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Infrastructure Integrity

Towards an Integrity 20

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INFRASTRUCTURE INTEGRITY

The G20 recognises the importance of infrastructure in enabling development, especially in developing countries. Infrastructure is necessary for increased economic activity and the building of that infrastructure will help kick start that activity. This can be done by public provision, private provision (including privatisation of existing publicly provided infrastructure) and public private partnerships (PPPs). The B20 emphasises the role of private investment in infrastructure – especially through PPPs. The C20 has argued against a 'bias' towards PPPs and consider alternative financing options, suitable to the particular project and the national or local conditions to which they apply. The Heinrich Böll Stiftung report asks: 'What kind of infrastructure is necessary and where? For whose benefit?'

All three approaches (public, private, and partnership) involve governance risks and challenges – including possibilities of inefficiency, maladministration and good old-fashioned corruption. Corruption is possible in all infrastructure development – kickbacks for contracts, favours in return for monopolies (what Adam Smith railed against), PPPs (from toll roads in Indonesia to water projects in NSW). Leonard McCarthy, World Bank VP in charge of integrity, astutely noted that, "At their best, PPPs can provide rapid injections of cash from private financiers, delivery of quality services, and overall cost-effectiveness the public sector can't achieve on its own. But at their worst, PPPs can also drive up costs, under-deliver services, harm the public interest, and introduce new opportunities for fraud, collusion, and corruption. Our experience at the World Bank Integrity Vice Presidency is that because PPPs most often are geared toward providing essential public services in infrastructure, health and education, the integrity risks inherent in these sectors also transfer to PPPs."

Few suggest that all infrastructure will be provided by either governments or the private sector. The B20 estimates a global need for approximately \$60–70 trillion in additional infrastructure of which the public sector will have to provide 20-25%. Zaggi, an enthusiast for PPPs in Nigeria estimates that only 15-20% of that country's infrastructure backlog could be covered by the private sector. Whatever balance is chosen, the integrity issues in each must be addressed.

PUBLIC PROVISION

Much infrastructure was provided by privately funded corporations in the nineteenth and early twentieth centuries. During the twentieth century, public provision has become the norm and now accounts for the vast majority of existing and new infrastructure. Integrity problems have traditionally included corruption in procurement and politically distorted choices.

Some Nobel laureate economists argue that this is a particularly good time for public investment in infrastructure, even in the US. Paul Krugman and Joseph Stiglitz point out that the US and Australia can borrow at extremely low or even negative real interest rates. Larry Summers joins them and sees a concerted, large-scale program directed at renewing national infrastructure as good economics and common sense. Chris Richardson from Deloitte Access Economics pointed out that given interest and inflation rates, Australian governments were effectively able to borrow interest-free. Richardson said that while the government could use the money to invest in infrastructure, neither political party would be willing to do so at the moment. "It's not as though we've asked ourselves the question, given money's cheap as chips, what's the best pay-off investments we can make for ourselves, ...It's politics much more than economics that's holding them back."

This does not mean that borrowing can or should be unlimited – for governments or business. For both of them, borrowing to buy assets (especially income earning assets – and those are the only ones open for alternative funding) is different to borrowing for recurrent income. A company with \$5bn in assets and \$1bn in borrowing is not less creditworthy than a company with \$2m in assets and \$1m borrowing. But most of the discussion of public balance sheets is only in terms of debt not assets. This is reinforced by ratings agencies which heavily discount publicly owned assets. This is not to say that it is not better to have less debt with the same assets or more assets with the same debt but to talk about debt without assets seems distinctly odd – if not ideological. Of course, neither companies nor countries should seek to borrow beyond certain limits of assets and income. But within those limits, investments should be calculated on the basis of costs (including depreciation), benefits (including income, capital gains and, for governments, uncaptured public benefits). Where government borrowing costs are considerably higher than those for private corporations there is a good case for well-structured private provision or PPPs. And there are some infrastructure investments in developing countries that can generate a return from those who can pay (e.g. airports) that understandably fall below more urgent priorities for public investment.

PRIVATE PROVISION AND PRIVATISATION

The 1980s and 1990s saw a strong push to privatise – a push that has been renewed in Australia in recent years. There was a good deal of ideology on both sides. Whether or not an activity should be in government or corporate hands should be subject to careful analysis and legitimate debate.

The biggest problems have arisen where the privately provided service is effectively a natural monopoly. Most network infrastructure is a natural monopoly in which duplication is extremely wasteful. This is what attracts buyers and should concern governments and consumers. Such monopolies generate temptations to price gouge which increases the cost base for trade exposed competitive industries. If usage increases, there is a temptation to charge more rather than increase capacity.

Of course, many of the activities related to networks can be highly competitive and sensitive to price signals – something that was always the case for road transport but was only learnt in the early 1990s on issues like selling phones that connect to phone networks. If the prices charged by natural monopoly networks is kept low, the more likely to be used by industry and consumers alike.

In privatisation there are risks that network infrastructure will be sold off too cheaply, to those who have the ear of government. While the opportunities for corruption with the annual income of government are considerable, there is much more opportunity when dealing with the assets of government. In addition there are transaction costs in transferring from public to private ownership (and vice versa) – not least the fees secured by some of the 'experts' who push them. Transaction costs must always be considered. Transaction costs including the costs of legislation, legal advice, due diligence, brokerage and underwriting fees. There is a related tendency to under-price the asset to ensure that the privatisation is a 'success'. This tendency to under-price an asset will be aided and abetted by the desire of underwriters to minimise their own risk.

The existence of transaction costs is a reason to leave assets with their current owners, absent an argument that the benefits of change outweigh the transaction costs. This does not mean that a case for a change of ownership cannot be made in a large number of cases. But, a case must be argued. For those who would benefit from unquantified transaction costs to argue the opposite does not qualify for the most ethical contribution to the argument.

Where someone entering the debate has an interest in the outcome, we should expect them to declare that interest and indicate how large the interest is. If the individuals concerned have not worked out how much they would benefit from the policy pushed by them, their capacity to accurately calculate anything else is doubtful. If such individuals follow theories that everyone acts in their own self-interest, we should regard this as an accurate reflection of their own motivations.

One can imagine how a competent corporate board would respond to an advisor who said they should sell their assets unless convinced otherwise or should leave expansion of their core business to others. One can imagine an accountant or auditor of a company that looked only at debt and not at assets, income, investment and depreciation. They would be laughed at before they were sacked. If those accountants and auditors would personally benefit if the advice were taken, they would be referred to the relevant disciplinary board immediately afterwards. As governments are being urged to be more business-like they are expected to operate in ways totally alien to any well run business. Governments should learn from business. Scepticism about people talking their own game is one such lesson.

States need to make an individual assessment of each privatization, in the specific time and context, taking into account the challenges of corruption and rent seeking. They should never be made on the basis of ideology – whether the ideology appears for or against.

Furthermore, cost should not be the only factor in making the decision to choose private provision. Quality and the ability to monitor and assess that quality are equally vital. The government's own costs of monitoring and assessing the outcomes must always be factored in and cost-cutting and staff shedding in this area can be the falsest of economies. Where the government is monitoring rather than delivering, the number of staff is necessarily much lower, increasing the danger of losing corporate knowledge. Communities and civil society can assist but not substitute for government in this monitoring – assisted by mandatory disclosure and online accessibility of procurement and infrastructure contracts.

ARE PPPs THE PROMISED LAND? AND IF SO, FOR WHOM?

There are many who advocate PPPs or, more recently, the privatisation of some assets to allow the government to invest in others. There are reasons for caution. The only assets that corporations will want to buy or 'partner' in are those that generate income. If so, it is important to consider the same issues of investment cost, operating cost, income and depreciation as for any investment. As a matter of public policy, it is also important to consider externalised costs and unrecovered benefits.

Over the last decade, there has been a strong push for PPPs in which new infrastructure projects are built by corporations created for the purpose, often highly geared with very large fees for those who set up the deals. Given the higher borrowing costs and the burden of fees, Gruen points out that 'hard' infrastructure projects, such as roads and water projects are inherently more expensive as a result of higher interest rates, transaction costs and the need to make a profit. Accordingly, it is very important to establish that there are extra efficiencies that justify these decisions. Given that the contractors are the same group for governments or their partners, if governments do not have the contracting skills to secure the best deal from the same set of contractors, how can they be presumed to have sufficient contracting skills to deal with those promoting PPPs. This does not mean that such projects should not be contemplated or implemented but the following concerns need to be recognised and addressed if such arrangements are going to benefit the community as well as their promoters.

1. PPPs restrict future infrastructure options by government. It is not easy to predict infrastructure needs 20-30 years in the future. If future development requires, for example, another road, it will reduce the value of the one that has been sold or partnered. Either a larger risk premium is charged or the government must compensate.
2. The diminishing interest of the 'private partner' to maintain and develop the asset, especially towards the end of the PPP.
3. Contracting risk caused by the asymmetric contracting skills of the parties, the sheer complexity of the contracts and the capacity to shift risk back on to governments.
4. Network inefficiency. Dividing up networks to make saleable chunks may lead to sub-optimal policy choices. It also creates issues at the boundaries of the government and corporate owned elements.

For some, the problem is the absence of a credible pipeline of productive, bankable, investment-ready infrastructure projects offering acceptable risk-adjusted returns to both public and private investors. It is not uncommon to hear that the returns required would be 7% real return with the government taking on some of the risks to reduce uncertainty. Why should governments choose more expensive infrastructure? Expensive infrastructure is a problem for growth, not a solution. Why not seek to provide their industries with a competitive advantage by providing lower cost infrastructure for industry and individual consumers? And if there are to be higher charges for governments to collect returns they may use them for public purposes – not least paying for some of the bulk of infrastructure that does not work as PPPs. And if the government packages up infrastructure projects with such high rates of return, investors will either be disinclined to invest in the new industries that use the infrastructure to provide growth or will demand even higher rates of return for the latter. Adam Smith wanted to get corporations out of monopolies – his followers should not seek to get them back in!

Superannuation is suggested as a source of infrastructure funds. Given the enormous tax advantages provided to superannuation, this provides a double slug on the public. A simpler solution might be to return to the practice of requiring superannuation funds to hold a proportion of their assets in government bonds in return for their favoured tax status (Australia used to require 30%). This would probably provide far more funding than could be tempted with high returns.

There is considerable opposition to privatisation and PPPs. Some suggest that this is a matter of better education. Hassan Zaggi suggests that "In order to convince Nigerians to accept the reality that PPPs is the best way to go in Nigeria's quest for industrial growth, the NIQS recommended intense advocacy by both the government and the private sector." He suggests that "governments should focus more on packaging good deals that can easily attract private financing rather than seek to contribute land or provide cash equity participation in PPP deals. The government however has a useful role to play in subsidising user fees where they are unaffordable or could be severely resisted." Governments need to answer the first question of whether PPPs are the most efficient and equitable means for infrastructure development rather than making the case for those who would profit from them.

CONCLUSION?

Growth will have to come out of the private sector. We need infrastructure to make that growth possible. But that does not entail that the private sector should be the source of infrastructure. The monopoly or quasi-monopoly of much infrastructure makes it attractive to investors but generates risks for consumers (including business users). It is surprising when those who otherwise decry regulation and warn against its cost and effectiveness promote such regulation as the answer.

Some insist that sovereign states have no money for infrastructure. The borrowing limits of sovereign states were not seen as a problem when massive guarantees and bail-outs were demanded by banking and finance institutions during the Global Financial Crisis. Meeting those demands and the deficits generated by the recessions and slow-downs has increased public debt in many western economies. There is a certain irony when the banking and finance sector argues that this means that infrastructure should be funded from more expensive sources in which much of the extra expense is generated by the profits they demand and the fees they extract.

WHAT SHOULD THE G20 DO?

1. The Brisbane leaders' declaration could recognise that there are integrity risks with all forms of infrastructure and task the working group to identify those risks and the means by which they may be addressed. This could usefully start with an annotated checklist. The infrastructure working group should consider the Construction Sector Transparency (CoST) Initiative (an integrity measure involving public disclosure, external monitoring and community engagement in infrastructure activities).
2. The working group should develop a code of practice for the promotion of infrastructure projects and methods of infrastructure financing that includes a full declaration and quantification of interest in the outcomes being promoted.
3. The G20 should promote and, if necessary fund, sources of independent advice for governments entering PPPs to reduce asymmetry of knowledge and bargaining skills.
4. The G20 should encourage the professions who are involved in infrastructure projects (lawyers, accountants, engineers and the potential profession of finance) to consider their role in developing and pursuing infrastructure.

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