

PRIVATELY FINANCED CAPITAL IN PUBLIC SERVICES*

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Recent changes in U.K. policy, notably the retirement of the 1981 Ryrie rules, presage a substantial increase in the use of private finance for public sector projects. The most important features of the relaxations of 1989 and 1992 relate to successive modifications of the value-for-money test, notably in connection with removing the requirement for a systematic comparison with a hypothetical publicly financed project (e.g. when the private sector can be directly remunerated by user tolls); less stringent rules on leasing; and allowing private borrowing on the security of Exchequer-funded assets. The crucial issues are identified to be the extent of private finance and the implications for macroeconomic indicators; whether the hypothesized operational efficiency gains are sufficient to offset higher financing costs; whether risk *is* genuinely transferred to the private sector; and whether risk *ought to be* transferred to the private sector.

I INTRODUCTION

Government policy in the United Kingdom is that “a steadily rising proportion of capital investment in the public services should be financed by private capital, based on a proper sharing or transfer of risk” (Treasury, 1994b, para. 3.28). The development of policy on the use of private finance for what have conventionally been publicly provided services now commands a high political priority. This is clearly related to the “hollowing out of the core state” (Rhodes, 1994) which has resulted in rapid and extensive changes in modes of public service delivery. Much of traditional government activity is being taken outside general government, with the associated financing flows for purchasing and/or formula funding being scored within general government expenditure (GGE). This transfer of service provision is to both the private sector and a growing quasi-public sector in which the delivery organizations are often constituted as private sector bodies, though remaining tightly controlled by government. The changes are complex: in some cases, there is a complete substitution of private financing and production for public financing and production, whereas in others public financing is associated with private production or private financing with public production. This transformation of the

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traditional production state into a procurement and funding state raises issues concerning relative efficiency, accountability and controllability (Bös, 1986, 1991; Dunleavy and Hood, 1993; Laffont and Tirole, 1993) which extend beyond the scope of this paper. Taken together, these policy reforms have originated from pressures to have better public services for less taxation and from the adoption of a strongly market-oriented framework of analysis.

The objectives of this paper are to clarify the rationale for this recourse to private finance for public projects, to analyse the potential implications and to focus attention upon areas where existing empirical information fails to satisfy the needs of policy evaluation. Accordingly, Section II identifies the issues raised by private finance, and shows the usefulness of approaching the topic separately from macroeconomic and microeconomic perspectives. Section III discusses the celebrated status of the 1981 Ryrie rules on the conditions under which the Treasury then permitted the use of private finance, and examines the policy changes which have occurred since 1989. Section IV addresses those issues which the earlier analysis demonstrated to be central to policy evaluation. Finally, Section V draws conclusions and identifies areas where further data and research are required.

Economic evaluation of government policy initiatives such as the Private Finance Initiative (PFI) often confronts two difficulties. First, there may be substantial ambiguity about objectives, partly because these are conflicting and partly because spoken and unspoken motives may differ (Hood, 1994). Second, the predicted consequences of a policy initiative may depend not only upon the model of the economy to which policy-makers subscribe, but also upon the model of the political process which is considered to be relevant. This point was forcefully illustrated by the failed implementation of the community charge, primarily because of faulty predictions about the interactions between adjacent political and fiscal systems (Gibson, 1990). In turn, evaluation of the use of private finance for public projects depends crucially upon empirically verifiable economic magnitudes (e.g. efficiency gains and higher financing costs) and upon judgements about the political process (e.g. whether the desire for higher infrastructure spending, thought to be frustrated by macroeconomic constraints, will lead policy-makers to shield private investors from risk).

II IDENTIFYING THE KEY ISSUES

A helpful starting point is to note that the Treasury approaches the issue of private finance from three different perspectives: macroeconomic policy because of the scoring of publicly financed projects in macroeconomic aggregates which figure prominently in policy formulation; microeconomic efficiency because of the Treasury's responsibility for public sector

efficiency; and government political strategy because of the way in which changes in the public/private mix of the U.K. economy have been a consistent theme since 1979. Approaches which start from macroeconomic policy may not necessarily be consistent with approaches which originate in the search for microeconomic efficiency. As this paper concentrates upon economic and financial issues, comparatively little is said about political strategy¹ other than to draw attention where appropriate to its implications for policy when these conflict with economic prescriptions (Dobek, 1993).

From a Macroeconomic Perspective

When approaching public expenditure from a macroeconomic perspective, it is natural to think in terms of decisions being taken politically about public expenditure aggregates and, perhaps but not necessarily, about the proportion which will be public capital expenditure. After top-down decisions have been taken, it will be left to decision-makers to optimize within their own policy sectors. Global optimization, between the public and private sectors or across the whole of the public sector, is infeasible as a decision-making rule. However, over the medium term, there ought to be an iterative process which leads to modified judgements about the desirable public/private balance and functional composition in the light of information about, *inter alia*, relative returns.

One key aspect of macroeconomic balance is the need to avoid an excessive expansion of public expenditure so as not to crowd out private investment. An important insight is that private investment is just as likely to be crowded out by privately financed public projects as by publicly financed public projects. The Treasury does not consider that the use of private finance to replace public borrowing will have macroeconomic effects measurably different from those of public finance:

The well developed system of capital markets in the UK, with the access to global markets, means that a wide range of funds is available to both Government and to private promoters to finance UK-based projects. It is possible that private promoters may be able to tap some funds which would not normally be used for gilts. But no *measurable* differences in macroeconomic effects are likely to follow. (Treasury, 1993a, p. 13, italics added.)

¹In the earlier formulation of the Treasury's "key strategic objectives" (Treasury, 1994a, p. 4), there was no explicit reference to the PFI. However, the fundamental review of Treasury running costs (Southgate *et al.*, 1994, p. 9) contained as Objective 8: "Promoting greater use of private finance in support of services currently provided by the public sector and privatising those parts of the public sector which do not need to remain in public ownership."

This statement prevents reliance by the Treasury upon a macroeconomic justification for using private rather than public finance. However, this characterization of the policy problem was disputed both by some opposition politicians (Brown *et al.*, 1994) and by some providers of private finance (Hancock, 1993). Attention returns to this matter later in the paper.

There is another dimension to the relationship between public and private investment, explored in a developing economic literature which examines the contribution of publicly provided infrastructure to private sector productivity growth (Ford and Poret, 1991; Munnell, 1992). It has been argued that recent falls in private sector productivity growth are attributable in part to reductions in new public infrastructure investment, and to deterioration in the quality and condition of existing public infrastructure because of the budgetary stress experienced by governments. The contribution of a particular "public" project to the stimulation of private sector productivity growth does not depend on whether that project is publicly or privately financed.

Extensive use of private finance for public projects would necessitate a reconsideration of existing data on the fiscal deficits of governments. This is particularly important in the context of European economic integration owing to the commitments undertaken through the Maastricht Treaty whereby member states have pledged themselves to "avoid excessive government deficits", interpreted as ceilings of 3 per cent for the ratio of the government deficit to GDP at market prices and of 60 per cent for the ratio of government debt to GDP at market prices.² To be meaningful, cross-sectional comparisons must take account of the different economic and institutional structures of member states within the European Union (EU). In the United Kingdom, public capital expenditure is scored against the Control Total, GGE and the Public Sector Borrowing Requirement (PSBR) according to the control status of the organization; for example, external financing limits (EFLs) contribute towards the PSBR. Extensive use of private finance for public projects would necessitate a reassessment of how the PSBR and the Public Sector Financial Deficit should be measured and interpreted. More general issues are raised, relating to wider debates on how fiscal deficits ought to be measured (Blejer and Chu, 1988; Cavanna, 1988; Blejer and Cheasty, 1991) and to how government contingent liabilities, whether derived from loan guarantees or from the structuring of government funding, ought to be valued (Towe, 1991). The fiscal rectitude obligations entered into under

²Article 104c of the (Maastricht) *Treaty on European Union* and Article 1 of the *Protocol on the Excessive Deficit Procedure* (Council of the European Communities and Commission of the European Communities, 1992).

the Maastricht Treaty render comparability of fiscal data more important, and also create powerful incentives to structure transactions in ways which evade those constraints.

From a Microeconomic Perspective

It has long been recognized that government can borrow cheaply³ because it has access to tax revenues; lenders to government do not have to be directly concerned with the quality of its projects. There are two distinct sets of circumstances which can lead to the adoption of low public sector discount rates: the ability of the Treasury to borrow more cheaply than the private sector; and acceptance of a theoretical rationale which has been extensively developed in the social discount rate literature. Much of that literature supports the adoption of a discount rate based upon social time preference (STP), the rate at which the social utility of consumption declines through time. Most estimates of the STP rate are substantially lower than average private sector rates of return. The displacement of private investment is dealt with, not through the discount rate but by means of a shadow price of capital, which means that £1 of public investment is weighted as greater than 1 (Atkinson and Stiglitz, 1980; Drèze and Stern, 1987; Stiglitz, 1988). Market failure arguments for low public sector discount rates on an STP rationale have obvious relevance to the division of economic activity between the public and private sectors. Flemming (1977) cautioned that the adoption of low discount rates could lead to much productive activity being transferred to the public sector, provided that there were limited differences in relative efficiency. On balance, however, the theoretical literature is unsupportive of approaches based on opportunity cost.

The Treasury's view, articulated within its guidance on public sector investment appraisal (Treasury, 1991; Spackman, 1991), is that the marginal opportunity cost of capital and STP are both relevant to public sector decision-making. Both are considered to be higher than the financing cost of government debt, and it is assumed for practical purposes that they can be taken to be equal. Although the Treasury's current guidance is based on STP, not on opportunity cost, this is obscured by the way in which the expression "opportunity cost" is often used in explaining discounting to non-economists. In order to prevent the public sector from becoming overexpanded because of access to cheap capital, the Treasury has shadow-priced capital, by means of mechanisms such as the test discount rate and the required rate of return, set at levels usually well above government financing costs.

³Though not directly relevant here, it should be noted that there are now many governments in the world for which this does not hold.

The extensive programme of market testing of central government services has heightened the importance of internal costing, so that the costs of in-house provision, including capital costs, can be compared at the margin with private sector costs (Spackman, 1991, p. 35).⁴ Those public sector organizations (i) to which returns from investment accrue in the form of cash flows, *and* (ii) whose operating statement records costs of capital as interest payments on National Loans Fund or other public sector debt, *and* (iii) which successfully earn their shadow cost of capital, will steadily accumulate surpluses on account of the difference between the shadow costs of capital and actual financing costs. They will gradually become debt-free, a situation which greatly concerned the Treasury in the mid-1980s in the context of the then nationalized electricity and water industries⁵ because of a fear that financial discipline would slacken. Exactly the same issue arises if certain organizations, whether in the private or public sector, can borrow “cheaply” from private sources because of their “closeness” to government, whether through contracting or grant arrangements. Whilst much will depend upon accounting conventions and the specifics of the control regime, it may be advantageous for the organization to opt for private finance, provided that the additional cost of private finance is less than the difference between the shadow and financing costs of capital. The Treasury recognized this point by requiring project appraisals following standard procedures, including the shadow cost of capital (Treasury, 1989, as amended 1992, para. 29.1.17); effective enforcement within a fragmented public and quasi-public sector is doubtful (especially as this section of guidance was withdrawn in August 1994).

Whereas EFLs are often discussed in terms of being manifestations of macroeconomic constraints, it is also important to note their microeconomic role as a mechanism designed to secure cost reductions. One justification for tough EFL controls, much stressed by the Treasury (Byatt, 1984), is that they provide general pressure to enhance cost efficiency, thus releasing internal resources for, *inter alia*, capital projects. The corollary is that any relaxation of such pressure, say because of the ready availability of private finance, might weaken the incentives for cost reduction.

⁴A rigorous comparison of public and private finance would need to take the annual financing charges in each case and discount these at, say, 6 per cent (Walshe and Daffern, 1990). This was standard central government procedure for a while but was abandoned as impractical and not sufficiently different from applying a 6 per cent discount rate to both public capital expenditure and private rental or service charges (Spackman, 1991, para. 49).

⁵Becoming debt-free was in part a consequence of the application of financial targets based upon current cost accounting (CCA) net assets, without there having been a comparable revaluation of liabilities. The Byatt Committee (Byatt, 1986) defended CCA as a means of moving financial reporting closer to economic principles.

Recourse to private finance for public projects is often claimed to lead to better-executed projects (Ryrie, 1989) and thus to enhance micro-economic efficiency. A key obstacle to the use of private finance in public projects is that private finance is always more expensive. Therefore, private sector financing must bring with it operational efficiency gains whose present value exceeds the present value of additional financing costs. Those advocating the use of private finance contend that these efficiency gains do outweigh the higher financing costs. This argument is rarely empirically documented, and is normally asserted to be a consequence of the better incentive structures which prevail in the private sector. Crucially, the driver for efficiency gains is argued by the Treasury to be the transfer of risk to the private sector.

The literature on public sector discount rates is notable for a major dispute about the policy implications of theory for the treatment of risk in public sector discount rates (O'Donnell and Rhodes, 1983), with distinguished economists on both sides. Arrow (1966) and Arrow and Lind (1970) contended that government can bear risk better than a private firm, with the consequence that public investment projects should be evaluated using a risk-free rate, with no premium levied for risk. In opposition, Hirshleifer (1965, 1966) contended that risky public investments should be required to earn the same rate of return as risky private investments, with the consequence that public investment projects should be evaluated using the same discount rates, set at the appropriate risk-adjusted cost of capital, as would be used to evaluate comparable private sector projects.⁶ Certain expressions need to be noted carefully, particularly "bear risk" and "comparable private sector projects".

Lind (1982) observed that these positions, often taken to be diametrically opposed, are not necessarily incompatible. Arrow and Lind (1970) advanced two theorems. By the first theorem, in an economy characterized by complete markets contingent upon states of the world, the risk-free rate should be used *provided that* the distribution of returns to the project is statistically independent of the distribution of returns to the economy as a whole. Indeed, a private firm adopting the capital asset pricing model (CAPM) approach would also use the risk-free rate, as such a project has a zero β .⁷ By the second theorem, if the government undertakes a risky investment which is small in relation to the economy as

⁶The discussion in this paper relates only to *whether* the public sector should adjust for risk, and not to *how*. There is a tradition in the public sector discount rate literature of hostility towards the practice of adding a risk premium to discount rates because such a practice exponentially increases the risk premium. Perversely, the adoption of higher discount rates makes catastrophic future events exert less weight in decision-making now (Stiglitz, 1988).

⁷This exposition blurs the difference between national income (relevant to the Arrow-Lind theorem) and the capital market index (relevant to the usual CAPM).

a whole and spreads that risk over a large number of people so that each holds only a small share, the cost of that risk is reduced to zero in the limit, even though that risk will not be optimally allocated among individuals as it would be in an economy with complete markets for claims contingent upon states of the world. Lind (1982) identified the critical question as being the correlation between the returns from public projects and either the returns from all other projects in the economy or national income. Whilst he considered that the projects with which he was particularly concerned (energy investments in the high energy cost OPEC world of the late 1970s) would be negatively correlated with all other projects and national income, the returns on public projects would in general be positively correlated with both. Accordingly, those energy investments which constitute insurance should be appraised using a discount rate lower than the risk-free rate whilst the discount rate for most public projects should incorporate a risk premium as well as the risk-free rate.⁸

An important assumption underlying the PFI is that private sector management will reduce variability risk (e.g. reduce capital overspends or operational underperformance), reflecting the proposition that risks ought to be borne by those best able to control them. It is believed that the private sector will exercise more discipline over its civil engineering contractors, exhibiting more resilience to cost overruns because these contractors know that the private sector firm is itself vulnerable to bankruptcy and lacks government's access to tax revenues. Capital budget constraints will be seen to be much harder than would be the case with a public sector principal. Better project design and management, leading to reductions in the variability of returns by reducing downside risk without sacrificing returns, are wholly beneficial; indeed, such measures also increase expected net present values. There is then the question as to whether a given degree of variability risk is more costly if borne by private sector bodies than if borne by government. Well-diversified private shareholders can diversify away unsystematic risk and hence require no reward for such risk bearing. Thus, the policy question resolves into two parts: whether there is empirical evidence that the private management associated with private finance does indeed deliver these hypothesized benefits; and what conclusions are drawn about the respective risk-bearing capacities of the public and private sectors.

⁸There are likely to be major difficulties confronting an attempt to implement this approach.

In particular, in the absence of output markets, it will be difficult to establish β for the public project. Moreover, Lind (1982) expressed doubts about the validity of using β calculated from the single-period CAPM and then applying this to long-lived public projects. Spackman (1991, para. 70 and Annex B) concluded that the correlation of project returns with national income would generally in practice justify no more than a small effect on the discount rate.

Government wants public sector managers to minimize risk through good project design and management where this can be done without sacrificing return. Then, government will bear the risk itself as part of its portfolio of projects. Public sector managers, however, will be undiversified and, if subject to performance appraisal systems which cannot discriminate between chance and managerial inefficiency, they will sacrifice return in order to reduce unsystematic risk. Moreover, the fragmentation of the public sector into decentralized managerial units—evaluated separately and with managerial pay and career prospects linked to unit performance—will create serious tensions. Although it may be optimal for government to bear risk, it will not be seen as optimal by the managers of individual units for them to bear risk. In consequence, public sector organizations may become more risk averse. Private sector principals face similar agency problems, though the threat of the capital market discipline of takeover may constrain the amount of attention which private sector managers can pay to unsystematic risk.

III THE RYRIE RULES

The retirement of the Ryrie rules has tellingly been likened to “the retirement of an opera soprano” (Beith, 1993, Q. 43). Over the period from their inception in 1981 until the first retirement in 1989, they acquired the status of Treasury bogey. The substance of the Ryrie rules was summarized by the Treasury in the following way:

- (i) decisions to provide funds for investment should be taken under conditions of fair competition with private sector borrowers; any links with the rest of the public sector, Government guarantees or commitments, or monopoly power should not result in the schemes offering investors a degree of security significantly greater than that available on private sector projects; and
- (ii) such projects should yield benefits in terms of improved efficiency and profit from the additional investment commensurate with the cost of raising risk capital from financial markets. (Treasury, 1988, Annex.)

These rules are best understood in terms of their origins. Prior to 1977, all the capital expenditure of nationalized industries and public corporations was scored within public expenditure and thus contributed towards the PSBR, even when wholly financed from internal resources derived from user charges. The 1977 redefinition of public expenditure and the 1978 White Paper on nationalized industries (Treasury, 1978) switched the focus of control to the EFL, the cash limit on external financing. During the recession of the early 1980s there was much public debate as to whether restrictive EFLs, designed to hold down the PSBR as a means of

controlling money supply growth, were frustrating profitable nationalized industry investment and thus needlessly exacerbating the recession (Brech and Whiteman, 1981; Treasury and Civil Service Committee, 1981). The specific question of the conditions under which nationalized industries might have access to private finance was the topic of a National Economic Development Council report, prepared by a tripartite committee chaired by Sir William Ryrie, then the Second Permanent Secretary of the Treasury (Ryrie, 1981).

Despite their origins having been specific to the nationalized industries, the Ryrie rules were subsequently taken to be a statement of the Treasury's position on the use of private finance across the public sector (Barr, 1989). In a speech on private finance for roads, John Major, then the Chief Secretary, stated that:

the view often prevails that "the Treasury" or "the Ryrie Rules" are a huge stumbling block to greater private sector participation in the infrastructure. The Ryrie Rules are thought to be incomprehensible, and to hamper private finance by setting impossible hurdles (Major, 1989, p. 1.)

David Willetts, a Conservative MP, wrote in 1993 that:

Ten years ago, as a junior Treasury official, the author helped to formulate and enforce the Treasury's rules on private finance for public projects. The Treasury's objective then, though not always openly stated, was to stop such schemes. The notorious Ryrie rules were a tease—the conditions they set for private financed projects were not intended to be met in practice. (Willetts, 1993, p. 5.)

In that same speech in Glasgow to the Institute of Directors (Major, 1989), John Major formally retired the "obsolete" Ryrie rules. The second retirement came when the then Chancellor of the Exchequer (Norman Lamont) used the occasion of his 1992 Autumn Statement (Treasury, 1992a) to announce "important changes" (Treasury, 1992b, p. 1) in the rules governing the use of private finance by public sector organizations (Treasury, 1992b, 1992c). Although the sequencing of these changes is itself of public policy interest, the exposition here concentrates solely on the cumulative effect.

- (1) The value-for-money criterion has been modified, by the delineation of a category of privately financed projects which will no longer be tested against hypothetical public sector alternatives and by restricting its application only to the public sector contribution to privately led projects.
- (2) There seems to have been a substantial relaxation of the Treasury's stance on additionality, from the "normal presumption" of a one-for-

one reduction in public expenditure allocations (unless there is an explicit policy decision to the contrary) to the post-1992 situation in which only the public sector contribution is scored against the public sector allocation. Even this leaves open long-term feedbacks on allocations, with the Treasury netting off forecast levels of private finance when determining allocations for planning years.

- (3) There has been a loosening of the rules on how leases are scored against allocations.
- (4) Higher Education Institutions (HEIs) can now borrow on the security of Exchequer-funded assets; these borrowings, which might be large, will be outside the PSBR and may establish a precedent.

The following presentational change has been made.

- (5) The Treasury no longer volunteers the argument—though it confirms the argument when directly questioned—that the private sector will be tapping virtually the same pool of finance as itself, albeit more expensively, in order to undertake privately financed public projects.

The following substantive ruling has remained unchanged.

- (6) The Treasury continues to insist that there must be a genuine and significant transfer of risk from the public sector to the private sector.

IV ADDRESSING THE KEY ISSUES

This section addresses issues identified above as fundamental to policy evaluation: modifications to the value-for-money criterion; additionality; measurement of efficiency gains and additional financing costs; determining whether risk has been transferred; and erosion of public expenditure controls.

Modifications to the Value-for-money Criterion

The first point concerns the reference comparison. The objective of investment criteria in the public sector has been to achieve “best” value-for-money for the taxpayer/citizen. For this to be achieved, there has to be an unrestricted choice of alternative projects, including those which are privately financed and those which are conventionally Exchequer-financed. A classic statement of the Ryrie rules presented the choice between conventional and private finance in the following terms:

The use of private finance instead of public finance for a specific project is justified if, and to the extent that, it provides the *most cost-effective solution*. Publicly and privately financed investment options

should therefore be compared using standard investment appraisal techniques. When comparing public and private finance options, the appraisal will take account of differences in financing costs; and the fact that transferring to the private sector the risk of project overruns, or a failure to secure the benefits of the investment, may provide a strong incentive to the private contractor to achieve greater efficiency than would be achieved by the public sector. The risk of losses—unprotected by public sector guarantees—is at the heart of market disciplines and the assessment of these extra incentives provided for the private contractor is a key element. (Treasury, 1988, para. 10, italics added.)

The wording here is important: it stressed the search for the “most cost-effective solution” which must necessarily involve a comparison of the privately financed project against the best available publicly financed alternative.

The successive “retirements” of the Ryrie rules in 1989 and 1992 modified this value-for-money criterion, most particularly by setting up different categories of project which will be treated differently. The 1989 retirement differentiated two categories:

- 1 where the private sector takes full responsibility for success or failure of the project: enterprises like the Channel Tunnel—*where the private sector is genuinely in charge*, and in competition, with all the benefits, and risks, that brings and where the return does not depend on income assured by Government contracts, subsidies or guarantees; and
- 2 where capital costs are privately financed but *the taxpayer’s interests are still directly or indirectly engaged*. For example, for one reason or another the Government may carry the ultimate liability if the scheme goes wrong. (Major, 1989, p. 3, italics in original.)

For category 2, where “we must safeguard the taxpayer’s interests as well as the user’s”, privately financed projects must “offer better value for money than the publicly funded alternative” (Major, 1989, pp. 3-4). The 1992 retirement subdivided category 2 into 2A and 2B:

- 2A if the private sector is wholly responsible for a project which needs Government approval and can recoup all its costs by charges at the point of use, comparison with a theoretical public sector alternative will not be needed Under the current rules a comparison has generally been required if a project is one the Government might have undertaken itself (Treasury, 1992b, p.1); and
- 2B where this condition does not hold.

The value-for-money test has been significantly weakened by this two-stage process: projects in category 1 have been assigned to the private sector, and those privately financed projects falling in 2A will no longer be tested against hypothetical public sector alternatives. Thus, one might envisage an implied certification procedure whereby the Treasury agrees with a policy ministry's assessment that the public sector alternative would "never" be financed.⁹ This modification may be characterized as a willingness to accept "good" rather than "best" value for money.¹⁰ Clearly, the delineation of categories 1 and 2A might result in a significant expansion of privately financed infrastructure sustained by tolls on use.

The second point of policy change is that, "where the private sector is a major partner", the value-for-money test will not refer to the project as a whole (that will be the private sector's responsibility) but only to the public sector contribution to the project (where that occurs):

If the public sector secures good value for money for the contribution that it makes to a project where the private sector is a major partner, then that should satisfy our prudential criteria. That is the major change that we sought to introduce and we are seeking to introduce as a consequence of what the Chancellor said in November. (Dorrell, 1993, Q. 6.)

The government's remit thus narrows, from an earlier focus upon the economy as a whole to an exclusive concern for public funds. This narrowing of the government's value-for-money test, from the project as a whole to the government's own contribution, is clearly a significant move, though one which has not been made anything like as explicit in Treasury guidance as it was in the then Financial Secretary's evidence to the Treasury and Civil Service Committee.¹¹

⁹Something like this had already occurred in the case of the Skye Bridge: "The bridge received the blessing of Highland Regional Council only after the Scottish Affairs Minister, Lord James Douglas-Hamilton, said that there was no possibility of a toll-free bridge for at least 20 years" (Johnston, 1989). The Skye Bridge and the Birmingham Northern Relief Road have been cited as specific examples of "projects which met whatever replaced the Ryrie Rules and therefore proved acceptable following that retirement, between 1989 and the Autumn Statement 1992" (Beith, 1993, Q. 43; Dorrell, 1993, Q.43).

¹⁰At the 1992 retirement, there was an interesting change of wording in official statements which appeared to have been carefully drafted: from "*better value for money*" (Major, 1989, p. 4, italics in original) to "good value for money" (Treasury, 1992b, p. 4). This rewording occurred when the "hypothetical publicly financed comparator" requirement was dropped for those privately financed projects which would be remunerated by direct user charges.

¹¹The current edition of the Treasury's Green Book on investment appraisal methodology (Treasury, 1991), which pre-dated this narrowing of the value-for-money criterion, provides no guidance on how the value-for-money of a government contribution should be assessed. It is difficult to envisage how this can be done in isolation from an assessment of whether the project as a whole is economically viable.

The third point concerns the nature of the benefits which flow from particular projects, notably concerning the extent to which they yield cash flows to the infrastructure operator. The problem can most readily be focused by identifying four possibilities: A, publicly financed untolled road; B, privately financed untolled road (remunerated via shadow tolls); C, privately financed tolled road; and D, publicly financed tolled road. Although tolling is regarded as a means of facilitating private finance,¹² the effects should be distinguished. The current thrust of transport policy is to move from A to C. Although economic appraisal should make six pair-wise comparisons, the 1992 establishment of project categories 1 and 2A means that only alternative bids for C are now judged relevant.¹³ A consequence of tolling is that projects which primarily yield non-monetary flows of benefits, such as time savings to non-users or environmental benefits, may be neglected, as greater priority becomes attached to projects whose benefits can be transformed into revenues. The pattern of infrastructure spending might significantly change, with greater emphasis being placed upon the revenue-raising potential of schemes and less upon cost-benefit considerations. Ownership will affect tolling policy, as the private operator is explicitly encouraged to maximize profitability (Cope, 1993), whereas public operators have traditionally subordinated profitability to perceived wider economic, social and political benefits.¹⁴ In order to mitigate some of the effects of tolling and ownership change, the government might use capital grants to signal its valuation of the social and environmental benefits attached to particular schemes or designs. For example, the accepted tendered design for the Skye Bridge has been much criticized on aesthetic grounds; it would have been possible for the Scottish

¹²There is international interest in the use of private finance for those infrastructure projects where tolling provides a direct means of remunerating the private investor (OECD, 1987; Department of Transport, 1989, 1993a; European Conference of Ministers of Transport, 1989; Augenblick and Custer, 1990; Congressional Budget Office, 1992).

¹³Information is available for the Birmingham Northern Relief Road (BNRR) concerning the loss of benefit due to the decision to adopt tolling: "Under the old policy the Government, before deciding to proceed with BNRR, assessed the economic benefits of the proposed scheme and compared it with a publicly financed tolled road and a publicly financed untolled road. This assessment showed that, on a conventional COBA assessment the MEL [Midland Expressway Limited] scheme gave discounted overall benefits of £195m at 1988 prices amounting to a ratio of present benefits to present costs of 2 (£385m over £190m). A publicly financed tolled scheme gave broadly comparable figures. The 1988 public untolled scheme gave discounted overall benefits of £350m (a ratio of 3, or £525m over £175m)" (Department of Transport, 1994, para. 16, literal corrected). Such C:D and C:A comparisons are no longer made. The Department of Transport (para. 19) advised the public inquiry that "The best guide to the benefits of private finance in terms of additional resources is to consider the effects of proceeding now with BNRR as a public untolled scheme."

¹⁴For example, the Forth Road Bridge Joint Committee, owners of the Forth Road Bridge, commissioned PIEDA Consultants (Mackay, 1985) to argue at a public inquiry against toll increases demanded by the Secretary of State for Scotland.

Office to offer a capital grant to cover the difference between the capital cost of the commercially chosen bridge and an aesthetically preferable bridge. A reluctance to make such capital grants is partially explained by the fact that these are scored against public expenditure allocations in the year in which grant is paid.

The fourth point concerns the distinction between freestanding facilities and those which constitute parts of larger integrated networks. When freestanding, the credibility of the bankruptcy threat is substantially enhanced. Moreover, private owners of such infrastructure assets may possess substantial monopoly power. The difficulties inherent in long-term forecasting of the usage of long-lived assets raises particular problems; the government has emphasized that infrastructure contracts should be put out to tender, but has not yet clarified whether price regulation might be envisaged.¹⁵ When part of a network, the privately financed link may be vital to network efficiency, thus weakening the credibility of the bankruptcy threat. When a tolled facility runs parallel to an inferior untolled facility, there is also the question of whether the private promoter receives assurances that the untolled facility will neither be upgraded nor reprovided.¹⁶

Additionality

“Additionality” is the term used in public expenditure contexts (e.g. EU aid to projects and programmes in disadvantaged regions; and privately financed public projects) in order to pose the question whether a policy initiative leads to expenditure higher than would have occurred in its absence. There is also the related question of whether additionality is desirable. Statements about additionality are notoriously difficult to evaluate, because there is no counterfactual benchmark of what would otherwise have happened. In the particular context of private finance for public projects, the key question is whether recourse to private finance leads to higher spending in that policy area, or is instead accompanied by offsetting reductions in public finance. A concern which traditionally inhibited the use of private finance as a means of supplementing public sector capital expenditure was the expectation that such recourse would be

¹⁵“It may in some cases be appropriate to impose separate regulatory controls” (Treasury, 1992c, para. 14). Policy is developing on a case-by-case basis. Whilst tolls on the BNRR are unregulated “since there are alternatives—the local toll-free roads and the government operated motorway network” (Department of Transport, 1993b, para. 6), tolls on the Dartford crossings are linked to the RPI since the “undertaking . . . represents a local monopoly” (Department of Transport, 1994, para. 4).

¹⁶The Scottish Office prohibited the nationalized Caledonian McBrayne from continuing to operate a ferry service when the Skye Bridge opened.

frustrated by offsetting reductions imposed by the Treasury to public expenditure allocations.

Whether additionality is perceived to be desirable depends upon how the policy problem has been defined, and which constraints are perceived to be binding; for example, whether there is a “shortage” of public finance for “worthwhile” projects. The Treasury has always explicitly linked the issue of additionality to the need to control the size of the public sector and to determine priorities rationally within pre-established totals. There has been strong Treasury opposition to what might reasonably be characterized as non-policy-driven additionality. In those areas of the public sector where there is a mixture of public and private provision, the investment expenditures of competitive private sector suppliers will shape the government’s decisions “over a period of time, [about] how much the public sector needs to do in the same area” (Treasury, 1988, para. 15). Stronger Treasury assurances after 1989 that there would be (some) additionality (Treasury, 1993c) have clearly been designed to counter the view that “there is no point in promoting privately financed roads because the Treasury will simply claw it back by reducing public expenditure” (Major, 1989, p. 5). There are therefore two aspects: the continuing desire of the Treasury to ensure that public finance is directed towards the areas which have the highest return, and the incentive effects of offsetting private finance against public expenditure allocations.

Measurement of Efficiency Gains and Additional Financing Costs

The case for recourse to private finance hinges not only upon the existence of efficiency gains but also upon their magnitude being sufficient to offset the higher financing costs.¹⁷ The U.K. government borrows more cheaply than private borrowers:

while we cannot ignore the fact that the Government can raise money relatively cheaply because it is a large low-risk borrower, we must also take account of the benefits that tend to go with private finance, such as improved efficiency, low costs, and reduction in the risks falling on the taxpayer (Major, 1989, p. 4.)

The Treasury has not attempted to quantify the efficiency gains through better construction and operation which are believed to be achievable through the use of private finance for infrastructure projects because

¹⁷Given the argument that there is no measurable macroeconomic difference between the effects of public and private borrowing for the same project, what is relevant here is the full difference between the private and public borrowing rates, not just the difference between the private borrowing rate and the shadow cost of capital (which is set above the public borrowing rate).

the size of the efficiency gains would depend on the particular characteristics of individual projects. The use of private finance would sharpen incentives to control risk and achieve an adequate rate of return. (Treasury, 1993a, p. 13.)

Ministers and civil servants assert that there will be efficiency gains because of the inherently greater efficiency of the private sector, and that these efficiency gains will more than offset higher financing costs. Measurement is held not to be required because it is taken as a prior assumption that there will be efficiency gains; the question of whether these will be sufficient to offset higher financing costs is thus never directly addressed.

The efficiency rule is easy to state, though undeniably difficult to implement and audit. The present value of efficiency savings on construction and operating costs must exceed the present value of higher financing costs. For this efficiency rule to be operationalized, comparisons must be made between the privately financed project and a hypothetical public sector project. Naturally, the assumptions built into these comparisons will affect the results, though the fact of rendering them explicit will itself be beneficial, since exposure will test their credibility. *Ex post* project audits are also required, though there is the obvious difficulty that the chosen option has been implemented whereas the rejected options have not. A degree of caution on the Treasury's part has been detectable. It insisted that

all proposals to use private finance to fund capital expenditure that would otherwise be the responsibility of the public sector should be referred to the Treasury, unless that capital expenditure would be an insignificant part of total cost; the public sector's period of use of the assets would be substantially shorter than their expected lives; or the proposal would fall within the limits of delegated authority, as for leasing. Even where Treasury approval is not required, the use of private finance should be supported by a full investment appraisal following prescribed procedures. (Treasury, 1989, as amended 1992, paras. 29.1.16 and 29.1.17; withdrawn August 1994.)

It is unclear whether such an approach would survive the proposed refocusing of the Treasury's expenditure divisions to a more "strategic role" (Southgate *et al.*, 1994).

The Treasury cannot or will not quantify the additional financing costs consequent upon financing infrastructure projects such as roads, bridges and tunnels by private finance rather than by government borrowing, or quantify the interest rate differential:

Any additional borrowing costs would depend on the characteristics of the projects concerned, including the risks involved. They could therefore only be assessed on a case-by-case basis. (Treasury, 1993a, p. 13.)

Spackman (1991, p. 22) quoted Melliss (1991) for the conclusion that "Bond finance for large private sector bodies typically costs up to a percentage point more than public borrowing". This conclusion relates to bond finance secured on the general revenues of government and large private borrowers, whereas much private finance in public projects is of a non-recourse nature, its security depending upon the success of particular projects. Given the confidentiality which attaches to loan arrangements, systematic evidence about the additional cost of private finance can only be produced by the Treasury or, with a considerable time lag, the National Audit Office. There may be cases in which the Treasury does not know the private promoter's financing costs, only total costs. If the public sector uses a shadow cost of capital and the private sector uses an actual rate, there arises the possibility of misleading comparisons; the private promoter's estimated cost of capital might be too low because of perceived "closeness" to government which shelters the promoter from risk.

Determining Whether Risk has been Transferred

The constant feature within Treasury policy on private finance has been the insistence that risk must be transferred to the private sector because such a transfer is the mechanism which secures efficiency gains. In order to demonstrate that risk has genuinely been transferred to the private sector, it is necessary to show that such a transfer is not undermined by mechanisms which allow the private lenders to evade risk. Such mechanisms include government guarantees of private borrowing, contracts for lifetime output, guarantees against financial loss from operations and funding devices (such as the structuring of grant systems). The Treasury (1993b, p. 13) has explicitly recognized that the structuring of grant finance so as to avoid private lenders facing risk is the equivalent of a government guarantee. Whilst explicit government guarantees are currently rather unlikely, the possibility that risk transfer is frustrated by other mechanisms deserves careful attention. It is necessary to distinguish between the formal position as legally defined and the informal reality as defined by economic, social and political considerations. For example, the subsidiaries of multinational companies may borrow without a parental guarantee, and a public authority may borrow without an (explicit) government guarantee, but, in the event of default, the parent or government would give careful thought to the reputational effects of lenders losing money, and to the effect on their own capital market ratings. Implicit guarantees may therefore be attached, even when explicit guarantees are absent or indeed vigorously denied. It becomes a matter of judgement whether the present government and its successors would allow default and bankruptcy.

In cases where some risks have clearly been transferred, some residual risk may attach to the public authority. A private firm which has lost all

its capital may abandon a project. There is a spectrum of possible outcomes, running from government being afforded the opportunity to acquire a privately financed asset at a distress price, to it becoming embroiled in the potentially expensive task of having to secure project completion through other means. It is clearly relevant whether the project is freestanding or part of a network, and whether the public authority has continuing/reverted statutory obligations to fulfil. Cases may arise when the consequences of “doing nothing” are judged to be politically unacceptable, resulting in the failing firm being rescued either by direct government intervention or via a funding/purchasing agency. There is also the question of what assurances are given to the private sector concerning compensation payable in the event of fundamental policy change: for example, less need for prison places as a result of a more lenient penal policy, or lower traffic growth resulting from an environmentally induced increase in petrol taxation. Such protection from future exigencies might greatly exceed the insulation available in the “conventional” private sector. In turn, the front-loaded public expenditure costs of policy change might be greatly increased.

When capital grants finance a substantial part of the capital cost of a marketable asset and the private lender is allowed to secure loans on the full asset value, there is a ready-made non-transparent way of sheltering the private sector from risk. Grants can be structured in ways which create a huge divergence between the formal and the effective incidence of risk, as in the case of Housing Association Grant (HAG) paid from the Housing Corporation to housing associations.¹⁸ Moreover, delivery organizations with private sector status may borrow money secured on

¹⁸Private finance raised by the Housing Corporation itself would be counted within the PSBR, as would any government guarantees extended by it to housing associations. Whilst no guarantees are extended by the Housing Corporation, financial arrangements are structured in such a way as to virtually eliminate private sector risk. First, HAG is so structured that the servicing of top-up private finance on programmes within a housing association’s approved development plan takes priority over central government’s claims. HAG is in essence a capital grant which reduces the net capital cost of privately financed schemes to the level which can be serviced by rent income, perhaps representing 85 per cent of gross capital cost. Private lending is secured on that specific property whereas the Housing Corporation has a floating charge on a housing association’s revenue. When the private lender may have loans for 15 per cent of the gross capital cost secured on the assets themselves, it would require spectacular calamities for the private lender to lose money. Second, in cases of large-scale transfers of local authority stock to housing associations, the pricing of the transfer is set at a ratio to open market value so low as to eliminate the risk to private lenders. Treasury (1993b) summarized the financial system for housing associations. At an earlier period, the Housing Corporation Finance Company Ltd (since wound up) was established as a limited company subsidiary of the Housing Corporation: the former could borrow outside the PSBR whereas the latter could not. Harold Lever, a senior minister in the 1974–79 Labour Government, was extremely proud of this “ripping wheeze” (Likierman, 1988, pp. 9–10).

specialized assets whose values heavily depend upon anticipated government grants or charges met by government. Certain organizations, funded by grant-in-aid rather than on the basis of votes or EFLs, have hitherto been prohibited from borrowing privately on the security of Exchequer-financed assets. In November 1992, the government ended the prohibition of borrowing by HEIs against the security of Exchequer-financed assets (Department for Education, 1992, p. 4; Bain, 1993). Whilst this relaxation applied only to HEIs, it undoubtedly created a powerful precedent for other parts of the quasi-public sector. Another important change in 1992 was the softening of the Treasury line on leases:

The public sector will have greater opportunity to use leases where they offer *best value for money*. The capital value of leased assets apart from property is at present usually set against spending allocations unless the lease meets only a short-term need. *In future, the criterion will in all cases be based on risk*, which is also the principle underlying the relevant accounting standard. Departments and nationalised industries will be able to enter into operating leases and count only the leasing payments against their provision, provided the *great majority of the risk* stays with the private sector. This change should give a new impetus in areas such as contract energy management. (Treasury, 1992b, p. 2, italics added.)

In terms of public expenditure controls, the crucial point has been that the capital value of leased assets has been chargeable against spending allocations,¹⁹ whether these be voted capital expenditure in the case of central government departments or the National Health Service, credit approvals/capital allocations in the case of local authorities, or EFLs in the cases of nationalized industries, public corporations or trading funds. Given that the public sector can borrow more cheaply than the private sector, this treatment for the purposes of public expenditure control has removed one of the two main motives for leasing, namely to circumvent spending limits. The other motive remained, namely to exploit tax treatments of leases which are available only to the private sector lessor.²⁰

The relevant U.K. accounting standard, SSAP 21: *Accounting for Leases and Hire Purchase Contracts* (Accounting Standards Committee, 1984), does indeed take as fundamental whether

¹⁹Except for property assets or non-property assets covering only a short-term need.

²⁰The consequent loss of tax revenue would increase the PSBR and then feed back into more onerous spending limits, though not necessarily on a pound for pound basis for the programme areas where such leases have been used. The loss of tax revenue will be net of capital allowances which would have been paid on private sector projects displaced by the additional public sector project.

all or substantially all of the risks and rewards of ownership have been transferred. It is clear from SSAP 21 that this is intended to be the primary test. This will usually mean that the present value of the minimum lease payments is 90% or more of the fair value of the asset, though this rule is not absolute. (Chopping, 1992, p. 390.)

A finance lease is a lease which “transfers substantially all of the risks and rewards of ownership of an asset to the lessee” (Accounting Standards Committee, 1984, SSAP 21, para. 15). If a lease is not a finance lease, then it is an operating lease (i.e. risk has not been transferred). Care is required in exposition. In terms of SSAP 21, an operating lease occurs when risk has not been transferred from the lessor to the lessee. In the case of the PFI, references by the Treasury to risks being transferred should be read to mean that the private sector lessor has *not* transferred risk to the public sector lessee.

The prescribed accounting treatments are as follows. Whatever the pattern of lease payments, SSAP 21 requires that operating lease rentals be charged to profit and loss account on a straightline basis, unless a more systematic and rational basis is available. A finance lease should be capitalized at the present value of the minimum lease payments, usually approximated by the fair value of the leased asset at the inception of the lease. This capitalized fixed asset is then depreciated over the term of the lease, if this is less than the life of the asset. The practice of deliberately setting the percentage just below the 90 per cent threshold may eventually lead to the substitution of qualitative tests for the 90 per cent quantitative test (Loveday, 1991).²¹ Probing beyond the 90 per cent rule, Davies *et al.* (1994, pp. 870–871) considered that

Affirmative answers to the following questions would tend to indicate that a finance lease exists:

- (a) If the lessee can cancel the lease, will he bear any losses associated with cancellation?
- (b) Will the lessee gain or lose from any fluctuations in the market value of the residual? . . .
- (c) Does the lessee have the ability to continue the lease for a secondary period at a nominal rental?
- (d) Is the expected lease term equal to substantially all of the asset’s expected useful life?

²¹Loveday (1991, p. 72) noted that the discounting equation is: “Fair value of leased asset = PV of minimum lease payments + PV of unguaranteed residual amount accruing to lessor”. Therefore, if the lessor can be persuaded to estimate a larger than realistic residual amount, and with the lessee having to estimate both the residual value and the implied discount rate, the lease can be made to fail the 90 per cent rule.

- (e) Are the leased assets of a specialised nature such that only the lessee (or a limited number of other parties) can use them without major modifications being made?
... In evaluating the risks and rewards, one should consider which factors are most likely to have an economic effect on the parties to the lease.

Accounting for leases is clearly a troubled and manipulable part of U.K. accounting practice, on which public policy cannot securely rely for control purposes.

How a leased asset is scored in terms of public expenditure allocations is often more important to a public sector organization than the financial accounting treatment; there is an important distinction between being disallowed (i.e. not permitted) and being scored against spending allocations. The Treasury has sought to base its control rule upon financial accounting treatments, making the former correspond more exactly to that in SSAP 21.²² This would be more convincing were it not for the difficulties which have been experienced with the application of SSAP 21 itself. In the private-for-profit sector, economic decision-makers have a clear objective of maximizing profits or shareholder wealth, and therefore they will choose between ownership and leasing on the basis of financial cost.²³ Specifying the objective functions of public sector decision-makers is much more difficult, as these are unlikely to be as simple as profit maximization or financial cost minimization. Because public finance (when available) is always cheaper than private finance, the only motives for using private finance in the absence of efficiency gains are (i) to circumvent public expenditure controls and/or (ii) to secure access to tax expenditures. Whilst—again in the absence of efficiency gains—there might be advantages in securing higher cost private finance from the perspective of particular public sector units, hemmed in by what are seen as excessively onerous and irrational limits on capital expenditure or on external finance, the public sector as a whole is unlikely to gain. The crucial point about the earlier practice was that the scoring of the capital value of the leased asset against public expenditure allocations meant that such leases had to compete directly against publicly financed projects for part of that allocation. There is now a supplementary channel by which assets available through leasing can be acquired.

²²However, there remains the question of the relationship between “great majority” (Treasury, 1992b, p. 2) and 90 per cent (Accounting Standards Committee, 1984, SSAP 21, para. 15). Some further guidance has been provided: “For leases involving assets with a value of between £1 million and £10 million, the Treasury will regard the test of risk transfer as satisfied if the present value of minimum lease payments amounts to less than 70 per cent of the fair value of the assets (or group of assets forming part of the same transaction)” (Treasury, 1993c, p. 11).

²³Non-neutral tax treatments may cause a wedge between economic cost and financial cost.

The Treasury's continuing adherence to the transfer-of-risk test is of paramount importance. Nevertheless, there are important participants in the policy process who publicly challenge this view. Hancock (1993), a former permanent secretary and now a merchant banker, has disputed the transfer-of-risk test:

One especially restrictive notion is that the public sector should not borrow at commercial rates—which are generally higher than the rate at which the Government can borrow—unless private finance secures benefits not otherwise attainable. This rule sounds reasonable but, in practice, prevents much-needed investment. The Government has not, until recently, been willing to acknowledge that the “extra-value-for-money test” makes no sense if Exchequer funds are not available as an alternative.

. . . the way in which the new [1992] guidance is currently drafted implies that the central test of acceptability is the degree of transfer of risk to the private sector. This is not central; what is important is that the taxpayer is getting best value for money. There is no *a priori* reason why this should be secured by imposing the greatest risk on the private partner. The smaller the risk transferred to the private sector, the finer will be the terms on which the private sector will be willing to put up the money.

Hancock thereby proposed that the public sector should continue to carry the risk whilst delegating responsibility for raising finance to the private sector. Moreover, he postulated a “shortage of public finance” as a result of macroeconomic constraints which do not affect private finance, a view which has already been shown to be unsupported by detailed argument or evidence.

Yet there has been a detectable shift in the language of Treasury documents, from implicitly presenting risk transfer as an all-or-nothing phenomenon towards references to risk sharing. Whilst continuing to emphasize that there must be risk transfer, Sir John Cope, then the Paymaster-General, vigorously denied that “the Government is seeking to transfer all risks to the private sector” and declared that “we are looking for a sharing of risk, with the public and private sectors each taking on those risks which they are best placed to manage” (Cope, 1993, paras. 16 and 18, italics in original). Ernst & Young (1993) disaggregated project risk into component parts as the basis for a discussion of which components should be transferred: front-end risks consisting of pre-bidding risk, bidding risk, planning risk, environmental risk and underwriting risk; and post-financing risks consisting of construction risk, operating risk, end-user or market risk, political and regulatory risk and financial risk. The Labour Opposition joined with City commentators, contending that the “Government has proved characteristically inflexible

in its approach to risk” (Brown *et al.*, 1994, p. 9); their document does not endorse the importance of risk transfer.

Erosion of Public Expenditure Controls

There are substantial dangers that recourse to private finance will be used as a means of undertaking hidden public borrowing and expenditure:

A cynic might . . . interpret the government’s recent promotion of private finance as a creative means of hiding the true extent of the PSBR. (Institute for Fiscal Studies, 1993, p. 62.)

Private finance should not be used simply to get around public expenditure controls, for example to defer payments to later years because direct public funding is constrained. (Treasury, 1989, as amended 1992, para. 29.1.15; withdrawn August 1994.)

. . . we are not interested in pure funding vehicles, and sale and leaseback arrangements, whose sole purpose is to get round our public expenditure controls. They will not pass any genuine value for money scrutiny. Nor should they. We have made it clear that we disapprove of local councils who lease parking meters. There is no room for that sort of creative accounting in Central Government. (Major, 1989, p. 5.)

Without a significant transfer of risk to the private sector, schemes for private finance look like an attempt to circumvent budgetary controls on public expenditure, whether by creative accounting around definitions or by retiming the scoring of expenditure.

In the 1980s, local authorities resorted to a range of private funding vehicles in order to evade public expenditure controls; these unconventional means of finance involving private parties became known as “avoidance instruments”.²⁴ The only knowledge the Treasury had of the extent of such use came from anecdotal evidence and from approaches by local authorities facing financial pressures as a result of earlier use of

²⁴A distinction should be drawn between financing new assets and realizing cash from existing assets. In the context of new projects, a covenant is a method by which a local authority may finance capital projects without the expenditure being counted against the authority’s capital consents at the time of payment. By contractual agreement, a development company subsidiary of a bank pays the contractor who constructs the asset. The local authority then repays principal, interest and fees to the development company over an agreed period, these being the amounts scored against consents. Moreover, local authorities took out parallel loans whereby they borrowed from the development company’s parent bank to pay the development company, thus stretching the period of indebtedness and public expenditure scoring from, say, 17 to 27 years. Second, in order to minimize reductions in revenue budgets, many local authorities resorted to sale and leaseback arrangements in connection with existing assets, in some cases reaching the extremes of realizing cash through sale and leaseback of street furniture such as lamp posts.

avoidance instruments; there are no separate returns to central government of local authorities' obligations under such instruments. Peak use of avoidance instruments may have occurred before the 1987 General Election, when it was reported that local authorities had massive liabilities from which they were looking for release had there then been a change of government. Such subversion of central government controls was ended by the Local Government and Housing Act 1989 which introduced a new capital finance system in England and Wales designed to prohibit avoidance instruments; the 1980s' schemes of extended credit were still permitted, but the incentive to undertake them was removed as they now scored equally with conventional borrowing against public expenditure constraints. Although the amount of outstanding liabilities is unknown, the passage of time since the implementation of the new capital finance system on 1 April 1990, and the reluctance of financial institutions to renew existing arrangements, mean that this is a disappearing phenomenon.

Outside the Treasury, private finance is typically viewed as a substitute for public finance which is not available because of macroeconomic constraints (Ernst & Young, 1993). Yet, if the macroeconomic effects are not measurably different, recourse to private finance does not relax any constraint on the availability of finance which genuinely originates from macroeconomic considerations. In practice, EFLs may frustrate public investment at the margin, thus imposing an opportunity cost in terms of forgone returns. In the light of the macroeconomic gains to be derived from stringent fiscal control, at least in principle the Treasury ought to be setting EFLs so as to equalize marginal returns. Similarly, the Treasury would have to reduce EFLs by an amount equivalent to the use of private finance in order to maintain its chosen macroeconomic stance. The use of private finance therefore does not release macroeconomic constraints, despite the claims of some of its advocates:

If the [private finance] initiative succeeds, it will produce more investment than the Government can afford in much-needed capital assets such as community health centres, day surgeries, roads, railway carriages, signalling equipment and bail hostels. *There is, fortunately, a limit to the amount of tax that the Government is willing to impose; and public borrowing is already too high.* If some public investments are privately financed, and added to what the Exchequer is able to fund, the consumer of public services will benefit. (Hancock, 1993, italics added.)

This list of "much-needed capital assets" includes those for which charges are not levied upon "consumers", and which must therefore be financed by taxes or public borrowing, both of which are stated above to be constrained. Although user charges provide a means of servicing the

private finance, taxpayers may resist paying both an existing level of taxes *and* newly introduced user charges (which themselves could be used to pay for public finance). The main effect of private finance is to alter the time profile of public expenditure scoring. There is a secondary effect, however: many public assets are scored to GGE and GDP both as capital (in the year of acquisition) and as non-trading capital consumption (in subsequent years). For these assets, private finance does have a national accounting impact on public expenditure.

The evident circularity has encouraged the view that the Treasury's use of rules is insincere: that they are primarily used to block things which the government does not want to happen on other grounds. This apparent lack of even-handedness in application naturally increases the willingness of opposition politicians to consider redefining those rules (Brown *et al.*, 1994). Moreover, given their timing, recent developments concerning private finance can be characterized as a hidden form of activist macroeconomic policy:

the construction industry is in a truly dreadful state and you have got to think of some ways in which it can be resuscitated and to think of some more or less respectable argument for providing them with what may be rather more expensive finance . . . the irony is that by the time you have finally worked out both the principles and practice of this system of private financing it is highly likely that the cycle of economic activity will have changed and once again you will have to think of some apparently important principle which will then make it more difficult for private finance because you will be told by those who manage the economy that this type of financing is inappropriate in circumstances of some strength of the economy. (Budgen, 1993, Q. 8–9.)

These quotations illustrate a clash of perceptions as to the true purpose of recourse to private finance, relating in part to how the PFI has been presented and in part to the conflicting interests of participants. Perceptions as to the rationality of public expenditure constraints depend crucially upon the vantage point of the perceiver; that is just as true now of central government and quasi-public sector bodies who are the main users of private finance in the mid-1990s as it was of local authorities in the mid-1980s. Irrespective of judgements about the likelihood of efficiency gains, there is a compelling case for securing transparency as public expenditure control systems have an inherent fragility.

V CONCLUSION

The PFI is an example of a policy which might have been expected to be controversial but which has in fact met little political opposition. For those who wish to privatize, it can be represented as a form of

privatization of core government functions. For those who wish to see more public investment, it can be represented as the only practical way of achieving this end; they are likely to recognize that, where public sector organizations are denied access to new government funding *and* to private capital, pressures will build up for them to be privatized. For those seeking new business opportunities, it affords new openings for construction groups, financial institutions and management consultants. Criticism is likely to come from those concerned about “honest government accounting”, a group that is neither numerous nor politically weighty.

In this paper we have demonstrated that there is a need for empirical evidence on several fronts: the amounts of private finance which have been raised for public projects; the extent to which risk has been transferred; the amount of efficiency gains; the amount of higher financing costs; and the implications for the interpretation of macroeconomic aggregates. Whereas the difficulties of such tasks should not be underestimated, systematic information can elevate the debate above point scoring about the cost overruns of the Channel Tunnel and the British Library (Treasury and Civil Service Committee, 1993, Q. 15–16).

Developments since 1989 appear to mark a decisive shift in government policy towards what had until then been widely regarded as the continuing core of the public sector. The government has sought to identify in the PFI an extension of the privatization policies which it judges to have been so successful in the formerly nationalized sector.²⁵ Increasingly, private finance is being presented by the government as being about a fundamental change in the approach to public services, going beyond assessments of capital and operating costs for particular projects to wider and longer-term perspectives on the nature of the project, the nature of the service and the potential for future change (Clarke, 1993). Such elevation of private finance to “fundamental belief” (Department of Transport, 1993b, para. 7) naturally poses difficulties for economic evaluation, as what must on those terms be evaluated is the entire reconfiguration of the core public sector. In practice, acceptance of this position would divert attention from the issues raised in this paper, probably leading to them not being addressed because of the non-availability of data and a lack of clarity about problem specification. Furthermore, there are important regulatory questions, though these have not been central to this paper. The longevity of assets creates scope for

²⁵“Since 1979 the Government has brought private sector enterprise and disciplines into an ever wider area of the economy. In the 1980s privatisation played a major role. It liberated large sections of the British economy from the dead hand of the public sector, improved efficiency and services, and often led to substantial increases in efficiency. Other measures in this vein included the increased use of market testing and contracting-out. These all reflected the changing role of the public sector, from being a provider of services to being an enabler and purchaser” (Treasury, 1993c, p. 6).

the abuse of monopoly power in the absence of regulation, when tempered only by intermittent competitions for new contracts and renewed concessions. With regulatory policy in this area remaining largely undeveloped, there is potential for market distortions.

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