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Harnessing private finance to attain public policy goals in times of austerity

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Introduction[1]

In recent years there has been a proliferation of policy initiatives that seek the participation of private portfolio investment to finance the attainment of goals that have traditionally been considered the responsibility of government. Governments have been less able or willing to find the money to finance important projects and policies, whereas the resource requirements to achieve political goals have in some cases increased. In this situation, policy-makers are increasingly looking to private institutional investors to fill the gap and contribute the funds needed to make investments or to finance projects – in return for a decent and not too risky profit. To that end, a number of financial instruments and hybrid financing arrangements have been or are being created that aim to attract capital contributions from institutional investors.

This affects policy areas as diverse as social policy, macro-economic policy and development assistance. Not just the policy areas are diverse. Harnessing private finance is also being promoted by very different institutions and in different parts of the world – from the OECD and United Nations in the case of bond financing for infrastructure and development, to the European Commission in the case of macro-economic policy, to national governments in the case of 'Social Impact Bonds'.

To be clear: financial investors won't take over 100% of the financing of a particular project. There is always a mixture or blending of public funds or guarantees with private sector funds. This is necessary because the projects or investments in question are usually not interesting for institutional investors whose strategy it is to buy low-risk assets with a moderately high yield. These projects are either too risky, not profitable (enough), too long-term etc. By contributing public funds or making guarantees, governments make investing in such projects less risky or more profitable and thus more attractive to financial investors. The term *'leveraging'* is commonly used to describe this. The idea is that modest amounts of public funds (or the mere promise to contribute public funds) can be used to attract, or 'leverage', far larger amounts of private investment.

Together these initiatives constitute a more general trend in policy-making that has the potential to redraw the public/private boundary in a way that broadly fits in with the general direction of neoliberal state restructuring.

Which policy areas are affected?

Policy-makers have suggested or applied the idea in various policy areas, including:

- **Infrastructure financing:** Efforts are underway to make infrastructure an asset class that appeals to institutional investors, as these are deemed to have a long-term investment horizon. European Union (EU) 'project bonds' are an example of a specifically designed financing instrument. They are like regular bonds, only they are guaranteed by the EU budget and the European Investment Bank. This type of financing for infrastructure development is also being promoted in (or rather to) developing countries.
- **Development assistance:** As in infrastructure financing, small amounts of public money are to be used to 'leverage' larger amounts of private finance. In this case the public money comes out of official development assistance (ODA).
- **Environmental policy:** Bond financing ('green bonds') is being promoted to finance, for example, investment in renewable energy facilities. The British Climate Public-Private Partnerships (CP3) are

another example. In their case environmental policy and development assistance overlap.

- **Social policy:** A recent development is the emergence of Social Impact Bonds (SIBs). They are not really bonds, but a new type of financial instrument. It is sold to investors and the proceeds are used to finance a particular social intervention with defined outcomes, e.g. reducing youth unemployment in a specific community. If these outcomes are achieved, the investor is repaid by the government, plus a return on their investment. This is supposed to lead to savings for the public sector. (DIBs are a variation of this instrument for development purposes.)
- **Macro-economic policy (in the EU)**: Instead of using Keynesian fiscal policy, i.e. targeted government spending, to stimulate investment and growth at a time of crisis, the European Commission is thinking about ways to mobilise private financial flows to stimulate investment from its current low level. An important example is the European Fund for Strategic Investment, which will try to use modest public funds to 'leverage' far larger amounts of private finance through guarantees.

Why do policy makers turn towards private finance?

The increasing involvement of private financial investors is often interpreted as 'financialisation', i.e. as a series of business-driven attempts to open up new investment spheres. This downplays the role of political circumstances and motives, especially attempts by policy makers to cope with, or exploit, a situation in which deficit reduction and austerity are reducing fiscal room for manoeuvre. I suggest an explanation based on the confluence of three independent causal factors:

- Fiscal: austerity and increasing gap between fiscal resources and political challenges
- Financial environment: large and growing pools of private savings and low interest rates
- Politico-ideological: decades of neoliberal dominance and preference for private sector solutions

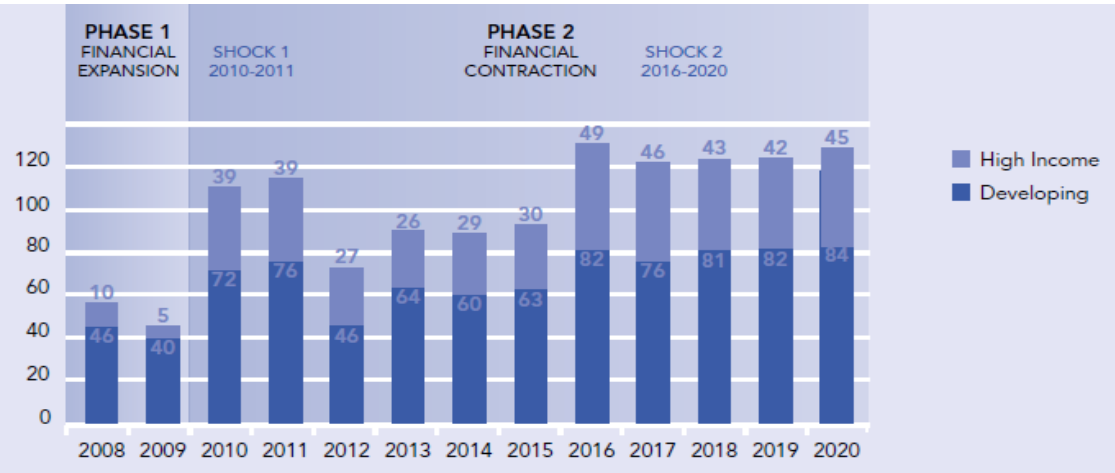
Virtually every publication or comment on harnessing private finance states that doing so is attractive or necessary for governments at a time when fiscal resources or ODA are insufficient to deal with social, economic or environmental problems. An OECD paper on infrastructure investment, for example, declares:

> "total global infrastructure investment requirements by 2030 for transport, electricity generation, transmission and distribution, water and telecommunications will come to USD 71tn. This figure represents about 3.5% of the annual World GDP from 2007 to 2030. There is a widespread recognition that governments cannot afford to bridge these growing infrastructure gaps through tax revenues and aid alone, and that greater private investment in infrastructure is needed."[2]

The gap between what governments can do with the financial resources at their disposal and what needs to be done is created and/or expanded by a fiscal squeeze and the budget consolidation policies in both developed and developing countries. This squeeze is further compounded by the fiscal effects of recession and conscious political efforts to bring down public debt levels. In the immediate post-crisis years, fiscal expansion was the norm across most countries in the world as governments sought to soften the blow from the financial crisis. In 2010, however, counter-cyclical fiscal policy was replaced by fiscal consolidation through cutting public expenditure and increasing taxes on consumption. In 2012, this changed yet again as many countries reduced their emphasis on austerity. Since then, there is no discernible dominant tendency in

fiscal policy. However, fiscal consolidation will certainly remain important. Ortiz et al. predict that austerity will become the global norm again from 2016 onwards (Figure 1).

Figure 1: No. of countries that contract public expenditure as % of GDP, 2008-20[3]



An important feature of the current financial environment is the existence of large and increasing pools of private savings that are desperately seeking opportunities for profitable portfolio investment. Insurance companies and pension funds, the primary non-bank investment vehicles for working and middle-class households, have grown in size for a while and are predicted to grow even more over the coming years, at least in absolute terms.[4] Figures 2 through 4 illustrate this growth in terms of absolute stock of financial assets managed by these institutional investors and in terms of the share of GDP in selected countries.[5]

Figure 2: Assets under management in insurance companies and pension funds, in trillion US$, selected countries (USA on right-hand axis)[6]

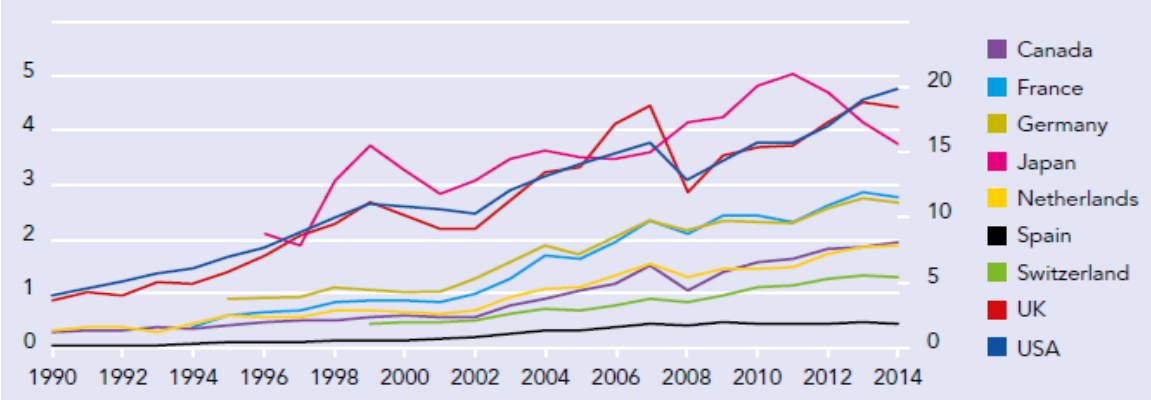


Figure 3: Total financial assets of insurance companies, % of GDP, selected countries

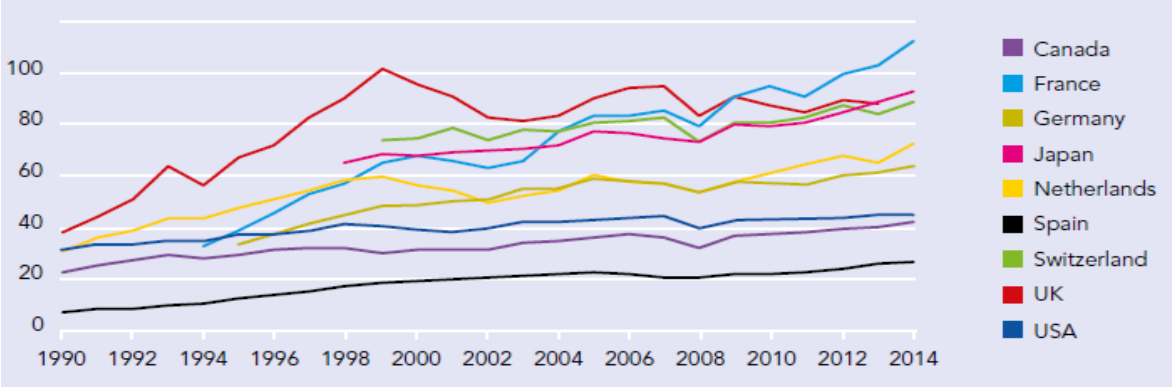
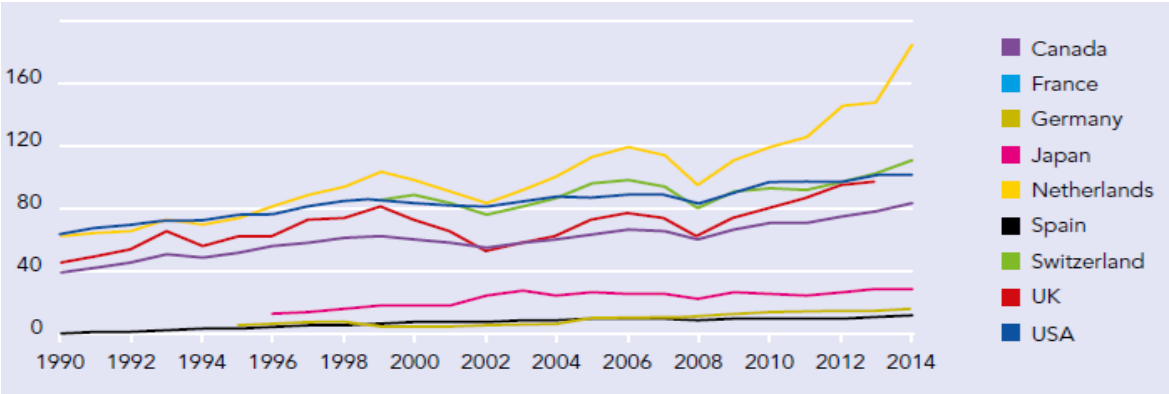
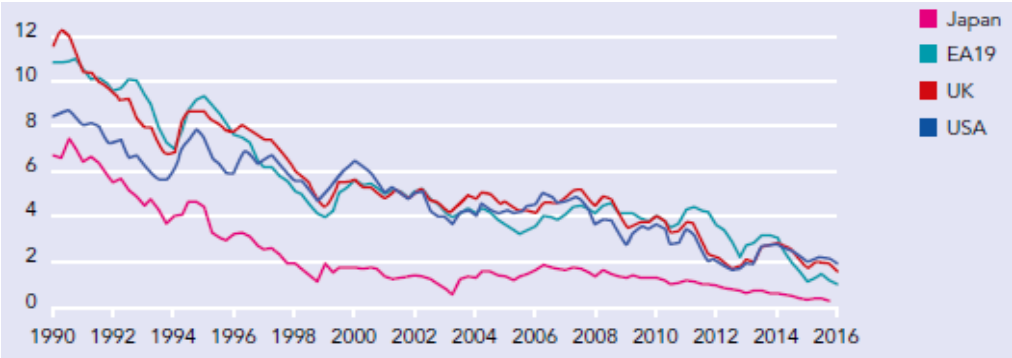


Figure 4: Total financial assets of pension funds, % of GDP, selected countries[7]



Traditionally, pension funds and insurers invest in financially relatively risk-free, interest-bearing securities. These cash flows are sensitive to interest rates, which have been on a long-term downward trend for a while and have fallen more steeply since the financial crisis to levels close to zero.

Figure 5: Long-term interest rates, % per annum, 1990Q1-2016Q1[8]



To make up for the shortfall in income, institutional investors have begun making forays into riskier asset classes, especially infrastructure debt and corporate bonds, which creates additional financial risks. Policy-makers have realised the problems, as well as the direction in which the industry is going, and have recently begun to facilitate/regulate this movement in a number of ways.

Finally, although not an immediate cause of the trends described here, there can be no doubt that decades of neoliberal dominance and indoctrination have produced an ideological preference among many policy-makers for letting the market or the private sector take care of social and economic problems.

To sum up: The fiscal resources required to deal with social or environmental problems, as well as the huge development challenges and infrastructure financing needs, currently exceed the budgetary capacities of governments all over the world. The result is a big and widely acknowledged funding gap. At the same time, there is a large and growing pool of private savings managed by pension funds or insurance companies. Low interest rates render the preferred investments of those funds, risk-free interest-bearing securities, less profitable, creating a funding gap between income from their assets and their obligations to clients. This sends funds on a desperate hunt for more lucrative, but also riskier, assets. Add to this decades of neoliberal dominance and private sector bias, and the result is a string of attempts to close these two funding gaps by combining them, i.e. by creating financing arrangements that let private investors pour money into the provision of what used to be government tasks, thereby providing long-term financing for those tasks while earning themselves a nice, stable income to fund their own obligations.

How significant are these initiatives?

The next question to ask is whether these financing arrangements will ever become quantitatively in the sense of making up a significant share in the portfolios of institutional investors and making a significant contribution to financing the attainment of public policy goals. There seems to be sufficient political will behind it, but when you look at the economic side and at investor appetite many obstacles appear. The projects that are undertaken in the above-mentioned policy areas do not naturally lend themselves to private business due to their higher degrees of uncertainty and risk, their complexity and lack of standardisation, their absence of relatively predictable cash flows and so on. Investing in them is not inherently attractive for risk-averse institutional investors.

Example infrastructure: Actual investment in infrastructure assets by institutional investors is low. An OECD survey of large pension funds found that they only held 1.1% of their assets under management in infrastructure-related assets in 2014 (in absolute terms: US$ 85.6 billion in US$ 7.7 trillion worth of total assets).[9] There is even stagnation at low level in recent years, despite a desire to invest more. There are many infrastructure facilities that deserve to be built, but there is a scarcity of *investable* infrastructure projects. Three obstacles to investability are usually mentioned: the general business risk of infrastructure, e.g. the risk that revenues are lower than projected; political risks that arise because governments might change conditions, user fees etc.; and a lack of standardisation. Policy-makers are being exhorted to work on these obstacles to make infrastructure more attractive as an asset class.

Example Social Impact Bonds: SIBs are genuinely new instruments. Despite their name, they are not really bonds because there is no underlying cash flow and no guaranteed repayment. Repayment depends on whether the project financed through their issuance achieves the social or development goals that were specified at the outset. If they are not achieved, investors may only get back their money without a return or

even lose all of it. In theory, Impact Bonds transfer financial risks to private investors and generate cost savings for governments.

Impact Bonds have so far remained a largely Anglo-American phenomenon (Table 1). Moreover, they are negligible in terms of financial volume and tend to offer unattractive returns. According to the Instiglio database on SIBs, the outcome payments on all SIBs in the UK where data is available amount to roughly £80 million and to about US$ 123 million in the US. The investment sums needed or raised amount to £32.4 million and US$ 135 million respectively.[10] The largest individual SIB by far required or raised US$ 30 million, while the smallest ones are just slightly above the 100,000 Pounds or Euros range. There is not much experience yet regarding the financial returns that investors can expect. However, it seems safe to say that, at least for now, they are well below the rates that can attract the interest of conventional financial investors (especially given the high risk of not being paid at all). SIB contracts generally define a maximum annual return to be paid out in case a project is successful. These are predominantly in the medium single-digit range, but even this might be optimistic. According to research commissioned by the City of London in 2013, expected actual returns for SIBs ranged between 2 per cent and 4 per cent, although this number may now be outdated.[11]

Table 1: Impact Bonds worldwide[12]

	Impact Bonds in design stage	Impact Bonds in implementation stage
UK	8	25
USA	9	12
Austria	0	1
Belgium	0	1
Finland	1	1
Germany	0	1
Ireland	0	1
Portugal	0	1
Netherlands	0	3
Switzerland	0	1
Australia	1	2
Canada	0	1
Colombia	1	0
Costa Rica	1	0
Chile	1	0
Uganda	1	0
Israel	3	2
India	0	1
Mexico	1	0
New Zealand	1	0
South Africa	1	0
South Korea	0	1
TOTAL	**29**	**54**

Currently the obstacles to making SIBs a financing instrument that will deliver an attractive and relatively risk-free return to institutional investors and measurable cost savings for the public sector appear formidable. Among those obstacles are: Defining and measuring social or development outcomes and attributing them to a project is very difficult, as is measuring cost savings to governments. Further complexity is introduced by the sheer number of parties involved. Moreover, bond financing only makes economic sense from a certain

financial scale upwards. However, social policy and development interventions do not normally require large sums of money. The considerable cost of setting up a SIB/DIB-financed project therefore compares unfavourably with the small sums of money to be raised. It also means that the number of bonds that can be issued in connection with a particular project is too small from an investor's point of view to make them worth the costs of due diligence.

Conclusion

It simply is too early to tell where all this is going. Political will is there, but the economic obstacles are high. I see three scenarios how this could play out.

1. Turning public-private financing arrangements *temporarily* into regular financing instruments, with all the costs and risk transfers that would entail, in the hope that one day the private financial sector will provide financing on a continuous basis *without the public ingredient*. This may be possible in the long run, but not without big initial investments from the public sector, the main beneficiaries of which would be private sector providers and financiers, and not without massive changes in the provision of services or projects on the ground that would negatively affect the final users/beneficiaries.
2. Though highly undesirable, it is possible – and not even unlikely – to establish public-private financing as a *permanent* feature of the public policy financing regime. Not as a self-sustaining form of finance, but a miserable compromise between fully public and fully private provision in which private sector actors continuously rely on explicit or implicit public subsidies.

   If scenario 1 or 2 becomes reality we would be looking at another chapter in the story of neoliberal state restructuring.
3. The third one is less of a realistic scenario and more what's politically desirable: Maintain or return to a regime of public provision and development assistance based on ODA. Public procurement would form a legitimate part of this regime in situations where private providers are genuinely more efficient than public ones. This would require abandoning austerity policies and returning to more progressive taxation to strengthen governments' fiscal capacities.

1 This paper is a shortened and adapted version of a study conducted for the Amsterdam-based *Centre for Research on Multinational Corporations* (SOMO) entitled "Harnessing private finance to attain public policy goals: How governments try to involve the private sector in times of austerity and what risks this entails" (https://www.somo.nl/harnessing-private-finance-attain-public-policy-goals/).

2 OECD (2015) *Fostering Investment in Infrastructure: Lessons learned from OECD Investment Policy Reviews*, p. 5 (www.oecd.org/daf/inv/investment-policy/Fostering-Investment-in-Infrastructure.pdf)

3 Source: Ortiz, Isabel et al. (2015) "The Decade of Adjustment: A Review of Austerity Trends 2010-2020 in 187 Countries", *Extension of Social Security Series No. 53*, Geneva: International Labour Office, p. 2. The authors used data from the IMF World Economic Outlook Database (April 2015). The majority of 2014 numbers and all numbers for 2015 and onwards are IMF staff estimates.

4 "Over the next five years pension funds are expected to grow 26% from an estimated USD 28.4 trillion in 2014 to USD 35.8 trillion in 2019; insurance companies 33% from an estimated USD 28.2 trillion in 2014 to USD 37.7 trillion in 2019." OECD (2015) *Business and Finance Outlook 2015*, p. 78 (see also pp. 88-90).

5 All data from the OECD.Stat Database, "Institutional Investors Statistics" (http://stats.oecd.org/Index.aspx?DataSetCode=QASA_7II; accessed 25 April 2016). This dataset includes two data series: an older one that was discontinued after 2013, and a recent, ongoing one. Data from the latter was used where possible, but in most cases the discontinued data series goes back further in time. In order to obtain more data points, data from the two were therefore combined in the figures in this box. This introduces a number of breaks in the series.

6 The OECD.Stat database does not provide one single number for assets under management, so the numbers given here includes the following assets as provided by the OECD.Stat database: Currency and deposits, Debt securities, Loans, Equity and investment fund shares. This should come close to the way in which assets under management are normally calculated. Assets are measured in US$ at current prices. Numbers for the USA far exceed those of the other countries and are therefore shown separately on the right-hand axis.

7 Data for France not available. 'Total financial assets' are not equivalent to 'assets under management' because the former include a number of asset categories that were deliberately excluded from the latter: for example, 'accounts receivable', to approximate what is commonly understood as 'assets under management'.

8 Source: OECD Data, Long-term interest rates (indicator), 2016, https://data.oecd.org/interest/long-term-interest-rates.htm (accessed 19 April 2016). Long-term interest rates are defined as yields on ten-year government bonds. "EA19" refers to the Euro-area, which currently includes 19 countries.

9 OECD (2016) *2015 Annual Survey of Large Pension Funds and Public Pension Reserve Funds*, pp. 19-21. See also McKinsey & Company (2014) *Rethinking Infrastructure: Voices from the Global Infrastructure Initiative*, pp. 13-26, (www.mckinsey.com/~/media/mckinsey/dotcom/client_service/infrastructure/pdfs/gii%20compendium/rethinkinginfrastructure_gii.ashx).

10 This understates the real amounts because financial data is not available for all SIBs, but even if they were included the general impression of a small market would remain (see also www.brookings.edu/research/interactives/2015/upfrontcapital-commitments-social-impact-bonds).

11 City of London (2013) *Growing the Social Investment Market: The Landscape and Economic Impact*, p. 24 (www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/Growing-social-investment-market.pdf).

12 Source: http://www.instiglio.org/en/sibs-worldwide/ as of 6 June 2016. Data for Netherlands also from ABN AMRO (2015) *Social Impact Bonds – October 2015: Opportunities and challenges in the Netherlands*, p.58 (www.abnamro.com/en/images/Documents/040_Sustainable_banking/ABN_AMRO_Rapport_Social_Impact_Bonds.pdf). This table probably misses out some projects, but the Instiglio database, on which it is based, seems the most comprehensive data source available.