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Introduction

Gerd Schwartz, Ana Corbacho, and Katja Funke

Upgrading public infrastructure and improving the delivery of public services are important challenges for all governments. Many countries—including the new member states of the European Union (EU) and several of the non-EU economies in Europe—have been facing particularly strong demands for increasing the quality of public infrastructure to improve competitiveness and accelerate economic development. At the same time, tight budget constraints have often forced governments to seek out new options for supplying public infrastructure, including by relying more on private sector resources. In this context, public-private partnerships (PPPs) are frequently being considered as an alternative to traditional public procurement to realize a wide range of infrastructure investments while achieving better value for money (VfM). However, PPPs generate significant fiscal, macroeconomic, and reputational risks for governments, including by creating large contingent liabilities that may have adverse implications for government budgets and for fiscal and macroeconomic sustainability.

How then should governments address these infrastructure challenges and manage associated fiscal and macroeconomic risks? This book discusses the key issues that arise in this context. The first part of the book provides the overall setting for the discussion, elaborating on the relationship between public investment and economic growth; recent trends in public investment spending in Europe; and options for improving the budgeting process and enhancing the efficiency of investment spending. The second part focuses on fiscal risks from PPPs: what are these risks and why should governments worry about them; what are the salient features of an efficient institutional framework to manage these risks; and what have country experiences been? The third part analyzes specific aspects of the institutional environment needed to handle PPPs. In particular, it sets out good principles for private sector participation in infrastructure; elaborates on legal regimes and on potential financing arrangements; and assesses experiences from various European and Latin American economies. The fourth and final part of the book is devoted to some often overlooked elements that are needed for the successful implementation of PPPs, including best standards for PPP accounting, reporting, and auditing.

The first part of the book focuses in particular on the important linkages that exist between achieving fiscal and macroeconomic sustainability and selecting and implementing priority public investment projects. Chapter 1 summarizes the recent empirical literature on the relationship between public capital and economic growth. It emphasizes several facts: (i) public capital generally has a significant (albeit not necessarily very large) growth-enhancing effect that differs across countries, regions, and sectors and is non-linear due to its network character; (ii) there is evidence of reverse causality running from higher growth to higher demand for infrastructure; (iii) the growth-enhancing impact of investment will crucially depend on whether it helps to alleviate real economic bottlenecks; and (iv) maintenance and efficient use of existing infrastructure may often be more important than building new infrastructure.

How has all this played out in Europe? This is analyzed in Chapter 2, which discusses various recent trends and developments regarding public investment expenditure in EU member states, assesses the impact of EU regulations, and reviews the impact of PPPs on public investment expenditure. Accordingly, public investment has generally been trending downward in the old EU member states (bar the cohesion countries) and has been volatile in the new EU member states. The downward trend is attributable to fiscal adjustment necessitated by long periods of unsustainable fiscal policies rather than to the fiscal rules of the Stability and Growth Pact or the emergence of off-budget financing mechanisms such as PPPs. As public budgets are likely to remain the most important source of infrastructure finance in the future, achieving adequate levels of public investment will require safeguarding budgetary space for these undertakings, which in turn puts the spotlight on the need to achieve efficiency for all components of public spending.

But, as already alluded to in Chapter 1, different types of public investment may have very different economic impacts. These are analyzed in more detail in Chapter 3, which looks at public investment patterns in the new EU member states, and particularly the challenges for public investment in the catching-up process. The chapter suggests that EU accession per se, with its stricter budgetary rules, did not have an adverse impact on public investment in the new member states. Also, public fixed capital stocks have already sufficiently caught up with levels in the old member states to enable profitable private investments, thereby easing somewhat the pressure on governments to invest. However, public investment is a dynamic process that changes over time. To sustain higher growth rates after the necessary initial build-up of physical infrastructure, the chapter argues that the new EU member states will eventually need to shift more investment into knowledge generation.

Still, all public investments need to be managed well to have their desired economic impact. Chapter 4 provides guidance in this respect by setting out an overall framework for good management of public investment projects, including

PPPs. As best practice is not always achievable, the chapter also describes a minimum set of features for a public investment framework, including a decision-making process that is based on a consolidated budget (even in the case of foreign-financed projects), a public investment agency (to develop guidelines for project design and cost-benefit analysis, review project proposals, and reject those that are inadequate), and full disclosure of future operating costs and their financing for all investment projects. Chapter 4 also emphasizes the need for close coordination of decisions regarding PPPs with the budget and full disclosure of PPP-related fiscal implications in budget documents.

The second part of the book focuses on PPPs, their advantages in realizing public investment, the fiscal risks they entail, and policy options for managing these risks. Chapter 5 points out that, compared to traditional public procurement, cooperation with the private sector through PPPs can offer increased efficiency, better quality, and lower-cost services, that is, better VfM. However, PPPs come with significant fiscal risks and governments need to address these risks proactively. In this context, the chapter outlines strategies for strengthening investment planning systems, the legal and institutional framework, and the accounting and reporting rules that would help to manage fiscal risks from PPPs. While PPPs should not be used to circumvent budgetary and spending controls, the chapter finds that current Eurostat accounting rules for PPPs provide incentives for governments to do just that, thus creating a moral hazard problem. The chapter then goes on to propose options for limiting the moral hazard problem in practice.

Chapter 6 is more optimistic in arguing that, whether or not governments report and disclose fiscal risks correctly, they usually are motivated to understand and control the expenditure commitments they undertake in PPPs. The chapter provides some concrete steps that would help governments to do so, including establishing a framework for comparing the cost of PPP commitments with the cost of publicly financed projects; incorporating expenditure commitments in fiscal monitoring, accounting and reporting; strengthening procedural controls on commitments by giving the minister of finance an oversight function within the PPP process; and imposing *ex ante* limits on PPP commitments.

Drawing on the experience of Portugal, Chapter 7 provides concrete examples of fiscal risks from PPPs and how they have been addressed. The chapter shows that Portugal, which was one of the first EU economies to use PPPs, has enjoyed sizeable success in terms of rapid development of infrastructure but has also experienced significant budgetary problems as a result. This suggests that the potential fiscal risks of PPPs were significantly underestimated initially. Much of the subsequent development of the institutional framework, including the gateway process for PPPs, was in response to the materialization of such fiscal risks. The upshot of this chapter is that, by establishing a solid institutional framework from the very outset, countries that are just now entering into PPPs can prevent many of the initial problems that Portugal encountered.

But what should a PPP framework look like? The third part of the book elaborates on specific aspects. Chapter 8 outlines the OECD principles for private sector participation in infrastructure. These principles are designed to assist governments seeking private sector involvement in infrastructure to attract investment and mobilize private sector resources; they can also be used as a self-assessment tool, particularly for governments with little or no experience with private sector involvement in public investment. A key underlying principle is that the decision to involve the private sector has to be guided by an assessment of the relative long-term costs and benefits and availability of finance, taking into account the pricing of risks transferred to the private operators and prudent fiscal treatment of risks remaining in the public domain. The principles also point out, however, that the success of private involvement in infrastructure depends on public acceptance and on the capacities at all levels of government to implement agreed projects. The chapter provides some further pointers on this and other issues.

Every institutional framework also has important legal dimensions. Chapter 9 looks at existing legal regimes for concessions in transition economies that are members of the EBRD and compares them against best international practice. Since the legal environment for concessions is vital to the implementation of many types of PPPs, the chapter reviews specific core areas of the legal regime, such as the definitions and scope of the concessions law, the rules governing the selection of the concessionaire, the availability of security instruments and state support, and the rules on the settlement of disputes. Overall, the chapter suggests that the legal regimes for concessions in transition countries leave scope for improvement, and that the majority of countries need to make significant progress in this area if they wish to implement complex PPPs effectively. But even when laws are “on the books,” there may often be an implementation gap. In this context, the chapter provides the results of a legal indicator survey that assesses how well existing frameworks are applied in practice.

Against the background of the large role of EU grants for infrastructure financing in the new EU member states, Chapter 10 assesses how EU grants could potentially be combined with PPPs, focusing in particular on the fiscal risks associated with EU grant co-financing. While there is a clear EU policy commitment to allow or even encourage PPP-EU grant blending, the chapter contends that it is still too early to say whether EU funding rules can be followed successfully while realizing the potential advantages that PPPs offer over traditional procurement methods.

The United Kingdom (UK) has often been cited as an example of successful implementation of PPPs. However, a key question is whether and to what extent the UK experience could be replicated elsewhere. The review of the UK experience with managing its Private Finance Initiative (PFI), presented in Chapter 11, allows some tentative conclusions. Implementing a successful PPP program requires a dedicated and sophisticated public sector apparatus that is fully geared toward

achieving VfM. Such an apparatus has been affordable in the UK due to the large scale of the PFI with 550 projects already in operation and 200 more in the pipeline until 2010. But it remains to be seen whether smaller countries with fewer potential projects would be able to put in place a full-scale apparatus geared toward achieving VfM or whether VfM itself could be obtained even in principle, given that much of the UK success derives from project standardization and bundling similar projects to achieve economies of scale.

Chapter 12 provides some further insights by looking at actual country experiences with negotiating and renegotiating PPPs and concession contracts. Based on the experience of Latin American economies, the chapter highlights the detrimental effects for VfM of contract renegotiation and the importance of proper regulatory and contract design, as well as implementation. Importantly, the chapter warns that, if not controlled early on, contract renegotiation can easily become the norm rather than the exception. Renegotiation can easily reduce the potential overall efficiency gains and benefits of PPPs, and shift financial surplus appropriations to the PPP operator. The chapter suggests that governments should more readily reject opportunistic requests for renegotiation and allow some concessions to fail. Still, the chapter acknowledges that governments have had a hard time adopting such a strategy as there are political costs to concession failures. All this goes again to emphasize the importance of having solid institutional, legal, and regulatory frameworks in place from the very outset. This also helps governments avoid being pressured into agreeing to suboptimal economic outcomes.

The fourth and last part of the book focuses on the accounting, reporting, and auditing of PPPs. Currently, internationally accepted accounting and reporting standards for PPPs do not exist and only a few countries follow adequate auditing procedures. Such standards and procedures would, however, help to promote transparency, including on the fiscal consequences of PPPs, and enable governments to manage better the fiscal risks.

Chapter 13 argues that, to reflect economic rather than legal ownership of PPP assets, a new approach for PPP accounting and reporting that is more sensitive to the degree of risk sharing is needed. Since accounting bodies may not stipulate such an approach, transparency could be enhanced by supplementary disclosure of information on PPPs and related guarantees, and by inclusion of PPP-related obligations in debt sustainability assessments. Chapter 14 agrees that more work is needed on developing International Public Sector Accounting Standards (IPSAS) for PPPs, and reflects upon the current state of the debate in the accounting profession. It highlights the key themes of a consultation paper that explores the relevant aspects of service concession arrangements for accounting purposes. Chapter 15 recognizes that the PPP area is quickly emerging as the most pressing challenge to the statistical reporting of fiscal data, to such an extent that it may put the comparability of fiscal statistics across EU member states materially at risk.

While the Eurostat criteria for classifying PPP assets as belonging either to the government or to the private sector were initially thought to be rather strict, they have not prevented that a large number of PPPs were moved off the government balance sheet, even when significant risks remained with the government. This may result in a situation where assets are no longer reported on either private or public sector balance sheets. These various chapters concur that the final word on accounting for PPPs is still outstanding. In the interim, countries would do well to follow existing best practice examples in this area, aiming to enhance transparency and the quality of policy analysis of the fiscal implications of PPPs.

The last three chapters of the book look at auditing experiences in three EU economies: the UK, Portugal, and Hungary. The Portuguese experience (Chapter 17) may be particularly interesting for many other economies of similar size, given Portugal's fairly rich history with PPPs. Portuguese audit reports show that most PPPs resulted in the private partners claiming additional funds from the state due to contractual changes imposed by the state, execution delays that the private partners attributed to the state, and inappropriate demand forecasts. But even the UK experience (Chapter 16) suggests that avoidable problems like insufficient project preparation and poor process management have not been uncommon. In addition, the UK experience shows that PPPs come with high fixed costs that are often underestimated. For example, the cost of professional (consulting) advice for projects was on average 75 percent higher than budgeted for by the public partner at the outset of the project. The Hungarian audit experience (Chapter 18) is also relevant in this context. Specifically, the Hungarian audit reports highlight inadequate risk sharing between public and private partners, inappropriate profit guarantees provided to the private sector, and the absence of adequate termination clauses in PPP contracts. The audit of the M5 motorway, for example, showed that both the operating risks and the responsibility for ensuring profit generation were fully borne by the state. Much of this may be attributed to inexperience of the public partner in handling the higher degree of complexity entailed by PPP contracts.

In summing up, there are some important elements of consensus that run throughout this book. The following seem particularly important. First, considerable public investment is needed in all EU member states, but particularly in the new member states. Second, the impact of public investment on economic growth depends crucially on the quantity and quality of the initial capital stock, the quality of the investment project itself, and on overall macroeconomic and fiscal sustainability considerations. Third, PPPs can be an alternative to traditional public procurement if they offer VfM. PPPs should not, however, be used to circumvent budgetary spending limits by pushing investment off budget. Also, PPPs do not alleviate the government's intertemporal budget constraint, except to the extent that they facilitate the mobilization of resources through user fees and promote efficiency gains. The latter have to be large enough to compensate

for the typically higher borrowing costs of private sector partners and the higher transaction costs involved in complex PPP contracts. Fourth, appropriate risk sharing is crucial for promoting efficiency gains and ensuring VfM. Governments should resist the temptation to tailor risk-sharing agreements so as to shift PPPs off balance sheet, as this could lead to inappropriate contract design, increased renegotiation incidence, and reduced VfM.

Given the complexity of PPPs, there is a need for a strong enabling legal and institutional environment, which includes several important elements. There has to be adequate and multidisciplinary capacity in the public sector to assess prospective PPP projects, manage the tendering process, and accompany the implementation phase. Also, there has to be a dedicated institutional structure in place to deal with PPPs, including an appropriate gateway process that is managed by the ministry of finance and gives the finance minister veto power at different stages of the PPP cycle. Finally, all future fiscal costs and risks have to be assessed. Also, they have to be transparently disclosed in budget documentation and fully taken into consideration in fiscal and debt sustainability assessments.

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Compiled by Sue Carlton

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