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Local Mixed Companies:

The Theory and Practice in an International Perspective

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Abstract:

Several factors have been contributing to the growing use of public private-partnership (PPP) arrangements by local governments, such as, the need for new investments on infrastructure (e.g. decentralization of responsibilities, regulatory requirements demanding better quality and environmental protection, renovation of the networks), imposition of strict debt limits to the localities, and local government reform policies/programs. Whereas contractual PPP arrangements, such as concession contracts, can be seen as an extension of traditional public procurement (with additional complexities in contract design and management) and are currently better handled by contracting authorities, institutionalized PPPs (mixed companies) are still quite puzzling for both practitioners and academics. In fact, the following questions deserve further investigation: When are mixed companies expected to depict a higher performance than other options? What are the risks involved and how should they be allocated and mitigated? How should mixed companies be monitored and evaluated? The articles in this Special Issue provide insightful answers to these and many other relevant questions to policy makers.

Keywords: institutionalized public-private partnerships; local government; partial privatization.

Introduction

Local governments are responsible for providing a vast number of services, many of them "essential" for social welfare. However, financial constraints and expertise limitations often represent palpable menaces to the sustainability of these services. For many years now this state of affairs has led practitioners and researchers to consider several alternatives for reforming local governments.

The processes of privatisation, reverse privatisation and corporatisation, for instance, are broadly documented and discussed in the literature (inter alia, Vickers and Yarrow 1988 and 1991, Bös 1991, Warner and Hefetz 2001, Greene 2002, Winston et al. 2002). The topic of purely contractual PPP arrangements (cPPPs), such as concession and *affermage* agreements, has earned special attention due to the increasing use of this type of procurement model and their difficult implementation because of asymmetric information (for a general overview, Hart 2002, Menard and Saussier 2002, Guasch 2004, Reeves 2008, Warner and Bel 2008, Koppenjan and Enserink 2009).

The selection, design and governance of mixed companies, instead, has been somewhat neglected. Mixed companies consist of joint ventures between public sector entities on one side and private operators and/or financial investors on the other. Nowadays, mixed companies are used by local governments all over the world, although with special incidence in Europe (mainly in Italy, Spain, France, Germany, and Portugal; Verdier et al. 2004) and South America (especially in Colombia, but also in Cuba and Mexico; Marin 2009).

Although theory tells us that mixed companies (or institutionalised PPPs) make sense and have advantages in comparison with cPPP (for example, Eckel and Vining 1985, Hart 2002, Viallet 1983, Schmitz 2000, and Marra 2007), practice does not confirm this in a clear-cut way and often tells us otherwise (Boardman and Vining 1989, Marques and Berg 2011, Albalate, Bel and Calzada 2011, and Cruz and Marques 2012).

Mixed companies represent an interesting governance structure. Well aware that in the vast majority of cases the preference of local authorities towards such alternative is determined by practical reasons, the purpose of this Special Issue is to provide some scientific body of knowledge to this governance structure which has not been sufficiently investigated in literature.

The rationales behind public intervention in the economy and, more specifically, in local services are well known. Local public services are intrinsically characterised by market failures: many of them, for example, are natural monopolies. This is not the only economic justification (although it may be the most important one) adopted by municipalities to intervene in service delivery. Further market failures, such as public or semi-public goods, asymmetric information and externalities, might need to be addressed by direct public sector intervention. Finally, sustainability is also an important factor in services having a strong impact on the environment.

These considerations weaken the case for privatisation of local services and support those in favour of enterprises totally owned and/or run by the public. However, although there is sufficient room to justify municipalities entering utilities, the public sector more often than not has to involve private operators due to their superior know-how, experience, flexibility and financial capabilities.

Then, the choice of a governance structure to deliver services over another is under the responsibility of municipalities. Roughly every local authority has four broad options. It can opt for traditional in-house production, indirect delivery trough corporatized public services (e.g. municipal companies), cPPP arrangements or mixed companies. The fact that with mixed companies the public entity might be both inside and outside the firm implies certain peculiarities that make it a special governance structure.

Unlike what happens with cPPPs, where the private partner is responsible for producing the services and its rights and duties are established in a (incomplete) written contract, with mixed companies, the public and private partners meet to jointly manage and deliver the services (Weber and Alfen 2010).

Mixed companies seem to be a type of constructive partnership, while purely cPPPs are said to be ‘transactional’ because usually they fail to cope with adaptations to shocks without triggering formal contractual revisions. By opting for mixed companies, local decision-makers try to adopt a relational approach to governance (Reeves 2008 and Cruz and Marques 2013).

The use of mixed companies should place a relatively high degree of control over the performance of the services on the public sector side. Indeed, in most cases the competent public authorities hold the majority of the shares, therefore retaining the dominant influence (Cruz and Marques 2012). The property rights should reduce information and monitoring costs due to the increased access of the public partner to information regarding day-to-day operations.

Schmidt (1996) argued that “*If the government gives up control of the firm and privatizes, then it will have less information about the firm’s costs (and profits) as compared to the situation where it controls the firm as a nationalized company. To justify this assumption, we have to explain why the government cannot write a contract with the private owner requiring that the government will receive all relevant information. The argument is that having access to inside information of a firm is not a specific right, which can be contracted upon easily, but rather a residual right, which is tied together with ownership. Information is not just available in a firm- it has to be produced, collected, accounted, processed, and transmitted, and it is the owner who in the end controls this process of* *information production. Therefore the owner is always able to manipulate the information. For example, she may manipulate transfer price, thus shifting profits from one division of her firm to another, or she may choose among different depreciation methods, thus shifting profits between periods, etc. After the information has been produced, it is impossible to verify it to an outsider even if the owner wishes to do so*" (Schmidt, 1996, 9).

A similar aspect was discussed by Williamson (1975), who emphasised that different organisational structures imply different information flows. In particular, the author distinguished the information that external auditors (versus internal ones) might collect: "*An external auditor is typically constrained to review written records and documents and in other respects restricts the scope of his investigation to clearly pertinent matters. An internal auditor, by contrast, has greater freedom of action, both to include less formal evidence and to explore the byways into which his investigation leads*" (Williamson, 1975, 29). According to the interpretation offered by Riordan (1990), Grossman and Hart (1986) seemed to deny that ownership gives more information. Discussing the change in information following vertical integration, they maintained that no advantage would derive from this in terms of information gathering and internal audit even if, in a footnote, they specified that the right to audit is sometimes a residual right rather than a contractible right, thus confirming that information depends on ownership patterns (Grossman and Hart, 1986, 695).

Thus, asymmetric information should be mitigated in mixed companies, enabling the 'internal regulation' and decreasing the risk of ex-post opportunistic behaviour (Marra 2007). Even in case of renegotiation of the initial contractual clauses, the public partner is better able to cope with principal–agent problems (Guasch 2004).

As emphasised by Hart (2002), when an incomplete contracting perspective is adopted, ownership becomes extremely relevant, and mixed companies can accomplish it.

"*One of the insights of the recent literature on the firm is that, if the only imperfections are those arising from moral hazard or asymmetric information, organizational form - including ownership and firm boundaries - does not matter: an owner has no special power or rights since everything is specified in an initial contract (at least among the things that can ever be specified). In contrast, ownership does matter when contracts are incomplete: the owner of an asset or firm can then make all decisions concerning the asset or firm that are not included in an initial contract (the owner has residual control rights). Applying this insight to the privatization context yields the conclusion that in a complete contracting world the government does not need to own a firm to control its behaviour: any goals - economic or otherwise - can be achieved via a detailed initial* *contract. However, if contracts are incomplete, as they are in practice, there is a case for the government to own an electricity company or prison since ownership gives the government special powers in the form of residual control rights*" (Hart, 2002, 69).

However risks of failure of such a governance structure are relevant.

In their theoretical investigations, Eckel and Vining (1985) found that mixed companies can result in the 'worst of both worlds', where neither profitable nor social goals can be effectively achieved. Currently, we have some indications of the causes for this unintended effect: low degree of expertise, absence of ethical standards and lack of clear and stable objectives. Moreover, the surrounding environment plays a role in determining the chance for the constitution of mixed companies. For instance, Bel and Fageda (2010) found that mixed companies are more likely to appear in municipalities with harsh financial constraints and where contracting costs are relevant.

This Special Issue addresses the governance of mixed companies and the use of this model by local governments. By accommodating research that combines both theoretical and empirical research from different fields of knowledge, the current issue of the *Annals of Public and Cooperative Economics* provides a useful resource to scholars who wish to frame their research agenda on the theme and to practitioners and local-decision makers trying to design optimal governance structures to provide local public services.

The research

The Special Issue starts with an article by Asquer (2014) who investigates the case of the Italian water sector and shows that mixed companies are related to the historical and institutional context as well as to the privatization policy process. The author invites the reader to pay attention to the causal role played by initial conditions, reform content features, and reform process features – including how these conditions may change over time in relation to contemporaneous events.

The article by Marra and Carlei (2014) presents, on a large-scale basis, an investigation on the institutional environment in which privatizations occur. It is well known that the planning of privatization operations requires much more than just the selection of which firms to privatize, the setting of price per share, the revenue target and percentage of stock to sell. The level of corruption, the consistency and continuity of action of the public partner, its strategic vision and government commitment and transparency significantly affect partial privatization processes and outcomes. This is relevant at both national and local level, no matter the sector under observation. In particular, the authors show that strategy and administrative burden are important determinants of privatization outcomes, and government commitment and strategic approach to privatization are usually associated with partial privatizations.

In the third article, Vining, Boardman and Moore (2014) address some of the gaps in both classification and theory pertaining to mixed companies. The authors sustain that without suitable theoretical and normative frameworks it is not possible to correctly evaluate the performance of mixed companies. It is argued that there has been insufficient attention to the basic normative question, namely: what should the main public policy goal of mixed companies be? The authors present three principal-agent models that offer contrasting theories of mixed companies' performance with differing assumptions about the motivations and behaviour of the relevant actors.

Peters, Pierre and Røiseland (2014) do not deny that mixed companies can be suitable arrangements for primarily economic functions but ask whether a mixed company would function for the management of health, education or even social service organizations. According to the authors, there appear to be some major impediments. The authors are more concerned with the political and governmental consequences of choosing public-private partnership as an instrument for policy and look at how the institutionalization of public-private partnerships, via the creation of mixed companies, can lead to a shift away from public values and towards private ones.

The article by Moszoro (2014) shows that, in theory, from the efficiency point of view the ownership of utilities does not have to be dichotomically public or private. Mixed companies can be superior to pure public or private ones because these allow benefiting from lower interest rates and efficient private management. The public sector can borrow money at a lower cost, while private investors can spawn life-cycle cost savings. In his model a Pareto-efficient capital structure is achieved with both the public and private parties as shareholders.

The Special Issue ends with two case-studies. In their article, Swarts and Warner (2014) refer to the Berlin transit system and suggest that mixed companies may be less important as a means to harness the benefits of private sector management and more important as a means to challenge labor rights. The authors find that the primary benefit of the partial privatization was to facilitate labor shedding, which was achieved in a manner that was inequitable to labor interests and resulted in a subsequent unionization effort that eroded many of the labor cost savings. Regarding process and service delivery improvement, the authors found that the restructuring of the public sector portions of the service was more effective than privatization, and that service quality to the riding public was maintained by keeping planning and accountability functions within the public realm.

Finally, Wang, Warner and Tian (2014) look at the Shanghai Public Bus System to investigate a new mixed model of contracting network to balance government, market and social groups. While the subject of the case study was not a mixed company in the sense found in Europe and elsewhere, the governance structure investigated (a mixed public-public contacting network) offers insights into the core challenges local decision-makers have emerged to address. According to the authors, the contract between government and operators and the participation of social groups helps balance the government control. This mixed network mode of management would reduce information asymmetries and promotes shared goals to ensure a higher quality and more responsive service.

Concluding remark

In its own way, each of the seven articles presented in this Special Issue helps to improve our understanding of local mixed public-private companies. It is acknowledged that iPPP models are endowed with interesting capabilities to provide local public services. Nevertheless, it is of the utmost importance that these arrangements are not merely erected to circumvent budgetary or other legal constraints (e.g. public employment laws) and that the sustainability of mixed companies is not guaranteed to the detriment of the public interest. The focus here has been on the political economy of this governance structure. However, mixed companies also pose several legal and technical challenges. Although with this model public decision-makers attempt to design a relational agreement to partner up with the private sector, local mixed companies are also regulated by the shareholders' agreements (binding the partners), the management contract (establishing the obligation of the mixed company towards the local authority), the bylaws (binding the managers), the public procurement documents (including the proposal of the winning bidder), the national legislation on PPP arrangements, and, if the firms operate in a regulated sector, they also are subject to the oversight of the sector-specific regulator. This regulatory puzzle significantly reduces the flexibility sought by local governments. In fact, future studies on these matters could look into 'How to establish an effective relational agreement where the protection of the public interest remains the main priority?'

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