Perspectives on Private Finance Initiative (PFI) in Japan
− *The Impact on Administrative Reform, Social Infrastructure and Public Services* −

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1. Expectations and Confusion Surrounding PFI

In the U.K., the Private Finance Initiative (PFI) was introduced in 1992 to privatize certain social infrastructure and public services as deemed appropriate and beneficial to taxpayers, with the objective of promoting a smaller and more efficient government.

PFI is being studied by many groups in Japan including the Ministry of International Trade and Industry, Ministry of Construction, Council for Real Estate Syndication, and Federation of Economic Organizations. PFI is seen as a way to harness the private sector's resources in funding, management, and technology for the efficient delivery of social infrastructure and public services.[1]

By following the U.K. precedent in PFI, Japan could achieve two things-expand the scope of the private business sector, and reduce public expenditures and tax and other burdens on taxpayers.

For these reasons, attention has focused on a bill to promote PFI that the LDP is scheduled to introduce in the present Diet session.

However, in its present form released on April 23, the bill's declared objective is only to promote the construction, maintenance and operation of public facilities by the private sector, thereby providing efficient and effective social infrastructure and contributing to the development of the national economy. The bill mentions nothing about administrative reforms such as those pursued in the U.K.

Moreover, its support measures for the private sector go beyond the *Minkatsu* Law (Extraordinary Measures to Promote Development of Specified Facilities Utilizing Capabilities of Private Businesses Law), including the provision of publicly owned land at no charge or below market rates, government investment, interest free loans, debt guarantees, support for land acquisition, provisions for technical assistance, coordination of patents and other rights, and promotion of the effective use of land held as collateral. There is concern that these measures could end up simply being a public dole.

The public interest would not be served if these lavish measures were implemented without fully considering the inefficiencies in the government itself and the actual need for projects. An indiscriminate approach to PFI would only result in increasing the burden on the public.

In light of these considerations, this paper looks at the underlying concepts, implementation procedures, and actual results of PFI in the U.K., notes major differences with the LDP bill, and considers the best way to introduce PFI in Japan.

2. PFI in the U.K.

(1) PFI and Administrative Reform

To overcome economic stagnation since the 1960s, expanding government deficits, and bloated government–the so called English disease–the Thatcher administration championed a leaner, smaller government.

The Major administration continued the policies of downsizing the public sector, deregulating, and introducing market principles into public services, and went a step further by reorganizing government functions into agencies, introducing the Citizen's Charter, and promoting market testing, in which the private sector competes with public services.[2] The underlying objective of these policies is to shift the paradigm of government from public administration to public management.[3] PFI is an extension of this policy trend.

Similar to Japan's public policies to support private sector activity, the U.K. has what is called Public Private Partnership (PPP). For PFI, whose real aim is administrative reform, PPP is the means to transfer much of the public sector's role to the private sector.

(2) The Emerging Effects of PFI

From the introduction of PFI in 1992 to February 10, 1998, the total value of PFI contracts was 9.4 billion pounds (2.1 trillion yen). The Blair administration has set the objective of reaching a cumulative total of 14 billion pounds (3.2 trillion yen) during fiscal 1998.

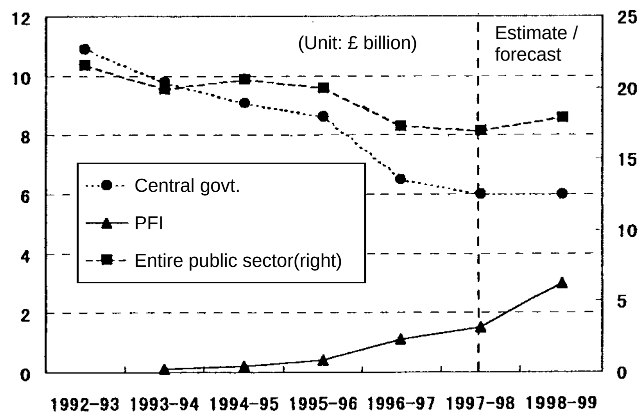
The ratio of government deficit to GDP, which stood at -7.8 percent in 1993, has declined by one percentage point annually, reaching -3.7% by 1997 (Table 1). Moreover, while PFI capital expenditures have grown steadily, public sector expenditures have been declining led by the central government. These results indicate that PFI is workable (Figure 1).

Table 1 GDP Ratio of National and Local Government Budget Deficits

	1993	1994	1995	1996	1997
Japan	-4.8	-5.0	-6.2	-7.0	-5.3
U.K.	-7.8	-6.8	-5.7	-4.8	-3.7
U.S.	-4.4	-3.2	-2.8	-2.5	-2.7

Source: Japan Long-term Credit Bank, *On PFI*, February 1998.

Figure 1 Capital Expenditure in the Public Sector



Source: *Financial Statement and Budget Report 1997-1998.*

(3) Basic Concepts of PFI

PFI is based on the following clearly defined concepts.

1) Public sector's role is to purchase appropriate services

The public sector, which has been a provider of public services, becomes a purchaser of appropriate services through PFI.

2) PFI is applicable to all public activities

All public operations and services are eligible for PFI. Conventional public investment is applicable only for activities in which PFI cannot be efficiently implemented.

3) Value for money (VFM)

PFI is to deliver services that offer the best value to taxpayers. Public expenditures must always satisfy the VFM requirement.

When PFI was first introduced, the calculation and confirmation of VFM was required from the project planning stage. However, to expedite PFI more efficiently, the Blair administration relaxed the requirement so that VFM is to be confirmed by the time of contract.

4) Market testing

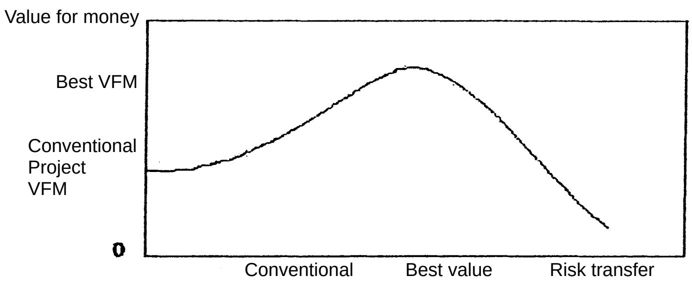
To improve the quality of public services, the public sector compete with the private sector. Under the VFM approach, if the private sector can deliver a public service more efficiently that the public sector, that service is privatized. Doing so both makes the delivery of services more efficient and reduces the size of government. It has been reported that public employees who are no longer needed are often employed by the private companies that took their place.

5) Transfer of risk to private sector

Based on the VFM approach, the method and extent of transferring risk to the private sector need to be examined.

Transferring all risk to the private sector produces an imbalance from the viewpoint of the public sector. Since private contractors who bear all the risk will charge higher prices, it is not necessarily the best VFM solution. In general, VMF can be maximized by transferring the appropriate amount of risk (Figure 2).

Figure 2 Risk Transfer and VFM Optimization



Source: http://www.treasury-projects-taskforce.gov.uk/

6) Full disclosure

Contracts stipulate that information on bidding and contract conditions are not to be disclosed if they are not against the public interest. However, public terms regarding the contractor selection process, progress of projects, and so forth are disclosed as a rule.

Moreover, under disclosure guidelines introduced in April 1994 (and revised in 1997), it is possible to petition the parliamentary ombudsman to have information disclosed by going through proper channels after an internal examination by the administration.

(4) Three Types of PFI

There are three PFI alternatives depending on the characteristics of the project.

1) Public service provider

This type is the ideal form of PFI in which the private contractor builds and operates a facility, and recovers its investment by selling services to the public sector. However, simple finance leases of facilities are not included. It has a track record in delivering public services such as hospitals, prisons, roads, and information systems.

2) Recovery of investment from fees

Here the private contractor builds and operates a facility under license from the government. Like toll roads and toll bridges, the investment is recovered through fee revenues, and public expenditures are not involved in principle. BOT (build, operate, transfer) projects commonly seen in Southeast Asia are of this type.

3) Public-private joint project

While both public and private sectors provide funding to build facilities, operations are managed by the private sector. Since the investment cannot easily be recovered from operating profit, the project often depends on value enhancement from redevelopment or railroad construction projects. In this type of PFI, effective support from the public sector is allowed. However, usually the support comes not as operating subsidies, but rather is limited to contributions for acquiring and using assets for the development.

(5) Implementation Process

1) PFI project supervision

In the beginning, a Private Finance Committee was established outside the Treasury to act as coordinator for central agencies, local public entities, and private contractors. However, it had no power.

To further promote PFI, the Blair administration established the PFI Task Force (TF) within the Treasury with the power of approval, support, and coordination for PFI.

The TF is composed of a Project Team of nine experts from the private sector including the head, and a Policy Team of Treasury personnel.

The Project Team is responsible for determining feasibility and approving PFI projects. The Policy Team is in charge of rules for PFI projects, procedural matters, and coordinating across agencies.

2) PFI project organization

Each PFI department in a public sector office plays the lead role in establishing business needs and moving the project forward. Through the Project Team, the TF supports each department, approves the project, and coordinates participants. Ultimate responsibility for the project rests with each department.

A major role is also played by the National Audit Office (NAO). It is an independent office that conducts financial audits and VFM audits, and reports directly to the Public Accounts Committee of the House of Commons.

3) PFI procurement process

The general implementation process for PFI projects consists of 14 stages (Figure 3).

In the preparatory stages, business needs are addressed (Stage 1), and realistic alternatives for meeting these needs are identified and assessed for their efficiency and effectiveness (Stage 2). If PFI is found to be the best method for procurement, an outline business case is prepared covering specific business plans, risk analysis and budget constraints (Stage 3). At this stage, market sounding is used to determine the level of interest among private contractors and the public. In major projects, the TF sometime participates from this stage.

Entering the bidding stages, with TF approval, a project team of experts is formed (Stage 4). Furthermore, a call for competition is issued with a sufficient explanation of the project. Interest parties are provided with a "Information Memorandum" containing further details (Stage 5). At the same time, the selection process is formulated (Stage 6). Bidders are screened in a prequalification process and a long list is compiled (Stage 7).

In the selection stages, the long list of bidders is reduced to a short list (Stage 8), and at the same time the original appraisal of business needs is refined (Stage 9).

An invitation to negotiate is then offered to bidders giving them detailed information to use in formulating their bids (Stage 10). After bids are received, discussions are conducted with each bidder to clarify and assess their proposal (Stage 11), and negotiations are aimed at ensuring that requirements are met and defining terms of the contract, and bidders are then asked to submit their best and final offer (BAFO). Based on the BAFO, plans are reviewed one more time to confirm that the objectives can be achieved (Stage 12). If there are no problems, the contract is awarded and a notice is publicized (Stage 13). The management of the contract defines the working relationship between the public sector client and PFI service provider (Stage 14).

While this is a brief description of the procurement process, the PFI guidelines contain detailed information on implementation procedures, including a standard contract form. These guidelines and training & development programs have been prepared for local governments implementing PFI.

3. Issues in Japan's PFI Bill

(1) Lack of Clear Objectives for PFI

In the LDP bill, the declared objective of PFI is to establish the framework for promoting private sector activity to build social infrastructure and contribute to the development of the national economy. While these are worthy objectives, they are too general. The bill lacks a clear objective that addresses the benefits PFI has to offer, such as reducing the size of government as seen in the U.K. case.

(2) Is the Objective to Build Public Facilities?

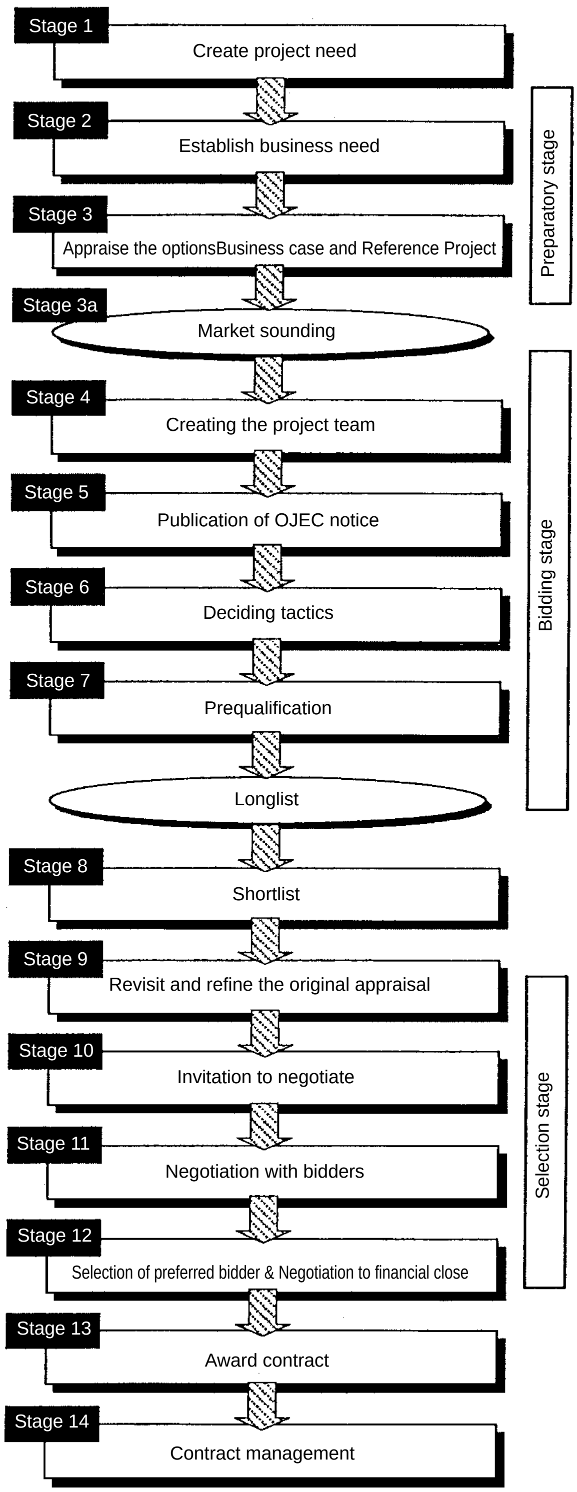
Like the *Minkatsu* Law, the PFI bill extensively lists eligible public facilities including roads, railroads and canals, parks, waterworks, public housing, educational and cultural facilities, waste processing facilities, information and communications facilities, new energy facilities, and recycling facilities. This leaves the impression that the sole purpose of PFI is to build facilities.

But what the public needs is not the construction of these facilities so much as the delivery of high quality, enhanced public services derived from a rational and fair tax burden.

Rather than public facilities, the bill should instead list public services that would be affected, including preservation of a rich natural environment, road networks that are free of traffic jams, enhanced medical and long-term care services, child care services, educational services, and waste processing services that do not cause local pollution.

In the U.K., the intention behind PFI is to shift the government’s role from being owners and operators of assets to that of purchasing cost-effective, high quality public services. Japan has much to learn in this respect.

Figure 3 14 Stages of PFI (Standard Type)



Source: http://www.treasury-projects-taskforce.gov.uk/

Figure 4 Objective of PFI

Article 1 The law would stipulate the basic conditions to promote the construction, maintenance and operation of public facilities (including related projects) by utilizing private sector funds, management, and technical expertise, with the objective of building efficient and effective social infrastructure, thereby contributing to the development of a sound national economy.

(3) No Guiding Concept

The basic concept of the bill, as expressed in its objective, is to use public funds efficiently and to rely on private businesses whose operating revenues can cover expenses (Figure 6).

However, something is wrong with the notion of profitability as the sole criterion for transferring projects to the private sector. The main emphasis should be on using public funds efficiently; whether privatization would generate profits for the private sector is a secondary concern.

For example, the bill rules out PFI alternatives for traditionally unprofitable operations as the management of waterways. Yet if we are to scale down the Ministry of Construction and transfer this responsibility to the private sector, the key consideration is not profitability but whether: (1) private operators can deliver the same services at less cost including direct labor costs, indirect costs, construction costs, support costs, etc., or (2) the private sector can deliver a better quality of service at the same cost.

This notion of implementing PFI based on the efficient use of public funds would be scorned in the U.K., where the VFM concept has been implemented and refined over the past five years to put the public's interest first and foremost.

Figure 5 Basic Principles of PFI

Article 3 For projects related to the construction of public facilities, assuming the appropriate sharing of roles between public and private sectors and the efficient use of public revenues, private operators are entrusted as far as possible if the operation of projects generates sufficient revenues to cover expenses.

2 While clarifying the responsibilities of public and private sectors, ensuring profitability, and minimizing public sector participation in private operations, designated projects must provide the public with low cost, high quality services by fully using the technology, management resources, and innovation of private businesses.

Moreover, the notion that the government is to take a hands-off approach to private operators seems difficult at best, considering the vast support measures stipulated by the bill (Figure 5). In particular, the provision of investment and debt guarantees to private operators would necessarily obligate the government to oversee how businesses are operated. This supervisory role contradicts the hands-off approach.

Figure 6 Support Measures for PFI (abridged)

Article 11	The national government's debt burden on designated projects is to last no more than 30 years (fees, rent, etc.)
Article 12	The government can allow public assets to be used at no charge or at less than market rates.
Article 13	Investments can be made within budgeted limits.
Article 14&15	The national and local governments can guarantee debt to designated operators.
Article 16	For projects with an especially high public need, interest free loans can be extended within budgeted limits.
Article 17	Special considerations is given to fund raising and local bond issue.
Article 18	Special consideration is given to the Eminent Domain Law to facilitate land acquisition for projects.
Article 19	Other legal and tax measures shal be made as needed to provide financing support.
Article 20	Regulations that impede the application of technology and innovation can be eased or abolished.
Article 21	National and local governments and private operators are to cooperate with each other.
Article 22	National and local governments are to promote educational activities to obtain the understanding and consent of the general public. Special consideration and cooperation is given to enabling operators to access patented technologies if necessary.
Article 23	Losses from the disposition of collateral on the land used in designated projects can be treated as assets carried forward. Straight line deqreciation of no more than 10 years is to be used.

(4) Missing Guidelines

Since basic PFI project guidelines will be established by the Committee to Promote Activities Utilizing Private Sector Funds in the Prime Minister's Office, the LDP bill contains virtually no procedural stipulations at present.

This means that many issues remain to be addressed, such as evaluating cost reductions from PFI projects compared to ordinary public sector projects, assuring the autonomy of private operators contracted to deliver public projects and services, protecting the public's interest, establishing evaluation criteria for bids and proposals, and making the selection process transparent.

(5) Project Promotion Committee Lacks Authority

The Project Promotion Committee, composed of nine appointed members, at first glance appears to be modeled after the Task Force project team of the U.K. However, the similarity ends there because the committee is essentially a discussion group with no real power. As such, its existence is pointless.

(6) Independent Auditors

The LDP bill does not provide for independent auditing of PFI projects and contractors. A new auditing organization is needed to replace the usual auditing procedures for government projects.

4. Public Interest

From the perspective of administrative reform, the proposed Japanese version of PFI hardly measures up to its U.K. counterpart. Indeed, PFI will merely be an extension of the *Minkatsu* policy, and lack the positive macroeconomic impact being enjoyed in the U.K.

But even as an extension of *Minkatsu* policy, the LDP bill is inadequate because its thoughtlessly conceived support measures cast doubt on whether tax revenues will be wisely and efficiently used.

However, since neither administrative reform nor genuine privatization can arise from bureaucratic initiative, the fact that Japan’s PFI bill was drafted by legislators is very significant. Hopefully, it will lead to widespread debate and cause more legislators to seriously confront the need for smaller government and efficient social infrastructure and public services.

Japan’s private sector is well adapted to the PFI approach in the sense that public agencies often place turnkey contracts. Private contractors have shown that they can successfully undertake massive projects such as the Hong Kong undersea tunnel project carried out by Nishimatsu Construction Co. and Kumagai Gumi Co., and BOT contracts for electrical plants in the Philippines.

Since the 1980s, Japanese companies in Malaysia have accepted comprehensive orders based on new construction methods. In taking on public construction projects previously allocated among specialized contractors in planning, design, licenses and approval, coordination, construction, and maintenance, the Japanese firms have drastically reduced construction time and cut the government's indirect expenses.

Takenaka Corp. has reduced the construction time for skyscrapers from five years to two and a half years, while local joint ventures involving Taisei Corp. and Hazama Corp. have churned out residential buildings for the Selangor Economic Development Corporation (SEDC) at a rate of approximately 10,000 units within three years while reducing costs below conventional methods and generating reasonable profits.

Interestingly, Malaysia's inefficient and rigid system, a legacy of British colonial rule, was transformed through private sector technology and comprehensive contracts by Japan, who is now in turn learning from PFI in the U.K.

However, both the public sector and private businesses who participate in the projects for the public lack the idea of serving the public interest by delivering high quality public services at a reasonable price. Ensuring this requires that transparency is achieved through fairness and disclosure.

In the past, overlooking this aspect has not only eroded the public's confidence in government, but increased global distrust and diminished expectations toward Japan's role in the world.

The time has come to introduce PFI oriented around public interest and thereby reform the administration of social infrastructure and public services.

Notes

1. PFI study groups include MITI's Minkatsu Infrastructure Research Group and Council to Promote PFI in New Energy and Recycling (such as energy generation from waste), the MOC's Committee on Attracting Private Sector Capital for New Social Infrastructure, and the Council for Real Estate Syndication’s Research Group on Utilizing Private Sector Capital to Build Social Infrastructure. Keidanren has issued a statement entitled "Social Infrastructure to Promote Prosperity and Vitality," and has also set up a PFI research group.

2. The Citizen's Charter, contained in a 1991 white paper, is a policy that strives to improve the quality of public services by empowering consumers. The policy emphasizes four aspects of public services: quality, market choice, standards, and value for money.

3. From H.Sakakibara, "The Shift from Public Administration to Public Management in England," in *Administrative Reform Keywords,* a special edition of *Horitsu Jiho* (Law Review), March 1998, Vol. 70, No. 3, p. 25.