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Assessing Fiscal Implications of a PPP Project

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Good practice consists of subjecting public investment projects to appraisal and approval processes to determine whether it is a good project. Close integration with the budget process is essential to elucidate whether and when the project is affordable. The finance ministry typically plays a central role in this endeavor. Because PPPs often involve neither capital investment nor other expenditure in the short term, they may slip through the standard control mechanisms designed for public investment financed by the public purse.

Government commitment is a key element of success of PPP programs, together with effective reforms to foster collaboration and coordination between various government institutions and overcome governance challenges.

The World Development Report 2017 (WB 2017c) describes the critical path to maximize the efficiency of policy reforms. The “policy effectiveness cycle” begins by defining the objective to be achieved; it then follows a series of six critical steps as follows: diagnosis; assessment; targeting; designing; implementation; and evaluation and adaptation. The process through which the various actors bargain about the design and implementation of policies within a specific institutional setting, must also be taken into account. The consistency and continuity of policies over time (commitment), the alignment of beliefs and preferences (coordination), and the voluntary compliance and absence of free-riding (cooperation) are key institutional functions that influence how effective policies will be.

The Ministry of Finance plays a critical role in all three functions. The assessment of fiscal implications of a PPP project/portfolio demonstrates the commitment of the government to the private sector and helps reduce uncertainty regarding project development. This in turn helps reduce the cost of private finance. It also helps attract the ablest and efficient PPP operators, instead of firms more interested in benefiting from uncertainty and contract changes by gaming government. The Ministry of Finance also coordinates and collaborates with sector ministries and other government agencies such as PPP units.

Having Ministry of Finance officials understand infrastructure risks and PPP fiscal risks is therefore critical for full government commitment. Most governments have established their central PPP units in the Ministry of Finance. Even those that have anchored it elsewhere, have felt the need to have a PPP team in the Ministry of Finance and therefore have fiscal management staff trained in PPP contracting. Those PPP teams help review PPP projects and assess PPP fiscal costs and risks, checking the fiscal sustainability of PPP programs, managing fiscal PPP risks, and reporting on PPP liabilities.

Commitment, collaboration, and coordination are also essential to formulate and implement policies on a broad set of issues including cross-sectoral issues, public finance management, and regulations concerning internal control and reporting mechanisms. Sustained efforts are also needed to develop a system to manage threats to the integrity of practitioners. Finally, because the electoral cycle is typically much shorter than the project cycle, politicians are most likely to inaugurate projects that were planned by the previous administration, and to select and plan those that will be inaugurated by the next administration. This requires a considerable degree of commitment and collaboration, particularly since politicians usually want to leave their mark.

PPP Processes and Institutional Responsibilities describes how governments often create an approval process for PPPs that mirrors that used for their large investment projects. Such processes generally provide a central role for the finance ministry. This section offers guidance on how the finance ministry can decide whether to approve the fiscal commitments to a proposed PPP project. In doing so, a finance ministry typically considers two questions: will the project provide value for money; and is the project affordable.

Assessing whether a PPP will provide value for money

For most projects, assessing value for money means assessing whether the project is cost-benefit justified, and the least-cost way of achieving the benefits. When assessing a PPP, some additional analysis is needed—to check whether the PPP has been structured well, and will provide better value for money than alternative public procurement modes. Appraising Potential PPP Projects describes this analysis, and provides links to examples and guidance.

Assessing whether a PPP is affordable

The second question is even harder to answer: Is the PPP project affordable? There are two main challenges in answering this question for a PPP project.

First, it is not always clear how much the PPP will cost. Direct fiscal commitments are long-term, and may depend on variables such as demand (in the case of shadow tolls) or exchange rates (where payments are made in foreign currency). Moreover, many fiscal commitments to PPPs are contingent liabilities, whose occurrence, timing, and value all depend on some uncertain future events. Appraising Potential PPP Projects provides guidance and examples on how the cost of fiscal commitments to a proposed PPP can be calculated. Mostly this involves considering the modal or best estimate value, hopefully correcting for optimism bias, and scenarios for how that value might vary.

Second, because costs are long-term, and may be contingent, it is not easy to decide whether they are affordable. An **OECD publication on PPPs** (OECD 2012, 21) defines affordability to mean the "ability to be accommodated within the inter-temporal budget constraint of the government." For most government expenditures, affordability is assessed by considering the annual budget constraint, and in some cases the medium-term (typically three-year) expenditure/fiscal framework. Options for Assessing the Affordability of Fiscal Commitments to PPPs describes two alternatives for PPPs. The approach may be different for different types of fiscal commitments. Limits on the total stock of fiscal commitments to PPPs may also affect decision-making for particular projects.

Options for Assessing the Affordability of Fiscal Commitments to PPPs

OPTION	REFERENCES AND EXAMPLES

Forecast budget limits—that is, make conservative assumptions for how overall budget limits will evolve, and consider whether the estimated annual payments for a PPP (under a reasonable range of scenarios) could be accommodated within those limits

An **OECD survey** described in (OECD 2008a, 42–43) found that:

- In **Brazil**, project studies must include a fiscal analysis for the next ten years.
- In the **UK**, procuring authorities must demonstrate the affordability of a PPP project based on agreed departmental spending figures for the years available, and on cautious assumptions of departmental spending envelopes thereafter.
- In **France**, affordability of a PPP is demonstrated by reference to a ministerial program—a multi-year indicative budgeting exercise.

The **PPP Manual of South Africa** section on affordability (ZA 2004a, Module 2) also describes a similar approach.

Introduce budget rules—that is, the affordability of PPP commitments is considered in the annual budget process

For example:

- In the **State of Victoria, Australia**, a department considering a PPP must first seek approval for the capital spending that would be required if the project received public funds—as required in the national PPP Guidelines (AU 2017) and described in Irwin's review of PPP contingent liability management (Irwin and Mokdad 2010, 10-11).
- **Colombia's law on contingent liabilities** (CO 1998, Article 6) requires implementing agencies to make a cash transfer to a contingency fund when a PPP project is signed. The cash transfer is set equal to the expected cost of programs including any guarantees provided. The payments may be spaced out over several years. This means the decision to accept a contingent liability has an immediate budget impact that must be considered.

The complexity of financial arrangements that are often entered into in a PPP project, especially in infrastructure investments, warrants that the government is able to identify up-front what its liabilities are over the life of the project. These could be explicit or implicit direct or indirect. Constructing a *Fiscal Risk Matrix* (for liabilities) and a *Fiscal Hedge Matrix* (for the asset side) to catalogue the potential sources of fiscal risks to the government, and factors that influence their size, is an important analytical exercise to be undertaken prior to signing a PPP agreement. These two matrices are displayed in Fiscal Risk Matrix: For Liabilities and Fiscal Hedge Matrix: Assets and Contingent Financing. This function is typically carried out in the Ministry of Finance and must be divorced from the sector ministry or entity promoting and negotiating the project.

Fiscal Risk Matrix: Liabilities

	DIRECT LIABILITIES	CONTINGENT LIABILITIES

		Guarantees for borrowing and obligations of sub-national governments and SOEs
		Guarantees for trade and exchange rate risks
Explicit liabilities	Foreign and domestic sovereign debt	Guarantees for private investments (PPPs)
(Legal obligation, no choice**)**	Budget expenditures—both in the current fiscal year and those legally binding over the long term (civil servant salaries and pensions)	State insurance schemes (deposit insurance, private pension funds, crop insurance, flood insurance, war-risk insurance)
		Unexpected compensation in legal cases related to disparate claims
		Defaults of subnational governments and SOEs on non-guaranteed debt and other obligations
	Future public pensions if not required by law	Liability clean-up in entities being privatized
Implicit liabilities	Social security schemes if not required by law	Bank failures (support beyond state insurance)
(Expectations – political decision)	Future health care financing if not required by law	Failures of nonguaranteed pension funds, or other social security funds
	Future recurrent cost of public investments	Environmental recovery, natural disaster relief

Source: (Polackova 1998)

Fiscal Hedge Matrix: Assets and Contingent Financing

	Direct (based on the stock of existing assets)	**Contingent** (dependent on future events, such as value generated in the future)

Explicit (based on government legal powers such as ownership, right to raise taxes and other revenues)	Asset recovery (workouts, sales of non-performing loans, state equity sales, etc.) Proceeds from privatization of state-owned enterprises (SOEs) and other public resources Recovery of government loan assets (e.g. resulting from earlier direct government lending)	Government revenues from natural resource extraction and sales Government customs revenues Tax Revenues less: • Tax Expenditures • Revenues from forward sales (e.g. commodity forward sales) ○ Hedging instruments and re-insurance purchased by government
Implicit (based on Government indirect control)	Stabilization and contingency funds (Note: These liabilities refer to fiscal authorities, not the central bank) Positive net worth of Central Bank	Profits of state-owned enterprises Contingent credit lines and financing commitments from IFIs Current account surpluses across currencies

Check out Assessing Fiscal Implications.

Related Content

- **INTRODUCTION**
- **PPP BASICS: WHAT AND WHY**
- **ESTABLISHING THE PPP FRAMEWORK**
- **PPP Policy**
- **PPP Legal Framework**
- **PPP Processes and Institutional Responsibilities**

- **Public Financial Management Frameworks for PPPs**
- **Broader PPP Program Governance**
- **Municipal and other subnational PPPs**
- **Key References - PPP Framework**
- **PPP CYCLE**

Additional Resources

- Selected World Bank Tools
- PPP Sector Specific Checklists

Find in pdf at PPP Reference Guide - PPP Framework or visit the PPP Online Reference Guide section to find out more.

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