

# Executive Summary Backgrounder

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## Contracting Out in Defense: Lessons from the British Experience for the U.S. and Great Britain

*Ted R. Bromund, Ph.D.*

Contracting out in defense is an important public and political issue in the United States. When based on the proper principles, contracting out allows the government to draw on the skills and resources of the private sector to deliver services more efficiently. Although the British and U.S. programs are financed differently, Britain's experience offers important lessons that both countries need to learn as they continue, where appropriate, to contract out in defense.

**Contracting Out in Britain.** The Labour government that was first elected in 1997 has won an undeserved reputation as a friend of the private sector. The reality is different. Within a decade, Britain went from being a country that followed the Anglosphere's model of a limited state and flexible economy to one that looked more like a continental economy.

The U.S. should recognize the failure of these state-led economic policies, but opposing the growth of the state is not enough. It is important to examine, sector by sector, how this growth was funded and the effects and efficiency of the funding model. Britain's Private Finance Initiative (PFI) is an important part of that story.

Under PFI, the government makes a long-term contract with private investors to provide goods or services. If Britain's liabilities under PFI were acknowledged as claims on the national income, its balance sheet would look substantially worse. The Ministry of Defence (MoD) is one of the largest users

of PFI, and its experiences of contracting out in defense through PFI offer important lessons for both nations.

PFI's proclaimed goal is to improve efficiency. The House of Commons should investigate the MoD's use of PFI to determine whether it has delivered value for money, produced perverse incentives, become a way to manufacture private-sector jobs that in reality are paid for by the public sector, supported ineffective procurement practices, or been used to conceal inappropriate levels of debt. It should also examine the successes and failures of the U.S. program of military family housing privatization.

**Learning from the British Experience.** The U.S. can benefit by applying the following principles and lessons from Great Britain's successes and failures:

- **If the government is involved, risks cannot be wholly transferred to the private sector.** The justification for placing most PFI projects off the balance sheet is that they transfer risk from the public sector to the private sector. In strictly financial terms and in normal times, this is correct, but political pressures will ultimately force the government to intervene if its private-sector

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partner fails. Congress and the executive branch, while supporting contracting out where it is suitable, need to resist introducing it where victory, not profit or loss, is at stake. The risk of defeat should never be transferred to the private sector.

- **The U.S. should take the lead in establishing best practices for contracting out.** The U.S. should create an office under the Assistant Secretary of Defense for International Security Affairs that, in consultation with allies, would produce a best-practices guide to contracting out in defense and, with due regard to national circumstances, standardize government policies. The intent would not be to enforce uniformity, but to create a menu of recognized options from which states could select and that would encourage competition in bidding and transparency in government.
- **Contracts with the private sector require effective government contractors.** Contracting out does not reduce the government's responsibilities: It increases them. Like any other buyer, the government must decide what it wants to buy, negotiate the contract, and then ensure that the other party fulfills its side of the bargain. The U.S. Commission on Wartime Contracting should study the U.S. and British experiences with care. As Britain expands its use of PFI to improve its service accommodations, it should examine the U.S. Military Housing Privatization Initiative (MHPI), which has won praise from civilian and military authorities for its successes. Both the U.S. and British militaries need better contracting forces. They should have the power and ability to decide when contracting out would be appropriate, and the skills and training of contracting officers should be improved.

The contracting forces need to emphasize continuity of practical experience and not allow officers to rotate so rapidly that knowledge is lost and responsibility is blurred. They also need to be subject to improved auditing and increased accountability for failure, both internally and to appropriate legislative bodies.

- **Contracting out should promote efficiency and improved quality, not hide spending.** The British experience with PFI offers a broader lesson for the U.S.: The only reason for government to contract out is that it has good reason to believe that the private sector will reliably deliver a better service. Contracting out should never be used to justify spending that increases the size of the state while simultaneously concealing this growth. Nor should the state resort to contracting out simply to obtain use of a defense asset without budgeting fully for it. To cut budgets and simultaneously demand the acquisition of assets poses unacceptable risks to national security and financial honesty.

**Conclusion.** Contracting out is an important instrument, both for the U.S. and for Great Britain, but it needs to be employed effectively. The British method of financing it has encouraged the continuing growth of the state and has created a series of risks and perverse incentives. Each country should learn from the other's experience about when to employ contracting out appropriately, how to fund it, how to design suitable programs, and how to improve its efficiency.

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# Background

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## Contracting Out in Defense: Lessons from the British Experience for the U.S. and Great Britain

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Contracting out in defense is an important public and political issue in the United States. When based on the proper principles, contracting out allows the government to draw on the skills and resources of the private sector to deliver services more efficiently. Although the British and U.S. programs are financed differently, Britain's experience offers important lessons that both countries need to learn as they continue, where appropriate, to contract out in defense.

Between 1997 and 2008, the British government's share of the national economy expanded from 38.4 percent to 41.9 percent. In 2008–2009, that share will rise to 49 percent.<sup>1</sup> It is time to ask detailed questions, sector by sector, about the increasing size of the British state. An official investigation into the British Ministry of Defence (MoD) would shed useful light on how this expansion was funded and how efficiently it was administered.

The MoD offers scope for such an investigation because, in theory, it has returned thousands of workers to the civilian labor market. However, the MoD has simultaneously expanded use of the Private Finance Initiative (PFI), which is one way the government has funded and disguised its spending spree.

The Defence Select Committee of the House of Commons should investigate the MoD's reliance on PFI and assess whether it has delivered value for money, produced perverse incentives, become a way to manufacture private-sector jobs that in reality are paid for by the public sector, supported ineffective procurement practices, or been used to conceal inap-

### Talking Points

- The size of the British state grew under Labour, and much of this growth was hidden from British taxpayers by borrowing off the balance sheet. This concealed debt will be a burden for decades.
- The British government's reliance on the Private Finance Initiative was central to this disguised borrowing. Unlike the privatizations of the 1980s, PFI has been used to expand government and has been ineffectively administered. U.S. contracting out is financed differently and is therefore not directly comparable to the British program.
- The British Ministry of Defence is one of the most important users of PFI. This poses a series of risks for British defense that should be investigated by the House of Commons Defence Select Committee.
- The British experiences offer lessons for the U.S. Congress, the executive branch, and the U.S. Commission on Wartime Contracting.

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appropriate levels of debt. The U.S.'s largely successful program of military housing privatization offers a series of valuable lessons, and its occasional failures offer other lessons, for the United Kingdom.

The U.S. should also learn from the MoD's use of PFI. One of the shortcomings of Britain's contracting-out program is a shortage of government personnel competent to oversee the contracts. The same issue has been identified in the U.S. In both nations, as a result, contracting processes have been heavily criticized for their inefficiency. More broadly, the MoD has extended contracting out into areas that are unsuitable for it and has not designed PFI contracts that preserve essential competitive pressures. The U.S. should take care to avoid both errors.

Contracting out is an important instrument, both in Great Britain and in the United States, but it needs to be employed effectively. The British method of financing it has encouraged the continuing growth of the state and has created a series of risks and perverse incentives. Each nation should learn from the other's experience about when to employ contracting out appropriately, how to fund it, how to design suitable programs, and how to improve its efficiency.

### Britain's Retreat from Economic Freedom

The Labour government that took office in 1997 has won an undeserved reputation as a friend of the private sector because it supposedly rejected Labour's formerly free-spending ways. The reality is different. Under Labour, the government's share of Britain's economy has risen sharply. In 1997, the average governmental share of gross domestic product (GDP) across the Organisation for Economic Co-operation and Development (OECD) was 38.8 percent, higher than Britain's 38.4 percent. Key

European competitors, such as Germany (45.7 percent of GDP), had substantially larger states.

By 2008, the OECD average had nudged downward to 38.5 percent, but this average concealed important variations. Germany's share had declined to 43.4 percent, a 2.3 percentage point drop, while Britain's had increased to 41.9 percent, a 3.5 percentage point rise.

Within a decade, Britain went from being a country that followed the Anglosphere's model of a limited state and flexible economy to one that looked more like a continental economy. It did this at a time when the continental economies were moving haltingly toward the Anglosphere model. In short, Britain went the wrong way when many other major industrialized economies were going the right way.<sup>2</sup>

The same wrong-way trends are evident in the data on Britain's public debt and the government's annual financial balance. Even the government's record of fostering economic growth is heavily tainted by the fact that increased state expenditure accounts for more than a quarter of economic growth from 1999 to 2006.<sup>3</sup>

Equally startling is the government's record on employment. The *Financial Times* has found that two out of three supposedly private-sector jobs that the government claims to have created are in areas of the economy dominated by government spending. They are, therefore, not meaningfully private. Indeed, because they have been paid for by a massive expansion of state borrowing, much of it in disguised forms, these jobs constitute a burden that will require financing for years to come.<sup>4</sup>

This increase in the size of the British state raises vital questions both for the British people and for supporters of private enterprise and limited government around the world. Like other nations, the

1. Ted R. Bromund, "The Stealth Nationalization of Britain's Economy Must Be Reversed," Heritage Foundation *WebMemo* No. 2260, February 2, 2009, at <http://www.heritage.org/Research/Europe/wm2260.cfm>.
2. Organisation for Economic Co-operation and Development, *OECD Economic Outlook* No. 84, November 2008, Annex Table 26, at <http://www.oecd.org/dataoecd/5/51/2483816.xls> (January 27, 2008).
3. Nick Bosanquet, Andrew Haldenby, Laura Kounine, Lucy Parsons, Helen Rainbow, and Elizabeth Truss, "A Lost Decade: Counting the Opportunity Cost of Public Spending, 1999–2008," *Reform*, March 2008, pp. 20 and 22, at <http://www.reform.co.uk/Research/Articles/tabid/79/smId/378/ArticleId/608/Default.aspx> (May 12, 2009).
4. Editorial, "The Big Boss State," *Financial Times*, November 24, 2008, at <http://www.ft.com/cms/s/0/fbf4e914-ba4f-11dd-92c9-0000779fd18c.html> (January 27, 2009).

U.S. should recognize the implications of the failure of these state-led economic policies. Yet simply describing and opposing the growth of the state is not enough. It is important to examine how this growth was funded and the effects and efficiency of the funding model. PFI is an important part of that story.

### Why Labour Relied on PFI

PFI was launched in 1992 under the Conservative government led by Prime Minister John Major. The Labour Party immediately attacked it as a disguised form of privatization. Yet after winning the 1997 general election, Labour vastly expanded Britain's use of PFI. As the junior Health Minister Alan Milburn put it, "When there is a limited amount of public-sector capital available, as there is, it's PFI or bust."<sup>5</sup>

Labour's resort to PFI, in spite of its previous objections, was thus based on its desire to square the circle of wanting to spend more without having to raise taxes or borrow more.<sup>6</sup> Under PFI, the government, instead of issuing debt to fund desired expenditure, makes a long-term contract with private investors to provide goods or services in return for regular payments.

Because PFI contracts are technically not debt, they allow the government to provide more services now without having to borrow more or raise taxes in the near term. However, like debt, PFI contracts oblige the state to make future payments to the other contracting party. Thus, while PFI reduces the

amount the government borrows (or raises in taxes) up front, it reduces future expenditures only if the private-sector contractor is efficient and if the contract is carefully drawn up and supervised. When used only to borrow off the balance sheet by committing the state to future unfunded expenditures, PFI falsifies the national accounts.

Contrary to Labour's early criticisms and the left today, PFI is not simply another word for privatization. The standard complaint of today's critics is that PFI is privatization and that the government is manipulating comparisons between the costs of government-led policies and contracting out to justify contracting out. Allegedly, these manipulations consummate the unholy alliance that supposedly exists between New Labour and "the PFI industry."<sup>7</sup>

As with many liberal criticisms of U.S. wartime contracting, which assert the existence of a vicious cycle of corruption between the Bush Administration, the Iraq War, and the contractors, this concept of an unholy alliance owes more to partisan rancor than to reality.<sup>8</sup> At its root, PFI is a result of the government's attempts to buy more public services than it is willing to finance through higher taxes or more debt. The problem is ultimately not the comparisons used to justify PFI—although there is cause to believe that these are being manipulated—but the ideology that drives the demand for the ever-expanding state.

As long as public funds are limited—as they always will be—and public demands are unlim-

5. BBC, "The NHS and the Private Sector," May 17, 2001, at [http://news.bbc.co.uk/vote2001/hi/english/main\\_issues/sections/facts/newsid\\_1182000/1182645.stm](http://news.bbc.co.uk/vote2001/hi/english/main_issues/sections/facts/newsid_1182000/1182645.stm) (January 27, 2009).
6. Dale Bassett, Nick Bosanquet, Andrew Haldenby, Lucy Parsons, and Elizabeth Truss, "The Hole We Are in and How to Get out of It," *Reform*, November 2008, p. 7, at <http://www.reform.co.uk/Research/ResearchArticles/tabid/82/smId/378/ArticleID/3/refTab/79/t/The-hole-we-are-in-and-how-to-get-out-of-it/Default.aspx> (May 12, 2009).
7. George Monbiot, "This Great Free-Market Experiment Is More Like a Corporate Welfare Scheme," *The Guardian*, September 4, 2007, at <http://www.guardian.co.uk/commentisfree/2007/sep/04/comment.politics> (January 27, 2009), and Allyson Pollock, "A Gauntlet for Brown," *The Guardian*, April 11, 2007, at <http://www.guardian.co.uk/commentisfree/2007/apr/11/comment.economy> (February 13, 2007).
8. The exhaustive report of the Special Inspector General for Iraq Reconstruction asks: "Was the [U.S.] program [in Iraq] grossly burdened by waste and fraud?" It answers: "Regarding waste yes; regarding fraud, no.... The vast majority of those who served the U.S. reconstruction program... did so honorably." The problem was not fraud, but poor management. Special Inspector General for Iraq Reconstruction, *Hard Lessons: The Iraq Reconstruction Experience*, February 2009, pp. viii–ix, at [http://www.sigir.mil/hardlessons/pdfs/Hard\\_Lessons\\_Report.pdf](http://www.sigir.mil/hardlessons/pdfs/Hard_Lessons_Report.pdf) (May 12, 2009). See also James Jay Carafano, "Contracting in Combat: Advice for the Commission on Wartime Contracting," *Heritage Foundation Backgrounder* No. 2228, January 13, 2009, pp. 1–2, at <http://www.heritage.org/Research/NationalSecurity/bg2228.cfm>.

ited—as they will be so long as the left worships the state—politicians will look for ways to square the circle. If the left-wing critics want to reduce the ties between the state and the private sector, they should advocate reducing the size and reach of the state.

In reality, contracting out is not the same thing as privatization. The only true form of privatization is the sale of government assets to the private sector, which eliminates the managerial responsibilities of the public sector. Privatization was central to the achievements of the governments led by Prime Minister Margaret Thatcher from 1979 to 1990, and it remains a valuable tool today.

Under PFI, the government, as one of the contracting parties, does not eliminate its responsibilities. It simply becomes a manager of contracts instead of a manager of assets. PFI is supposed both to transfer risk from the public sector to the private sector by making the private sector responsible for delivering its contractual requirements and to relieve government departments of responsibility for handling assets outside their core competencies. Contracting out has merit, and condemning it wholesale would be wrong. Yet by its very nature, it places the responsibility of being a careful contractor on the government.

### Questions of PFI Managerial Competence and Fiscal Honesty

Since 1997, instead of bringing the efficiency of the private sector to the public sector, PFI has too often brought the inefficiency of public finance to the private sector. The result is that PFI is now regularly condemned as a bad bargain for the taxpayer.<sup>9</sup> In a November 2007 report, the Committee of Public Accounts found:

[T]he Treasury has done little to apply what it has learned from the large number of PFI

deals that have now been signed. There has been no improvement in tendering times, significant risks to value for money continue to be taken when public authorities make late changes to deals, and there is a continuing lack of skills and experience in public sector PFI teams. As a result, there are signs that market interest is weakening, with fewer serious bids for recent deals.<sup>10</sup>

Concerns about the competence of government contractors were echoed by the Confederation of British Industry (CBI), the leading lobbying organization for British business. In a survey of its members, the CBI found that “49% said they had experienced changed specifications by the contracting authority after contracts [had] been signed.”<sup>11</sup> Changing requirements after signing a contract implies, as the committee emphasized, that the contracting authorities lack the necessary skills and expertise to negotiate successfully.

Oversight of signed contracts was also proving problematic. Most PFI contracts contain provisions to test the value of services through benchmarking or market testing. In theory, these should reduce prices. In practice, in more than half of the cases the committee examined, the supplier had used them to increase prices. With over 70 percent of recent PFI contracts attracting three or fewer bidders, and given the limited competitive pressures after a contract is signed, PFI is in serious danger of becoming a mechanism for eliminating, not enhancing, competitive bidding.<sup>12</sup>

It is not possible to assess objectively Prime Minister Gordon Brown’s claims that PFI has delivered value for money. The studies the government cites to back up its claims suffer from serious errors, and the government refuses to release the underlying data for PFI contracts, claiming commercial con-

9. Jon Swaine, “Government Failing on PFI Contracts,” *Daily Telegraph*, September 1, 2008, at <http://www.telegraph.co.uk/news/newstopics/politics/2662953/Government-failing-on-PFI-contracts.html> (January 16, 2009).

10. U.K. House of Commons, Committee of Public Accounts, *HM Treasury: Tendering and Benchmarking in PFI*, November 27, 2007, p. 3, at <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmpubacc/754/754.pdf> (January 27, 2009).

11. David Hencke, “Taxpayer May Have to Pay £170bn for PFI Schemes, Says Treasury,” *The Guardian*, November 27, 2007, at <http://www.guardian.co.uk/uk/2007/nov/27/politics.economy1> (January 27, 2009).

12. U.K. House of Commons, *HM Treasury*, pp. 8, 5, and 7.

fidentiality.<sup>13</sup> This does not mean, as critics are wont to imply, that the conventional state-based approach is superior, but it does reinforce the suspicion that the government has adopted PFI primarily to conceal its borrowing.

### How Large Are Britain's Obligations Under PFI?

PFI contracts are not a minor entry on the state's account books. In late 2007, the Treasury estimated the total current value of all signed PFI contracts at £91 billion through 2032.<sup>14</sup> As this figure ignores the payments due after 2032, the true value of the contracts is higher. Nor, of course, can the Treasury know the value of contracts that either the current government or future governments will sign in years to come.

Markets worldwide are already alarmed that Britain's balance-sheet debt (47.5 percent of GDP) is at its highest level since 1978.<sup>15</sup> Leading politicians are beginning to speculate that Britain will be forced to turn to the International Monetary Fund for an emergency loan, as it was in 1976.<sup>16</sup> Then, the price of IMF assistance was substantial cuts in public expenditure. If Britain is forced down the IMF route again, the same remedy will likely be demanded, with the result that many of the programs on which the government prides itself, and that it has funded by borrowing, would disappear. This would devastate its political legacy.

If Britain's liabilities under PFI were acknowledged as claims on the national income that must be paid by raising taxes or issuing more traditional debt, Britain's balance sheet would look substantially worse. On their own, PFI contracts (at 7 percent of GDP) comprise one-third of Britain's liabilities off the balance sheet. Taken together, these liabilities raise Britain's public debt by almost one-third, to 62.8 percent of GDP.<sup>17</sup> Nor will these liabilities disappear soon. Many PFI contracts have terms of 20 years or more. Taxpayers will be paying for the government's spending spree for decades.

In short, Britain's public debt is higher than the official figures imply, PFI is an important part of this hidden debt, the government has used PFI to avoid issuing traditional debt, and PFI has not demonstrably offered the taxpayers value for their money.

### The MoD's Reliance on PFI

The logic behind the MoD's turn to PFI was set out in the 1998 *Strategic Defence Review*, which called for developing "increasingly innovative forms of Public Private Partnerships" as part of a broader drive to improve contracting efficiency, especially in areas such as military housing that are not central to the mission of the MoD.<sup>18</sup> From the start, the MoD recognized that it was vital to develop "an acquisition stream for both military and civilian staff which would provide core personnel for the Integrated Project Teams" and to emphasize getting contacts right at the start of the acquisition process.<sup>19</sup>

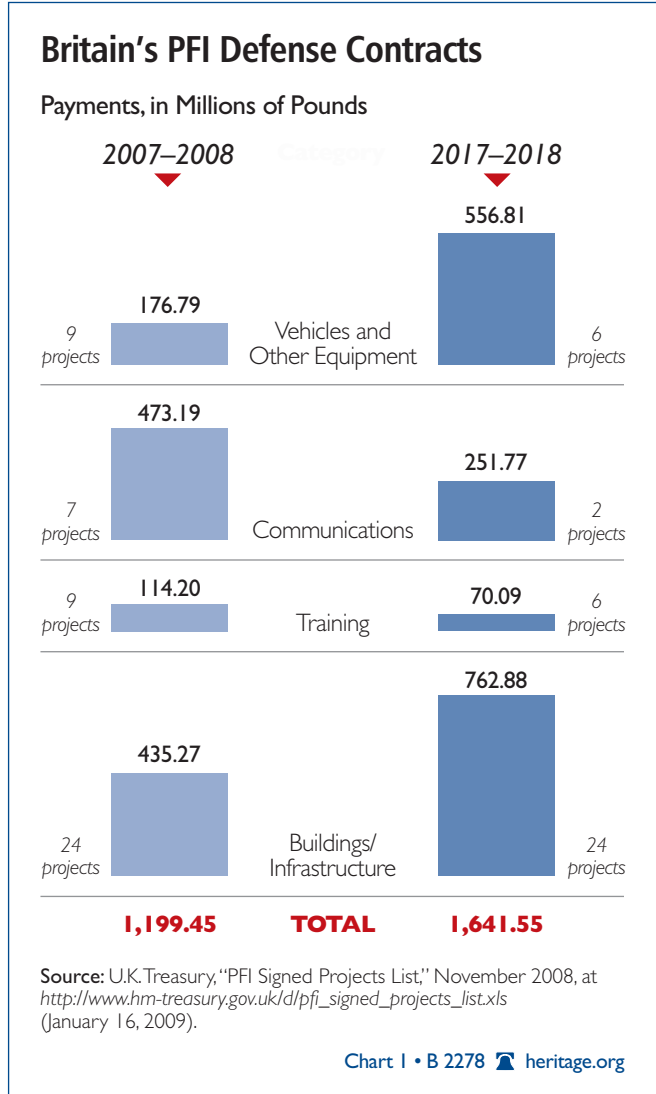
13. Pollock, "A Gauntlet for Brown," and Allyson M. Pollock, David Price, and Stewart Player, "An Examination of the UK Treasury's Evidence Base for Cost and Time Overrun Data in UK Value-for-Money Policy and Appraisal," *Public Money & Management*, April 2007, at [http://www.health.ed.ac.uk/CIPHP/Documents/PMM\\_2007\\_Time\\_and\\_cost\\_overrun\\_Pollock.pdf](http://www.health.ed.ac.uk/CIPHP/Documents/PMM_2007_Time_and_cost_overrun_Pollock.pdf) (February 13, 2009).
14. Hencke, "Taxpayer May Have to Pay £170bn for PFI Schemes, Says Treasury."
15. Angela Monaghan, "UK National Debt Highest Since 1978 as RBS Goes on the Books," *Daily Telegraph*, January 21, 2009, at <http://www.telegraph.co.uk/finance/economics/4305807/UK-national-debt-highest-since-1978-as-RBS-goes-on-the-books.html> (January 27, 2009).
16. Nicholas Watt, "Cameron: Britain May Have to Seek IMF Bail-Out," *The Guardian*, January 23, 2009, at <http://www.guardian.co.uk/politics/2009/jan/23/davidcameron-conservatives> (January 27, 2009).
17. Bassett *et al.*, "The Hole We Are in and How to Get out of It," p. 35. This figure does not account for support offered to the financial sector after the report's publication date, which has further increased Britain's liabilities.
18. U.K. Ministry of Defence, "Support and Infrastructure," Supporting Essay Eleven, in *Strategic Defence Review*, July 1998, para. 49, at [http://www.mod.uk/NR/rdonlyres/65F3D7AC-4340-4119-93A2-20825848E50E/0/sdr1998\\_complete.pdf](http://www.mod.uk/NR/rdonlyres/65F3D7AC-4340-4119-93A2-20825848E50E/0/sdr1998_complete.pdf) (September 29, 2008).
19. U.K. Ministry of Defence, "Procurement and Industry," Supporting Essay Ten, in *Strategic Defence Review*, para. 25.

As the review projected, the MoD's use of PFI has expanded dramatically since 1998, although the MoD still does not rely as heavily on PFI as do several other departments. By way of comparison, the Department of Health has 133 projects worth over £11 billion, and the Department for Transport has 53 projects worth over £28 billion.<sup>20</sup> The MoD is the second-largest government contractor by total value of signed PFI projects and will surpass Health in 2010–2011, when it will make the largest annual payments on PFI contracts.<sup>21</sup>

In 2007–2008, the MoD made payments of £1.199 billion on 48 separate PFI projects.<sup>22</sup> In total, it has 52 signed or completed projects with a total capital value of £19.688 billion—23.9 percent of the total capital value of all signed projects.<sup>23</sup> It is important to note that the cost of building capital assets is only part of the total cost of the MoD's PFI contracts because PFI contracts require the private-sector contractor to deliver and be paid for ongoing services.

As Chart 1 illustrates, MoD payments on PFI contracts in 2007–2008 fall into four categories: buildings and infrastructure (24); communications and information technology (7); provision of training and training-related equipment (9); and provision of vehicles and other equipment (9). By value, the largest two categories are buildings and infrastructure (£435 million) and communications (£473 million), with the remaining categories totaling only £291 million.

By 2017–2018, this structure will shift significantly as new contracts come on stream and old ones end. In that year, annual MoD payments on the 38 signed contracts will be £1.642 billion. Communications and information technology will decline to £252 million, and training will shrink to £70 million. However, spending on buildings and



other infrastructure will jump by £328 million to £763 million, and spending on vehicles and other equipment will rise by almost £400 million to £556.81 million.

Not surprisingly, a few projects account for most of the expenditure, both now and as projected for

20. PPP Forum, "Signed Projects," at <http://www.pppforum.com/projects/projects.asp?type=signed> (January 16, 2009). Different British authorities provide slightly different figures on the exact number and value of PFI projects signed by the MoD. The figures from the PPP Forum's database are representative.

21. PPP Forum, "Signed Projects," and U.K. National Audit Office, *Allocation and Management of Risk in Ministry of Defence PFI Projects*, October 30, 2008, p. 12, at [http://www.nao.org.uk/publications/0708/mod\\_pfi\\_projects.aspx](http://www.nao.org.uk/publications/0708/mod_pfi_projects.aspx) (January 27, 2009).

22. U.K. Treasury, "PFI Signed Projects List," November 2008, at [http://www.hm-treasury.gov.uk/d/pfi\\_signed\\_projects\\_list.xls](http://www.hm-treasury.gov.uk/d/pfi_signed_projects_list.xls) (January 16, 2009).

23. PPP Forum, "Signed Projects."



2017–2018. In 2017–2018, more than £1 billion of the £1.642 billion for PFI projects will go to four projects: the Allenby/Connaught accommodations and services project (£271.56 million), which will provide living and working accommodation for some 18,000 military and civilian personnel; Skynet 5 (£243.23 million), a system of secure communications satellites; Aquatrine (£96.74 million), a collection of water and wastewater projects; and the Future Strategic Tanker Aircraft (FSTA) project (£390.92 million), which will replace the current air-to-air refuelling capability and elements of the air transport service.<sup>24</sup>

### Assessing the Record and Risks of PFI

PFI's proclaimed goal is to improve efficiency and thus to save taxpayer money. However, measuring efficiency in government, much less achieving it, is difficult. Efficiency is a particularly nebulous goal in the realm of defense, and the MoD's record does not encourage confidence in the quality of its oversight.

According to the MoD, PFI has been a success. A December 2005 report by the MoD's Private Finance Unit concluded that "PFI projects in MOD are performing well and are delivering the services required."<sup>25</sup> Yet this report was based on a survey of the MoD's PFI teams, who have few incentives to view their own performance critically, and was produced by a unit that has everything to lose from uncovering problems in PFI.

Other official investigators do not share the MoD's generous self-assessment, although some credit it with being more competent than other ministries. The November 2007 report by the Committee of Public Accounts found, in addition to other serious flaws, "a continuing lack of skills and experience in public sector PFI teams."<sup>26</sup> The head of PFI policy at

the Treasury acknowledged that "the quality of individual public sector project teams was mixed" but argued that the Private Finance Unit was an example of the improvement seen in recent years.<sup>27</sup>

Other reputable observers continue to argue that the MoD suffers from serious managerial shortcomings. In a March 2008 report, the Defence Select Committee of the House of Commons expressed astonishment that "the MoD only now acknowledges that it needs to include in the project management skills of its staff the ability to examine a contractor's programme schedule and consider whether it is credible."<sup>28</sup> These managerial weaknesses have contributed to cost and schedule overruns on many of the MoD's large procurement programs.

The most recent assessment, in an October 2008 report from the National Audit Office (NAO), took a middle view. It praised the MoD for achieving "a good service delivery on a broad and diverse portfolio of PFI projects" and found that, once a suitable contract was negotiated, the private sector usually delivered as agreed. The most significant risks came early, in the contracting stage, when services desired were not always well specified. The result was that all eight projects examined by the NAO presented a moderate to significant risk of failing to deliver value for money.<sup>29</sup>

Regrettably, neither the NAO nor the Defence Select Committee has conducted a full audit of the MoD's PFI portfolio. The NAO has not examined Skynet, FSTA, Aquatrine, or any accommodations project. These contracts will account for the vast majority of PFI spending by 2017–2018. The Defence Select Committee devotes little attention to PFI in its annual reports.

24. U.K. Treasury, "PFI Signed Projects List."

25. U.K. Ministry of Defence, Private Finance Unit, "Review of MoD PFI Projects in Construction and Operation," December 2005, p. 3, at [www.mod.uk/NR/rdonlyres/AB2251DB-7E36-42AA-872C-1F663828366E/0/pfu\\_op\\_review\\_051205.pdf](http://www.mod.uk/NR/rdonlyres/AB2251DB-7E36-42AA-872C-1F663828366E/0/pfu_op_review_051205.pdf) (January 27, 2009).

26. U.K. House of Commons, *HM Treasury*, p. 3.

27. *Ibid.*, p. 15.

28. U.K. House of Commons, Defence Committee, *Defence Equipment 2008*, March 27, 2008, p. 3, at <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmdfence/295/29508.htm> (January 16, 2009).

29. U.K. National Audit Office, *Allocation and Management of Risk in Ministry of Defence PFI Projects*, p. 24.

The fairest assessment, based on the currently available evidence, would seem to be that, while PFI has been used to move borrowing off the books and has not been administered effectively across the government as a whole, the MoD is one of the more competent PFI contractors. Yet this assessment should be validated by a thorough review either by the NAO or, preferably, by the Defence Select Committee.

### Other Questions About PFI

Such an assessment is particularly important because, contrary to the impression conveyed by most evaluations of PFI, the question of whether PFI is an efficient use of public funds is not the only one that can and should be asked. At least four others are equally important.

**Does PFI produce perverse incentives?** The MoD has shown a disturbing willingness to rig the bidding processes to ensure that it achieves its short-term financial goals. Particularly egregious was the 2003 privatization of QinetiQ, which advises the MoD on the procurement of equipment. QinetiQ was bought, in part, by the Carlyle Group. A 2008 investigation by the Public Accounts Committee found that:

The Department began the competition for a strategic partner when market conditions were poor and before the terms of QinetiQ's most significant contract had been agreed. It also eliminated the only trade bidder at a very early stage. These decisions weakened the competitive process for selecting a strategic partner....

The Department relied on Carlyle to design the incentive scheme but did not put safeguards in place to protect its interests.... QinetiQ's management were consequently

able to influence the design of their incentives before Carlyle were appointed preferred bidder.<sup>30</sup>

The committee also found that the MoD drove the sale forward because of an agreement with the Treasury that would credit the MoD's budget with £250 million if the sale was completed quickly.<sup>31</sup> Indeed, according to Lord Moonie, then Dr. Lewis Moonie and a junior MoD minister, the MoD was reluctant to sell, but "a combination of the Treasury [pressure] and the fact we needed the money for items in our budget persuaded us to go on with it."<sup>32</sup>

This privatization, which moved 8,000 jobs from the public sector to the private sector—and is thus responsible for 18 percent of the MoD's job reductions—shortchanged the taxpayer by £90 million and resulted in "QinetiQ senior management receiv[ing] £200 for each £1 they invested whilst the taxpayer received just £9."<sup>33</sup>

By itself, the MoD's handling of this sale was scandalous. However, in the broader picture, it demonstrates that programs that aim to promote efficiency can have the perverse effect of encouraging inefficiency if they reward departments for achieving arbitrary targets.

This is exactly the situation in the MoD today. The ministry is under pressure to save money because of procurement cost overruns. Over the past four years, the MoD was required by the Treasury to make efficiency gains of at least £2.8 billion.<sup>34</sup> Because PFI both takes debt off the government's balance sheet and is supposedly more efficient, the MoD has an incentive to use PFI, whether or not it is appropriate, to claim that it has achieved those gains.

Hence, the National Audit Office concluded that PFI "may present a temptation to public sector bod-

30. U.K. House of Commons, Committee of Public Accounts, *The Privatisation of QinetiQ*, June 10, 2008, p. 3, at <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmpubacc/151/151.pdf> (January 16, 2009).

31. *Ibid.*, p. 5.

32. BBC, "Qinetiq Deal 'Cost UK Taxpayers,'" November 23, 2007, at <http://news.bbc.co.uk/2/hi/business/7108444.stm> (January 29, 2009).

33. U.K. House of Commons, *The Privatisation of QinetiQ*, p. 5.

34. U.K. House of Commons, Defence Committee, *Ministry of Defence Annual Report and Accounts 2005–06*, December 13, 2006, p. 24, at <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmdfence/57/57.pdf> (January 16, 2009).

ies...to structure contracts so as to achieve off balance sheet treatment rather than the best possible value for money.”<sup>35</sup> Bluntly put, this means that the pressure to use PFI to conceal spending encourages officials to manipulate data to justify proceeding under PFI instead of through conventional procurement. The NAO prefers that PFI contracts be put on the balance sheet, but 62 percent of the MoD’s PFI contracts by capital value are off the balance sheet.<sup>36</sup>

In a previous report, the NAO found that more than half of the £781 million that the MoD claimed to have saved on procurement in 2005–2006 was actually redefinitions.<sup>37</sup> The same skeptical eye should be applied to the question of whether the pressure to achieve efficiencies and move expenses off the balance sheet has encouraged the MoD to use PFI and has affected the structure of its PFI contracts.

**Has the MoD used PFI to move jobs off its books?** One of the MoD’s proudest boasts is that it has cut tens of thousands of jobs. Official total civilian employment in the MoD has fallen from 133,300 in 1997 to 89,500 in 2008,<sup>38</sup> but the MoD also expanded its reliance on PFI during the same years. Like the government as a whole, PFI uses public money to pay for nominally private-sector jobs. The Treasury’s efficiency drive has put intense pressure on the MoD to reduce its civilian staff. This environment is tailor-made to encourage bureaucracies to produce results, regardless of how well those results accord with reality.

The MoD’s PFI contracts should be scrutinized to determine how many of the “eliminated” MoD jobs were merely moved into the nominal private sector.

To date, the Defence Select Committee has done a poor job of holding the MoD to account, both on the size and cost of its workforce and on PFI as a whole. In its most recent review of the MoD’s annual report, the committee said nothing of substance about PFI and applauded the MoD for reducing its staff.

It did not ask why, while the MoD’s civilian employment has fallen by 18 percent since 2004, the cost of that smaller workforce has increased by 15 percent. Nor was it concerned that the MoD’s expenditures on civilian wages increased almost twice as fast as pay for the forces between 2003–2004 and 2007–2008.<sup>39</sup> A thorough investigation of PFI might help to explain that paradox. It is significant that civilian employment in the upper pay grades and within the central MoD has expanded since 1997, while the lower grades have shrunk significantly.<sup>40</sup> Those grades include the jobs that can most easily be folded into PFI contracts.

The committee conducted a searching evaluation of only one part of the MoD’s employment practices. It expressed its “disappoint[ment] that the MoD only met two of its nine diversity targets in relation to civilian personnel.”<sup>41</sup> The committee adduced no evidence that the MoD discriminates against qualified job seekers.

Achieving an arbitrary ratio of diversity within the MoD is not relevant to national defense. The committee should perform the proper role of the House of Commons: examining the effectiveness, honesty, and efficiency of the government’s use of the taxpayer’s money. That includes scrutinizing the MoD’s reliance on PFI.

35. U.K. National Audit Office, *Financial Auditing and Reporting—General Report of Comptroller and Auditor General 2005–06*, February 9, 2007, p. 24, at [http://www.nao.org.uk/publications/0607/general\\_report\\_2005-2006.aspx](http://www.nao.org.uk/publications/0607/general_report_2005-2006.aspx) (January 16, 2009).

36. U.K. National Audit Office, *Allocation and Management of Risk in Ministry of Defence PFI Projects*, p. 13.

37. Ted R. Bromund, “British Defense Cuts Threaten the Anglo–American Special Relationship,” Heritage Foundation *Backgrounder* No. 2210, November 18, 2008, p. 9, at <http://www.heritage.org/Research/Europe/bg2210.cfm>.

38. U.K. Ministry of Defence, Defence Analytical Services and Advice, *UK Defence Statistics 2008*, 2008, Table 2.1, at <http://www.dasa.mod.uk/UKDS2008/c2/table201.html> (January 16, 2009).

39. *Ibid.*, Table 1.3.

40. *Ibid.*, Table 2.30.

41. U.K. House of Commons, Defence Committee, *Ministry of Defence Annual Report and Accounts 2006–07*, January 28, 2008, p. 21, at <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmdfence/61/61.pdf> (January 16, 2009).

**Does PFI reinforce inefficient procurement policies?** While the MoD has won praise for reducing the official size of its workforce, few observers believe that its procurement system is efficient. The procurement problem is complex, but many of the difficulties are the result of the fact that procurement decisions are often made for reasons that have little to do with value for money or military effectiveness, such as preserving British jobs or pleasing “partners” in the European Union. With preserving British jobs comes the need to buy British, which limits competition among bidders. The result is a backlog of increasingly expensive projects that has created a budget crisis for British defense.<sup>42</sup>

The Future Strategic Tanker Aircraft project illustrates many of these shortcomings. It will cost £391 million in 2017–2018, when it will be the MoD’s single largest PFI contract.<sup>43</sup> Instead of seeking to combine its buying power with that of the U.S. and other allied states, the MoD decided go it alone by developing an independent national solution. Even today, the MoD continues openly to dismiss calls for cooperation on air-to-air refueling capability.<sup>44</sup> The claim that fast and independent action was necessary for operational reasons is difficult to accept given that, although air-to-air refueling was first nominated as a potential PFI project in 1997, FSTA is not scheduled to deliver its first plane until 2011 or to complete deliveries until 2016.<sup>45</sup>

The MoD pursued a PFI solution because the limits imposed on its budget left it unable to purchase the planes outright.<sup>46</sup> The resulting competition was between only two bidders.<sup>47</sup> It is not uncommon for large defense procurement projects to attract a limited number of bids, because only a few companies in the world have the necessary expertise to compete. However, this implies that PFI may not be the best solution for large, complex procurement contracts—a conclusion that the U.S. reached in 2004 when the U.S. Air Force abandoned its effort to lease modified Boeing 767s as tanker aircraft.<sup>48</sup>

In 2004, Britain opted for the bid from AirTanker, a consortium of companies including the VT Group, European Aeronautic Defense and Space Company, and Rolls-Royce offering a version of the Airbus A330-200, over a bid from Tanker Transport Services Consortium (TTSC), composed principally of Boeing and BAE Systems, offering converted Boeing 767s. AirTanker will supply aircraft on a lease basis to the Royal Air Force (RAF) and be free to sell surplus capacity on the open commercial market. Owing to the complexity of the contract and turmoil in the global financial markets, the deal was not finalized until March 2008.<sup>49</sup>

The reasons why the AirTanker bid was chosen are complex. Nor was the decision in favor of the Airbus necessarily without merit, as shown by the

42. Bromund, “British Defense Cuts Threaten the Anglo–American Special Relationship,” pp. 11–12 and 17–19.

43. U.K. Treasury, “PFI Signed Projects List.”

44. U.K. House of Commons, Defence Committee, *Strategic Lift: Government Response to the Committee’s Eleventh Report of Session 2006–07*, October 12, 2007, para. 26, at <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmdfence/1025/102504.htm> (February 11, 2009).

45. U.K. Ministry of Defence, “Future Strategic Tanker Aircraft (FSTA) Questions & Answers,” July 25, 2008, at <http://www.mod.uk/DefenceInternet/FactSheets/ProjectFactsheets/FutureStrategicTankerAircraftfstaQuestionsAnswers.htm> (January 27, 2009); Craig Hoyle, “UK Signs £13 Billion Tanker Deal,” Flightglobal, March 27, 2008, at <http://www.flightglobal.com/articles/2008/03/27/222521/uk-signs-13-billion-tanker-deal.html> (January 27, 2009); and U.K. House of Commons, Defence Committee, *Strategic Lift*, July 5, 2007, para. 108, at <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmdfence/462/46202.htm> (February 11, 2009).

46. BBC, “Airbus’ £13bn MoD Deal Under Fire,” June 22, 2004, at <http://news.bbc.co.uk/2/hi/business/3830255.stm> (January 27, 2009).

47. U.K. Ministry of Defence, “Future Strategic Tanker Aircraft (FSTA),” at <http://www.mod.uk/DefenceInternet/FactSheets/ProjectFactsheets/FutureStrategicTankerAircraftfsta.htm> (January 27, 2009).

48. Major James L. Fisher, “The Tanker Conundrum: The Failed Lease of the KC-767 and the Acquisition Way Ahead,” U.S. Air Force, Air University, Air Command and Staff College, April 2006, at [https://www.afresearch.org/skins/rims/q\\_mod\\_be0e99f3-fc56-4ccb-8dfe-670c0822a153/q\\_act\\_downloadpaper/q\\_obj\\_8ee3856f-1b37-49be-9f71-8097941eb6a1/display.aspx?rs=enginespage](https://www.afresearch.org/skins/rims/q_mod_be0e99f3-fc56-4ccb-8dfe-670c0822a153/q_act_downloadpaper/q_obj_8ee3856f-1b37-49be-9f71-8097941eb6a1/display.aspx?rs=enginespage) (January 27, 2009).

U.S. Air Force's similar selection of the Airbus A330-200 in February 2008 after an exceptionally contentious competition.<sup>50</sup> Yet, as with most large aircraft contracts, performance was not the only criterion that mattered. From the start, the contest was perceived as a political competition between an Anglo-American solution from TTSC and a European solution from AirTanker.<sup>51</sup>

The British government has been a vocal supporter of both the European Security and Defence Policy and programs such as the Eurofighter and the Galileo satellite system, both of which were launched for essentially political reasons.<sup>52</sup> The Air-Tanker decision is open to serious criticism on operational grounds because it amounts to leasing eight aircraft for day-to-day use and paying for another six that are guaranteed to be available only within 30 days after they are requested.<sup>53</sup>

But the deal also fits into Britain's long-standing habit of subsidizing the European aerospace industry with military contracts to save British jobs and send signals within the European Union. This is a poor and expensive basis for procurement decisions. Then-Secretary of State for Defense Geoffrey Hoon identified the benefits to British industry as one of the factors that led the MoD to select AirTanker, which hints at the ways that inappropriate domestic and European factors influenced these decisions.<sup>54</sup>

The comments of David Ruff, a former PFI team leader at the MoD, reinforce the impression that PFI—and defense procurement as a whole—is less a means of efficiently acquiring assets than a disguised, inefficient industrial policy. In June 2004, Mr. Ruff, after claiming that he was “motivated by the MoD's self-proclaimed need to derive very best value for money,” acknowledged:

We have also seen a shift from the dogma of “PFI is the answer, now what is the question,” to a much more confident approach to procurement, as much intent on ensuring the UK's defence industrial base, as securing very best value for money.<sup>55</sup>

Just as serious are the delays that the PFI risk-transfer model imposes on the procurement process. As the MoD admitted, “industry needs to be very confident that they understand the requirement and how they are going to deliver it, and that does take a long time.”<sup>56</sup> This implies that PFI is, as one witness put it to the Defence Select Committee, “a good business for banks and lawyers”<sup>57</sup> and a poor way of meeting service requirements because of the expensive delays it creates.

Because its advantages rest in part on competitive tendering, PFI is most suitable for programs such as construction projects, where a well-developed civilian market and a large number of firms are

49. Hoyle, “UK Signs £13 Billion Tanker Deal”; BBC, “Airbus Lands £13bn MoD Contract,” January 26, 2004, at <http://news.bbc.co.uk/2/hi/business/3429111.stm> (January 27, 2009); and Sylvia Pfeifer, “RAF's 13bn Project That Nearly Never Was,” *Financial Times*, March 31, 2008, at [http://us.ft.com/ftgateway/superpage.ft?news\\_id=fto033120080024316277](http://us.ft.com/ftgateway/superpage.ft?news_id=fto033120080024316277) (January 27, 2009).

50. The U.S. Air Force was later forced to cancel the contract. “The USAF's KC-X Aerial Tanker RFP: Canceled,” *Defense Industry Daily*, September 10, 2008.

51. Philip Butterworth-Hayes, “Tanker Contract Opens European Fault Lines,” *Aerospace America*, April 2001, at <http://www.aiaa.org/aerospace/Article.cfm?issuetocid=73&ArchiveIssueID=12> (January 27, 2009).

52. Bromund, “British Defense Cuts Threaten the Anglo-American Special Relationship,” p. 19.

53. Hoyle, “UK Signs £13 Billion Tanker Deal.”

54. Geoffrey Hoon, “Future Strategic Tanker Aircraft,” written statement to the U.K. House of Commons, January 26, 2004, at [http://www.publications.parliament.uk/pa/cm200304/cmhansrd/vo040126/wmstext/40126m02.htm#40126m02.html\\_sbhd1](http://www.publications.parliament.uk/pa/cm200304/cmhansrd/vo040126/wmstext/40126m02.htm#40126m02.html_sbhd1) (January 27, 2009).

55. David Ruff, “Combining Forces Newsletter in the First Person,” interview, *Armed Forces International*, at <http://www.armedforces-int.com/categories/lex-defence-ltd-company-news/combining-forces-newsletter-first-person.asp> (February 13, 2009).

56. U.K. House of Commons, Defence Committee, *Strategic Lift*, July 5, 2007, para. 108.

57. *Ibid.*, p. Ev 32.

capable of doing the job and, hence, bidding on the contract. For major procurement projects, the limited number of bidders means that competitive tension is lacking. This reduces PFI's advantages in efficiency over conventional procurement while its contractual complexities remain. These complexities create delays, impose additional expenses, reinforce the British inclination to go it alone, and allow further scope for making procurement decisions on grounds other than cost and effectiveness.

**Is PFI foreclosing too many options?** Like any debt, PFI forecloses options in the future. Money that the MoD has committed to pay for its PFI contracts will not be available for other purposes. Labour's broader criticisms of PFI before 1997 were generally incorrect, but Alastair Darling, the current Chancellor of the Exchequer, was right to warn that the "apparent savings now could be countered by the formidable commitment on revenue expenditure in years to come."<sup>58</sup> The Defence Select Committee echoed that concern in September 2007.<sup>59</sup>

In 2007–2008, the MoD spent slightly over 3 percent (£1.2 billion) of its budget on PFI contracts.<sup>60</sup> This would appear to be a manageable proportion, but while £1.2 billion is not "formidable," it is also not negligible. The MoD's 2008 budget crisis centered on the government's determination to trim £2 billion from the 2009–2010 MoD budget.<sup>61</sup> In today's dangerous strategic environment, the MoD would be wise to retain as much budgetary flexibility as possible. To the extent that the MoD relies on PFI, it loses that flexibility.

### Lessons for Britain from the MHPI

The MoD's turn to PFI after 1997 has no exact parallel in the U.S. However, the U.S. does have the Military Housing Privatization Initiative (MHPI),

which seeks to improve the quality of military housing by attracting private-sector financing, expertise, and innovation.<sup>62</sup>

There is no one-size-fits-all model in contracting out, and the MHPI is not exactly comparable to most British accommodation projects for many reasons. One of the most important is that the MHPI focuses on military family housing, whereas some MoD PFI accommodation projects are barracks for single servicemembers. In Britain, most military family housing was privatized on a lease-back arrangement in 1996. This deal has been heavily criticized for leaving the MoD responsible for maintenance and for failing to generate funds to improve other MoD housing.<sup>63</sup> Nonetheless, the MHPI offers important lessons for British contracting out.

The problem that the MHPI set out to solve was threefold: personnel, facilities, and priorities. In its October 1995 report, the Defense Science Board Task Force on Quality of Life, commonly known as the Marsh Quality of Life Panel, argued that the quality of military housing was an important element in recruitment and retention of the all-volunteer force. The Marsh Panel also found that military housing was on average 33 years old; that "inadequate and inconsistent funding [has] resulted in poor maintenance and repair, and has deferred revitalization and replacement of unsuitable homes"; and that remedying the problem would cost at least \$20 billion.

Finally, military housing was always the last priority for funding and the first to be cut, which caused the deferred maintenance bill to grow to such massive proportions. Fixing military housing would require balancing the natural—and to some extent desirable—bias in favor of buying

58. Monbiot, "This Great Free-Market Experiment Is More Like a Corporate Welfare Scheme."

59. U.K. House of Commons, Defence Committee, *The Work of Defence Estates*, September 14, 2007, para. 35, at <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmdfence/535/53507.htm> (January 30, 2009).

60. U.K. Ministry of Defence, *Defence Statistics 2008*, Table 1.1.

61. Ted R. Bromund, "Britain's Armed Forces: Victorious Abroad, Imperiled at Home," *Heritage Foundation WebMemo* No. 2166, December 11, 2008, p. 1, at <http://www.heritage.org/Research/Europe/wm2166.cfm>.

62. U.S. Department of Defense, Office of the Deputy Under Secretary of Defense (Installations and Environment), "Military Housing Privatization," at <http://www.acq.osd.mil/housing> (January 27, 2009).

63. U.K. House of Commons, *The Work of Defence Estates*, September 14, 2007, paras. 50–57.

weapons against the need for regular spending on housing.<sup>64</sup>

The Marsh Panel found that “artificial constraints placed on the military housing delivery system prevent the Defense Department from taking full advantage of U.S. market efficiencies, run up costs and seem to serve no rational purpose.” It also criticized the financial rules that precluded using “innovative, creative methods to encourage or promote private-sector resource opportunities.”<sup>65</sup> The essential problem was that the Omnibus Budget Reconciliation Act of 1990 enforced the concept of the unified budget, first devised in 1967 by the President’s Commission on Budget Concepts.<sup>66</sup> The unified budget made it impossible either to move expenses off budget as Britain does through PFI or, as the panel pointed out, to access private sources of capital.

The panel’s recommended changes in this system were accepted, laying the foundations for creation of the MHPI. The prohibition on moving expenses off budget remains. All MHPI spending is “scored,” or accounted for, on budget, although the precise mechanisms for achieving this are subject to constant debate. Nor is the MHPI a single program: The Air Force, Army, and Navy work through it in significantly different ways, with oversight from the Office of the Secretary of Defense (OSD).

Yet the services’ different programs have important elements in common. The services either make a loan or form a limited partnership through an equity contribution to a contractor to support initial construction costs, which are partially financed through the private sector. Housing units are then rented by the contractor to servicemembers, who

receive a housing allowance from the funds that the services formerly would have spent to maintain the houses. Servicemembers can rent MHPI housing or use their allowance to rent outside the program through the private sector.<sup>67</sup>

Five aspects of this program deserve notice:

- **The MHPI’s primary purpose is not to save money**, though it is forecast to cost about 10 percent less than traditional methods of military procurement. Rather, it is a way to force the services to spend money on a dull but necessary commodity—military housing—that they traditionally have preferred to underfund in deference to more exciting items such as weapons systems. It produces a better product more quickly today and more reliably over time for slightly less money.<sup>68</sup> This is an important fact to bear in mind when evaluating British claims that PFI delivers value for money.
- **The MHPI preserves competition.** Because servicemembers chose their housing, the contractors have an incentive to be good owners. As conditions in the local housing market change, servicemembers can benefit from this change.
- **The MHPI is accounted for on budget.** In British terms, it is a public–private partnership, not a PFI.
- **The MHPI has layers of oversight.** Each service has built a core of experienced contractors, which is overseen by the OSD and the Office of Management and Budget.
- **The average MHPI project has approximately 2,000 units, which contains the risk if a project goes bad.** In Britain, the Allenby/

64. U.S. Department of Defense, Office of the Under Secretary of Defense for Acquisition and Technology, *Report of the Defense Science Board Task Force on Quality of Life*, October 1995, pp. 2, 19, and 15, at <http://www.acq.osd.mil/dsb/reports/qualityoflife.pdf> (February 12, 2009).

65. *Ibid.*, pp. 15 and 27.

66. James V. Saturno, “The Budget Enforcement Act: Its Operation Under a Budget Surplus,” Congressional Research Service *Report for Congress*, February 11, 1998, at <http://www.rules.house.gov/Archives/98-97.htm> (February 12, 2009); Larry DeWitt, “The Social Security Trust Funds and the Federal Budget,” Social Security Administration, Historian’s Office *Research Note* No. 20, June 18, 2007, at <http://www.ssa.gov/history/BudgetTreatment.html> (February 12, 2009); and U.S. Department of Defense, Office of the Deputy Under Secretary of Defense (Installations and Environment), “Military Housing Privatization: FAQs,” at <http://www.acq.osd.mil/housing/faqs.htm> (February 12, 2009).

67. *Ibid.*

68. *Ibid.*

Connaught project contains 18,000 units. If it went wrong, that single failure would taint about 17 percent of the MoD's 2017–2018 spending on PFI.

The MHPI has been a substantial, albeit not perfect, success. At a scored cost of \$2.7 billion, it has produced \$24 billion in capital spending on construction. Of course, this ratio reveals nothing about the overall cost of the program because the services will continue to pay into it for decades through the rent allowance given to servicemembers.

Nonetheless, the MHPI's record is impressive. As of December 2008, the MHPI had 94 projects involving more than 183,000 units. Almost all standard military family housing in the U.S. is currently under improvement through the MHPI. Recognizing these achievements, Congress made MPHPI legislative authorities permanent in the National Defense Authorization Act of 2004.<sup>69</sup>

The blot on the MHPI's record is the American Eagle fiasco, which came to light in 2007. American Eagle, a contractor for six MHPI projects with a total of 8,351 units, did not live up to its responsibilities, causing significant delays and financial losses. Investigations by both the Senate and the press strongly suggest that the firm should never have received a contract and that the armed services involved were too slow to recognize and remedy its deficiencies. The fact that American Eagle received its first contract in 2003, when the MHPI was successfully under way, demonstrates that the services should never allow contracting out to become routine. Standardization is desirable, but there is ultimately no substitute for a well-trained and alert contracting force.<sup>70</sup>

Both the MHPI's achievements and its failures offer lessons for Britain:

*First*, the primary reason to contract out is not necessarily to save money. Rather, it can ensure quicker and more reliable delivery of a superior product for about the same amount of money. Left-wing critics of PFI, with their enthusiasm for state spending, ignore the reality that budget processes are political and that important needs—including maintenance of existing infrastructure—often fall prey to their own demand for exciting and expensive new programs. On the other hand, British authorities should be more forthcoming about releasing the underlying data for PFI contracts and should acknowledge, as U.S. authorities do, that the advantages of public–private partnerships do not necessarily revolve around saving money.

*Second*, the MHPI shows that contracting out does not and should not depend on off-budget spending.

*Third*, the MHPI preserves competitive pressures, which help to ensure that both the Defense Department and servicemembers receive value for money. This is a significant failing of PFI, which often locks the MoD into uncompetitive, single-source, long-term contracts.

*Fourth*, the MHPI's failures came about through poor contracting and inadequate oversight. The same problem of competence in contracting has also vexed the MoD.

*Fifth*, the MHPI keeps projects relatively small to make oversight easier and to spread risk.

## How Great Britain Could Contract Out Better

The next British government should bear these lessons in mind when it considers the problems and virtues of contracting out in defense. Specifically, Great Britain should:

69. U.S. Department of Defense, Office of the Deputy Under Secretary of Defense (Installations and Environment), "Military Housing Privatization"; "Project Awards as of December 2008"; and *Military Housing Privatization Initiative: Program Evaluation Plan*, June 30, 2008, pp. 19–20.

70. Eric Nalder, "In Military Housing Disaster, a Whistle-Blower Awaits Vindication," *Seattle Post-Intelligencer*, August 7, 2008, at [http://seattlepi.nwsource.com/local/373921\\_militaryhousing07.html](http://seattlepi.nwsource.com/local/373921_militaryhousing07.html) (February 11, 2009); press release, "Senators Urge Changes to Air Force Housing Privatization Oversight and Management Process," Office of Senator Mark Pryor (D-AK), December 12, 2007, at <http://pryor.senate.gov/newsroom/details.cfm?id=288870> (February 12, 2009); and Wayne Army, statement before the Subcommittee on Military Construction, Veterans Affairs and Related Agencies, Committee on Appropriations, U.S. Senate, April 24, 2008, at [http://www.acq.osd.mil/ie/ie\\_fy09\\_posturestmt.shtml](http://www.acq.osd.mil/ie/ie_fy09_posturestmt.shtml) (February 12, 2009).



- **Not contract out when victory on the battlefield is at stake.** Contracting out can and should be applied where suitable. It is not suitable in cases like the FSTA program in which the state must make strategically risky decisions to write a commercially viable contract.
- **Not use contracting out to spend off budget.** Britain should follow the NAO's recommendations and place all PFI programs on budget. This would bring Britain closer to the U.S. system of unified budgeting. This system will not guarantee less government spending, but it would make it more difficult to conceal the financial implications of programmatic decisions.
- **Not use contracting out to conceal the growth of the state.** From Labour's point of view, PFI's great advantage is that it has allowed the state to supply more services than it has paid for in taxes or borrowing. However, this advantage is temporary and comes with serious disadvantages in the longer run. The problem is not contracting out, but that PFI has been used to expand the power and reach of the state.
- **Conduct a full and fair audit of all MoD PFI programs.** To date, no competent authority has fully assessed the value for money offered by many of the MoD's major PFI programs or how effectively they have been administered. The next government should immediately order such an assessment. It should buy out contract holders if it finds that conventional contracting offers better value. This assessment should take into account lessons from the U.S. and consider whether PFI creates financial, procurement, or strategic problems for the MoD.
- **End the practice of providing government financial support for PFI programs.** The fact that the Treasury is now providing financial support for PFI programs because the private sector

is unable or unwilling to do so means that the government has taken back the riskiest portion of the financial risk that it had sought to privatize through PFI. This makes nonsense of the entire PFI concept. If the private sector is not willing to fund a PFI program, the program should not be done through PFI.

### Principles and Lessons for the United States

Similarly, the U.S. can benefit by applying principles and lessons from Great Britain's successes and failures.

- **If the government is involved, risks cannot be wholly transferred to the private sector.**

The justification for placing most PFI projects off the balance sheet is that they transfer risk from the public sector to the private sector. In strictly financial terms and in normal times, this is correct. Yet as the American Eagle failure shows, political pressures will ultimately force the government to intervene if its private-sector partner fails.

Similarly, when market turmoil threatens the private sector's ability to secure the necessary funding, the government will eventually be forced to reassume the risk it thought it had handed off.<sup>71</sup> In the worst-case scenario, the government can be stuck with a PFI contract that privatizes risks and rewards for which it guarantees the financing and thereby takes back a substantial share of the risk.

That scenario is unfolding in Britain, as the government has set up the Infrastructure Finance Unit to enable PFI projects to proceed in spite of the financial crisis.<sup>72</sup> The bottom line is that, unless the asset in question is genuinely privatized, the idea that its associated risk can be transferred to the private sector—or that the government can have a hands-off relationship with its contractual partners—is a fallacy.

71. Polly Curtis, "Government May Have to Take on Risk of PFI Deals," *Guardian*, January 27, 2009, at <http://www.guardian.co.uk/politics/2009/jan/27/pfi-deals-bsf-government-underwriting> (February 11, 2009).

72. Philip Webster, "Chancellor to Rescue Public Works Projects with Billions in Bridging Loans," *The Times* (London), February 13, 2009, at <http://www.timesonline.co.uk/tol/news/politics/article5721261.ece> (February 13, 2009), and Michael Faehy, "Crain's Manchester Business: Waste PFI Rescued by First Investment from Treasury," *TaxPayers' Alliance*, April 20, 2009, at <http://www.taxpayersalliance.com/media/2009/04/craains-manchester-business-waste-pfi-rescued-by-first-investment-from-treasury.html> (April 27, 2009).

These dangers are particularly pressing when the purpose of the PFI project is to deliver front-line capabilities. For example, if the private sector fails to deliver on FSTA, it will lose money, but the RAF will be grounded. Of course, all spending choices in defense involve decisions about levels of acceptable risk, but extreme battlefield risk is ultimately incommensurate with financial risk to the private sector. The implication is that contracting out works best when the government has a financial stake in providing well-defined and essentially civilian assets, such as housing. It is not appropriate when the nation has a win-or-lose battlefield stake in the success or failure of the contract for a one-off military asset.

Congress and the executive branch, while supporting contracting out where it is suitable, need to resist introducing it where victory, not profit or loss, is at stake. The risk of defeat should never be transferred to the private sector.

- **The U.S. should take the lead in establishing best practices for contracting out.**

Policy initiatives from one nation often show up, a year or two later, in the other. In 1997, the U.S. began to privatize government-owned electric, water, wastewater, and natural gas utility systems; the U.K. followed in 2003.

However, the U.K. has usually been in the lead. Britain privatized much of its military family housing in 1996, and the U.S. launched the MHPI in the same year. In 2001, the U.S. considered—and ultimately rejected—a leasing plan for air tankers; Britain began to consider this option in 1997. In 2002, the U.S. abandoned its Joint Simulation System and started to consider pri-

vate-sector training solutions; Britain began to implement this approach in 1999.<sup>73</sup>

It is important not to exaggerate the similarities between the U.S. and Britain. The unified U.S. budget model will not allow, and should not be stretched to allow, PFI. Honestly accounting for costs of contracting out is essential, and this is a challenge the next British government must address. But the U.S. and Australia, which has its own successful program of military housing privatization run by Defence Housing Australia,<sup>74</sup> already consult regularly on military housing privatization. Just as Anglo-American information-sharing in recruitment and retention policies should be expanded,<sup>75</sup> so should both states seek to learn from each other about contracting out.<sup>76</sup>

The U.S. should take the lead by creating an office under the Assistant Secretary of Defense for International Security Affairs that, in consultation with the U.S.'s allies, would produce a best-practices guide to contracting out in defense and, with due regard to national circumstances, standardize government policies. The intent would not be to enforce uniformity, but to create a menu of recognized options from which states could select. In an era of international contractors—the top two MHPI contractors are based in Australia and London—this standardization would encourage competition in bidding and transparency in government.<sup>77</sup>

- **Contracts with the private sector require effective government contractors.**

Contracting out is not privatization because it does not reduce the government's responsibilities: It increases them. The government must

73. U.K. Treasury, "PFI Signed Projects List"; Philip W. Grone, testimony before the Subcommittee on Military Quality of Life and Veterans Affairs, Committee on Appropriations, U.S. House of Representatives, March 2, 2005, at [http://www.acq.osd.mil/housing/ct05\\_grone.htm](http://www.acq.osd.mil/housing/ct05_grone.htm) (January 30, 2009); and Christopher Paul, Harry J. Thie, Elaine Reardon, Deanna Weber Prine, and Laurence Smallman, *Implementing and Evaluating an Innovative Approach to Simulation Training Acquisitions*, RAND Corporation, 2006, at [http://www.rand.org/pubs/monographs/2006/RAND\\_MG442.pdf](http://www.rand.org/pubs/monographs/2006/RAND_MG442.pdf) (January 27, 2009).

74. Defence Housing Australia, "About DHA," at <http://www.dha.gov.au/about/about.html> (February 12, 2009).

75. Bromund, "British Defense Cuts Threaten the Anglo-American Special Relationship," p. 22.

76. For one example of Anglo-American cooperation, see Ellen M. Pint and Rachel Hart, *Public-Private Partnerships: Proceedings of the U.S.-U.K. Conference on Military Installation Assets, Operations, and Services, April 14-16, 2000*, RAND Corporation, 2001, at [http://www.rand.org/pubs/conf\\_proceedings/2007/CF164.pdf](http://www.rand.org/pubs/conf_proceedings/2007/CF164.pdf) (February 13, 2009).

77. Nalder, "In Military Housing Disaster, a Whistle-Blower Awaits Vindication."

decide what it wants to buy, negotiate the contract, and then—like any other buyer—ensure that the other party fulfills its side of the bargain. In short, government contractors need to be as capable as private-sector contractors. Given generally lower government pay scales, this is a demanding requirement.

The U.S. and British experiences with contracting out are not identical. In the U.S., much of the criticism has focused on contracting out in times of war, whereas most British contracting out has been behind the front lines. Yet in both nations, failure to staff a fully competent contracting force has led to criticism and inefficiency.

In Britain, PFI's shortcomings center around the government's inability to meet the negotiating standard of the private sector. In the U.S., the Special Inspector General for Iraq Reconstruction "found that shortage of personnel (and the widespread lack of required skill and experience among those available) affected all facets of reconstruction assistance."<sup>78</sup> The American Eagle failure shows that these shortcomings are not completely restricted to wartime contracting.

The U.S. Commission on Wartime Contracting, which is expected to issue an interim report in 2009, should study both the U.S. and the British experiences with care. By the same token, as Britain expands its use of PFI to improve its service accommodations, it should examine the MHPI, which has won praise from civilian and military authorities for its successes, despite the failure of American Eagle.<sup>79</sup>

The lesson of these experiences is that both the U.S. and British armed forces need better contracting forces.

*First*, each force should have the power and ability to decide when contracting out would be appropriate.

*Second*, as the examples of American Eagle and Iraq suggest, the skills and training of contracting officers should be improved.

*Third*, the forces need to emphasize continuity of practical experience and not allow officers to rotate so rapidly that knowledge is lost and responsibility is blurred, as occurs too often in Britain.

*Fourth*, this force needs to be overseen by improved auditing and be subjected to increased accountability for failures, both internally and ultimately to appropriate legislative bodies. It is striking that none of the problems uncovered by even the inadequate investigations of PFI in Britain have been followed by public disciplinary action.

- **Contracting out should promote efficiency and improved quality, not hide spending.**

The British experience with PFI offers a broader lesson for the U.S.: The only reason for government to contract out is that it has good reason to believe that the private sector will deliver a better service and deliver it reliably.

The British government has contracted out for many reasons that have little or nothing to do with this logic. Most important has been its desire to fund additional government spending by borrowing off the balance sheet. As a result, the British state expanded considerably. With the British economy now plunging into recession and less able to pay for the state's growth, the failure of this state-led economic model is now manifest.

The lesson for the U.S. is clear: Contracting out should be considered on its merits, case by case. However, it should never be used to justify spending that increases the size of the state while simultaneously concealing this growth.

Nor should the state resort to contracting out simply to obtain use of a defense asset without budgeting fully for it. If the asset is necessary for national defense, the budget should include it. To cut budgets and simultaneously demand the acquisition of assets poses unacceptable risks to national security and financial honesty.

78. Carafano, "Contracting in Combat: Advice for the Commission on Wartime Contracting," p. 4.

79. Geoffrey F. Segal, ed., "Annual Privatization Report 2005—Military Housing Privatization," Reason Foundation, January 1, 2005, at [http://www.reason.org/apr2005/military\\_housing.shtml](http://www.reason.org/apr2005/military_housing.shtml) (January 27, 2009).

## Conclusion

The problem with Britain's program of contracting out through the Private Finance Initiative is not that it involves the private sector. Nor is PFI a form of privatization, although that term is often wrongly applied to it. The problem with PFI is that the British government has used it for reasons unrelated to delivering value for money. The government wanted to spend more than it collected in taxes and was willing to borrow. It turned to PFI to square this circle.

The result is that PFI has financed a hidden and inefficiently administered expansion of the British state that will be a drag on British taxpayers for decades to come. While PFI has the potential to bring welcome improvements in government services, especially in areas with strong competitive

pressures, it has also created a series of perverse incentives for the ministries that rely on it.

The solution is not to reject contracting out, but to restrict it to the areas for which it is best suited. The government should preserve competition within it, avoid using it for any purpose other than improving the quality of the services the government delivers, account for it honestly, and recognize that it requires strong and effective administration precisely because it involves the government as a contracting partner. Britain and the U.S. should each learn from the other's experience, carry out the necessary investigations, and reform their contracting out practices.

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