Reconsidering Public-Private Partnerships in Developing Countries

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Abstract: Where large-scale investments are needed, especially for infrastructure projects, public-private partnerships (PPPs) have been touted as an option. With encouragement by the international financial institutions, PPPs have been promoted in developing countries, especially those facing large public sector debt burdens. PPPs can be very diverse and complex. Many developing country governments lack the institutional and human resource capacity to handle the complexities of PPPs, and hence, PPPs may not yield the results promised. Complex financial contracts, involving commitments to future payments, often reduce transparency. Thus, PPPs can suffer similar problems – such as corruption, cronyism, monopolies – faced in privatization. The transfer of risks to private contractors may be partial, with the government having to step in if something goes wrong. A further consideration is to ensure equitable access for poor and low income households to maintain political support for PPPs. Even when PPP contracts take investments off government balance sheets, and thereby seemingly improve the fiscal balance, commitments to pay for future service flows and other contingent liabilities have similar economic effects to public debt. PPPs do not necessarily entail lower capital costs than investments financed by public borrowing.

Keywords: public-private partnership, public debt, privatization, developing countries

JEL classifications: I38, O22, R42, R48

1. Introduction

Concerns about the level of public debt, which grew rapidly during the macroeconomic dislocation of the 1970s and 1980s, created pressures to change the standard model of public procurement. Thus, a trend began to develop in the 1980s in a number of developed countries, notably the United Kingdom, to increase involvement of the private sector in the provision of
goods and services traditionally provided by, and seen as a responsibility of, the public sector. After controversies and criticisms during the early decades of privatization, new types of arrangements have been experimented with, including public-private partnerships (PPPs).

Similar trends in developing countries have involved a shift in the role of the public sector from supplying to buying services, with private firms designing, constructing, financing, operating and maintaining infrastructure, and the public sector paying for these services. It is increasingly believed that the government alone cannot meet development goals and public provisioning expectations.2

Thus, developing countries have been encouraged, particularly by international financial institutions (such as the International Monetary Fund and the World Bank), to use other methods of service delivery in partnership with the private sector (domestic and foreign). These include privatization, quasi-private arrangements, and public-private partnerships (PPPs). It is argued that the needs of developing countries are truly vast, and hence should be addressed through various combinations of partnerships between philanthropic or faith-based organizations, non-government organizations (NGOs), community-based organizations, corporations (domestic and foreign), and government entities. Ideally, these partnerships should involve win-win arrangements for the government and private providers as well as for the public in the country. They promise profits for private providers, increased revenue for the government, while at the same time improving the lives of people who often do not have adequate access to basic health-care, safe water, electricity, all-season roads or other physical infrastructure or social services.

However, in practice, PPPs are not without problems and can generate outcomes contrary to expectations. The problems arise mainly due to the fact that the government and the private providers do not share the same objectives. For example, the private sector is mainly driven by the profit motive while the government is supposed to uphold public interest. Therefore, if not properly managed and contracted, they can cause loss to the public exchequer or poor service delivery. This paper seeks to explain what PPPs are, their rationale and some complexities. This paper does not directly examine the reasons for individual PPPs’ alleged success or failure. As the idea of PPPs originated in developed countries, the paper lists some additional issues that need to be considered for PPPs in developing countries.

2. What are PPPs?

Presently there is no clearly agreed definition of public-private partnerships. For example, the International Monetary Fund (IMF, 2004: 4; 2006: 1) defines PPPs as “arrangements where the private sector supplies infrastructure assets
and services that traditionally have been provided by the government”, while according to the European Investment Bank (EIB, 2004: 2), PPPs are “relationships formed between the private sector and public bodies often with the aim of introducing private sector resources and/or expertise in order to help provide and deliver public sector assets and services.”

According to Grimsey and Lewis (2005: 346), PPPs “fill a space between traditionally procured government projects and full privatisation” (also see Malone, 2005: 420). Thus, PPPs, as defined by the IMF, are not the only form that occupies this space. The spectrum between traditional procurement and full-scale privatization also includes short-term management and outsourcing contracts, concession contracts and joint ventures between public and private sectors, as implied in the EIB definition. In addition, the extent of ownership of assets, capital and expenditure by private partners may vary, with limited or no capital expenditure in the case of a management contract, whereas the private sector is responsible for the design, building, operation and financing of a capital asset in a full-scale concession or PPP contract (Malone, 2005: 420). To deliver the service, the private partner receives payment from either the government (at regular intervals) or user charges, or both.

Public-private partnerships are clearly different from traditional public procurement, privatization and even concessions (which are more closely related to PPPs). Whether a project is defined as traditional public procurement or as a PPP should, therefore, depend on whether or not sufficient risk has been transferred (OECD, 2008).

PPPs may be depicted on a spectrum, representing possible combinations and levels of public and private sector involvement in various modes of service delivery, classified by risk allocation between the parties (see Figure 1). Except where the government is entirely responsible for all aspects of investment in the services, all the modes involve the private sector to some extent. The modes of delivery range from traditional public procurement, where the government procures the services from the private sector, to full private delivery, where the government is not involved at all, with PPPs in the middle of the range.

Some observers argue that partners usually share the same objectives while the public and private parties in a PPP do not. After all, the private sector seeks to make a profit, while the government is supposed to deliver a service. However, a wider definition of “partnership” would not only include cases where the partners share the same objectives, but also where partners with different objectives align their different objectives so that the objectives of both parties can be realized together. For example, if a PPP contract requires that the private partner maximizes profit by delivering a service efficiently and effectively, then, the objectives of both the private party and the government will be achieved jointly.
Figure 1: The spectrum of combinations of public and private partnership (classified according to risk and mode of delivery)


Such a “partnership” distinguishes PPPs from privatization. Privatization involves no such alignment of objectives since the government is not usually involved in output specification for the privatized entity while allowing the privatized entity to maximize profit. In the case of a public-private partnership, the government usually specifies the quantity and quality of the service required, and both partners agree on the price. The private company then seeks to maximize profit at the agreed price.

With traditional public procurement, the government specifies the quality and quantity of the service required, and negotiates the price with the private provider, often through a tender process. Usually, such goods and services are inputs for government service provision to citizens or the government buys from the private sector to supply to citizens, with the government bearing the risk involved in service delivery. With full private provision, the providers set the quality and quantity of the goods or services delivered, specifying design, setting the price (possibly after negotiation with clients), and bearing the risks involved.

With PPPs, the government usually sets the quality and quantity required, and allows the private partner to design it. Leaving design to the private partner allows the private partner space to be innovative in design to improve efficiency. If the government prescribed the design, it would also have to bear the risk of poor design. Thus, with PPPs, the government leaves that risk, as well as possible efficiency gains, to the private partner (Corner, 2006). As with public procurement, the government and the private partner negotiate a price, usually also involving a tender process.
In contrast with traditional procurement, however, the government does not buy the asset directly from the private partner, but instead buys the services the private partner produces with the asset. Thus, the private partner becomes responsible for the operation and maintenance of the asset and for service delivery.

Contract responsibilities normally require compliance with the agreed quality and quantity specifications. In addition, the private partner carries part of the risk associated with service delivery. Compliance with the specifications at the agreed price should yield the value for money the government intended to achieve when entering into the PPP agreement, such as best quality and other specifications at the best price. Thus, value for money to the government should optimally combine best features at the lowest possible price over the contract’s duration.3

In sum, a public-private partnership is an agreement between the government and one or more private partners (which may include operators and financiers) in which the private partners deliver the service such that the government’s service delivery objectives are aligned with the private partners’ profit objectives. The effectiveness of the alignment depends on sufficient risk transfer to the private partners. The government’s service delivery objectives involve efficiency and effectiveness, defined in terms of the quantity and quality of the service. The profit objectives of the private partners also involve improving efficiency and minimizing the impact of risk on profit. Thus, this definition of a PPP implies that:4

- Private partners usually design, build, finance, operate and manage the asset, and deliver the service, either to the government or directly to the end users. Such involvement of private partners is different from where the private actor either constructs and operates the asset, or provides finance for the investment which the government would otherwise finance (see Box 1 for different PPP permutations).
- Private partners receive payments either from the government or from end users, or from both.
- The government specifies the services required from the private partners. If the government is responsible for payments to the private partners for services delivered, these may depend on the private partners’ compliance with government specifications.
- Sufficient risk is transferred to the private partners to ensure operational efficiency.
- The government may eventually own the asset after paying the private partner a contractually agreed residual value. Since that value is unlikely to differ from its actual market value, the government bears the residual value risk.
Box 1: Different permutations of public-private partnerships

Public-private partnerships usually involve a series of activities such as design, build, operate, finance. Not all PPPs will have all of these activities; instead PPPs can combine these activities in several permutations. Following IMF (2004) and Malone (2005), OECD (2008) lists the following permutations. The wording here reflects the activities of the private partner.

- Build-own-maintain (BOM)
- Build-own-operate (BOO)
- Build-develop-operate (BDO)
- Design-construct-manage-finance (DCMF)
- Design-build-operate (DBO)
- Design-build-finance-operate (DBFO)
- Buy-build-operate (BBO)
- Lease-operate (LOO) or Lease-develop-operate (LDO)
- Wrap-around addition (WAA)
- Build-operate-transfer (BOT)
- Build-own-operate-transfer (BOOT)
- Build-rent-own-transfer (BROT)
- Build-lease-operate-transfer (BLOT)
- Build-transfer-operate (BTO)

For more details on the definitions, see IMF (2004) and Malone (2005).

PPPs may be organized as special purpose vehicles (SPVs) which typically consist of financial institutions and other private companies responsible for all the PPP activities including coordination of finance and service delivery (IMF, 2004: 9; Hemming _et al._, 2005: 8). A PPP can be led by the private service provider (as in the United Kingdom) or by the financial institution mainly responsible for financing the project (as in Australia) (Grimsey and Lewis, 2005: 363).

2.1 _PPPs and Concessions_

What distinguishes PPPs from concessions? OECD (2006: 19) defines the features of a concession as follows:

- A concession grants the right to a private firm to operate a defined infrastructure service and to receive revenues from it.
- The concessionaire usually pays the concession-granting authority a fee to obtain this right.
- The concessionaire carries the bulk of the risk.
• The asset involved in service delivery remains government property, though the private firm has the right to operate it and use it to generate income. Typically, the private firm is also responsible for maintenance of the asset.
• The asset must be transferred to the government at the end of the concession’s contract.

Concessions usually differ from privatization insofar as the asset remains government property and the contract is of limited duration (OECD, 2006: 19). Contractual negotiations usually involve a more detailed relationship between the government and the concessionaire. Contracts may contain detailed clauses on service quality and quantity that the private firm must deliver. These details often determine which firm is awarded the concession. Such concessions include municipal water provision, cable television, mobile phone services and toll roads. Assets involved in concession contracts may be notional and intangible including the right of a mobile telephone network or a television channel to operate at a contractually specified frequency.

Concessions and PPPs both claim to use the private sector to improve value for money (VFM) and efficiency, and recognize risk transfer to the private operator as key to enhancing VFM. Both concessions and PPPs involve private firms that operate, maintain and finance the asset during the contract period, and a government that regains control of the asset at the end. Concessions and PPPs also typically use a “whole-of-life” project cycle approach when considering a project’s net benefits. Risk and payment distinguish a PPP from a concession. Although both PPPs and concessions transfer risk to the private operator, the level of risk transferred might generally be higher in the case of a concession.

Second, although both PPPs and concessions receive payments from the government and for user charges, concessions usually depend on user charges for most of their income; many do not receive any government payments. Instead of the government paying private operators for services delivered, the private operator pays the government for the right to operate the asset in the case of a concession. Much of the literature does not distinguish clearly between PPPs and concessions, due to the significant definitional overlap as well as the issues and problems affecting both modes of service delivery.

3. Arguments for and against PPPs
The main reason for PPPs is to improve service delivery – to create better value for money, even if traditional procurement is effective, presumably if the service is not of the best quality or provided at least cost. The Government
of New South Wales in Australia puts the case for using private sector finance in PPPs as follows:

“privately financed options demonstrate superior value-for-money to the Government and community compared to conventional, publicly funded approaches to infrastructure provision. This is the sole reason for considering private financing and delivery…. The importance of the finance element of privately provided infrastructure lies in the incentive it can provide for the performance of the infrastructure, and the disciplines external financiers can provide on the delivery of project to time and budget. It is difficult to replicate the strength of these incentives and disciplines within a conventional funding process where all the risks of delivery reside with the government” (NSW Treasury, 2002: 2, 4).

Thus, governments may have PPPs to draw on the capacity of the private sector to more efficiently deliver quantity or quality. However, even if private sector participation in PPPs may contribute to higher levels of efficiency, mere private sector participation is not sufficient to ensure improvement in service delivery and efficiency. As mentioned earlier, improvements depend crucially on sufficient transfer of risk from the public sector to the private partner; otherwise, service delivery can be deemed as public procurement even if a private company is involved.

Murphy (2008), offers the following public policy rationale for PPPs:

1. “Off-book financing”
2. Accelerating construction
3. On-time and on-budget delivery
4. Shifting risks to the private sector
5. Cost-savings
6. Customer service improvements
7. Enabling the public sector to focus on outcomes and core business.

According to Farlam (2005), PPPs offer opportunities for the transfer of economic power to the local population through greater participation in and ownership of businesses. PPPs can be good for local empowerment in a number of ways:

• the long-term nature of contracts allows the growth of local equity and management over time;
• risks are clearly identified in PPPs, costed and appropriately allocated, so participants know in advance what they are committing to;
• the utilization of a range of large, medium and small enterprises, through subcontracting and procurement, can bring tangible local economic development benefits to targeted groups.
In sum, the rationale for PPPs includes the potential for value for money, early project delivery, gains from innovation, obviating the need to borrow to finance infrastructure investment, and access to improved services. Some governments might find PPPs politically attractive as they operate at the boundary of both public and private sectors, being neither nationalized nor privatized assets and services. They entail private sector partners supplying ‘public’ services. Thus, politically, PPPs may represent a third way for governments to deliver some public services.

3.1 Arguments against PPPs

Critics have pointed out that PPPs involving private sector finance are not necessarily cheaper. It is generally more expensive for the private sector to raise capital through private capital markets, than for the government to do so directly, especially in developed countries. They claim that governments can use PPPs to understate debt by not recording, in public balance sheets, the total value of payments payable to private sector providers. That is, PPP obligations are “off the balance sheet”. For example, despite the recommendation of the United Kingdom Accounting Standards Board to bring PPP related payments into the balance sheet, subsequent UK Treasury guidelines allow most PPP transactions to be excluded from government borrowing statements on the grounds that they are operating and not finance leases.

Murphy (2008) also notes the following possible arguments against PPPs:

- real costs higher than traditional government procurement, and, as a result, do not meet the value-for-money test;
- design and service quality often fail to meet standards of publicly delivered services over time;
- reduced transparency and unclear lines of responsibility mean PPPs are less accountable;
- threaten the rights of workers (particularly the unionized ones) and job security; and
- reduce public sector flexibility to respond to public demands.

Farlam’s case studies of PPPs in Africa identified the following problems with PPPs:

- PPPs suffer many of the same ills that afflict privatization and public tenders.
- The process has sometimes become so corrupt that promises remain unfulfilled and services have dramatically deteriorated. Contracts have
been poorly prepared to the detriment of governments, the public and workers.

- Public procurement processes the world over – even when governments call for tenders – have frequently lacked transparency and involved cronyism and graft.
- Well-connected relatives and friends of powerful politicians or officials are routinely awarded lucrative contracts despite inferior bids, higher costs and limited competence.

These case studies have shown that PPPs pose similar challenges as privatization for many governments. PPPs will continue to be fraught with problems unless governments effectively draw lessons from the failures of privatization, tender systems, and past relations between business and government.

4. Ensuring Successful PPPs

Any major deal involves many risks, including things that presumably can go wrong. Ideally governments should prefer PPPs where business is willing to bear all the costs and risks, e.g. those associated with demand shortfalls, regulatory compliance and currency fluctuations, while accepting minimal profit. But presumably, private businesses are unlikely to accept such deals. Private businesses presumably want PPPs that yield guaranteed (incentive) profits, no risk, government subsidies and monopoly control. Crafting a good PPP involves mitigating the risks that each side fears. Table 1 provides a typology of such risks.

According to Murphy (2008), achieving enhanced value for money is supposedly at the core of the case for PPPs. Three variables are usually invoked: the nature of the project, a government with effective project and contract management skills and clear and effective risk allocation. Four conditions should encourage public officials to favour PPPs:

1. The services provided respond to a clearly identified and measurable public need.
2. The public sector has the expertise to assess and manage risk.
3. Delivery of high-quality services efficiently and responsibly with optimal risk allocation.
4. Clear lines of accountability and redress.

For the OECD (2008), merely concluding a contract with a private operator to deliver a service does not ensure that value for money will improve. The “off budget” character of PPPs is especially appealing for governments with self imposed fiscal rules or budgetary limits that create
Table 1: Types of risks in public-private partnerships

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<thead>
<tr>
<th>Risk</th>
<th>Explanation</th>
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<tbody>
<tr>
<td>Completion risk</td>
<td>The possibility that a project’s construction or installation will be delayed, with additional cost or other implications.</td>
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<tr>
<td>Cost overrun risk</td>
<td>The possibility that during the design and construction phase, actual project costs will exceed projected costs.</td>
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<tr>
<td>Design risk</td>
<td>The possibility that the private party’s design may not achieve the required specifications.</td>
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<tr>
<td>Exchange rate risk</td>
<td>The possibility that exchange rate fluctuations will impact on the costs of imported material or the project’s debt or equity.</td>
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<tr>
<td>Interest rate risk</td>
<td>Fluctuations in the interest rate at which the project borrows money.</td>
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<tr>
<td>Market/demand risk</td>
<td>Demand for the services generated may be less than projected.</td>
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<tr>
<td>Force Majeure risk</td>
<td>The occurrence of certain unexpected events – natural or man-made – beyond the control of the parties.</td>
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<tr>
<td>Operating risk</td>
<td>Factors other than force majeure such as projected operating expenditure, skill requirements, labour disputes, employee fraud.</td>
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<tr>
<td>Political risk</td>
<td>Unforeseeable conduct by a government institution that materially and adversely affects the expected return on equity, debt service or project costs, including expropriation and nationalization</td>
</tr>
<tr>
<td>Regulatory risk</td>
<td>Consents required from government authorities or an independent regulatory agency are not obtained or result in additional costs.</td>
</tr>
<tr>
<td>Utilities risk</td>
<td>Utilities (water, electricity, gas) for the project are not available.</td>
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Incentives to move expenditures to the future, instead of financing them up front. Regardless of whether the government uses in-house production, traditional procurement or a PPP, the decision should depend on affordability in terms of the government’s inter-temporal budget constraint, not the set of books on which the project appears.
When a government chooses between traditional public procurement and a PPP, the key issue should be which option is the most affordable and will deliver the highest value for money (VFM). The more effective and efficient the outcome, the higher the value for money. Thus, the choice is not straightforward and depends on several determinants, including:

- affordability and value for money
- limited budget allocations and legally imposed budgetary limits
- the role and nature of risk transfer
- the degree of competition
- the nature of the service.

As PPPs are relatively new and originally developed in the context of developed countries, especially the UK, the following additional considerations need to be taken into account in developing countries:

4.1 Providing a Range of Service Options
In privatizing basic services, governments in developing countries have often set high quality standards and imported standards and approaches used in developed countries. This has often meant that the services are too costly for the poor. Governments should help poorer or un-served consumers by introducing alternatives. For example, in the case of water, although indoor plumbing for all may be desirable, cheaper options can guarantee everybody access to clean water supplies.

4.2 Creating Political Support
Governments and private sectors often underestimate political opposition to privatization and PPP initiatives. Opposition may be reduced if governments effectively explain the need for PPPs and publicly discuss options well before contract deals are made. Many governments turn to PPPs or privatization when they cannot afford to continue to provide free or subsidized services, or, significant capital expenditure is required to extend services. Allowing companies to raise prices rapidly on previously cheap public services can spark political opposition. But ignoring market forces and cost increases can force private businesses to back out of PPP deals. Thus, the process should be gradual and supported by compensating affected consumers, especially the poor.

4.3 Guarding against Corruption
Corruption has been an enormous problem affecting public procurement in developing countries. Even with public tenders, officials have found ways to
give contracts to favoured bidders. Because the choice of PPP partners cannot be reduced to the single variable of price, PPPs offer far greater latitude for manipulation by foreign or domestic firms or government officials that are difficult for the public and anti-corruption efforts to spot. Therefore, the process should be as transparent as possible.

4.4 Building Capacity

Capacity may be a serious constraint for developing governments to conduct successful partnerships with the private sector. Countries need to develop their capacity to plan, negotiate, implement and monitor successful PPP projects. While the argument can be made that PPPs are too complex for governments lacking adequate capacity, starting with smaller projects and developing such capacity gradually may help to overcome this problem.

5. Concluding Remarks

Using the example of developed country experience, the international financial institutions – particularly the IMF and the World Bank – are encouraging developing countries to embrace the idea of PPPs. In addition to relieving budgetary pressures, PPPs are thought to enhance transparency in public procurement, and thus reduce corruption as well as improve service delivery.

However, surveys of PPPs in developing countries show that the initial results are not very encouraging. They face the same challenges as full privatizations, and PPPs will continue to be fraught with problems unless governments effectively draw lessons from the failures of privatization, tender systems, and past relations and arrangements between business and government. An additional aspect that needs to be considered, especially in developing countries, is equity in access. As in the case of full privatization, unless strict provision is made in the contract and enforced, PPPs in public utilities and social services, such as healthcare, may adversely affect the access of poor and low-income households.

Many developing country governments do not have the administrative, institutional and human resource capacity to successfully negotiate and implement PPPs in order to minimize risks to the public exchequer and maximize the quality of service delivery. Even in developed countries, not all PPPs are found to have produced the expected results and protected the public interest, both in terms of impact on government budget and service delivery. PPPs are potentially fraught with difficulty. The design and implementation of PPPs are usually very complicated. The essence of the business relationship between the public and private sectors is contractual. This requires that the
services to be delivered have to be specified in great detail. Assessment of whether a PPP would offer value for money is often difficult to determine. Some risks are difficult to identify, let alone quantify, and it is difficult to assess to what extent the transfer of risk is deemed optimal.

Notes

1. Anis Chowdhury is on leave from the University of Western Sydney, Australia.
2. In the early days, the governments in newly decolonized developing countries had to take the main responsibility for large scale infrastructure investment projects as well as for provision of social services such as health-care and education. It was necessitated not just by market failure, but mainly because the private sector did not have the capacity for such projects; they were too weak and lacked capital as well as experience. These newly independent countries also did not attract much foreign direct investment which was mainly interested in extractive industries. Since then, the private sector in developing countries has grown and the interests of foreign investors in developing countries have also diversified. Thus, it seems that circumstances have emerged where the private sector can effectively support developmental goals, especially when the government budget is under severe strain.
3. The United Kingdom government (Treasury, 2006: 29) has defined it as: “the optimum combination of whole-life cost and quality (or fitness for purpose) to meet the user’s requirement”.

References