Cooking The Books

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UK Chancellor Kenneth Clarke and other politicians are strong proponents of the Private Finance Initiative (PFI), which encourages private financing of public infrastructure projects. However, PFI may be a bad deal for taxpayers because it does not always allocate resources efficiently.

ALONGSIDE tax cuts, one of the most hyped bits of the budget on November 28th is likely to be the Private Finance Initiative (PFI). Three years after it was launched as a means of encouraging the private sector to invest in public infrastructure, Kenneth Clarke, the chancellor, will claim that the initiative has now built up a head of steam. As well as listing a host of PFI contracts signed this year, he will announce grand plans for billions of pounds' worth of schemes, ranging from hospitals and prisons to roads and computer systems, for next year and beyond. He will be criticised mostly for timidity. The City of London and construction firms, which do well from infrastructure deals, and the Labour opposition each reckon that the government has barely begun to tap the potential of using private money for public works. Yet the PFI may prove a terrible deal for taxpayers. Mr Clarke's likely bullishness about the PFI will be despite a series of recent setbacks. The chancellor was embarrassed last month when the financial troubles of Eurotunnel prompted Sir Alastair Morton, its chief executive, to step down as chairman of the Private Finance Panel, a group of big shots from the public and private sectors appointed by Mr Clarke to promote the PFI. Treasury officials have struggled to persuade civil servants to abandon lifelong habits and to tap the private sector, rather than the public purse and public borrowing, for money to pay for new projects. Difficult negotiations, notably over the Pounds 2.7 billion ($4 billion) fast- rail link to the Channel tunnel, mean that the chancellor is unlikely to achieve even half of his target of signing Pounds 5 billion of PFI contracts this year.

Yet deals worth Pounds 2 billion in 1995 would represent a giant step forward from the paltry Pounds 500m-worth agreed in the previous two years. Moreover, more deals are likely in future because, by requiring all putative publicly financed investments to be first vetted for their suitability for PFI, Mr Clarke has given civil servants little option but to learn new tricks. And, crucially, Treasury officials have become enthusiasts for PFI, abandoning their traditional scepticism about private funding of public projects.

This scepticism stemmed from the fact that the government can borrow money more cheaply than any private firm, which means that privately financed projects need to be significantly more efficient to offset their higher financing costs. Prodded by Tory ministers to think again, Treasury officials now reckon that forcing a private firm to put its money on the table can concentrate the minds of its managers enough to achieve the required efficiency gains. Paying contractors to maintain a bridge or hospital or to run a prison, as well as to build it, should encourage them to construct such facilities in ways that minimise future management costs, a feat the public sector cannot match, reckons the Treasury.

This is plausible, but it must be set against the potential which the PFI offers governments for creative accounting designed to disguise their spending commitments. In particular, the timing of spending can be obscured. If a project, such as a road, is publicly financed, the construction costs are counted as public spending as they occur; if it is privately financed, they are added to public spending years later, when the road is complete and the government starts to pay the contractor for it, perhaps through a "shadow" toll pegged to how many cars use the road. And if a project, say a toll bridge, is financed by the operator levying a charge on users, its cost will never appear in the public-spending total.

The temptation is obvious. Economic commentators watch public spending and borrowing closely, not only to judge the government's own finances but as indicators of how well it is managing the economy as a whole. The PFI can lower both these numbers, at least for a time. Even if successful in transferring risks to private investors and achieving efficiency gains, most PFI projects will simply be a form of "buy now, pay later". This will seem to reduce public spending in the early years. Because the obligation to pay for the service or facility provided by the private investor will not be counted as public borrowing (though it will be just as binding), the borrowing figure will be lowered too. This may allow the government to make tax cuts or spending increases which would otherwise have been viewed as risky or unacceptable. No wonder both main parties are so keen on the PFI. To "prove" that the government is not using the PFI as an accounting scam, the Treasury constantly stresses that PFI projects involve genuine transfers of risk to private investors. Likewise, the Private Finance Panel publishes apparently detailed analyses of the efficiency gains achieved by recent projects. For example, a study of the bidding process for supplying a new computer system to process national insurance contributions suggests that private investors will shoulder much of the risks of the project and that overall costs will be reduced by about a third compared with a publicly financed alternative.

Yet these attempts at explanation raise more questions than answers. For instance, private contractors appear to be willing to bear risks over which they have no control--in the case of the national-insurance computer, the supplier will bear much of the risk of demand volumes being lower than expected because of, say, the impact of new social-security legislation. This seems hard to swallow. Moreover, it is impossible to assess the financial impact of any risk transfer because contracts between the government and its suppliers are usually kept secret to protect commercial confidentiality.

This point is taken up in a paper by David Heald, an economist at the University of Aberdeen and a special adviser to the House of Commons Treasury Select Committee. He argues that, so far, there is little information on how much private finance has been raised; how much risk has been transferred to the private sector; what efficiency gains are likely to be achieved; how much higher financing costs are under the PFI; and the extent to which macroeconomic data, such as public spending and borrowing, have been distorted.

This should ring alarm bells. Even where risk is ostensibly transferred to the private sector, there may be all kinds of government guarantees that, in practice, limit risk. It is striking that on October 16th, the very day that the privately financed road bridge to the Isle of Skye opened for business, the profitable ferry service operated over the same stretch of water by the publicly owned Caledonian MacBrayne was withdrawn under orders from the Scottish Office. Similar guarantees--whether explicit as in the case of the Skye bridge, or implicit--may take the form of pledges to use PFI-built hospitals and prisons in preference to those of state-owned ones, not to upgrade existing facilities, or not to build new ones where they would compete with a PFI scheme.

In an ideal world, each PFI project would be judged according to the likely efficiency gains, the extent of risk transfer, and need. Future payments would be included on the government's books as obligations. However, while so little hard information is available about the PFI, and the opportunities for creative accounting remain so great, it would be better to view all claims made for privately financed public-sector investments with deep suspicion.