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PUBLIC SECTOR MODERNISATION:
THE USE OF MARKET-TYPE MECHANISMS IN THE PROVISION OF GOVERNMENT SERVICES

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This document is presented to the Committee for comment by written procedure. Please send any comments you may have to the Secretariat by 15 November 2004.

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PUBLIC SECTOR MODERNISATION
THE USE OF MARKET-TYPE MECHANISMS IN THE PROVISION OF GOVERNMENT SERVICES

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EXECUTIVE SUMMARY

This paper focuses on the use of market-type mechanisms in the provision of government services – including outsourcing (contracting out), public-private partnerships (PPPs) and vouchers. It is an interim report. There will be an Expert Meeting early next year to broaden the information base for the final report.

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. In most cases, these services were previously performed in-house by the respective ministry or agency.

Public-private partnerships (PPPs) refer to the private sector financing, designing, building, maintaining, and operating (DBFMO) infrastructure assets traditionally provided by the public sector.[1] 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.

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 which entitle 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. The vouchers are for the use of specific services only; they are not in the form of cash. The voucher can equal the total expense of the service or can be partial. The eligibility for the voucher may extend to the whole population or may be limited to certain groups or be means-tested. The suppliers can be both government bodies and private bodies, or private bodies only.

The use of such market-type mechanisms is clearly increasing in member countries although it is difficult to quantify precisely since governments do not maintain standardised or comparable data over time on their use. The primary objective of introducing market-type mechanisms is to increase efficiency, by reducing costs and/or increasing quality. This is achieved by introducing competition among different suppliers in areas where the government was previously the monopoly provider. The discussion in the paper shows however that care needs to be taken in their design to achieve these efficiency gains. These focus primarily on the development and sustainability of competitive supplier markets.

Governance issues need to be considered as an inherent part of the decision to adopt market-type mechanisms. These focus primarily on the accountability of the private sector providers and the government's long-term 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.

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1. In some countries the term PPP's is used in a more limited capacity to refer to only private sector financing, designing and building of assets. It can also involve the private sector purchasing already existing infrastructure assets and redeveloping them.

Questions for Discussion

What are the key trends with the use of market-type mechanisms in individual member countries? Are there new areas where MTMs have recently been used? Are there areas where the use of MTMs has ceased?

How is the use of MTMs altering the traditional profile of government? Are there concerns that specific public sector values – justice, equity, citizenship, community – are being lost?

Are there specific concerns for ensuring accountability for service delivery by private sector suppliers? How does it differ from accountability for traditional service delivery?

How do governments strive to maintain their long-term capacity in areas where MTM's are being employed – in terms of co-ordination, technical knowledge of the respective area, and the commercial skills for the application of MTM's?

INTRODUCTION

1. This paper is part of the OECD Government Modernisation series and focuses on the contribution of market-type mechanisms.

2. 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." [2] In the area of service provision, examples include outsourcing (contracting out), public-private partnerships (PPPs) and vouchers. In the area of financing, examples include user charges and unfunded mandates. The use of transferable permits is a market-type mechanism for allocating and managing limited-supply "public" goods (greenhouse gas emission, for example).

3. The use of market-type mechanisms is clearly increasing in member countries although it is difficult to quantify precisely since governments do not maintain standardized or comparable data over time on their use. The assessment of their use is therefore dependant on one-off studies, proxy measures and anecdotal evidence.

4. In this context, governments can be viewed as having three main roles. First, mandater. This is the policy-making role of government whereby it formally declares its intentions in terms of laws and regulations. Second, provider. The government is the supplier of the services needed to carry out its laws and regulations. Third, financier. The government makes available the necessary resources from general taxation to carry out its laws and regulations.

5. Traditionally, governments performed all three roles concurrently. With the advent of market-type mechanisms, governments are separating these three roles. The only exclusively governmental role is that of mandater in the interest of the common good. This is the government's *raison d'etre*. Both financing and – especially – provision do not inherently have to be part of government. The role of provision can be assigned to private sector entities acting on behalf of the government; financing can be assigned to the direct beneficiaries of government-mandated services.

6. At present, the use of market-type instruments is secondary and operates at the margin of a still dominant traditional role for government provision and financing. The governance implications of their use are likely to magnify as the use of market-type mechanisms increases further..

7. This report 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 member countries, analyses the key issues involved with each – both in terms of design and governance issues, and offers an overall assessment. A box at the end of the paper highlights the other principal market-type instruments. It concludes by drawing together the main messages emerging from the discussion in the paper.

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2. As approved by SBO (1992), PUMA Committee (1993).

OUTSOURCING

8. Outsourcing is the most common market-type mechanism employed by governments. Different terminology is used in different countries, including competitive tendering, contracting, and contracting out. The term outsourcing is used throughout this paper.

9. 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. In most cases, these services were previously performed in-house by the respective ministry or agency.

10. In order to encourage outsourcing and/or to put competitive pressure on government's own service providers, some government have established mandatory policies of market testing or competitive sourcing.

11. 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 current provision is unsatisfactory. This is rare and limited to cases where there is a long history of poor performance.

12. The use of outsourcing per se is not new in member countries. For example, the use of private contractors for the construction of various infrastructure projects has been the norm in most member countries for an extended time. Conceptually, this was viewed as an acquisition (procurement) rather than as outsourcing.

13. In the past 15 years, partial data shows a significant increase of outsourcing in member countries although strong variations exist between individual countries. Countries such as Australia, Denmark, Iceland, the United Kingdom and the United States have been especially active. For example, outsourcing is estimated to have increased by 33% over the past 10 years in the United States. Outsourcing remains limited, however, compared to direct provision of services by government.

14. The range of services outsourced in 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 member countries. In many countries, 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 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.

15. 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 and not considered critical to the mission of the agency. These however, can take place under extreme circumstances – catering for combat soldiers in hostile environments or the protection of high-risk facilities such as nuclear sites.

16. 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 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.

17. 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) and enforcement activities, such as food inspection (Iceland).

18. The use of outsourcing in social services has made important in-roads in certain countries. This includes employment (placement) services, child welfare services, long-term care institutions for the elderly and for the handicapped. Outsourcing in this field has in some cases been motivated by poor performance of the previous government providers.

19. 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 member countries. Similarly common is the outsourcing of technical assistance in foreign aid programs of member countries. The use of outsourcing for the operation of various infrastructure assets – transportation, water supply, sewage – is also increasing in individual member countries.

20. The evidence that the outsourcing done so far 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%.[3] A study of over 2 000 outsourcing initiatives in the U.S. Federal Government found an average cost savings of 33% with same or higher levels of service.[4] In other countries average cost savings have been estimated at 20% in the United Kingdom, 15-20% in Australia, 5-30% in Denmark and 20-25% in Iceland.

3. Dilger, R.J., *et al.* "Privatization of Municipal Services in America's Largest Cities." *Public Administration Review.* Vol. 57, No. 1. January/February. 1997.

4. Clark, F., *et al*. Long-Run Costs and Performance Effects of Competitive Sourcing. 2001.

Key Issues

21. A number of governance-related issues arise from outsourcing, many of which are applicable to the use of market-type mechanisms more generally.

22. There are strong obstacles to the introduction of outsourcing. This can be due to public concern about private sector involvement in traditionally 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 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.

23. Outsourcing can generate governance concerns in terms of the accountability for the services being provided by a private contractor. Outsourcing should not diminish the government's overall responsibility for the delivery of the services. This is especially relevant when that service is being provided directly to citizens on behalf of the government but also if the service has or attains high political visibility – for example, the outsourcing of post-conflict reconstruction in Iraq. Any contract must clearly specify the service required, the respective roles (responsibilities) of the government and the contractor, and appropriate arrangements for monitoring and reviewing the contractor's performance. Some governments have similar accountability systems in place for government ministries and agencies themselves. The involvement of private sector providers accentuates the need for such accountability mechanisms. A particular concern, for outsourcing is that overall transparency may diminish since some aspects of the contract may be treated as confidential for commercial reasons.

24. The capacity of governments to out-source 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 member 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's important that these skills become an established and on-going management function rather than being seen as a one-off exercise each time. This has important implications for human resource management and internal organizational structures of organizations.

25. 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 marketplace of individual outsourcing decisions.[5]

"Lowest" Cost

Lowest cost is traditionally the main criterion that determines a winning bid. There are examples of suppliers submitting unrealistically low bids 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 marketplace in general.

26. Finally, 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 could well have an improved career track in a firm that specialises in that "ancillary" function.

27. There is specific legislation in place for the transfer of employee rights with outsourcing in the European Union. In the United States, legislation is in place that stipulates that health care benefits 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.

Conclusion

28. 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, risks to the perception of government legitimacy, and the need to maintain government's core capacity now and for the future. The benefits of outsourcing in terms of increased efficiency can be substantial and the services that have been outsourced rarely revert back to government provision. Outsourcing can be expected to increase substantially in the coming years.

5. See *Increasing Competition and Improving Long-Term Capacity Planning in the Government Market-Place*. UK Office of Government Commerce. December 2003.

PUBLIC-PRIVATE PARTNERSHIPS

29. Public-private partnerships (PPPs) refer to the private sector financing, designing, building, maintaining, and operating (DBFMO) infrastructure assets traditionally provided by the public sector.[6] 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.

30. Private sector involvement in individual aspects of DBFMO has been the norm in most 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 PPP, a single entity is responsible for the infrastructure's "whole-of-life."

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

32. PPPs have most commonly been applied for the provision of highway infrastructure. For example, Portugal's ambitious €5 billion National Road Programme employs PPPs. It is 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 specialized 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.

33. 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 2003-2004 are through PPPs and this has been relatively consistent over time. In other words, about nine-tenths of investments are conducted through traditional procurement practices.

34. Appropriately structured PPPs have the clear potential to improve the efficiency of the design-build-maintain and operate phases. The largest analysis of a PPP program was undertaken in the United Kingdom in 2003.[7] Nearly 90% of all PPP projects were delivered on time by the private partner whereas only around 30% of non-PPP projects were delivered on time. Four-fifths of all PPP projects were

6. PPPs can also involve the private sector purchasing already existing infrastructure assets and redeveloping them.

7. *PFI: Meeting the Investment Challenge*, HM Treasury, July 2003.

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. Analysis of other national PPP programs 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

	Roads & bridges	Light railway	Heavy railway	Schools	Health & hospitals	Central accommodation	Airports	Housing	Ports	Prisons	Water & wastewater (id solid waste)
	Principal sectors of PPP activity					Subsidiary sectors of PPP activity					
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	★	★		★	★	★	★	★		★	★
Applicant countries/EFTA											
Bulgaria	●						●				♦
Romania	♦				▲			●			♦
Turkey	●	●	●				♦				♦
Norway	♦		●	▲	▲	●				●	

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: *Summary of PPP's By Country and Sector*. European Investment Bank and PricewaterhouseCoopers. June 2004.

The Transfer of Risk

35. 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.

36. 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.[8]

37. Construction risk covers events like 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.

38. 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.

39. 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 risk.

40. 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 building 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.

41. 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 will entail 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.

Financing

42. 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 they will continue to be responsible for servicing the debt associated with the project. This is a powerful financial incentive for performance..

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8. This categorisation of risks and discussion draws on Eurostat's ruling on the treatment of PPP in the context of deficits and debt. (STAT/04/18, 11 February 2004).

43. 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.

44. 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 be limited by the annual fees required to be paid to the private partner. In the United Kingdom, just over 2% of annual resources are obligated in such a manner in 2003-2004.

45. 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 criteria for EMU allows governments to record transactions this way if the construction risk and either the supply risk or demand risk is transferred to the private partner. This is not, however, an especially restrictive criteria. Outside the EU, not even such criteria apply. In fact, governments could retain all the risk and use the PPP device solely for this purpose.

46. 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.[9]

47. 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, analyze and quantify this 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.[10] 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 comparison of the benefits and costs of each approach.

Conclusion

48. The use of PPPs stabilized 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 standardized contracts may be possible for certain smaller projects. The unique efficiency gains associated with PPPs

9. A private partner may enjoy lower borrowing costs than the government in certain non-member countries, or than certain lower levels of government.

10. Public-Private Partnerships. International Monetary Fund. February 2004.

derive from the interaction of the design-construction-maintenance-operate phases. The greater the maintenance and operate components, the greater the potential for efficiency gains.

49. 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 investments and debt off-budget.

50. A comparison of the benefits and costs of PPPs versus traditional procurement needs to be rigorously conducted and PPPs should be subjected to at least the same scrutiny as traditional expenditures in the budget process.

51. Many of the issues identified for outsourcing – new skills required for officials, the importance of competitive markets, and the monitoring of private provider performance – apply equally to PPPs.

VOUCHERS

52. 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 which entitle 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 expense of the service or can be partial. 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 them. This should lead to greater efficiency, notably in terms of quality improvements.

53. Conceptually vouchers can take at least three main forms, if defined in a broad sense. 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 qualifying suppliers. This would most often be through the tax system, but can equally take place as a traditional government expenditure program. From the point of view of the user, these three main forms offer a choice of suppliers with the government financing the service.

54. With this broad definition, the extent of use of these three forms of vouchers is significant in member countries with their use being mainly focused on education, housing and social services sectors. This includes childcare (nursery education), primary and secondary schooling, higher education, assistance for homebuyer’s and renters, care for the elderly and care for the physically disabled.

55. The largest and oldest explicit voucher program in member countries is unique. It is the United States Food Stamps Program. 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 program cost $23.9 billion in 2003. Peculiarly, the program is operated by the Department of Agriculture rather than a social services body.

56. Other large explicit voucher programs are to be found in housing assistance to low-income families. Vouchers in this field generally provide for the difference between actual rent paid, up to a limit based on family size and local area, and a certain percentage of the recipient’s salary. The amount of the housing voucher is adjusted based on housing market trends. Examples include the Section 8 vouchers in the United States (launched in the mid-1970s) which provides benefits to about 2 million low-income households and had a total cost of $21.2 billion in 2003 and the Accommodation Supplement (launched in 1993) in New Zealand, which provides benefits to 250 000 people. The New Zealand voucher program does not discriminate between rent or mortgage payments.

57. The largest implicit vouchers programs are to be found in the area of primary and secondary education – most notably in the Netherlands and Sweden. The Netherlands has a long tradition of guaranteeing equal government funding for students in public schools and private schools. Most of the

private schools have some linkages to churches. Over 70% of total funding in the Netherlands goes to private schools. The standard national curriculum applies for both public and private schools. Public schools are not permitted to charge additional fees whereas private schools can. In practice, they limit their charges to financing smaller class sizes and to the funding of “fringe” benefits such as excursions and sports facilities.

58. 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 specialized 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.

59. The use of explicit vouchers for primary and secondary education is most documented in the United States but its use is very limited where they have met strong resistance from public school teachers and their allies. Vouchers are used in some cities but they 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 programs are so small in aggregate that their overall impact is minimal. 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.

60. Vouchers are also used for the provision of child care services which can include in-home care, day care centres, outside school-hours care and similar services. Examples include the Australian Child Care Benefit which is available to families whose income is less than a standards amount and is reduced as income progresses. Similar options are available in other countries, notably in the Nordic countries. Tax credits for actual expenditures up to a certain maximum are vehicles used in other countries.

61. Vouchers have also been used for long-term care for the elderly and the handicapped. A key motive for their introduction in this sector is to promote home care by paying a benefit to professional or informal “carers,” 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.

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

Critical Design and Contextual Factors

63. An analysis of member countries’ experience with the use of vouchers shows that there are several critical factors associated with the successful use of vouchers.

64. 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.

65. For some types of vouchers, there is a tendency to establish very 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.

66. 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.

67. 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 it is costly to switch.[11] 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 themselves make and this itself has a positive impact on their experience of the goods.

68. 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.

69. Voucher programs 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 desired and can lead to increased product differentiation which is a key benefit of the voucher concept. Such prohibitions therefore need to be reviewed carefully.

70. 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 to provide services and exclude higher-costs recipients. A payment structure that recognizes such differences is key to alleviating this potential problem.

Conclusions

71. The extent of voucher use in 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.

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11. This discussion is based on Cave, M. “Voucher Programmes and their Role in Distributing Public Services.” *OECD Journal on Budgeting.* Volume 1. No. 1. 2001.

72. 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 programs. Previously, the expenditure associated with these programs 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 concerns from a budgetary point of view. The rental vouchers in the United States are coming under strain for these reasons.

Other Market-Type Mechanisms

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

User charges assign 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 thereby 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 concern 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, then 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 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.

CONCLUSIONS

73. This paper has separated the three roles of government – mandater, provider and financier. Traditionally, governments performed all three roles concurrently. Market-type mechanisms have seen the separation of these three roles.

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

- The diversity of experiences among 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, and improved resource allocation economy-wide. The discussion showed, however, that care needs to be taken in their design to achieve these efficiency gains.

- Governance issues need to be considered as an inherent part of the decision to adopt market-type mechanisms. These focus primarily on the government's reputation and long-term 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. It is possible that governments will meet ceilings for the use of market-type mechanisms above which governments could not maintain capacity in core government affairs.

- Finally, there is always the risk that governments have the capacity to appropriately introduce market-type mechanisms once in a sector, and then become beholden to that provider due to loss of capacity.