CofFEE

Centre of Full Employment and Equity

PFI/PPP arrangements

Some considerations?

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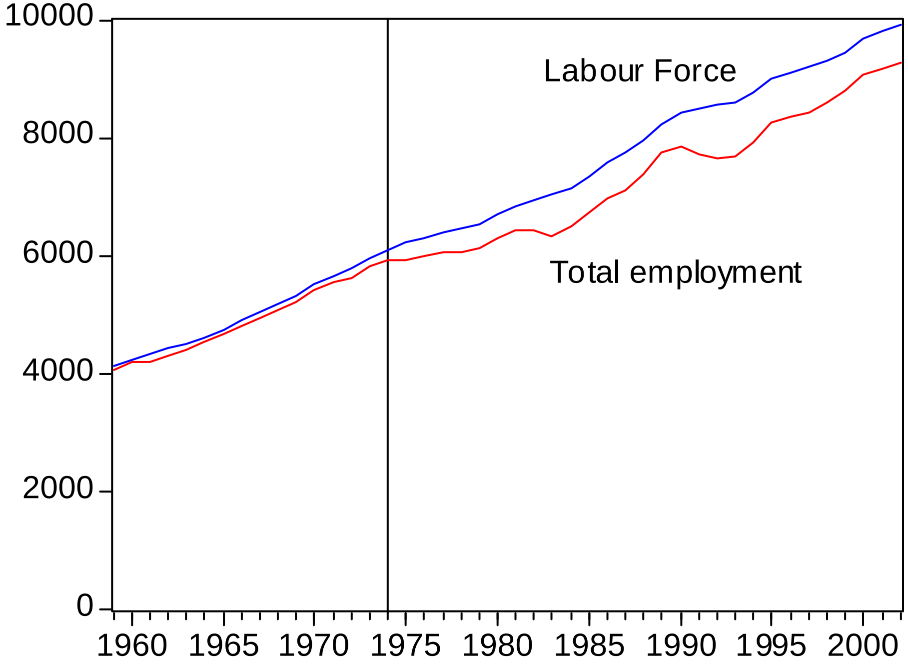
The starting parameters …

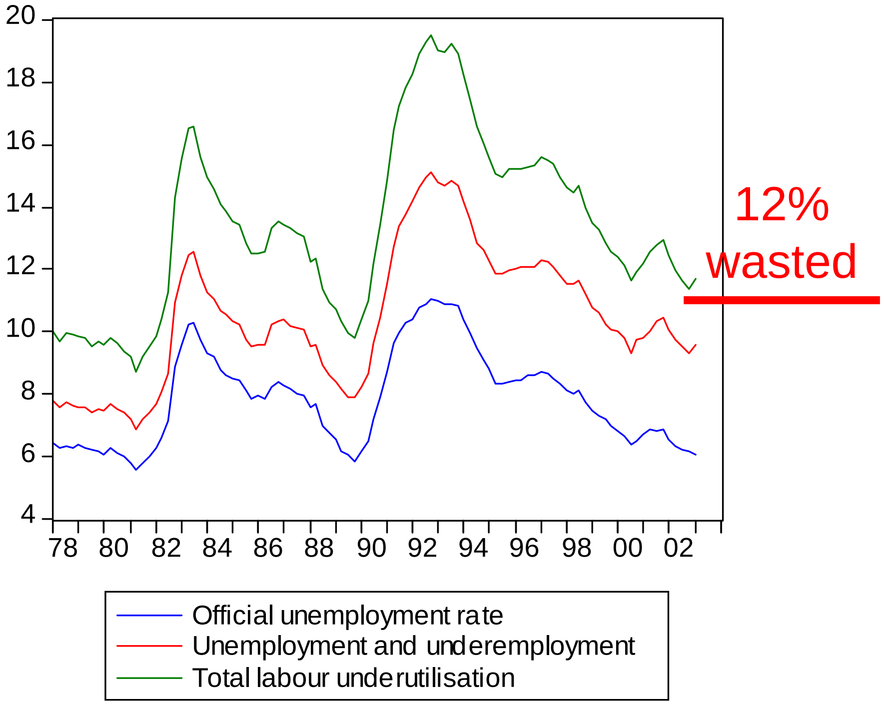
- What is role of government?
  - to maximise social welfare
  - this is different to maximising private welfare
- What do we mean by efficiency?
  - it requires that net social benefits are maximised
  - This is not the same thing as maximising net private benefits.

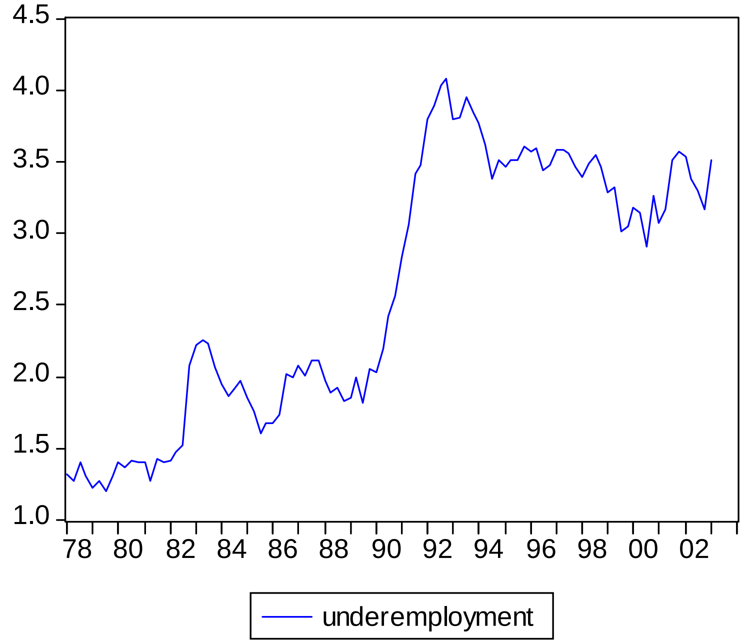
Manifest policy failure …



The Australian economy fails to generate enough employment…

which leads to massive waste …





PFI/PPP debate has been about efficiency…

- In pursuit of small (questionable) microeconomic gains we allow massive losses to persist in the form of macroeconomic inefficiency – labour underutilisation.
- This reality makes most of the PFI/PPP discussion about Value for Money pale into insignificance.
- But it gets worse – because the PFI/PPP agenda is also driven by false premises that further degrade the role of government in maximising social welfare.

What our governments should do …

- Government should use its fiscal power to:
  - be a major employer ensuring full employment
  - to maintain high quality public infrastructure
- In the second role, governments face two questions:
  - What is the best way to provide for the rising demand for best practice public infrastructure?
  - What is the best way to gather the resources necessary to guarantee this provision?

The public infrastructure challenge …

- Due to our inefficient constitution, state and local governments have to deliver most of the essential services but face constant revenue issues.
- There is a real case for realigning spending and taxing responsibilities to allow the federal sphere more influence.
- Why?
- The Federal government does not have a financial constraint and much of the PFI/PPP debate would be irrelevant if it was conducted at this level.

Public provision of public infrastructure?

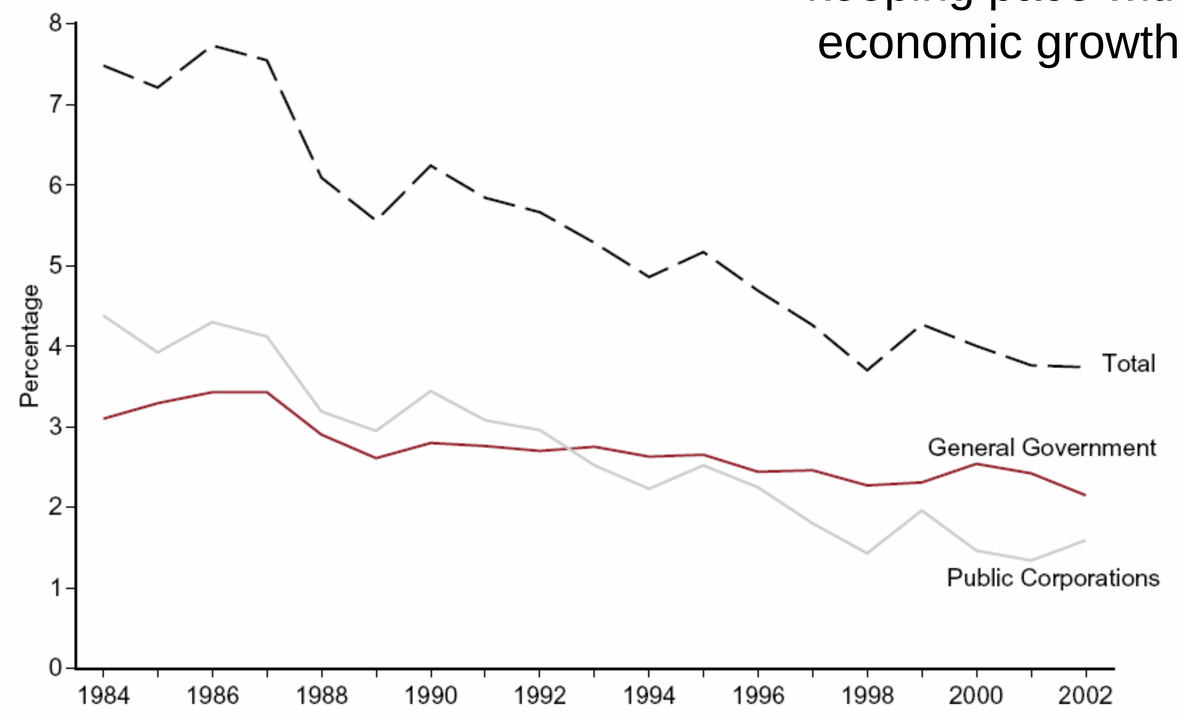
- Government should provide public infrastructure because of market failure considerations - existence of public goods, externalities and such does not support sufficient private returns from charges.
- The presence of natural monopolies will generate excessive prices and returns should a private supplier be present.
- Typically, public infrastructure services – generate benefits across time and beyond the immediate users (schools, hospitals, sewage, etc).

What is the role of public infrastructure?

- Sometimes, socially optimal user charges are often too low for a private return to be generated (railways?)
- But public infrastructure investment promotes productivity and economic growth.
- Provides a fundamental training ground for skilled labour – apprenticeships etc…
- Beyond its economic contribution, public infrastructure provides a social fabric – social benefits.

Government capital investment % GDP

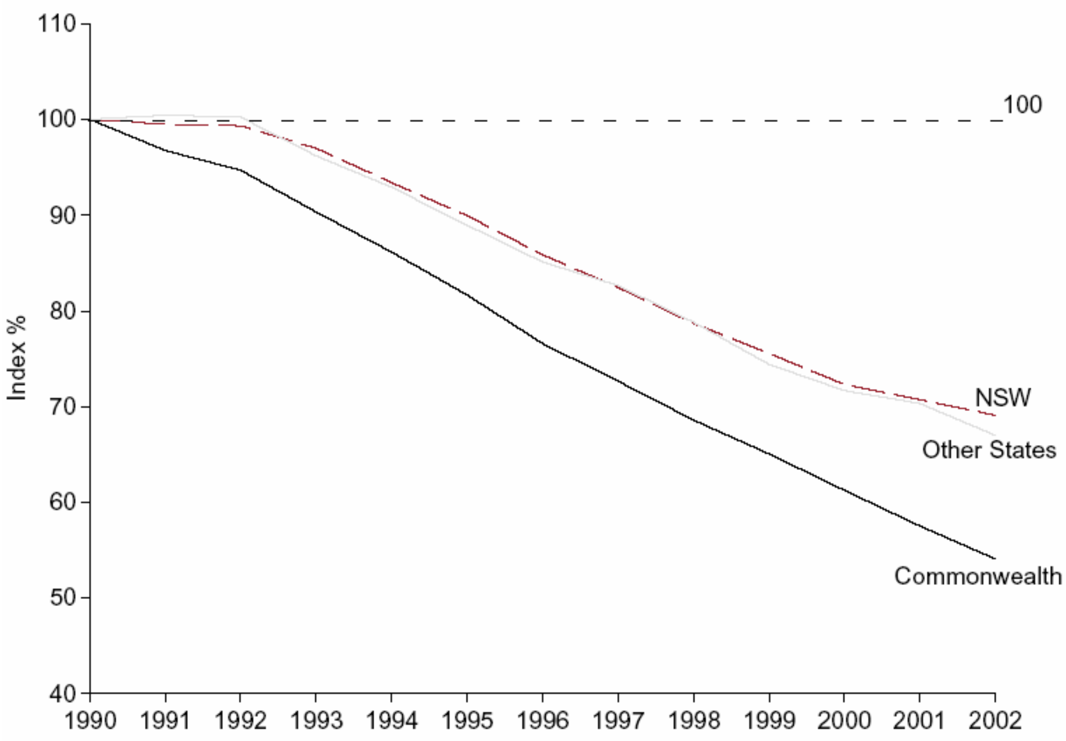
Public infrastructure not keeping pace with economic growth



Source: ABS Cat no. 5220.0, Allen Consulting (2003)

Federal and state capital formation, 1990 = 100

The ugly side of fiscal consolidation



Source: ABS Cat no. 5220.0, Allen Consulting (2003)

Myth of privatisation…

- It was argued that privatisation would create new employment opportunities with no net losses.
- Data clearly reveals this to be untrue.
- Large decline in public employment has not been taken up by an increased private employment growth rate.

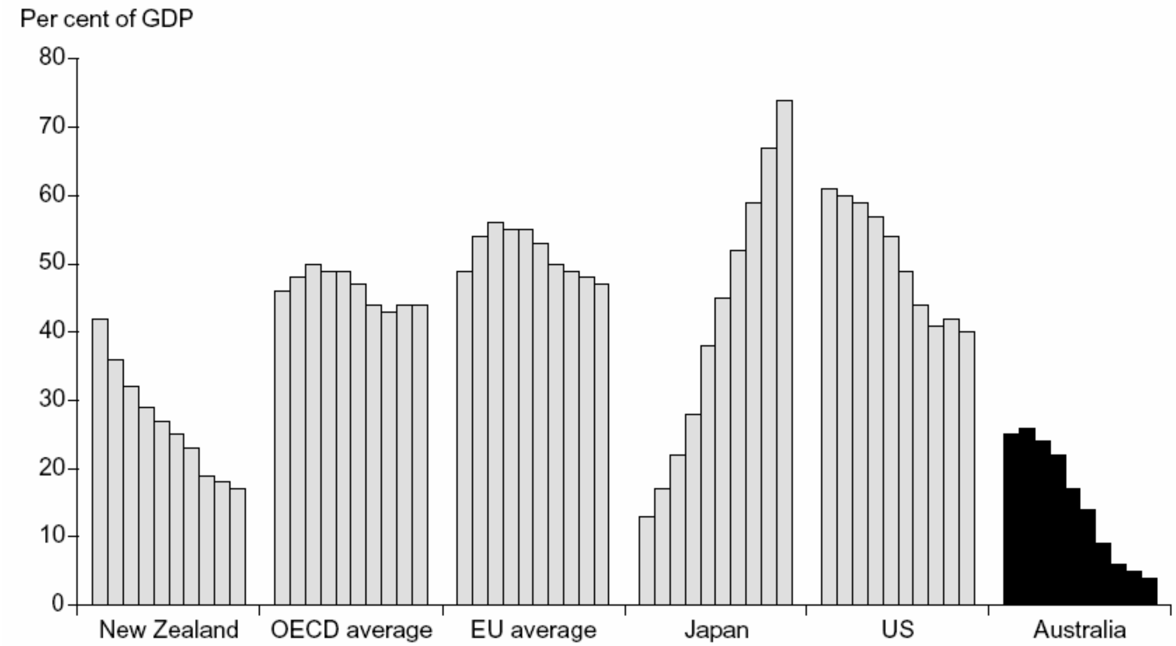
The costs of fiscal consolidation

Category	2003 NSW Grade	2001 Australian Grade	Category	2003 NSW Grade	2001 Australian Grade
National Roads	C+	C	Metropolitan Urban Potable Water	B-	not rated
State Roads	C+	C-	Non Metropolitan Urban Potable Water	C-	not rated
Local Roads	C-	D	Metropolitan Urban Wastewater	C-	not rated
Rail	D	D-	Non Metropolitan Urban Wastewater	C-	not rated
Electricity	B	B-	Stormwater	D	D

Source: http://www.InfrastructureReportCard.org.au

GG (all levels) net debt - 1994-2003

Denial of fiscal opportunities – at State level



Source: Commonwealth Budget Paper 1, 2003, Allen Consulting (2003).

PFI/PPP arrangements

- Contractual partnerships between the public sector and the private sector to finance, construct and/or operate projects which would normally be the responsibility of the public sector.
- Key steps:
  - Private partner invests in public infrastructure
  - Contract extends to operation of the facility – usually with bundled services.
  - Government pays annual fees for capital and services which include risk premium, private profit margin.

PFI/PPP arrangements

- So various forms:
  - Design, construct and maintain (DCM)
  - Build, operate and transfer (BOOT)
- Questions about how much service delivery should government retain.
- Typically government is reduced to:
  - policy development, and
  - brokerage and management of contracts with private service delivery partners.

Rationale for PFI/PPP arrangements

- But typically debate is based on false premises.
- Federal level:
  - government is financially constrained.
  - borrowing drives up interest rates.
  - deficits imply higher future taxes.
  - surpluses facilitate private savings.
- State level:
  - government borrowing is bad – logic of AAA rating?
  - surpluses are efficient.

Value for money (VFM)

- Proponents of PFI/PPP arrangements argue that they offer Value for Money – an efficiency concept.
  - Lower construction costs
  - Lower operating costs
  - Higher quality services.
- Evidence from the UK - is mixed but generally does not support these alleged advantages across education, health and other sectors.

The scarce funds myth …

- Government has ‘more funds’ available for other vital uses – service delivery etc.
  - this is a nonsense argument at Federal level
  - at state level it implies that private borrowing is better than public – again a nonsense argument.

The financing myth

- Critics often fail to make their case properly.
- They say that the private sector has to price its debt in the market whereas public debt prices at the long-term bond rate.
- There is typically a 3-5 per cent difference between private and public funds.
- Therefore, PFI can never be cheaper unless services (employment) are cut dramatically or construction quality reduced.

Have to consider risk…

- But the difference reflects project risk and lower public rate implies that government will rescue a failing project via drawing on consolidated revenue.
- Therefore PFI/PPP is constructed as an efficient transfer of risks from public to private.
- The gains are alleged to arise from the private sector being better able to manage risk – largely because they have a higher incentive to do so – private profit.
- PFI/PPP contracts can contain punitive terms to ensure profit is 'earned'.

Risk …

- Who ultimately bears the risk?
- The risk premium in private financing is based on the fact that a private entity can become bankrupt with its product and service exiting the market.
- Why should the government be risk-averse?
- With an essential public service it is a fantasy to say that the PFI/PPP contract transfers risk to the private sector.
- If the private partner defaults, the public always has to pick up the pieces.
- There is no real risk transferred.

The refinancing dilemma…

- Evidence from UK reveals that PFI partners profiteer from the 'risk' transfer component built into the contract payments.
- The private provider aims to minimise financing costs over the life of the contract.
  - early repayment
  - refinancing existing loan at lower interest rates.
- Risks are typically high in construction phases and drop to near zero one service operations begin.
- Private partner reduces costs by refinancing at lower rates once construction is completed.
- Who captures these gains?

Evidence on refinancing

- Major issue in the UK.
- Once case, a prison completed 5 months ahead of schedule and refinancing allowed private shareholders to increase returns from 16% to 39%.
- Massive public spending subsidy transferred to the private sector
- The public should ‘capture’ the benefits of the refinancing rather than the private sector.
- Private agent made the decision on the initial estimated internal rate of return.
- It is clear that the initial public decision to enter into the PFI/PPP agreement is flawed because the contract payment stream to the private partner is based on inflated present values.

Private profit margin

- The public payments also include the profit margin.
- Why?
- Is ownership or management the key to sound project outcomes?
- This is a rehearsal of the privatisation debate which failed to show ownership mattered.

Allen Consulting MMRF comparisons

Type of financing	NPV of GSP gains	% NPV gain over taxes	Annual Job Creation	% Job gain over taxes
Public Debt	$13.0 billion	218 per cent	12684 jobs	581 per cent
SPV	$10.9 billion	182 per cent	10749 jobs	492 per cent
Residential rates	$7.3 billion	122 per cent	5881 jobs	269 per cent
Average aggregate state taxes	$6 billion	0	2184 jobs	0
User charges	$5.0 billion	86 per cent	3973 jobs	182 per cent
Producer levy	$0.8 billion	14 per cent	minus 3103 jobs	minus 142 per cent

Simulations of benefits from $5 billion investment over 5 years for a 15-year forecast period

Allen Consulting conclusions…

- Government at state and local levels should view that recapitalising our cities is essential to maintain and enhance their economic, social and environmental sustainability
- The case for the greater use of government debt is strong
- Fundamental public finance arrangements need to be revisited
- The trend towards ad hoc and wasteful infrastructure funding techniques should be halted.
- PFI/PPP arrangements - “changes are needed to make these approaches more workable.”

Conclusion …

- Governments should use their fiscal powers to maximise social welfare – full employment and appropriate capital provision.
- There is no case for service delivery being part of PFI/PPP contracts.
- Construction should debt-financed.
- There is a sound case for government returning to construction – at least it should enforce apprenticeship clauses on private construction contractors.

End of Talk