More public rescues for more private finance failures – a critique of the EC Communication on PPPs

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Preface by EPSU

The European Commission has over many years promoted Public-Private Partnerships. The Commission sees these as an efficient tool to spend public funding. With the financial crisis in full swing funding for PPPs dried up in 2008 and early 2009. PPPs ran into difficulties. To support private business the European Commission published a Communication "*Developing Public Private Partnerships*" in November 2009. It is a first class propaganda piece for private business rather than a balanced account of risk and advantages of public private partnerships.

The risks of PPPs were highlighted when Aquiris, a subsidiary of French multinational Veolia Water, charged with treating waste water in Brussels, home of the European Commission, stopped doing so, 8 December 2009. Untreated water of 1.1 million citizens polluted the river Zenne during 10 days when the company was forced to start up operations again. Research of *Corporate Europe Observatory* revealed how the company was seeking more money of public authorities, could not fulfill its contract and had basically lied about its technology in its response to the tender.[i] But more worrying is that Brussels is now lumbered with the contract. Pulling out will be extremely costly. CEO concludes its research:

> "Behind these spectacular events is the story of how a private corporation used public money to develop a new technology which will be sold elsewhere for the company's sole profit (Veolia Water used the Aquiris case extensively in its marketing, because a safe and more environmentally-friendly method to dispose of wastewater sludge is much in demand at the moment). Unfortunately this proved to be a riskier bet than originally envisaged, and the two "partners" of the costliest water Public Private Partnership (PPP) in Belgium now face mountains of sludge waiting to be treated, piles of debt and a brand new plant which has still not been shown as up to the job."

When we learned that the forthcoming EU 2020 strategy would again seek to promote PPPs EPSU decided to ask *Public Services International Research Unit* to comment on the European Commission´s proposals in the earlier mentioned Communication. PSIRU has researched and published reports on PPPs in Europe and internationally over the last decade, carries out international studies like the EU-funded €1.5million Watertime project, and provides evidence and advice to public authorities and elected representatives at all levels.

This report makes clear that PPPs suck up public funding, increase risks to public finance and in general are a bad way to spend tax payers' money. It also reveals the extent to which DG Internal Market is pursuing an ideological course to suit its core constituency: private business. And now BusinessEurope, the European organization for big corporations, wants more corporate welfare. It published its call for more public money for big business on 15 March 2010 in a report *Combining fiscal consolidation with sustainable growth: A European action plan*. It is a full scale attack on public service workers, on public pensions and health care. But guess what – BusinessEurope argues that private business should receive funding to run your health service, child care, drinking water and all other public services. And of course treat your waste water: one of the authors is a key Veolia representative. BusinessEurope does not shy away to push its agenda on your Ministers for Finance which met 16 March 2010 arguing that if they are not listened to Europe will grind to a halt. And to do so it propagates myths on PPPs. This new report of PSIRU debunks these myths.

Our conclusion is that the European Commission does not promote the public interest when coming out in force in support of PPPs. It should have a far more critical and balanced attitude on how private business operates PPPs. This balance can possibly only be restored if public procurement and PPPs are moved to the

[i] http://www.corporateeurope.org/water-justice/content/2010/02/aquiris-veolias-lost-bet-brussels

European Commission´s DG which deals with consumer protection. After all, with the Procurement directives in place, it is a matter of protecting the interests of citizens over those of capital.
But you might disagree. You might have comments on the report. You might have done research that contradicts the findings. Please inform us. But equally, if you know of cases that confirm what is argued in the report please do not hesitate to send it to us. It will assist the workers in public and private companies and institutions delivering public services to citizens every day in often difficult and dangerous circumstances. Because in the end our members and you as tax payer have to share the burden of faulty public-private partnerships.

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1. Introduction

In November 2009 the EC published a Communication on 'Developing Public Private Partnerships'.[1]

The paper does not offer a balanced assessment of experience with PPPs, or trends in PPPs in Europe. In particular, it does not address the way that PPPs reduce the resources available for public services by absorbing a higher proportion of spending. The main purpose of the paper is rather a review of various policy instruments of the EU, focussed on the single overriding question of how these can be used to subsidise and create more PPPs than would otherwise be the case.

This report reviews and criticises the Communication in a number of respects:

- Its inadequate analysis of existing experience
- Its unbalanced attempt to maximise the use of public finance and public institutions to support PPPs, including in particular it s use of 'innovative financial instruments'
- The emptiness of the role of PPPs in the 2020 economic strategy
- The wider problems of public authorities using 'innovative financial instruments'

This critique follows a number of other PSIRU reports on PPPs, which are listed in the bibliography at the end of this paper.

2. Assessing PPPs

2.1 Unbalanced and weak arguments

The section on 'the case for PPPs' is too superficial and one-sided. As the title suggests, it only sets out arguments in favour of PPPs, it does not offer a balanced assessment. A recent PSIRU paper set out an analysis of the risks and impact of PPPs, including a number of examples.[2] The present Communication does not mention any such cases, (although 7 years ago, a Commission briefing on PPPs did acknowledge these risks, and gave examples).[3] These problem cases have continued to increase.

- The paper claims that PPPs are mainly on-time and on-budget, but fails to observe that this is because they are based on turnkey contracts, which require successful completion before payments are made - but at a cost which is 25% higher than normal procurement. [4]

- It claims PPPs provide better value for money, and quotes the results of a PPIAF study on water and energy which found evidence of higher efficiency - but (a) it fails to note that the PPIAF study found no evidence at all of increased investment or lower prices, so none of the benefits of any efficiency gains go to the public sector, they only increase profits (b) the PPIAF study is only one amongst many, the great majority of which find no significant differences in efficiency between public and private sectors. This is extremely damaging for the case for PPPs: as the IMF has observed, since their cost of capital is always higher, they would have to make major efficiency gains in operations to even match the public sector option. [5]

- The claim that they 'spread the cost over the lifetime of an asset' is trivial - this is the effect of any borrowing by governments, not only through PPPs. The claim about risk-sharing also needs more hard evidence rather than an assertion - the many cases where services have been cut or taxes increased must be examined as part of a full assessment.[6]

- The paper provides no evidence for its claim for innovation by PPPs, yet there is fresh evidence confirming that the private sector spends little or nothing on R&D in crucial sectors such as electricity (see below). The 2020 economic strategy paper also acknowledges that R&D spending in

Europe is too low compared with Japan and the USA "mainly as a result of lower levels of private investment"[7]

- The final two points - that the private sector gets a central role in planning infrastructure, and gains experience that is useful for winning projects overseas - are true, but these are benefits to the private sector, not to the public interest. There is clear evidence, for example, from Italy and Estonia, that the private sector dominance in the evaluation process leads to highly distorted results. There is also much evidence that PPPs in developing countries, especially in sectors like water and electricity, do not produce economic or social benefits, and are strongly resisted by their publics. [8]

- Finally, the claim that "PPPs offer capacity to leverage private funds....these benefits are of particular importance in the present economic conditions" is contradicted by the rest of the paper itself, which attempts the opposite – i.e. it tries to find ways for the public sector to raise funds for PPPs, precisely because the private sector is now unable to raise funds for PPPs at rates even close to the public sector. As the paper says in discussing TEnT projects: "PPPs....often face difficulties in attracting competitively priced private financing." [9]

2.2 PPPs: consuming public finance

At the heart of the paper is the misleading idea that PPPs somehow bring additional private resources into public services or infrastructure. Thus the conclusion claims that: "Developing PPP as an instrument becomes critical as the financial and economic crisis is taking its toll on the ability of the public purse to raise adequate financial means and allocate resources to important policies and specific projects."

But the opposite is true. The great majority of PPPs rely on a stream of income from payments by government (for the hospital, school, railway, etc) – i.e. public spending. [ii] The Communication itself says at the start that PPPs include "important safeguards for private investors, in particular the stability of long term cash-flows from public finances". PPPs do not supplement public spending – they absorb it.

In a context where there are political demands to cut public spending, the existence of PPPs creates greater threats to other spending on public services... This is because PPPs create long-term contractual rights to streams of income, and so governments are legally constrained from reducing payments to PPPs. That in turn means that reductions in spending are concentrated on non-PPP areas. This is made worse because PPP/PFI schemes have much longer contractual periods (25-30 years or more) than conventional service contracts e.g. for refuse collection, 3-5 years). The effect is thus larger than with ordinary outsourcing – switching public spending from direct employment to purchase from a private company.

The claims of PPPs are vigorously pursued by corporate lawyers. In healthcare, PPPs are being increasingly used for hospital and other construction, led by the PFI initiative in the UK. The transaction costs and risks of contract disputes are a further problem: "the development of quasi-markets has already led to a contractual culture...... the health sector is becoming increasingly more of a playground for lawyers and legal firms." [10]

The contracts may even explicitly protect companies against the consequences of democracy. Contracts for private road schemes in the USA include clauses giving companies "the right to object to and receive compensation for legislative, administrative, and judicial decisions". Contracts have become standardised with as much as 70% of identical content, reflecting the cumulative expertise of corporate lawyers, whereas

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[ii] With the exception of true concessions, where the private company makes all the investment "at its own risk", expecting to get the necessary income from payments made by consumers (e.g. water charges or road tolls).

the public authorities with which they deal often have none.[11] Public policy thus becomes subordinate to the imperatives of designing a commercially viable contract.

2.2.1 Transport in UK

These risks can be very clearly seen in the UK experiences in the transport sector – road, rail, bridges and tunnels – the sector in which the great majority of European PPPs have been set up. The collapse of the London underground Metronet PPP cost the UK's public finances between £170million and £410 million [12]. The continued operation of the remaining PPP, Tube Lines, has only been possible by forcing up the price of the service, despite the fact that it is already badly behind schedule. The mayor of London has commented that:

> "We are being asked to write a blank cheque in order to prop up failing Tube Lines. In other countries this would be called looting, here it is called the PPP."[13]

Apart from the PPPs in London, the UK Department of Transport is potentially liable for at least £27 billion, due to its implicit and explicit guarantees of other major PPP transport projects. A parliamentary committee has commented:

> "the scale of the known liabilities, plus the possibility of further large unquantified liabilities, represents a significant financial risk that could impact upon the ability of the Department to perform its core functions". [14]

Similar contingent liabilities arising from PPPs will overhang the transport budgets of governments throughout Europe. This problem of contingent liabilities in relation to PPPs is well known: it was pointed and discussed in some detail by the IMF in 2004, and conferences of European auditors and bankers have discussed the issue. [15] The Commission's paper, however, appears completely unaware of the problem of contingent liabilities, and equally ignorant of – or unwilling to mention - the scale of the economic and social costs incurred in failed PPPs. [16]

2.2.2 PPPs in central and eastern Europe

A report based on actual experiences with PPPs in central and eastern Europe presented similar concerns.[17] It warns that:

> "there are wider and more systemic issues that have not been sufficiently taken into account by PPP advocates and governments, particularly in terms of the cumulative impacts of PPPs on public budgets during the coming decades...... not only are there an unacceptably high number of 'bad Apples' but that using a large number of PPPs in itself is likely to lead to affordability problems."

It gives a number of examples:

- "There are a range of cases – such as the Zagreb wastewater treatment plant and several motorway projects – where very little risk has been transferred, at great cost to the taxpayer."

- "The persistent over-estimation of traffic figures by CEE decision-makers not only leads to difficulties with the concessionaire's income or the public budget's expenditures, but also leads to attempts to increase the amount of traffic"

- "The South Bridge in Riga, Latvia, is already causing a scandal due to its constantly rising costs."

- "the attempted PPP [for the Trakia Highway, Bulgaria] only delayed the implementation of the project, and has involved spiralling costs that are causing an increased burden on the state budget."

3. Political and financial problems with PPPs

The case against using PPPs at all remains as strong as ever. But PPPs are now also finding it difficult to raise finance, and are faced with greater public resistance. There are a number of reasons why PPPs are now unable to support themselves without state aid from governments and the EU.[18]

The main attraction of PPPs – that they can be used to conceal government borrowing and debt, in order to evade the constraints of EU and national limits on borrowing and debt – has been undermined by new international accounting standards, and greater scepticism by some statistical authorities, so that many PPPs are now recorded 'on the books' (for example, only 3 out of 19 PFI projects in the UK since April 2009 were 'off' the books).[19] This means that they are a less useful instrument for evading fiscal rules.

As the Communication acknowledges, far fewer PPPs are being set up. There is stronger public opposition to such schemes, especially in the light of damaging experiences with actual PPPs. To take again the example of the UK, PPPs are now seen as such an unpopular policy that the opposition Conservative party has promised that, if it wins the next general election, it will end the UK's private finance initiative (PFI) – which has been held up as a model for the whole world.[20]

Most of all, the financial crisis has made it very difficult for any private companies to raise finance except at very high interest rates, which make PPPs prohibitively expensive, even for their greatest supporters. Although most countries have reduced official interest rates to very low levels, in order to stimulate the economy, banks are insisting that private companies pay much higher interest rates than governments, because of perceived risk and general economic uncertainty. Banks are also less willing to offer long-term loans. As a result, the difference between corporate and government interest rates has grown larger. By mid-2009 companies had to pay interest rates about 4% higher than governments. [21]

In March 2010 this remains true:

> "Rating agency Moody's reckons companies need to consider the possibility of restricted access to all funding markets simultaneously: 'The current turmoil in the capital markets will continue to make it harder for the more leveraged companies to refinance without some debt write-down…..Reduced access to capital markets would be one of the factors that could lead to a higher default rate.'".[22]

As a result, existing PPPs face problems with refinancing debt that falls due for repayments. Proposed PPPs cannot find anyone prepared to lend money at rates even close to government interest rates.

The most obvious strategy for governments and the EU would be take this opportunity of winding down PPPs, as a failed and dangerous model, and return to conventional public investment and operation of infrastructure and public services. Instead, the Commission and some countries are taking the bizarre approach of providing public guarantees and subsidies to enable PPPs to continue.

4. State rescues for PPPs

4.1 EU and Government support

The core objective of the Communication is well summarised by the heading of the central chapter : 'The EU contribution to PPP projects'.

This approach extends to member states. The paper acknowledges that: "The ultimate decision to use PPPs lies with the Member States' public authority", which is at least a recognition of national and democratic sovereignty on the issue, but then immediately continues that "it is for the Member States to review the national framework as necessary to enable it". There is no attempt to encourage a framework for objective analysis of whether or not PPPs are desirable: the Commission expects "Member States' actions to remedy the obstacles to the development of PPPs and to promote their use". The same approach runs through the specific proposals for actions.

For example, under the heading 'Improve information and disseminate relevant expertise and know-how', the paper nowhere mentions the gathering of information on actual experiences to improve the ability to judge whether a particular investment programme would be better carried out conventionally or through PPPs. Instead, it sets out a series of exercises designed solely to promote the use of PPPs:

- "The Commission will issue guidance on the legal and methodological issues involved in combining EU funds with PPPs... in order to facilitate and increase the uptake of PPPs in structural funds."
- "Working with the European PPP Expertise Centre (EPEC) to identify means to deliver enhanced **long term support** to those Member States that seek to use PPP.....EPEC should... act as a focal point for a European network of national bodies established to support PPPs."
- "Working with Member States to **identify provisions** in national legislation that **prevent or hinder setting up PPPs..."**[23]

Member states are always able to carry out infrastructure investments through conventional means. But in the Commission's presentation, there is, literally, no alternative to PPPs.

This is better described as propaganda rather than an information service.

4.2 International institutions lobby for PPPs

The Commission's attempt to provide state aid for PPPs is part of a wider drive by international institutions. In November 2009, the UN economic commission for Europe organised a meeting in Geneva to try and combine global and national institutions into a wider international pressure group to support PPPs, asking for donations and subscriptions.[24] This initiative emerged following an international conference on PPPs in May 2009, involving the World Bank, ADB, UNECE and various Asian governments, which was presented with a lucidly expressed argument that PPPs were becoming dysfunctional and discredited because of the crisis:[25]

> "Discontent, even outright hostility, among the general public against the capitalist system has gained ground during the crisis....The 'system' is mistrusted, and confidence in capitalism and its future is low... The crisis appears to have had its roots in the era of deregulation and is replaced by the growing role of the state in managing financial capitalism and exercising accountability previously absent in the system; ...PPPs are equated with the now discredited privatisation and financial liberalisation."

The same presentation also argued that the crisis also brought opportunities for potential PPPs because of the economic, social and environmental needs for public spending:

> "The potential demand for social infrastructure such as public lighting, hospitals, and schools, is amplified in volatile times when financial and economic crisis negatively affect low-income people's life. The social infrastructure can not only serve as a safety net but also generate economic flow-on effects with increased human resource investment …There are ongoing needs to restore and replace much of the existing physical infrastructures, to accommodate population growth and to deal with the threats of global warming in response to the call for sustainable development". [26]

The conclusion was that there was a need for "tools to bring back the banks and new institutions able to articulate a pro-PPP policy in the crisis (and those in the future)...a global advocate to spread support and the message around the globe: an alliance of PPP units."[27]

Thus, the international financial institutions and national finance ministries – all public sector institutions sustained by public finance – combine to act as an international lobby group to protect PPPs and discourage a revival of direct public sector financing and provision of infrastructure.

4.3 Public sector guarantees, subsidies and loans

Apart from this lobbying, governments and international public sector bodies are supporting PPPs through substantial state aid, in the form of privileged access to government guarantees or public finance.

As the Communication notes, some national governments – including the UK, France, Germany, and Portugal - have already set up schemes which rescue PPPs through the simple device of providing government guarantees, or by government borrowing money at low rates and then lending it on to PPPs at similar rates, and then pretend that this 'private finance'.[28] The Spanish government has given similar general guarantees to transport PPPs.[29] Internationally, the IFC has created an "infrastructure crisis fund", aiming to use $1.2-10 billion of public finance from the IFC itself and donors to provide PPPs with the loans they cannot raise in the market.[30]

At EU level also, various schemes, policies and institutions support and promote PPPs. The EC Communication lists all these, which are summarised in the table below. Every one of these is a public sector body or activity, financed by European citizens through taxation.

Table 1 EU: public assistance to PPPs

Category	Instrument	Mechanism
Research funds	JTI	Public finance, private activity
Financial engineering	JASPERS	Administrative support for designing PPPs
	JESSICA	Channelling EU money via funds to PPPs
	JEREMIE	Money to SMEs
EIB	Public sector development bank	Low interest rates
TEN-T	Loan Guarantee Instrument for TEN-T Projects (LGTT), Construction cost grants, state equity investment,	'also an expression of a political commitment by the EU'
R&D funding	Risk Sharing Finance Facility (RSFF), CIP),	Loans out of public finance to PPPs (€4billion via RSFF since July 2007)

Source: EC Communication on PPPs, 2009

4.3.2 EIB: public interest rates for private companies

One of the most significant roles is played by the European Investment Bank (EIB). This is an EU-wide development bank, 100% owned and guaranteed by all the member states of the EU. It was created under the founding treaty of the EU, the Treaty of Rome, in 1958, with the objective "to contribute towards the integration, balanced development and economic and social cohesion of the EU Member States." Thanks to its public sector ownership and guarantees, the EIB can raise funds at the lowest possible rates; because it does not try to maximise profits, it also lends at a rate very close to its own cost of borrowing.[31]

No private sector institution can or would do this. Channelling more of this money into PPPs means that the private partners are benefitting from a much lower cost of capital than they could arrange for themselves. Since the credit crunch, the EIB has been a crucial source of finance for PPPs that are unable to raise funds from the private sector. The public sector's commitment to development is being used to subsidise private ventures which would otherwise not be bankable. The EIB has lent €500m for motorway projects to the private Gavio Group in Italy, for example: the interest rate will certainly be considerably lower than the group could have obtained for itself from private banks.[32]

4.3.3 Financial engineering to channel public money to private contractors

The Commission has already developed a number of 'financial engineering' instruments to help PPPs, by making it easier for them to use EU (public) money from the cohesion funds. The EU's structural funds are subject to rules which restrict them being used to subsidise private companies, and this has made it difficult for member states to use these funds in areas where they have set up PPPs. The Czech republic, for example, has been unable to draw on EU cohesion funds for its numerous privatised water concessions, because "the operational agreements in question were unbalanced and did not ensure the safeguard of the public interest". A report by Transparency International estimated that the Czech republic had thereby lost access to €350m. in EU funds.[33]

One such instrument is the Jessica initiative, which can be understood as a kind of money-laundering device, which allows money from the structural funds to be fed into special Holding Funds, or Urban Development Funds, which can then be used to lend the money on to PPPs. The Czech region of Moravia-Silesia, for example, has established a €20m. fund, including €17m. from the structural funds.[34]

The TEN-T projects also include instruments using public finance to support PPPs that would otherwise not be economically viable, or would be less profitable.

For example, the **construction cost grant** reinforces the turnkey contract mechanism used in PPPs, by providing 30% of the costs after construction is complete.

The **loan guarantee** from the EU to private companies - "by making up shortfalls in revenue that result from lower than expected traffic growth in the early operational periods of projects" - is especially alarming since it gives private companies an increased incentive to win PPP contracts be exaggerating forecasts. This is already widespread through 'systematic misrepresentation, i.e. lying' by contractors, as demonstrated in comprehensive studies by Flyvbjerg and others. The Commission would do better to pay attention to their conclusion that: "The problem of misinformation is an issue of power and profit and must be dealt with as such, using the mechanisms of transparency and accountability."[35]

The TEN-T budget also allows for €80 million of public finance to be invested in PPPs as equity through **a special 'infrastructure fund'**. This is a benefit to PPPs because they often cannot find sufficient private investors willing to risk investing either equity or debt. But this benefit comes by taking a risk with public money which the private sector is not prepared to take - which is a bad way of using public money, especially if the justification is in the form of a benefit to a private company, which creates obvious incentives for corruption. If the EU runs this facility like the private infrastructure funds created by Macquarie Bank and others, it is even more alarming. These were denounced by The Economist in 2008:

> "Their entire business models now seem headed for the scrap heap…. [Macquarie Investment Group's] long-standing practice of paying out more in distributions to shareholders than it received from the underlying investments worked when it was cheap to borrow money. It no longer is." [36]

Finally, the Communication also notes the ways in which the EU has promoted PPPs in other countries, including specific references in international trade agreements to open tendering for PPPs.

4.4 The 'Key actions' of the Communication[37]

The '5 key actions' in the conclusions of the Communication should be substantially modified, or abandoned.

- any PPP group for 'relevant stakeholders' should include voices of those who are concerned about the effects of PPPs e.g. on employment and the environment. The group should thus include public sector trade unions, to address the impact of tens of thousands of employees; and civil society organisations such as Bankwatch, which have expressed strong concerns about the environmental impact of PPPs. The outputs of this group should not be restricted in advance to 'reducing the administrative burden and delays', otherwise it may be seen as an EC-financed lobby group for the interests of private companies, but should rather be expected to issue guidance on how employment, environmental and other public interest issues can be protected.
- Work with the EIB should not simply be concerned with increasing the funding available for PPPs. As argued above, there is no evidence to support such a policy. In any case, any discussions with the EIB should be firmly placed in the framework of the next point, namely the need to ensure that the EIB, like other Community institutions, is not discriminating in favour of private rather than public options. The EIB should be required to ensure that their allocation of public funds follows the

objective of social and economic optimisation of investment methods, and is not distorted by any direct or indirect favouring of the PPP option.

- If the Commission wants to ensure that the allocation of public funds in general does not bias the choice between public and private sector management, then it should ensure that PPPs are not given any new privileged exemptions from EU procurement law, nor given any additional state aid. The achievement of this objective means rejecting the preceding proposals, which are manifestly aimed at favouring private sector participation.
- This proposal to encourage greater ‘innovation’ (presumably financial) and for the EU itself to participate in private law bodies should be abandoned. As noted above, the economic crisis has partly arisen from the spread of ‘innovative’ financial instruments, and the Commission should be rather seeking ways to discourage all public sector bodies in the EU from placing public services at risk from PPPs.
- The Commission has been proposing new legislation on concessions for many years now. Any new legislation should avoid creating a discriminatory advantage for private concessions that somehow makes them ‘easier’ than other public contracts. It is necessary to bring concessions fully under the rules of the procurement directives, so that there can no longer be the possibility of awarding such economic privileges without transparent public tendering. This would also confirm the direction in which ECJ rulings have been moving, using the basic provisions of the treaty to infer a duty to tender. Public authorities must of course retain the fundamental right to prefer inhouse operation and not tender at all.

4.5 IMF warnings ignored

An IMF paper on PPPs and the crisis in July 2009 warned that any state aid for PPPs should be subject to strict criteria: “intervention measures should be consistent with the wider fiscal policy stance, be contingent on specific circumstances, and be adequately costed and budgeted. Governments should be compensated for taking on additional risk.” The IMF paper also argues that support which is related to the economic crisis should be temporary, and ‘switch off’ as economic recovery takes place.[38]

The Communication makes no reference to these warnings, and does not provide much evidence of such specific conditions, costings, and compensation for risk, in the support already provided by the Commission and some member states. State support for PPPs seems unconditional.

5. The role of PPPs in the economic strategy of Europe 2020

5.1 Economic and fiscal strategy

A ‘new economic strategy’ in Europe was published by the EC in March 2010, under the heading of ‘Europe 2020’.

In discussing the impact of the crisis on the ability of businesses and governments to finance investments, the strategy states that Europe must “pursue new avenues in using a combination of private and public finance and creating innovative instruments to finance the needed investments, including public-private partnerships (PPPs)”. [39]

The immediate priority is described as “a credible exit strategy”, which means an exit from the current levels of government financial deficits. These deficits have been crucial to countering the recession, but have exposed the damaging limitations of the stability pact. The EC presents these deficits – which have protected millions of jobs – as a damaging effect of the crisis on a par with the recession, and so deplores “two years of crisis erasing twenty years of fiscal consolidation”. The proposed strategy also gives the objective of cutting government deficits and debt the same status as the resumption of economic growth, so the EC says that it will help member states “return to sustainable growth and public finances”. The link is further cemented in the practical details: the EC will monitor this economic strategy “simultaneously” with the stability pact monitoring of government finances, and “policy warnings could be issued in case of inadequate response”.

Since member states are unlikely to be 'warned' about excessive growth, or lack of it, effectively the only instrument in the strategy is warnings against breaches of the stability pact. Such a policy is increasingly out of touch with reality – it fails to curb irresponsible private sector debt, which caused the crisis, while attacking public sector deficits, which have been central to dealing with the consequences of the crisis. It is very likely to be counter-productive, by demanding reductions in economic stimulus before economies have recovered, and means that the Commission has no way of dealing with issues more directly concerned with EU-wide recovery, such as the need to increase consumption in countries with export surpluses, especially Germany.[40] This strongly echoes the policies demanded by European business lobbies, which are demanding cuts in public deficits, debt and spending, in such areas as pensions. [41]

Enforcing the arbitrary, 12 year old limits negotiated in the stability pact also helps PPPs. While these limits remain at the heart of official policy, there will always be an incentive to use PPPs. As the IMF paper states: "In practice, PPPs have also been used to circumvent government accounting rules by moving borrowing off the public sector balance sheets".[42] So if governments want to increase infrastructure spending as a way of stimulating the economy, they will be forced to use PPPs to do so – as long as they can still be recorded 'off-balance sheet'.

But the continued or increased use of PPPs will not ease pressures on public finance: rather, as noted above, they will capture a part of public spending that is then frozen by the rigidities of contractual obligations. Any cuts will be excessively concentrated on other public spending.

5.2 Private sector failures in infrastructure investment

PPPs are also a poor instrument for generating new investment. The strategy paper claims that "the crisis and severe constraints in public spending have made it more difficult for some Member States to provide sufficient funding for the basic infrastructure they need in areas such as transport and energy". But the problem in these sectors is the failure of the private sector to invest. In transport, as noted above, PPPs have a bad record of creating risks, while continuing to require government guarantees which increase contingent liabilities and threaten transport budgets.

In energy, the paper itself notes the need for: " the development of necessary energy infrastructure where commercial interests provide insufficient investment incentives". This is especially true for the investments needed in green energy. Even in the UK, which has been the most committed of EU countries to the liberalisation of the system, official bodies are recognising the need to introduce public finance and reduce the role of the market. In October 2009 the UK government's official climate change committee advised that developing renewable energy resources requires a move away from liberalised markets. The committee pointed out that countries with a high proportion of non-carbon generation have built their capacity through large-scale government investment, not through markets, and concludes that: "we should not accept the significant risks and costs associated with the current market arrangements… changes to the current arrangements are both required and inevitable." In February 2010 the UK regulator, OFGEM, acknowledged the same truth: "leaving the current arrangements unaltered is not in the interests of consumers". [43]

Even within liberalised markets, it is only the state-owned companies which invest in R&D: the private sector does not invest in R&D:

> "The last two decades have witnessed a staggering decline of R&D investment in the fields of energy and electricity. This paper contends that this widespread phenomenon is mainly ascribable to the processes of liberalisation and privatisation of electricity markets which have induced electric utilities to dramatically reduce R&D expenditures. However, a closer inspection to recent data concerned with ten major electric companies of the world shows that not all of them behaved in the same way. The drop of research expenditures was particularly strong among the private or newly privatised companies, while those that remained under public control did not reduce R&D efforts." [44]

The same is also true in telecoms, where private network operators are also reluctant to make sufficient investment in the fibre-optic networks which are crucial to greater use of the internet. Governments are having to provide public finance: in Portugal, for example, the state provided 85% of the financing for a €1 billion investment programme. The 2020 strategy paper demands more public finance, calling on governments: "To draw up operational high speed internet strategies, and target public funding, including structural funds, on areas not fully served by private investments". [45]

6. Annex: 'Innovative' financing instruments

6.1 The cost to public authorities in Europe and the USA

The PPPs Communication claims that: "The interest of the public sector in innovative financing instruments has increased". Many of the instruments used to support and subsidise PPPs, such as Jessica and Jaspers, are described by the EC as 'Financial Engineering', and DG Regio organised a conference about them in October 2009, under the title of 'Innovative financial instruments in EU Cohesion Policy'.[46]

It is now widely known that the growth of 'innovative financing instruments', such as credit default swaps, has been at the heart of the financial crisis. According to Joseph Stiglitz, these instruments were allowed to create such damage was because key regulators were reluctant to "interfere with "innovation" in the financial system".[47] It is less well known that public authorities throughout the EU and North America have already suffered greatly as a result of using 'innovative' financial instruments. The impact on public finances is summarised below.

PPPs resemble these innovative financing mechanisms in at least two respects. Firstly, the main incentive for public authorities to adopt them is as a way of getting around fiscal rules. Countries such as Greece, and many municipalities, used debt swaps in order to reduce the apparent level of debt, in order to avoid breaching fiscal debt limits imposed by the EU or national governments; similarly, the greatest incentive for using PPPs is to reduce the apparent level of debt and deficits. Secondly, the promoters of these instruments insist that there is very little risk associated, but the impact has in many cases been disastrous for public finances and public services.

6.2 Greek debt swaps

These instruments were at the heart of the financial manipulations of former governments in Greece and elsewhere to avoid revealing the true scale of their debts. These are already the subject of investigations in the USA, both by Congress and by the Federal Reserve Bank, and in March 2010 EU countries started demanding curbs on the use of such derivatives, including action by the Commission: [48]

> 'Angela Merkel, German chancellor, called on Tuesday for the "fastest possible" adoption of new rules to clamp down on the most speculative elements of derivatives trading.... "We are all agreed that we must put a stop to financial speculation."...... Germany and France, working with Luxembourg and Greece, are planning a joint anti-speculation initiative to galvanise action by the European Commission to tighten regulation of derivatives trading, and in particular of credit default swaps (CDS) in the sovereign debt markets.'

As part of this, the Commission should stop encouraging public authorities to engage in 'financial engineering'.

6.3 Financial havoc for European municipalities

The public finances of Europe have also been badly damaged at municipal level as a result of extensive sales of 'innovative' financial instruments to municipalities. The scale of this, in particular the damage done to the budgets of Italian municipalities, was set out by the Financial Times in March 2010, in an article worth quoting extensively:

> "During the past decade, investment banks have sold complex derivatives to state authorities across the Continent, in countries such as Austria, Belgium and Portugal either with the aim of flattering their balance sheets or on the promise of high returns…..

"Between 2001 and 2008, 525 Italian local authorities entered into almost 1,000 interest rate swaps with an aggregate value of €35bn, according to Italy's audit office and the central bank. This equates to almost one third of all of the debt owed by Italy's regions, provinces and municipalities…….Scores of these deals are now turning sour, dragging Italian banks such as BNL and global institutions such as Merrill Lynch, UBS, Deutsche Bank and JPMorgan, into court…….Investigations by Italy's finance police have led to raids, the seizure of assets and bankers being named in criminal cases. One prosecutor in south Italy has asked that Merrill Lynch be banned from doing business with municipalities for two years……

"Over time, however, local authorities found themselves inundated with approaches from investment banks offering inducements and schemes for managing debt. .... the structure of deals became increasingly complex. More importantly, the London offices of the major international investment banks jumped into the fray, lured by a new source of derivatives demand and the hope of fat fees. The roll call of those involved included Merrill Lynch, Deutsche, UBS, JPMorgan, Nomura International and Dexia of Belgium……

"In 2006, Taranto, one of the largest cities in south Italy, defaulted with an extensive exposure to derivatives. A few months later, in separate allegations related to a whistleblowing case in London, Piero Burragato claimed Nomura, his former employer, had levied illegally high fees and violated disclosure requirements in a €200m deal for Liguria's regional government…..The state banned local authorities from entering derivatives transactions in 2008. Then, the same year, the municipality of Milan lodged a legal case accusing banks that in 2005 underwrote a €1.8bn bond and swap financing transaction - Deutsche, JPMorgan, UBS and Depfa, a German state funding institution - of making €100m profit at the city's expense. In a parallel criminal case, bankers, including Gaetano Bassolino of UBS, the son of a Naples politician Antonio Bassolino, were accused of aggravated fraud.

……..Senior Italian bankers say total losses, including sinking funds, could reach €10bn. Mario Ristuccia, chief prosecutor of Italy's administrative court, last month said derivatives losses could "wring sacrifices from future generations for 20 or 30 years". In Baschi, Ms Dominici is angry and ready to fight, having filed a suit in the local town, Orvieto. "Derivatives must be banned - anywhere, everywhere - for all local authorities," she says, adding that she hopes her case will send a "message" to governments.

The example of the UK is instructive. Here, the market for selling derivatives products to local authorities closed in the early 1990s, when the House of Lords held that interest rate swap contracts entered into by the London council of Hammersmith and Fulham were null and void, and legally unenforceable………"

(Financial Times March 9 2010An exposed position By Vincent Boland, Guy Dinmore, Rachel Sanderson and Gillian Tett http://www.ft.com/cms/s/0/0f1fe74a-2b1b-11df-93d8-00144feabdc0.html)

6.4 USA: public authorities, bribes, and innovative financial instruments [iii]

The same thing has happened in the USA. JPMorgan and other banks persuaded hundreds of public authorities to enter into 'innovative' financing deals which turned poisonous. Jefferson County, the largest in Alabama, refinanced billions of dollars of debt (which it raised for a sewerage system) with innovative 'swaps' from JPMorgan. The securities firm which brokered the deal was convicted of paying $241,000 bribes to the mayor in order to get this business. The county was overcharged by $100 million for the fees

[iii] The section owes its origins to information disseminated by Edward Sussex, Peter Rossman (IUF) and the Global Unions Forum on IFIs managed by Peter Bakvis.

alone, and in 2008 the interest rate on its swaps leapt from 3% to 10%. New York State lost $103m. when Lehmann Brothers collapsed, because of innovative 'swap' deals they had entered into.

The criminal conviction in Alabama resulted from the bribe being paid to an individual. But JP Morgan systematically offered 'cash incentives' to municipalities, which had the same effect: "JPMorgan lured municipalities into derivative deals by offering upfront cash payments in exchange for a pledge by the local government to agree to enter interest-rate swaps with the bank at a future date. ..these deals... were rarely put out for public competitive bidding". In New Castle, Pennsylvania, a school district was given $280,000 to put $9.7 billion into derivatives with JP Morgan; when the credit crunch arrived in 2008, the interest rates on this deal more than doubled to 10.6%. The bank then charged municipalities fees that were larger than the cash payment, thus getting their 'bribe' back as well: "In Erie, Pennsylvania, JPMorgan gave the school district $755,000 upfront and collected $1.2 million in fees." JP Morgan managed to get some criminal charges dropped by agreeing to pay $75m. and waive $647m. in claimed fees.

Sources: New York Times March 5, 2010 The Swaps That Swallowed Your Town . http://www.nytimes.com/2010/03/07/business/07gret.html?emc=eta1 ; Bloomberg.com 27 October 2008 FBI Probe of JPMorgan Fees Focuses on Swaps Roiling Muni Debt . http://www.bloomberg.com/apps/news?pid=20670001&sid=alL9gsK5wG40; Wall Street Journal March 5, 2010 Birmingham's ex-mayor gets 15-year sentence. http://online.wsj.com/article/SB10001424052748703915204575103700626756686.html#articleTabs%3Darticle ; The Bond Buyer January 21, 2010 Ex-JPM Bankers Seek End to Swap Charges

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