Private Finance Initiative—The Theory behind the Practice

James Edwin Kee and John Forrer

Prepared for presentation by James Edwin Kee at the 14th Annual Conference of the Association for Budgeting and Financial Management

October 10-12, 2002, Kansas City, Missouri.

James Edwin Kee

Professor of Public Administration

The George Washington University

jedkee@gwu.edu

Private Finance Initiative—The Theory behind the Practice

James Edwin Kee and John Forrer

Beginning with the Thatcher Government in the 1980s, the United Kingdom has been the leading proponent of privatization. Support for privatization has continued and expanded under Thatcher's successor John Major and today's Labor Prime Minister Tony Blair. At first the emphasis was on the sale of state-owned enterprises—of which the UK had many. However, in recent years the emphasis has shifted to using the private sector to design, build, own and operate government facilities and provide public services. In contrast to the traditional capital budgeting approach, which relies on government borrowing or tax revenues to finance infrastructure, the UK has attempted to harness private sector's access to investment capital and management expertise to upgrade the quality and reduce the cost of providing public goods and services.

Governments, historically, have used many mechanisms for providing public goods and services, from direct delivery to "outsourcing," to franchised delivery through private monopoly. Many of these mechanisms involved partnerships with the private or non-profit sector. The last 20 years in particular have witnessed an explosion in the use of Public Private Partnerships (PPPs)—defined by one proponent as "any arrangement between a government and the private sector in which partially or traditionally public activities are performed by the private sector." (Savas 2000, p 4).

In the autumn of 1992, the United Kingdom embarked upon a new type of PPP to increase private sector involvement in the delivery of public services. Referred to originally as the Private Finance Initiative (PFI), the British Treasury Department has now raised over £20 billion to invest in private financing and management of UK public services. PFI in the UK itself has been privatized; Partnerships UK was established in July1999—a private company with a public

mission, jointly owned by the government (51 percent) and private sector (49 percent). It was created to promote the use of PFI on a wide range of public services, including modernization of the London Underground and more intensive usage of the network of canals throughout the UK.

With many nations in both the developed and developing worlds in dire need of improving public infrastructure—roads, bridges, schools, and water and sewer systems—PFI may be an innovative capital budgeting approach for financing and managing public infrastructure. This paper will explain the nature of PFI, examine its underlying theoretical basis, and explore why it may be an attractive alternative to more traditional capital budgeting approaches.

Private Involvement in Delivering Public Goods and Services

In the United States, the private sector and the non-profit sector are heavily involved in the delivery of public goods and services. Government contracting is the most common method. Most tangible materials—supplies, equipment, personnel, facilities and materials—used as *inputs* in government programs are obtained from contractors. Contractors also are increasingly providing ancillary components of government operations, such as printing and building maintenance, using their own personnel and materials. Finally, governments contract for some *output* services directly to the public, such as refuse collections and ambulance services. All of these arrangements could be classified as types of PPPs (Savas 2000).

For example, PPPs include government support for the private sector to build a facility, transferring ownership to the public sector, but agreeing to operate that facility in accordance with a contract—sometimes referred to as build-transfer-operate (BTO). Some public prisons are operated in this fashion. Or the private sector might agree to build, own and operate (BOO), generally under government franchise or regulation, sometimes with an agreement to transfer the facility back to the public sector as some point in the future. The Dulles Greenway, a privately

owned toll road in Virginia, is an example of this type of PPP, which is backed by tolls paid by Greenway users (Forrer, et. al, 2002).

What Is Private Finance Initiative

PFI, introduced in the UK in 1992 by Prime Minister John Major's government, is an innovative means of financing social infrastructure by inducing private capital to invest in infrastructure projects such as hospital, schools, roads and housing. The previous government, led by Prime Minister Margaret Thatcher (1979 -1989), made privatization of state-owned enterprises (e.g. British Telecom, British Gas, British Airways, British Petroleum) the hallmark of its market-oriented political philosophy. By the early 1990s, the dilapidated condition of British public infrastructure and services emerged as the one of the most important political issue of the day. PFI was the Conservative Party's approach to financing and managing an upgrade of British "social infrastructure." Tony Blair's Labor Party's has continued to back the concept under the Public Private Partnership banner and according to one member of the House of Lords has gone further than the Conservative Party ever anticipated (Sharman 2002).

PFI is ideologically in tune with the global trends towards privatization of public services and a wider "New Public Management" movement that attempts to increase the efficiency of the public sector through the introduction of managerial skills, entrepreneurship, expertise, etc. all drawn from the private sector.

How Does PFI Work

In PFI projects, a consortium of private sector firms undertakes to design, build, finance, and operate (in whole or in part) an infrastructure facility. In addition, public services are provided by the PFI consortium of firms on a long-term contractual basis (up to 30 years) with the relevant government agency. The PFI project is structured so that the consortium is

guaranteed a full return on costs, including interest on the capital borrowed, plus a return on its investment. The return might include all or a percentage of the revenue collected for the service—especially where that services requires user fees. Or the government may pay a periodic fee-for-service to the consortium based on an agreed to service contract. In effect, the public sector is purchasing the cost of financing the new social infrastructure, bundled with the flow of services, through a long-term financial commitment to a private vendor. All these arrangements are negotiated and agreed to before construction begins.

PFI negotiations typically involve three parties: the public-sector agency that conducts the procurement, the private sector consortium that bids to build and provide the public infrastructure and services, and the bank or other financial entity that finances the project. The typical steps involve (Grout 1997):

1. The establishment and definition of a service need and an assessment by the public agency of the applicability of the PFI approach;
2. A tendering and negotiation process involving detailed specifications with short-listed firms;
3. Negotiation of a contract with the preferred bidder;
4. Construction by the private consortium; and
5. Private supply of public service.

The contractual terms are lengthy, often 25-30 years, to ensure an adequate return on the capital borrowed by the private consortium.

According to Grout (1997), the main criteria used to justify a PFI scheme are the following:

- Funding is to be predominantly (usually fully) from the private sector and the contractual relationship relates to the consumption of services not the assets itself;

- A ‘substantial’ amount of risk is transferred into the private sector; and
- The project must be shown to offer value for money to the taxpayer.

PFI Growth

After its launch in Britain in the autumn of 1992, PFI initially developed slowly. However Timmins (2000) reports that more than £12bn [US $15bn] worth of PFI deals had been signed by 1999 – more than £16bn (US$20bn) worth if the Channel Tunnel rail link is included in the total. As of September 1, 2001 there had been almost 450 PFI deals signed with a total capital value of £20 billion. The increased level of activity must be paid for by higher public expenditure in the future, as the stream of payments to the private sector grows. PFI projects signed to date have committed the UK Government to a stream of revenue payments to private sector contractors between 2000-01 and 2025-26 of almost £100 billion (Allen 2001).

As an approach to financing and delivering public services, the use of PFI has begun to spread to other countries. An authorizing PFI Act was enacted in Japan in October 1999 to promote infrastructure facilities and 49 PFI projects were in the pipeline by 2002. PFI is currently operating in various governmental departments in Canada and South Africa. And PFI has become a popular means for infrastructure financing in OECD countries, including roads in Finland, France, Italy, Ireland, Spain and Greece, health care facilities in Portugal, rail in the Netherlands, and water projects in several countries (Middleton 2001/2002, Stone 2002b).

Capital Budgeting Practices

Every year, governments spend resources on the construction of facilities or the purchase of equipment that will continue in use for many years beyond the year of purchase. The purchase or construction of such a long-lasting physical asset is a capital investment for the public sector. For budgeting purpose, therefore, governmental expenditures traditionally are distinguished into

capital expenditures and current or operating expenditures. Capital spending is financed in a variety of ways, including use of current revenues or "paying as you go (PAYGO)," debt financing (usually general obligation or revenue bonds), and lease purchases, where governments lease a facility/equipment for some period of years with an option to buy the facility at the end of the term.

Practices in capital budgeting vary widely internationally and within the United States. It is still possible, however, to outline a general format for capital investment planning or capital budgeting process. According to Lee and Johnson (1998, 371), this process consists of 8 general steps as follows:

1. Identify present service characteristics (inventory facilities and services levels)
2. Identify environmental trends
3. Develop service objectives
4. Develop preliminary list of capital projects and cost estimates
5. Identify financial resources (this would include both current revenues and potential debt)
6. Select subset of projects for inclusion in five year capital investment plan (CIP)
7. Identify future recurrent cost impact of CIP on operating budget
8. Include first year of CIP in annual budget estimate

Some governments (including most state governments in the Untied States) have separate capital and operating budgets; however the US federal government intermingles operating and capital spending in its budgets and appropriation bills.

There are many reasons why political decision-makers prefer to spread out large capital costs over an extended period of time, rather than to include them in their operating budgets.

Capital spending is "lumpy" and very visible; it creates an increase in spending that may not be politically popular. Borrowing may increase the lifetime costs of the investment, but it lowers the one-time, up-front costs, reducing political visibility. Spreading the costs of a long-term investment also allows future beneficiaries to pay for the increased services through user fees or taxes. By spreading the costs and reducing the visibility, political leaders may have a greater opportunity for getting their program approved.

However, capital borrowing may not completely solve the problem of infrastructure need versus political willingness to pay. Government borrowing is constrained by limitations (legal, financial or political) on the amount of debt. Some infrastructure projects are less politically attractive and may lose out to more popular projects such as schools or roads that may be popular with voters. Thus, decision-makers are seeking additional sources for public infrastructure finance.

The PFI process has some similarities and some differences from the one outlined above for capital budgeting. Steps 1-4 are the same; however, in developing cost estimates, public sector agencies would typically develop a public sector cost comparator to weigh against the PFI option. PFI than becomes an option along with debt and PAYGO to finance new infrastructure. If appropriate, the public sector agency would go through the processes outlined by Grout, above.

PFI and Public Capital Expenditure

PFI capital expenditures are an addition to traditional governmental capital expenditures. According to the 2001 UK's *Pre-Budget Report*, public sector capital expenditure is projected to rise from £19.0 billion in 2000-01 to £33.2 billion in 2003-04. As a proportion of GDP, public capital expenditure will rise from 2 percent of GDP to 3 percent over this period. It is expected

that the rise in public sector capital expenditure under the PFI will increase total publicly sponsored capital expenditure from £22.9 billion in 2000-01 to £35.6 billion in 2003-04 (see Table 1).

Table 1
Public Sector capital expenditure

£ Billion

	Outrun	Projections		
	2000/01	2001/02	2002/03	2003/04
Total public sector capital expenditure	**19.0**	**26.0**	**28.8**	**33.2**
(As % of GDP)	2.0%	2.6%	2.8%	3.0%
Estimated capital expenditure under PFI	**3.9**	**3.5**	**3.1**	**2.4**
(As % of total public capital expenditure)	17.0%	11.9%	9.7%	6.7%
Total publicly sponsored capital expenditure	**22.9**	**29.5**	**31.9**	**35.6**
(As % of GDP)	2.4%	3.0%	3.0%	3.2%

Source: Pre-Budget Report, Cm5318, November 2001

The Case for PFI

There are two major arguments traditionally put forward for the advantages of PFI—both revolve around the belief that private provision is often superior to public provision. The first argument regards PFI as an improved form of government contracting or outsourcing, which under the right circumstances could yield even greater efficiency savings and "value-for-money." Arthur Andersen and Enterprise LSE identified six key drivers of value-for-money in PFI (Arthur Andersen and Enterprise LSE 2000):

1. Risk transfer from public sector to private sector including construction and operation costs, technological change, and the long-term fit between a facility and its public purpose.
2. The long-term nature of contracts enables the private investment to be recovered over a reasonably long period and leads to lower costs to government for public services.

3. The use of an output-based service specification; PFI is based on delivery of a certain level of service—the output desired—rather than on the inputs used to provide the service, e.g., the building or other assets involved in producing the output.
4. Competition in the bidding process lowers cost of capital and services over the long-term.
5. Performance measurement and incentives are developed and used as the basis for holding the PFI provider accountable for results and can be used to create financial incentives for superior performance.
6. Private sector management skills increase operating efficiencies including economies of scale and the delivery of the services requiring skills that are non-core to government.

Why PFI? The Case Study of Northern Line Trains

The Northern Line of London Underground is one of the busiest sections of the network. For some considerable time, it has been the candidate for major modernization. In 1993, a PFI deal was signed with ABB Transportation Limited. The advantages of the PFI project included risk transfer and value for money.

Risk transfer. The Northern Line contract transfers the following risks to the supplier: (1) ***Design and construction risk***. The supplier carries risk for the design, manufacture and delivery of the trains and equipment. (2) ***Service availability***. The supplier is responsible for specifying the number of trains against a maximum specified service requirement. (3). ***Performance risk***. The supplier carries risk for performance and reliability of the trains throughout the 20-year primary usage period. (4) ***Residual value risk***. Government is committed only to procure a service for 20 years representing a significant residual value risk to the supplier. (5) ***Early termination***. The supplier must achieve a pre-agreed performance and reliability target, substantially better than the present best on the underground or government can exit the contract. **Value for money**. The Northern Line PFI contract provides better value for money when compared to the equivalent purchase of trains, equipment and service by the government agency. This includes earlier (and superior) delivery of services, tax benefits, and reduced risk.

Source: Source: Private Finance Panel, HM Treasury. (1995). *Private Opportunity, Public Benefit: Progressing the Private Finance Initiative*. London, UK. P. 32-33

The second argument is that PFI helps government respond to the need for greater capital spending on public infrastructure in an era when public support for these expenditures can be difficult to sustain. In the UK, PFI enables infrastructure to be built without it appearing in the report on capital budgeting – the Public Sector Borrowing Requirement (PSBR). In the US, where state and local governments often face limitations on their ability to issue debt for capital facilities, PFI might provide a method to achieve the necessary services without the need for government borrowing. Even if a PFI project might have to be included as a long-term obligation in a government's annual audit, according to generally accepted accounting practices (GAAP reporting), a government might avoid a constitutional or legislative limit on general indebtedness. While the US federal government does not have such debt limitation, fiscal discipline has become a recent political imperative, and PFI has the potential to allow expanded infrastructure programs without the full cost and risk borne by the government.

Under the PFI scheme, if a capital project is financed by PFI, the capital expenditure itself does not normally score as public expenditure. This is known as 'off-balance-sheet' financing as the liability for the debt is not recognized as a government debt. However, government is committed to pay in the future. Philip Stephens (1996) commented:

'The most obvious effect [of the PFI] on the public finances is to reduce spending now and replace it with a stream of future liabilities. A private contractor picks up the bill for the construction of, say, a new prison, while the taxpayer guarantees it an income spread out over the lifetime of the asset. Today's capital investment thus becomes tomorrow's current spending."

KPMG's Timothy Stone argues that PFI is a misnomer and should not be viewed primarily as a financing mechanism: "the true intent and practice is emphatically not about the replacement of government borrowing by private sector finance." Rather, it is an attempt to

involve the private sector to a much greater degree in the delivery of public services; while making an attempt to drive political decision making towards a recognition of the long-term consequences of those decisions (Stone, 2002a).

Theoretical Justifications for PFI

Unlike some privatization efforts whose prime purpose is to "shrink the state," (Feigenbaum, et. al 2000), PFI envisions expanded and improved government services, albeit with private financing and provision. However, practically speaking, these expanded services could have been provided by the public sector, through capital financing and state operation. What, therefore, is the theoretical justifications for PFI?

The Competitive Market Model

At its core PFI assumes the superiority of the competitive contract model in delivering goods and services. Government can take advantage, or may even create, competitive markets for the delivery of government services. This competition will produce more efficient delivery of the goods people want. The standard market model envisions many markets composed of a large number of buyers and sellers, complete knowledge of information on quality and production costs, arms length negotiations, no impediments to entry of firms, etc. If all of these conditions hold, the market is considered to be a producer and allocation of social services superior to the government.

PFI focuses on the outputs government require to achieve policy objectives—the "what" not the "how" of delivering public services (Stone 2002a). This requires governments to place as few as possible constraints on the private sector provider. Thus government needs to be able to specify the objectives and then largely release the control. Stone claims that assets, per se, have no inherent value to governments. They are valuable only to collectors or traders, or to be used in

a business or to deliver a public service. The real interest of government should be the efficient long-term service delivery itself—and that can be made subject to the competitive processes.

While the use of competitive markets to deliver private goods and services is common in the world economy, there may be reasons to question its applicability for delivery of some government services. For example, contracting with the government never is completely at "arms length," politics often interceding into the contracting process. There are often only a few vendors for complex government goods and services. The size of the project, the information needed to operate efficiently, and up-front capital requirements, may serve as impediments to firm entry (Sclar 2000).

Despite these concerns, the market model provides powerful incentives for efficient service delivery. PFI has the potential to overcome the two major problems of long-term service delivery: the principal agent problem and the accountability problem.

A New Principal-Agent Relationship

Proponents of PFI argue that government cannot finance, construct and operate a facility as efficiently as the private sector. At the heart of this argument is principal-agent failure. The principal (the political leaders, representing the people) wants to have efficient delivery of services. However, the bureaucratic personnel (the agent) have their own aims. They might want to increase their power and authority or to enhance their salaries at the expense of efficiency. The public choice school of economics has detailed this and other efficiency failings of the public sector (see, e.g. Niskanen, Jr. 1971, Tullock 1965 and Downs 1967).

Principal-agent theory deals with problems of asymmetric information between contractual parties. In theory, the principal-agency paradigm can be divided into "adverse selection" and "moral hazard" problems. According to Salanié (1997, 11), the "adverse

selection" problem rises when a characteristic of the agent is imperfectly observed by the principal. This term comes from a well-known phenomenon in the insurance market: if the insurance company only offers a tariff tailored to the average risk in the population, this tariff will only attract the higher risks and will therefore lose money. Public sector incentive structures are tailored around the "average" worker (the agent), thus political decision makers (the principal) may never know whether they have created a structure to achieve the most efficient result in terms of capital and operating costs.

This is also true, to some extent, in the case of PFI as some characteristics of the agent – the private consortium in the case of PFI – are imperfectly observed by the principal – the government agencies. Generally, the agent is better informed of alternative approaches to implement a project and the costs and effects associated with each approach. The attempt in a PFI transaction is to persuade (or compel) the private consortiums to reveal their characteristics: their management capability, their price preferences for construction and service delivery in the future; and their better informed knowledge of alternative approaches to implement those PFI projects. Therefore, critical to the success of PFI projects, are the mechanism designed to induce the agents to reveal their preference. Mechanism design is the core of "adverse selection" problem. The PFI, through contract invitation and bidding process, make private sectors reveal information about their capacity to perform.

The basic idea conveyed in "moral hazard" is simple. The agent acts on behalf of the principal, but the principal faces difficulties in trying to monitor the actions of the agent. What the principal sees, essentially, are results. For example, if the principal is the owner of a firm and the agent serves as the firm's manger, the results are the profits at the end of the year. Provided there were no exogenous disturbances, the principal could assess the firm's results and draw

conclusions about the behavior, such as the effort level of his agent. However, if outside disturbances that could influence results did occur, the agent may have valid excuses for bad results, and the principal cannot determine definitively what the reason is for the results observed. This is a particular problem in the public sector where there is no "bottom line" result that is clear to the principal.

According to Salanié (1997, 107), a "moral hazard" problem occurs when (a) the agent takes a decision or action that affects his utility or welfare and that of the principal; (b) the principal only observes the "outcome"; and (c) the action the agent chooses spontaneously is not efficient. Since the agent's action is unobservable, the principal cannot force the agent to choose an efficient action. The principal can only influence the agent's choice of action by conditioning the agent's utility to the only variable that is observable—the outcome. Therefore, the core of "moral hazard" problem is to maintain the agent's incentives for an efficient level of effort.

In the public sector, outcomes are influenced by many factors: changing political demands, environmental influences, union and legislated rules of procedure, etc. This makes it very difficult for the principals to know whether their agents are performing in an efficient manner. Further, the principal has limited incentives available to ensure the agent's efficient effort. The PFI, through risk transfer, attempts to trigger the agent's incentive for efficient financing and operation of capital projects. It does this through its payment structure that can be both affirmative—payments for service at the desired or higher level, and negative—deductions for service below expectations.

Shifting of Risk

Governments traditionally have borne the risk in the delivery of public services, even when they contract with private sector vendors to be the providers. However, government

employees are not trained or rewarded for taking or managing risks. One of important arguments in favor of PFI is a more optimal allocation of risk. The HM Treasure *Private Opportunity, Public Benefit* report (1995) states that "as a general rule of PFI schemes should always transfer to the supplier design, construction and operating risks (both cost and performance). Demand and other risks should be a matter of negotiation with the value for money impact being tested, where appropriate, through bids on alternative risk transfer bases against minimum and conforming requirements."

According to Grahame Allen (2001, 29), risks retained by the public sector could be distinguished to include: (a) the risk of a wrongly specified requirement, (b) the risk of catastrophic events, and (c) the political risk of criticism. A failure of a public service, even if entirely the responsibility of a supplier, may result in criticism of the government or local authority along with the supplier. If a prisoner escapes from a private prison, the chief political officer will likely take the heat more than the CEO of the private contractor, regardless of the financial penalties. The risks of a PFI projects should only be transferred to the private sector if, and to the extent that, the private sector is capable of managing such risk. Therefore, the risks of major catastrophic events should remain with the government.

The Accountability Problem

Governments and their political leaders often have short-term horizons and there is little or no accountability for the long-term consequences of their decisions and actions. This poses a unique problem when considering the efficient delivery of public services. In the ideal world, an infrastructure facility would be constructed using the best life-cycle costing techniques with annual appropriations sufficient to cover maintenance and major repairs of the facility as needed. However, in the political arena, little credit is given for long-range success. The political horizon

is only as long as the next election. Thus, low-cost bidding requirements may ignore life cycle cost issues, while change orders (sometimes the result of political pressures) drive up costs above original estimates. Facilities are notoriously under-maintained (the National Research Council 1998 estimates the US figure in the billions of dollars) as annual appropriations for facility maintenance are superceded by new capital budget items that politically provide more instant gratification.

PFI solves this short-term horizon problem by defining the level of acceptable service (the outcome) over a long period of time, at the lowest possible long-term cost to society. Thus, successful bidders are less concerned with short-run cost and give a high priority to what is most efficient over the long run. Ongoing preventative maintenance keeps the facility running to standards while minimizing facility downtime and major repair. What is to prevent successful PFI contractors from attempting to maximize short-term profits by under maintaining the facility? Not only does the contractor need to meet current service specifics but, in addition, the public sector has an ally in the bank or other financial house that holds the long-term financial debt .

PFI addresses the accountability problem, in effect, by forcing government to fund the facility at an appropriate ongoing level necessary to provide the services as defined in the agreement. Rather than one-time construction costs with an uncertain level of ongoing funding, governments must buy a level of service for the long haul, not just a facility.

The Cost of Capital

While the cost of capital would normally favor government finance and construction, this may not always be the case. Developing nations may pay a higher price in the capital markets

for funds. Even where government may borrow at a lower cost, there may be good arguments for private finance:

1. Using "lower" government cost of capital obscures the fact that through its borrowing the government is taking funds that otherwise would be used by the private sector. Thus, in analyzing public vs. private provision, the opportunity cost is the private sector interest rate and not the government rate. This is essentially the same argument made by those who argue that government should use a private sector interest rate in justifying government projects(Mikesell 1997).
2. From a budgetary perspective, lower capital costs by the government may well be more than offset by higher taxes paid by private firms, engaging in private finance. However, from a cost-benefit perspective, taxes are simply a transfer and should typically not be included in the analysis (Kee 1994).
3. By using a private finance for some government services, you save the government's borrowing capacity for those areas that are uniquely governmental and for which there is no private finance option.

Limitations of PFI

While there are many advantages to PFI, its success depends, in large part, on the ability of government agencies to define the public service level outputs with specificity and, for those outputs to remain fairly constant over a long period. A clear definition of the public services to be provided is the guide to the private sector provider on the quality and quantity of services to offer. In addition, there are other major concerns with PFI.

Transaction Costs

Kenneth Arrow (1969, 48) defined transaction cost as the "costs of running the economic system." Such costs are distinguished from production costs. Transaction costs are the economic equivalent of friction in physical systems. According to Furubotn and Richter (1997), transaction costs can be divided into three categories: market transaction costs, managerial transaction costs, and political transaction costs.

Market transaction costs consist primarily of information and bargaining costs, and supervision and enforcement costs (Furubotn and Richter 1997, 44-45). An individual planning a specific market transaction must look for a suitable party with whom to deal, and the process of search or obtaining those information for transaction inevitably results in costs. The bargaining costs relate to the expenditures that must be spent when a contract is being prepared and the concerned parties must bargain and negotiate over its provisions. In addition, market transaction costs also include supervision and enforcement costs. These costs relate with monitoring the implementation of the agreed contract. PFI market transaction costs are higher than those public financed capital projects. However, these costs are decreasing along with the maturity of PFI contract signing and enforcement.

Managerial transaction costs are those costs of running an organization. In the case of PFI, the costs of running organization have been reduced with the establishment of public-private partnership agencies such as Partnership UK and International Financial Services Limited (formerly British Invisibles), a PPP/PFI group that helps foreign governments learn from the UK experience.

It is not clear whether political transaction costs are greater or less with PFI than with other infrastructure service delivery systems. Both have the potential for political interference;

however, once a PFI deal is in place, the contract itself, if well structured, may reduce ongoing political interference and costs.

In order for the private sector to recover its costs and earn a profit, PFI agreements are typically of a long-term nature, often 20 years or more. This may make sense if the nature of the service is fairly constant over the length of the contract. Changing service requirements create sources of friction in the contract that must be negotiated. To the extent that the type and quality of service needs are likely to be volatile over time, transaction costs increase and PFI may not be appropriate. Long-term contract terms may not always be optimal. The incentives for the service provider to make changes in changing circumstances may be weak and those incentives will tend to be directed toward cost-cutting rather than service-enhancing activities

Equity

The private sector has limited interests in equitable concern, that is, who actually receives the services provided under the contract. Such distributional consequences are important to government. While it may be possible to take these issues into account when drafting the contract, private sector organizations will never have the same concern over the equitable provision of services as will government agencies. If the PFI contract allows for the imposition of fees, low-income families may suffer, unless government provides a subsidy to provide service for those who can not pay.

Distortion of priorities

The PFI process may distort spending priorities as potential projects may be taken forward because they are "PFIable" or can generate a bankable revenue stream, rather than because they will deliver the greatest overall social benefits. To the extent that this occurs, public resources may not always be spent in the most efficient manner, i.e., to achieve the maximum

benefit, given the level of spending. However, this assumes that funding decisions are made in a rational framework. Whereas, public spending decisions are a political process that seldom seeks as its principal goal, the maximization of net benefits.

Conclusion

The primary argument for PFI remains the notion of "value for money." Underlying that notion is the theoretical justification that market competition and better incentives (solving the principal-agent problem and the accountability problem) will create public services that are more timely and as good or better than are now provided by the public sector. These advantages arguably outweigh the likely increase in transaction costs involved in PFI. Equity issues are left unresolved, to be solved by other government policies.

Critical to the success of PFI are three problematic concerns. First, government must be able to define, over a considerable length of time, the good or service that it is purchasing. This will obviously be easier for some services than others. Second, an appropriate understanding and allocation of the various risks, to the public sector and the private sector, is essential. Third, the public sector may need to help create a competitive market to produce the service and to manage effectively that market development activity. If these problems can be solved, PFI can provide public official and managers with an optional approach to the production of cost-effective government services.

Note: Zhibin Zhang, doctoral student in Public Administration, George Washington University, assisted in the research of this article.

References

Allen, Grahame (2001), *The Private Finance Initiative (PFI),* London: House of Commons Library, Economic Policy and Statistics Section.

Arrow, Kenneth (1969), "The Organization of Economic Activity: Issues Pertinent to the Choice of Market versus Non-Market Allocation." In *The Analysis and Evaluation of Public Expenditures: The PBB-System*, Joint Economic Committee, 91st Cong., 1st sess., vol.1. Washington, DC: Government Printing Office.

Arthur Andersen and Enterprise LSE (2000), *Value for Money Drivers in the Private Finance Initiative*, January 17

Downs, Anthony (1967), *Inside Bureaucracy*, Boston: Little, Brown.

Feigenbaum, Harvey, Henig, Jeff, and Hammett, Chris. (2000), *Shrinking the State*. Cambridge: Cambridge University Press.

Forrer, John, Kee, James, and Zhang, Zhibin, "Greenway Case Study," Draft 2002, The George Washington University, Washington, DC.

Furubotn, Erik and Rudolf Richter (1997), *Institutions and Economic Theory: The Contribution of the New Institutional Economics*, Ann Arbor: The University of Michigan Press.

Grout, Paul A. (1997), "The Economics of the Private Finance Initiative", *Oxford Review of Economic Policy*, 13 (4), 53-66

HM Treasury (1995), *Private Opportunity, Public Benefit: Progressing the Private Finance Initiative*. London: HM Treasury.

Kee, James Edwin (1994), "Benefit-Cost Analysis in Program Evaluation," in Wholey, Hatry and Newcomer, eds. *Handbook of Practical Program Evaluation*. San Francisco: Jossey-Bass.

Middleton, Nigel (2001/2002), "Public Private Partnerships: Argument Turns to Action, *International Privatization Review*.

Mikesell, R.R. (1997), *The Rate of Discount for Evaluating Public Projects*. Washington DC: The American Enterprise Institute.

Niskanen, William Jr. (1971), *Bureaucracy and Representative Government*, Chicago: Aldine-Atherton.

National Research Council. (1998), *Stewardship of Federal Facilities*, Committee to Assess Techniques for Developing Maintenance and Repair Budgets for Federal Facilities. Washington DC: National Academy Press.

Robinson, Peter (2000), "The Private Finance Initiative: the Real Story", *Consumer Policy Review* 10 (3), 82-85

The Stationery Office (2000), *Public Private Partnerships: the Government's Approach*, London.

Salanié, Bernard (1997), *The Economics of Contracts: A Primer*, Cambridge: The MIT Press.

Savas, E.S. (2000), *Privatization and Public-Private Partnerships*. NYC: Chatham House.

Sclar, E.D. (2000). *You Don't Always Get What You Pay For.* Ithaca: Cornell University Press.

Sharman, Lord Colin (2002). Presentation to George Washington University class, Privatization and Competition as Reform. London, July 18.

Stone, Timothy (2002a) "Privatization & PPP: What are the differences?" *Privatization & Public Private Partnership Review 20002-2003*. Euromoney Publication.

Stone, Timothy (2002b) Presentation to George Washington University class, Privatization and Competition as Reform. London, July 18.

Timmins, Nicholas (2000), "Momentum Increases Though Doubters Remain", *Financial Times*, November 29

Tullock, Gordon (1965), *The Politics of Bureaucracy*, Washington: Public Affairs Press.