THE COMPLEXITY OF PRIVATE ACTOR INTERESTS IN PUBLIC-PRIVATE ARRANGEMENTS: THE NATURE OF THE FIRM AND ITS SOCIAL VALUE ORIENTATION

An extended abstract
by

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Submitted to the 19th Annual SIOE-ISNIE Conference –

Harvard University in Cambridge, MA, USA - June 18-20, 2015.

ABSTRACT: Collaboration between public and private organizations creates a density of interactions. The interests are numerous: at the partnership level as well as for each partner. The prevailing view is that these interests are clear and unambiguous. However, in this exploratory paper, we discuss how a multitude of underlying private actor interests may interact and shape the way a firm behaves in public sector engagements. Contrary to the existing literature, which emphasizes the return-maximizing objectives and opportunistic behavior of a private actor, we disentangle the complexity of firm incentives and behavior in public-private arrangements. By embracing a multitude of interests embedded in the "firm as nexus of contracts" approach, we focus on four sets of dimensions likely to impact considerably the distribution of interests and incentives guiding the private action and social value orientation, specifically: 1) organizational architecture, 2) multiple principals and the divergent preferences stemming from firm's governance, 3) executive interests and 4) third-party or social forces. Far from being homogeneous, private actor interests are shown to exhibit important discrepancies and interactions between various internal goals and different claimholders to a firm.

Keywords: interorganizational relations, organizational behavior, incentives, governance, social performance, theory of the firm

INTRODUCTION

Public-Private Partnerships (PPPs) as New Organizational Forms

Among various forms of economic organization, hybrid arrangements between public and private actors are increasingly prominent (Cabral et al. 2013; Henisz 2006; Mahoney et al. 2009). By combining public oversight with private sector efficiencies and industry specific competences, these new organizational forms are argued to create both social value and private benefits, thereby representing the best interests for public actors and firms alike (Bennett and Iossa 2006; Iossa & Martimort 2014; Rangan et al. 2006). For example, in the sphere of public services, engagement of high-powered incentives is expected to enhance productive efficiency and innovation (Hart, Shleifer & Vishny 1997, Levin & Tadelis 2007). For the private sector, long-term ties to public bodies may not only deliver new rent-generating opportunities, but also enhance organizational legitimacy or even survival (Baum and Oliver 1991; Dacin et al. 2007).

Prevailing Views on Private Firm and Public-Private Partnership (PPP) Performance

Potential benefits notwithstanding, the actual firm performance and impact on public services of these novel arrangements remain ambiguous (Glachant and Saussier 2006; Hodge and Greve 2007). A range of problems or potential failures appear to surface, such as contractual inflexibility and frequent renegotiation (Guasch 2004; Guasch et al. 2008), limited affordability or socially suboptimal pricing (Chong et al. 2006; Estache 2006), and either private or public opportunism (Spiller 2010; Williamson 1999). A number of theoretical approaches are traditionally sought to explain this underperformance, such as the well-known problem of franchise bidding with risks of hold-up and ex post opportunism in the conditions of high bilateral dependency and uncertainty (Chong et al. 2006; Williamson 1999), or incomplete contracting perspective to highlight the adverse incentives prevailing for the private players, such as cost reduction at the expense of non verifiable quality (Hart 2003; Hart et al. 1997; Williamson 1999). A lack of probity on private partner’s side is further drawn upon to explain poor private actor performance in services with high social or public significance (Williamson 1999).

Private Firm in PPP: a Complex Nexus of Interactions and Interests

All of these approaches rely on two critical assumptions about private actor’s incentive structure and behavior that may need to be called into question. First, they assume private actors are driven exclusively by profit-maximizing objectives, hence, expected to engage in an opportunistic behavior at the cost to public or partner. Second, firm interests are assumed homogeneous, i.e. no discrepancy or conflict is recognized between various internal goals and different claimholders to a firm.

We argue that such an approach misses important insights into the nature of the firm and private actor's incentives, especially in the light of advances in the management and economics literature. Firms are long recognized as more than homogeneous, centralized organizational structures with hierarchical governance. Instead, they represent a nexus of contracts and interests linking the executive management and its various stakeholders with important interactions (Jensen and Meckling 1976; Laffont and Martimort 1997). As Laffont et al. (1997) point out, a range of explicit and implicit contractual ties exist among different claimholders of the firm, its employees, customers or suppliers. The multitude of such interaction within the contractual context create important repercussions and distortions in the firm's activities, affecting the incentives, distribution of value as well as the costs of transaction, coordination and adaptation. For example, at the governance level, multiple principals may exist that compete against each other in the imperfect contracting and coordination framework characterizing the firm. As a consequence, firm's as private actor's incentives and objectives are likely to be considerably more ambiguous and diverse, depending upon interactions arising between these various underlying contracts. One effect of such complex set of interactions can be, for instance, firms being substantially more implicated in social or public concerns than expected by the classic shareholder-value optimization approach (Margolis and Walsh 2003). Other distortions may directly impact and limit the private actor's renegotiating power or contractual flexibility in interorganizational ties, including public sector, in particular.

In this paper, we discuss how different underlying private actor interests may interact the way a firm behaves in the public sector engagements, specifically, in terms of the social value orientation of the firm. We expose four sets of dimensions that are likely to shape considerably the distribution of interests and incentives guiding the private action in public-private arrangements: organizational architecture; multiple principals and the divergent preferences stemming from firm's governance; executive interests and third party or social forces. Adopting this more complex and multi-level perspective on private actor's interests and behavior allows us to shed new light on one of the key theoretical concerns dominating in the partnership literature recently, namely, if corporations are always prone to adverse incentives and „capture" of public interests for private profit (Mahoney et al. 2009) and what factors may moderate this effect (Kivleniece and Quélin 2012).

THE DENSITY OF PRIVATE ACTOR INTERESTS IN PUBLIC-PRIVATE ARRANGEMENTS

The Role of Organizational Architecture: The Impact of Multiple Private Partners

The concept of "organizational architecture" defines the scope of a firm (Jacobides and Billinger 2006) and the extent to which it is open to complementary activities able to provide the underlying public-private asset and services, and serve the business objectives (usually called Special Purpose Vehicle (SPV)). It describes the configurations of transactional choices along a firm's value chain with subsidiaries and suppliers. Two extreme cases are: the close to fully integrated configuration through which a large firm brings its subsidiaries and in-house suppliers and controls the full range of vertical value added activities; or a loosely-held consortium pooling different independent firms under the same project-driven SPV, retaining each a large degree of decision-making autonomy. The performance of public-private contractual arrangements may be considerably altered upon the presence of such consortium, i.e. multiple private actors engaged in a common project with a public body (see the example of the consortium for the London Underground public-private contract), rather than a single firm as a private counterpart. On one hand, a semi-integrated organizational model (i.e. equity-based common venture by several private partners as opposed to subcontracting by a single sponsor firm like Bouygues in France) may deliver important benefits, such as access to important firm-specific competences and skills, interest alignment and safeguarding against contractual hazards, when the scope of activities and risks of hold-up are high (Oxley 1997; Williamson 1991). However, as existing literature on joint ventures and large project management (Gil and Baldwin 2014) illustrates, collaboration between multiple principals often comes at an added cost and considerable impact on the timing and quality of the project execution.

An integrated or semi-integrated, consortia-based model of project delivery, even if reducing hold-up risks, may translate in higher internal costs of organization, particularly, if the complexity and diversity of operations to be performed within the project are high (Masten et al. 1991). Higher costs of monitoring, coordination and supervision of multiple actors may substantially reduce the overall project efficiency and raise the cost for the public. Presence of multiple principals, whose interests may diverge, can result in conflict over organizational decisions reducing the service quality and creating delays in the timing of project execution. In many cases, disagreement or delays by one or more of consortium partners to the project is likely to impede the whole chain of activities, and translate in an overall unsatisfactory performance of the whole consortium.

Furthermore, as the number of private partners increases, contractual completeness and cooperation levels generally are expected to decrease (Gong et al. 2007). As a result, the incidence of private party led renegotiations may increase, whereas ability to reach informal contractual adjustments will be considerably hampered. The effect of multiple principals is likely to be particularly felt in cases where private action is called to provide public goods or benefits beyond the contractually set or initially agreed levels. If private partners' social and economic preferences diverge considerably, reaching an agreement on the extent of additional costs and their distribution among the partners will be notoriously difficult. As a result, the social performance of a consortium in public sector may be considerably weaker compared to a single private firm.

A Multi-Dimensional View on Governance

Potentially diverging shareholder interests. While most of the literature operates under the classic assumption of shareholder value maximization, recent studies in management (Coff 1999; David et al. 2009) increasingly recognize a more complex shareholder utility function. From the agency theory perspective, collectively organized actors may act as multiple principals to the private contractor, driving up the exchange complexity due to non-identical structure of preferences as well as increased political bargaining (Aghion and Tirole 1997; Sappington and Stiglitz 1987). Moreover, in attempts to explain the paradox of private provision of public goods, scholars increasingly point out to strong “warm glow” preferences that may prevail among certain equity holders and provide firms with social incentives along with profit ones (Baron 2008). Under heterogeneous shareholder preferences and substantial demand for socially responsible activities, private firms are expected to pursue the latter, even if the present value of firm’s cash flow may be reduced (Henisz et al. 2013; Mackey et al. 2007).

Assuming significant part of shareholders of a private firm do exhibit preferences for a social expenditure and public goods provision, one can expect important repercussions in public-private contractual ties. First of all, contracts may be more adhered to, with reduced likelihood of renegotiation from private side or any opportunistic action. If driven by exogenous factors, renegotiation and contractual adjustment are also more likely to favor public, i.e. community, interests. Social preferences of some shareholders, by lessening the inevitable trade-offs between social expenditure and private economic objectives, are likely to improve the coordination and information flow between the public and private counterparts and provide opportunities for informal, relational interaction. Such public-private engagements, as a result, may face substantially lower overall costs of coordination and adjustment than predicted by transaction cost and contracting theory arguments.

Empirically, socially-oriented shareholders may impose claims or even dominate in a number of settings, such as in publicly listed companies, where a significant part of private company’s equity is held by wider public or socially-concerned institutional investors, such as mutual or pension funds seek to ensure a socially responsible investment (Johnson and Greening 1999; Mackey et al. 2007). In other cases, social preferences may surface when the equity holders are socially active (Dunfee 2003) or represent a significant part of local community directly affected by the private actor’s action in the provision of public goods or services. For example, Shell, in its commitment to improve the wellbeing of local communities, has created local partnerships. It has provided health facilities and supported the development of local schools and universities. Moreover, one of Shell's initiatives is named *Shell LiveWire* - an online community for young entrepreneurs wanting to start a business. It provides information and resources (such as free guides) to help young people turn ideas into business reality[1].

The impact of financial institutions, banks and other external investors. External capital holders also play important, albeit underemphasized role in public-private partnership deals, especially in the sectors with high capital expenditure, such as infrastructure (Estache 2006). In many instances, a typical partnership structure for a private actor involves a set-up of a project company, for which external lenders provide most of the investment financing through various forms of non-recourse debt (Blanc-Brude and Strange 2007). Typically, private sector consortium forms a special company called a "special purpose vehicle" (SPV) to develop, build, maintain and operate the public asset and service for the contracted period (Zheng, Roehrich, & Lewis, 2008). Depending on the contractual framework and the degree of involvement assumed by external finance providers, effects on firm incentives and action may be considerable.

The World Bank mentions the following case: "*in La Paz-El Alto, the government focused on extending service through in-house connections engineered to first-world standards. One target for service expansion was the poorer areas of El Alto. A concession contract was designed and awarded to the bidder that offered the most rapid expansion of in-house water and sanitation connections. The winning bidder proposed ambitious expansion targets, which were written into the contract. As the expansion program got under way, however, it became clear that: i) the newly connected households used less water than already connected households and less than expected; ii) this meant lower revenue for the operator, causing financial problems. The government, the regulator, and the operator addressed the problem by allowing for lower cost connections, such as condominial sewerage. However, this proved insufficient, and disagreements over service in La Paz resulted in Government requests for cancellation in early 2005*" (Escobedo 2008).

The principal problem in the settings of high financial leverage relates to important agency problems that may arise between the external finance providers and shareholders, in particular – to moral hazard, where private actor (i.e. entrepreneur or sponsor of the project company) may be tempted to engage in excessive risk-taking or act counter the interest of credit providers, who cannot verify the actions of the former to full extent (Holmstrom and Tirole 1997; Repullo and Suarez 2000). To offset these risks, lenders may engage in actions with a complex set of consequences and repercussions for the underlying partnership. For example, presence of important lender/debt-holder interests is likely to increase contractual

[1] http://www.shell-livewire.org/about/

complexity, as well require an adaptation of various contractual safeguards between public and private counterparts. Resulting contacts are likely to be more complete, yet, also more rigid (Bhojraj and Sengupta 2003). This increased contractual rigidity - due to presence of external finance - may result in higher incidence of renegotiation and/or litigation risks, and, overall, reduced social value orientation of the firm.

At the same time, given the lenders' dependence upon project revenue flows for loan repayment, the degree of supervision and operational monitoring by external finance providers is likely to be considerably higher than in the case of in-house financing (Estache et al. 2007). This increased enforcement and monitoring of private actor actions may improve firm's private *and* social performance and adherence to pre-set contractual obligations. It may also ensure improved coordination and adaptation between the private and public counterparts, and thereby boost the overall partnership performance. The presence of external finance institutions through their screening, monitoring and enforcement roles may in such case alter the course of the private business action towards higher social or public value (Scholtens 2006). However, by pushing aside other interests, for example, minority shareholder demands, external credit providers may also offset the incentives and preferences coming from other governance channels.

Managerial Perspectives: The Role of Executive Layer

Important dissonance of interests may also arise between the stakeholders of the private enterprise as principals and executives as their agents, when maximizing the corporate objectives do not overlap with the latter's own preferences and agenda – a classical agency theory dilemma (Jensen and Meckling 1976; Shapiro 2005). In public-private ties, managerial preferences may produce important departures from the corporate-value-only driven incentives and behavior. For example, in many instances, executives may engage in the social expenditure and activities far beyond the ones mandated by formal contract or shareholder value-considerations guided by either personal acclaim and consumption (Baron 2008) or more intrinsic organizational sense-making process (Basu and Palazzo 2008).

The effects of such divergent executive preferences may often distort implicit contracts between shareholders and firm management, and even tilt the distribution of total partnership benefits considerably more in favor of the public side – increasing the social value orientation by the firm. In public-private arrangements, the presence of social concerns and considerations on executive side may not only reduce likelihood of any opportunistic action on private side, but also enhance the overall project performance through timelier project delivery, or attention to wider public goals and social objectives. On a contractual level, one may observe reduced incidence of formal renegotiation, as informal contractual adjustments are more likely, and coordination improves.

Another, related set of internal pressures to a firm arise from employees and lower levels of hierarchy in an organization. Scholars of corporate social responsibility, for example, argue that employees can act as important force which, though perceptions of general justice, may push corporations to engage in socially responsible activities (Aguilera et al. 2007). Similar arguments are put forward for multinational companies involved in cross-sector partnerships (Bhanji and Oxley 2013). The intrinsic values (voluntary collaborative efforts, solving problem behavior or social and mutual concerns) held by some employees may lead them to focus on elements and attributes of the company able to contribute to the broader social rather than solely economic value derived by the firm. For example, employees are at the core of learning processes and can successfully capture the benefits from cross-sector and public-private partnerships. They are involved in the collaboration processes and bring new knowledge and know-how through the reintegration process when they return to the firm. Such pressures can be particularly strong in decentralized organizations, with social orientation increasing downwards the organizational hierarchy (Marz et al. 2003). On another hand, if the scope of decentralized action is limited and emphasis on profitability objectives too strong, a dissonance between corporate and individually held preferences are likely to penalize the productivity and efficiency levels, adversely affecting the social value outcomes of the public-private arrangement.

The Influence of Activists and External Social Forces

Organizational architecture, governance and executive layers do not exhaust the sets of players expected to exercise considerable influence upon private actor interests and actions in the public sector ties, influencing the social value orientation of the private firm. While overlooked by most of the current literature on public-private contracting and private party opportunism, another set of influential actors - external stakeholders, such as consumers and organized interest groups, are likely to exercise considerable control over private firm actions on both individual and collective level. By definition, third parties or external stakeholders are not part of the formal public-private arrangement but have a keen interest in what its outcomes and may influence private company's decision-making. The firm, in turn, is affected by a requirement to satisfying the diverse needs of its external stakeholders: customers, local communities, opinion formers and interest groups.

The customer-as-citizen claims. Consumers, representing the primary external force that both rewards a firm for pursuing socially responsible action as well as penalizes it by modifying the consumption, may be a key factor driving a firm to engage in social expenditure and non-opportunistic behavior (Baron 2008). The effect of such individual acts in public-private sector ties is going to be particularly acute in the partnership models, where private actors are carrying the operational and revenue risks associated with direct provision of the service or good to the end users, e.g. in concessions (Kivleniece & Quélin 2012). In this case, any deficiency on quality or an opportunistic price rise by the private provider is likely to create feed-back effects through individual claims, withholding of payment, or even boycott. Furthermore, such an influence need not be limited only to the consumers and acts on individual level. Given the social significance of public-private contractual arrangements, important actions to challenge or reverse private party contracting with public sector can be undertaken by any third party outside the initial agreement (Spiller 2008).

The pressure of third-party and activist groups. Besides direct consumers of public service or goods, any third-parties and activist groups may act and represent external stakeholders to public-private arrangement (Moszoro and Spiller 2012; Spiller 2010) – to be affected by the private firm's decisions or action, or and likely to influence such decisions or action, in turn.

As the responsibility for public services and social tasks passes from state to the private hands, a variety of third-party and activist groups are likely to increasingly challenge private actors to take up a more socially responsible and public value stance (Den Hond and De Bakker 2007). Their influence may take the form of both material actions, such as boycotts, and more symbolic impacts, aimed at indirectly changing the social responsiveness of the private actor. Such a collective action carried out by organized groups of social actors may turn out to be a critical mediating factor in the incentive structure of the private player and the total value derived within the given partnership. As result of such actions (or even threat of action) one can expect private actor return maximizing interests and behavior in public sector ties to be considerably restrained, favoring higher adherence to contractual engagements, quality commitments and social expenditure.

Moreover, third-party activism is likely to affect the firm through interaction at both structural or governance levels, as well as at the executive or managerial level. Both shareholders and executive managers may be required to adopt an inclusive approach which takes into account the interests of third-party claimants and, as far as possible, acknowledges their involvement in either formal or informal aspects of the underlying arrangement. Moreover, third-party action is likely to spill over an affect private actors also on the architectural or network level. For example, a recent case of activism by Greenpeace demonstrates how activist pressures targeting Shell corporation, yet aimed at Lego corporation, forced the latter to end the long standing toy distribution partnership between the two corporations – despite the social value and interest derived from partnership outcomes (Vaughan 2014).

Of course, not all public-private arrangements will face an identical strength and scope of pressure. The impact of third-party activism on firm incentives and behavior is likely to vary considerably depending on the underlying partnership model (Kivleniece and Quélin 2012), issue saliency as well as interest group power and legitimacy (Bhanji and Oxley 2013;

Eesley and Lenox 2006; Mitchell et al. 1997). Partnership models that depend on external support and acceptance by wider groups of society will be more susceptible to such external pressures. Likewise, the presence of various nongovernmental and other powerful social organizations that monitor corporate behavior and mobilize to change it (Campbell 2007), are more likely to shape the organizations than dispersed activities by local, isolated groups.

Towards a Conceptual Framework on the Complexity of Private Actor Interactions and Interests in Public-Private Ties

We conclude by highlighting that public-private collaboration is related to important social, political and pecuniary benefits for social, public as well as private actors or firms. Among the benefits are reputational enhancement, political access, and ability to address the economic, developmental and social needs as well as, potentially, a new market development. We have demonstrated that the complexity of interactions and interests embedded on private actor's side require easing the restrictive assumptions on uniform private actor incentives, homogenous preferences and rent-maximizing, opportunistic firm behavior as formal drivers of performance and outcomes in public-private collaboration. Organizational or value chain architecture, formal governance features as well as executive management aspects influence and in turn, are influenced by third party or external claimant behavior. Jointly taken, these diverse sets of interactions are likely to determine the social value orientation of a firm in its public-private arrangements. Public actors must prove that they pay attention to social objectives and common pool concerns. Private actors must legitimate their actions and cope with different shareholders and stakeholders requests.

Insert here Figure 1

Our analysis leads us to develop a conceptual model, shedding the light on potential complex set of actions embedded under the "private actor" notion in public-private engagements (see Figure 1). Whist not exhaustive, it paints the network of complex linkages connecting the diverse organizational governance and managerial levels as well third party claims – and influencing, in turn, the social value orientation of the focal private actor.

CONCLUDING PERSPECTIVES

As the importance of cooperation between public and private sectors of the economy rises, important questions linger as to the underlying incentives and performance issues for private actors engaged in these socially important ties. Whilst the existing literature, drawing on the transaction cost, incomplete contracting and game-theoretic perspectives, provides crucial insights, in prevailing assumptions missing is a more fine-grained understanding of the nature and importance of various interests represented within a firm as a complex, multi-layered economic actor.

In this exploratory article, we attempt to embrace a multitude of interests embedded in the "nexus of contracts" approach, by highlighting a range of actors – consortia members, shareholders, investors as multiple principals, executives, as well as third parties activists – as crucial forces modifying and shaping firm behavior and, specifically, social value orientation in public sector ties. By adopting this perspective, we hope to contribute and enrich the existing debate on the role that private economic initiative can and should play in the provision of public or social value. Far from providing exhaustive theoretical answers, this conceptual article is aimed, instead, at opening up of a range of novel issues and themes for future research. Important work remains to be undertaken on establishing the exact causal links and mechanisms guiding the private actor action in public sector engagements, as well as determining their likely impact and effect on the performance and effectiveness of these intricate interorganizational ties.

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FIGURE 1: AN OVERVIEW OF THE THEORETICAL FRAMEWORK