3. Improving public services?

The government spending plans that were set out in the July 2000 Spending Review run until 2003–04. This summer, the government will publish the findings of its 2002 Spending Review. This will reconsider the spending levels for 2003–04 and set plans for what will probably be the final two years of the current parliament (2004–05 and 2005–06). Section 3.1 looks in detail at the issues facing the government in the run-up to this Spending Review.

In addition to increased resources, the government has also stressed the need for reform in order to deliver substantial improvements in public services. An increasingly important part of its reform agenda seems to be the involvement of the private sector in the delivery of public services. Section 3.2 describes the pattern of private sector involvement across government departments and outlines the potential benefits and costs of increasing reliance on public–private partnerships.

3.1 Issues for Spending Review 2002

The affordability of increases in ‘priority’ areas – such as education, health and transport – will largely depend on the extent to which spending growth can be constrained in other areas. This section looks in detail at the current spending growth in health and education and discusses the extent to which savings from elsewhere might be possible.

Spending on health

Taken together, the increases in NHS spending that were announced under the July 1998 Comprehensive Spending Review (CSR) and the July 2000 Spending Review were large when compared with the increases that the NHS has received in the past. Table 3.1 shows that spending should grow by an annual average of 6.4% a year in real terms between April 1999 and March 2004. This is equal to the rate achieved during the five-year period with the biggest spending increases in NHS history, from April 1971 to March 1976.

While the current period is clearly one of large NHS spending increases, it follows on from four years in which spending growth was extremely low by historical standards – averaging just 1.5% a year. At least part of the current spending increases might therefore be thought of as ‘catch-up’ – the necessary after-effect of several years of very tight growth if current standards are to be preserved. For example, NHS wages may have been squeezed in the years up to 1999, and so may now need to rise significantly in real terms simply to retain existing staff.

In the last 20 years, the NHS has often experienced periods of relatively high increases in funding followed by periods of lower increases. But if the current plans are adhered to, the April 1999 to March 2004 period will represent...
growth in the NHS budget that is both relatively strong and sustained, so improvements in the quality of healthcare provided might well be expected.

Table 3.1. Real increases in NHS spending

<table>
<thead>
<tr>
<th>Description</th>
<th>Annualised average real increase, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current planned expenditure for next two years: April 2002 to March 2004</td>
<td>5.5</td>
</tr>
<tr>
<td>Period since Labour came into power: April 1997 to March 2002</td>
<td>5.0</td>
</tr>
<tr>
<td>Conservative years: April 1979 to March 1997</td>
<td>3.1</td>
</tr>
<tr>
<td>Four-year period preceding the first CSR: April 1995 to March 1999</td>
<td>1.5</td>
</tr>
<tr>
<td>Five-year increase from start of first CSR: April 1999 to March 2004</td>
<td>6.4</td>
</tr>
<tr>
<td>Highest five-year increase in history of the NHS: April 1971 to March 1976</td>
<td>6.4</td>
</tr>
<tr>
<td>Long-term NHS trend (since April 1954)</td>
<td>3.8</td>
</tr>
</tbody>
</table>

\(^a\) NHS trend is assessed since 1954, rather than from the foundation of the NHS, because the first few years involved atypically high costs as a backlog of previously untreated cases was dealt with.

Notes: NHS spending is defined here as UK National Health Service expenditure net of NHS charges and receipts. For the periods in office of each political party, we assign financial years according to who was in office for the majority of months in that financial year.


**International comparisons**

The result of these increases in spending is that UK NHS spending is forecast to rise from 5.3% of national income in 1996–97 to 6.2% of national income in 2003–04.\(^1\) Despite these large increases in public spending, the UK is still unlikely to be devoting as high a proportion of national income to spending on health as many other developed economies. Figure 3.1 shows the total proportion of national income spent publicly and privately on health in the G7 countries in 1998 – before the current period of significant NHS spending increases got underway.\(^2\) These data are constructed by the OECD using its definition of health spending – in the case of the UK, this differs from the share of national income consumed by the NHS not only because of the

\(^1\) NHS spending is forecast to be £69 billion in 2003–04. Due to changes being introduced under full resource accounting, this figure will, under the new accounting methodology, rise to £71.7 billion. The government has clarified that it will continue to use the existing accounting system for international comparisons rather than the new system. See paragraphs 4.44 to 4.48 of HM Treasury, *Better Management of Public Services: Resource Budgeting and the 2002 Spending Review*, London, 2001 (www.hm-treasury.gov.uk/mediastore/otherfiles/ResourceBudgeting2002.pdf).

\(^2\) Information on health spending in various countries comes from OECD Health Data 2001, CD-ROM. Unfortunately, the most up-to-date information on health spending across all countries is for 1998, although data for some countries are available for 1999. For more details of the OECD Health Data, see [www.oecd.org/els/health/software](http://www.oecd.org/els/health/software).
Improving public services?

inclusion of private spending, but also because some non-NHS public expenditure is included.

**Figure 3.1. Public and private health expenditure as a percentage of national income in the G7 countries, 1998**

<table>
<thead>
<tr>
<th>Country</th>
<th>Public Spending (Percentage of National Income)</th>
<th>Private Spending (Percentage of National Income)</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>5.8</td>
<td>7.1</td>
</tr>
<tr>
<td>Germany</td>
<td>7.8</td>
<td>2.5</td>
</tr>
<tr>
<td>France</td>
<td>7.1</td>
<td>2.2</td>
</tr>
<tr>
<td>Canada</td>
<td>6.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Italy</td>
<td>5.5</td>
<td>2.2</td>
</tr>
<tr>
<td>Japan</td>
<td>5.8</td>
<td>1.6</td>
</tr>
<tr>
<td>UK</td>
<td>5.7</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Source: OECD Health Data 2001, CD-ROM.

On this measure, the UK spent a total of 6.8% of national income on health in 1998, of which 5.7 percentage points were spent publicly and a further 1.1 percentage points were spent privately. Amongst the G7, the USA is the biggest spender, with almost 13% of its 1998 national income going to healthcare. Germany and France also have relatively large healthcare sectors, taking up 10.3% and 9.3% of their 1998 national income respectively. Japan and Italy spend similar amounts on public healthcare to the UK, but they have more private healthcare spending.

If instead of the G7 we look across the 15 member countries of the European Union (EU), we see that only Luxembourg, at 6.0% of national income, devoted a significantly smaller share of its 1998 national income to health. The Prime Minister has stated that he would like to see UK health spending reach the European average by 2005. If EU countries are all treated equally, then average health spending among the other 14 countries in the EU in 1998 was 8.0% of national income. This is known as the unweighted average.

The level of health spending undertaken by, or on behalf of, EU citizens is better captured by the alternative ‘weighted’ measure. This is calculated by

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1 See *Hansard*, 28 November 2001, col. 964.
dividing the total health spending undertaken in other EU countries by their combined national incomes. The advantage of this measure is that it allows large countries to count for more than small countries. As large European countries, such as France and Germany, tend to spend more of their income on health than small countries, such as Luxembourg and the Republic of Ireland, this measure of average health spending is higher – it is estimated to have been 8.9% of national income in 1998.

Whether the UK reaches the average level of spending seen across the EU depends not only on NHS spending, but also on what happens to other public and private elements of UK health spending and on spending levels in other EU countries. If health spending in other European countries and non-NHS UK health spending remain constant as a share of national income, then, by 2003–04, UK health spending will be just £1 billion short of the unweighted average but would remain some £9.9 billion short of the more meaningful weighted average.\(^4\) This compares with NHS expenditure in 2001–02 of just under £60 billion.

Regardless of the precise way in which financial input into healthcare is measured, ultimately one would think that relative performance in terms of health outcomes should be the real concern. Different countries’ healthcare systems are likely to operate with varying levels of efficiency, and if, for example, the NHS were especially efficient, then it could be that the UK could achieve world-class health outcomes while spending relatively little. Also important is demographic variation, as older people have higher healthcare needs. This would imply, for example, that if the UK population had an unusually high average age, then it might need to spend even more of its national income than other countries if it were to match the standard of their healthcare, which would mean that the degree of ‘catch-up’ required would be understated by the raw expenditure numbers. In either of these scenarios, if the aim were to match the quality of healthcare in other countries, then a policy that pursued their level of spending would seem misdirected.

So what sort of targets in terms of health outcomes could policy work towards? No single measure can fully capture the quality of healthcare. Life expectancy has the advantage of being quite general, although, of course, it takes no account of the effect of healthcare on quality of life. An even more important problem is that cross-country variations in life expectancy reflect differences in populations’ underlying health (in turn reflecting variation in diets, smoking habits and other socio-economic factors) alongside the effect of the national healthcare systems. This makes it difficult to infer much about whether the UK is underspending on health from the fact that it performs

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\(^4\) Cash figures are derived as a proportion of current national income. For more details of how the different averages are calculated and how long it will take the UK to reach the 1998 weighted average level of spending if NHS spending continues to grow at its current rate, see C. Emmerson, C. Frayne and A. Goodman, *How Much Would It Cost to Increase UK Health Spending to the European Average?*, Briefing Note no. 21, Institute for Fiscal Studies, London, 2002 (www.ifs.org.uk/health/bn21.pdf).
Box 3.1. Measuring quality of healthcare systems: potential years of life lost through preventable causes

An indicator that focuses a little more directly on the performance of the healthcare system is the potential years of life lost (PYLL) through ‘preventable’ causes amongst those aged under 70. Deaths are preventable either where they reflect a failure to apply the best treatment adequately or where they are attributable to particular environmental or behavioural factors, such as smoking. Some of the non-healthcare influences on life expectancy are thereby stripped out, but others, such as smoking, remain.

The recent Wanless Report looks at several variants of this measure and finds that ‘the UK does not generally compare well with comparator countries in terms of [PYLL]’. Here, we focus on the broadest measure of PYLL (including suicides as preventable deaths) in G5 countries over time. Unsurprisingly, the number of PYLL has fallen considerably over the last 40 years across most countries, as healthcare systems have improved – in the case of the UK, from just over 8,300 years per 1,000 people in 1960 to under 4,000 in 1997. Figure 3.2 shows how the performance of other G5 countries compares with that of the UK in each year from 1960 to 1997. In 1997, the UK performed slightly better than France or Germany and considerably better than the USA, although it was substantially inferior to Japan. Japan’s strong performance dates to very large improvements relative to other countries between 1960 and 1979, a time when its population was becoming rapidly richer. The poor US performance reflects a failure to match improvements seen in other countries since 1979.

Figure 3.2. Potential years of life lost among those aged under 70 per 100,000 population in G5 countries, relative to the UK

Source: OECD Health Data 2001, CD-ROM.
relatively badly on the life expectancy measure in the G7 league table. Indeed, the USA, which spends more of its national income on health than any other major economy, actually performs the worst on this measure. In part, this discrepancy may reflect the inefficiency of US healthcare spending, but it might also reflect factors unrelated to healthcare inputs.

An indicator that focuses a little more directly on the role of the healthcare system is the potential years of life lost (PYLL) through ‘preventable’ causes amongst those aged under 70. This is discussed in more detail in Box 3.1. In 1997, the UK performed slightly better than France or Germany and considerably better than the USA, although it was substantially inferior to Japan.

The outcomes of healthcare policy can be even more directly focused on by looking at survival rates from particular diseases. When this is done for selected important diseases, such as breast and lung cancer, the UK performs relatively badly. Such measures might indeed be taken as evidence that the quality of UK healthcare is undesirably low, and that extra expenditure is therefore needed. But even this is not conclusive. These measures might be thought of as undesirably narrow, ignoring as they do the role of healthcare in treating the whole range of diseases and its impact on quality of life. Part of the reason why the current political debate over the NHS focuses on inputs rather than outcomes is that there is no single straightforwardly quantifiable measure of what the NHS would ideally deliver.

**Public attitudes towards health**

Evidence that the recent increase in NHS resources had not yet fed through into improvements in the quality of healthcare by 2000 is provided by the British Social Attitudes Survey (BSAS). Respondents are asked how satisfied they are with a range of institutions, including the NHS. In the 2000 survey, which is the most recent for which results are available, 42% of respondents stated that they were very or quite satisfied with the NHS while 39% reported that they were very or quite dissatisfied. This is actually a higher level of dissatisfaction than in either the 1998 or the 1999 survey.

As shown in Figure 3.3, the current levels of satisfaction and dissatisfaction are comparable to those seen in 1993 and 1994. The highest levels of satisfaction, and the lowest levels of dissatisfaction, with the NHS over the period covered by the BSAS were back in 1983 and 1984. Care should be taken with the interpretation of these figures since it may be that the levels of satisfaction partly reflect respondents’ satisfaction with the government of the day in general, in addition to the quality of any NHS services that they have received.

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Figure 3.3. Levels of satisfaction with the National Health Service

Notes: 'Satisfied' refers to those responding that they were very or quite satisfied, while 'dissatisfied' refers to those reporting that they were quite or very dissatisfied. For a more detailed discussion of attitudes towards the NHS, see, for example, J. Mulligan and J. Appleby, ‘The NHS and Labour’s battle for public opinion’, in A. Park, J. Curtice, K. Thomson, L. Jarvis and C. Bromley (eds), British Social Attitudes, The 18th Report: Public Policy, Social Ties, Sage, London, 2001.
Source: British Social Attitudes Survey, various years.

Given the differences between countries in the resources that they devote to healthcare, the way in which their healthcare system is arranged and the variation in health outcomes delivered, it is of interest to look at how attitudes towards healthcare systems vary across countries. Recent studies suggest that the level of satisfaction in the healthcare system is higher in the UK (57%) than that in either the USA (40%) or Canada (46%), is similar to that in Germany (58%) but is lower than that in France (65%), the Netherlands (70%) or Denmark (91%). Again, care should be taken in interpreting these figures since cultural or linguistic factors may affect responses differentially. Nonetheless, they may still be indicative of the relationship between the desired level of healthcare quality and what the combination of healthcare spending and organisation in each country achieves.

Spending on education

As with spending on the NHS, the years covered by the July 1998 Comprehensive Spending Review and the July 2000 Spending Review represent periods of relatively large increases in education spending. Over the next two years, spending on education will, under current plans, grow by some 5.5% a year in real terms, as shown in Table 3.2. This will lead to education spending continuing to increase as a share of national income, as it has done since April 1999. Again as with health, the period of high spending growth since April 1999 follows on from four years of very small increases. It is therefore likely that some of the increased expenditure will simply be making up for the effects of the preceding period of very low spending growth, rather than contributing towards significant improvements in the quality of education provided.

Table 3.2. Real increases in education spending

<table>
<thead>
<tr>
<th>Description</th>
<th>Annualised average real increase, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current planned expenditure for next two years: April 2002 to March 2004</td>
<td>5.5</td>
</tr>
<tr>
<td>Period since Labour came into power: April 1997 to March 2002</td>
<td>4.0</td>
</tr>
<tr>
<td>Conservative years: April 1979 to March 1997</td>
<td>1.5</td>
</tr>
<tr>
<td>Four-year period preceding the first CSR: April 1995 to March 1999</td>
<td>0.5</td>
</tr>
<tr>
<td>Five-year increase from start of first CSR: April 1999 to March 2004</td>
<td>5.4</td>
</tr>
<tr>
<td>Long-term education trend (1953 to 1996)</td>
<td>4.0</td>
</tr>
</tbody>
</table>

Notes: UK education spending, excluding the sale of the student loan book in 1997–98 and 1998–99. For the periods in office of each political party, we assign financial years according to who was in office for the majority of months in that financial year. Sources: HM Treasury, Public Expenditure Statistical Analyses, London, various years (most recent – www.hm-treasury.gov.uk/mediastore/otherfiles/32.pdf); HM Treasury, Financial Statement and Budget Report, London, various years (most recent – www.hm-treasury.gov.uk/Budget/Budget_2001/bud_bud01_index.cfm); long-term trend figure from Blue Book (various years, 1965 to 1997). Spending figures deflated using the latest GDP deflators from the Office for National Statistics.

For example, in order to preserve the quality of education provided, wage increases may be needed merely to achieve sufficient staff numbers. This problem is demonstrated by the number of teacher vacancies in England and Wales – in January 2001, there were 4,793 vacancies in maintained nursery, primary and secondary schools. This is a vacancy rate of 1.3% and it represents an increase on previous years – for example, in 1997, the vacancy rate was 0.5%. There is also considerable regional variation in vacancy rates, ranging from 3.5% in London to 0.5% in both the North West and Yorkshire and Humberside.8

Compared with health, the increases in education spending experienced under the 1979 to 1997 Conservative governments appear to be much more dramatically below the long-term trend. Of course, when comparing the spending rises seen in different eras, it is important to bear in mind that the school population has changed in size significantly. In particular, it increased sharply between the 1950s and 1960s, as the ‘baby-boomer’ cohort entered education, and fell back somewhat in the 1980s. Even so, the fact that education spending growth has been relatively low for two whole decades might be expected to exacerbate the extent to which current increases will be used in making up for the effects of earlier low spending.

**International comparisons**

As a result of the relatively large increases in education spending since April 1999, spending on education as a share of national income is set to rise from 4.7% in 1996–97 to 5.2% in 2003–04. Table 3.3 uses OECD data to show how UK levels of spending on education compare with those seen in other countries. According to this definition of education spending, which includes public and private spending, in 1998 the UK devoted a larger proportion of national income (4.9%) to spending on education than Japan (4.7%) but a smaller proportion than Italy, Germany, France or the USA.

<table>
<thead>
<tr>
<th>Country</th>
<th>Education spending, % of GDP</th>
<th>£ per student spent on:</th>
<th>Spending per student per unit of average income, relative to UK</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Primary</td>
<td>Secondary</td>
</tr>
<tr>
<td>Japan</td>
<td>4.72</td>
<td>4,120</td>
<td>4,782</td>
</tr>
<tr>
<td>UK</td>
<td>4.92</td>
<td>2,344</td>
<td>3,683</td>
</tr>
<tr>
<td>Italy</td>
<td>5.01</td>
<td>3,429</td>
<td>3,917</td>
</tr>
<tr>
<td>Germany</td>
<td>5.55</td>
<td>2,621</td>
<td>4,609</td>
</tr>
<tr>
<td>France</td>
<td>6.24</td>
<td>2,774</td>
<td>4,883</td>
</tr>
<tr>
<td>USA</td>
<td>6.43</td>
<td>3,928</td>
<td>5,047</td>
</tr>
</tbody>
</table>

Note: £ per student measured using the average spot exchange rates over the entire year from OECD Health Data 2001, CD-ROM. An alternative methodology is to use Eurostat purchasing power parities. The main effect of this would be to reduce spending in relatively expensive Japan and increase spending in relatively less expensive Italy.


One potential problem with looking at these raw figures is that differences may, in part, reflect different numbers of students. Looking at spending per student, the UK is still a relatively low spender on primary and secondary education (£2,344 and £3,683 per student respectively), but it actually spends more on each student in tertiary education than either France or Italy. In part, this could reflect differences in the average length of tertiary education courses and the extent to which students tend to live at home with parents.

The numbers we have discussed so far have been calculated using average exchange rates to convert spending in other countries into UK pounds. But differences in expenditure per student may partially reflect differences in the cost of providing the same standard of education. Unfortunately, at least to our knowledge, no index of the relative costs of education in each country exists at present. If spending is measured to adjust for the general cost of living in
different countries (purchasing power parities), then spending in relatively expensive Japan is reduced while spending in relatively cheap Italy is increased. But the UK’s position is little affected: it remains the lowest spender per student on primary and secondary education, although it does overtake Germany in terms of tertiary education spending.

It is also of interest to take account of differences in overall national incomes in order to get a sense of the relative priority given to each sector of education spending. The last three columns in Table 3.3 show spending per student relative to the UK once differences in national income per head are controlled for. Even after considering the fact that Japan and the USA are considerably richer countries than the UK, it remains the case that the UK devotes a relatively small amount of resources to primary and secondary education. In sharp contrast, in tertiary education only the USA spends more per student than the UK relative to per capita national income. This is principally due to US private spending being twice as high as that of the UK on this relative measure.

Other areas of spending

While education and health are probably the most discussed areas of public expenditure, combined they actually consume just over a quarter (28%) of government spending. Given any overall level of tax and borrowing, the scope for further increases in these areas will depend on savings in other spending areas that can be identified by the forthcoming Spending Review. This is unlikely to be an easy task. Saving money from social security is difficult, as expenditure largely depends on factors (such as demographics) that are beyond the government’s control. And the share of government spending on most other areas has already declined over the last 50 years (as an increasing share has been consumed by health, education and social security), which might mean that savings from these other areas are becoming increasingly difficult to find. This perhaps explains why neither the public expenditure reviews of the last Conservative and Labour governments – respectively the 1994 Fundamental Expenditure Review and 1998 Comprehensive Spending Review – succeeded in finding areas of government spending where large savings could be made.

Table 3.4 shows growth in total public spending and particular programmes within it for various periods. The relatively large real growth in education and health spending under Labour so far has occurred within relatively low growth in total spending. Current estimates suggests that public spending outside of the NHS and education should have risen by an average 0.9% a year in real terms over the period 1996–97 to 2001–02. This is due to very low growth in discretionary public spending during 1997–98 and 1998–99 and also due to savings arising from the favourable effect of reduced unemployment on social security spending and of lower government debt and long-term interest rates on debt interest payments.
Table 3.4. Real increases in selected components of public spending

<table>
<thead>
<tr>
<th></th>
<th>Real average annual increase over:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Conservatives, April 1979 to March 1997</td>
</tr>
<tr>
<td></td>
<td>Period since Labour came into power, April 1997 to March 2002</td>
</tr>
<tr>
<td></td>
<td>Labour’s planned increase, April 2002 to March 2004</td>
</tr>
<tr>
<td>Total government revenues</td>
<td>1.8</td>
</tr>
<tr>
<td>Total government spending</td>
<td>1.6</td>
</tr>
<tr>
<td>Education</td>
<td>1.5</td>
</tr>
<tr>
<td>NHS</td>
<td>3.1</td>
</tr>
<tr>
<td>Total spending excluding health and education</td>
<td>1.4</td>
</tr>
<tr>
<td></td>
<td>Of which:</td>
</tr>
<tr>
<td>Social security</td>
<td>3.6</td>
</tr>
<tr>
<td>Defence</td>
<td>–0.2</td>
</tr>
<tr>
<td>Transport</td>
<td>n/a</td>
</tr>
<tr>
<td>Debt interest</td>
<td>n/a</td>
</tr>
<tr>
<td>Memo: GDP growth</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Notes: Includes spending financed by the windfall tax. UK education spending excludes the sale of the student loan book in 1997–98 and 1998–99. UK NHS spending is net of NHS charges and receipts. Social security spending includes expenditure on the working families’ tax credit and the disabled person’s tax credit in order to ensure consistency over time. Spending on defence excludes revenues from the sale of married quarters in 1996–97 and 1997–98. Debt interest is gross central government interest payments only. For 1996–97, this has been approximated by adding £400 million to net central government borrowing, in line with footnote 3, Table B13 (p. 182) of HM Treasury, Pre-Budget Report, Cm. 5318, The Stationery Office, London, 2001. For the periods in office of each political party, we assign financial years according to who was in office for the majority of months in that financial year. Spending figures deflated using the latest GDP deflators from the Office for National Statistics.

Growth in non-education and non-NHS public spending is forecast to be faster, at an average of 2.9% a year, over the next two years. This reflects higher growth in certain spending programmes, such as transport, and also the fact that interest repayments are not expected to continue declining as rapidly as they have done over the last few years.

Social security spending

Social security spending is forecast to grow at an average of 1.8% a year over the next two years which is a similar growth rate to that seen under the first five years of the current Labour government. This is an extremely low rate of growth by historical standards – over the past half century, social security
spending has grown in real terms by an average of 4.2%\(^9\), reflecting changes in demographics, work patterns and benefit increases.

Spending on social security will depend on the numbers receiving benefits and their generosity. The low overall growth during Labour’s first five years is the product of two distinct phases: the first two years, when social security spending actually fell, by an average 0.9% a year, and the next three years (1999–2000, 2000–01 and 2001–02), in which spending is forecast to rise by an annual average of 3.8%. The low growth in the first period reflected falls in unemployment and very little growth in the generosity of social security benefits. The subsequent three years, during which spending grew, saw selective but large increases in benefit generosity, most notably directed towards low-income pensioners and families with children.

Looking forward, the future growth in social security expenditure shown in Table 3.4 for the next two years is likely to be an understatement. These figures exclude the additional expenditure likely to arise from the planned introduction of the working tax credit and child tax credit in 2003–04. More generally, if progress is to be made towards meeting the government’s aim of reducing child and pensioner poverty, then further significant real increases in benefit levels beyond those it is already committed to will very likely be needed. (For a discussion of the kind of measures that might be implemented, see Chapter 5.) Finally, in contrast to Labour’s first term, it seems that significant reductions in unemployment to offset the cost of the benefit increases are unlikely. Indeed, the government plans shown in Table 3.4 are formed on the basis that unemployment will rise modestly. As discussed in Chapter 2, these forecasts are in fact less cautious than they have been in recent years.

**Defence and security spending**

Defence spending has been considerably reduced by successive governments from 5.2% of national income in 1984–85 to 2.5% in 2000–01. The total effect of this reduction is now a saving of more than £27 billion a year. In Labour’s first five years, defence spending was cut by an average 1.1% a year in real terms compared with cuts averaging 0.2% a year over the 18 years of consecutive Conservative governments. According to the latest published plans, over the next two years, defence spending will continue to be cut in real terms, albeit by just 0.4% a year on average. Whether defence expenditure can continue to be constrained in this way will depend partially on whether large efficiency savings can be found and partially on what choices are made over the role that the UK defence force should play. A combination of these factors has allowed spending to be reduced since 1984–85 – they have meant, for example, that the total number of civilian and service personnel has fallen from 605,000 in 1980 to 487,000 in 1990 and 322,900 in 2001.\(^{10}\)

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\(^{10}\) Figures from Section 2.1 of Ministry of Defence, *UK Defence Statistics 2001*, London, 2001 ([www.dasa.mod.uk/ukds.html](www.dasa.mod.uk/ukds.html)).
Improving public services?

While the actual conflict in Afghanistan may have had little direct financial cost to the UK exchequer, world events since 11 September might mean that the government will now be less likely to continue reducing the role of the armed forces or, perhaps, will scale back their role more slowly. If so, the extent to which savings from the defence budget can contribute towards higher growth in areas such as health and education will be reduced. Similarly, the government may now approach any possible cutbacks in areas of spending such as intelligence and law and order with more caution than it would previously have done.

Public spending on investment

Since coming to power in 1997, the government has repeatedly stressed its belief in the importance of public investment and its concern about the cuts in this element of spending seen since the mid-1970s. It has argued that, over recent decades, investment spending has been given a low priority for political reasons and that increased investment is now required in order to deliver improvements in public services and the economy in general.

The fall in public investment since the mid-1970s has indeed been dramatic, as shown in Box 3.2. The downward trend that began in the mid-1970s continued through the 1979–97 Conservative governments and the first years of the 1997–2001 Labour administration. The total decline was from 8.9% of national income in 1975 to 1.7% in 2000. The post-war record low was reached in 1999, when just 1.6% of national income was spent on public investment.

Looking forward, investment spending is due to grow at a rapid rate over the next few years. But this growth is from such a low base that, even at the end of the current spending round, in 2003–04, public investment will probably remain below the level that was seen in the early 1990s.

The inclusion of capital spending under the Private Finance Initiative (PFI; see Section 3.2 for more details) does not alter this story because it is small relative to total public investment. Even if it is included, the rates of public investment seen over the years 1997 to 2000 remain lower than at any time since the Second World War. The effect of planned PFI capital spending over the next few years will also be relatively modest.

So far, much of the planned increases in investment spending have not ended up being realised within the intended time frame. But there are signs that this is changing – £7.1 billion of public sector net investment has been undertaken between April and December 2001 compared with £2.9 billion in the same period last year. These figures suggest that investment is now rising rapidly, although investment underspends in 1999–2000 and 2000–01 mean that the


12 Source: Blue Book, various years.

public sector capital stock is considerably smaller than it was envisaged to be in the government’s original plans. Given that public investment remains very low by historical standards, the government may want to consider further increases.

Box 3.2. Twenty-five years of falling investment in public services?

Figure 3.4 breaks down public investment into the capital spending undertaken by different branches of the State – central government, local government and the public corporations. This enables us to see that the decline in public investment is made up of three distinct phases:

- Local authority investment cuts dominate over the years 1975–82. The biggest single casualty was council house building, but local authority investment in schools was also sharply reduced. Public investment has failed to recover significantly in either service since the early 1980s.
- The effect of privatisation of the nationalised industries dominates over most of the 1980s, as investment by public corporations fell away extremely rapidly in the years 1984–1988. The investment carried out by companies such as British Telecom will now count as private rather than public investment.
- The years after 1992, when there was a general decline, with investment by central government falling most dramatically. Health was amongst the services most significantly affected.

Figure 3.4. Public sector gross investment, by different branches of the State, as a percentage of national income

Source: Blue Book, various years.
3.2 Private involvement in public services

The government has stated that it wants to deliver world-class public services. As shown in the previous section, the government has pledged to increase spending on public services, in particular health and education, at least until March 2004. In addition to increased resources, the government has also stressed the need for reform of public services. And central to what it seems to mean by ‘reform’ are public–private partnerships (PPPs), which it sees as ‘a key element in the Government’s strategy for delivering modern, high quality public services’. This section assesses the current and likely future scale of private sector involvement in public service delivery, and then turns to consider the validity of various arguments for and against this involvement. Before looking at either, though, it will be useful to try to pin down some definitions.

Public–private partnerships and the Private Finance Initiative

Understanding PPPs requires a contrast with purely public and purely private service delivery. Pure public provision would see the State fully finance, control and deliver a service, as well as owning and providing any infrastructure it required. By contrast, pure private provision occurs when companies fulfil all these roles. At a minimum, PPPs are arrangements where some of these roles are fulfilled by private companies and others are provided by the State. But this definition would probably be too general. NHS hospitals have always been built by private companies and its GPs are self-employed, but we are not used to thinking of the service as a partnership with the private sector. And since the BT sell-off, the telecommunication industry is thought of as fully privatised, even though regulation through Oftel means that the State retains significant control over it.

Tighter definitions have been attempted but none is likely to prove watertight. It might be better to supplement our minimal definition (that some aspects of service delivery are public while others are private) with features that are characteristic but not universal amongst those arrangements called ‘PPPs’ in the current debate:

- The private sector increases its role in sectors that have traditionally been primarily public.
- The private sector’s involvement is defined in long-term contracts.

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16 On page 40 of IPPR, Building Better Partnerships, London, 2001, PPPs are defined as ‘A risk-sharing relationship’ between the sectors ‘based upon a shared aspiration to bring about a desired policy outcome’. But the authors claim this only as a ‘working definition’, and point out that ‘it is far easier to say what a partnership is not rather than what it is’.
Finance required for any capital projects is borrowed by the private partner, not the government.

The State retains the role of providing the main source of ultimate funding for the service by paying an income (often tax-financed) to the private partner.

Other characteristics vary greatly between cases. For example, sometimes the ownership of assets remains with the public sector, sometimes it is completely transferred to the private sector and sometimes it is temporarily transferred before reverting to State ownership.

Interest in ‘partnerships’ in general developed as first Conservative and then new Labour governments began to push the use of a particular form of PPP, the Private Finance Initiative (PFI). Under the PFI, private companies invest in an asset required for the provision of a publicly sponsored service. The private partners’ role includes financing and organising both upfront construction and maintenance. The public sector contracts to purchase use of the asset over a prolonged period. For example, the private sector could design, build and maintain a hospital in order to provide the public sector with hospital beds over 25 years in return for a stream of annual payments. Similar examples exist in the provision of classrooms, roads and prisons.

The PFI was in part initially advanced as a way of getting additional revenue into public investment. This argument hinged on its apparently favourable effects on the public finances, but over time the rationalisation has come to focus instead on the potential to transfer risk away from the public sector and to increase efficiency. But if the private sector really can improve the general efficiency of public services, then it ceases to be obvious why its involvement should have to centre around providing an asset. So forms of PPP broader than just the PFI have now moved up the agenda. This simple chronological story is complicated by the recognition that certain arrangements that have been established for a considerable time might be thought of as PPPs. For example, had the current parlance been in circulation when the contracting-out of services such as refuse collection and cleaning was initiated, they might well have been dubbed ‘PPPs’.

Much of the data that are available relate exclusively to the PFI, so in the rest of this section our focus will sometimes be restricted to this. When dealing with general principles, however, we will focus on PPPs, the more general case.

How important is the Private Finance Initiative?

The PFI is still only a fairly small component of overall government expenditure. In 2000–01, payments under the PFI (from the State to private contractors) totalled £2.9 billion, just 0.8% of total government expenditure.

and 0.3% of national income. Given that much government spending is on transfer payments (such as debt interest and social security), which could not, in principle, be converted into PFI spending, we might be more interested in the share of spending on public services that PFI expenditure represents. As about 50% of government spending is on services, the share of this that payments under PFI represent would be around 1.6%.  

Figure 3.5 shows the expected payments over the next 25 years from PFI contracts that have already been agreed. It shows that if no further contracts are agreed, payments should rise to 0.4% of national income in 2003–04 before falling to less than 0.1% of national income in the mid-2020s. But this decline is actually unlikely to materialise because current policy is that new contracts should be signed. The signing of new contracts shows up in Figure 3.5, for example, in the upward revision to the projected future flow of payments under the PFI between the 2000 and 2001 Budgets. If current policy continues, further upward revisions will follow.

Figure 3.5. Estimated future payments under Private Finance Initiative contracts, as a percentage of national income


19 We might class as ‘public service’ expenditure investment and ‘final government consumption’. The 2001 Blue Book shows that, in 2000, these together comprised 50.4% of government expenditure.
The numbers presented so far describe income paid out to the private sector under PFI contracts. These figures show that the PFI represents a small share of government spending but tell us little about the amount of capital spending that the private sector is currently undertaking on behalf of the public sector. This is because the cost of any PFI capital spending carried out will be shared across future payments made to the private sector. Another way in which we might want to gauge the quantitative significance of the PFI is therefore to look directly at the amount of investment that private companies are doing under the PFI and to compare this to the total amount of publicly sponsored investment.

Despite the very low level of public sector investment (as discussed in Box 3.2), it is still the case that most publicly sponsored investment expenditure is conducted through conventional means rather than through the PFI. Table 3.5 shows that, in 2000–01, total publicly sponsored investment was £23.3 billion, which comprised £19.0 billion financed by the government and £4.3 billion financed by private companies. Whether the proportion of publicly sponsored investment that is financed by the private sector increases or declines in future will depend on how much publicly funded investment actually materialises and how many new PFI contracts are agreed.

Table 3.5. Estimated capital spending by the public sector under both conventional finance and the Private Finance Initiative, by year and status of the contract

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total signed deals (£bn)</td>
<td>3.9</td>
<td>3.5</td>
<td>3.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Total at preferred bidder stage (£bn)</td>
<td>0.4</td>
<td>0.8</td>
<td>0.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Total PFI investment (£bn)</td>
<td>4.3</td>
<td>4.4</td>
<td>3.6</td>
<td>2.8</td>
</tr>
<tr>
<td>Public sector gross investment (£bn)</td>
<td>19.0</td>
<td>26.0</td>
<td>28.8</td>
<td>33.2</td>
</tr>
<tr>
<td>Total publicly sponsored gross investment (£bn)</td>
<td>23.3</td>
<td>30.4</td>
<td>32.4</td>
<td>36.0</td>
</tr>
<tr>
<td>PFI investment as a percentage of total publicly sponsored gross investment</td>
<td>18.4%</td>
<td>14.5%</td>
<td>11.1%</td>
<td>7.9%</td>
</tr>
</tbody>
</table>


The role of the PFI in providing capital spending is not equally spread across government departments, as Table 3.6 shows. And, indeed, it turns out that there is considerable variation across departments in the proportion of capital spending that is now being undertaken privately. In defence, for example, only 2.2% of capital expenditure is undertaken under the PFI, whereas in health the proportion is far higher, at 25.9%.

As well as differences between types of public service programmes, it seems that there are significant differences in the extent to which different branches of government rely on the PFI. Table 3.6 shows that a large proportion (37.6%) of total PFI capital spending is carried out for local authorities. This is disproportionate, given the total amount of investment that councils sponsor. Looking at local authority sponsored gross investment, 34.3% was undertaken under the PFI in 2000–01, compared with the 18.4% shown in Table 3.5 for
the total of publicly sponsored investment.\footnote{We will touch later on possible reasons for this.}

Table 3.6. Estimated capital spending under the Public Finance Initiative, by department, 2000–01

<table>
<thead>
<tr>
<th>Department</th>
<th>£bn</th>
<th>% of total PFI capital spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defence</td>
<td>0.121</td>
<td>2.8</td>
</tr>
<tr>
<td>Foreign &amp; International Development</td>
<td>0.007</td>
<td>0.2</td>
</tr>
<tr>
<td>Agriculture, Fisheries &amp; Food</td>
<td>0.000</td>
<td>0.0</td>
</tr>
<tr>
<td>Trade &amp; Industry</td>
<td>0.046</td>
<td>1.1</td>
</tr>
<tr>
<td>Environment, Transport &amp; Regions</td>
<td>0.619</td>
<td>14.4</td>
</tr>
<tr>
<td>Education &amp; Employment</td>
<td>0.015</td>
<td>0.3</td>
</tr>
<tr>
<td>Home Office</td>
<td>0.171</td>
<td>4.0</td>
</tr>
<tr>
<td>Legal Departments</td>
<td>0.040</td>
<td>0.9</td>
</tr>
<tr>
<td>Culture, Media &amp; Sport</td>
<td>0.000</td>
<td>0.0</td>
</tr>
<tr>
<td>Health</td>
<td>0.559</td>
<td>13.0</td>
</tr>
<tr>
<td>Social Security</td>
<td>0.042</td>
<td>1.0</td>
</tr>
<tr>
<td>Scotland</td>
<td>0.559</td>
<td>13.0</td>
</tr>
<tr>
<td>Wales</td>
<td>0.190</td>
<td>4.4</td>
</tr>
<tr>
<td>Northern Ireland</td>
<td>0.061</td>
<td>1.4</td>
</tr>
<tr>
<td>Chancellor’s Departments</td>
<td>0.104</td>
<td>2.4</td>
</tr>
<tr>
<td>Cabinet Office</td>
<td>0.155</td>
<td>3.6</td>
</tr>
<tr>
<td>Local authorities</td>
<td>1.618</td>
<td>37.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4.307</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>


We have examined the relative importance of PFI investment by examining it as a proportion of total publicly sponsored gross investment – which includes both the construction of new assets and the restoration of old ones. Our focus partly reflects the data that are available, but it risks underestimating the significance of the private sector’s role as a provider of new facilities. This is because the large stock of existing public sector assets makes it likely that a higher proportion of public than PFI investment will be concerned with repair, given that the private sector does not currently possess a large capital stock geared to public service delivery. This helps explain, for example, how it is that the PFI should provide the majority of new hospitals envisaged under the NHS plan, even though less than a third of publicly sponsored health investment is currently under the PFI.\footnote{‘The 100 hospital schemes [in the NHS plan] include the 34 major and 29 medium sized PFI hospital schemes already in procurement or completed’, Department of Health, *Departmental Report 2001–02*, The Stationery Office, London, 2001.}

Costs and benefits of greater private sector involvement

Various arguments have been advanced to support the expansion of PPPs – most importantly, financial considerations (especially in the case of the PFI),

\footnote{Authors’ calculation based on capital spending for local authorities, as reported in Table 3.6, and data on local authority gross investment reported on page 25 of HM Treasury, *Public Finances Databank*, December 2001.}
the management of risk and general efficiency improvements. Here, we evaluate the merit of each in turn, and also consider offsetting considerations, which argue for more conventional forms of public service delivery.

To determine whether a particular investment project should be delivered and financed publicly or privately, the Treasury contrasts the expected cost of privately run provision with a ‘public sector comparator’. Whether this comparison is a fair test of best value hinges on the assumptions about the extent to which the risk-transfer and efficiency-saving arguments apply. So we consider this process in the light of our evaluation of these arguments.

Reduced borrowing and therefore interest payments by the public sector?

Under conventional public procurement, investment spending leads to an immediate increase in government borrowing and hence greater future interest payments. In contrast, under the PFI, private firms borrow to undertake publicly sponsored investment and so neither borrowing nor government debt interest payments increase. This has given rise to the argument in favour of the PFI, which asserts that it allows the public sector to secure from the private sector additional resources for public investment – in other words, that it eases an economic constraint and so allows new facilities to be built that would not otherwise be built.

The argument is flawed because, although government debt and interest payments are indeed reduced, the annual payment to the private sector provider will naturally include the interest and capital repayments that company has to make on the money that it has borrowed on the government’s behalf. If the private sector could borrow at the same rate as the government, and all else were equal, then the two methods of delivering the service should give rise to no differences in the government’s underlying financial position: PFI investment would merely replace the stream of interest flowing from the debt incurred under traditional public procurement with a contractual obligation to pay the same amount. If real resources were being released by such a switch, then it would seem to be because accounting rules were failing to pick up the equivalence between a debt and a pledge to pay an income stream, in which case economics would suggest that it was the accounting rules, rather than the method of public service delivery, that needed to change.

Given that this ‘balance sheet’ argument seems erroneous, any attempt to use it to push the PFI in place of traditional public procurement could result in the PFI being inappropriately pursued. It is therefore unsurprising (and welcome) that, in recent years, the Treasury has downplayed it. The aim of meeting the Chancellor’s fiscal rules should not produce an incentive to pursue PFI investment for ‘balance sheet’ reasons – the golden rule explicitly allows borrowing for investment, and the sustainable investment rule, as currently defined and in current circumstances, would potentially allow the government to invest substantially more than it does at the moment without raising tax, since, in 2000–01, public sector net debt was just 31.2% of national income, 8.8 percentage points below the 40% limit prescribed by

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Improving public services?

Gordon Brown.\textsuperscript{23} A quick, back-of-the-envelope calculation suggests that, had all of the projects carried out under the PFI been delivered publicly, public sector net debt would, in March 2002, be around 2\% of national income higher, still comfortably below the 40\% limit.\textsuperscript{24}

The ‘balance sheet’ argument may still have some influence in at least some parts of the public sector, however. We saw in the previous subsection that local authorities were doing significantly more of their investment through the PFI than was central government. It could be that local authorities are responsible for spending that is better suited to use of the PFI; but an alternative explanation is that local councils (which need central government approval before they can borrow money to spend on capital projects) experience cash constraints that leave them with incentives to minimise the amount of debt appearing directly on their balance sheets.\textsuperscript{25} In addition, individual departments still have an incentive to minimise the borrowing that they engage in directly since their budgets do not yet include a full cost of capital charge. This should be put right in Spending Review 2002, when full resource accounting will be introduced.\textsuperscript{26}

The discussion so far has assumed that financing costs are the same in the public and private sectors. In fact, private sector financing costs are higher than those of the public sector. This is because the cost of borrowing is higher for private sector firms than it is for the government. The difference principally arises because the risk of default is higher for any private firm than for the government, since future governments can always increase taxes to pay for any outstanding commitments while private firms always have a risk of bankruptcy. This might seem to suggest that strong countervailing gains are required before private finance is ever used to build public sector infrastructure. But this effect should not be overstated, because estimates suggest that only 22\% of expenditure under the PFI actually represents the initial capital investment – in other words, most of the payments under the PFI are for services other than finance.\textsuperscript{27}

\textsuperscript{23} The government is not free to increase debt right up to the limit of the sustainable investment rule: if it increased investment by 8.8 percentage points of GDP, it would, in absence of other tax increases or spending cuts, miss the golden rule since the resultant increase in debt interest and depreciation figures would score against current spending.

\textsuperscript{24} 2\% of GDP is approximately equal to the sum of the cash value of all capital spending under PFI projects agreed to date.

\textsuperscript{25} Indeed, sometimes it seems that the Treasury is still advancing the ‘additionality’ argument. In comparing public corporations’ bonds with PFI finance, it recently offered as a consideration in favour of the PFI option the fact that ‘bonds issued by state-owned businesses represent public sector borrowing’ – page 34 of HM Treasury, Public Private Partnerships: The Government’s Approach, The Stationery Office, London, 2000 (\url{www.hm-treasury.gov.uk/mediastore/otherfiles/80.pdf}).


\textsuperscript{27} Source: Arthur Andersen and Enterprise LSE (2000), Value for Money Drivers in the Private Finance Initiative.
Transfer of risk?

Public–private partnerships typically see the private sector being guaranteed a specified stream of income in return for guaranteeing the provision of a contractually defined service. In theory, this arrangement should mean risk is transferred away from the public sector: without the PPP, the State would have to provide the service directly itself, in which case it would face uncertainty about how expensive it will turn out to be to provide a particular quality of service over a prolonged horizon; under the PPP, both the quality and the cost should be fixed for the State.

The transfer of risk per se is not necessarily desirable. For example, consider a project where the State commissions a company to provide some buildings, and assume that world-market-determined building materials costs are a major determinant of the total cost of the work. A fixed-fee contract would pass the risk flowing from material cost variations on to the private company; an alternative arrangement would be to allow full cost pass-through for building materials, in which case the government would keep the risk. Assuming the cost of materials is known to both parties, the second arrangement should be preferable, as the large scale of the public sector and its very diverse interests probably make it more likely than the private company to be able to offset any cost overrun on this project against savings on other projects.28 As a result, the extra expected profit that the company would need to take on the risk would be likely to exceed the cost to the public sector of maintaining it.

Risk transfer becomes desirable when it alters the private contractor’s incentives in a manner that means that the risk the public sector would otherwise face is not just transferred, but also reduced. For example, if the government pays a company a fixed sum to construct a road, and if it cannot accurately monitor the quality of the work, then the company has an incentive to cut costs even where this produces a high risk of the road eventually proving defective. If the government can instead use a PPP contract to purchase 25 years of the road ‘services’ of a specified quality, then the consequences of the road proving defective are transferred to the company, and this should ensure it reduces the risk of this happening. Similar conclusions hold when the different elements of the project’s costs cannot be separately monitored, producing the risk that it will be run inefficiently because the company could pass the resulting costs on to the government. If, instead, a fixed-payment-for-fixed-output agreement is reached, the company should be incentivised to manage efficiently.

An offsetting consideration is the risk resulting from the impossibility of writing complete contracts. If a PPP ties a government into a 25-year arrangement to purchase, say, health services, then there is a risk that, over this period, the contractor will find a way to cut costs (and so increase profits) in a way that is detrimental to the quality of service in a manner that was not anticipated in the contract. Other ‘risks’ arise if there is some chance the State will want to alter the quality of the service it is sponsoring during the period of

28 This difference will depend on the ability of private sector investors to diversify risk effectively. If diversification is cheap and effective, then private firms may be as happy to accept risk as cheaply as the State.
the contract. For example, the government might want to increase the quality of service offered in a particular hospital 10 years after it has signed a 25-year contract purchasing the use of its beds. Unless the contract specified what happened in such circumstances, the provider might be able to charge well above cost for the unforeseen service improvement on the grounds that the State was already tied into using it as a provider of the basic service.

Transferring risk in a manner that promotes value for money for the State is an important argument in favour of the use of PPPs. This helps us understand why it is that the decision to use a PPP often hinges on the amount of risk transferred. But we should not lose sight of the fact that the desirability of this transfer taking place hinges on the type of risk transferred, nor of the fact that an imperfectly written PPP contract involves new risks. The difficulty in accurately and separately quantifying the various types of risk involved makes the decision about whether to use a PPP more difficult and potentially more subjective.

*How much risk is being transferred?*

We have seen that transfer of the right type of risk to the private sector could be an important reason why PPPs might deliver better results than traditional public procurement: it could mean that project managers face sharpened incentives to improve efficiency. This makes it interesting to ask how much risk has, in fact, been transferred. Given that the actual costs of delivering a PPP contract are unknown, the rate of return a firm will require to finance a PPP project will depend on the amount of risk that the markets believe the firm has undertaken. For the PFI, project-specific bond ratings give us an idea of how much risk investors believe they are assuming.

In fact, the bond ratings of PFI projects suggest that investors in these projects do not think that they are taking on significant risks. But inferring anything from this about how much risk is transferred is extremely difficult. It does not necessarily mean that little risk is being transferred from the public sector, as the low PFI bond ratings could arise for one of three reasons. First, the markets may see that the risks that the State would otherwise have faced have been dramatically reduced by their transfer to the private sector, which is exactly what should happen if risk transfer works well. Second, the project may involve very little risk for the contractor, either because it is inherently unrisky or because the contractors anticipate that political pressures will result

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29 One study concluded ‘In all of the business cases we have examined, the value-for-money of the PFI option is dependent on the valuation of the risk transferred to the private sector’ (page 24 of UCL Health Policy and Health Research Unit, *Public Services, Public Finance*, Unison, London, 2001).

30 UCL Health Policy and Health Research Unit, *Public Services, Public Finance*, Unison, London, 2001. In the specific example of project-specific bonds sold to finance NHS PFI contracts, Standard and Poors have stated that ‘Compared with many other types of project financings, the U.K. hospital Private Finance Initiative (PFI) projects display a number of strong credit characteristics, including a relatively stable income stream that covers debt service and more limited operational risk’ ([Standard and Poors, Rating U.K. NHS PFI Projects, 10 November 1999](http://www.standardandpoors.com/ResourceCenter/RatingsCriteria/NonUSPublicFinance/Articles/111099_ratinguknhs.html)).
in them being bailed out by the State if things turn out badly. Third, significant risk may have been transferred, but the markets may be underestimating it.

Even though the extent of genuine risk transfer is a crucial determinant of whether the private sector can realise efficiency savings, it is (unfortunately) extremely difficult to quantify.

Does the public sector comparator correctly gauge risk transfer?

The risks transferred also bear importantly on whether the ‘public sector comparator’ – against which the desirability of doing a project through the PFI is established – is a fair yardstick. Grout (2001) points to two reasons why the private sector firm will bear more risk than the public sector comparator. First, the company runs the risk of large costs if it proves impossible to finish the project on time. 31 Secondly, under a PPP arrangement, any future uncertainty regarding the costs of providing a public service are borne by the private firm, effectively insuring the State against future changes to input costs. Ignoring any advantage from the private sector assuming these risks might mean that use of a public sector comparator discriminates against private sector involvement.

This is not the only potential problem with the use of a public sector comparator. There are offsetting risks that the ‘comparator’ process may also overlook. These follow from the loss of public sector discretion that PPP deals involve. We have already argued that long-term contracts with the private sector for public service delivery can involve risks when there is a chance that there might be a desire to change the standard of service provision in a way not provided for in the contract. These increased risks to the public sector from using the PFI will not be picked up in the comparator process. Their importance is likely to vary across public services – for example, it might be easier to assess the quantity and quality of roads that we want in 2020 than it is to anticipate the quantity and quality of healthcare. This bias against the use of the public sector might therefore be especially likely in some sectors.

Ex post evaluation of value for money and the Railtrack affair

The true cost of delivering a PFI contract is uncertain. This means it is possible for a private sector firm to be observed making large profits from a PFI contract without it necessarily following that it originally overcharged for the contract. Similarly, just because some projects lead to private sector losses does not necessarily mean that the charge made was too low or that the original deal was an especially good one for the public sector. The important distinction here is between what was expected at the time the contracts were signed and what subsequently occurred.

If the markets had underpriced the risk that contractors were assuming, then this would imply that the public sector should have gained, by effectively

31 Normally, a delay to a project would be costly since it would delay the date at which payments would start. Under PFI contracts, it is actually more costly since the end-date is fixed. For example a five-year delay to a 25-year project would lead to the private firm only receiving 20 years of payments. Source: P. Grout, Is the Private Finance Initiative a Good Deal?, Leverhulme Centre for Market and Public Organisation Bulletin, Issue 6, December 2001.
acquiring especially cheap insurance against some risk. This gain would not have been due to greater efficiency but would have been at the direct expense of bondholders, who would have found themselves assuming more risk than expected. This underpricing of risk transfer could have led the government to use the PFI even where it was not efficient.

If the risk bondholders had taken on was initially underestimated, then, over time, as the risks actually acquired become clearer to bondholders, we would expect the cost of borrowing to finance PFI arrangements to increase. Although this should increase overall economic efficiency, it would also make it harder to show that the PFI or PPP offered value for money when compared with conventional public sector service delivery. It is possible that the recent decision to bring Railtrack PLC into administration will increase the market’s assessment of the risk undertaken by companies whose value is largely dependent on future payments from the UK government. However, a leading credit-rating agency has stated that ‘the Railtrack affair has no direct implications for rated PFI projects’. It also highlighted a number of differences between many PFI/PPP projects that it had not rated and the Railtrack case (including differences in scale and regulatory frameworks) which it argued could generally limit the implications of Railtrack for PFI financing costs.

**Relative efficiency in the public and private sectors**

Aside from any gains that may flow from the transfer of risk, advocates of PPPs point to additional reasons to expect them to improve efficiency and so reduce the cost of providing public services. Sometimes it is asserted that private sector management is, in general, superior; sometimes the emphasis is on the removal of particular purported public sector weaknesses, such as a tendency to have inappropriate patterns of employment or distorted pay rates. In practice, in healthcare at least, the government’s election manifesto may constrain the private sector’s ability to deliver such savings – ‘We have said that Private Finance Initiative (PFI) should not be delivered at the expense of the pay and conditions of the staff employed in these schemes’.

Private sector efficiency savings might be expected if, for example, the threat of bankruptcy or the presence of competition means that private sector managers will be forced to push harder for efficiency than their public sector counterparts. But if private sector efficiency only reflects incentives produced by such factors, then it might be that changing the incentives for the public sector workers – for example, through the increased use of performance-related pay and targeting – would be an alternative to using PPPs to deliver public services. Indeed, it might even be that the possibility of public sector managers being replaced by outsiders (as in the PPP bidding process) could be sufficient to drive up efficiency even if the public sector continues to run public services. But if overhauling public sector incentives produces its own

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problems, or if the private sector has more general managerial advantages, it might still be that PPPs would deliver better value.

Again, however, there are countervailing considerations. For one, there are the possible effects of a public sector ethic, which might mean that public sector personnel are willing to work harder than their private sector counterparts because their workplaces are especially infused with a sense of dedication. Such forces must be distinguished from any general professional ethic that applies in, say, health and education: the point is that employees have to care about whether their employer has the sole aim of service delivery rather than making a profit, not just the nature of their work. If public sector employment can have this special effect, then the State would have a special ability to deliver high-quality services efficiently.

Another consideration is the potentially significant legal and accounting costs that arise when services are farmed out and it becomes necessary to draft and monitor long-term contracts that need to be complex enough to cover all envisaged contingencies. Interactions with the remaining public sector element of the service provision could also become more legalistic. Finally, the market power that certain large public sector organisations possess will be diluted as they are joined by private sector operators. For example, the ability of the NHS to contain the prices of drugs or the wages of its employees might be undermined, which could reduce value for money.

3.3 Conclusion

UK spending on health and schools is relatively low in an international context. But current increases in health and education spending are large by historical standards, and are planned to continue at least until 2003–04. By this time, they should have been sufficiently sustained to exert a discernible effect on the quality of service provision. Beyond this, if continued substantial spending increases in the health and education budgets are deemed necessary, then one option would be to try to fund them from savings out of other departments. But this does not look easy – it seems unlikely that falling unemployment will continue to provide significant savings on social security, and the claims of many other spending departments – for example, transport and defence – might be seen as relatively strong at the moment. It seems likely, therefore, that continued large increases in health and education spending beyond 2003–04 would need finance from increased borrowing or taxation.

Alongside increased public expenditure, the government sees reform of public services as an important means of improving their quality. In particular, it hopes that it can find new ways to involve the private sector and that this will increase efficiency. We have seen that, at the moment, economics can provide more arguments both for and against this process than it can hard evidence,

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34 Tender costs as a proportion of total project cost were found to be far larger in PFI projects than traditionally financed projects in E. Butler and A. Stewart, *Seize the Initiative*, Adam Smith Institute, London, 1996.
and this limits our ability to reach a firm conclusion. Our overview of these suggests that the arguments for greater private sector involvement are likely to be strongest in cases where the public sector is confident in its own ability to anticipate its needs over a long time horizon. Conversely, the arguments against tying the State into a long-term deal with the private sector seem most compelling when there is significant uncertainty about exactly what type of services we will want in the future.

*Tom Clark and Carl Emmerson*