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The economics of the private finance initiative

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Abstract

This article outlines and assesses the private finance initiative in the UK. The initiative has been slow to develop despite pressure from governments (anxious to limit the PSBR) and several revamps to facilitate the PFI approach. Within a PFI project there are beneficial incentives to avoid cost over-runs but not to reduce costs where they affect long-run services. These incentives and the limits to their effectiveness are explored. Such contracts require the transfer of risk from the public to the private sector. The role and pricing of risk in the PFI is analysed. It is argued that the PFI does not value risk correctly and that the value for money test is biased against private-sector provision. Policy implications are discussed, including a revamp of the value for money test and the introduction of explicit assessment of the impact of potential renegotiation and other contractual difficulties.

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