# THE UTILITY OF USING PUBLIC-PRIVATE PARTNERSHIP FOR LOCAL GOVERNMENTS

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**Abstract:** *The purpose of this article is to present which are the main advantages and risks associated with the use of the public-private partnership for local government. Knowing and understanding them is important, because the use of such cooperation form do not represent an all-heal solution for every problem of the local government, but must be analysed taking in consideration both the advantages and risks associated. Thus, by making a critical incursion in the literature will emphasize in this article the utility that the use of the public-private partnership in the local government might have, especially in the context of assuming both benefits and risks associated.*
**Keywords**: *local governments, public-private partnership, public services, risks*

## Introduction

All the European states provide public services to its citizens, having different names and scopes, according to every country's particularities. The public services from the EU countries have undergone some changes determined by the political, economical and social evolutions, and the notion of public service can have different meanings, according to the state in which we relate, thus, in every state, they are insured in different proportions. In many states it is ingrained that the public sector is responsible for delivering the basic services, but this thing can change, especially since the public sector wishes to exploit the advantages offered by the private sector. One of the possibilities at hand for the local governments is to collaborate with the private sector to provide public services through private operators, this form of collaboration being called public-private partnership. In this respect, the present article aims to make an incursion into the literature of the domain to correlatively analyse the benefits and risks that the public-private partnerships presume, in order to outsource the administrative activity.

## Conceptual framework regarding the public-private partnership

The public-private partnership is a concept that stirs controversy regarding its area of use. In this respect, there is a dilemma about how much of certain administrative services can be outsourced, which of the public services can be made in the public version and which in the private one, aiming at choosing the most efficient option that will best correspond to the citizens' needs. When making these decisions, the public-private partnership must not be seen as the all-heal solution that can solve any problem, but it must be analysed from the associated benefits and risks' point of view.

Regarding the definition of the public-private partnership, we consider that until now it has not been reached a unanimous consensus in this matter, but can be grouped in two big categories. A first category defines the public-private partnership in a wide meaning, being considered an umbrella notion (Bovaird, 2004; Hodge & Greve, 2007) that covers a wide range of public-private collaboration forms and considers that any public interference in providing a public service or making an infrastructure work can be called a public-private partnership. The second category defines the public-private partnership in a narrow meaning, considering that for being able to talk about public-private partnership, the meeting of some characteristics is mandatory, such as: sharing between partners, one public and one private, the risks, costs, benefits, resources and responsibilities. We consider that the second category is the closest to what the public-private partnership means, but in the international practice, the public-private partnership takes many forms, due to various domains, particularities of the states and different needs that it is used for.

At a community level, the public-private partnership term is not defined, but it is used by the European Committee (2004) with the sense of cooperation form between the public authorities and the private environment that aims for the guarantee, financing, construction, renovation, management of the infrastructure and public services. Calleja (2010) is taking in consideration the neutral community law, because it leaves to the public authorities the liberty to choose the way of satisfying the public services, but enters in the game only when the public authorities decide to involve third parties through regulations that refer to public acquisitions and concessions.

### *Benefits and risks of the public-private partnership usage*

The local governments will run projects in public-private partnerships as long as the advantages of such collaboration, from both the financially point of view and from efficiency growth motives and the responsibility in providing public services and/or in making infrastructure works, overcome the disadvantages and risks they assume.

One main motive that is considered an advantage of the public-private partnership usage is represented by attracting private investments in domains traditionally considered public, this is especially important since most states are facing, both at central and local levels, with budgetary constraints. In the case of the public-private partnership, the investments made are not directly supported by the public budget, but through the private partner that will recover the investment and will obtain profit either through taxes paid by the final users (concession model), either by amount paid by the public authorities (the case of the *Public Finance Initiative* from the Great Britain) that can have the shape of subsidies, guarantees or *shadow fees* (Engel, Fisher & Galetovic, 2008). Through the contribution of the private investment capital, the public resources can be supplemented or they can be later redirected towards other public needs, thus seeking the enhance of the efficiency in using the financial resources and even the reform of the public sector based on the reallocation of roles, incentives and responsibilities. Because of the private investment in domains that used to be financed in a traditional way by the public sector, the public authorities relieve it's budget from some of the investment expenses, especially in the context in which the ordinary incomes are insufficient and thus they avoid public loans.

The budgetary restrictions that the public authorities confront itself with are important, also because they are closely monitored and managed in the EU states, where, according to the Stability and Growth Pact stipulations, it has established that the limit of the public debt will represent 60% of the gross domestic product and the budgetary deficit will not exceed 3%.

What must be specified is that by the version of the public-private partnership usage the responsibilities of the private sector will not be eliminated. The public sector must continue to assume an active role in providing public services and infrastructure, for several reasons such as that the public sector does not take into account the externalities, that without the intervention from the state the infrastructure works such as street constructions and street lighting would not be able to be provided free of charge (public goods), that providing them only on competitive basis of the infrastructure would not be effective, meaning that it needs a public control and even if the competition is possible, the public sector must supply those public goods that through private supply would exclude certain social categories (in the case of the existence only of private schools, the social categories that cannot afford to pay would be excluded from the educational process), that there are domains, such as the one of the road infrastructure that need a high initial investment and the recovery period is long, which makes unattractive a private investment without public support (Yescombe, 2007). But, it cannot be called in question the importance of the private sector that disposes of a better mobility than the public sector, because not only that it is capable of decreasing the costs of the projects in the planning, designing construction and operation phases, but can also avoid paper work and can diminish the administrative formalities.

Regarding the decrease of the investment expenses by using the public-private partnership, there are some controversies in this regard, because various specialists consider that this concept is surrounded by numerous myths, one of which being that there is no alternative for making different projects than through the public-private partnership (Hall, 2008). Before using the public-private partnership, it is mandatory to make a rigorous justification of the decision regarding the exploitation modality of a public service, the use of the method called Public Sector Comparator being necessary. The Public Sector Comparator is a modality to compare whether the private exploitation version of a public service brings value for money compared to the most effective modality of public exploitation. Thus, based on the advantaged and disadvantages of each way of providing public services and making of infrastructure works must be decided if the traditional version of public acquisitions is or not more advantageous than the public-private partnership. Among the value for money principle, it must take into consideration the criteria such as minimizing the total social costs. More specifically, the governments should reduce the production costs that they have (including payment to third parties), plus the transaction costs, plus the negative externalities (net), keeping at the same time constant quality. The specialists in this domain emphasis that when taking a decision it must not take in consideration only the accounting costs, but also the social costs of such a project. The government must use the public-private partnership only if it brings value for money to a project, being mandatory to establish whether the payments made in the public-private partnership (taking in consideration the risk as well) bring value for money in relation to the cash-flow (and the assumed risk) compared to the traditional or alternative versions that the state has at hand. Before a decision is made whether a certain public service or a certain work must be outsourced by the private sector, it is mandatory to have an analysis of the cost-benefit that will take in consideration all the important aspects of the given project.

Although the advantages of having such a comparison are clear, many times, it is either not used or not used properly. These deficiencies have been seen in European countries such as Estonia, Italy or Holland. In Estonia, the national authority audit report reflected the fact that because of the improper use of the Public Sector Comparator, many projects have been assigned to be implemented in the public-private partnership that on the long term would have been 25% more expensive than in the public sector version (Friedrich & Reiljan, 2007). Only in the case where all the particularities of the project are taken in consideration it will be decided that the public-private partnership is the most efficient, only then it can be said that public funds are being saved.

Other advantages of the public-private partnership use that do not refer to financial aspects, refer to the added value brought by the collaboration with the private sector that has as strong points: innovation, financial capacity, knowledge of new technologies, managerial effectiveness and entrepreneurship (Bennet, James & Grohmann, 2000). Thus, by collaborating with the private sector by making projects through the public-private partnership, the public sector does not share only the financial costs of the projects, but also the risks, better services are being provided, a better monitoring of projects is being done, it benefits from the efficiency and flexibility of the organizations from the private sector (Hodge, 2004). In this respect, the European Committee (European Committee, 2007) has identified the following benefits of the public-private partnership use: providing additional capital, offering alternatives in managing the public services, offering added value to consumers and assuring a better identification of the needs and an optimal use of resources.

Also, by involving the private sector, better services are being provided and a good risk-profit balance can be maintained in the project from the public-private partnership. In this context, the private investors will start projects with higher risks as long as the profit they predict is directly proportional to the risk they assumed.

Another benefit of the public-private partnership is that through it an effective use of the resources is being made (Cheung, Chan & Kajewsky, 2009), due to the fact that the long term costs for the provided services are being analysed, which generates a much more realistic and objective analysis in selecting the projects. Once the private partner is involved not only in the construction phase of an infrastructure work, but also in the exploitation and maintenance phase, it focuses not only on the minimization of construction costs, but also in the minimization of costs for the entire life of the project. Also, it tries to control much better the deadlines, because by a faster execution of the project, the investment can be recovered earlier and thus the profit as well.

The call for public-private partnership is determined also by the increase of the demand in services and public infrastructure, thus the World Bank estimates that in the developing countries the total annual demand for infrastructure works, that includes domains such as roads, railways, ports, water supply, health, telecommunications and energy overcomes 1000 billion dollars (Menendez, 1998). Also, the same source shows that in the 1990-1996 periods the private investments multiplied, so that in the telecommunications and energy infrastructure domain they represented 70% of the total investment. We can conclude that the public authorities have turned in the recent years their attention toward financial, human and technological resources of the private sector.

For example, the dates regarding the public-private partnership in Slovenia and Croatia show that in these two countries an exceptional growth of the public-private partnerships has been registered regarding the construction of public infrastructure and supplying public services. The factors that determined this development have been represented especially by the economic motivation. By involving the private sector in financing infrastructure projects and supplying public services, the public sector was capable to obtain financial resources sufficient to make the proposed projects without increasing the public debt. At the same time, because of the good private management, the public sector was capable to offer better, cheaper and more efficient public services. Based on this study, it has been noticed that in two states of the Central and South-East Europe, where the public-private partnership has been used at the local government level, it has been registered a growth of the quality of public services and infrastructure, of the investments in public objectives, without being accompanied also by a growth of the local government's public debt (Grafenauer & Klaric, 2010).

The advantages of making projects in the public-private partnership have to be felt by both parts, because only in this manner the business environment representatives will be interested in running such projects. In the first place, by running projects in the public-private partnership new investment opportunities arise in domains that could not be exploited before either because of the role assumed by the state in the economy, or because it required bid investments with uncertain recovery. The public-private partnership offers the possibility to make investments in domains like: road, railway, port, telecommunication and energy infrastructure, but also social infrastructure (schools, hospitals, prisons).

Another important aspect both for the public and private sector is the way the risks are shared between the two sectors. Most authors consider that the risk should be shared based on the benefits perceived by each associated part of the project. The risks are grouped in two categories: endogenous and exogenous risks for each of the two sectors. Most risks are exogenous, thus the private partner is not better informed about this risk than the public partner, nor can it manage it better. However, although it is in the state's interest to isolate the contractor from the exogenous risks and to support it, this doesn't mean that it will be automatically transferred to the public sector. In case of inflation risk, that is exogenous to the private partner, but endogenous for the state, because the inflation is the result of its monetary and/or fiscal policies, the public sector cannot compensate the private partner of future price growth, and it will lead to the situation where this risk will be transferred to the public through increases of fees or prices for the goods or provided services. We can observe that in the literature, the opinions are divided, regarding the way in which the risks should be divided; this decision must be taken based on the particularities of each project.

The participants from the private sector are more reluctant to risk than the ones in the public sector; therefore they are more willing to give up on a part of the future profits to assume a smaller risk. This is due to the fact that the managers from the private sector and the private capital investors bear the consequences in a more direct and personal way, in the case the risks become a reality. For the public-private partnership to become more attractive to them either the state should assume a significant part of the risks or it should offer more significant risk premiums that will make the investment attractive for the investor. They will invest only when the risks will be lower than the profit expected to be obtained from the project. The risks are of many types, such as: market and income risks, risks from the design phase, risks from the construction phase, exploitation risks, financial risks, political risks, legal risks, environment risks, force majeure risk (Yescombe, 2007).

The risks that are supported by the state are in lots of cases the ones that the private operators have little control of, such as political, financial and usage risk. For example, for running a project in the public-private partnership, a political support is necessary. This is due to the fact that the public-private partnership contract is closed on a long period of time, in this period major political changes could occur. The public-private partnership contract not being under the auspices of the commercial law, can be discretionary modified by the public authorities against the private partner. The specific political risks also refer to war or civil conflict situations, expropriation regime (the public authority being able to expropriate the private partner without compensation) or the unilateral termination of the contract. The private investors will be more attracted by investments in stable states from a political point of view and in which there is a climate that offers a safe investment. However, the international practice has proven many times that either the public part assumes too many responsibilities, which determines the financial risk to be transferred to it. The solution in this case could be given by the existence of a legal framework that establishes in clear terms the terms of the contract, but leaves at the same time a certain flexibility through which the particularities of the contract are taken into account. The risk sharing should be fair and determined by the responsibilities of each part assumed through the contract.

The financial risks that influence the public-private partnership refer to the exchange rate risk and the interest rate risk. Another threat that the projects running in the public-private partnership have to deal with is given by the exchange rate’s fluctuation. In case the private partner has to cover a high external debt, the exchange rate’s fluctuations can have repercussions regarding the project. This situation appears especially in the case where the private partner has underestimated the exchange rate risk or it is in the construction phase and needs import goods whose acquisition leads to an increase of expenses that has not been estimated. The financial crisis has been felt, leading to the increase of the interest rate, this situation has determined the private investors to be in a state of expectation regarding future investments.

## Conclusions

The public-private partnership is a notion that covers a great range of cooperation shapes between the public and private sector, which has determined in the international literature and practice the inexistence of an unanimous accepted opinion regarding what this partnership represents. The differences in opinion regarding the public-private partnership exist also because of the different approach of each state. This diversity of opinions from the literature is found also in what it's use by the local public administration in concerned. However, we can conclude that despite this diversity of opinions, the decision to run a project in the public-private partnership must be taken based on a cost-benefit analysis that relatively analyses the version of running a project in the public-private partnership and the version of running one in a traditional way. Only when all the particularities, benefits and risks of a project are taken in consideration, the version of running a project in the public-private partnership is more viable and brings value for money, only then we can stipulate that the public-private partnership bring value to the public administration.

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