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Market-type Mechanisms and the Provision of Public Services

by
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Market-type mechanisms are defined as "encompassing all arrangements where at least one significant characteristic of markets is present." In the area of service provision, the prime instruments include outsourcing (contracting out), public-private partnerships (PPPs) and vouchers. This article describes each instrument, surveys its use in OECD countries, analyses the key issues involved, and offers an overall assessment.

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1. Introduction

Market-type mechanisms are a broad concept. In the early 1990s, the OECD adopted the very comprehensive definition of "encompassing all arrangements where at least one significant characteristic of markets is present." In the area of service provision, the prime instruments include outsourcing (contracting out), public-private partnerships (PPPs) and vouchers. Other examples of market-type mechanisms include user charges and the use of transferable permits for allocating and managing limited-supply "public" goods (greenhouse gas emissions, for example).

The use of market-type mechanisms is increasing in OECD member countries, although there are marked country differences in this respect. The driving force behind this phenomenon is the need for governments to secure increased value for money in their operations. Some market-type mechanisms, most notably vouchers, move beyond this and have as their primary goal to increase the choices offered to the users of services.

The evidence that market-type mechanisms can secure such efficiency gains, either through lower costs or improved service levels, is substantial. However, the decision to use market-type mechanisms needs to be made on a case-by-case basis and the specific design of these instruments is critical to their successful application.

There are significant management challenges for governments in moving to a market-type mechanism model, especially in separating the roles of government as purchaser and provider of services. Traditionally, governments performed these roles concurrently. Governments will have to invest in capacity for specifying services and contract management skills that they have not typically possessed in the past. It concerns both new technical skills and an overall culture change in the public sector. By definition, it will not happen overnight.

Concerns have also been raised about the governance implications of the use of market-type mechanisms. At present, their use is secondary and operates at the margin of an overall dominant traditional role for government provision. The governance concerns will therefore likely increase as the use of market-type mechanisms expands. This is especially relevant for accountability, transparency, regularity, and the access to redress mechanisms for citizens.

This paper covers the main market-type mechanisms used for public service provision with a section each on outsourcing (contracting out), public-private partnerships (PPPs) and vouchers. Each section describes the instrument, surveys its use in OECD member countries, analyses the key issues involved – both in terms of design and governance factors – and offers an overall assessment. A box at the end of the paper highlights the other principal market-type instruments. The paper concludes by drawing together the main messages emerging from the discussion.

2. What are market-type mechanisms?

A broad definition of market-type mechanisms is that they encompass all arrangements where at least one significant characteristic of markets is present. Examples of specific kinds of market-type mechanisms are defined below.

Outsourcing is the practice whereby governments contract with private sector providers for the provision of services to government ministries and agencies, or directly to citizens on behalf of the government. Different terminology is used in different countries for outsourcing, including competitive tendering, contracting, and contracting out. The range of services outsourced in OECD member countries is very wide. They include blue collar support services (building cleaning, catering), professional services that are considered ancillary to the core mission of the ministry or agency (information technology), and core government functions (prisons).

Public-private partnerships (PPPs) refer to arrangements whereby the private sector finances, designs, builds, maintains, and operates infrastructure assets traditionally provided by the public sector. PPPs can also involve the private sector purchasing already existing infrastructure assets and redeveloping them. Public-private partnerships bring a single private sector entity to undertake to provide public infrastructure assets for their "whole of life", generally 20-30 years. (The asset generally reverts to the government at the end of this period.) The private sector partner then charges an annual fee for the use of the infrastructure assets. This can either be paid by the government or through user charges, or a combination of the two. PPPs are also known as private finance initiatives (PFI), projects for public services, and private projects. PPPs have been most extensively used in the provision of transportation infrastructure, but other examples include schools, hospitals, office buildings, and water and sewage treatment facilities.

Vouchers separate the provision of public services from its financing. The funding remains with the government in the form of a voucher that is issued to individuals and which entitles them to exchange the vouchers for services at a range of suppliers. The individual voucher-holder chooses among the

different suppliers and pays with the voucher. Vouchers have been used for the provision of low-income (social) housing assistance, primary and secondary education, child care services, and care for the elderly.

Each of these mechanisms will be examined in turn.

3. Outsourcing

The primary objective of outsourcing is to increase efficiency by introducing a competitive environment for the provision of the services. The specific "business cases" for outsourcing generally cite one or more of the following points:

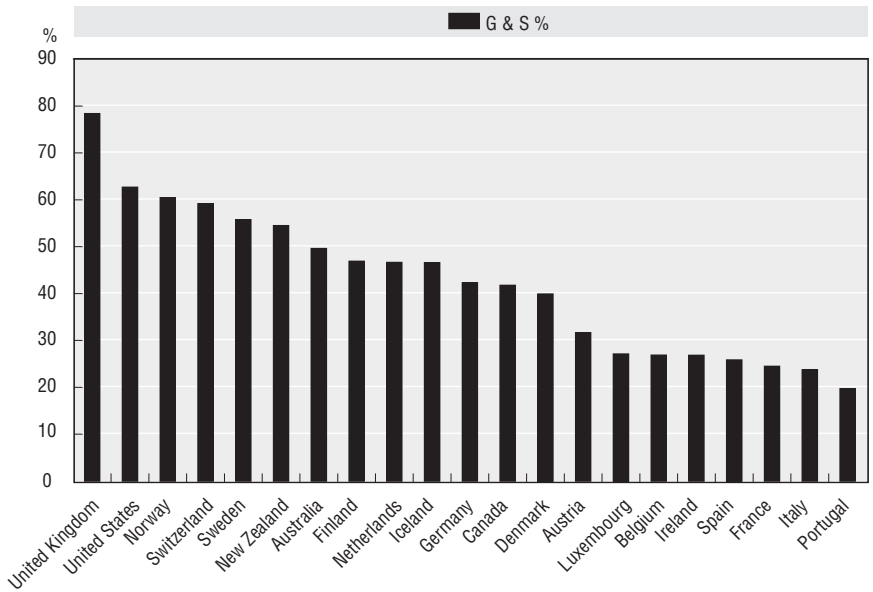
- to reduce costs;
- to access expertise not available in-house to meet one-off needs;
- to access expertise on a long-term basis in order to be able to vary its quantity and mix over time;
- to replace current government operations in extreme cases where their provision is unsatisfactory. This is rare and limited to cases where there is a long history of poor performance.

The use of outsourcing is clearly increasing in OECD countries although it is difficult to quantify precisely since governments do not maintain standardised or comparable data over time on their use. It should also be emphasised that outsourcing *per se* is not new in OECD countries. For example, the use of private contractors for the construction of various infrastructure projects has been the norm in most countries for an extended time. Conceptually, this was viewed as an acquisition (procurement) rather than as outsourcing.

Figure 1, using data from Government Finance Statistics (GFS; see International Monetary Fund, 2001) as a proxy, quantifies the use of outsourcing in selected OECD member countries. The figure looks at the share of government's purchase of all goods and services from outside vendors as a proportion of total expenditures, excluding transfers and interest payments. As such, the figure includes purchases of items that would generally not be classified as outsourcing, and the aggregate numbers should be deflated appropriately – most likely equivalent to about 15-20 percentage points of reported total outsourcing. The figure also applies only to central (national/federal) governments. As a result, country differences may in some cases reflect the different assignment of functions among different levels of government. Nonetheless, the strong variations between individual countries are striking.

Based on these calculations, the United Kingdom has the highest level of outsourcing activity among the selected countries. Its level of outsourcing is nearly four times that of the country with the lowest calculated level of

Figure 1. **Outsourcing of government services**
(purchase of goods and services vs. in-house provision)



Source: OECD Secretariat calculations based on GFS data.

outsourcing. In general, outsourcing is applied to a greater extent in the English-speaking countries and the Nordic countries, and much less so in the continental European countries. Among the first group of countries, outsourcing has also been increasing significantly in recent years. For example, outsourcing is estimated to have increased by 33% over the past 10 years in the United States (Eggers and Goldsmith, 2003).

Aside from different views of the appropriate role of the State, the strong country differences in the use of outsourcing also reflect the nature of the public sector labour market in individual countries. Continental European countries tend to have a less flexible public service which can make it prohibitively expensive to retrench public servants and outsource their activities.

3.1. Outsourced activities

The range of services outsourced in OECD member countries is very wide. These can be divided into three distinct groups. The first consists of various blue collar support services. These are generally the first activities that

governments outsource and are common to all countries. In some, the outsourcing of such services is essentially complete, with the government having withdrawn completely as a direct service provider. The second group consists of various activities that are considered ancillary to the core mission of the ministry or agency. This moves beyond the blue collar support services to include various high-value professional services – often "back-office" activities. This is an area where the greatest growth has occurred in recent years but country variations are more pronounced. The third group includes the outsourcing of mainline functions previously conducted by the government. These are core activities that many would view as inherently governmental. This type of outsourcing is rare across OECD member countries but is prominent in certain sectors in individual countries. The three groups are also progressively more challenging in implementation, including the availability of competitive supplier markets.

The first group includes services such as the cleaning of buildings, facilities management, waste management, operations of food service outlets and the provision of guard services. The common thread is that these services are generally low-value, relatively labour-intensive and not considered critical to the mission of the agency. However, these can take place under extreme circumstances – catering for combat soldiers in hostile environments or the protection of high-risk facilities such as nuclear sites.

The leading example of the second group is the outsourcing of information technology functions. This has been a major trend over the past years with private providers taking on ever larger parts of the information technology infrastructure in government ministries and agencies. This often entails the outsourcing of related back-office operations. Other common examples include the outsourcing of legal, human resource management, banking and financial services. These are generally high-value services that are ancillary to the core mission of an agency but are nonetheless critical to its operations. Another characteristic of this group is that the functions outsourced are often complex in nature and involve rapid change in their operating environment.

The extreme example of outsourced services that many would view as inherently governmental is the outsourcing of prisons (Australia, Canada, United Kingdom, United States). Other core functions that have been outsourced include emergency rescue and fire services (Denmark), enforcement activities such as food inspection (Iceland), and the services of the audit office (New Zealand).

The use of outsourcing in health, education and welfare services has made important inroads in certain countries. This includes employment (job placement) services, diagnostic services, specialised hospital care, care

centres for children, education, child welfare services, and long-term care institutions for the elderly and for the handicapped. Outsourcing in this field has in some cases been motivated primarily by the poor performance of the previous government providers. In some cases, contracts are awarded based on a standard competitive tendering process. In other cases, contracts are made with a set of suppliers allowing users a choice of supplier as with a voucher scheme (see the section on vouchers below).

The outsourcing of research and development functions whereby private institutions compete for project-based funding has increased significantly and is an area where government withdrawal from a core area has been most pronounced across OECD member countries. Similarly common is the outsourcing of technical assistance in foreign aid programmes of OECD countries. The use of outsourcing for the operation of various infrastructure assets – transportation, water supply, sewerage – is also increasing in individual countries.

The evidence that outsourcing increases efficiency is substantial, with extensive studies having been conducted on the impact of outsourcing on service quality and costs. A survey of 66 large cities in the United States found that 82% of the cities reported they were satisfied or very satisfied with the resulting performance, and the remaining 18% were neutral. None were dissatisfied. The report found a 25% improvement in service on average. The shift to a competitive environment also resulted in savings of up to 60% (Dilger *et al.*, 1997). A study of over 2 000 outsourcing initiatives in the United States federal government found an average cost savings of 33% with same or higher levels of service (Clark *et al.*, 2001). In other countries, average cost savings have been estimated at 15-20% in Australia, 5-30% in Denmark, 20-25% in Iceland, and 20% in the United Kingdom.

3.2. Key issues

A number of governance-related issues arise from outsourcing, many of which are applicable to the use of market-type mechanisms more generally. There are strong obstacles to the introduction of outsourcing. This can be due to public concern about private sector involvement in traditional government activities. The variety of services outsourced in different countries shows that there are very few services that technically cannot be outsourced. Where outsourcing involves a direct challenge to existing government service provision there may be strong resistance from affected government employees, unions and their political allies.

Some OECD member countries have introduced mandatory policies to require market-testing (competitive sourcing) where existing employees compete with private providers for the provision of the services. This may be

appropriate in the introductory phases of a new outsourcing policy but it creates a very adversarial relationship. More sustainable is to mainstream outsourcing policy and for it to become an established feature of everyday management decisions. Tight budgetary restrictions are a key impetus for achieving this as they promote the use of best value-for-money solutions for the provision of government services. Such an approach also makes outsourcing a more dynamic opportunity for re-engineering government services rather than being a mechanistic consideration of outsourcing existing services.

Outsourcing can generate governance concerns in terms of the accountability for the services being provided by a private contractor. This is especially relevant when that service is being provided directly to citizens on behalf of the government.

In the traditional provision of public services, accountability was essentially an in-house affair based on hierarchical controls focusing on inputs and processes. Outsourcing introduces a separation between the purchaser and provider and requires the specification of the services to be delivered together with appropriate performance measures. This should serve to significantly enhance accountability. Performance is now monitored against explicit standards, and the potential conflict of interest of having the same organisation (or even the same official) responsible both for assessing performance and acting as the service provider is avoided.

Accountability can however become blurred in this environment simply because of the introduction of a new actor. In the traditional model, accountability was clear in the sense that it was one organisation responsible for the whole process. With outsourcing, the government entity is still accountable for the service provided, including actions carried out on its behalf by the contractor, but day-to-day responsibility for specific actions will lie either with the government entity or the contractor. It may be difficult for the users of services to determine who is responsible for the delivery of the service, especially if this division of responsibility is not clear as can be the case.

In this context, the inherent political nature of the public sector needs to be recognised as well, and the role it can play in superseding a purely commercial framework. The public and the media will always hold a minister accountable overall and responsible for the specific actions of contractors. Similarly, public and media pressures focused on specific outsourcing activities can serve to override specific commercial terms in a contract, generally resulting in a renegotiation of the contract at higher cost. Such risks need to be taken into account.

The capacity of governments to outsource effectively needs to be established and sustained over time. This involves both retaining the technical expertise of the function being outsourced and developing the

commercial skills for managing the outsourcing process. Based on countries' experiences, there is a risk that the technical capacity to assess future outsourcing options will be lost over time as the government is no longer directly providing the service. This may lead to a dependency on the incumbent contractor when the activity is re-tendered and/or may preclude the government from taking the activity back in-house. The commercial skills inherent with outsourcing are typically new to governments and need to be built up. It is important that these skills become an established and ongoing function rather than being seen as a one-off exercise each time. This has important implications for human resource management and internal structures of organisations.

The implications are well demonstrated in a report by a committee of the Australian Parliament reviewing the use of outsourcing for support services by the Australian Defence Forces (ADF):

> *Frequently, the successful tenderer for the support contract relies on recruiting the trained Defence personnel who have been made redundant in the ADF because of the function's transfer to the commercial sector. Through employing these already-trained personnel, the successful civilian tenderer is able to provide a commercially attractive initial price for a support capability because there is no need to factor in staff training costs in the contract. This process becomes disadvantageous to Defence where the successful tenderer becomes the monopoly supplier of the support service, and Defence must subsequently renegotiate that contract from a position of weakness, having eliminated its own in-house capability to perform the particular function.*
>
> (Joint Standing Committee on Foreign Affairs, Defence and Trade, 1998, p. 35)

Concerns have been raised about the nature of contract specificity in the public sector. Government contracts have a tendency to be prescriptive and process oriented, whereas private sector contracts tend to be more output (or outcome) oriented. There are several reasons for this. First, government agencies are rightly concerned with the accountability implications of outsourcing as noted above and are often more comfortable with these traditional means. Second, this may be a manifestation of resistance to outsourcing in agencies and designed to undermine its success. Third, it may be difficult to specify outputs (or outcomes) in concrete terms in some instances – in which case the decision to outsource in the first place should be questioned. The more prescriptive or input oriented the contract is, the more difficult it is for the contractors to be flexible and innovative in order to secure efficiency gains, which is the *raison d'être* for outsourcing.

The studies cited above on gains from outsourcing generally show the lower range of savings coming from input or process oriented contracts

whereas the higher range of savings come from output (or outcome) oriented contracts. An innovative solution is for governments to engage in a two-stage bidding process. First, the government formally issues a tender offer but specifies its needs only in general terms. Contractors are invited to be creative in responding to those needs. Based on the information gathered in this first round, the government puts out a more detailed tender offer in the second phase (Healy and Linder, 2003). This strives to achieve a balance between efficiency (flexibility) and specificity.

In general, the flexibility (discretion) of a contractor needs to be weighed against the notion of regularity (equal treatment) which is a hallmark of the public sector. Contractors' discretion can become an issue when a service provider is accorded "the power of the State" in determining eligibility or levels of eligibility for certain services (for example, case management in social services). Similarly, contractors could offer services to different client groups in different manners. For example, an outsourced job placement provider may decide to provide an individual client with a bicycle in order to commute to a new job. As a result, the service provider secures a payment from the government for having successfully placed the individual in a job. However, there may have been another individual in a largely similar situation who was not provided with a bicycle. *Prima facie* this could be interpreted as violating the regularity principle of the public sector. As part of their contracting functions, governments will need to be clear in establishing the boundaries for appropriate flexibility (discretion) in such cases.

Competitive supplier markets are a prerequisite for successful outsourcing. The government has a clear role to play in developing and sustaining such markets. Depending on the service that the government is outsourcing – commodity-like services *vs.* highly specialised services – such markets may not be in place when the government embarks on outsourcing. The government may in effect have to create such markets through its volume buying. As a result, the full efficiency gains achieved by outsourcing may materialise over time. The government also needs to ensure that its outsourcing policies promote sustainable competitive markets by avoiding over-reliance on a single supplier. Similarly, the length and size of individual contracts can impact the number of potential suppliers. In short, the government needs to focus on the impact on the supplier market-place of individual outsourcing decisions (United Kingdom Office of Government Commerce, 2003).

Lowest cost is traditionally the main criterion that determines a winning bid. There are examples of suppliers submitting unrealistically low bids ("low-balling") and then engaging in post-contract negotiations over the lifetime of the contract to increase the price. Such practices undermine individual

outsourcing projects and may lead to reliable suppliers withdrawing from the government market-place in general.

As discussed above, transparency is clearly enhanced with the specification of services to be delivered together with appropriate performance measures. However, there are some aspects inherent with market-type mechanisms that can reduce transparency. This is due to the fact that information which was previously in the public domain is now in the hands of private contractors; the public's right to access that information may be impaired. The general tendency in the private sector is for contents of contracts not to be made publicly available. They are considered commercially sensitive. This may justifiably apply in some cases (for example, protection of intellectual property) but is otherwise inappropriate in the public sector context. Appropriate information needs to be publicly available in order for outsiders to be in a position to make an informed judgement about the contracting decision. More generally, contract provisions need to ensure that sufficient information is turned over from the private provider to the purchaser organisation in order for the latter to maintain up-to-date knowledge of the activity for future tendering, *i.e.* maintaining capacity to avoid capture by the private provider.

Finally, the public sector has over time developed elaborate redress instruments for citizens. These include laws on administrative procedure, Ombudsmen, freedom of information, whistleblower protection and the like. In general, the jurisdiction of such instruments does not extend to private sector providers. It is therefore important for contracts to incorporate appropriate redress mechanisms. These will of course vary on a case-by-case basis but are most applicable to where the contractor is exercising a degree of flexibility (discretion) as noted previously. Governments will also need to ensure that contractors employ appropriate mechanisms to protect the privacy of confidential information they acquire on individual citizens.

3.3. Conclusion

Outsourcing has grown significantly over the past 15 years. It has been shown to be applicable to a wide range of government services. Apart from transitional concerns relating to the disturbance of vested interests, or change in the familiar profile of government, the constraints relate to the degree to which the delivery of the service can be monitored at arm's length, the need to maintain government's core capacity now and for the future, and the protection of other core governance principles. The benefits of outsourcing in terms of increased efficiency can be significant and the services that have been outsourced rarely revert back to government provision. Outsourcing can be expected to increase substantially in the coming years.

Box 1. **Staff issues associated with outsourcing**

The manner of moving to outsourcing is important. Staff will generally resist outsourcing initiatives, and morale among staff can decline during the process. The outsourcing process can take an extended period of time with anxiety building up during this period especially if communications with employees are poor. This insecurity caused by not being kept informed has been cited by some as the main staff concern in outsourcing.

Employees are often transferred to the private provider with their working conditions guaranteed, at least for a certain time period. It is by no means a given that working conditions will deteriorate with outsourcing. For example, a staff member whose function is ancillary to the core work of an agency will likely have an improved career track in a firm that specialises in that "ancillary" function.

There is specific legislation in place for the transfer of employee rights with outsourcing in the European Union. In the United States, federal legislation is in place that stipulates that certain benefits (for example, health care) offered by private providers have to be comparable to those for government employees. In some countries, a "clean break" approach is preferred whereby the government settles any redundancy payments and there are no transfers of rights. Governments may also have policies in place whereby preference is given to staff affected by outsourcing for other positions if they do not want to leave government employment.

4. Public-private partnerships

Public-private partnerships (PPPs) refer to arrangements whereby the private sector finances, designs, builds, maintains, and operates (DBFMO) infrastructure assets traditionally provided by the public sector.[1] Private sector involvement in individual aspects of DBFMO has been the norm in most OECD member countries for an extended time. Governments contract with private sector architects for the design of assets, with private sector contractors for the construction of assets, with various private sector entities for the maintenance and operation of assets. These have, however, been discrete activities with different private sector contractors performing each different aspect. With PPPs, a single entity is responsible for the infrastructure's "whole of life". As such they can be viewed as a specialised form of outsourcing, with the very notable difference that the private partner is responsible for providing the financing for the project.

Public-private partnerships – as a distinct concept – originated in the United Kingdom in 1992. The United Kingdom is today by far the largest user of PPPs among OECD member countries. Their use has, however, expanded to virtually all other OECD countries. Table 1 provides an overview of PPP activity in selected countries.

PPPs have most commonly been applied for the provision of highway infrastructure. For example, Portugal's ambitious EUR 5 billion National Road Programme employs PPPs. They are also used for other transportation infrastructure, such as airports and railways. The Netherlands is using a PPP programme to introduce high-speed rail links for the Thalys trains in the Netherlands. The new Athens airport was built on a PPP basis. The light rail linking Stockholm with Arlanda Airport employed the PPP model. PPPs are increasingly being used for environmental infrastructure projects such as water systems and solid waste facilities. In terms of number of projects, the greatest use has been for the provision of buildings – including schools, hospitals, nursing homes, prisons, embassies and general office buildings. In these cases, PPPs generally cover the building only and not the specialised services operated in the respective building. For example, the clinical services of a PPP-procured hospital would not be the responsibility of the private partner.

The extent of use of PPPs should, however, not be exaggerated. In the United Kingdom, only about one-tenth of its total capital investments in public services in 2003-04 were through PPPs and this has been relatively consistent over time. In other words, about nine-tenths of investments are conducted through traditional procurement practices.

Appropriately structured PPPs have the potential to improve the efficiency of the design-build-maintain-operate phases. The largest analysis of a PPP programme was undertaken in the United Kingdom in 2003 (H.M. Treasury, 2003). Nearly 90% of all PPP projects were delivered on time by the private partner whereas only approximately 30% of non-PPP projects were delivered on time. Four-fifths of all PPP projects were delivered on budget whereas only one-fourth of non-PPP projects were delivered on budget. All PPP projects that experienced budget overruns were due to changes in requirements by the government. In terms of operational performance, 35% of projects were assessed as "expected", 16% as "surpassing", 25% as "far surpassing" expectations. One-quarter of projects, however, did not meet expectations. (This analysis can also be seen as an indictment of the traditional procurement process for such projects in the United Kingdom.)

Analysis of other national PPP programmes have not been undertaken in such a comprehensive manner but the general assessment is similarly positive with the design-build-maintain-operate phases.

Table 1. **Summary of PPPs by country and sector**

	Principal sectors of PPP activity					Subsidiary sectors of PPP activity					
	Roads and bridges	Light railway	Heavy railway	Schools	Health and hospitals	Central accommodation	Airports	Housing	Ports	Prisons	Water and wastewater (including solid waste)
EU Member States											
Austria	▲		▲	●	▲	●	●			●	●
Belgium	▲	●	●	●			▲	▲			▲
Cyprus	▲						♦		▲		▲
Czech Republic	▲	●	●	●	●		●	●			♦
Denmark	▲		▲	▲		●			▲	●	
Estonia	●			●	●						
Finland	▲	●	●	▲	●	●					●
France	★	★	▲	●	▲	▲	▲		▲	▲	★
Germany	♦	♦	♦	♦	●	▲	●			▲	■
Greece	♦					●	★				
Hungary	♦	●		♦	▲			●		▲	♦
Ireland	■	▲		♦	▲	●		▲			■
Italy	■	♦			♦	●	▲	●	▲	●	▲
Latvia	●							●			
Lithuania		●									
Luxembourg							●				
Malta					▲			●			
Netherlands	♦		♦	▲	●	●		●	●	●	♦
Poland	▲	●	●			●	●	●	▲		▲
Portugal	★	♦	●	●	▲		●	●	●	●	♦
Slovakia	●						●				●
Slovenia											♦
Spain	★	♦	●	●	▲	●	●		★		♦
Sweden	●	●	●		●						
United Kingdom	★	★		★	★	★	★	★		★	★
Others											
Bulgaria	●						●				♦
Norway	♦		●	▲	▲	●				●	
Romania	♦				▲			●			♦
Turkey	●	●	●				♦				♦

Legend
• Discussions ongoing
▲ Projects in procurement
♦ Many procured projects, some projects closed
■ Substantial number of closed projects
★ Substantial number of closed projects, majority of them in operation

Source: European Investment Bank (2004), *The EIB's role in public-private partnerships*.

4.1. The transfer of risk

The objective of PPPs is to achieve efficiency gains through competition by private sector providers, transferring risks from the government, and taking advantage of private sector expertise. The effective transfer of risk is paramount to the success of PPPs and a key distinguishing factor of the PPP concept. There are a great number of specific risks but they can usefully be divided into three broad categories: construction risk, availability risk and demand risk.[2]

Construction risk covers events such as late delivery, additional costs, and technical deficiency. If the government is obliged to start making regular payments to a partner without taking into account the effective state of the asset, this would be considered evidence that the government bears the majority of the construction risk.

Availability risk is when the partner does not deliver the volume that was contractually agreed or fails to meet specified safety or public certification standards relating to the provision of services to final users. It also applies where the partner does not meet the specified quality standards relating to the delivery of the services. If the government is obliged to continue making regular payments regardless of the lack of availability of the asset, it is deemed that the government bears the majority of the availability risk.

Demand risk covers the variability in demand (higher or lower than expected when the contract was signed) irrespective of the behaviour of the private partner. This risk should only cover a shift in demand not resulting from inadequate or low quality of the service provided by the partner or any action that changes the quantity/quality of services provided. Instead, it should result from other factors, such as the business cycle, new market trends, direct competition or technological obsolescence. If the government is obliged to ensure a given level of payment to the private partner independently of the effective levels of demand expressed by the final user, rendering irrelevant the fluctuations in level of demand on the private partner's profitability, the government is deemed to bear the majority of the demand risk.

The efficiency gains with PPPs derive from these transfers of risks and the whole-of-life perspective. For example, the quality of the design and build phases will have a significant impact on their subsequent maintenance and operation. The private partner has a direct financial interest in ensuring the long-term success of the project.

The objective, however, is not simply to transfer as much risk as possible to the private partner, but to assign risks to the party that is best able to manage them, whether they remain with the government or go to the private partner. In short, the entity that is best able to mitigate each risk should be responsible for it. Transferring too little risk and transferring too much risk are

both equally undesirable. The government will expose itself to excessive contingent liabilities if it transfers too little risk whereas transferring too much risk can result in the private partner demanding an excessive fee for taking on the risk. There are no comprehensive rules as to what is the appropriate distribution of risk since all projects are different.

4.2. Financing

It is crucial that the private partner provide the project financing in order to have the proper incentives and assume the appropriate risks. If non-performance occurs, not only will the private partner be deprived of the annual fee paid by the government, but it will continue to be responsible for servicing the debt associated with the project. This is a powerful financial incentive for performance.

The major debate with PPPs, however, concerns the financing phase – notably how PPP financing relates to the traditional budget system and the cost of capital for the private partner.

The use of PPPs may offer governments – specific ministries – the possibility to bypass the established processes for ensuring budgetary discipline and constraining expenditure. Traditional procurements would record the investments as a "lump sum" up front and would form part of the government's bottom-line surplus or deficit in that year. It would be subject to the same scrutiny as other expenditures. In a PPP environment, the investment may not be recorded up front, with only the annual fee paid to the private partner being recorded in each year's budget for the infrastructure's "whole of life". The original investment could escape the scrutiny of the budget process, and future flexibility could be limited by the annual fees required to be paid to the private partner.

If a PPP is structured in such a way as to move the majority of the risk to the private partner, it may be appropriate to record investment and associated debt off budget. For example, the fiscal criteria for the European single currency allow governments to record transactions this way if the construction risk and either the availability risk or demand risk are transferred to the private partner. These are however very liberal criteria. Outside the EU, not even such criteria apply. No international public sector accounting standards (IPSAS) have been developed. In fact, governments could retain all the risk and use the PPP device solely for the purpose of not recording the transaction on budget.

The private partner's cost of capital will always be higher than the government's "risk-free" cost of capital. This is regardless of whether the payments by the government for the project, as called for in the PPP contract, are used as collateral by the private partner for obtaining financing for the loan.

The government's power to tax reduces default risk *vis-à-vis* other borrowers such that the private sector is willing to lend money to governments at a risk-free rate regardless of the underlying risks associated with the projects that the government may use the money for.[3]

It is, however, important to note that PPPs involve a transfer of risk from the government to the private partner, thus relieving the government of such contingent liabilities. The government's risk-free cost of borrowing does not reflect such project risks as discussed above, whereas those risks are very real. The private partner's cost of borrowing will, however, incorporate the project risks. It is inherently difficult to isolate, analyse and quantify this risk premium. It is nonetheless a fact that a private partner will have a higher cost of capital than the government, and whether the transfer of risk from the government is commensurate with that is difficult to establish (International Monetary Fund, 2004). From a public finance point of view, a PPP can only be justified if the transfer of risks and the efficiency gains outweigh the higher cost of capital. It is therefore essential that the decision to use the PPP model as opposed to traditional procurement be based on a rigorous and dynamic comparison of the benefits and costs of each approach.

4.3. Conclusion

The use of PPPs stabilised at around one-tenth of total annual capital procurement in the one country where it has been most extensively used. PPPs appear to be most appealing for large-scale projects that involve extensive maintenance and operating requirements over the project's "whole of life". This explains why highways are such prominent examples of PPPs. The size of the projects is a prerequisite since the transaction costs involved in preparing the project for bid and negotiating the contracts are such that they can only be justified for large-scale projects. The bundling of projects or the use of standardised contracts may be possible for certain smaller projects. The unique efficiency gains associated with PPPs derive from the interaction of the design-build-maintain-operate phases. The greater the maintenance and operation components, the greater the potential for efficiency gains.

The appropriate allocation of risk between the government and the private partner is fundamental to the success of PPPs. Certain risks – such as changes in government regulatory or taxation policy – should not be transferred since they serve only to increase costs. A more common problem is the tendency for governments to retain the majority of the risks with PPPs. This undermines the PPP concept and may reveal that it is only being used as a vehicle to move the transaction off budget.

A comparison of the benefits and costs of PPPs versus traditional procurement needs to be rigorously and dynamically conducted, and PPPs

should be subjected to at least the same scrutiny as traditional expenditures in the budget process. In general, the governance issues identified for outsourcing apply equally to PPPs.

5. Vouchers

In a voucher environment, the provision of public services is separated from its financing. The funding remains with the government in the form of a voucher which is issued to individuals, entitling them to exchange the vouchers for services at a range of suppliers. The individual voucher-holder chooses among the different suppliers and pays with the voucher.

Four definitional issues are in order. First, the vouchers are for the use of specific services only; they are not in the form of cash. Second, the voucher can equal the total or part of the cost of the service. Third, the eligibility for the voucher may extend to the whole population or may be limited to certain groups or be means-tested. Fourth, the suppliers can be both government bodies and private bodies, or private bodies only. Regardless, the government monopoly on service provision is ended and consumers have the right to choose among suppliers. This should lead to greater efficiency, notably in terms of quality improvements.

Vouchers can take at least three main forms. An explicit voucher is a physical coupon or smart card as described above; the supplier of the services in turn exchanges this for cash from a government body. An implicit voucher takes the form of a qualifying recipient choosing from a number of designated suppliers and, upon registering with one of them, the government pays directly to that provider of the service. The third form is for the government to reimburse the user for expenditure on qualifying services from approved suppliers. This would most often be through the tax system, but can equally take place as a traditional government expenditure programme. From the point of view of the user, these three main forms offer a choice of suppliers with the government financing the service.

5.1. *Use of vouchers*

The extent of use of these three forms of vouchers is significant in some sectors in OECD member countries, with their use being mainly focused on housing, education (primary and secondary), child care (nursery education), and care for the elderly.

Housing assistance to low-income families is a particularly good example of vouchers. Instead of large housing estates that cluster low-income families together, vouchers in this field offer them the possibility to participate in the general housing market. These explicit vouchers are generally designed such that they provide for the difference between actual rent paid, up to a limit

based on family size and local housing market conditions, and a certain percentage of the recipient's salary. The amount of the housing voucher is then adjusted regularly based on housing market trends.

Examples include the "Section 8" vouchers in the United States (launched in the mid-1970s) which provide benefits to about 2 million low-income households and had a total cost of $21.2 billion in 2003. A report by the independent congressionally-chartered Millennial Housing Commission strongly endorsed the voucher programme in its May 2002 report, describing the programme as "flexible, cost-effective, and successful in its mission."[4] Another prominent example is the "accommodation supplement" in New Zealand (launched in 1993), which provides benefits to 250 000 people. The New Zealand voucher programme does not differentiate between rent or mortgage payments. Similarly, tax credits for the reimbursement of mortgage interest expense can be viewed as a type of "reimbursement" voucher as described above.

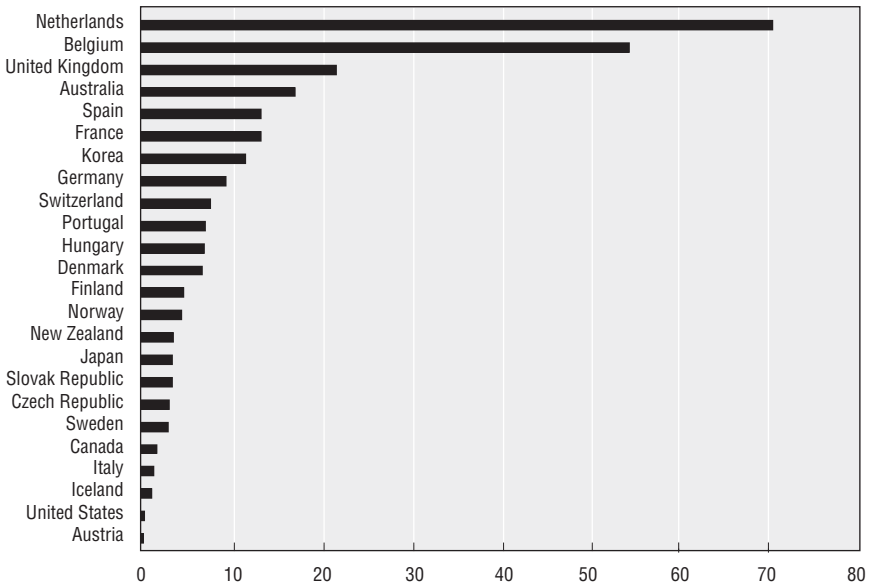
Box 2. **United States food stamps programme**

The United States food stamps programme is the largest and oldest explicit voucher programme in OECD member countries. Started in 1961, it provides 19.1 million low-income individuals with an electronic card they can use like cash at most grocery stores to ensure that they have access to a healthy diet. The programme cost $23.9 billion in 2003. Interestingly, the programme is operated by the Department of Agriculture rather than a social services body.

Vouchers are most often discussed in terms of primary and secondary education. Figure 2 shows the percentage of total public expenditure for primary and secondary education that goes to private institutions in selected OECD member countries.

Most strikingly, over 70% of public funding for primary and secondary education in the Netherlands goes to private schools. There is a provision in the constitution (since 1917) which guarantees equal government funding for students in public schools and private schools. Most of the private schools have some linkages to churches. There is a standard minimum national curriculum which applies for both public and private schools. Public schools are not permitted to charge additional fees whereas private schools can. In practice, the private schools limit their charges to financing smaller class sizes and to the funding of "fringe" benefits such as excursions and sports facilities.

Figure 2. **Public expenditure on private institutions**
(percentage of total public expenditure on education)



Source: OECD Education Database.

The government funding is provided through an implicit voucher in that each school – whether public or private – receives an equal amount per student enrolled.

In 1992, Sweden embarked on a policy that also guarantees equal government funding to public and private schools. The share of students attending private schools has grown to 4%. Unlike the Netherlands, these schools are for the most part not affiliated with any religious group but rather differentiate themselves according to teaching methods or a focus on specialised subjects. Some schools use a foreign language as the main teaching language and/or cater to specific ethnic populations. The private schools are not allowed to charge tuition fees and must accept all pupils from their immediate geographic area. The government funding is also provided through an implicit voucher.

The use of explicit vouchers for primary and secondary education is most documented in the United States but its use is very limited. They have met strong resistance from public school teachers and their allies. Explicit vouchers are indeed used in some cities but they generally provide funding to relatively few students to opt out of the public school system and enrol in private schools. They cater mainly to students from disadvantaged

backgrounds. The programmes are so small in aggregate that their overall impact is minimal as can be seen from Figure 2.

A related development in the United States is the creation of charter schools which operate on an implicit voucher basis, *i.e.* the government provides funding for them in the same manner as public schools. In fact, most of the schools are part of the normal public school system but cater specifically to students from disadvantaged backgrounds. A few of these schools can however be viewed as private in nature.

Vouchers are also used for the provision of child care (nursing care) services.[5] The most comprehensive of such reforms have been implemented in Australia. Those reforms aimed at equalising the level of public funding per child across public and private institutions by channelling all public funding through users, replacing the previous system based on grants to non-profit organisations and local governments. Now, public funding is distributed to families via the "child care benefit" earmarked for child care provided in government-approved services. As a result, the public subsidy is equal across different institutional settings, including for-profit and non-profit community-based day care centres and to some extent family-based day care. The Netherlands and Norway are currently considering similar comprehensive reforms. In the United States, child care vouchers have gained ground in federal family support programmes since the early 1990s. Whereas previously under this programme services were provided through direct funding to public institutions or through grants or contracts with selected private child care institutions, recipients are now entitled to a voucher or cash benefit giving access to a wider range of care facilities.

Tax credits and cash benefits conditioned on documented expenses for private child care, however, exist in many OECD countries. In some cases these subsidies and tax credits are targeted at low-income and working families to improve their work incentives. This is the case in Canada, Germany, the United Kingdom and the United States. Indirect public funding through tax credits and other support for employer contributions to child care expenses play a role in some countries including Belgium, Italy, the Netherlands and the United States.

Vouchers have also been used for the long-term care for the elderly where publicly funded provision is growing relatively rapidly in OECD countries. Care may take place in public and private residential institutions or at home, and there are often tax credits and income support for the (informal) employment of personal attendants acting as carers.

Providing publicly funded long-term care in private nursing homes and residential institutions typically takes the form of vouchers – either implicit vouchers paid directly to the institution based on the number of residents, or

reimbursing the fees paid by residents in part or in whole. Table 2 and Figure 3 show that publicly funded long-term care expenditure is significant in many countries. Furthermore, increasingly often, public finance goes to private providers. For example, over 80% of beds in institutions are private in Germany, the United Kingdom, and the United States, and around half of institutional beds in Canada, Ireland and the Netherlands are privately run. Exceptions are Finland, Norway and Sweden, with only 10-15% private residential institutions.

A growing range of programmes provides allowances for the families of the elderly and disabled to retain their role as caregivers, or for the elderly to employ personal attendants of their own choice. A key motive for their introduction in this sector is to promote home care, as this form of assistance is substantially less expensive than institutional care. This most often takes the form of an explicit voucher or the use of tax credits. The French scheme, introduced in 1997, allows the user to choose among different forms of care, including employing a personal attendant, with the restriction that family members can only be hired if currently unemployed. Likewise, the Finnish

Table 2. **Public and private expenditures on long-term care as a percentage of GDP**

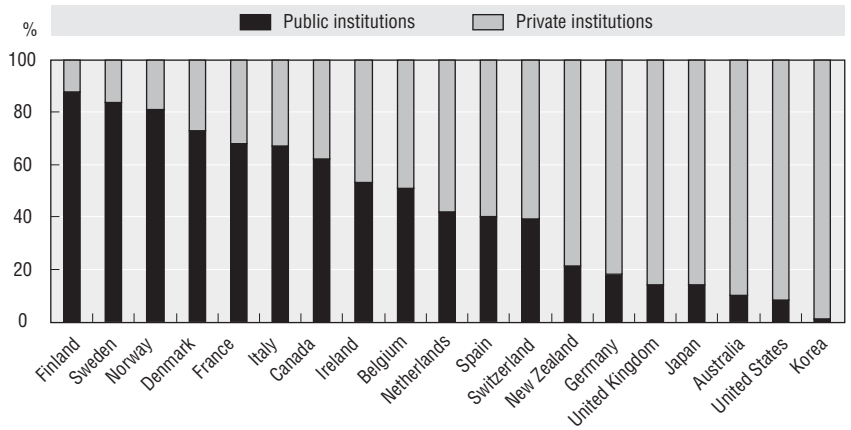
	Public expenditure			Private expenditure		
	Home care	Institutions	Total	Home care	Institutions	Total
Australia*	0.31	0.57	0.88	0.08	0.26	0.34
Austria	0.81	0.51	1.32	n.a.	n.a.	n.a.
Canada	0.25	0.83	1.08	0.00	0.17	0.17
Germany	0.42	0.50	0.93	0.05	0.17	0.22
Hungary	--	--	<0.20	--	--	<0.10
Ireland	0.19	0.33	0.52	0.00	0.10	0.10
Japan	0.25	0.51	0.75	n.a.	n.a.	n.a.
Korea	<0.10	<0.10	<0.20	n.a.	n.a.	n.a.
Luxembourg	0.15	0.37	0.52	n.a.	n.a.	n.a.
Mexico	--	--	<0.10	--	--	<0.10
Netherlands	0.56	0.78	1.34	0.05	0.02	0.07
New Zealand	0.11	0.39	0.50	0.00	0.27	0.27
Norway*	1.03	1.08	2.10	--	--	0.11
Spain*	0.05	0.11	0.17	0.18	0.26	0.44
Sweden*	0.82	2.06	2.89	--	--	0.14
Switzerland	0.17	0.53	0.70	0.04	0.85	0.89
United Kingdom	0.32	0.58	0.89	0.03	0.20	0.23
United States	0.25	0.50	0.74	0.13	0.38	0.52

* Data is for age group 65+.

Source: Pearson and Martin (2005, forthcoming).

Figure 3. **Public and private institutions in long-term care for the elderly, late 1990s**

(share of beds in nursing homes and residential care institutions)[1]



1. This figure is based on collection of available national material where the exact definitions may vary. Generally only staffed homes providing nursing care and/or practical help with activities of daily living are included while long-stay hospital sections are not included.

Source: OECD based on national sources.

informal carer's allowance introduced in 1993 allows the user to employ a personal attendant, with the allowance being paid directly to that person. The German scheme introduced with the separate mandatory insurance for long-term care in 1995 allows users a choice from a menu of service provision and cash benefits.

This shows the wide range of sectors where vouchers can be utilised. Some of the areas are in their infancy or development phase, and the use of vouchers can be expected to increase in future years.

5.2. *Key issues*

An analysis of OECD member countries' experience with the use of vouchers shows that there are several critical design and contextual factors associated with the successful use of vouchers.

As with all market-type mechanisms, the need for competitive markets is paramount – the voucher-holders must be able to exercise a genuine choice of suppliers. Some of the areas where vouchers are most commonly used – primary and secondary schools being the outstanding example – tend to exhibit characteristics of local monopolies. Consumers place such a value on the proximity of the service that it outweighs the fact that more distant service

providers may offer a higher quality of service. As a result, the provider will not be under competitive pressure to improve performance.

For some types of vouchers, there is a tendency to establish rigidly defined service standards so that little or no product differentiation may be possible from suppliers. Again, this is especially the case in education. The benefit of multiple providers offering innovative services, perhaps serving niche markets, is therefore pre-empted. A preference for using "minimum" standards with room for substantial differentiation should be made.

A short-term shortage of attractive suppliers is not uncommon. Many services where vouchers are used require a heavy investment in order to expand the supply of services by individual providers. For housing vouchers, a tight housing market may also make their use difficult since the built-in adjustment mechanisms for market conditions tend to lag.

It may also be difficult for users of services to make informed judgments about individual service providers. This undermines the competition mechanism. Many public services are not "search goods", with the characteristic that an individual can find out everything about the service before making a choice. Rather, they are "experience goods" where the consumer only finds out about the service in the course of using it. This problem is accentuated by the fact that many public services are not consumed repeatedly, or that it is costly to switch from one provider to another.[6] League tables of performance of individual providers, such as test scores for schools or quality ratings by current and past users, can serve to alleviate this problem. Users, however, have much greater ownership of decisions they make themselves and this itself has a positive impact on their experience of the goods.

The capacity of individuals to assess the services offered by different providers may also be impaired in some instances, long-term care for the elderly being a prime example. This calls for a stronger role for the government in certifying suppliers and guiding the choice of users. Although it can mitigate the competition mechanism inherent with vouchers, the information provided by the government can lead to more informed (and more competitive) choices.

Voucher programmes often entail a prohibition of top-up payments whereby recipients can use their own resources to supplement the voucher. These are seen as unfair by some observers since they allow richer recipients to enjoy higher quality public services. On the other hand, such payments will facilitate a better match of the quality of services offered and the users' capacity to pay and can lead to increased product differentiation which is a key benefit of the voucher concept. Such prohibitions therefore need to be reviewed carefully.

The payment structure of the voucher can have perverse incentives. If a voucher offers a uniform payment level irrespective of the costs associated

with servicing different categories of users – such as disabled children in child care, lower-score students in education or weaker persons in long-term care – this can accentuate cream-skimming behaviour from suppliers. In such conditions there is an incentive for private suppliers to screen voucher recipients for those who cost less than others and to exclude higher-cost recipients. A payment structure that recognises such differences is key to alleviating this potential problem.

The extent of voucher use in OECD member countries is significant. They are, however, subject to unique challenges in terms of design and contextual factors. An inappropriately designed voucher can simply accentuate pre-existing problems with the delivery of public services.

A major concern raised about vouchers is that they exert an upward pressure on public expenditure. Vouchers are generally available to all who meet a certain eligibility criteria. They are therefore demand-driven entitlement programmes. Previously, the expenditure associated with these programmes could generally be controlled by limiting supply. Similarly, vouchers that are based on formulas for the calculation of the benefit, for example rental assistance vouchers that are related to developments in wages and the cost of housing, can lead to significant and sudden expenditure increases. Both of these factors demonstrate the strength of vouchers from a consumer point of view, but they are sources for concern from a budgetary point of view. The rental vouchers in the United States are coming under strain for these reasons.

6. Findings and future challenges

There are several key messages emerging from this paper concerning the use of market-type mechanisms and their implications:

- The diversity of experiences among OECD member countries shows that market-type mechanisms can be applied to a very wide range of government functions.
- There are strong entry barriers to adopting market-type mechanisms. This is a function of the public's view of "the role of government" and also a function of the resistance by government staff affected by their introduction. This explains, for example, why the resistance is greatest to outsourcing and vouchers which directly challenge existing government service provision but less pronounced with other market-type mechanisms.
- The efficiency gains associated with market-type mechanisms can be substantial. These can be either in the form of decreased costs, improved service quality levels, or improved resource allocation economy-wide. The discussion showed, however, that care needs to be taken in their design to achieve these efficiency gains.

Box 3. **Other market-type mechanisms**

This paper has surveyed the experience in OECD member countries with outsourcing, public-private partnerships and vouchers. This box briefly highlights two other market-type mechanisms.

User charges assign to the specific consumers the full or partial cost of providing the respective services. User charges thereby create a direct link between the benefits and costs of consuming public services and thus aim at removing excess demand for previously "free" public services. Three types of user charges can be observed. The first concerns internal charges among government agencies. Previously, common service agencies may have received direct appropriations for services which they then supplied "free" to other agencies. With user charges, it is the agencies that consume the services that are given the budget. They now have an incentive to limit their use of common services – or seek them from alternative sources if permitted – since any savings accrue to them. The second form of user charges concerns services delivered to business and industry. These may include various regulatory services. Such charges are generally full cost recovery, and the primary motive is to relieve the general taxpayer of services benefiting specific users. The line between user charging and taxation is especially thin in this case. The third type is charges to individual citizens. These may include various education, health care and social services. These charges are usually partial, and the primary motive is to discipline user demand.

Transferable permits are mainly used for the allocation of scarce resources instead of regulatory measures such as comparative hearings ("beauty contests") and lotteries. The government establishes a maximum amount of the resource that can be used, allocates it in the first instance by grandfathering current/past users or auctioning the permits to the highest bidder, and then allows a secondary market in the permits to operate whereby they can be sold to the highest bidder. This is the optimal economic allocation. This mechanism has been used for fisheries (where the allocation is the percentage of each year's allowable catch), airport landing and take-off slots, and the radio spectrum (3G mobile phone licenses). It is much discussed for greenhouse gas emissions as well, since one ton of greenhouse gas emitted anywhere in the world has the same effect, and an international system of transferable permits would allow the reductions to take place at lowest cost.

- It is perhaps most surprising that market-type mechanisms are not more widely used in OECD member countries considering their potential for efficiency gains. Again, this highlights the strong entry barriers for their adoption.
- The ability to maintain key governance principles needs to be considered as an inherent part of the decision to adopt market-type mechanisms. These principles include accountability, regularity, transparency, and the availability of avenues for redress.
- Finally, there is always the risk that governments have the capacity to appropriately introduce market-type mechanisms only once in a sector, and then become beholden to that provider due to loss of capacity. Governments need to ensure that they continue to have the operational knowledge to make good policy and to choose – and alter – service delivery options in such a dispersed (or networked) environment and actively promote competitive supplier markets.

Notes

1. PPPs can also involve the private sector purchasing already existing infrastructure assets and redeveloping them.
2. This categorisation of risks and discussion draws on Eurostat's ruling on the treatment of PPPs in the context of deficits and debt (STAT/04/18, 11 February 2004). See European Union (2004) and *http://europa.eu.int/comm/eurostat*.
3. A private partner may enjoy lower borrowing costs than the government in certain non member countries, or than certain lower levels of government.
4. Report available at *www.mhc.gov/MHCReport.pdf*.
5. This discussion draws on Pearson and Martin (forthcoming, 2005).
6. This discussion draws on Cave (2001).

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