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# *Public-private partnerships and audits*

*International overview and domestic experience*

As a result of aging societies, during the last fifteen years the scope of government responsibilities and public services has been reconsidered especially in Europe. Governments face similar problems nearly everywhere: while there is an increasing social demand for public health, education etc. services, the workforce is decreasing. At the same time, unemployment figures are high: the number of those out of work exceeds 5 million in Germany, for example. Due to the demographic trends and the high unemployment rate, the revenues that can be centralised are continuously shrinking, but more and more expenditure is generated. Therefore, governments should seek to answer questions such as how to provide services at the highest possible standards when less and less sources are available, how to make services more efficient when the available funds are decreasing and how to involve external sources to supplement the poor state funds in order to provide public services.

One of the possible solutions is using various forms of market type mechanisms as recently discussed by the OECD<sup>1</sup>. The meeting identified four areas of the coordination of the public and the private sectors and the market type mechanisms: outsourcing, public private partnership (hereinafter: PPP), vouchers and user charging.

As this article is focusing on the situation in Hungary, we are going to discuss primarily the first two methods. Vouchers and user charging are used infrequently, and do not fall in the scope of the Hungarian coordination practice<sup>2</sup>. Of the two methods described here in detail, we would like to focus primarily on PPP, which was introduced in its classic form approximately two years ago, and has been rapidly expanding since, while the outsourcing process, which started in the mid-1990s, has been completed.

This article has been written with the aim of reviewing experience gained abroad and in Hungary and summarising the relevant conclusions. We are going to discuss these processes from the point of view of the State Audit Office (SAO), i.e. we are going to rely on the SAO's experience, if such exists (in the field of outsourcing), and in areas where no experience has been gained so far (classic PPP projects), we would like to identify the SAO's tasks. These tasks currently include calling attention to the relevant issues, transferring international experience and recommendations and revealing alarming deficiencies in control and other areas, which may lead to the inefficient use or the disappearance of public funds in the long term. Accordingly, this essay is concluded with a summary of the basic standards and the recommendations of the SAO.

## OUTSOURCING

Outsourcing is the most wide-spread market type mechanism in the area of government services<sup>3</sup>. Its primary goal is to boost efficiency. In order to reach goals, the public sector should flexibly adapt to business approaches and opportunities in the market. Another important target is to make the expertise, which has been lacked in certain institutions, available.

In developed countries the range of services outsourced is very wide and can be divided into three distinct groups. The first consists of various “blue collar” support services. These are generally the first activities that governments outsource and are common in a number of countries. The first group includes services such as the cleaning and maintenance of public buildings, waste management and the provision of guard services. The second group consists of generally high value services, which are considered ancillary to the core mission of the given ministry or institution. The leading example of the second group is the outsourcing of information technology functions, as well as legal and financial activities and the outsourcing of human resources management. Another characteristic of this group is that the functions outsourced are often complex in nature and involve rapid change in their operating environment. The third group includes activities that many would view as inherently governmental. Such activities include outsourcing of prisons (Australia, Canada and the United States). Other interesting functions that have been outsourced include fire services (Denmark) and food inspection (Iceland). The use of outsourcing in health, education, and welfare services has made important inroads in certain countries. This includes specialised hospital care, diagnostic services, care centres for children and long-term care institutions for the elderly and the handicapped.

It is difficult to quantify the use of outsourcing and consequently countries cannot be com-

pared as no standardised, comparable databases are available. According to a survey carried out by the OECD, outsourcing is applied to a greater extent in the English-speaking and the Scandinavian countries, and much less so in the continental European countries.

In Hungary there have been attempts to reduce government services and make them more efficient through the establishment of business and public interest companies and foundations by the institutions under the chapters of the budget. Such attempts have been supported by changes in the legislative environment: from 1994 a part of these services could be rendered by public foundations and public interest companies. Such entities have been set up to reduce the workload of the state and carry out the task at less cost, while private funds are involved to reach public goals.

In its report on the review of the system rendering government tasks outside the scope of public finance<sup>4</sup>, the State Audit Office assessed *the organisations established by the Parliament, the government or the chapters*, the public property, the scale of subsidies and the efficiency of the 35 public foundations. In 2002 and 2003, a review was carried out based on data supplied by 42 foundations, 100 public interest companies and 147 business entities. These organisations<sup>5</sup> received significant subsidies from the central budget: more than HUF 600 billion (primarily from the appropriations managed under the chapters) for operation, accumulation in the form of capital grant and capital formation. As far as the scope of activities is concerned, public interest companies were set up primarily for technical research and development purposes. Business entities were principally involved in flood and inundation protection, agriculture and forestry and water supply. Public foundations were set up for the support of those living abroad, sports and cultural tasks; however, these were only involved in the redistribution of the central funding.

Earlier audits carried out by the SAO<sup>6</sup> and the latest comprehensive assessment have clearly proved that the operation of these organisations *do not meet the expectations*. Such organisations were often established solely to implement the streamlining objectives (both for the number of staff and tasks) set by the government, which means that no useful function and task analysis or efficiency assessment were made. According to the findings of the comprehensive reviews, no demonstrable savings were made and a third of the organisations under review made losses or no sufficient funds were available, although these were established in order to provide public services in a more efficient manner. When outsourcing decisions were made, decision-makers failed to have an appropriate system approach, to elaborate requirements and uniform organising principles or to prepare an impact assessment. No uniform organising principles were defined for financing these organisations: in most cases funding was provided based on individual decisions. The experience gained so far does not confirm that the provision of public services has become more efficient by introducing market type mechanisms.

The classic outsourcing process resulted in the establishment of an excessive number of new organisations, which were set up practically for all new public tasks outside the scope of public finance, making significant amounts get out of the state control. The network of background institutions set up by the ministries and other central bodies are typically oversized or often concealed as public or business companies; ministry organisations (central, office etc.) are often enlarged indirectly through business entities with permanent assignments with the introduction of consultancy networks etc., public bodies and public foundations are set up as semi-government organisations in excessive numbers and consequently, such organisations are devaluated<sup>7</sup>.

In addition to the results of the previously mentioned reviews carried out by the SAO, the

assessment launched by the government in the framework of the so-called 'Glass Pocket' programme and the survey of the affected organisations<sup>8</sup> have contributed to the identification of the problems.

However, only 17 central budgetary institutions, 5 public companies and 1 public foundation were dissolved by 2004<sup>9</sup>. For those wishing to reform the public administration system, it has become clear (and it is supported by the financial administration, too) that such measures are not sufficient any more: 'the traditional as well as the outsourced coat should be buttoned up again'.

This means that appropriate organisational forms, which fit best the provision of public services should be identified and rules should be established for these<sup>10</sup>.

## PUBLIC-PRIVATE PARTNERSHIP (PPP)

Public services may be rendered in two forms: through a state-owned company set up for this specific purpose or through a private company contracted by the government for a long term period. However, the outcome, i.e. the service is the same, the organisational and the financing structure is different. The idea of concession emerged for this purpose and has been in use in Hungary for at least 100 years. PPP is a modern-age version of concession, first deployed in the English-speaking countries. These countries are still by far the largest users of PPP's. This is why we have adopted the definitions from these countries. The most experience has also been gained in these countries since they pay much attention to ex-post evaluations on the implemented projects.

Having regard to the large number of relevant publications available in Hungarian<sup>11</sup>, which describe the concepts, objectives, advantages and disadvantages of PPP in detail, we are going to give only a brief summary of these issues.

## Typical features of PPP

PPP refers to the partnership of the public and the private sectors (primarily development), where the design, building, operational and financing functions traditionally provided by the public sector are carried out by the private sector to a greater extent than usual or entirely in certain cases and in a more complex manner. PPP's are generally long-term assignments (20 to 30 years), where the private partner is responsible not only for the implementation of the project, but also for the provision of the public service in question: it sells its services to the government or – when state guarantee exists – to third (user) partners. The analysis of such projects shows that it is a good idea to have the same company build and maintain a facility providing public services.

As far as its extensive use is concerned, in general, *the benefits provided by PPP's are similar to those of privatisation*. In the public sector privatisation, however has gained ground primarily in areas, where production and services were traditionally rendered by private businesses, and more competition was needed. Privatisation in the infrastructure sector, for the well-known reasons of economy, has been less dynamic similarly to other countries. While a robust wave of privatisation took place in Hungary in the 1980s and 1990s in trade, in the key areas of the public sectors (gas and oil industry, water management, air travel, culture, education and public health) privatisation was less significant due to the monopoly and strategic importance of certain companies/institutions.

The question in countries implementing privatisation projects (especially in countries in transition) was how to finance the operation and the further development of the 'remaining infrastructure' when central funding was constantly unavailable. PPP, which is increasingly significant in the global economy and in countries on the way of catching up, could be a possible answer.

Due to the similarity of PPP and privatisation as well as the continuity in time we can consider the partnership of the public and the private sectors as a new stage of privatisation in Hungary having started in 1999<sup>12</sup>. In terms of economic policies *this stage is characterised by a new way of providing public services* instead of government undertakings and selling the 'remaining' assets. The history of transferring public services to the private sector and concession projects is only about to start – followed by debates motivated by welfare related issues. There is no agreement among experts to what extent the privatisation of bigger public supply systems is going to be similar to the sale of manufacturing companies as far as techniques and methods are concerned. The 'continuation of privatisation' approach of the authors of this document can be disputed, nonetheless *in such cases the starting point is (or should be) the principle that the transfer of assets to the private sector (joint public or private ownership) is not the ultimate goal: it is only an instrument of the efficient provision of public services*.

## International models and rules

In addition to the English model of PPP applied all over the world, we should mention – among others – *the French or continental model*<sup>13</sup>, too. In the French model the chief co-operators are the local government bodies (and their various associations) and private entrepreneurs (under the control of the state and the legislation), while the English model is much more based on the operation of competing markets and the principle of maximum use. Another difference is that the French model is more flexible (institutionally and technically), while the English is characterised by detailed contracting practice and monitoring organisations set up for this particular purpose.

The classical forms of PPP's and the related

terminology may be learnt from the directives of the Commission of the European Union<sup>14</sup>; however, these terms and definitions cannot be interpreted globally. The development of PPP is very dynamic. It seems that countries with substantial experience in this field, apply various new solutions and contractual structures as the interpretation of these principles is increasingly flexible. At the same time, individual project types are getting crystallised, which is again a result of the leading countries' intention to deploy *model contracts*. The most typical form of PPP's is probably the DBFO (design, build, finance and operate) solution, where the private partner is responsible not only for planning, building and operating the infrastructure, but also for providing funds for the project. The combined responsibility of the private sector guarantees increasing efficiency and appropriate quality for the entire period.

A private operator may get involved directly with the enduser in cases such as toll paying motorways or railways. A typical form of such projects is *the concessions*, where the concessionaire pays a set amount or a certain percentage of its profits to the state and upon the termination of the contract the ownership of the assets is transferred back to the state usually under the actual market value.

Compared to PPP's, *in the traditional model or other forms of the co-operation of the private and public sectors the assets remain in state ownership and the private company takes only a limited responsibility for certain well-defined tasks. In contrast, in PPP's the individual stages (design, build, finance and operate) of the project are managed in an integrated manner, and the financial and operational risks, which are substantial, are transferred to the private sector.*

Briefly, the most important benefits of the PPP solutions are high quality, cheaper, i.e. more efficient services and less reliance on the budget: the burdens of an investment may be distributed to a number of years in the form of future pay-

ments. We should also note that *an implemented investment has a positive effect* on macroeconomic indicators: it boosts growth and as a result of the decreasing deficit of the central budget, more funds are available to the private sector.

These benefits are, however, not automatically available; there is a need for circumspect preparation and control in order to realise such benefits through the implementation of the appropriate contracts.

In connection with the benefits of PPP's, we must highlight *the issues of the budgetary accounting*. The only related international methodological guide so far was published by the Statistical Office of the European Communities (Eurostat)<sup>15</sup>, which was outlined in the Public Finance Quarterly<sup>16</sup>. The rules laid down by the EU, which are detailed by the referenced sources, consider *risk analysis* as a key element of classification: *a PPP instrument is not regarded as a public instrument (i.e. it should be recorded as cost for the budget at the time of the investment) if most of the risks are demonstrably transferred to the private partner.*

Taking into account that the Hungarian budget has got little room for manoeuvre in the long term, the selected solutions should not burden the budget, which is a prerequisite for the implemented project to be classified as a private investment. If, for example, the state is providing 50 per cent of the funding of the investment, the entire project is considered as a government investment increasing the budget expenditure and the Maastricht deficit for the year in question, which means that one of the main benefits of the PPP projects cannot be realised.

## Scope

Nowadays the use of PPP's is so wide-spread, that we can speak about a global tendency. In order to bridge the 'infrastructural gap' the European Union recommends that the new

Member States<sup>17</sup> should exploit PPP's and other solutions. Catching up in terms of infrastructure offers great opportunities by creating a 'market' for PPP projects in these countries. Government investments amounted approximately to 3 per cent of the GDP in the EU-8 countries with the exception of Latvia, where it reached only 1.5 per cent. As a result of the catching up phase this number could be as high as 3.5 per cent in the EU-8, while the share of state investments in the EU-15 is not more than 2 per cent of the GDP, which clearly reflects the discrepancies in development of the infrastructure within the EU. As far as the future is concerned, according to EU projections, investments of euro 10 billion is required for transport infrastructures<sup>18</sup>. According to another estimate, euro 47-49 billion is needed for environmental investments, out of which 10 billion is to be used in Hungary<sup>19</sup>.

Since the scope of fiscal instruments is limited, an increasing demand for PPP projects, through which many could exploit the creative use of the public finance accounting, is expected. This is to be understood in a wider context, in the framework of the priorities of the government investment programme: regardless of the field of the PPP projects, in the short run they release funds that are available for the development of other areas, such as the development of the infrastructure. According to a survey carried out by Eurostat, PPP programmes are implemented in the old EU Member States mainly in the following areas: infrastructure (railway, road and utility investments), health investments (hospitals) educational, cultural and social investments (residences, museums and social housing schemes), prisons, defence investments (logistics centres) and sports facilities (stadiums)<sup>20</sup>.

As for *the educational investments*, the first educational investment (school construction) PPP contract was concluded in Ireland, in 2001. In a model contract a private company undertakes to build, finance, operate and maintain the

school, however the school remains the property of the state, and listed as government assets in the system of national accounts. However, it is the private company, which should provide for the school devices, and it receives a monthly fee from the state in return to cover the operational costs, i.e. the investment costs become current costs. In the Netherlands, there are plans to build halls of residences in PPP's.

Although the main source of funding in the developed countries of Western Europe is still the central budget, various types of PPP solutions are increasingly popular especially *in the field of motorway construction*. Solutions for the construction and long term maintenance of the motorways are grouped as follows: toll motorways and free motorways, where the state pays an availability fee (shadow toll DBFO model)<sup>21</sup>. Since the introduction of PPP's in the United Kingdom, 10 motorway and other road building/construction projects have been launched mainly in the latter format, but similar solutions may be found in Finland, Portugal or Norway.

There are good examples in *the prison and hospital constructions sectors*, too. In the pioneering United Kingdom, PPP's were first introduced in the prison building and maintenance area and now experience is available in connection with seven prisons. A report prepared by the British National Audit Office (NAO)<sup>22</sup> indicates that prisons operated by the private sector – after certain initial difficulties – after three years of operation become more cost efficient than their state run counterparts. In the first wave of PPP's 15 hospitals are built with private funding to be operated by private companies in the United Kingdom. These investments amount to HUF 40 billion on average. It is interesting to note that the hospital staff members remain employed by the National Health Service (NHS)<sup>23</sup>. In spite of the fears of the public, that the number of hospital beds will be determined by the local private management, the British government still believes that PPP's will enhance the quality and

cost efficiency of hospital services.<sup>24</sup>

PPP is spreading fast not only in Europe, but also in Latin America. It has got a significant role in Brazil, where such projects are supported by long-term integrated planning with set development policy objectives. In Brazil PPP projects are primarily introduced in railway and motorway construction, education and training and foreign relations related developments.

## PPP'S AND AUDITS

We are going to identify the audit related tasks arising in connection with the such spending of public funds, the challenges for the audit offices in general and based this we are going to discuss how the SAO could prepare for such tasks. For this reason we are going to summarise the opinion and guidelines of the International Organization of Supreme Audit Institutions (INTOSAI), which contain useful warnings and tips for the participant of PPP's and the control bodies. As you have seen, the United Kingdom is today by far the largest user of PPP's; private funds were first involved here and so far most extensive PPP's are found in the UK. The most important findings and recommendations of the British National Audit Office (NAO) are summarised in the end of this document.

### Theoretical model for the control of PPP programs

Financial control is developing with changes taking place in the institutional environment. Such environmental changes include the spread of PPP projects in the modern economy. Therefore, it is not surprising that circumspect financial control and audit, in particular, have proved to be integral elements of PPP projects. Let's consider briefly how this important institutional change is getting integrated in the pos-

sible scenarios of financial control.

The researchers of the State Audit Office have outlined a theoretical model for the assessment of the impacts of the institutional changes based on the pioneering works of the late 1990s. The model is based on various scenarios for the socio-economic environment of such control.<sup>25</sup> Among the scenarios reviewed, the spread of PPP programmes is related to the 'high probability growth of competition' scenarios.

The importance of environmental forecasts is quite obvious. *These scenarios include the conditionality and the mutual impact of three factors: economic performance, institutional changes and public administration (control)*. In this framework four coordinating elements determine the participants' behaviour.

- The first coordination mechanism is the market itself (market coordination). Factors: freedom of prices, liberal trade, privatisation and efficient and stable financial system.

- The second coordination mechanism is the government control, the most essential elements of which are control based on legal certainty and efficient administration. Control has got an increasingly important role in the enforcement of such requirements.

- The third mechanism is *the voluntary adherence to the common values and norms* of various economic groups and the self-controlling impact based on this.

- The fourth mechanism is the partnership of various groups of stakeholders, the coordination of values, which is similarly self-controlling.

The so-called *change generating organisations* play a key role in these mechanisms. On a local level, these organisations are the manufacturing and service provider companies, political and civil organisations, state institutions and the jurisdiction. On a global level, transnational corporations, supranational organisations, international professional organisations and associations could generate changes. As far as

PPP's are concerned, *change generating organisations also include contracting state institutions, private entrepreneurs and banks providing funds.*

In connection with PPP programmes, two requirements may be defined for the practical adaptation of the results of the theoretical research related to audits, which determined the principle to be followed.

■ In the developed world, in addition to the enforcement of the qualification of the accounting in the framework of the traditional financial control and transparency, control activities supporting economic assessment and decision making, which focus on performance and efficiency, have come to the fore. A minimum requirement of the operation of the public finances is the adherence to the rules. Without this, performance and efficiency cannot be interpreted. Consequently, the control for transparency and accountability is the primary condition of competitiveness.

■ In public finance control performance review has become a basic value. Since the turn of the millennium the audit offices have been paying more attention to areas, such as the examination of the ethical and human political connections of the economy or the professional support of programmes against corruption and money laundering.

■ Based on the above, the principle to be followed is clear: there is a need for audits, which promote the transparency and accountability of public funds and public assets.

The above have been described from the point of view of *the external supreme control organisation of the institutions of the governance and public administration in its capacity of supporting the Parliament.* In order to make the whole system competitive a strategy for the government and the internal control had to be prepared. This strategy was completed and it is in line with the audit principles. In order to implement this, attention, resources and funding are required and the focus from the classical methods and

areas of internal control should be shifted towards a profound and comprehensive review of PPP projects.

### International guidelines for PPP's

In order to be well-prepared and spread the good practice in Hungary, we shall consider the advice of INTOSAI, the international organisation of supreme audit institutions (SAI's). In their view, SAI's play an important part, primarily in determining and examining whether partners deal with the risks of PPP projects adequately and efficiently. INTOSAI<sup>26</sup> draws attention to the fact that while auditing modern relations, *SAI's themselves face several risk factors.*

■ SAI's may lack the commercial expertise needed to evaluate either how well the public sector partner is protecting the state's interests or whether the public sector has taken unreasonable risks in the projects.

■ In many cases SAI's do not have sufficient access to information because the private sector partner is reluctant to provide it, focussing on their commercial interest.

■ Existing methodologies do not always equip the auditor to assess the performance of new types of PPP adequately. Benchmarking the quality, efficiency, and cost efficiency of services is difficult when there are few comparable projects. This in itself makes it hard to judge what a reasonable return on investment for the public and private sector partners is.

■ Finally, it is necessary to take into consideration that the state incurs liabilities through a PPP. It makes it necessary for the state to include a risk register in its accounts which includes an estimated value for the liability. The register is to be audited by the SAI, with a special view to the reasonableness of the estimates.

Several risk factors can be detected concerning the relation of the private sector and the



state as a partner. INTOSAI draws attention to the risks which primarily *the state is to face* prior to forming such partnerships and in the course of concluding the contract.

- The state has a range of objectives, some of which may be competing. Therefore, it is necessary to accurately assess and prioritise these objectives, in order to be able to create an accurate picture of the (expected) advantages originating from the partnership.

- Several of the objectives deemed important by the state may be regarded as especially attractive by the private sector partner. Therefore, the state ought to ensure that the private sector partner is unable to pick only the areas yielding the highest profits.

- In the course of the selection process, higher efficiency and/or the more considerate solution for the budget may clash, in other words it may be necessary to prioritise and select. By focussing on the budgetary considerations at all costs, one may risk not selecting the most suitable offer considering efficiency, which entails losing the long-term advantages and yields of the other solution.

- In the course of the public procurement process, employing specialist financial and legal advisers is necessary, but it is crucial to prevent the state from becoming dependent on them and paying them more than the market rate. There is also a risk of corruption both on the part of advisers and public employees. It is necessary that a third party review the selection process and the agreed terms and conditions before the partnership is finalised.

- The state's payment of the contractual fees should be suitably scheduled, preventing the private partner from failing to deliver or delivering services of inadequate quality. Similarly, contractual guarantees (payment of penalty, damages, etc.) should ensure the uncompromisingly thorough delivery of the services undertaken.

- Prior to the conclusion of the contracts, it

is advisable to ascertain that the necessary statutory basis is in place for the partners to enter into the desired form of partnership.

- The need to comply with the requirements of the Public Procurement Act deters competition; therefore it is necessary to have preliminary communication with potential partners.

- Concerning assets of national importance, it is necessary to take into consideration that once assets have been transferred to the private sector, the public sector will lose control over them. In such cases, leasing may be a more expedient form. Thus the state retains its “step-in” rights in the partnership even if by doing so it reduces the private sector's interest.

- The guarantees and indemnities given by the state often fail to appear in the assessment of a contract. During the audit, the SAI should consider what risks these guarantees entail, price the risks, and compare them to the share and yield of the public sector.

- To find solutions which are considerate towards the budget, i.e. to prevent the partnership from being classified as a public undertaking, the public sector may have to participate in the project as a minority stakeholder. In such cases the contract should include adequate protection and a system of guarantees for governance and management. It is a real risk that the state may lose the value of its share. To avoid it, it is necessary to obtain regular information as to whether the majority stakeholder fulfils its obligations.

The state as a partner does not always have adequate financial, legal, or technical expertise to successfully participate in the execution of the project, and thus it is not able to fully exercise its rights in each case. The state is often not provided with adequate information on the performance of the private partner. Therefore, the partnership contract needs to contain the project elements necessary for the execution and operation in depth and in detail. Taking all

this into consideration, the SAI's audits are to facilitate that the projects be adequately consolidated with both the state and the parent company of the private partner.

Besides the PPP guidelines, exchanges of expertise on program audits in the INTOSAI Working Group dealing with the auditing of privatisation are useful for the different countries, thus for Hungary, too. For instance, in 2004, at the annual meeting of the Working Group (in Sofia), the representatives of Estonia, the UK, Norway and Brazil gave an account of their own experience, providing useful information on the public finance and economy of their countries, and also spoke of such relevant relating issues as the regulatory legal problems, the transparency of the programmes, and the selection of expediently employable audit types in detail. Their approaches were consistent in stating that such programmes were not to serve to provide the opportunity for the public finance of a country to be granted (invisible, hidden) loans, and that it was necessary to have guidelines to serve as a basis to assess the expediency of each programme. Finding the continuation of auditor training programmes dealing with privatisation, based on the best practices of audit and procedures, useful, the participants suggested that the extension of training programmes relating to PPP's be a new key area.

In 2005, at the annual meeting of the Working Group (in Brasilia), the representatives of Norway, the UK, and Hungary gave an account of their audit experience concerning PPP programmes. The Norwegian presentation focussed on the huge challenge which these programmes represent concerning the professional preparedness of the auditors and the necessary audit capacity, pointing out that no official guidance concerning PPP programmes existed in Norway. The British presentation dealt with the new features of performance audits of PPP programmes which better impose the requirement of providing a

comprehensive account of performance, especially in the operational phase. After outlining the main principles of PPP programmes and the role of the government, the presentation of the representative of SAO<sup>27</sup> reviewed the experience gained by Hungarian auditors during the audits of Budapest Sports Hall, the National Theatre, and motorway M5. Among the main conclusions, the Working Group recommends the completion of the guidelines by stating the expediency of the creation of an interministerial PPP committee, specifically referring to the Hungarian experience presented. The importance of that was underlined by *Sir John Bourn*, Chairman of the Working Group and Comptroller and Auditor General of the UK, through his questions and comments.

### The warnings of the British National Audit Office (NAO)

As we have mentioned before, it is the Anglo-Saxon countries that employ PPP structures the most widely, and among them it is Great Britain that lays the greatest emphasis on the assessment of the operation of projects, and on comparing them to traditional models. After reviewing the INTOSAI guidelines, we shall summarise the recommendations of the British National Audit Office, based on the audits of the nearly 50 PPP projects and the experience that they have gained.

The English sister organisation, which has a close working relationship with the SAO, is definitely top-ranking, considering not only project auditing, but also the passing on of their experience through consulting. Their data bank, established last year, also aptly illustrates the aspiration of the NAO, which has made over 200 – audit-based – recommendations available for organisers of PPP projects.<sup>28</sup> We wish to present only a few pieces of their advice<sup>29</sup>, recommending them to government organisations dealing with this issue and to project organisers.

■ Managements of private sector companies can often better assess the risks of a given business venture. Also, they can usually audit and record performance data more efficiently than the public sector. For this reason, it is necessary that the public sector make use of the information systems utilised by private companies and continuously train the participants. It is necessary to establish more intensive co-operation and organise regular exchanges of expertise between privately and publicly run institutions providing similar services, and it is also expedient to swap staff between the two types of institutions, especially at senior level.

■ It is necessary to clearly define the way to quit PPP contracts in case the supplier proves unable to continue providing the service in the desired manner. It is important that both the tenderee and the winning tenderer have identical rights concerning quitting the project. (It is often not so; e.g. we have already referred to the concession contract of the first section of motorway M5.)

■ The method of providing aid (support) for PPP projects that have been jeopardised in any way has to be contractually clarified. For instance, the participant in trouble may be granted a loan, based on necessary circumspection, and the accurate assessment of the expected situation.

■ SAI's need to have the right to audit both the prime contractor and the subcontractor, and trace the way of state funds.

The foregoing, including the above recommendations, suggests that the most important prerequisite of a successful project – as we have amply emphasised it – is the good, careful preparation of the contract, as experience shows that most problems originate from contractual mistakes and shortcomings. This is the reason why we find it of great importance that standardised contracts<sup>30</sup> have been outlined and published in Britain, using which it is possible to avoid repeating fatal errors.

## EXPERIENCE IN HUNGARY

Among the different new forms of performing tasks by the state, those involving private equity are gaining more and more ground in Hungary. At the same time, some attempts to make institutional forms which are implemented through the utilisation of public money appear as non-state-related are also being made.

### Assessment of the early attempts

We shall present *the first instances of gaining real experience* of the co-operation of the state and the private sector in Hungary through the processes of decision making and implementation of some large-scale investments, which have already been completed. In his article quoted above<sup>31</sup>, Mr Mibály Varga presented two case studies. Firstly, we wish to make some comments on them.

As far as the assessment of the first section of *motorway M5* is concerned, we may conclude that this investment is a thoroughly negative example of private equity involvement – on the part of the state. Here, even though the resources necessary for the implementation of the investment were provided by a private partner, who also undertook the task of operation, the risks of the operation and of ensuring a – relatively high – profit were fully borne by the state, together with all the financial burdens that they presented. The most important lessons of this badly drawn contract and the obvious losses that originated from it may be summarised as follows.

■ *Bearing all risk*: the private party only bore the risk relating to the construction project, and shifted all operational risk to the state in the course of their long-term co-operation.

■ *Providing unilateral profit guarantee for the investor, making misuse possible*: keeping the toll high meant that drivers were not drawn to

but deterred from using the motorway, causing serious environmental damage etc. to the settlements along the parallel road and to the whole area.

■ *Conditions of quitting missing from contract:* frequent changes concerning who the minister was and other changes concerning the persons in charge appointed by the government weakened the Hungarians' position, and even though the Hungarian party tried to back out of the dead end street of AKA Alföld Koncessziós Autópálya Rt. (AKA), negotiate more favourable conditions, and perhaps find a new conessor, AKA insisted on keeping the market share it had obtained. Due to their more favourable position than that of their potential competitors, they have been granted the right to construct the second as well as the third sections of the motorway.

The second case study in the article by Mihály Varga, quoted above, deals with *Budapest Sports Arena* (BSA), and definitely needs some further comments.

In the original concept, BSA was to be built within the framework of a classic PPP project on the location where another sports hall had previously burnt down. The facilities were to be constructed, and at least half financed and operated by the private partner company, in return of which the state promised to pay a service fee for twenty years, following which the state was to gain full ownership of all the facilities, and their further utilisation was to be decided upon then. However, the government was not able to make the commitment concerning a period of twenty years then, so – upon reviewing the different compromise solutions – the project was implemented in a different form.

The winning foreign project company was able to contribute less than 10 per cent to the financing using its own capital, the rest was covered by the state (the Ministry of Children, Youth and Sports), basically through a long-term – 12-year maturity – credit, which evident-

ly increased the national debt, and the future national debt burden. Since then the facilities have become the property of the nearly 100 per cent state-owned Rendezvénycsarnok Rt. – through a state buy-out of foreign ownership – and they have been operated by Aréna Üzemeltető Rt., owned by the limited company. The operator of the facilities pays the owner a rental fee and a so-called asset replacement contribution.

In the autumn of 2003, the SAO audited the whole project<sup>32</sup> and although it rated it basically in order professionally, it disapproved of the fact that at the beginning, when essential investment decisions were made, and the most important contracts were drawn, the foreign partner had a 75 per cent, while the Hungarian state a 25 per cent share in the joint venture established for the implementation of the investment, and, accordingly, in the decision making rights. According to the SAO, this failed to ensure the adequate promotion of the state interest concerning essential decisions, and especially, was not proportionate to the rather scarce final proportion of private equity, which only accounted for 6 per cent of the cost of the whole investment, while 90 per cent was provided through a bank loan (with a 100 per cent state guarantee), and 4 per cent from budget resources.

Thus, it can be concluded that although this investment looks like a typical, classic PPP solution, due to different circumstances – scarcity of time, expectations concerning the high professional standards of the implementation of the project, etc. –, but especially *the lack of practical experience and the professional unpreparedness* in the application phase, *the attempt to exploit its advantages for the benefit of the state and the public failed*. Private equity may have supported fast implementation. On the other hand, the considerations of efficiency and the cost saving utilisation of public money failed to assert themselves.

Another PPP-type project that can be classified as an already implemented “early attempt” is

*The Palace of Arts*. In the beginning, in 2001, the government wished to implement it as a PPP-type investment in view of the already little budgetary latitude. Pursuant the original contract, the full risk of the investment – from obtaining all permissions to financing – was to be borne by the investor. However, the state undertook to repay the investor the costs in instalments within ten years of the opening. In actual fact, this is financial leasing, i.e. a sort of loan; in other words, the private investor gave a loan for the investment with full state guarantee. *The model failed to fulfil the triple principle of PPP-investments, i.e. that the implementation (construction), availability, and operational risks should be undertaken by the investor.* Only in such cases can the investment expenditure relieve the state budget, or rather, only provided that at least two thirds of the risk is borne by the private investor. For this reason, the contract needed to be renegotiated, in the course of which approximately 99 per cent of the operational risk was successfully transferred to the investor. As a result, the investor is to operate the institution, and finance all repair, maintenance and refurbishment activities relating to the operation, while the state is to pay availability payment for thirty years<sup>33</sup>. In spite of this, Eurostat qualified the model as a government investment. Consequently, the investment cost of the facilities of HUF 32bn was to be recorded as government expenditure with the simultaneous increase of the national debt in the investment period, i.e. between 2002–2004.

In summary, as far as the first initiatives are concerned, PPP was hardly ever applied unless exigencies or the lack of funds made it necessary for the performance of a given task. Unfortunately, in none of the cases was the criterion of private equity involvement, which would have been vital for Hungary so that the investment cost should not burden the budget of the given year or influence the debt indicators, satisfied. Previous the SAO audits have also

made it clear that neither could efficiency or cost efficiency be detected in these cases, whereas the state granted private equity absolute profit guarantee.

### Assessment of ongoing PPP projects

In Hungary, Government Decision No. 2098/2003 (V.29.) made way for the conscious, more circumspect application of PPP, a modern form of co-operation between the state and the private sector relating to development and services, wishing to enhance the general acceptance of this modern solution by creating an interministerial committee<sup>34</sup>. Then, the *legislative background*, which has been presented in several publications<sup>35</sup> in detail, began to be outlined. It is typical that the statutory amendments first guaranteed safety for the private sector (through the relevant amendments of the Public Finance Act and the Civil Code), and only later did the provisions to serve to assert and defend state interests begin to be outlined. Another typical feature of the process of outlining the regulatory background and procedures is that due to the motivation to be considerate about the ongoing budget, it is paramount that the project meet the criteria established by Eurostat, i.e. the investment expenditure should not burden the expenditure side of the ongoing budget. In other words, it should not increase public finance deficit. At the same time, the hope of more efficient and cheaper implementation of projects seems to be pushed in the background.

We find the first instance of its conscious application by the government in the proposal of the budget of the year 2005, based on several Government Decisions and Parliamentary Decisions in 2003 and 2004. In accordance with those plans, the estimated net present value of the developments to be implemented in the PPP format was to exceed HUF 460bn, the bulk of

which was to account for the continuation of motorway M5 and the first section of motorway M6, while the government planned to allocate a HUF 71bn investment to build prisons and HUF 50bn to build students' halls of residence. In its opinion on the plan, the SAO urged the completion of the outline of the regulatory background, the organisation of the treasury registration of state liabilities, and the numerical financial analysis of the budgetary effect of the projects launched in the PPP format. Also, in order to ensure future budgetary latitude, the SAO found it necessary for an upper limit of state liabilities to be stated in the Budget Act. Accordingly, the budget for the year 2006 provides more detailed and more accurate information on the PPP projects that have been decided upon (*see Table below*). The adequate amendment of the Public Finance Act can also be deemed as an important step forward, setting an upper limit for budgetary expenditures relating to the so-called PPP investments and for other liabilities. It maximises the nominal total value of such liabilities within a budgetary year as 2 per cent of the sum of the expenditure total of the central budget, which equals approximately HUF 120-130bn annually.

Nonetheless, the outline of the regulatory background and procedures has not been completed as yet even though – as it can be seen in the table below – investments have been launched and contracts have been concluded. Unfortunately, a suitable methodology to calculate cost effectiveness is still unavailable; procedures of statutory force, indispensable for cost effective and efficient project implementation, are still non-existent; and often, so is an organisation responsible for the tasks of co-ordination, assessment and audit. Specific the SAO audits have pointed out that the lack of these entails great risk for the state in the case of launched projects. It is also true that the European Commission has only recently published a communication concerning certain reg-

ulatory issues, such as the community law of public procurement, concessions and PPP solutions, which can serve as a starting point to lay a better foundation for the competition-driven conclusion of PPP agreements.<sup>37</sup>

The data in the Table below shows that the estimated present value of the PPP projects launched and decided upon so far approximates HUF 700bn, which is the approximate equivalent of 3 per cent of the 2006 GDP, and 9 per cent of the sum of the expenditure total of the budget. This already represents a significant accumulative burden and liability for the budgets of the years to come. Still, according to the forecast figures until 2008, albeit with an annually increasing burden, this will stay below the 2 per cent limit.

Now, we wish to assess some significant projects listed in accordance with the criteria established for the SAO audits, focussing on the ones that the SAO has already had the opportunity to audit. Such projects include the investment of motorway M5 and the prison construction project of the Ministry of Justice.

The Table shows that the motorway construction projects account for the largest sum and constitute the most significant state liability. As we have already mentioned, the construction and early operation of the *first section of motorway M5* was implemented through an early attempt to involve private equity, which can be assessed as an absolutely negative example concerning the performance of the state. It is especially worrying that – for several reasons – the participants' responsibility was either non-existent, or responsibility as such cannot be attributed to anyone.

Within the audit of the execution of the budget of the year 2004<sup>38</sup>, the SAO separately dealt with the issue of the motorway M5 contracts. Concerning the original contract, the audit confirmed the legal opinion that the real consequences of any legal act on behalf of the Hungarian State aiming to terminate the conces-

**MAIN DATA OF PPP-PROJECTS**

Ministry	Project	Short description	Gov./Parl. Decision	(Expected) launch	Expected length of project (yrs)	Estimated present value of project (HUF m) Total	Budgetary expenditures (HUF m)			
							2006	2007	2008	
Ministry of Economy and Transport	M5 1st section	Operation and maintenance	2336/2003. (XII. 23.)*	March 2004	27	246 000	23 125	28 188	28 188	
	M5 2st section		2036/2004. (II. 19.)*	July 2004	27					
	M5 3st section		90/2004. (X. 23.)**	February 2005	26					
	M6 1st section		1124/2004. (XI. 27.)*	October 2004	22					
		Design, build, finance, operate (DBFO)	2336/2003. (XII. 23.)*				9 564	12 284	12 583	
		operate (DBFO)	92/2004. (X. 28.)**							
Ministry of Justice	Prisons	Create 2 penal institutions in DBFO format	2126/2004. (VI. 28.)*	From November 2005 to January 2006	18	71 732	731	4 020	5 848	
Prime Minister's Office	MTV headquarters	Design, build, finance, operate (DBFO)	Act XXVI. of 2005	2005	20	78 000	393	516	699	
National Sports Office	"Sport 21st Facility Development Program"	Design, build, finance, operate (DBFO); leaners' swimming pool, gymnasium	1055/2004. (VI. 8.)*	From 2006	15-17	n. a.	0	6 268	6 400	
Ministry of Education	Accommodation in residential halls or educational infra-structures	Design, build, finance, operate (DBFO)	2207/2004. (VII. 27.)*	From 2004	construction + 20 years of operation	155 788	1 116	6 500	10 000	
<b>Total</b>	<i>as a percentage of GDP</i>						<b>668 755</b>	<b>34 939</b>	<b>57 776</b>	<b>63 717</b>
							2.9	0.1	0.2	0.2
<i>as a percentage of the expenditure total of the 2006 annual central budget</i>							8.9	0.5	0.8	0.8

Source: state budget of the year 2006

\* Gov.

\*\* part. Decision

sion contract would only be discovered subsequent to receiving the legally binding court verdict. It also means that it is impossible to expose all genuine interests and protection of interests, as the position of the same group of private equity remained unchallenged.

As it is known, on February 11, 2004, an agreement with AKA Rt. was concluded, in accordance with which, from March 12 on, the system of using motorway stickers was extended to motorway M5, too, and further constructions would be (and have been) implemented within the framework of a “real” PPP project, pursuant the contract. These, i.e. the state's gaining ownership together with the modification of the PPP model and the introduction of the sticker system, represent a new stage in the history of motorway M5, now characterised by the classic PPP project characteristics:

- further sections are to be constructed from credit, and the state is to pay availability payment, to be determined based on the ownership structure, for the sections that have been completed,
- risk is to be jointly borne by the investor and the state (primarily, the risk of AKA relates to the unexpected hardships of the technological implementation, and maintenance and repairs to be carried out above what was originally allowed for).

Also according to the SAO, the model outlined to include motorway M5 in the sticker system accomplished the objectives that had been set: in 2004, the volume of traffic on the motorway was over twice as big as in the previous year, and the shares purchased (39.48%) adequately enable the Hungarian State to assert its interests in the future. Since then, the second section of motorway M5 has been completed and opened pursuant the amended contract.

Pursuant Parliamentary Decision No. 92/2004 (IX.28.), the construction of the first section of *motorway M6* also happens within the framework of a concession contract, which, in

accordance with private equity involvement, i.e. the so-called DBFO-format, includes design, building, repair, operation and maintenance, as well as the financing of these activities. According to the orientating data available, the estimated present value of the project is HUF 117.2bn. The beginning of the concession period is October 2004, the whole-of-life of the project is 22 years, and opening is planned in 2006 (making 2007 the first full operational year). The sums of the availability payment are calculated accordingly.

The SAO dealt with the preparation of the *prison building construction projects* to be implemented as a PPP<sup>39</sup> within the framework of the comprehensive audit of the Ministry of Justice chapter in 2001–2004. The report states that the overcrowdedness of penal institutions, as well as the efforts to comply with the EU requirements demanded financial resources which exceeded the opportunities of public finance, which diverted the attention to the application of the modern forms of co-operation between the state and the private sector concerning developmental and service projects. In 2004, the government decided on the establishment of two penal institutions utilising the PPP solution.<sup>40</sup> Preparation started when the regulatory phase had not been completed yet. For this reason, the SAO report deemed the project risky in several respects.

■ It pointed out that the procedures to constitute the theoretical and legislative basis of PPP solutions were missing, and not even an organisational background suitable for carrying out the co-ordinational, assessment and audit tasks had been established, which together represented a high risk for the state as a participant in the first so-called pilot project, and, consequently, in the prison construction PPP project, too.

■ Among the regulatory shortcomings that increase the risk of the preparation, the report also mentions that the Government Decree on the methodology of the calculation of the net



present value of liabilities that entail a commitment over several years has only recently<sup>41</sup> been published. This can jeopardise its correct application, not to mention the lack of compliance based on content.

■ One of the most difficult elements of project planning is to prove the cost efficiency of the PPP model, and to substantiate that its application is more advantageous and useful than state investment. The calculations concerning the prison construction projects, i.e. the calculation of the so-called PSC (Public Sector Comparator) value contained several uncertainties, which also increases project risk.

■ Finally, it is an essential project element whether the investment, i.e. the fixed asset created, becomes the property of the investor or the state at the end of the whole-of-life of the project. This aspect may influence the future statistical status of the project, in other words it may jeopardise the positive budgetary effect, which, because of the need to comply with the convergence programme, is an issue of cardinal importance in Hungary.

The SAO report directs attention to the necessity of the urgent elimination of the regulatory shortcomings, as well as to the fact that in a contrary case significant surplus risks may be created, to be borne by the state side, as early as in the preparatory stage. In this respect, experience abroad, especially in Britain have also mostly proved positive concerning the efficiency of services, which arouses hope that – applying the positive experience gathered there – we will also be able to label and actually find these project successful in this country.

The table shows that significant efforts to implement a certain proportion of the developments necessary to provide *residential hall accommodation* from private equity resources have also been made in the Ministry of Education chapter. This area – due to its characteristics – is nearer to the competitive sector, so the efficiency requirements can be more easily

seized and analysed. Since we can give an account of the completion of its implementation, we shall assess this area through the Debrecen University residential hall investment<sup>42</sup>. After the two-round negotiation for the procurement of the residential hall service, the selection of the winner took place utilising PSC-calculations. The calculations were preceded by detailed risk assessment. The service risk is mostly borne by the private sector, while the university bears the demand risk for 10 months a year. The Students' Hotel was implemented based on the classic DBFO-model. One half of the investment opened in the summer of 2005 is to function as a residential hall, while the other half as a market-based hotel (hostel). 55 per cent of the residential hall fees are covered by the university, 45 per cent by the students. The profit generated through the operation of the hotel is to be shared by the private and the state partners. The private partner bears the burdens and avails of the profit of the operation, incomes and risks of the service units of the building, as well as of the profit of refinancing.

## CONCLUSIONS AND PROPOSALS

The above paragraphs make it clear that market mechanisms appear in various forms in the performance of public functions. All of these have been created to provide and promote more efficient and cheaper public service of a higher standard. Why does the SAO worry then and why does it sometimes seem to object to their spreading? Is that caution justifiable?

We can establish that the co-operation described above, its potential usefulness, or even necessity cannot be questioned. At the same time, we ought to take into consideration what has actually been happening. Before the so-called Glass Pocket Act<sup>43</sup>, the SAO was not authorised to audit the utilisation of public money outside public finance, i.e. by non-budg-

etary organs. It was at that time that *outsourcing* happened on a large scale, and public interest companies, public foundations, and businesses mushroomed. They have been managing significant financial assets of the state, concerning the correct utilisation of which – often for want of internal audits – and, especially, concerning the result of their financial asset management, very little is known. The situation is further aggravated by the treatment of business secrets in a manner equivalent to that applied in the private sector, which may have grave consequences concerning both corruption and other misuse. It is an especially important risk generating factor because – theoretically – it cannot even be detected. Later, increased statutory austerity enabled the SAO to extend the scope of its audits, so by now we have learnt that the application of the market forms did happen in a “typically Hungarian”, i.e. expensive and often wasteful manner.

The topicality of the application of PPP solutions in Hungary is especially heightened, on the one hand by the significant state development demand to comply with EU requirements, and on the other hand by the scarcity of budget resources and the deficit of the ongoing budget. The organisation of such projects is vigorously supported by the government because it has become clear that in a number of areas (education, health care, prisons, and last but not least, motorway construction) we have significant backlogs in the infrastructure, while our budget resources are rather scarce. At the same time, the private sector is seeking market opportunities, and it “readily” privatises public service functions, thus there is an opportunity for them to meet. The quickest possible, efficient implementation of the necessary investments constitutes the most important advantage expected for the national economy. However, achieving this goal is only viable through successful projects.

But what ensures that the project will turn out to be successful, and for example will not

have a negative effect on employment figures? What can the SAO do for this? PPP's, as we have already pointed out, characteristically entail *the danger of waste and corruption*, which, primarily, derives from the short-term interests represented in government decisions, and from the unpreparedness of the public sector<sup>44</sup>. It is also well-known that the SAO conducts posterior audits, so it can assess the project upon its completion at the earliest. Moreover, it will only be able to audit and assess the adequate standards of the service some years later, during operation, when these decisions have already become irreversible, i.e. repairable only by making considerable sacrifices. This is the reason why the SAO is a protective partner. Currently it cannot do anything but make its – albeit rather initial – experience public, together with much ampler international experience, focussing on the audits that have been conducted, and the analysis of the negative phenomena exposed by them at as many forums as possible. This – as we have seen – is greatly helped by the guidelines published by the international organisation of SAI's (INTOSAI), as well as the recommendations put forward by the National Audit Office (NAO) in the course of its project audits.

On the basis of these, we recommend that the Hungarian legislators and decision-makers primarily consider the following.<sup>45</sup>

■ In planning and assessing programmes, it is a fundamental requirement to *harmonise short-term opportunities to save state funds with the considerations of long-term return (efficiency)*. A solution that creates a real identity of interests between the parties in this respect, and provides appropriate advantages and profit for both sides is to be formulated.

■ Concerning *projects*, it is a crucial requirement to *regularly monitor, analyse and assess* the changes affecting them. Among these, special attention is to be paid to the consequences of the changes in the government development policy. The importance of this is highlighted by

the findings of NAO, i.e. that in the course of the execution of the contracts concluded, as many as 55 per cent of them were affected by different changes. Another key requirement is to *increase the efficiency gain of projects*. For this reason, it is advisable to determine the lower limit of the expected yield of projects; it is an important objective to enhance the public procurement process through better training provided for the experts and consultants participating in it, and it is also important to employ framework financing far more extensively among the different forms of financing.

■ Regarding that changes also abound in the private sector, in order to make PPP projects successful it is crucial to *establish relationships of real strategic partnership* and to form different partnership alliances which may function well e.g. in the fields of education and health care.

■ The different risks and uncertainties relating to PPP projects necessitate that – in the preparatory stage – *alternative concepts be prepared* to enable participants to select the mutually best solution – especially, with respect to the method of financing.

■ It is a task of primary importance to provide those participating in the preparation of projects and contracts with continuous, *high level training*, especially in the public sector.

■ Use of *standardised contracts*: as it is made clear both by the INTOSAI guidelines and the NAO recommendations, firstly, the most important prerequisite of a successful project is the adequate preparation of the contract, as most problems derive from contractual shortcomings. For this reason, we wish to repeatedly draw attention to the standardised contract samples utilised in the United Kingdom. In our opinion, the preparation of a similar standardised contract, and making its use obligatory statutorily could significantly lower the risks of the implementation of PPP projects, and would help to prevent mistakes which can otherwise only be detected through a posterior audit, and

which may even be fatal and corrigible only by making major sacrifices in certain cases.

■ The preparation of *comparative analyses*: it is necessary that the acceptance of the project be preceded by a feasibility study containing details of the difference between the proposed PPP project and the traditional (state development) solution concerning costs and the standards of the services. The application of the new solution is justified if and only if it is unambiguously verifiable that the discounted present value of all sums to be paid by the state are lower than the discounted present value of the up-front and continuous expenditures of the development to be implemented as a classical budget investment – including the proportionate part of the interest burden of the state debt. It is expedient to extend this to the multiplying, indirect effects (e.g. environmental protection, employment figures, the income generating capacity of the whole national economy, etc.). The projects that have been decided upon and implemented are to be regularly audited and analysed. Certain circles of experts find it necessary to establish a *separate institution*, where the preparation of projects, the efficiency analyses and the regulatory issues would be concentrated in one hand.<sup>46</sup> It would also be important to ensure that not only budgetary considerations, but efficiency and better service standards be regarded as important aspects of the decisions, too.

■ The objective is to *create long-term financial planning* by strengthening the right institutions, which may be the basis of transparency and accountability.

■ The application of PPP in the future would be largely enhanced if *information relating to it, or rather all information was made public*. It would enable decision makers to gain awareness of the long-term costs and risks at all levels. Today, only a certain part of the information concerning the risks relating to PPP's is available in Hungary and the other Central European countries. Modern standards of financial report-

ing require the publication of liabilities, unforeseeable obligations, and other financial risks. These considerations require a different treatment of business secrets, identically to the purely private sector.

■ To enhance risk management, the government needs to *establish a comprehensive database* of the contracts concluded, the projects implemented and their operation, containing all major risk factors. Further important typical conditions of adequate risk management: clarified strategy, a centralised risk management institution, and an independent audit organisation. The task of the main audit institution is to examine all aspects of the government's risk management.

Finally, the future application of the PPP solution would be largely enhanced by *a shift in attitudes* concerning the mutual perception of

the private and public sectors. Today, due to the prejudices prevailing, the private sector regards those employed by the state as bureaucratic and inflexible partners, and consequently considers each action of the state to be ineffective and unprofitable. The state-employed players, on the other hand, often only notice the exaggerated assertion of the profit-making interest of the market with regard to the private partners. As we have already emphasised, the basis of a good PPP is not only the conclusion of a good contract, but also the establishment of a long-term partnership, and continuous communication. Through this, it is possible to answer new challenges during the whole-of-life of the project together, successfully. This is especially true in Hungary, so it is necessary to encourage the creation of trust among the parties in order to foster a fruitful relationship.

## NOTES

<sup>1</sup> The role of market-type mechanism in the provision of public services, *OECD Symposium, Paris, 2005*

<sup>2</sup> In the voucher system the provision of services and funds are separated. Funding remains the government's responsibility and the citizens may use vouchers after selecting the most suitable provider. Competition enhances the quality of the service and reduces costs; however, the fact that in a number of cases vouchers are received by the citizens automatically, saving is not appropriately encouraged. This method is widely used in primary education and care for children and the elderly. If users are required to pay a certain fee, the users of public services pay a part or the full price of the service. One of the latest examples is the payment obligation of those driving in the centre of London.

<sup>3</sup> The primary types of outsourcing are the following:

- Servicing agreements: The state concludes an agreement for the provision of services with one or more private companies through tendering. The investment and the government services are managed solely by the state.
- In case of operating agreements the given private company is liable for the operation and the man-

agement of the assets, while investment related decisions are still made by the state.

- In case of leases, the beneficiary private company is responsible for the operation and maintenance of the state owned assets. Lease agreements are entered into for a period of 5–15 years, and are typically applied in transport and water utility services, where revenue is generated.

<sup>4</sup> Report on the review of the performance of government tasks outside the public finance, State Audit Office, 2005.

<sup>5</sup> These include the public media.

<sup>6</sup> Report on the review of the use of non-normative contribution received from the central budget between 1998 and 2001, *State Audit Office, 2002*; Report on the review of budgetary subsidies received by social organisations and public bodies, *State Audit Office, 2002*

<sup>7</sup> A similar tendency in the growth of the state organisations is seen in the more developed OECD countries; the funds received by the ministries from the government spending is only 25–50 per cent and the figures are similar in the

education sector. The fact that this 'divided identity' is gaining ground is explained by two things: this control model is more efficient and effective, and it avoids or at least decreases direct political intervention in decision-making.

<sup>8</sup> Government decree nr. 2396/2002 and Act XXIV of 2003.

<sup>9</sup> Hungary's updated convergence programme for 2004–2008, *Ministry of Finance, December 2004, pages 27–28*

<sup>10</sup> Such proposals were presented by Prof. Tamás Sárközy, for example at the meeting of the Hungarian Economic Association in Miskolc, 3–5 July 2005.

<sup>11</sup> This is the third article in the *Pénzügyi Szemle* (Public Finance Quarterly) in this area. See: M. VARGA (2005): PPP in Hungary: is it harmful or beneficial?, *Public Finance Quarterly*, (comprehensive edition) and Z. AGG–G. CSONKA (2003): The public sector – with a new approach (section XXVII), The partnership of the public sector and the private businesses, *Public Finance Quarterly, March*

<sup>12</sup> G. BÁGER–Á. KOVÁCS (2004): Privatisation in Hungary, Volume 1, *the SAO Research and Development Institute, Budapest, June*

<sup>13</sup> D. LORRAIN (1995): Urban Services, the Market and Politics, In: *Private Financing of Public Infrastructure, The French Experience, DAEI. Paris*

<sup>14</sup> European Commission: *Guidelines for successful Public-Private Partnerships, 2003*

<sup>15</sup> Eurostat: PPP-related issues, 2003

<sup>16</sup> See: footnote 11

<sup>17</sup> Among the Member States in the Czech Republic, Poland, Latvia and Hungary central co-ordination institutions are promoting it.

<sup>18</sup> European Commission (2001), "European Transport Policy for 2010, Time to Decide"

<sup>19</sup> CASE (2005), "Background Paper on Fiscal Risks from PPP's" Mimeo, Warsaw, Poland

<sup>20</sup> For details, see: Z. AGG–G. CSONKA (2003): The government sector – a new approach (Part XXVII), The partnership of the government and

the corporate sector, *Financial Review*

<sup>21</sup> Successful co-operation of the public and the private sector, PPP Handbook, *Ministry of Economy and Transport, Budapest, 2004*

<sup>22</sup> The Operational Performance of PFI Prisons, *NAO, 2003*

<sup>23</sup> Centre for Public Services: The Private Finance Initiative in the NHS – 2002, via Internet

<sup>24</sup> NHS Executive Public Private Partnerships in the National Health Service: The Private Finance Initiative Good Practice

<sup>25</sup> Á. KOVÁCS (2003): Financial control and audit in a changing environment, *Perfekt, pages 350–371*, and Á. KOVÁCS (2005): Competitiveness and public finance, *Public Finance Quarterly, double issue, pages 25–47*

<sup>26</sup> INTOSAI: Guidelines on Best Practice for the Audit of Risk in Public/Private Partnerships (PPP), 2004

<sup>27</sup> G. BÁGER–ZS. BIHARY (2005): Hungarian Audit Experience of Investments Implemented with Private Equity Involvement, *Brasilia, September 27*

<sup>28</sup> <http://www.nao.org.uk/Recommendation/>

<sup>29</sup> For more details, see Transformation of Higher Education, Modernisation of Financing, Research and Methodological Institute for the *Hungarian State Audit Office, December, 2004*

<sup>30</sup> Standardisation of PFI Contracts, HM Treasury, 2004

<sup>31</sup> See Footnote 11

<sup>32</sup> Report on the Audit of the Operation of the Chapter of the Ministry of Children, Youth and Sports, *Hungarian State Audit Office, 2003*

<sup>33</sup> See Is PPP the cure-all? *Audit Observer, 2/2005*

<sup>34</sup> The main force behind these decisions was the recognition that the EU accession and the demand to comply with the EU requirements as quickly as possible imposed significant and urgent developmental and investment tasks on the state in several areas, for which – even provided that the future EU resources was granted – there were scarce state funds available. The situation is fur-

ther aggravated by other circumstances burdening the budget, the high national debt, the high public finance deficit, which is to be significantly decreased in accordance with the Convergence Programme, and the constraint to decrease taxes in order to become more competitive. Thus it is self-evident that the state should seek the opportunity for private equity involvement, especially when willingness is shown, and the required capital is available.

<sup>35</sup> E.g. see Report on the Audit of the Operation of the Chapter of the Ministry of Justice, *Hungarian State Audit Office, 2005*

<sup>36</sup> Report on the Audit of the Operation of the Chapter of the Ministry of Justice, Hungarian State Audit Office, 2005

<sup>37</sup> See [http://europa.eu.int/comm/internal\\_market/publicprocurement/ppp\\_en.htm](http://europa.eu.int/comm/internal_market/publicprocurement/ppp_en.htm)

<sup>38</sup> Report on the Audit of the Execution of the 2004 Budget of the Republic of Hungary, *Hungarian State Audit Office, 2005*

<sup>39</sup> Report on the Audit of the Operation of the Chapter of the Ministry of Justice, *Hungarian State Audit Office, 2005*

<sup>40</sup> Government Decision No. 2126/2004 (VI. 28.)

<sup>41</sup> Government Decree No. 161/2005 (VIII. 16.) on the methodology of the calculation of the net present value of liabilities that entail a commitment over several years and the discount factor to be applied

<sup>42</sup> R. KOVÁCS (2005): The Investment of the Students' Hall of Residence of the Debrecen University in the Framework of a PPP Solution, *Seminar to explain NAO audit practice for PPP/PFI, Budapest, April*

<sup>43</sup> Act XXIV of 2003

<sup>44</sup> Á. KOVÁCS (2004): The Efficiency of Public Finance as a Factor of National Competitiveness, *PPP Conference, Győr, January*

<sup>45</sup> See in more detail: International and Hungarian Experience relating to the Co-operation of the Public and Private Sectors, by: G. BÁGER, L.-NÉ HAMZA, R. KOVÁCS (2006), Research and Methodological Institute for the *Hungarian State Audit Office, April*

<sup>46</sup> Currently, this task is performed by the PPP Secretariat, a division of the Ministry of Economy and Transport. The drafts are submitted to the government by the Ministry of Economy and Transport based on the opinion of the Interministerial Committee.