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Impact of Financing Public Welfare Projects by Private Sector on the Economic Growth of Country

Dilshad Zafar[1], Rukhshinda Begum[2,*]

[1]Faculty of Business Administration, Commerce & Economics, Jinnah University for Women, Karachi, Pakistan
[2]Department of Commerce, University of Karachi, Karachi, Pakistan

ABSTRACT

This research discusses the reasons for reluctance by the private sector in financing projects for public welfare, the impact of their participation in such projects in the economic growth and ways to identify and minimize risks inherent in the same. This paper is thoroughly qualitative. Related literature is reviewed in detail, and findings are based on the theoretical analysis of the evaluated literature. The results of the study suggest that the involvement of private sector in public welfare projects seems to be in higher interest for developing nations where the revenues from government sources are not sufficient to finance the massive, risky and time taking projects. Lowest rate of project finance in developing nations is mainly assumed to be the cause of reduced investments in this area. This scenario provided an opportunity for the private sector to extend its participation in these projects as well. However, the prime objective of the private sector is earning and maximizing profits rather than working for the welfare of the public and society. It is the primary concern if it turns to project financing that is being developed and implemented primarily with the goal of public welfare rather than profit motivation. However, if private investors move towards financing these types of projects along with adopting risk mitigation strategies and support from the government is also enhanced through policy reforms then these will turn into enhancing the GDP, standard of living and overall growth of the economy.

Keywords: Public welfare project, private sector, economic growth.

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***Address of Correspondence:**
rukhshinda.b@uok.edu.pk

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1. INTRODUCTION

Project Finance is the non-recourse financing of long-term infrastructure, industrial projects, and public services based upon a complex financial structure where debt and equity are usually combined with financing the projects. These providers of the funds are paid back from the cash flows that are generated from that particular project. Hence, they are not so interested in the other assets of the business and its worth.

The preliminary challenge for the project financiers is that the outflow, i.e., investment is made up front, whereas the expected paybacks are to be received in later years as the project starts operations. Since these projects are to be executed in a high-risk environment, therefore, they are required to be systematically planned, designed, implemented, and monitored to secure the required outcomes. Extensive knowledge of the financiers for the project and associated circumstances is of primary concern in such projects. Moreover, it is also needed to be decided that which form of financing may be required in these projects. Financing may be in terms of any the partnership or the syndication.

Essential reasons behind project financing may be: (a) easier in obtaining financing if the creditworthiness of the business or company itself is not so inspiring, (b) sharing the burden of associated risks in case of financing in the form of a partnership or syndication (c) Facilitating public through infrastructure projects those are difficult to be handled with only government revenues in the form of taxes.

1.1. Types of Project Financing

The main types of projects being used for these high-risk investments are BOT (Build, Operate & Transfer) and PFI (Private Finance Initiative) respectively.

1.1.1. The Procedure to be Adopted for Project Financing

Project Finance is more expensive and complicated than other financing methods. Therefore, the project fund providers have greater leverage over the assets and revenues of the project. Generally, the project is started & implemented by the creation of a particular purpose entity, i.e., the entity formed to execute this particular assignment. Capital Contribution Commitments by the owner of the project are considered to be detrimental to ensure viability and soundness of the project.

1.1.2. Risks Involved in Project Finance

Since every project is different from the other; therefore, it is not possible to align a fixed list of the associated risks. However, most common risks may be discussed along with their mitigation techniques. Mainly, the project risks may be divided into the following:

Construction Phase Risks, Involve the risks that project under consideration will not be completed or succeeded.

Operation Phase Risks, Involve all the risks after the construction of a project. For example, mine is built with the expectation of extracting an enormous quantity of coal from the same. However, once the mine is built, it is observed that the coal's extracted value could be sufficient to meet even the project's cost and payback to the fund suppliers.

Nevertheless, some risks are common in both construction and operating phases. These may be Technical Risk, Exchange Rate Risk, Regulatory Risk, Political Risk, Force Majeure Risk,

1.2. Research Objective & Scope

The objective of this study is to bring to the front the need for private investment in public welfare projects, the reasons why the private sector seems to be reluctant in financing such projects, and the ways of such financing by private sectors. The findings of the study will help support the Government of Pakistan as a developing country in adopting policies to attract private sector and suggesting useful ways of project financing in order to enhance the public welfare and resultantly the overall growth of the economy.

1.3. Problem Statement

Public Welfare projects require massive financing and are highly risky with long term objectives and consequences expected from the same. These projects are challenging to finance by the government due to limited financial and technical capabilities. Besides, the private sector is reluctant to fund these projects because of the inherent risks of maximizing profits rather than the welfare of society as well as their primary motive. This study, therefore, addresses these issues and emphasizes the importance of these projects to a country's economic growth.

1.4. Research Hypothesis

H_1: Contribution of Private Sector in the public welfare projects improves the economic growth of a country and living standard of its people.

H_0: Contribution of Private Sector in the public welfare projects does not have any impact on the economic growth of a country and living standard of its people.

The rest of the paper is arranged as follows: literature review is outlined in section two, section three explains the research methodology and findings and conclusions are reported in section four, section five mentioned suggestions.

2. REVIEW OF LITERATURE

Huge studies on project financing are conducted in various directions. Vaaler, James, and Aguilera (2006) discussed the project financing in Asia and termed it as Foreign Direct Investment. They state that earlier researches identify the gap to be studied because risk factors in the projects have not been thoroughly addressed therein. As per the study, Foreign Direct Investment based on Project Finance is a global observable fact. However, it currently has the supremacy in Asian Countries. Various risk factors have been included and discussed, along with their impacts on project financing. The size of the project remained the dominant factor related to the project in elucidating its leverage.

Jakob Mullner (2017) analyzed the project finance in international perspective, taking into consideration its financial and managerial aspects. This study is based on the findings of earlier researches on a different dimension. Kayser (2013), covered the period of five years from 2009 to 2013 to review and analyze the various researches conducted on the project finance. It also represents the progress made in this area during the stated period. According to the author, this field of project financing has many aspects of being studied due to the continuous growth of industries.

2.1. Project Financing and Economic Growth

Kleimeier and Versteeg (2009) study the relationship between project financing and economic growth with special consideration towards less developed countries where neither financial health nor the controls are sharp. The main objective of project financing is considered to be the minimization of costs occurring due to various weaknesses of the transaction process. The results of the study revealed that project financing is vital to handle the situations where risks are higher than usual, and internal controls are essential for accurate monitoring. Ganbat, Popova, and Potravnyy (2016) analyze financing of the projects related to the environment, i.e., being termed as the projects for social causes. It is to say that the choice of a project, i.e., not only fruitful economically as well as socially. These types of investments are the necessity of recent times and are known as impact investment.

2.2. Risks and Limitations Inherent in Project Financing

Ray (2015) studied the ways and limitations in financing the projects going across the boundaries of a territory. He has also mentioned that commercial banks lessen their participation in the project financing that caused other financial institutions to enhance their part in it. Restrictions in financing such projects are surveyed and elaborated taking the assistance from the particular cases and the participation of these other institutions to minimize such hindrances was enlightened.

Waqas (2015) describes project finance and study the same in the purview of the Oil & Gas sector. He states that provider of funds for project finance is not concerned with the health of the business on the whole instead they are interested in the cash flows that will be generated from the project because their funds will be paid back from the same. Assets of the business serve as additional security for the funds. As per his conclusions, project finance is considered to be the sole of development in the Oil & Gas Sector. Nevertheless, it does not seem to grow further due to the involvement of commercial banks in this type of financing again, i.e., less costly than that of the project finance.

Blumental (1998) analyzed how project finance is helpful to benefit the energy sector in developing nations. He further studies the ways of financing the projects along with the risks inherent in the project so that an appropriate set could be obtained to fund the project. This study reveals that increased growth in the developing economies caused participation of private sector in the infrastructure development and relaxations by the government in various areas. Said pattern required attention towards handling and mitigating the risks associated with these developing nations mainly related to the political environment and economies of these nations. The point of concern here is whether international investments, for instance, in the form of FDIs is in the interests of the general public as the government secures the same through various checks.

Khan, Gazder, and Ali (2015) studied project financing with special consideration towards the industry of construction in Pakistan. This study highlights the two main pillars of the Construction Industry, i.e., management of finance and the time with an enhanced focus on the acts being applied to manage finance in the industry of construction in Pakistan. Projects are selected based on various capital evaluation techniques. Results of the study reveal that Finance Managers are not playing their stringent rule in the construction industry of Pakistan, thus resulting in the lack of required strategies.

Annamalai and Hari (2013) examined the connection of project finance from that of the investment in a high-risk environment. Findings of the study reveal that the share of the foreigners in total financing of a risky project is higher in developing countries that reflect the value of project financing in these countries. On the other side, higher gearing in developed countries may be considered the result of their less risky environment.

Junior and Carvalho (2013) elaborated the impact of Risk Management on the accomplishment of a project. This relationship was found to be affirmative. Hence, it supports the presence of risk managers in project management. National Federation of Municipal Analysts (NFMA) also presents its study on the risks associated with project finance and their mitigation techniques. This study elaborates the reasons for preference of state government to project financing over the financing through the issuance of bonds. Besides, the fulfillment of the financing requirement, project financing causes an increase in economic growth, e.g., through providing employment opportunities and timely satisfaction of the customers' demand. Various risks are mentioned to be considered while evaluating the risk of a project for the success of the same. Wang (2012), studied the process of project financing through the detailed review of related literature, and his findings are based on the same literature. As per the study, project financing is mainly a two-phase process; the first one is the phase of deciding whether to make an investment in a project or not and second is investing, i.e., financing the project. According to the study, the element of uncertainty must be accounted for while deciding on investing. Likewise, all probable risks associated with the project must be taken into consideration while making a cost-benefit analysis of the project. Thus, he has given enhanced concern to the management of risks in a project and emphasized to avoid financing through debt in the high-risk environment. Cost and time are the other essential areas for the project assessment, management, and monitoring.

2.3. Participation of the Private Sector in Public Welfare Projects

Ahmed, Abbas, and Ahmed (2013), attempt to learn the ways of financing the public infrastructure. Earlier, the public infrastructure was assumed to be in the hands and under the responsibility of the government. With rising commodity prices and limited government resources to spend on infrastructure, however, private sector involvement has resulted throughout the world, particularly in developing countries. It is because of the relationship of economic growth with infrastructure development. The results of the study reveal that from two methods of public investment in infrastructure, i.e., Production Taxes and Foreign Aid, both caused the economic growth in the long run. However, in the short run, production taxes caused a heavy burden on the industrial sector, thus leading negative impacts in the industrial growth and consequently the growth of the economy. They further state that the amount of investment does not ensure the economic growth rather efficient and appropriate utilization of this investment is indispensable for the same.

EY Study as per the order of Queensland Government (2016), emphasizes on the concept of value sharing in financing infrastructure projects. As per the study, the need for the infrastructure is based on two main concerns; one is to meet the public demands to enhance their living standards, and another extract higher value of the infrastructure financing. Irshad, Xin, and Arshad (2015) explain the financing by China in Pakistan through an agreement called CPEC. He argues that this investment and buildup of China, Pakistan Economic Corridor will not only be supportive of these two countries, but the economic growth of other countries of the world too.

3. RESEARCH METHODOLOGY

This study analyses the involvement of Private Sector in the public welfare projects and influence of the same on economic growth of a country and living standard of its people. The study is totally based on the qualitative analysis made in the literature reviewed for the stated subject that supported the findings of this paper.

4. RESEARCH FINDINGS AND CONCLUSION

The findings of the study conclude that project finance involves the high risk, greater cost and time taking projects. Hence, government revenues through taxes are neither sufficiently to fund these projects nor capable to bear the risks associated with the same. Though, current increasing involvement of the commercial banks in such financing may cause the growth of Project Financing to become stagnant. However, there are still strong evidences that Project Financing through a special purpose vehicle via a combination of financing from both public and private sector and involvement of the owners of the project most often cause success of these projects. Since, these projects are normally executed for the public welfare, e.g. Transportation, Health and Education; therefore, the success of the same has a great influence on the standard of living of the people thus improving the growth of the economy specifically in developing countries.

5. SUGGESTIONS

In view of the above discussion and findings, it is suggested to keep the participation of private sector alive and continued in project financing and growth of the same should not be stopped in order to have continuous growth of the developing economies.

6. LIMITATION OF THE STUDY

The above study is limited to the literature reviewed. Moreover, resources required to proceed with the research procedure are scared i.e. limited financial resources, accessibility to the desired personnel in data collection (for interviews) etc.

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