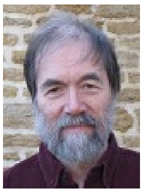
What Carillion's collapse tells us about public sector outsourcing



Simon Wren-Lewis *reflects on the collapse of the construction firm Carillion and on the problems that have ensued for the government. Weighing the pros and cons, he suggests that it is likely that some of the current Private Finance Initiative (PFI) outsourcing was influenced by ideological considerations rather than being purely evidence-based, and warns that the next government should conduct a thorough review.*

Jeremy Warner, an editor at the Telegraph, once said there are either 'big state' people or 'small state' people. I felt the same way following the reaction to the collapse of Carillion: there are either 'private good, public bad' people or 'public good, private bad' people. Of course, reality is somewhere in between.

Carillion went bust because of cost overruns or delays in three large construction projects. The nature of such projects involve that kind of risk, but clearly the company – despite its size – was not resilient enough to withstand those failures. It did not go bust because of privatisation of public services, unless you think the government should build its own hospitals or roads. If anything, it shows that those contracting out public contracts were getting a good deal.

There will always be public projects contracted out to the private sector. Much of the increase in public investment planned by Labour if it wins the next election will be undertaken by private firms. Getting the contracting relationship right is difficult and fraught with dangers.

The government clearly has questions to answer about why it continued to award contracts after the profit warning, and we need some informed analysis to determine whether the government, as they claim, had fully protected all but one (!) of these projects and will not lose any money as a result of the collapse. As David Allen Green suggests, this smacks of ministerial failure. (The link also shows public procurement can have its funny side.)

Also**,** why was the position of the 'crown representative' (who was meant to be overseeing scrutiny of, among others, Carillion) left vacant? The government should also ask whether companies should be allowed to pay large dividends when their own pension fund is underfunded. And why Carillion's auditors, KPMG, gave it a clean bill of health when its balance sheet was already showing signs of stress.

To see what lessons the collapse of Carillion does have for the debate over whether the public sector should privatise certain of its activities or do them in house, we need to go through some of the pros and cons.

There is one main benefit of contracting out public services, which is that it can save money. To mention 'the market' here is not very helpful, because with one buyer and only a few sellers for something (the contract) agreed once every few years, this is hardly a normal market. It is instead about the incentives faced by managers and workers, both in achieving efficiency and fostering innovation. Managers have a clearer incentive system in a private sector firm to maximise profits, and that incentive is provided by the need to bid low to win the contract and nevertheless make a profit. As Carillion shows, margins on most public sector outsourcing are not large. In that sense, Carillion confirms that part of this mechanism is working. A single public sector entity cannot replicate this advantage, unless it too is in competition with private sector firms. In short, competition improves incentives.

One important qualification to this argument involves information. The temptation of a bidding system based on the lowest price is to cut quality. So the public sector has to have a clear means of not just specifying quality in the contract, but of ensuring the contract is being fulfilled once it is awarded. Sometimes politics can get in the way of that happening. For activities where quality is difficult to observe, contracting out is not a good idea.

Another qualification involves the attitude of public sector workers before privatisation. If they, for whatever reason, internalise the need for efficiency and innovation, because for example they can see how both improve the outcome for customers, then contracting out to the private sector will achieve little. The NHS could be a case in point.

A further problem with privatisation is finance. When people argue that public money should not be wasted paying the shareholders or creditors of private firms, they are both right and wrong. They are wrong in the sense that without contracting out the same amount of money has to be raised by the public sector, and so it "wastes" money by having to pay interest on government debt. But they are right in that the rate of interest on government debt is much less than the rate of interest a private firm has to pay on any debt, or in the form of dividends to shareholders. The reason for this is that investors do not like risk: people who lend to the UK government know they will always get their money back, while as the shareholders and creditors to Carillion have just found this is not true for private sector firms.

This is why Private Finance Initiative (PFI) projects undertaken just so that the borrowing is done by the private rather than the public sector are costly from an economic point of view. It is why it makes sense to exclude public investment from any fiscal rule: fiscal rules that restrict public investment are an open invitation to politicians to undertake PFI type financing. In my view, the best constraint on public investment is the expected social return, assessed with the help of an independent body. It is often said that PFI type projects 'avoids risk to the taxpayer'. Again this is the wrong way round. It is far easier and cheaper for the public sector to take risks than the private sector, so PFI projects are paying far too high a price to avoid risk to the public sector.

Another problem related to risk is the interrelationship between what the private company contracts to do and what actually happens when government forecasts go wrong, as they always will. This may have happened with the East Coast line "bailout" (but if it was, we should be told), and it did happen with privatising the probation service. Public sector contracting out forces each side to commit to guesses about the future, whereas if everything remains in-house there can be much more flexibility. There is also the cost of having to train more civil servants in the art of writing good contracts.

One further problem that Carillion reminds us of is that privatisation runs the risk of a degree of interruption if the company goes bankrupt. Disruption is nothing new. If privatisation is to have any benefits, the contract from the public sector has to come up for renewal every few years, and if the private sector provider is changed that will involve some dislocation of service.

One final point, which is contingent on what I hope will be a temporary state of affairs. Nowadays, the management overheads for private sector firms are likely to be far higher than in the public sector, for reasons that have little to do with management quality. Ben Chu sets out how much management was being paid at Carillion compared to equivalent public sector managers. And what on earth were shareholders doing allowing the directors to relax clawback conditions on management's pay if things went wrong, which even the Institute of Directors described as "highly inappropriate" and "lacking effective governance". In truth the public sector is much better at stopping managers using their monopoly power to be paid over the odds than the private sector appears to be.

So the economist's answer on public sector outsourcing is, it depends: on all the factors outlined above and probably more I have momentarily forgotten. (Like economies of scale and expertise: no one would ever suggest the public sector makes its own paperclips.) Where the balance will be is bound to be case dependent. But it would be incredibly surprising if at least some of the outsourcing undertaken by this government was not ideological rather than evidence based. This suggests that Labour, if it wins the next election, should undertake a thorough independent review when it has all the facts at its disposal. That at least might ease fears that we will lurch from one ideological position to its opposite.

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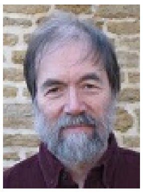

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