

Public Investment and Public-Private Partnerships

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Richard Hemming,
and Gerd Schwartz**



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Preface

Traditionally, governments have built, maintained, and rehabilitated the physical infrastructure—such as roads, ports and airports, and telecommunications and electricity networks—without which most economic activity would be impossible. In fact, investment spending, particularly on infrastructure, used to be one of government’s main activities. Over the past three decades, however, public spending on infrastructure, as a share of GDP, has been on the decline worldwide. Both the causes and the consequences of this decline are far from clear.

Fiscal adjustment undertaken to stabilize the macroeconomy has sometimes been singled out as the main factor, but this overlooks the many other contributing factors. These include a decrease in public saving; the completion of major infrastructure networks; a pick-up in privatization activity in light of a growing preference for a smaller public sector; an increasingly diversified private sector that has expanded into infrastructure services; and a rise in current spending, including for civil service wages and social security. In addition, part of the decline may be purely statistical in nature: a broadening of financing options for infrastructure—for example, governments frequently contract out infrastructure services to the private sector—has allowed some infrastructure-related spending traditionally recorded as capital spending to be recorded as current spending.

Whether the decline in public investment in infrastructure has created bottlenecks for economic growth is an object of much debate. Infrastructure spending has been linked to higher economic growth in some cases, and individual infrastructure investments may generate fairly high social returns. However, it is far from certain that increasing spending on infrastructure would, in itself, be more growth-enhancing than, say, increasing spending on health care and education. Empirical studies have yielded widely different estimates of the impact of infrastructure investment on economic growth, and

it is difficult to disentangle infrastructure-related effects from the impact of other factors, such as spending on human capital or the business environment. Nonetheless, the quality of physical infrastructure clearly affects a country's productivity, competitiveness in export markets, and ability to attract foreign investment.

Does this mean that countries should increase public investment in infrastructure? If the answer is yes, how can they do so in a fiscally responsible manner? Are public-private partnerships (PPPs) a viable alternative?¹

The IMF has devoted several studies to these questions. In March 2004, it published "Public Investment and Fiscal Policy," and "Public-Private Partnerships."² To test the analytical frameworks developed in those two overviews, the IMF carried out eight additional studies in a diverse group of developing and emerging countries in Africa, Asia, Latin America, and the Middle East. The studies' findings were summarized in two papers that were released in April 2005, "Public Investment and Fiscal Policy—Lessons from the Pilot Country Studies," and "Public Investment and Fiscal Policy—Summaries of the Pilot Country Studies."³ An additional study looks at the fiscal risks arising from government guarantees.⁴ This Economic Issue draws on these three studies as well as on a recent IMF Special Issues paper that covers similar ground.⁵

¹As used in this Economic Issue, the term public-private partnership (PPP) refers to arrangements in which the private sector supplies infrastructure assets and services traditionally provided by governments. PPPs can be established through concessions and operating leases. They can be created for a wide range of social and economic infrastructure projects but, so far, have been used mainly for transportation infrastructure (such as highways, bridges, and tunnels) and "accommodation" projects (such as hospitals, schools, and prisons).

²Available on the IMF Web site at www.imf.org/external/np/fad/2004/pifp/eng/index.htm and www.imf.org/external/np/fad/2004/pifp/eng/031204.htm, respectively.

³Available on the IMF Web site at www.imf.org/external/np/pp/eng/2005/040105a.htm and www.imf.org/external/np/pp/eng/2005/040105b.htm, respectively.

⁴The study, "Government Guarantees and Fiscal Risk," is available on the IMF's Web site at www.imf.org/external/np/pp/eng/2005/040105c.htm.

⁵"Public-Private Partnerships, Government Guarantees, and Fiscal Risk" was prepared by an IMF staff team led by Richard Hemming. For more information, see the IMF Web site at www.imf.org/external/pubs/cat/longres.cfm?sk=18587.

Public Investment and Public-Private Partnerships

While infrastructure needs and financing constraints are more severe in developing countries than in advanced economies, all economies need to maintain fiscal discipline and respect constraints on taxation and borrowing, the usual sources for funding public investment. The Stability and Growth Pact of the European Union (EU), for example, imposes ceilings on deficits and public debt in EU members, limiting their room for maneuver with regard to public investment. Also, all economies, rich and poor alike, must allocate limited resources among competing needs, balancing investment in physical capital against investment in human capital—education, health care, and other social sectors—while ensuring that they have enough revenue to cover current spending.

The IMF's Pilot Case Studies on Public Investment—Background

The IMF, in collaboration with the World Bank and the Inter-American Development Bank, carried out pilot studies that looked at how eight countries—Brazil, Chile, Colombia, Ethiopia, Ghana, India, Jordan, and Peru—were addressing their public investment needs, including in infrastructure. The pilot countries' need for new roads and better road maintenance seems particularly acute, but infrastructure bottlenecks also appear in other sectors, including ports, energy, telecommunications, and water and sanitation. These bottlenecks reflect, at least in part, recent declines in public investment,⁶ which have been

⁶However, the existence of infrastructure bottlenecks also frequently reflects inappropriate public pricing decisions that result in poor cost recovery and waste.

offset—but only to a small extent—by an increase in private investment in infrastructure. However, in Brazil and Peru, the completion of several large privatization projects (in telecommunications, notably) accounts for at least some of the decline.

Although it was clearly not the only factor, fiscal consolidation is likely to have contributed to the observed decline in public investment. For example, public investment in India was held back as part of crisis-induced fiscal adjustment efforts in the early 1990s. In Brazil, the significant fiscal adjustment efforts carried out since 1999, while crucial for pulling Brazil out of an economic crisis and stabilizing the macroeconomy, also went hand in hand with lower public investment, which, at the federal government level, declined to 0.4 percent of GDP in 2003 from 1.1 percent of GDP in 1998. The Ghanaian authorities resorted to lowering public investment during 1998–2000 and again in 2002 to support a fiscal adjustment effort.

In addition, falling public saving may have played an important role in limiting public investment spending. In general, the decline in public saving is due to the expansion of current public spending—including, for example, growing or rigid outlays for public sector wages, pensions, and transfers to households—that may have been accentuated further by a generally high degree of revenue earmarking (for example, in Brazil, Colombia, and Ghana). In some federal countries (for example, India), public saving may also have been constrained by a lack of fiscal discipline at subnational levels of government.

Estimates of the amount of investment needed to meet the infrastructure needs of any given country vary significantly. Those based on the notion of catching up with more advanced countries (or “regional leaders” in infrastructure) tend to be much larger than those based on what it would take to overcome specific bottlenecks. A shortcoming of all such “needs-based” approaches, however, is that they overlook the resource and absorption-capacity constraints

Underpricing for the use of public assets (for example, port fees, landing fees, and road user charges) or key inputs (such as domestic fuel, electricity, and water) as well as undercollection of existing fees and user charges have contributed to overconsumption and infrastructure bottlenecks in many of the pilot countries.

of individual countries and are therefore unable to provide concrete guidance on how, and within what timeframe, to address infrastructure needs in a fiscally sustainable manner. A better approach would be to assess the scope for mobilizing both private and public resources for infrastructure spending within a macroeconomically sound and fiscally sustainable policy framework and, in parallel, to identify the projects that should be given priority based on their economic and social rates of return.

In principle, countries seeking to build up their infrastructure in different sectors have several options, including raising financing for public investment by borrowing, increasing public saving, and reallocating public spending from other sectors; getting more out of their investments by improving investment planning and project evaluation and implementation procedures; and encouraging private sector investment. The appropriate strategy will vary from country to country, depending on a country's fiscal position.



How to increase public investment?

Countries have been adopting different approaches to ensuring that key public investment needs are being met. The United Kingdom, for example, concerned that a relatively low level of public investment over a number of years could damage the long-term performance of the economy, introduced the so-called “golden rule” in the mid-1990s, which allows it to borrow to finance infrastructure and other capital projects. This was possible because of the country's small public debt, focus on achieving value for money in public spending, and high level of fiscal transparency. A “debt-ratio rule” adopted at the same time sets limits on the amount that can be borrowed so that public debt does not become unsustainable.

While the usefulness of such simple policy rules is questionable from an optimal fiscal policy perspective, the option is not even available to many developing countries. In particular, countries with high levels of public debt and countries that are vulnerable to macro-economic shocks need to match increases in public investment with

commensurate increases in public saving by mobilizing additional revenue, for example by raising taxes or by changing spending priorities.⁷

Even when debt sustainability is not a cause for concern, other considerations may make it inadvisable to accommodate additional public investment by relaxing fiscal targets. It is worth noting that Chile, which has low levels of public debt, has consistently striven to increase public investment within its existing fiscal framework as well as to increase private investment in infrastructure through well-structured PPPs.

There may be exceptional cases, however, when a small, temporary relaxation of fiscal constraints makes sense. For example, Brazil permitted a small adjustment in its fiscal targets (of up to 0.15 percent of GDP) for priority infrastructure investment projects included in a pilot program to improve project evaluation, selection, and management. The potential gains from a successful demonstration of how to improve the quality of public investment in infrastructure were judged to be sufficiently large to justify the small risk of a modest fiscal easing in the context of an overall strong fiscal performance.

Policy options for increasing public saving depend on each country's specific circumstances. In general, countries should avoid ad hoc revenue or expenditure measures that cannot (for political reasons) or should not (because of economic efficiency or equity concerns) be sustained over the medium term. In most cases, lasting increases in public saving can be achieved only by broadening the tax base, making tax collection more efficient and reducing tax evasion, diminishing budget rigidities, rationalizing the civil service and social security systems, and strengthening public expenditure management to better assess the productivity of public spending programs.

The three main findings that emerged from the pilot studies were as follows:

⁷In principle, it would be desirable to include the estimated impact of additional infrastructure spending on growth in the assessment of medium-term public debt sustainability, but it was not possible to obtain such estimates for most of the pilot countries.

- In countries with high taxes, increased public saving should come first and foremost from reducing current expenditure. In Brazil, for example, structural reforms of the pension system and the civil service would seem key for increasing public saving.
- In countries with comparatively low taxes, increases in public saving should be achieved by a combination of tax and expenditure measures. In India, for example, the ongoing overhaul of the tax system could be supplemented by efforts to rationalize poorly targeted subsidies and moderate the growth of the civil service wage bill.
- Infrastructure investment may not necessarily have higher returns than social investment or current spending, including in low-income countries. Ethiopia, for example, has very large infrastructure needs (including roads, electricity, telecommunications, and water and sanitation), but it also has urgent current spending needs in the education sector (where student-teacher ratios often exceed 100 to 1) and the health care sector (which has only one doctor for every 50,000 persons).

Governments seeking to increase public investment faster than public saving should take steps to safeguard macroeconomic sustainability, bearing in mind the following lessons from other countries' experiences:

- Increases in public investment should be limited to amounts consistent with a moderate or declining debt-to-GDP ratio over the medium term under a range of stress-test scenarios.
- Increases in public investment should be concentrated first and foremost on high-priority, high-return projects in economic sectors with clearly identified bottlenecks.
- Complementarities between infrastructure and non-infrastructure spending need to be taken into account when increasing public investment or changing spending priorities.
- Cost-benefit analyses show that investing in the rehabilitation and upkeep of existing infrastructure facilities usually has higher returns than investing in new projects.⁸

⁸However, even countries with a long tradition of public investment planning, such as Brazil, tend to give a higher priority to new projects, often for political reasons.

- The likely future recurrent costs of operation and maintenance should be taken into account in assessing the appropriateness of new investments.



Can public enterprises help relax fiscal constraints on public investment?

Since public enterprises (PEs) are often responsible for major infrastructure investments, it has sometimes been argued that government fiscal targets covering PEs could be an obstacle to such investments. However, experiences from around the world suggest that PE investments are not necessarily driven by cost-benefit considerations. In many countries, PEs run persistent losses or accumulate excessive debt and frequently end up being bailed out by the government—their main or sole shareholder. To safeguard the ability of commercially run PEs to invest in economically sound projects, an IMF study carried out in 2004 recommended excluding commercially run PEs from overall fiscal targets and indicators and established nine criteria to ascertain commercial orientation. However, only three of 115 PEs assessed in six of the eight pilot countries met a sufficient number of the criteria.⁹

The study, however, also raised questions as to whether “lack of commercial orientation” or “fiscal risk posed” should be the main criterion for including PEs in the fiscal targets. The pilot studies suggested making the following refinements to the original criteria:

⁹The nine criteria were grouped under four areas of performance as follows: managerial independence—(1) pricing and (2) employment policies; relations with the government—(3) subsidies and transfers and (4) regulatory and tax regimes; financial conditions—(5) profitability and (6) creditworthiness; and governance structure—(7) stock listing, (8) outside audits and annual reports, and (9) shareholders’ rights. A PE was considered commercially run if it met criteria (1)–(4) and at least one each of criteria (5)–(6) and (7)–(9). For more details see “Public Investment and Fiscal Policy” at www.imf.org/external/np/fad/2004/pifp/eng/index.htm.

- Giving greater emphasis to the economic and financial performance, such as rates of return on past investments, and the sustainability of PEs, including whether they are investing enough to remain viable;
- Attaching more importance to transparency in the form of observance of codes of good governance and the completion of audits by reputable private firms adhering to international standards;
- Paying close attention to the fact that some PEs operate in regulated sectors (for example, in assessing pricing policies, what is relevant may not be whether prices are set without government interference but whether tariff-setting rules for private firms and PEs are the same);
- Focusing on the operating balance in assessing PE profitability and using broader performance benchmarks for PEs that have no obvious comparators in the private sector and whose accounting may be difficult to interpret;
- Recognizing in the analysis of subsidies that even some private firms perform quasi-fiscal operations and receive subsidies, and focusing on whether subsidies to PEs are transparent, implemented through the budget, and available to private competitors.

Based on these considerations, a flexible approach to the coverage of PEs in fiscal indicators seems warranted. First, over time, all IMF member countries should begin systematically to compile and disseminate statistics on the operations of their PEs, ideally in a form comparable to government statistics. But the decision as to whether fiscal reporting and monitoring, and fiscal indicators and targets, should focus on the consolidated public sector or, alternatively, on the general government and PE sectors separately, should be taken on a country-by-country basis. Second, the decision as to whether or not the fiscal indicators and targets on which national fiscal policies are based should cover PEs should be informed by an assessment of the fiscal risk posed by the PEs' operations. PEs that pose a low fiscal risk and can therefore be excluded from fiscal targets and indicators may have room to increase investment spending—subject, of course, to the proviso that any additional borrowing incurred to

finance investment is consistent with maintaining a sound financial position.¹⁰



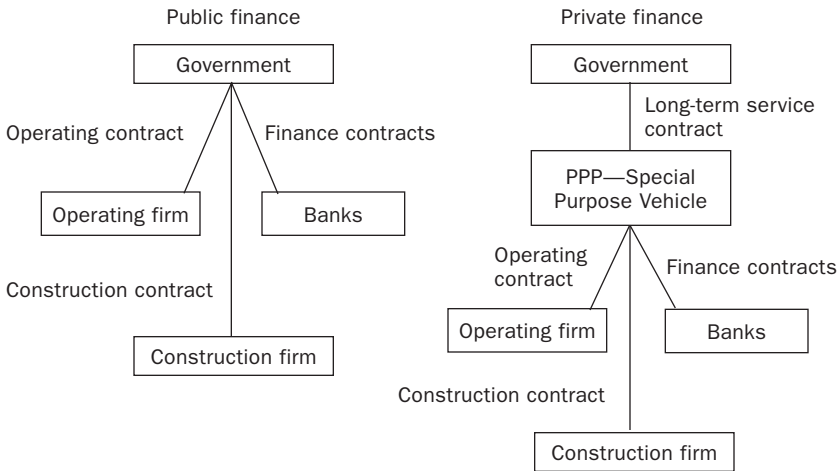
Are public-private partnerships a viable alternative?

An increasing number of countries have entered into PPPs to promote the private sector supply of infrastructure assets and infrastructure-based services.¹¹ The experiences of different countries suggest that economic infrastructure (for example, transport) is usually a more straightforward candidate for PPPs than is social infrastructure (for example, health care and education) for three main reasons. First, sound projects that address clear bottlenecks in infrastructure such as roads, railways, ports, and power are likely to have high economic rates of return and are therefore attractive to the private sector. Second, user charges are often both more feasible and more desirable in economic infrastructure projects. Third, economic infrastructure projects usually have a better-developed market for bundling construction with the provision of related services (for example, construction and operation and maintenance of a toll road) than social infrastructure projects. Based on these considerations, the emphasis

¹⁰However, if the retained earnings of PEs excluded from fiscal targets were making significant positive contributions to the government's fiscal position, the government may have to tighten its fiscal stance to ensure fiscal sustainability. This may well be the case in some Latin American countries where, for example, national oil companies account for a sizable share of the consolidated public sector's primary surplus but for little of its debt.

¹¹A fundamental difference between PPPs (private finance) and standard public procurement (public finance) is the structure of the contracts involved, as shown in Figure 1. Whereas, with public finance, debt is incurred by the government, it is incurred by the private sector under a PPP. The government, in turn, has a long-term service contract with the private sector that specifies its payment obligations and other responsibilities vis-à-vis the private sector. In a few cases, the government may have no direct payment obligations (for example, for a toll road), but in most cases, it has direct obligations (for example, availability payments and shadow tolls). In addition, it usually has explicit or implicit contingent obligations.

Figure 1. Standard procurement (public finance) and PPPs (private finance): A comparison



Source: Based on Hana Polackova Brixi, Nina Budina, and Timothy Irwin, 2005, "Managing Fiscal Risks in PPPs," in *Current Issues in Fiscal Reform in Central Europe and the Baltic States 2005* (Washington: World Bank), pp. 135–156. Available at www-wds.worldbank.org/external/default/main?pagePK=64193027&piPK=64187937&theSitePK=523679&menuPK=64187510&searchMenuPK=64187283&theSitePK=523679&entityID=000160016_20060413170346&searchMenuPK=64187283&theSitePK=523679.

on using PPPs for road infrastructure (including in several of the pilot study countries) is not surprising.

In general, PPPs allow governments to avoid or defer spending on infrastructure without forgoing its benefits. This can be especially attractive to governments that are restricted in their current ability to spend but fairly unrestricted in their ability to promise future spending. Hence, while PPPs can ease fiscal constraints on infrastructure investment, they can also be used to bypass spending controls, and to move public investment off budget and debt off the government balance sheet. Where this is the case, governments can be left bearing most of the risk involved in PPPs and facing potentially large fiscal costs over the medium-to-long term.

Yet well-structured and well-implemented PPPs offer the prospect of efficiency gains in the construction of infrastructure assets and the

provision of infrastructure-based services and, therefore, also lower the government's costs in making these services available.

How can governments ensure that PPPs provide high-quality infrastructure services efficiently? Three key factors are (1) the legal framework governing PPPs, (2) the processes for selecting and implementing PPPs, as well as the role the ministry of finance plays in this context, and (3) the contractual obligations on which PPPs are based that directly determine the fiscal risk incurred by the government. In addition, governments should aim at transparent fiscal accounting and comprehensive disclosure of all fiscal risks.

The legal institutional framework

The case studies point to the importance of a sound legal framework that covers all aspects of the PPP process. However, given very different legal traditions, frameworks for handling PPPs differ considerably across countries. For example, dedicated laws on PPPs may not exist in countries with a common-law framework, the result being that all stipulations must be incorporated into the contracts themselves. However, this can add significantly to the cost of negotiating contracts.

The comparative success of Chile's concessions program can be attributed in significant measure to the fact that it is backed by a comprehensive concessions law. Brazil has recently enacted a PPP law, although some forms of PPPs were already governed, in part, by legislation on concessions and procurement, and by the transparency requirements of the legislation on fiscal responsibility. In Peru, it is acknowledged that the relaunching of the concessions program needs to be accompanied by the strengthening of a lax legal framework.

The processes for selecting and implementing PPPs

In general, the decision to undertake a PPP has to be well informed. This can be achieved through a two-stage process. The first stage consists of deciding whether a particular project is worthwhile based on sound investment planning and project appraisal procedures (for example, using cost-benefit analysis). An important aspect of this first stage is to rank all projects based on their returns (economic or social) and decide which are fiscally affordable and should be undertaken. The second stage consists of deciding whether a worthwhile

project should be procured traditionally or as a PPP. To this end, a *public sector comparator* (PSC) indicating the cost of public provision can be used to determine whether the best private sector bid for a PPP contract offers the government better value for money.¹²

When a decision has been taken in favor of a PPP, it is important that the process of preparing the project continue to be geared toward achieving value for money and safeguarding fiscal affordability. This is best achieved through a “gateway process” that is overseen by the ministry of finance—that is, the ministry of finance must give its permission at specific stages of the preparation cycle (such as planning, tendering, bidding, and contract signature) for the project to move on to the next stage.

Contractual obligations and fiscal risk

Infrastructure projects usually come with a range of different risks, including, for example, risks related to obtaining all the licenses needed for construction (such as those related to the project’s likely environmental impact), delays in construction, cost overruns, service availability and quality, uncertainty about the medium-to-long-term need for the project, and changes in asset values. These basic risks are also present in PPPs.

A difference between PPPs and traditionally procured projects is that PPPs allow the government to share significantly more risks with the private sector. At the same time, a badly designed PPP may result in a much larger risk exposure for the government because of the long-term contractual arrangement that it entails.

A basic principle of risk sharing is that each risk should be borne by the party that can manage it best. Thus, construction and operating risks should typically be borne by the private sector, while the government should bear the risks over which it has control—most obviously, political and regulatory risks. There are also risks that the government can influence but that it may or may not have to

¹²To compare the cost of the two payment streams, the government needs to calculate the present values of these streams, taking into account the time value of money and any relevant differences in the degree of risk associated with the two payment streams.

bear—such as demand, exchange rate, and residual value risks. The pilot study countries handled risk-sharing stipulations very differently, with Colombia being particularly clear in outlining which party should bear which type of risk.

Government guarantees¹³ are a legitimate form of government support for infrastructure investment when the government is best placed to anticipate and control risk, thereby minimizing its cost. However, such guarantees create problems insofar as they are not usually subject to the same degree of scrutiny through the budget process as regular spending. These problems are compounded by the fact that guarantees often have potentially significant fiscal consequences, which can be particularly severe during times of crisis. This places a premium on developing a rational, forward-looking policy toward guarantees, for which fiscal transparency is a precondition.

Guarantees must be well designed and limited in scope and duration. In particular, governments should avoid providing guarantees that are wider-ranging than required to achieve their objectives.¹⁴ Partial guarantees may help limit moral hazard and adverse selection. Deductibles, ceilings on government exposure, collateral requirements, delays before compensation is paid, and seniority of government claims to assets in the event of default are all mechanisms that provide the private sector with incentives to manage risk efficiently while limiting the government's overall risk exposure and, ultimately, the fiscal impact of called guarantees.

The potential fiscal costs associated with guarantees argue in favor of carefully controlling them with a view to managing fiscal

¹³Government guarantees are a common feature of PPP contracts and other purchase arrangements between the government and the private sector. A government guarantee legally binds the issuing government to take on an obligation should a clearly specified uncertain event materialize. Thus, for example, a government that provides a loan guarantee to a private sector entity with which it has entered into a PPP may have to repay the loan (taken by that entity to finance the project) if the entity defaults.

¹⁴It should also be noted that the need for guarantees may diminish over time. As a country accumulates experience with PPPs and strengthens its policy framework, and, as the uncertainties surrounding the use of PPPs are reduced, it may be possible to transfer more risk to the private sector.

risk. Centralized controls over the granting of guarantees are often appropriate, and a government wishing to assert firm discipline should consider introducing a quantitative ceiling on guarantees. Governments should also appropriate in their annual budgets the expected cost of payments to meet called guarantees in the next year. In addition, if estimates of the future expected costs of guarantees are reasonably reliable, these costs should be reflected in the budget when the guarantees are granted. While this will require an appropriation, funds do not have to be set aside or earmarked to meet the full expected cost of guarantees. Charging fees to beneficiaries can also help control guarantees.

Fiscal accounting and disclosure of fiscal risks

Existing standards provide only a starting point for addressing the accounting and reporting treatment of PPPs. The *1993 System of National Accounts (1993 SNA)* and the *1995 European System of Accounts (ESA 95)* cover some operations that characterize PPPs, including leases, while *ESA 95*, supplemented by the *ESA 95 Manual on Government Deficit and Debt*, covers public infrastructure built and operated by the private sector. The IMF's *Government Finance Statistics Manual 2001 (GFSM 2001)* proposes a fiscal reporting framework that integrates flows and stocks, and shifts the emphasis toward accrual reporting and balance sheets; this framework is therefore also well suited to reporting on PPPs, although it does not currently provide comprehensive coverage of such operations.

Currently, there are no commonly accepted fiscal accounting and reporting standards for PPPs. This makes it difficult to prevent PPPs from being used to bypass expenditure controls—that is, move public investment off budget and debt off the government's balance sheet. Moreover, the use of guarantees to secure private financing can expose the government to hidden and often higher costs than traditional public finance. An internationally accepted accounting and reporting standard could promote transparency about the fiscal consequences of PPPs and, in the process, make increased efficiency rather than a desire to meet fiscal targets the main motive for using PPPs.

A 2004 Eurostat decision on accounting for risk transfer provides an initial attempt to provide guidance on fiscal accounting for PPPs

but appears to underestimate the fiscal cost implications of PPPs. According to Eurostat, countries can consider as private investment any PPP project that is judged by the relevant national statistical body to transfer to the private partner (most of) the construction risk and either the availability (continuity of service supply) or the demand risk. Since the private sector usually bears the construction and availability risk, it seems likely that most PPPs will be treated as private investment, even when the government bears substantial demand risk (for example, when it guarantees to the private operator a minimum level of demand for the service provided through the PPP). Also, the Eurostat decision creates moral hazard, making it more likely that PPPs will be designed to meet a minimum standard of risk transfer rather than an optimal level of risk transfer.

Hence, until a comprehensive international accounting standard for PPPs emerges, there remains a substantial risk that, in designing PPPs, value-for-money considerations are traded off against other considerations. This would both defeat the objective of using PPPs for efficiency gains and disguise the medium-to-long-term implications of many PPPs for public finances.

To counteract these risks, a comprehensive disclosure of the known and potential future costs of all PPPs for public finances should be encouraged. Specifically, as regards disclosure, Box 1 sets out proposed requirements for PPPs, while Box 2 deals with the comprehensive disclosure requirements for guarantees.

In addition to disclosing fiscal risks, it is recommended that PPPs and guarantees be incorporated in debt-sustainability analyses. The way this is done depends on whether PPPs are considered private investments or public investments.

- For PPPs that are considered to be private investments, future payments by the government under PPP contracts and expected future payments arising from called guarantees should be counted as future primary spending.
- For PPPs that are considered to be public investments, the service component of future payments by the government under the contracts should be counted as primary spending, while the debt-service component should be separated out and included in the overall projected interest and amortization payments.

Box 1. Detailed disclosure requirements for PPPs

For each PPP project or group of similar projects, government budget documents and year-end financial statements should provide information on the following:

- Future service payments and receipts (such as concession and operating lease fees) by government specified in PPP contracts for the following 20–30 years;
- Details of contract provisions that give rise to contingent payments or receipts (such as guarantees, shadow tolls, profit-sharing arrangements, and events triggering contract renegotiation), with the payments and receipts valued to the extent feasible;
- Amount and terms of financing and other support for PPPs provided through government on-lending or via public financial institutions and other entities (such as special purpose vehicles (SPVs)) owned or controlled by government; and
- How the project affects the reported fiscal balance and public debt, whether PPP assets are recognized as assets on the government balance sheet, and whether PPP assets are recognized as assets on the balance sheet of any SPV or the private sector partner.¹

¹The suggested disclosure of the private sector partner's accounting treatment has been made by David Heald, 2003, "Value for Money Tests and Accounting Treatment in PFI Schemes," *Accounting, Auditing, and Accountability Journal*, Vol. 16, No. 3, pp. 342–71. While there is no question of enforcing symmetrical accounting treatment by the government and the private sector, any lack of symmetry may point to areas worthy of scrutiny, especially if no part of the PPP asset is on either balance sheet.

When contingent liabilities¹⁵ related to PPPs cannot be reliably quantified, greater use should be made of scenario analysis to stress-

¹⁵Contingent liabilities are costs that the government will have to pay if a particular event occurs. They are therefore not yet recognized as liabilities. In addition to guarantees, such obligations arise mainly from government insurance schemes, including deposit, pension, war-risk, crop and flood insurance, but they can also be the result of warranties and indemnities provided by the government, and outstanding and potential legal action against the government.

Box 2. Disclosure requirements for guarantees

Irrespective of the basis of accounting, information on guarantees should be disclosed in budget documents, within-year fiscal reports, and year-end financial statements. Guarantees ideally should be reported in a fuller Statement of Contingent Liabilities that is part of the budget documentation and accompanies financial statements, with updates provided in fiscal reports.

A common core of information to be disclosed annually for each guarantee or guarantee program should include the following:

- A brief description of its nature, intended purpose, beneficiaries, and expected duration;
- The government's gross financial exposure and, where feasible, an estimate of the likely fiscal cost of called guarantees;
- Payments, reimbursements, recoveries, financial claims against beneficiaries, and any waivers of such claims; and
- Guarantee fees or other revenue received.

In addition, budget documents should provide the following:

- An indication of the allowance made in the budget for expected calls on guarantees; and
- A forecast and explanation of new guarantees to be issued in the budget year.

During the year, details of new guarantees issued should be published (for example, in the Government Gazette) as they are issued. Within-year fiscal reports should indicate new guarantees issued during the period, payments made on called guarantees, and the status of claims on beneficiaries, and update the forecast of new guarantees to be issued in the budget year and the estimate of the likely fiscal cost of called guarantees.

Finally, a reconciliation of the change in the stock of public debt between the start and end of the year should be provided, showing separately that part of the change attributable to the assumption of debt arising from called guarantees.

test debt projections under alternative assumptions about calls on guarantees. Other things being equal, the larger the expected liability associated with guarantees, the less favorable a particular debt path.

If a debt-sustainability analysis shows that a proposed PPP program has significant risks, the government should consider imposing a cap on the overall size of the program. The cap could usefully be specified in relation to the capacity of the country to service future obligations under the PPP program, proxied by its future stream of revenues. For example, Brazil's recently enacted PPP law prohibits undertaking new PPPs if the projected stream of payments under the program exceeds 1 percent of government revenue in any future year.



Conclusions

The pilot studies confirm that many countries have limited scope for increasing public investment by relaxing overall fiscal targets. In countries with an already large public debt burden, increases in public investment will need to be accompanied by commensurate increases in public saving through expenditure reprioritization, and, where appropriate, revenue mobilization. More policy options are available to countries with a relatively low debt burden and countries that can secure additional concessional financing on a sustained basis, consistent with long-term debt sustainability. In increasing public investment, important trade-offs between public infrastructure spending and other public spending (for example, for health care and education) will also have to be addressed on a case-by-case basis. The appropriateness of including public enterprises in fiscal indicators should be determined by the fiscal risks they pose, rather than by the need to increase public investment. The pilot studies propose a set of criteria to inform this decision.

PPPs offer a limited avenue for increasing infrastructure investment, provided that they are appropriately structured. Although they offer an increasingly popular vehicle for providing infrastructure, they are no panacea. It is important to ensure that PPPs are carried out for the right reasons (increasing efficiency) rather than being driven by a desire to move expenditure off budget and debt off balance sheet. High priority should be given to strengthening countries' capacity to

identify and select opportunities for PPPs; establish appropriate legal and regulatory frameworks for such operations; structure contracts to ensure an adequate transfer of risks to the private partner, including through appropriate pricing of such risks; and appropriately reflect PPPs in the fiscal accounts and in debt-sustainability analysis.

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Public Investment and Public-Private Partnerships

