

Public-Private Partnerships: The Relevance of Budgeting

by

Paul Posner, Shin Kue Ryu and Ann Tkachenko*

This article examines the budgetary implications of public-private partnerships (PPPs) and how to strengthen budgetary review, budget treatment, accounting and assessment of PPPs.

* Paul Posner is Professor of Public Administration at George Mason University, United States. Shin Kue Ryu and Ann Tkachenko are research assistants at the same university.

1. Introduction

Public-private partnerships have constituted a growing movement worldwide for at least the past decade. Countries have been seeking private partners to finance, manage and maintain infrastructure serving public purposes in a growing range of areas. Transportation, hospitals, prisons and schools are among the leading candidates for private partnerships.

A previous OECD report provided a comprehensive overview of the numerous public management and finance issues raised by this emergent tool of government (OECD, 2008). The issues addressed in that report included: definitions; trends; criteria for assessing economic viability; budget scoring and accounting treatment; and managerial and regulatory issues.

This article examines the budgetary treatment and issues raised by PPPs in more depth. Given the unique budgetary and accounting issues posed by privately financed capital services, the budgetary rules, institutions and procedures applying to these transactions warrant greater assessment.

This article examines the budgetary implications of PPPs, in particular the following questions:

- What are the issues posed by PPPs for central budget offices?
- How do such proposals affect near and longer-term fiscal targets and priorities?
- What approaches are currently in practice to budget for these partnerships and what are their implications for public finance?
- What budgetary strategies and processes should be considered by OECD countries to promote greater consideration of the short-term and longer-term affordability of PPPs with regard to each country's fiscal space and priorities?

The article draws from conversations with budget officials in seven OECD countries (Australia, France, Hungary, Korea, Portugal, the United Kingdom and the United States) and one observer country (Chile). In addition, the experiences of other countries both within and outside the OECD area are included, to highlight emerging budgetary practices and issues. This article also draws on a review of many reports and publications by individual countries as well as by multilateral institutions including the IMF, the World Bank, the InterAmerican Development Bank, the European Union and the United Nations.

2. Background on the use of public-private partnerships to finance capital infrastructure services

Countries have increased their reliance on public-private partnerships in recent years to finance capital asset acquisition and operation. While private firms have perennially been engaged in specific phases of traditional capital construction and servicing, public-private partnerships constitute a different tool to finance and deliver infrastructure and other forms of public capital.

Countries have stepped up their use of PPPs in recent years: PPPs have grown to comprise a portion, although not the majority, of capital budgets in the countries reviewed here. The United Kingdom has had the longest experience, with PPPs currently comprising from 10% to 15% of the capital budget in recent years. France and Korea have had similar experience, with PPPs comprising 20% and 15% of those countries' capital budgets respectively. Portugal reported the highest payments for PPPs, representing nearly 28% of the national budget or 9.4% of GDP; projects could add up to nearly 20% of GDP eventually. In the United States, on the other hand, PPPs are quite limited: the cumulative project costs of such partnerships that had been funded or completed by October 2006 totalled over USD 48 billion (in nominal dollars), a small share of the USD 1.6 trillion in public capital spending on infrastructure by all levels of government during a similar period.

Countries have many reasons for pursuing partnerships with the private sector to deliver goods and services. Much of the impetus is political in nature, arising from constraints on governmental roles and spending, whether from domestic policies, financial markets or regulatory measures such as the deficit and debt limits of the European Union. Some of the push is opportunistic: private provision attenuates the negative aspects of higher fees for services and gives the illusion of making public budgets look smaller, at least in the near term.

However, the principal analytical rationale is that the private sector can achieve equal or greater levels of service with lower costs than pure public sector provision. The private sector has incentives to achieve greater efficiencies than public agencies operating alone, thanks to the competition provided by healthy markets. In his theory of "creative destruction", Joseph Schumpeter attributes economic growth in free markets to a process where entrepreneurs introduce new technologies, new kinds of products, new methods of production and new means of distribution that make old ones obsolete, forcing existing companies to quickly adapt to a new environment or fail (Schumpeter, 1976). As will be discussed below, most countries have rigorous procedures to compare the long-term value-for-money prospects of private partnerships with purely public provision prior to authorising PPPs, and sometimes prior to determining the winning bids on PPP contracts. Since the interest charged to government is inherently lower than private finance, the cost savings for equivalent levels of service must be sufficient to overcome this natural public sector advantage.

Table 1 locates the various combinations of public and private roles in the delivery of public services. When acquiring and operating capital assets, the government traditionally uses a combination of public finance and some form of private delivery for some aspects of capital services. Typically, governments will contract for the design and construction of a major asset, such as a building or a highway, with highly specific public conditions and oversight. Once the asset is completed, the government often performs operation and maintenance functions with public employees. For instance, the Australian national government only uses private contractors to construct traditional government-owned capital.

Table 1. Public-private roles and tools

	Public finance	Private finance
Public delivery	Direct government	User fees
Private delivery	Contract	Vouchers, PPPs

Traditional capital infrastructure is financed entirely by government but is often provided through procurement contracts with private firms. The design and construction of school buildings or prisons, for instance, are often accomplished by the government financing a contract with a private company that builds the facility to government specifications. The operation and maintenance of capital projects following construction is typically done by government employees, although separate contracts can also be used. This arrangement obviously varies among countries. The role of the central government in providing infrastructure in federal systems such as Australia, Germany or the United States is often confined to providing public grants to states or localities who are the principal builders and owners of public infrastructure.

When compared to traditional capital infrastructure services provided by government, PPPs are characterised by several important differences:

- First, the private sector provides upfront financing for the costs of building and operating the asset. While the extent of the private role varies as discussed below, the government's role shifts from financing the building and operation of the asset to providing an annualised stream of payments to the private financing partner.
- Second, the private role in most PPPs goes beyond the design and construction of the asset, to also include its operation and maintenance. The comprehensive control of the asset from cradle to grave provides one of the major incentives that motivate private firms to complete the construction of the asset on time and within cost estimates. Delays and cost overruns will hamper the ability of the private partner to collect payments from the government or the public for delivering capital services.
- Third, the private sector bears a significant and appropriate portion of the risk that arises from project operation and management. Private sharing of risks is another critical factor in promoting efficiency gains from private partnerships. The following comprise many of the most important types of risks that can be present in PPPs, risks which under traditional government-owned capital projects are largely borne by the government itself (IMF, 2006, p. 12):
 - ❖ Construction risk: delays and cost overruns.
 - ❖ Financial risk: increases in financing costs.
 - ❖ Availability risk: threats to the continuous supply of capital services.
 - ❖ Demand risk: potential shortfalls in use of the asset by the public.
 - ❖ *Force majeure*: risks from natural or man-made disasters and war.

The OECD report on PPPs (OECD, 2008) went into depth on the factors involved in striking an optimal balance in sharing risks between public and private partners. As the crucible of efficiency gains over public sector provision, the nature and degree of risks borne by the private sector is a key factor for government officials in determining whether to engage in a PPP and how to price contracts to compensate private parties for increased risk.

Beyond the three defining characteristics discussed above, other design features are deemed to be critical for PPPs to realise their efficiency gains. Competition among bidders is crucial to enable the government to negotiate the best value at lowest cost. Competition encourages competing firms to create winning proposals that achieve public value at lowest cost. Competition can also ameliorate principal-agent problems by providing greater information to government officials about costs and outputs. The absence of

competition, in effect, can lead to the replacement of a government monopoly by a privately owned one, with all the costs and sluggish responsiveness that monopolies tend to bring in their wake (Donahue, 1989).

Closely related is the ability of a government to specify all of its major performance goals in the contract. Specifications that cannot be measured are often not met, leading to incomplete contracts which fail to achieve all significant public goals and objectives. While efficiency and output goals are easily specified, quality and equity considerations are notoriously resistant to measurement. When these and other difficult-to-measure considerations become more important in achieving public objectives, there is a stronger case for retaining government ownership and delivery.

3. Public-private partnerships for capital infrastructure services take various forms across countries

There are many forms through which public-private partnerships take shape. As the OECD report indicated, many variations of partnerships fill the broad space between government provision and full privatisation (OECD, 2008, p. 20). The private roles for capital asset creation and operation can include all or several of the following: design, build, operate and maintain. The private sector can either build a new asset or purchase an existing asset from the government. The private firm can own the asset fully or transfer it back to the government at a specified time. In all cases, the financing responsibility is shifted in whole or in part to the private sector, whether it is for construction or just for operation and maintenance. Box 1 contains a taxonomy of potential permutations of PPPs.

The most common form of PPP is “design-construct-manage-finance” (DCMF), in which the private sector finances, builds and operates the asset for a period of many years, often ranging from 20 to 50 years. Here, the government’s financing responsibility shifts

Box 1. Different types of public-private partnerships

There are many variations in the roles played by each partner in a PPP. A government may assign a greater or a lesser role to the private partner. The following list indicates possible roles that the private sector can assume:

- Build-own-maintain (BOM).
- Build-own-operate (BOO).
- Build-develop-operate (BDO).
- Design-construct-manage-finance (DCMF).
- Design-build-operate (DBO).
- Buy-build-operate (BBO).
- Lease-own-operate (LOO).
- Build-operate-transfer (BOT).
- Build-own-operate-transfer (BOOT).
- Build-rent-own-transfer (BROT).
- Build-lease-operate-transfer (BLOT).
- Build-transfer-operate (BTO).

from upfront payment of asset creation to the purchase of a stream of services that the private partner generates with the asset.

In the case of existing assets, the private sector in effect agrees to operate, upgrade and maintain the asset. This buy-build-operate model (BBO) is being implemented by several states in the United States. For instance, the Indiana Turnpike was purchased from the State of Indiana by a private consortium for USD 3.8 billion in exchange for a contract to operate, maintain and upgrade the highway for 75 years (United States Government Accountability Office, 2008).

Another closely related form of public-private partnership is the concession. A concession transfers the operation of an infrastructure service to a private firm which operates, maintains and finances the asset. Like a PPP, the private partner takes on certain risks specified in the contract, perhaps taking responsibility for a greater share of demand risk than traditional DCMF or other forms of PPPs. Unlike a classic PPP where the government pays the private partner an annual fee, however, the concessionaire pays a fee to the government for the privilege of operating the asset which remains the property of the government. Also, unlike a PPP, the concessionaire receives payment not from government appropriations but typically from user charges levied on the consumers of the asset – for example, highway tolls. However, governments in many cases subsidise and underwrite the risks of the concessionaire through such mechanisms as guarantees and other forms of contingent subsidies triggered by demand shortfalls.

While not defined as PPPs by most observers, operating leases and financial leases share some of the features of PPPs as well. Unlike PPPs, the government leases an asset from a private owner, either for a short time or for a longer period. However, leases have similar budget implications. In effect, they enable the financing of asset construction and operation with private rather than public resources, thereby circumventing upfront funding requirements and other disciplinary constraints in the budget process.

Financial leases are classified as a form of borrowing, since the government bears the risks. International Public Sector Accounting Standards and budget offices in some countries have rules that reclassify operating leases as financial leases based on the substance rather than the form of the transaction. The State of Victoria in Australia, for instance, classifies arrangements as financial leases based on the share of total asset costs financed by the government, the extent of the asset's useful life covered by the lease, and the provision for government acquisition at bargain basement prices (IMF, 2006, p. 22). In the United States, the Office of Management and Budget (OMB) has similar rules, and financial leases require the agency to record the budget authority for the lease up front rather than annually as lease payments are made (United States Office of Management and Budget, 2007).

The United States national audit office, now called the Government Accountability Office (GAO), found that federal agencies often sidestep the upfront funding requirements of the OMB financial leasing rules, by structuring their leases as short-term operating leases. The GAO found that such leases had the function of providing for long-term fiscal space needs, but generated a much higher cost to the government than government ownership or lease-purchase. To ensure that the underlying costs of competing asset financing options were compared on the same terms, the GAO recommended that all tools for financing long-term fiscal space needs be budgeted up front in agency budgets. When provided with a level budgetary playing field, the GAO concluded that there would be a

greater chance that the most cost-effective option to the government would be chosen (Posner, 1994).

Each of these forms of PPPs has its own unique attributes and consequences. What they have in common is upfront financing of asset construction or enhancement with private rather than public resources. However, these are not free resources. In return, the public sector must either provide annualised payments over a number of years to the private firm, or must provide the firm with concessions which permit it to use public resources such as land or to charge fees from the public. These annualised costs have budgetary effects for operating budgets rather than capital budgets. In effect, the costs of capital are converted from upfront payment to annualised payments.

4. The impetus for PPPs: infrastructure and capital budgeting

Public infrastructure, if well chosen and financed within appropriate fiscal constraints, can play an important role in economic growth. Public investment is important for economic growth, but only as part of a sustainable fiscal framework providing a stable long-term macroeconomic platform of longer-term growth, savings and sustainable commitments. The IMF provided a good overview of the criteria that should be used in considering public infrastructure spending proposals:

A proper assessment of the scope for increasing investment spending in any particular country requires a careful analysis of aggregate demand conditions, absorptive capacity, short-term financing constraints and medium-term public debt dynamics, as well as trade-offs with other types of expenditure in that country (International Monetary Fund, 2005, p. 4).

Government spending on infrastructure can potentially increase the stock of publicly owned capital and may improve the long-term productivity of the private sector and, in that sense, it represents an investment in the future productivity of the private sector. However, the economic payoff from public spending on infrastructure depends on the usefulness of the investments themselves and the extent to which the spending “crowds out” or reduces the funding available for investment in private capital. A recent report by the United States Congressional Budget Office (CBO) concludes that the relative payoff from infrastructure projects tends to be concentrated in the transportation sector and that additional infrastructure spending in other areas is more difficult to justify. Moreover, the agency noted that building new infrastructure is only one option for transportation; upgrading the condition of existing assets and employing congestion pricing to rationalise demands are strategies that may be more cost effective (United States Congressional Budget Office, 2008).

Significant backlogs exist in infrastructure across all countries. A recent World Bank study indicated that for the new EU member states – the so-called EU8 – major investments will be necessary to upgrade their infrastructure to match the levels in other EU countries. A 2004 study showed that EUR 500 billion would be needed during the next 15 years. Furthermore, the environmental investment needs constitute an additional EUR 47-69 billion (Budina *et al.*, 2007, p. 2). For the United States, the CBO concludes that growing delays in air travel and surface transportation, bottlenecks in transmitting electricity, and inadequate school facilities all suggest that some targeted additional infrastructure spending could be economically justifiable. Federal transportation agencies estimate that an additional USD 12 billion in highway funding and USD 4 billion in airport funding will

be necessary just to maintain current levels of service in the face of expanding populations and congestion (United States Congressional Budget Office, 2008).

In one sense, the presence of backlogs and unmet needs for infrastructure is not unusual. While resources are limited in the public sector, needs are relatively unlimited. Policy domains beyond infrastructure have their own inventories of backlog and unmet needs for government spending and other subsidies, whether they be affordable housing, child care for low income mothers, health care for uninsured or underinsured populations, or subsidies for university students. Advocates of spending characterised as “public investment” have asserted a presumptive place in budgetary priorities over pure “consumption” programmes, owing to the potential impact of investment in expanding the economy.

The rationale for public-private partnerships is in no small part predicated on the alleged bias against capital investment in most cash-based budgetary regimes. This central issue makes it important to better understand how political incentives and budgetary regimes interact and what their implications are for both the overall level of public capital investment and the choices of capital projects within the overall budget constraint.

Some would argue that capital spending can provide highly visible benefits to political officials to claim credit with their constituents for delivering specific benefits at the expense of the entire country. Some derisively label capital projects as “pork” and suggest that public officials, if anything, allocate too much infrastructure spending for specific local projects that have little national benefit. In the United States, for instance, earmarking of capital projects has grown exponentially in the past 20 years, as congressmen strive to favour specific projects in their districts to enhance their election prospects.¹ More broadly, public officials face a political asymmetry in the interest group system which one political scientist calls “clientele politics”. In short, groups that benefit from narrowly defined projects, such as certain capital projects, have greater intensity about claiming these specific benefits than the broader diffuse public that has to pay for the benefits. Thus, capital projects that concentrate benefits on narrow constituencies while spreading costs more broadly often constitute a winning political formula (Wilson, 1980).

Others argue that capital spending is disadvantaged in cash-based systems because funds for construction must be provided up front in the years when design and construction take place. The uneven, lumpy nature of capital spending makes it difficult to plan for such items in hard-pressed budgets (Premchand, 2007, p. 92). As the modern entitlement state has grown, mandatory items for pension and health care often crowd out discretionary resources such as capital, particularly in recent years when fiscal pressures to reduce deficits and achieve surpluses have become ascendant. Some argue for a separate capital budget freed of the constraints and trade-offs with operating programmes, in recognition of the importance that public investment plays for future growth. Robert Eisner, for instance, has long argued for borrowing for capital, given the rates of return that such programmes provide the country at large (Eisner, 1992). Countries such as the United Kingdom adopted borrowing as part of their fiscal policy, explicitly providing for deficit financing of the capital portion of spending. Countries that have switched to accruals point to the potential to smooth out spikes in capital funding as a distinct advantage of their approach.

In most budgets, countries budget for capital on a unified basis. This means that capital and operating accounts are allocated under the overall budget constraint in the same process. This has important macroeconomic and allocational advantages. Countries

ensure that their total budgets capture all significant outlays from the government in a given year affecting the near and medium-term economy, an important barometer for national economic policy. Countries can also assure themselves that all claims compete against one another within the ceiling of limited resources. Agencies are encouraged to assess trade-offs between capital and labour costs and to explore alternatives for achieving public policy goals from a range of capital and non-capital strategies.

Some countries have provided for a separate capital budget process. In some cases, this involves only separate displays or “pullouts” of capital accounts whose funding is determined through a unified process. In other cases, it may entail a separate budget cycle with its own separate budget constraint and targets. In some countries, such as the United Kingdom, capital budgets have a different fiscal decision rule than the rest of the budget. In the case of the United Kingdom, the capital portion of the budget is intentionally targeted to be in deficit in order to encourage greater building of infrastructure. Under the “golden rule”, the budget as a whole must be balanced over the business cycle, with capital deficits being offset by balances in other accounts in expansionary phases. In the United Kingdom, moreover, departments have separate budgets for resources (operating costs) and for capital for new investments.

The accounting treatment is also relevant to both the macro and allocation objectives of budgeting. Countries in cash-based systems generally require capital projects to be funded up front for traditional government-provided capital projects, since the cash flows for design and construction occur in the first several years of the project. This has the advantage of ensuring that public decision makers have to recognise the full construction costs of assets up front at the time when the irrevocable commitment to begin the project is made. Alternatives such as borrowing and depreciation stretch out the budgetary recognition over time to reflect the longer-term benefits and actual consumption of the asset. However, these alternatives fail to force decision makers to consider the full costs at the time they are in effect taking credit for the full benefits of the projects. This potential mismatch of benefits and costs may lower the incentives to carefully deliberate and compare specific capital projects as well as alternatives to achieving their goals through non-capital means such as congestion pricing.

In addition to cash, some countries budget for the total commitment that is encumbered by programmes in the budget. This may be similar to cash outlays for salaries and expense accounts and social services, but it can be very different in timing for capital projects. In the United States, budgets are prepared on both a cash and obligations basis. Budget authority is appropriated by the Congress to provide agencies with the formal legal authority to commit the government to actually expend cash. For capital projects, the OMB requires the budget authority to cover the full costs of building the asset, even though the cash for design and construction may spend out over several fiscal years. This upfront commitment is similar to the capital budget accounts in the United Kingdom and to the new French system which requires parliamentary approval for commitments that involve future payment.

The several countries with accrual budgeting use a different accounting system for capital projects. In these countries, the costs of capital are not budgeted up front, but rather paid over time through a depreciation charge to reflect the consumed cost of that asset in each year. While some assets such as national “Crown assets” are excluded from this regime, agency-owned capital is largely budgeted on an incremental, annualised basis.

New Zealand is the only country that awards funding for depreciation, providing agencies with a funding source to acquire new capital assets. In the United Kingdom, the budget uses cash-based or near cash-based accounts which differ from resource accounts prepared according to generally accepted accounting principles (GAAP).

Accrual-based systems can smooth out capital funding and overcome the spikes associated with cash-based budgets. In cash-based systems, the requirement to assemble sufficient authority or cash becomes challenging and may discourage governments from undertaking important capital projects. However, absent other controls, accrual-based approaches do not provide the discipline of upfront funding. As a result, the government becomes committed to new projects without being forced to budget for the full costs of those commitments. While accrual-based countries do have separate approval processes for projects exceeding certain thresholds, nonetheless at the agency level these projects do not have to compete on a full cost basis against other priorities for limited funds. Those countries that enable agencies to use depreciation as the source for new capital funding have experienced measurement and allocation problems; depreciation is not easily calculated for certain assets, and the government can lose control and flexibility to reallocate to agencies with greater relative needs (United States Government Accountability Office, 2007).

Countries with cash-based budgets have developed various strategies designed to overcome or mitigate the spiking problems that are said to discourage public infrastructure budgeting. Some of the strategies are internal to the government itself. In some cases, funds have been used to accumulate resources over several years from components within or across agencies to enable larger projects to be undertaken. In other cases, incremental budgeting occurs, where agencies build projects in discrete stages designed to reduce the marginal impact on budgets in any one year.

Notwithstanding the particular budgetary concepts and systems used for capital projects, countries that wish to increase the level of public infrastructure have heretofore had a limited and politically painful set of options. They can:

- raise taxes;
- levy or increase user fees;
- cut spending elsewhere in the budget;
- borrow;
- reduce or manage demand.

5. Assessment of the implications of PPPs for resource allocation

Given these difficult options, private financing has become more alluring as an option for public officials to fund increased infrastructure services. Public-private partnerships have obvious economic and political advantages. This section reviews the budgetary implications of PPPs to date, bringing in various other dimensions that have a bearing on the budgetary costs and consequences of these projects. First, the efficiency record will be reviewed: those PPPs that achieve greater efficiency and cost savings than comparable publicly financed projects may ultimately provide greater fiscal space and flexibility, as the government is able to reduce the costs of building and delivering capital services. Conversely, if PPPs increase costs, then budgets are more encumbered than otherwise. Second, the aggregate fiscal impact will be examined: even if individual projects achieve greater value for money relative to conventional public capital (*i.e.* “relative affordability”), it is possible that

the budgetary treatment of PPPs may prompt a government to fund more projects than it can afford under intertemporal budget constraints (i.e. “absolute affordability”).

5.1. The efficiency imperative

PPPs have clear potential to promote greater efficiency and possible cost savings by involving the private sector. To achieve value for money in comparison to traditional capital, private efficiency must be sufficient to overcome the extra financing costs of using private interest rates and transaction costs. Assuming effective competition, risk sharing and contract metrics, a PPP might motivate a private partner to reduce lifecycle costs through higher construction standards, more frequent maintenance, or investments in cost-saving technology. Efficiencies also could result if a private entity charged prices that were more closely aligned with costs, thereby reducing inefficient demands for services.

The comprehensive nature of contracts which include construction as well as operation and maintenance can have several salutary effects. First, this can ensure a level of funding for maintenance over the long life of PPP contracts, thereby providing for improved infrastructure operation and repair when compared to traditional public provision where maintenance is often the first item to be cut in periods of budget austerity. Moreover, the bundling of capital construction and operation and maintenance provides important incentives to private firms to complete construction earlier and with higher quality since this will bring the asset into service more quickly, thereby earning annual income through either fees or government payments.

PPPs, in fact, have shown some early gains in construction timeliness and costs. The United Kingdom National Audit Office reports that PPPs are delivered on time and on budget more often than traditional arrangements. Traditional infrastructure is on time and on budget 30% of the time, while PPP projects are on time and on budget over 75% of the time (Hodge and Greve, 2007, p. 549). Michael Pollitt also concluded that PPPs deliver on time and on budget a higher percentage of the time. While public agencies could do this too, they needed PPPs to stimulate and innovate (Pollitt, 2005). Beyond this, some studies have shown that PPPs were less costly in the United Kingdom for prisons and roads. The National Audit Office estimated that a sample of projects studied in the 1990s experienced cost savings of 10%, attributable to risk transfers from public to private firms (Hodge and Greve, 2007).

In the aggregate, cost savings are achieved through PPPs only if their efficiencies outweigh the higher financing costs and transaction costs that private financing and partnerships inevitably bring. Real cost savings can also be achieved if PPPs enable public officials to impose user charges by shifting potential blame from themselves to the private firms now responsible for managing the asset. Indeed, Portugal was able to impose additional fees for road projects once it became apparent that annual shadow toll payments were insufficient to finance the costs of the private partner under the transportation PPP (Monteiro, 2007).

Yet it is unclear whether value for money has actually been achieved. While the promising evaluations discussed above suggest that project management of the construction phase is more efficient, it remains to be seen whether these projects will ultimately deliver greater value for money than conventional government provision and financing. OECD countries have only invested in PPPs over the past ten years; the United Kingdom, a forerunner, began significant activity under the PFI formulation (private finance initiative) only in the

mid-1990s. Given the long-term nature of contracts, it remains to be seen whether these projects will ultimately deliver greater benefits at lower costs. A recent comprehensive review of international experiences concluded that the efficacy of PPPs is still subject to debate; insufficient research has been undertaken to date (Hodge and Greve, 2007, p. 552).

Some studies suggest that the long-term costs may be higher than traditional government provision when transaction costs and higher private financing charges are taken into account. Transaction costs for PPPs can be higher than traditional procurement; one study suggests that bidding costs represent 3% of total project costs. Moreover, public bodies are often required to compensate the costs incurred by reserve bidders in order to promote competition. Advisory costs can also be significant, amounting to over 5% of contract costs (Marty, 2008a). Shaoul's work provides evidence of flawed value-for-money appraisals, with arbitrary risk transfer allocations that tip the balance in favour of PPPs but that are not sustainable in real-world policy making (Shaoul, 2005). Case studies of PPPs in Canada suggest that governments have found it difficult to reduce either their total costs or their budgetary risks by transferring revenue risks to private partners (Vining and Boardman, 2006). Even where cost savings are achieved, the private sector will have an incentive to realise higher private sector returns in the first instance rather than lower public sector costs.

Classic public management problems complicate the implementation of PPPs and undercut their ability to deliver on their promises of efficiency. Agencies that deliver services directly with their own employees have certain accountability advantages: transactions are internalised within hierarchies that are more cohesive and responsive to central leadership (Lehman, 1989). Obvious challenges are presented when the government must use independent actors it does not fully control to achieve its goals, especially since, as Don Kettl has noted, transferring the work to someone else does not relieve the government of responsibility for the performance (Kettl, 1989). Private partners have independent bases of political power and goals and interests that may conflict with those of government agencies. Fundamentally, public-private relationships are consequently best characterised as bargaining relationships in which both partners have independent sources of leverage over the other. Classic problems include (Posner, 2002):

- Goal conflict: The differing priorities and accountability chains of private and public actors can compromise efficiency and distort the goals themselves, becoming manifest in excess profit taking and failure to achieve public objectives.
- Principal-agent problems: Principal-agent theory tells us that agents enjoy influence by virtue of their inside knowledge about their own behaviours and motivations (Arrow, 1991). Thus, when shortfalls are experienced or costs increase above targets, it is difficult for the government to challenge the private partner due to the latter's control of information about their costs and programme operations.
- Limited competition: These information asymmetries can be offset by competition which provides principals with greater information from multiple agents competing for a contract. However, for many PPPs, competition is limited, partly owing to the large amounts of private capital that must be assembled to finance infrastructure projects. PPPs in the United Kingdom have an average of only three bidders per contract (OECD, 2008, p. 78).
- Rent seeking: Government contracts can draw opportunistic private firms that seek to gain excessive profits and incomes, which can undermine the efficiency goals of PPPs.
- Moral hazard: The more a project embodies a public good, the less the government will be able to let it fail, regardless of formal allocations of risks in contracts. In particular,

when demand shortfalls occur, the government has stepped in to bail out projects that have become financially unviable for the private partner. This undermines efficiency: i) governments lose leverage since private partners know that a government will provide a safety net; ii) private partners can shirk their responsibilities and avoid making tough decisions in the interests of efficiency, safe in the knowledge that the government will not let them or the project fail.

- **Interdependency:** Both actors become dependent on the other to achieve their goals. While this situation can be productive, it can also make the government wary of imposing sanctions or other forms of discipline related to a contractor's performance, in fear of the possible impacts on the contractor's ability to deliver services to clients.

The traditional advantages enjoyed by contractors become accentuated with long-term contracts under PPPs. Contracts that are short term can be reviewed, changed and renewed, but long-term contracts increase the stakes and fortify the position of the contractor who gains expertise and a monopoly over production and over resources. The long time periods make it difficult for governments to write detailed specifications and conditions, leaving important issues to be resolved in subsequent negotiations during the long implementation phase. It has been observed that long-term contracts erode competition as governments become more dependent on the contractors' expertise and familiarity. It is inherently difficult to keep contractors in a state of "healthy insecurity" fostered by a robust and competitive marketplace over long periods of time. Contractors often have an incentive to underestimate their costs in original contracts, leading to large overruns as the project evolves. Chilean officials indicate that contract changes for concessions resulted in payments that were 35% higher than original estimates.

Since the cost effectiveness of PPPs depends in no small part on the transfer of risk, it is important to note that, regardless of the formal terms of the contract, governments face asymmetrical risks owing to their abiding interest in continuing with the provision of the capital service. A government is often left with a disproportionate share of the demand risk, but it is difficult to anticipate this at the outset of the contract, leaving the government with uncompensated costs. In effect, governments face uncertainty beyond risk – uncertainty that is difficult to price in PPP contracts or to record as liabilities or even contingent liabilities in the balance sheet. For instance, Portugal's initial contract for suburban rail service – the Fertagus contract – transferred risk to a private provider but stipulated that the government should assume risk if traffic was lower. When this materialised, the contract was renegotiated with the government in a weaker bargaining position.

When a project is too big or important for a government to let it fail, a fundamental discipline of the market which causes private firms to be more efficient – the prospect of market failure – may no longer be influential. If a government is perceived to stand behind the venture, then the project is really public rather than private, and a moral hazard could arise if the private firm realises that it faces no liability from demand failures. It has been said that public-private partnerships have the effect of privatising profits while socialising losses.

This is not to say that private partners do not also face risks as well; indeed, it appears that many PPPs successfully transfer risks for construction and availability. However, private firms can anticipate these risks and adjust their price during contract negotiations. Moreover, the private firm's risks, while greater than traditional procurement, need to be compared with other forms of investment. Some analysts suggest that the alliance with government provides

rent-seeking opportunities, as the guaranteed payment stream strengthens the market position of private partners in dealing with banks and other investors.

In effect, the boundaries between public and private become blurred. As the government becomes more reliant on the private partner to deliver essential public services, the relationship becomes more of a collaborative one of mutual dependence than a competitive or arm's-length relationship such as in traditional procurement. The private firms become dependent on a steady payment stream and business opportunity while the government becomes dependent on the firm as a monopolistic service provider. While both parties can gain, each also loses some of the value that makes them unique and valuable partners. The government loses control over the production of public services, surrendering a portion of control to the private firm that has different interests than government agencies. Private firms lose their competitive edge, as they no longer have to face the discipline of the market. At some point, the private firm becomes functionally similar to a government agency, particularly if it is "too big to fail".

While there is no single bottom-line answer to the efficiency question, there is reason to believe that PPPs outperform traditional government-financed capital in the construction phase, but that this advantage may not be sustained in the operational phase (Renda and Schrefler, 2006). Once the contract has been issued, the government loses leverage. Once the contract is under way, competitors fade away, leaving the government to work with a single contractor.

5.2. The fiscal imperative

The different budget treatment of PPPs compared with traditional public financing also explains their growth as a public infrastructure tool. As will be discussed further below, the private financing of upfront capital investment often means that PPPs do not encumber near-term budgets in the same way that traditional publicly funded capital projects do. As a result, PPPs can enable governments to fund more infrastructure projects earlier than under traditional public capital investment processes within existing deficit or fiscal constraints. One consulting company report summarised the opportunistic case well:

Because individual projects become more affordable, the public sector can afford to procure a greater number of projects in aggregate, financed over a realistic long-term period (PricewaterhouseCoopers, 2005, p. 18).

PPPs carry important political benefits for public officials under pressure to reduce spending to meet fiscal targets. Fiscal pressures were a prime consideration for using PPPs in some of the eight countries studied. Budget officials in Hungary, for instance, said that bringing the deficit under the 3% target has been critical since its entry into the EU in 2003. When compared to traditional government capital investment, PPPs are a strategy to undertake capital projects with minimal impact on the deficit.

The argument above that PPPs do not have immediate budgetary consequences is a political and perceptual point, but not a substantive one. By assigning financing to the private sector, initial costs do not appear in budgets at the outset of projects. As a result, projects can appear to be far cheaper than they really are. In fact, PPP projects shift the costs from the capital portion of budgets to the annual operating budgets for years to come. This shift appears to free up near-term fiscal space, but at the expense of long-term fiscal space. In a triumph of form over substance, PPPs succeed politically through budgetary

alchemy: costs do not disappear; rather they become less immediately obvious through stretching and amortisation.

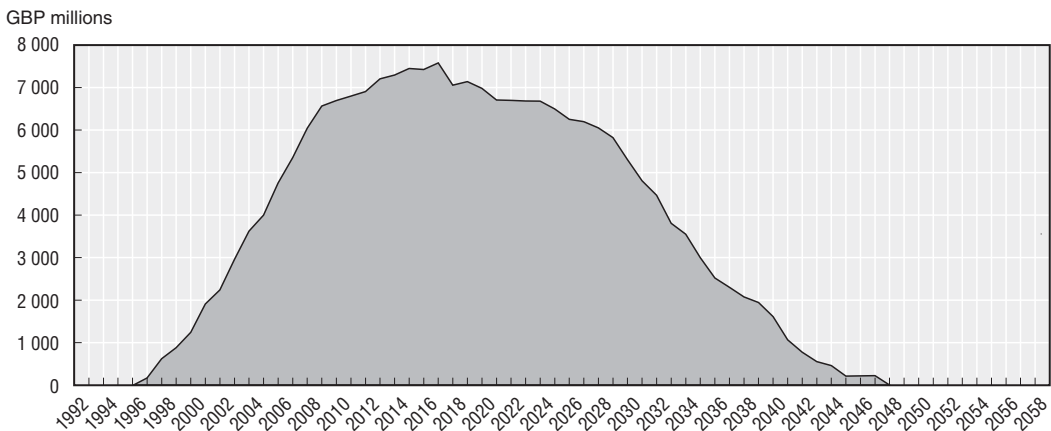
Once choices are made to appear less costly than they really are, the prospects increase for the distortion of priorities and for higher long-term spending within national budgets. Fiscal and allocation risks and distortions occur when there is a mismatch between benefits and costs for projects. In the case of PPPs, benefits can be claimed in the near term while costs can be spread beyond the immediate political horizon. This creates greater potential for several budgetary consequences:

- Higher levels of capital can be funded than can be afforded given current and long-term budget constraints.
- Costs can be shifted to future budgets, placing greater burdens on future generations of taxpayers and public officials.
- Lower-value projects can be selected due to the lack of upfront budgetary recognition of full costs.

The decision to launch a PPP today serves to encumber future budgets for years to come with required annual payments. As a result, a government's ability to adapt to emerging priorities or to fund competing needs is correspondingly constrained. In effect, these mandatory payments further reduce the ability of governments to use spending cuts or shifts as instruments of countercyclical economic policy.

The long-term shift of costs is clearly shown in the United Kingdom. Thanks to the transparent budgetary information from the United Kingdom, it is possible to illustrate the long-term impacts of current PPP commitments (called private finance initiatives – PFIs – in the United Kingdom). Figure 1 shows the annual payments due for all PFI projects launched in recent years. For each PFI project, a series of annual payments, known as the unitary charge, encumbers future budgets for over 20 years into the future. Figure 1 shows that payments begin to subside in about 15 years, but this assumes that no further PFI projects will be initiated when, in fact, the government is continuing to use this tool. United Kingdom Treasury officials indicate that annual PFI charges for larger local governments have grown to encumber 25% of future operating budgets.

Figure 1. **Long-term payment projections for PFI projects in the United Kingdom (GBP millions)**



Source: HM Treasury (2008), "PFI Signed Projects List", www.hm-treasury.gov.uk/ppp_pfi_stats.htm.

Notably, the growth of these annual PFI payments corresponds with the growing fiscal pressures faced by the United Kingdom, along with other advanced countries, as a result of the retirement of the “baby boom” generation. Not only will spending on pensions and health care be higher, but economic growth will be slower due to slower growth of the workforce. Notwithstanding these other fiscal trends, these annual PFI unitary charges constitute mandatory payments that must be allocated each year pursuant to the long-term contracts supporting each PFI. While the government can attempt to renegotiate the contracts as technology or fiscal constraints change, the private partner would have to agree.

Importantly, budgetary distortions can occur even when the investment is well chosen and represents value for money. There are limits in any budget to funding even effective projects and programmes. At some point, capital spending crowds out other types of spending, and long-term budget constraints can be undermined as well.

Most OECD countries have focused considerable analytic attention on comparing PPPs with traditional government-owned capital prior to authorising new PPP projects. This focus on what can be called “relative affordability” is commendable and represents real progress. However, countries also need to focus on “absolute affordability”, *i.e.* the point at which even projects surviving value-for-money trade-offs exceed some budget constraint. Affordability criteria are not as well institutionalised as value-for-money comparisons. One study of the PPP for financing the London Underground found that affordability was not formally considered, leaving the project with a more than GBP 500 million gap (Shaoul, 2002).

PPPs may also carry allocation risks. By sidestepping the upfront allocation of budgetary resources, PPPs may enable lower-value projects to gain funding. When the full costs of irrevocable decisions committing public resources do not have to be budgeted out of scarce resources at the front end of projects, chances increase for the funding of lower-priority projects that would not survive in a more constrained and disciplined process. In Portugal, while traditional government capital projects must compete against a resource constraint, this is not the case for PPPs, opening the door for funding lower-value projects. Officials in the United Kingdom also report that low-value projects can be supported when PPPs are off the balance sheet and therefore not formally considered in the capital budget on an upfront basis.

Hungary’s experience illustrates how budgeting for PPPs can lead to low funding of capital projects that have lower value. In 2003, the Ministry of Education obtained a government licence allowing schools throughout the country to obtain funds to build university housing. Under the PPP framework, universities were automatically eligible to claim approval and funding. A pilot project at the University of Debrecen was followed by 11 similar PPP schemes in other universities. As a result, substantially more housing was built than needed; some of it is now being used for unrelated purposes.

6. Budgeting processes and practices for PPPs

The foregoing suggests that PPPs are not only challenging managerially but also give rise to problems of budget control and accountability. Budget formulation and accounting processes play critical roles in determining the impact that PPPs will in fact have on fiscal policy, resource allocation and public management. This section examines the specific nature of budgetary processes applicable to PPPs, drawing from the eight case studies reviewed in this study. The following specific questions will be addressed: i) whether PPPs are on or off budget; ii) when they are included in the budget, how PPP costs are recorded

there; iii) whether and how PPPs are included in longer-term expenditure frameworks; iv) whether specific limits apply to PPP outlays or commitments; v) the degree of legislative oversight and review of PPPs; and vi) whether and how guarantees and other subsidies provided for PPPs are recorded in budget totals and documents. Wherever possible, a comparison will be made between the processes used for PPPs and those applicable to traditional government-owned capital assets.

The implications of PPPs for the budget are pervasive, if not obvious. The specific public sector costs that have a bearing on current and future budgets include:

- Annual payments for the life of PPP projects.
- Capital contributions to establish PPPs.
- Revenue losses from forgoing user fees.
- Contingent liabilities such as guarantees.
- Tax expenditures such as accelerated depreciation taken for private investment.

The first question is whether the PPP costs are recognised in the budget at all. Unified budget principles call for all significant government financial commitments to be included in a comprehensive budget. Such documents are not only useful for fiscal policy, but ensure that transactions involving government resources all benefit from common guidance and controls. If the PPP is off budget, then none of the budgetary controls that can promote fiscal discipline and accountability for PPP decisions are applicable. Moreover, government officials will be tempted to disproportionately rely on those techniques even if they are more costly. The treatment of PPPs in financial accounting statements often plays a major role in determining whether the transactions will be recorded in the budget. If PPPs are defined as private rather than public assets, they are not accounted for on the government's balance sheet or counted as part of the public debt.

Accounting standards vary across countries, and there are no internationally recognised standards for accounting and reporting in place for PPPs. Countries in the European Union are guided by a decision of Eurostat which governs the statistical data on government expenditures that member states must report for purposes of compliance with EU fiscal rules. This guidance recommends that PPP projects be classified as nongovernmental if the private partner bears the construction risk and either the availability or the demand risk – a characteristic that most projects can easily meet. This 2004 ruling has given rise to concerns that PPPs would be disproportionately classified as nongovernmental, enabling governments to more easily comply with the EU deficit and debt limits. However, countries can and do go beyond this guidance in adopting their own accounting definitions and guidelines to govern the treatment of PPPs for internal budgetary and policy-making deliberations (see Box 2 for an example).

Budgets need not reflect or mirror accounting standards and definitions. After all, many budgets are cash based even though their financial accounting statements are prepared pursuant to accrual-based standards. However, for PPPs, accounting standards play a formative role in determining budgetary treatment. In the United Kingdom, PPPs that are off the balance sheet are not included in the capital budget and are thus not part of the budgetary totals recording capital investment. However, annual unitary payments to PPPs are on budget, regardless of the project's status as on or off the balance sheet. If the London Underground is excluded, most United Kingdom projects are off the balance sheet; only 13% of PPPs, representing 46% of the total value, are recorded on the balance sheet

Box 2. Eurostat's decision on the accounting treatment of PPPs and the emergence of a dual PPP investment record system in France

A decision of Eurostat in 2004 mandates that assets involved in a PPP should be classified as non-governmental assets – and recorded off the government balance sheet – if the private partner bears the construction risk AND the private partner bears at least one of either the availability or the demand risks. In all other cases, assets are classified as government assets.

France records all investments in contracts before project implementation starts. Yet not all risks are estimated at the time of contract preparation, which makes it impossible to determine whether a project will be off or on the government balance sheet. As a result, the French government prepares two budgetary documents:

- External documentation presented to Eurostat. These documents do not include PPPs that do not meet Eurostat's risk transfer requirements.
- Internal documentation that includes all PPPs in a balance sheet, whether both risks are transferred to a private party or not. The balance sheet determination for internal purposes is based on which party has control of the project. Given the difficulties and uncertainties of allocating risk, the government decided that the presumption should be given to recording PPPs on the balance sheet.

As a result, the visibility of PPP investments in France is higher in internal budgetary documents than in those presented to Eurostat.

(Marty, 2008b). Experience varies by department: 100% of health care PPPs are off the balance sheet, as are 36 of the 47 defence projects. In Hungary, most PPPs are also recorded as off budget, leaving only the annual payments in the budget.

The budgetary inclusion of concessions varies among countries. In France, concessions are not defined as PPPs and are considered private assets since all risks are formally transferred to the private partner. Portugal includes its concession PPPs as part of the balance sheet, in view of the government subsidies for these projects. However, the commercial-status government agencies are exempted from budgetary controls and information presented on PPPs in the budget. These include projects sponsored by the highway department, which is no longer a government agency but a privatised governmental body funded by user payments.

Budgeting for all financial commitments up front is often viewed as essential to ensure that decision makers can fully consider all known costs at the time that irrevocable commitments of government resources are made. Most of the countries in this study, however, do not require agencies to budget for the full costs of PPPs up front at the time that the commitment of the government is made. Hungary, Korea and Portugal, for instance, only budget for PPPs once the annual charge is payable. This gives rise to a perception that PPPs are zero-cost projects. The annual charges are only recognised and paid over time rather than up front. Moreover, the annual charges are reflected in budgets only several years after the project is authorised and construction has been completed. Thus, the budget reflects the costs of PPPs on a much-delayed basis, far after the fundamental decision has been made.

The budgetary recognition of private engagements differs from traditional government capital projects. Since most countries budget on a cash basis, agency budgets must reflect the estimated cash needed up front to finance design and construction costs, concentrated in the first or second year of funded projects. Accordingly, there is greater upfront recognition for

traditional government capital than for PPPs. However, unlike PPPs, there is no comprehensive accounting for the lifecycle costs including design, construction, operation and maintenance over the lifecycle of the asset. Rather, budgets for operation and maintenance are developed on an annual basis during the entire life of the project.

Another important long-term difference between PPPs and traditional capital involves the nature of the annual payments supporting capital projects. For traditional capital projects, the existence of the asset implies some government obligation to budget for operation and maintenance, but the actual levels of support are decided on a discretionary basis each year. However, for PPPs, the annual payment comprises a mandatory cost in the budget for every year of the project's life, reflecting a combined charge amortising capital financing and operating and maintenance costs. As noted above, the long-term contracts dictate the length of time that annual budgets will be encumbered with this annual payment mandate. In Hungary, for instance, PPPs for motorways are contracted for 20-35 years and airports for 75 years.

Two countries in this study – France and the United Kingdom – do recognise the upfront costs of PPPs in capital and investment budgeting at the time that decisions are made. In the United Kingdom, for projects on the balance sheet, agencies must budget the full costs of the capital portion up front as part of separate capital budget accounts. Similar to traditional capital, this PPP cost must be traded off with other capital budget proposals and budgeted under the agency's fixed budgetary allotment for capital under the separate departmental expenditure limits for capital spending. The PPP proposals are examined at the time of the three-year spending review done for each agency as part of the budget process.

France budgets for PPPs in two ways – for the gross investment costs covering the duration of the contract, and for gross upkeep payments. Thus there is some recognition of the costs of commitment up front when projects are launched. However, this presented a problem because French law prohibited deferred payments from commitments, necessitating a change in statute to accommodate the delayed annual payments for PPPs.

The budgetary treatment for PPPs in some countries is still evolving. In the United States, budgetary recognition of private engagements varies and is done on a piecemeal basis, according to the Congressional Budget Office (2003). There is disagreement between the two budget agencies – the OMB and the CBO – over the proper scoring of public-private partnerships for military housing. OMB guidelines enabled the Defense Department to use housing provided by private partners without recording large budgetary obligations up front. The CBO urged the OMB to score the partnerships as government-owned investments since the government will eventually be responsible for the housing.

The form of budgetary recognition makes a difference for the quality of deliberation on proposed projects. Officials from several countries said that there is more scrutiny of appropriations for traditional government-owned capital for two reasons. First, capital costs are budgeted up front and, second, they must compete with other projects for a limited pool of funding. Since PPPs are not funded up front and are not recorded for several years, the budget itself does not prompt a similar level of debate. However, recognising the longer-term financial issues, a number of countries have initiated scrutiny outside the formal budget process through analytical reviews of value for money for PPP projects. In fact, in some countries such as Portugal and the United Kingdom, officials indicate that PPPs get greater scrutiny through these analytical processes than traditional government-

owned capital. Portugal has decided to extend the same review process and criteria for PPPs to all government-owned capital.

In addition to budgetary payments, some countries provide more indirect forms of subsidies for PPPs and concessions. Guarantees and other forms of payment are often triggered when projects fall below certain financial thresholds, constituting a contingent liability. In most countries, budget and accounting rules do not require appropriations for these contingent claims. France and Korea, for instance, have guarantees, but they are not recorded or recognised until they are triggered. Australia does not reflect contingent liabilities in budget totals but rather in a statement of risk accompanying the budget. The United States, which has very few PPPs, is among the few countries that do budget the costs of guarantees up front in the budget. The credit subsidy records the net present value of costs to the government over the life of the guarantee based on interest subsidies and projected defaults. Chile has an intemporal budget constraint that limits the guarantees and subsidies for concessions, as discussed in Box 3.

Some countries have imposed budgetary limits on annual PPP spending, partly to compensate for the lack of upfront budget recognition and controls. Hungary has a limit of 3% for PPPs as a share of government revenues, while Korea has a limit of 2% of spending. While not having specific PPP ceilings, countries like the United Kingdom that budget for the upfront costs of PPPs have inherent limits since the PPP projects must be allocated from a limited pool of funds provided to agencies for capital projects.

Effective scrutiny and review of PPP proposals calls for a perspective that goes beyond the annual budget to encompass the lifecycle of proposed projects. However, most countries traditionally devote weaker scrutiny to non-cash items and long-term obligations compared to immediate outlays (Budina *et al.*, 2007, p. 14). Having said this, countries are moving in the right direction by providing more information and perspectives on longer-term PPP trajectories as well as longer-term budgetary outlooks.

Box 3. Concession risk guarantees in Chile

Chile has developed sophisticated analytical methodologies for the valuation of guarantees provided in the context of concessions. The government guarantees under the PPP contracts are centred in protecting the concessionaire from risks related to demand and exchange rates. Starting in 2002, the demand guarantees are provided at a cost.

The major guarantee offered to cover demand risk is called the IMG. The government compensates the concessionaire if the revenues from the tolls are less than the projected minimum. In exchange for the guarantee, the concessionaire shares 50% of the revenues that exceed the projected revenues. Starting in 2003, a premium is charged for the provision of the guarantee. The guarantees which are triggered are paid in the budget year following the year in which they were triggered. The deferred payment, together with only a partial compensation of the difference with respect to the total projected revenues, limits the moral hazard and problems of adverse selection, as well as the government's exposure to risk and the fiscal cost of triggered guarantees.

The aggregate net present value of the guarantees for PPPs for 2006-30 is 0.15% of GDP. Chile established an "intertemporal budget restriction" (RPI) to limit the total amount of subsidies and guarantees, measured on a net present value basis. While this ceiling is not formally in the budget and does not flow to the bottom line, it is presented in a supplemental analysis of contingent liabilities and is enforced by the budget office.

Most countries include annualised PPP costs in their medium-term frameworks which typically extend from three to five years. In countries like Hungary and Korea, this provides some longer-term assessment of cash payments for PPPs, but falls far short of capturing the full costs. Some countries go further and undertake longer-term analyses of full PPP costs over the life of the project, which appear as supplements to the regular budget. The United Kingdom, for instance, provides data on the year-by-year costs of annual payments for all PPPs in a chapter in the budget. These long-term schedules are included as part of the initial assessment of value for money for each project. Since 2003, Portugal has prepared a memo to the budget director providing the long-term costs for all PPPs, a memo that is appended to the budget document.

The growing movement in OECD countries to examine the longer-term projections for current budgetary policy is also helpful. The United Kingdom, the United States and other countries have developed models to simulate budget outcomes over as much as 50 to 75 years (Ulla, 2006). While these long-term projections do not incorporate or highlight the long-term trajectories of PPPs, they do provide an overall perspective of the fiscal space that will be available over the many years that PPP payments appear in budgets. For most OECD countries, the long-term outlook is worrisome and shows that budgets will increasingly be devoted to paying for the elderly and their doctors, with less fiscal space available for financing capital – either investing in the future or paying debts from the past.

The degree of legislative and public oversight over PPPs appears to be less extensive than for traditional government-owned capital. In most countries, the annual appropriations process will not disclose the presence of new PPPs since there is no upfront budget authority required to start these projects. For traditional capital, the legislature must appropriate the upfront funding necessary to begin design and construction. Among the eight countries, Hungary requires that any major capital project above a certain threshold, whether it be traditional capital or PPPs, gain legislative approval. However, many countries with extensive PPP activity do not obtain legislative approval prior to approving projects. Korea, the United Kingdom and Chile have all decided not to require legislative review and approval. Some officials indicated a concern that legislative review might bring “pork barrelling” into the decisions.

While the budget process is critical, other components of policy making and management also play a vital role in ensuring that PPP projects deliver public value within budget constraints (Akitoby *et al.*, 2007):

- Investment planning: Determination of which projects are suitable for PPPs and whether such projects satisfy both value-for-money and affordability criteria through the use of public sector comparators. For instance, the IMF suggests that PPPs are better suited to economic infrastructure than social infrastructure due to the greater return of sound economic projects for business and the higher potential to charge users for services.
- Legal and institutional framework: Such issues as clear definitions for PPPs, competition and contract management, specific metrics linking contracts with outputs and outcomes, oversight and review units to provide consistency and expert assistance to agencies, and clear delineation of the roles and responsibilities of central budget and line agencies for project review, approval and monitoring. “Gateway processes” are being instituted by countries to provide a strong role for the ministry of finance in project selection and approval (see Box 4).

Box 4. The gateway process

Countries such as Portugal have relied in recent years on a gateway system that includes review and appraisal processes addressing efficiency and fiscal risks of PPPs. Specific roles are provided for the line agencies and for the finance ministry, which must sign off on projects at each step of the process. The following is a description of this process based on the experience of Portugal:

Phase 1: Planning, design and preparation of tender

- Project team prepares value-for-money analysis and tender document.
- PPP unit reviews the analysis.
- Budget department evaluates affordability of project.
- Finance minister approves or rejects project.

Phase 2: Bidding and negotiation

- Tender board assesses bids and selects preferred bidder.
- PPP unit assesses draft contract.
- Finance minister approves or rejects the contract.

Phase 3: Construction and operation

- PPP unit monitors implementation by project manager.
- Budget department monitors budgetary flows on regular basis.
- All actors involved in renegotiation of contract if necessary.
- Finance minister must approve any contract renegotiation.

Many countries with weak budgetary controls nonetheless sustain separate analytic reviews focused on PPP projects. Some of these elements can compensate for weak budgetary controls. For instance, most of the eight countries in this study have a dedicated PPP unit in the central budget office, in a line agency, or in both, to review PPP assessments, provide technical assistance and guidance, and oversee implementation of PPP projects. Units in Portugal are constituted as an independent board, while France has established a special task force to review PPPs. The United Kingdom Treasury has a 12-person PPP unit. These units can help ensure that PPPs are selected and designed to be consistent with the government's overall budget constraints. For instance, the units oversee the crucial value-for-money assessments, where PPPs are compared with public sector comparators prior to project approval.

As a result, these review processes do provide transparency about PPP proposals, at least inside the government. Some officials suggested that there is actually a greater degree of review of PPPs than for traditional government capital projects. Portugal extended its analytic reviews of PPPs adopted in 2003 to all proposed capital projects, partly out of concern that special PPP analytic procedures might bias decisions against PPPs.

7. Conclusion

The use of private financing and delivery for public services has advantages. Private efficiencies can deliver real benefits that might overcome higher financing and transaction charges. The risk sharing and bundling of all phases of capital services may very well promote incentives to achieve improved outputs with lower costs.

However, these promises rest on heroic assumptions and ideal conditions that are too often missing in many cases. Deep markets are often not available to provide the level of competition necessary to motivate private innovation and efficiency. Clear demarcation and sharing of risks is often overturned in practice, as public officials face asymmetrical risks that are often impossible to measure and delineate for the long timeframes involved with PPP contracts. Fundamentally, public and private partners have differing interests and, while these differences can lead to a healthy marriage between the partners, they must also be acknowledged as a source of uncertainty and entropy that can complicate and perhaps erode the attainment of public goals and values.

Some policy domains and countries may be better candidates than others: economic infrastructure that can deliver greater productivity for private firms offers better prospects for aligning public and private interests in constructive partnerships. However, the more a service takes on the character of a pure public good, the less private incentives will be congruent with public interest, leading to greater public disappointment with the results. The long-term financial impacts of PPPs may be better absorbed in countries with good long-term growth prospects, while countries with slowing economies and large long-term commitments are advised to be far more cautious.

Public-private partnerships, while promising performance breakthroughs, create significant uncertainties and risks for governments. The lack of upfront budget scoring lowers the level of deliberation for these projects and invites decisions to be taken on the basis of opportunistic exploitation of budget rules rather than evaluations of longer-term risks and rewards. The risks and uncertainties intensify over the long term, as projects face new challenges and as budgets become more encumbered with financial commitments. Accordingly, countries should be wary of using private capital to finance infrastructure and capital assets.

Countries have sought to compensate for the weakness of budgetary controls with impressive analytic initiatives and information that go beyond anything done for conventional public capital projects – and with good reason, given the higher stakes, greater uncertainty and longer-term commitments that public-private partnerships entail.

However, stronger budgetary processes and controls are necessary to provide greater assurance that PPPs are being funded for the right reasons. Given limited fiscal resources both now and over the longer term, countries need to ensure that the projects selected represent the most cost-effective and affordable approach to financing infrastructure and that this particular strategy is compared with other competing needs across the entire budget using similar budgetary concepts and scoring.

The following elements constitute a strategy for strengthening budgetary review and deliberation for PPPs:

- The establishment of upfront funding in the budget for the total commitment entailed for PPP projects should be institutionalised in the budget formulation process. This would help ensure that decision makers face the full cost consequences of their decisions.
- The funding for PPPs should compete with other claims in agency budgets for inherently limited resources. The full funding of commitments up front from scarce resources provides the best assurance that decision makers will deliberate about the relative value of PPP projects compared with other programmes and priorities.

- There should be a presumption that all PPPs will be fully recorded in the budget, even if projects are deemed to be off the financial balance sheet based on relative risks.
- Countries should strengthen the process for analysing PPP proposals by providing for explicit criteria assessing affordability to accompany existing value-for-money reviews.
- Affordability can be operationalised by establishing limits on the total level of PPP commitments undertaken in a given year. Limits can be measured on the basis of total net present value of long-term costs and/or total annual payments for approved projects.
- Guarantees and other subsidies for PPPs, and for other purposes, should be estimated at the time that commitments are authorised. Consideration should be given to using accrual-based approaches to measure guarantees, such as the credit subsidy concept used in New Zealand and the United States. Limits on total guarantees should also be explored.
- Countries should consider establishing or strengthening longer-term budget frameworks for many reasons, including providing a more informed basis for considering the long-term affordability of PPP projects. Modelling long-term fiscal outlooks is the first step. Following this, countries should consider developing their near-term and medium-term fiscal targets with the longer-term outlook in mind.
- Countries should also work to provide greater disclosures on future payment obligations for PPPs in budget documents. The extensive information published in the budget documents of the United Kingdom and the new budget memos prepared by Portugal provide two excellent examples of transparency in support of PPP decision making.

Note

1. One estimate from the United States Congressional Research Service (2006) shows a growth of earmarked transportation projects in congressional appropriations from 140 in 1994 to 2 094 in 2005, or 5% of total transportation appropriations in that year.

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