

Public-Private Partnerships and Fiscal Risk

Introduction

Public-Private Partnerships and Fiscal Risk Introduction Public-Private Partnerships (PPP) refer to arrangements in which the private sector supplies both infrastructure assets and services that have traditionally been provided by the government. In addition to private sector provision of infrastructure assets and services, PPP have two key related characteristics: execution and financing of public investment projects by the private sector; and significant risk transfer from the government to the private sector.

The main argument in favor of PPP is that, through private-sector management and innovation, PPP generate efficiency gains, i.e., they provide better value-for-money (VFM) than traditional public procurement of the same assets and services. Hence, while successful PPP deliver high-quality services at lower cost than potential government alternatives, this generally requires efficiency gains to be large enough to cover the higher private sector borrowing costs (which would be passed on the government in PPP contracts).

However, PPP can also be used to bypass spending constraints and normal budgetary procedures: they may move public investment off budget and debt off the government balance sheet, while the government still bears most of the risk involved and faces potentially large fiscal costs down the road. Indeed, even PPP that do not deliver VFM can be a tempting alternative for financially constrained governments as PPP may generate increases in investment without immediately adding to government borrowing.

PPP and Fiscal Risks

Even where PPP are carried out for the right reasons, i.e., to achieve efficiency gains, there is a need to address potential fiscal risks. In general, in the context of PPP, fiscal risks are due to weaknesses in the legal and institutional frameworks, and to inadequate policy formulation. The main risks confronting PPP projects are:

- **Technical risk.** This refers to cost and schedule overruns; the private sector generally bears this risk
- **Financial risk.** This refers to the possibility that a project's cash flow may fall short of the level needed to repay the project loans and capital invested. The private sector generally bears the financial risk, although in some cases governments may provide debt guarantees, equity guarantees, and other types of financial guarantees. For projects involving foreign capital, the private sector generally assumes the exchange rate and inconvertibility risk, although in some cases political risk insurance may be available to cover inconvertibility

- **Political risk.** This refers to situations where government actions could impair the private sector's earnings potential. Governments generally bear the responsibility of such risk when fair and timely procedures are in place to compensate the private concessionaire against breach of contract by the government. Private concessionaires generally assume the risk associated with dispute resolution and the ability to obtain compensation in the event of a government violation of the contract
- *Force majeure.* This refers to risks beyond the control of public and private partners ("acts of god"). These risks are assigned primarily to the private sector and usually handled through insurance.

In practice, the fiscal consequences of these risks are either direct or contingent, and result in either explicit or implicit liabilities. They can take different forms, such as future commitments for the government budget to honour minimum income guarantees; contingent liabilities in the form of guarantees to secure private financing; and bailing out of the private partner when the latter becomes financially distressed.

Conditions for Successful PPP

The shift to a new model for providing infrastructure services implies major challenges for governments in terms of how investment decisions are handled. In this context, governments face a need to strengthen both their in-house technical capacities and the overall legal and institutional environment in which PPPs are carried out. Some key conditions for successful PPP can be summarised as follows:

- PPP should be pursued only when they offer VFM compared to standard public procurement
- PPPs should be fully integrated with the government investment strategy, medium-term fiscal framework, and government budget cycle, i.e., they should be subject to the same approval and oversight procedures as the budget
- The quality of services under PPP should be contractible. There is a need to specify the quality of services the private sector is to supply, and translate these into measurable output indicators. Service payments by the government can be linked to service delivery by the private sector only when this is the case
- Risk-sharing should be adequate to allow the delivery of high-quality, cost-effective services. Successful PPP require that each specific risk be borne by the party that can manage it best. The allocation of risks in each PPP should be disclosed transparently
- To handle PPP, a strong institutional framework is needed, with a clear allocation of responsibilities within the government. The institutional setup for PPPs varies by country, but experience suggests that a central PPP unit, preferably at the Ministry of Finance and responsible for the entire PPP program, can serve as a useful vehicle to facilitate PPP. While PPP can be advanced by sectoral ministries, a central PPP unit would function as a

“gate keeper,” where, at specific stages of the project preparation cycle, the Ministry of Finance has to give its approval for a project to move ahead

- Governments need to strengthen their technical expertise to appraise, prioritise and manage investment projects, and ensure that investment projects that are to be carried out as PPP are consistent with broader fiscal and economic policy objectives
- The legal framework should cover all major aspects of the PPP process and be conducive to private participation. A strong and reasonably detailed legal framework can set the parameters for handling PPP and also provide reassurance to the private sector that contracts will be honoured
- PPP contracts should be based on competition or incentive-based regulation. Open bidding for contracts provides the principal opportunity for fostering competition in a PPP setting
- The fiscal implications of PPP should be properly accounted for and reported, including in government budgets. In the absence of international standards for PPP accounting, best practice requires that, for all PPP contracts, actual and potential fiscal costs be transparently disclosed and reported, and taken into account when assessing debt sustainability.

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