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The role of properly structured public-private partnerships in promoting economic development

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Abstract

Purpose – The purpose of this paper is to find the characteristics that determine the success of public-private partnerships (PPPs) in promoting economic development and specifically to determine the long- and short-term public involvement.

Design/methodology/approach – A grounded theory approach is utilized, involving desk research and a review of the current literature, as well as examining case studies. This reduction in data collection was based on the availability of literature and case studies which can be assimilated to develop theoretically justifiable conclusions.

Findings – In less-than-developed countries (LDC), the lack of private investment capital severely hinders economic development. In developed countries it is often high risk factors and very large capital investment that slows economic development. In both cases, an input from the public sector is needed. The findings suggest that government involvement should be time limited, so that to achieve long-term success, a public sector exit strategy should be formulated. The length of time for public sector involvement varies but is generally longer in the LDC.

Research limitations/implications – While the current literature provides some conclusions regarding the effect of PPPs on economic development, there is a gap when examining the proper structure particularly for developing countries.

Originality/value – While the current literature provides some conclusions regarding the effect of PPPs on economic development, there is a gap when examining the proper structure. This paper also provides some guidance for participants to determine the optimum length of time that public involvement is needed. Both academics and practitioners should find this to be valuable information.

Keywords Entrepreneurship, Sustainable development, Governance, Ethics, Social responsibility, Public-private partnerships, Values, Finance, Joint ventures, Partnerships for development

Paper type Research paper

Introduction

Public-private partnerships (PPPs) are defined in many ways. According to Hodge and Greve (2007) PPPs are defined as "cooperative institutional arrangements between public and private sectors". They also note that there is not complete agreement concerning the role that PPPs play in economic development. Some argue that PPPs present a new method to handle infrastructure projects such as highways (Savas, 2000). Others note that PPPs involve a new paradigm for private involvement in traditionally public projects (Linder, 1999). With regard to economic development, PPPs may be more clearly defined. In order for economic development to occur, the private sector must be able to grow. In order to accomplish this, firms need to be able to accumulate the inputs necessary to produce output. The basic inputs are capital and labour. In less-than-developed countries (LDC) labour is usually available. The problem is the accumulation of capital. If capital can be provided by a public entity, then the ingredients for growth will be present. Therefore, in this context, PPPs will be defined

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as a partnership between a public entity and private concern where capital is provided by the public concern, in order to foster economic growth.

There are examples, in the literature, that site successful PPPs and the factors that likely lead to the success. This study will examine and evaluate those factors, based on successful PPPs. Jacobson and Choi (2008) examined two PPPs in the USA that were designed to foster redevelopment in downtown areas of cities. They found ten success factors: specific plan/vision, commitment, open communication and trust, willingness to compromise, respect, community outreach, political support, expert advice, risk awareness and clearly defined roles. These success factors were found from examining two specific PPPs used for a specific purpose.

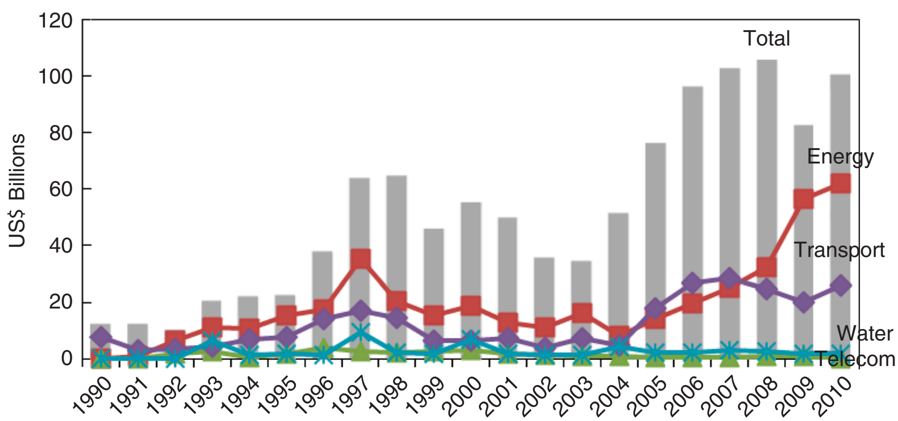
Trafford and Proctor (2006) constructed a model which identified five key success factors. They include good communication, openness, effective planning, ethos and direction. The task of this paper is to determine if these success factors are critical to PPPs that are used to foster economic development in LDC, and also to determine what additional factors may be needed.

Historical perspective

The literature indicates that virtually all PPPs have been utilized to provide infrastructure to growing economies. Roads, tunnels, utilities, communications and other channels of distribution have been the focus of PPPs over time (Osborne, 2000) (Figure 1).

Figure 2 provides information regarding the number of contracts and the form of the PPPs.

In the fastest growing economies of Brazil, China and India, PPPs have provided the infrastructural means necessary for growth. Recently, in the USA, the public sector has provided the capital for large firms that were deemed to be "too big to fail". These firms were in the manufacturing sector and in the banking/insurance sector. The US government invested in companies like General Motors and AIG along with financial firms. These were companies that did or would have filed for bankruptcy protection, had it not been for the infusion of capital by the US government. While government



Note: Private investment commitments in PPP infrastructure projects in developing countries by sectors, 1990-2010
Source: World Bank and PPIAF (2010)

Figure 1. Private investment commitments in PPP infrastructure for developing countries

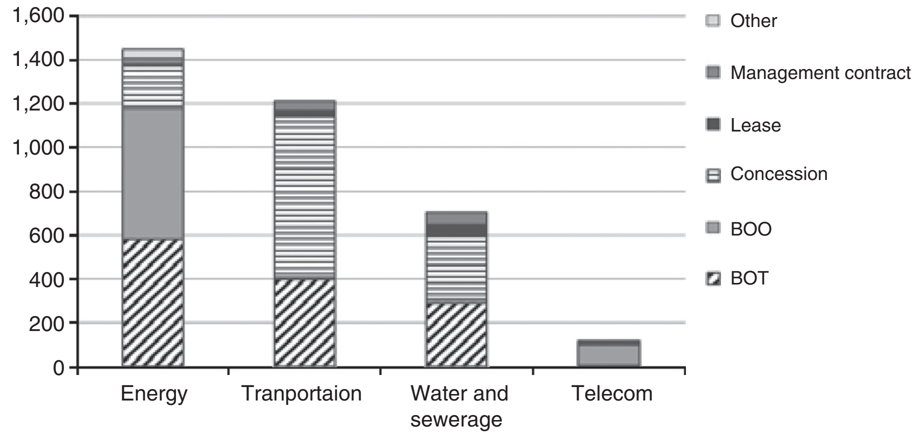


Figure 2.
Number of contracts awarded

Note: PPP contracts implemented in infrastructure projects in developing countries by types, 1990-2010
Source: World Bank and PPIAF (2010)

funds had been lent to companies in the past, these actions represent the first time that the US government had taken an equity position.

Other countries like France, Italy and Russia own shares in private companies. Becker and Posner (2008) pointed out that the results have been counter-productive and in their words "appalling". They note that Alitalia Airlines, in which the government owns about half of the stock, is very inefficiently managed and has often been held hostage by powerful unions. They note "Strikes have been common, flights frequently takeoff and arrive quite late, and baggage losses are high – experienced travelers try hard to avoid using Alitalia. Since Alitalia's command of routes into and out of Italy has market value, stronger European Airlines, such as Air France and Lufthansa, have wanted to take this airline over. However, the Italian government has resisted these efforts and continues to finance the sizeable monthly deficits of the airline. It fears the power of the unions who realize that many airline jobs at Alitalia will be lost if a more efficient airline takes charge".

Another use of PPPs in the USA has been in the entertainment industry, particularly related to professional sports. In 1950, almost all professional sports teams played in privately financed and owned buildings (Groothuis *et al.*, 2004). Fifty years later, the situation changed dramatically. By 1999 about two-thirds of the $21.7 billion spent on 95 buildings used for professional sports teams came from government sources (Siegfried and Zimbalist, 2000). The reasons cited for this were public choice and civic pride. Most of these structures were owned by the government entity established to monitor construction and manage the facility with lease arrangements made by the participating team. The reasons noted were that the facilities needed to be large enough to accommodate big crowds that attended the events and the resulting very high cost to build, particularly in urban settings. The rationale was that the spillover effects would greatly benefit the local municipality both in terms of civic pride and in terms of economic benefit. But even with these considerations, greater transparency, better-directed funding and genuine public debate on these policies are needed to better consider the evaluation of costs and benefits (Pomfret and Wilson, 2011).

For General Motors, the US government has been selling their shares, but even with the stock market at record highs and the auto industry in general producing record profits, the US government will likely lose about $25 billion of taxpayer money. Many question whether this is the best use of taxpayer money while the government has argued that a firm as large as GM can not fail because of the loss of jobs and the rippling effect this would have on the entire economy. In a well-developed economy, the question of government investment in established companies becomes a debatable point. Free market economists, like Nobel Prize winning Milton Friedman and Gary Becker, have long argued that the marketplace will pick the winners and losers and it is not a function of government to do so. But does this apply to LDC?

The literature does not provide answers for LDC. There are examples of government involvement in infrastructure projects and loan programmes that have been established, but no real evaluations of governments taking an equity position in new or small- to medium-sized enterprises. With the shortage of capital for these firms, perhaps taxpayer funds should be considered. The downside seems to be that since government is not motivated by profit, having a public stake in a private concern may prove to be counter-productive.

History also indicates that there are examples of industries where the government has been the sole producer and has thus taken a monopoly position. The National Aeronautics and Space Administration (NASA) began operations in 1958 (Dimitroff *et al.*, 2005) about one year after the Soviet Union launched Sputnik 1, which was the world's first satellite. The US government saw the potential and the threats of space exploration so that NASA was formed to provide protection and eventually take advantage of new technology. After the cold war ended, the USA began to privatize this government agency and open the market to private investment. Because the dollar amounts were so large and the risk so high, firms were reluctant to enter this market. Recently, however, private firms have entered this market to provide services that will deliver cargo to the orbiting space station and eventually carry passengers. While NASA remains active and the government provides funding, this market is beginning to be privatized. This example provides the basis for PPPs in LDC.

PPPs and corruption

As noted, in order for LDC to grow, entrepreneurs need access to both labour and capital; the restricting component is capital which is why the government will consider PPP. One problem that has plagued government involvement, particularly in LDC, is corruption. As noted by Otusanya (2012), corruption has often played a major role, which has caused very serious damage to the social and economic landscape in developing countries. This corruption tends to reduce the investment in public services and undermines social welfare, which eventually erodes the quality of life and slows the development process (Amundsen *et al.*, 2006). Corruption is associated with activities of presidents, politicians, bureaucrats and other public officials (Sikka, 2008). Unfortunately successive governments in LDC appear to have done little to bring the corruptors to justice due primarily to poor regulation and ineffective sanctions (Bakre, 2007). Since some of the factors leading to successful PPPs include open communication and trust, willingness to compromise, respect, community outreach and political support, corruption can destroy all of those factors. This is the most serious problem facing LDC when implementing PPPs.

An empirical analysis of corruption in developing countries was provided by Gander (2011). Using empirical data from the World Bank and PPIAF (2010), he developed a two-equation game-type corruption reaction function model, testing what he referred to as the "monkey see, monkey do" hypothesis. The key variables used were "the percent of domestic firms expecting to make informal payment to public officials to 'get things done,' and the percent of foreign firms doing likewise". Using data from 2002 to 2010, he found the statistical results supported the hypothesis. Both reaction functions were positively sloped. He further noted that over time, developing countries are more likely to bring corruption under control among domestic firms but less likely for foreign firms. This implies that PPPs should be established with public funding for domestic rather than foreign firms.

Although likely difficult, it appears that a separation between politics and government involvement is necessary if the PPP is to be successful. That means the government civil service agency that monitors the public's position in a PPP should be as free from politics as possible, so that there is a continuation of policy even if the elected officials change through the normal election process cycle.

Structuring the PPP

Considering the history of PPPs and the goal of promoting economic development particularly in LDC, the question centres on how the PP should be structured. Here we consider how the government can efficiently use taxpayer funds to promote economic growth recognizing that entrepreneurs in these countries lack the capital need to start or expand a business. There are a number of questions that must first be examined. First the government must consider how to structure the agency that will monitor the funding. Then it must be decided which industries and specific markets will be targeted. Once those questions have been answered, which individual entrepreneurs will be funded and what characteristics those entrepreneurs must possess will be decided. Finally an exit strategy has to be determined for the public portion of the PPP. It appears that any public funding to start or expand an enterprise should be a short-term venture so that in the longer term the enterprise becomes completely private. While considering this, the government will also determine what specific return it is seeking for the funds.

The literature indicates that the agency set up to monitor the government's position should be headed by elected officials. This is somewhat controversial but if the elected officials serve for a specific term with re-election an option, the problems of changing political climates and corrupt appointments can both be avoided. The agency must be completely transparent and report regularly to the general public.

The government should always have a minority interest in the PPP so that decisions can be made from a market perspective rather than through a political one. That means the government agency will own less than 50 per cent of any PPP. The result of this will be that the agency will act as a minority shareholder and not have control over the operations of the enterprise. If the new enterprise is to succeed in the long run, its management must have the ability to respond to market conditions without seeking any government approval, beyond what normal regulations require.

The next question is difficult to answer, and involves trying to decide which markets should be targeted for government investment. Typically this can be examined by looking at a hierarchy of needs. Maslow (1943) developed a hierarchy of needs. He said that individuals strive to satisfy needs in a particular order: Physiological, safety, belonging (love), esteem and self-actualization. LDC are primarily concerned with the lower level needs so that the government agency should concentrate on establishing PPP in the order of need satisfaction. Perhaps PPPs that develop the agricultural industry which can produce larger amounts of food using more capital intensive techniques should be initially considered. Then once those needs are satisfied, the agency can move on to security needs. Businesses in the agriculture industry or building industries might be the best place to start. Once the population is secure, other areas can be considered. Developing countries might concentrate on products that satisfy slightly higher-level needs.

In order to increase the wealth of the country, it may be determined that some of the output could be exported. If the input of capital from the government agency results in a company producing more of a specific commodity than is required by the population, then exporting to near-by countries is a good option. While this approach makes sense, we should not exclude ventures from entrepreneurs who have developed goods and/or services not related to the lower level needs, if there is a strong market need.

Determining which entrepreneurs to fund will also be difficult. Generally those with experience and those who represent domestic interests are likely to be the best candidates. The success rate for new ventures in any country is usually very, very low. In order to increase the chance of success, the agency will provide all necessary funding as determined by a detailed business plan submitted by the applicant, as it is noted that the failure rate of new firms is heavily influenced by capital requirements and proper planning. To increase the probability of success further, experienced local entrepreneurs should be selected. There is always the potential problem of cronyism. By having the agency headed by an elected official and by insisting on complete transparency in the selection process, this problem should be minimized.

Finally, an exit strategy must be determined, recognizing that with all of the variables involved in a successful business enterprise, modifications are likely to be made. Usually it takes three years for an enterprise to establish itself so that it can be viable into the long run. After that period, a high growth rate follows. According to Vernon (1967) and his Product Life Cycle Theory, rapid growth usually follows the three-year (on average) introductory period for new products. During this growth stage, firms are typically very capital-short, so that recovery of capital by the government agency will be difficult. Often new capital may be required, which the firm should be able to acquire without government assistance. Once the rapid growth has plateaued, the maturity stage sets in when sales of the product or service tends to be relatively stable. It is at the beginning of this period that the entrepreneur should seek to have the agency exit, either by attracting outside capital to purchase the agency's shares or by a direct repurchase by the entrepreneur. This means that the time frame for the agency to exit is likely to be in the five- to seven-year range. It could be longer or shorter depending on the industry and specific market.

Conclusion

As noted, properly structured PPP have provided economic growth. Historically these partnerships were concerned with developing infrastructure, utilities, tunnels and later sports complexes in urban areas. The literature indicates there are a number of factors that affect the success of PPPs. These include: specific plan/vision, commitment, open communication and trust, willingness to compromise, respect, community outreach, political support, expert advice, risk awareness and clearly defined roles. These factors are important when considering the structure of PPP in developing countries for the purpose of economic growth.

This paper presented a framework for public investment in private enterprises. These PPP should be monitored by an agency headed by an elected official with complete public transparency regarding the decision-making process. The government agency owns less than 50 per cent of the enterprise, so that the entrepreneur owns more than 50 per cent. The next step is to determine which markets are best for supplying this public capital. One suggested approach is to concentrate on markets following a hierarchy of needs. Then a decision must be made regarding the selected entrepreneurs. Usually an individual with experience, who is local to the product and has appropriate character, is best.

Finally an exit strategy should be part of the business plan. These public investments into private enterprises are meant to be short term in nature, just long enough for the new firm to acquire its own private capital. The long run result of this should be significant increases in economic growth. Since most less-than-developed and developing countries have ample supplies of labour, the factor most constricting growth is the lack of capital. Pooling of taxpayer funds to establish an agency that provides start-up and growth capital for private companies will add the economic growth. As the firms grow, the taxpayer's share of the PPP grows so that when the exit is complete, the taxpayer should see a sizable gain. It should benefit everyone.

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