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# Transaction costs, relational contracting and public private partnerships: a case study of UK defence

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## Abstract

This paper is concerned with the economics of public private partnerships (PPPs)/private finance initiative (PFIs) and in particular the role of transaction costs and the importance of trust in relational contracting. The discussion is illustrated by reference to the UK defence sector. The paper begins by discussing the nature of PPPs/PFIs before moving on to consider how the economics of contracting literature can shed light on their strengths and weaknesses. The transaction cost literature is reviewed alongside a resource-based perspective of procurement decisions. The concepts of trust and reputation are then considered in the context of minimising procurement transaction costs. The theoretical framework developed is then applied and illustrated through a case study of UK defence contracting, in an attempt to assess whether the use of PPPs will necessarily lead to improved economic efficiency. The case study highlights both the scope of PPPs/PFIs and their potential transaction costs in defence procurement, with the normal perils in terms of contracting given information asymmetry, asset specificity and the resulting scope for opportunistic behaviour. © 2003 Elsevier Science Ltd. All rights reserved.

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## 1. Introduction

Public private partnerships (PPPs) are intended to harness the incentives of private markets to the public interest criteria of the state. Private capital and private sector companies finance and operate infrastructure that previously was publicly funded and managed. In recent years, PPPs have become popular in a number of countries. Governments keen to reduce government spending and borrowing and aware that private enterprise can provide services at lower cost, have introduced PPP programmes in place of or to supplement direct state investment. This paper considers the economics of public private partnerships and more specifically the roles of transaction costs, trust and relational contracting in the achievement of successful PPPs. The discussion is illustrated with reference to the

UK defence sector, which has a long track record of partnerships with the private sector.

PPPs including in the UK ‘private finance initiative’ (PFIs) are part of a wider policy of ‘privatisation’ based on the expectation that the private sector provides services more efficiently and more effectively than the public sector. PPPs/PFIs permit an expansion of infrastructure provision; an expansion beyond what the state on its own could achieve given budgetary constraints and a lack of project management skills (Roger, 1999). At the same time, however, concerns have been raised about their true long-term costs and therefore on their ability to provide public investments more cheaply on a life-time cost basis. The purpose of the paper is to set out a framework for assessing PPPs drawn from economics to assess the use of PPPs in the UK defence sector. The main research question is, will the use of PPPs necessarily lead to improved economic efficiency in defence procurement?

The structure of the paper is as follows. First there is a general discussion of the rationale for PPPs. Then the theory of transaction costs from economics is reviewed,

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followed by a discussion of the roles of reputation and trust in relational contracting and joint ventures. The theoretical framework developed is then applied to UK defence contracting, where many difficult issues relating PPP deals feature. Finally, the main conclusions for defence procurement are summarised.

## 2. Public private partnerships

Under the title of the PFI, in the UK a Conservative Government began from 1992 to tap the private sector to manage the building and sometimes the operation of investments previously undertaken within the public sector (Terry, 1996). The Labour Government elected in May 1997, although previously critical of the PFI, re-launched the programme under the banner of PPP and acted to speed up the process by which public–private contracts are awarded (HM Treasury, 1998a).<sup>1</sup> The latest initiative is the establishment of Partnerships UK.<sup>2</sup> The objective of Partnerships UK is to accelerate the process by which PPP contracts are agreed, in part by taking equity stakes in projects and in part by providing loans to public bodies. Another recent initiative by government is the proposal to publish model contracts so as to reduce the costs to private firms of tendering for public sector work.

To date the UK has dominated in Europe in terms of both the number and value of PPPs. For example, in 1999 around 40% of all PPPs in Europe by value occurred in the UK, compared with 8% in Germany, 4% in Spain and 9% in Italy, France and the Netherlands combined (Privatisation International, 2000, pp. 4–5). PFIs and now PPPs have been adopted in the UK in such areas as new government IT programmes, education, hospital building, waterways, road schemes, prison management, re-development of the London Underground, estate transfers by government departments and Ministry of Defence projects. The total value of capital projects is estimated at around £22.5bn (The Business, 6/7 October 2002, p. 16). Concerns have been raised in the UK, however, about the resulting costs and benefits. For example, the National Audit Office (NAO) that supervises probity and efficiency in public spending

in the UK, criticised the first big hospital development project. The NAO found that savings from the contract were greatly over-estimated by the NHS Trust that awarded it. Instead of achieving cost savings of £17m, the NAO estimated the likely savings to be around only £5m (Financial Times, 1999, p. 13). The NAO has also criticised the profits made by private companies on certain deals (NAO, 1997a, b).

In principle, PPPs involve clarity in specification and requirement, clear and enforceable contracts with proper cost efficiency incentives, and transparency in the bidding process. The intention is that government sets either the general objectives or specific outputs and leaves the private sector to design and manage the project, including the input mix. Typically, the private sector becomes responsible for the initial design and construction and operation and maintenance, thereby aligning incentives for low-cost construction with minimising life-time costs of operation. By contrast, capital constrained governments are tempted to lower the construction costs of a publicly financed project at the expense of much higher long-term costs of maintenance and operation. Other expected advantages of PPPs include risk allocation, e.g. cost over-runs managed more effectively through incentive-based contracts; greater transparency when political meddling in project specification occurs; and encouragement of innovation in project design, construction and operation and maintenance. Another reason for PPPs, however, is much weaker, the desire by governments to transfer expenditures from the public budget (and hence the public sector borrowing requirement) to the private sector. The opportunity costs of resources used in projects, and therefore the impact on economic welfare, is only lower by using PPPs rather than other methods of public procurement, including direct state provision, if there are real cost savings. Simply transferring expenditures between the public sector and private sector budgets has no effect on efficient resource allocation if identical resources are used. Also, PPPs can be a mechanism for inter-generational welfare shifting. Public sector financing costs are reduced in the short term at the expense of eventual higher tax burdens, triggered by future leasing costs or similar payments. Heald and Geaughan write (1997, p. 15): ‘The present generation of voter/taxpayers benefits from the assets (for example prisons, roads and hospitals) inherited from earlier generations but in turn bequeaths to the next generation a run-down public asset base and an extensive web of contractual obligations to buy the output from PFI assets.’

Governments can always borrow more cheaply than the private sector. For PPPs to produce overall cost savings, therefore, the extra financing cost (estimated at between one and three percentage points in the UK) needs to be offset by savings in other aspects of the

<sup>1</sup> ‘..... through which the public sector can secure improved value for money in partnership with the private sector’ (HM Treasury, 1998b). In the UK the terms PFI and PPP are both used and often interchangeably. However, correctly PFIs involve the provision of an asset and possibly a full-service package under a long-term contract. PPPs integrate the private and public sectors, with assets not returning to government. The Government has identified partial asset sales, concessions and joint ventures and partnerships as comprising PPPs. In this paper for brevity we often refer simply to PPPs, but the comments apply to PFIs too.

<sup>2</sup> Another recent initiative is the creation of the Office of Government Commerce to issue guidance on government procurement matters.

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