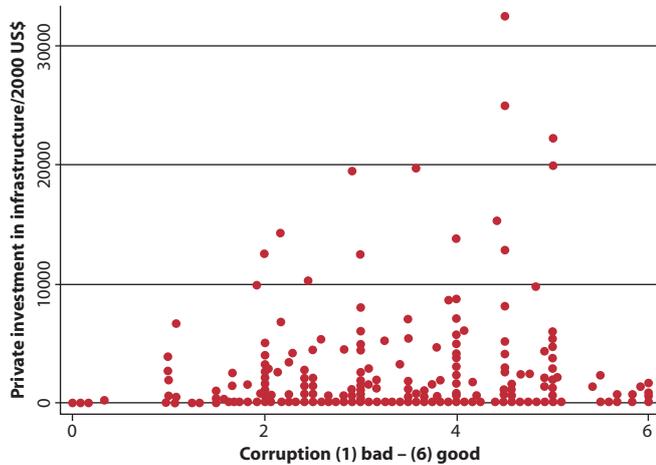
To retain power, New Labour had to meet the expectations of voters and party members while simultaneously convincing the financial markets that the party was prudent and would not adopt a 'spend and tax' policy. The Chancellor's stringent financial policies, particularly during the first term of the New Labour government, indicated that they were not anxious to abandon the Conservatives' 'private finance initiative' (PFI).

But since the PFI was strongly associated with Conservative policy, the terminology was pushed into the background and the term PPP came into common usage instead. New Labour's reliance on PPPs limited the government's need to borrow and enabled it to display the required prudence.

So what are the received facts? PPPs are now common throughout the world. But because of the long-term contractual relationships, it is hard for some developing countries to 'get into the market'. Indeed, the attractive option of improving public services without having to pay upfront is not available for many countries.

Figure 3 shows the relationship between private finance for public works and the level of corruption (higher numbers mean less corruption). It is clear that a country that is highly corrupt will struggle to get any private funds.

Figure 3: Private infrastructure and corruption

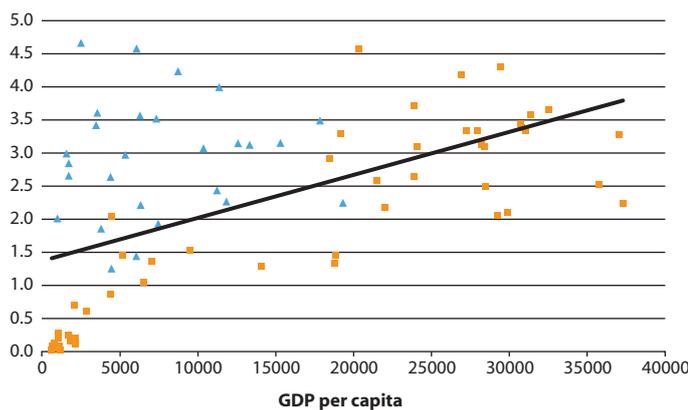


Transition countries have also made limited use of PPPs, particularly those outside the EU. This is likely to change because there are several factors pushing these countries in the direction of PPPs. A primary issue is that they have an unusual mix of labour and infrastructure. Relative to their GDP per head, transition countries have highly educated workforces. For example, Figure 4, shows the relationship between the number of doctors per thousand people and GDP per head for all middle-income countries.

The solid line shows the best fit between the two and the blue triangles are the transition countries. It is clear that they have far more doctors per thousand than would otherwise be expected given their GDP. These countries are also not comparatively short of infrastructure for public services, but it is often old, in poor condition and frequently inefficiently located.

With the exception of a few resource-rich transition countries, resorting to PPPs appears to be one of the few ways to resolve these problems, and the countries are indeed moving in this direction. A particular issue is how the local politics and power

Figure 4: Doctors per thousand and GDP per head



bases will play out, particularly in terms of the allocation of benefits between private providers, local government and the general public. The evidence from the privatisation programmes suggests this is likely to be a major concern.

6.2(a). Evidence on performance

The contract structure of PFI partnerships is designed to provide incentives to deliver on time to start the money flowing and the evidence suggests that this happens.

For example, the National Audit Office (NAO, 2003a) has surveyed the PFI construction projects up to 2002 and assessed them against comparable traditionally procured projects. The NAO finds that nine out of the eleven PFI hospitals and all seven PFI prisons were delivered on time or early. This compares very favourably with 61 traditionally procured hospitals, 75% of which were delivered late.

Mott MacDonald (2002) look at 39 UK infrastructure projects procured by conventional methods and find that completion time was 17% above estimated duration and, on average, costs exceeded estimates by 47%. The study also looks at 11 PPPs. On average, these were almost exactly on budget and, on average, they were delivered before the contractual completion date.

There are comparable results elsewhere. A European Investment Bank (EIB) study (Thomson, 2005) evaluates 10 PPP projects financed by the EIB: three of the ten PPP projects had time delays and cost overruns. Of 50 public infrastructure projects under conventional procurement, 60% were more than one year late.

Of course, being on time is not the same as being better value. A detailed study of 200 roads funded by the EIB (Blanc-Brude et al, 2006) finds that PPP projects are 24% higher than the traditionally procured roads at contract signing. There is a sample selection issue that make it hard to interpret the results. For example, projects that are thought to be particularly expensive might be more likely to be put out as PPPs to try to use competition to control costs. This would make PPPs look abnormally expensive.

But apart from such issues, the results are statistically significant. There appears to be a large additional cost to increase the delivery on time, but the authors point out that the value of cost overruns in traditional projects is between 20% and 28%, suggesting that at the build stage, these PPPs are neither more expensive nor cheaper than traditional public projects.

Theory suggests that the building costs of PPPs should be higher than traditional public projects since the PPP contractual structure should create incentives to ensure better quality delivery over time. So as well as obtaining better delivery at no greater cost, this research suggests PPPs may be better value than expected.

But currently there is insufficient data to know whether this is true. There is evidence that financial risk is passed on to contractors, though investigations are limited to specific markets. Using a large sample of debt payments, Blanc-Brude and Strong (2007) find that spreads do indeed reflect the systematic risk that PPPs face (notably traffic risk).

The NAO has compared private prisons with equivalent public prisons (NAO, 2003b) concluding that 'with one exception, PFI prisons perform well relative to comparable public prisons'. PFI were among the best and the worst of the sample. Taking account of quality and overcrowding, privately run prisons are better value than public prisons, but their complex financial structure makes it harder to say whether all private prisons are better than public prisons.

6.2(b) Problems and benefits

There are some well-established problems with PFI partnerships that arise because of the long-term contracting structure. One is procurement. Because a single provider signs a long-term contract, the chosen company enjoys some monopoly power. As a result, any benefits that a private contractor can make from this must be extracted upfront in a competitive bidding process.

This leads to a major change in the status of various jobs in the public sector. In traditional public sector delivery, those involved with the delivery of services have a critical role and procurement is somewhat secondary. In the PPP world, delivery shifts more to the private sector and good quality procurement is the critical requirement of the public sector. While the role of these positions has changed, the process and status has been slow to adopt and there are real problems with PPP procurement.

Another big issue is renegotiation. Renegotiation is a major concern for developing countries where over 50% of water and road projects are renegotiated within a few years. The most detailed studies of renegotiation are in developing countries. Guasch (2004), finds limited renegotiation in telecoms (average 1.1%) and energy (9.7%), but significant renegotiation in water (74.4) and transportation (54.7%). Hirschhausen (2002)

documents significant renegotiation in Eastern Europe.

The issue is also prevalent in the UK. One in five of the PFI construction projects assessed by the NAO (2003a) were expanded within a few years of contract signing because of the changing needs of the public sector. In the UK, detailed renegotiation rules are now built into contracts but it is too early to say whether this will resolve the problem.

Overall, PFI partnerships have proved particularly beneficial in some areas, notably construction. But the experience in other sectors, particularly information technology, has been rather poor. The evidence that the cost of PPPs may roughly be equal to traditional public sector procurement suggests that the delivery capability may play an important role in determining whether PPPs are beneficial. Evidence suggests that PPPs are more likely to deliver on time but this evidence is still limited.

There is a detailed literature on comparisons between public and private delivery – for example, Heald (2003), Grimsey and Lewis (2005), Grout (2003, 2005) and HM Treasury (2003, 2006). But as already emphasised, it makes more sense to compare private delivery under PPPs with the experience of public delivery, which includes the restrictions on investment as part of the disadvantages of public delivery.

In this case, PPPs look attractive and it is clear to see why PPPs are proving so popular around the world. Indeed, even the United States is now turning to PPPs to modernise its transport structure. They are not a panacea for all the problems that bedevil public delivery. But the evidence from around the world suggests that PPPs should be seen as a legitimate part of a package to deliver better public services and are here to stay.

7. Not for profit

7. Not-for-profits

A central attraction of involving the private sector in public service delivery is that the profit motive can be harnessed to bring about reductions in the cost of delivering the services. This is particularly valuable in services where cost reductions do not have significant detrimental effects on the quality of the service.

But where cost reductions can have significant negative impact on quality, then the profit motive could be damaging and standard private sector involvement may not be desirable. One way to mitigate these problems is to adopt an organisational form that blocks the profit motive and hence cannot fall prey to these particular problems.

Following this line of argument, it appears that not-for-profits could have a role to play in public service delivery. Of course, simply blocking off the profit motive does not in itself provide much of an argument. There needs to be a positive element.

The standard argument is that blocking the profit motive fosters other socially valuable motives and allows these to flourish. If this argument were true, then the role of not-for-profits would appear to lie in those services where employees feel that their motivation is important. This section considers the theoretical justification for a not-for-profit role in public service delivery and then looks at the empirical evidence.

7.1 Not-for-profit forms

The not-for-profit form has been very popular in the United States. The delivery of US healthcare has many large not-for-profit organisations and a huge number of smaller ones too. It is estimated that there are 1.4 million not-for-profits in the United States (Inland Revenue, 2006), but these are mostly religious organisations and public charities, which do not fall under the public service definition used in this report.

In recent years, there has been a shift towards not-for-profit delivery of public services operating within a more traditional framework. For example, in the UK utility sector, Network Rail and Dwr Cymru (previously Welsh Water) both operate under standard price cap relationships.

There is a vast array of structures that can be described as not-for-profit, and these differ in the extent to which not-for-profit status is explicitly incorporated in the legal structure. Among the incorporated forms, a company limited by guarantee without share capital (a CLG) is one of the most familiar not-for-profit legal forms, local versions of which are in use in the UK, Australia, South Africa and other countries with common law based legal systems.

In these cases, the not-for-profit status is absolutely explicit. For example, according to the UK Companies Act 2006, a company is incorporated as a CLG 'if their liability is limited to such amount as the members undertake to contribute to the assets of the company in the event of its being wound up'. In effect, each member commits in the constitution to pay a nominal sum (typically £1 or \$1) as liability in the event that the CLG is dissolved.

The CLG form has proved popular with not-for-profit organisations attracted by the simplicity of its constitutional arrangements and the equality associated with such a set-up.

The defining characteristics of not-for-profits are that income is only to be used to promote the company's objectives, dividend payments to members are prohibited, and on winding up, all assets must be transferred to another body with objects similar to its own or to a charity. The first two characteristics are typically referred to as the non-distribution constraint and the last one is referred to as the asset lock.

7.2 Evidence on donated labour

Section 4.3 provided arguments why not-for-profits might attract levels of donated labour absent in for-profit firms. These arguments suggest that donated labour will be focused on public services where employees with pro-social motivation are likely to care about the outcome.

To test this idea, unpaid overtime can be used as a proxy for donated labour, assessing whether it differs by industry and sector. The hypothesis is that in caring work, there will be a higher level of unpaid overtime in the not-for-profit sector than in the private sector. In non-caring work, this would not be the case: indeed, because of career concerns (Dewatripont et al, 1999), the opposite might be the case.

Table 1 shows the ratio of not-for-profits over for-profits for total overtime, paid overtime and unpaid overtime over four industries: construction, business services, health and education. The conjecture is that the ratios for unpaid overtime will be greater than one in health and education but equal to or less than one in construction and business services. This is exactly what the data show.

These results would appear to prove the organisational form view of the world. But Gregg et al (2008) use similar data from the British Household Panel Survey (BHPS) to show that this need not be the case. Unfortunately, because of the shortage of data for the questions at hand, this study divides the data into non-profit (public sector and not-for-profit) and for-profit. While this addresses the main distinction – between non-profit and for-profit – it imposes limitations on comparing not-for-profit with for-profit.

The BHPS data are ideally suited for examining the relationship between donated labour and institutional form for a number of reasons. As well as standard information on industry and sector (for-profit, public and not-for-profit) of employment, the BHPS can be used to calculate a measure of donated labour – unpaid overtime. The data set allows the authors to include a very rigorous set of controls for career concerns. Finally, as a panel, it enables the study to follow the same individuals switching between sectors and observe any change in their pro-social behaviour.

The research shows that there is a positive and significant correlation between sector and donated labour. After including a robust set of individual and job-specific controls, individuals in the non-profit sector are more than 40% more likely to do unpaid overtime than individuals in the for-profit sector.

Of course, this difference may simply be explained by different implicit contracts or social norms operating within each of the sectors. The authors are able to exploit the panel nature of the data to answer this question. Surprisingly, given the conclusion of the extensive theoretical literature on the subject, they authors find no evidence that individuals change their donated labour when they switch sector. Thus this approach rejects the organisational form approach as being the primary explanation of donated labour.

Table 1: Not for profit/private over time

	Overtime	Paid Overtime	Unpaid Overtime
Construction	0.12	0.00	0.44
Business Services	0.66	0.65	0.67
Education	1.34	0.55	1.57
Health	0.87	0.56	1.39

British Household Panel Survey (averaged over eleven waves: 1991-2001)

This study has a negative message for analysis of not-for-profits. Although not-for-profits are clearly able to attract employees who donate labour and hence may be more efficient as a result, these employees are sucked away from other employees who may lose as a result. So any aggregate efficiency gains that might arise from extending the not-for-profit sector would have to come from the improved efficiency that could arise from having a better match of employees and firm. The employees do not appear to engage in more pro-social behaviour as a result of changing sector.

7.3 Evidence on the comparative performance of not-for-profits and for-profits

There is a significant literature looking at the comparative performance of not-for-profit and for-profit firms, much of which looks at US not-for-profits since these are well established, notably in health. Despite the appeal of arguments suggesting that not-for-profits should have clear advantages, it is hard to see this effect in the evidence, which tends to be mixed. Of course, in terms of global reach, the evidence is drawn from a limited pool so further analysis is certainly needed.

Research finding that not-for-profits are more efficient than for-profits includes Cutler and Horwitz (2000), Ferrier and Valdmanis (1996) and Wilson and Jadlow (1982) on hospitals, and Nyman and Bricker (1989) on nursing homes. Research finding the opposite includes studies undertaken by Woolhandler and Himmelstein (1997), Becker and Sloan (1985) on hospitals, and Blau and Mocan (2002) and Mocan (1997) on day care centres.

In response to these inconclusive results, Eggleston et al (2006) use a quantitative meta-analysis approach to review the literature

on US hospital performance systematically. They find that many of the results were driven by differences in the way that studies accounted for market variation and regional differences. Yu et al (2006) find only tentative evidence for higher patient care costs and profits at for-profit hospitals.

Comparisons of factors other than pure efficiency also indicate limited difference between for and not-for-profit. For example, Malani and Choi (2004) investigate executive compensation at non-profit firms and conclude that their research supports the hypothesis that principals at non-profit firms either care about profits just like principals at for-profit firms or behave as if they do. Using US hospital market regions Gaynor and Vogt (2003) model the effects of hospital mergers and show where merger creates a near monopoly in their data set (San Luis Obispo County) that the predicted effect of merger is a significant increase in prices whether the hospitals are for profit or not-for-profit. Lakdawalla and Philipson (2006) suggest that even if not-for-profits are individually more efficient this will not affect industry performance because for-profit firms are the marginal firms and it is these firms that determine prices. They argue that this is supported by the empirical evidence.

A well-established argument for the not-for-profit form is that it provides a trust signal – essentially a third sector supplier will not cut quality in the way that a for-profit supplier may. There is some evidence of self-selection of less well-informed consumers into non-profit institutions (e.g., Holtmann and Ullmann, 1991) although the proxies for less well informed are difficult to capture well. Where competition is low, not-for-profits provide a higher level of access – for example, Mas (2008). However, Malani and David (2008) argue that the trust signal may be over emphasised. They show that the majority of not-for-profit firms do not give their status in listings and that over 35% do not even disclose their status on their own web pages.

Analysing contracts of the UK's Department for International Development, Huysentruyt (2006) finds that not-for-profit firms compete most where there are important non-contractible quality innovations and that ex-post transactions costs are higher with for-profits than non-for-profits. But not-for-profit firms are less likely to adhere to procurer's terms of reference, which may be another reason for the lack of evidence on productivity.

Overall, the idea that not-for-profit firms deliver something that for-profit firms cannot is not confirmed by the evidence in existing studies. Indeed, although not-for-profit firms may attract individuals that offer more donated labour, there is as yet no evidence that these individuals only provide this when they work in a not-for-profit environment.

There is an enormous amount of analysis needed before these questions can be answered. But currently the limited evidence does not point to a clear not-for-profit effect. Of course, it is easy to see how not-for-profit delivery appeals to politicians who wish to appease voters who are sceptical of more and more privatisation. But the evidence suggests that the justification of not-for-profit as a method of delivery is yet to be proved. It should be emphasised, however, that most of the empirical analysis on not-for-profits has been conducted on US data and there is no guarantee that the UK experience will be identical.

8. Conclusions

By the 1970s, the public sector dominated the delivery of public services to such an extent that in many western, developing and communist countries the terms 'public services' and 'public sector' had began to appear almost synonymous. Since then we have witnessed a dramatic swing away from this position and the private sector is playing an ever-growing and diversified role in the delivery of public services around the world.

The report identifies three models of private delivery: full privatisation; public private partnerships (encompassing outsourcing and PFI-type partnerships); and not-for-profit organisations. It has argued that the private sector has an important role to play, but at the same time, the profit motive could be damaging in some cases, generally in public services where workers have strongly pro-social motivation.

The report shows that there are good theoretical justifications for each of the models of delivery, but 'political economy' issues around the incentives of public officials are also important. In particular, private delivery should always be compared with feasible public sector alternatives. Otherwise, it is likely that the contribution made by the private sector will be underestimated.

The beneficial aspects of the full privatisation models that have been adopted on a large scale around the world in the last 25 years are well documented. But there are also limitations, and it is these that have focused attention on partnership and not-for-profit models.

The gains from outsourcing type-partnerships are well documented and PFI-type partnerships have proved beneficial in some areas, notably construction, but the experience in other sectors, particularly information technology, has been rather poor. The cost of PFI partnerships seems roughly equal to traditional public sector procurement yet the former seem to be far more likely to deliver on time. The full benefit of PPPs can only be assessed when the situation is compared with actual public sector investment. Politicians frequently restrict expenditure to a point where public delivery is associated with poor quality assets. PPPs provide a mechanism to circumvent this problem and look more attractive once this is 'factored in'. It is clear to see why they are politically popular globally. Indeed, even the United States is now turning to PPPs to modernise its transport structure.

In contrast, though there is detailed and careful theoretical research on the benefits of not-for-profit organisations, this analysis is not supported by the data at present. Not-for-profit firms may attract individuals that offer more 'donated labour' – work effort beyond what is explicitly or implicitly contractually required. But to date there is no evidence that these people only provide this when they work in a not-for-profit environment. Indeed what evidence there is suggests the opposite.

It is easy to see how not-for-profit delivery appeals to politicians who wish to appease voters who are sceptical of more and more privatisation. But the evidence suggests that the justification of not-for-profit as a method of delivery has yet to be proven.

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