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Social Services Europe

Boosting Investment in Social Infrastructure in Europe

Briefing paper on the report of the High-Level Task Force on Investing in Social Infrastructure in Europe

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Introduction

This briefing paper is a summary of the report of the High-Level Task Force on Investing in Social Infrastructure in Europe released in January 2018. This group was chaired by Romano Prodi and Christian Sautter. The other members of the group were: Benjamin Angel, Antonella Baldino, Guido Bichisao, Thomas Bignal, Giorgio Chiarion Casoni, Jérôme Hamilius, Lleve Fransen, Lutz-Christian Funke, Edoardo Reviglio, Valeria Ronzitti, Bernadette Ségol, Jonathan Watson, Eva Witt, Luk Zelderloo, Eugene Zhuchenko, Laurent Zylberberg.

The high-level task force purpose was to examine the requirements for boosting investments in social infrastructure in the areas of education, health and social housing and to offer recommendations and proposals on how to fill the investment gap that exists in these areas[1].

"Social infrastructure" for this group was defined as *a subset of the infrastructure sector and can broadly be defined as long-term physical assets in the social sectors (in this report these are sectors related to education and lifelong learning, health and* ***long-term [and short-term] care*** *and* ***affordable****, accessible energy-efficient* ***housing****) that enable goods and services to be provided*.

Key Messages

1. **Investment and demand in social infrastructure**: Since the global economic and financial crisis, the EU has been suffering from low levels of investment, social infrastructure investments were the ones suffering the most, mostly due to local budget constraints. Increasing demographic and technological transformations lead to bigger demand in social services. There's a need to adapt social infrastructure to the new needs and changes in the social models.

2. **Inequality and divergence in Europe are hard to overcome:** Long-term social investment is needed, especially in regions at the lower end of the diverging economies, and it should benefit people on lower incomes in the interests of promoting upward convergence. This can only be done through a real boost in public and private investments.

3. **Social infrastructure sector often relies on public funding:** Given the 'public' nature of social infrastructure, public procurement is the most widely used contractual arrangement. The group calls upon improvement and promotion of strategic public procurement schemes.

4. **Social infrastructure can be attractive for private/institutional investors**: Besides allowing a diverse portfolio, it's also characterized by (i) low volatility of returns - predictable and steady real returns are desirable for investors and (ii) low correlation to other assets - the 'public' nature of social infrastructure investment often makes it less exposed to market risk and to systemic risks within capital markets. Still, it is often unattractive to the large long-term investors to **invest directly in social infrastructure due to its small size**. Financial intermediates are crucial to channel institutional investors' money towards social infrastructure investments. Bundling of projects could also bring a partial solution by

[1] Social care and support was seen as a transversal issue; with stronger links to healthcare.

lowering the cost for the public sector and the risk profile for investors.

The Main Drivers for Change

- According to the latest Eurostat Population Projections, the number of **people aged 80+ will increase in all EU countries until 2060**. The population aged 65+ in the EU-28 is projected to increase from 18.9% in 2015 to 209% in 2060. **There will be just 2 people aged between 15-64 for every person aged 65+ in 2060.**

- **Increased mobility and migration** (of non-EU citizens): a total **of 4.7 million people entered one of the EU-28 MS as immigrants in 2015.**

- **Innovation and digitalisation**

- **Upward Social Convergence in the EU**: unemployment, poverty and income inequality increased throughout the EU and became particularly high in southern and eastern MS – there was a divergence between the decline of the poverty rate for older people (-1.9%) and its increase for young people (0.8%): youth unemployment remains almost double the overall rate, contributing to large inequalities in the EU.

Reforming Social Models

Social policies focusing on human capital provide return on employment, wellbeing, productivity and growth, reducing the expenditure on social protection.

- In an aging economy, raising human capital is essential to sustain effective welfare states.
- Social models are **adapting continuously** to: (a) the reality of people **working and living longer;** (b) the increasing number of single-women households and high **participation of women in the workforce**; (c) **rapid changes of the skills** required for the jobs (without the education systems catching up). As such, additional efforts are needed to provide for those who are typically inadequately served by current services and infrastructures.

The ultimate objective of social investment policies is to break the intergeneration transmission of poverty by investing in **human capital** (education and healthcare) or **deprived urban areas**, for example

- ***In Europe, infrastructure investments in 2016 were 20% below the level experienced in 2007.***
  - While all levels of government saw public investment decline below pre-crisis peaks in 2015, **local government levels were noticeably lower (down 12%) than those of central government**. Fiscal consolidation during the crisis has strongly reduced fiscal space for public investments in some regions. For economic infrastructure the reduction has been less pronounced.
  - Local governments **tend to invest more** than central governments in housing, social amenities and social protection (of course the level of decentralisation is highly

diverse in Europe), as such cuts in investment at local level can have serious negative political and economic effects.

- Public spending on **long-term care** ranges from more than **4% of the GDP in the Netherlands to less than 0.5% of the GDP in countries like Latvia and Poland.**

- Public investment in **affordable housing infrastructure in the EU was EUR 28 bn in 2015. This equals to 0.2 % of GDP.** This does not include investment in energy efficiency of affordable housing nor community amenities. The highest spend is in IE, DK, FR and UK. The lowest reported spend is in AT, CZ, LV, LT and PL.

Investment Gap for Social Infrastructure

According to the European Commission, the EU needs EUR 2 tn of investment in infrastructure by 2020. The European Investment Bank (EIB) estimates that the region needs to invest 3.6 % of GDP, (including investment into social infrastructure) if Europe's economy is to continue to recover and set itself on a path to sustained growth. However, the EU is experiencing a chronic lack of investment in social infrastructure: **decreasing from 2% of the GDP to negative 0.6% since the last economic crisis.**

- Investments in health are often delayed, producing a negative effect for people and institutions. They also still **neglect new approaches** as community/local facilities and short-term care, being centralised in hospitals (with bed oversupply and lack of technological innovation). **5% of the total annual health expenditure is spent on infrastructure**.

- **Long-term care**: There's a clear gap of EUR 50 bn p.a. on long-term care. Investments in health, long-term care and social **care are safe because they tap into a secure and steady publicly-backed source of income** (insurance) and into an ever increasing and invaluable personal need for health and wellbeing.

- **Affordable housing:** Existing affordable housing stock is falling across Europe (except for France), and homelessness is rising. According to Housing Europe, approximately 450-500 000 new homes are needed and 800 000 homes require renovation. **The investment needed would represent an increase of 25% of the current percentage of the GDP.**

Financing Social Infrastructure Investment

When financing infrastructure we should put less pressure on public finances. Long-term institutional investors are searching for low risk inflation-linked long-term financial instruments to match their long-term liabilities.

Social infrastructure, which needs almost full payment by the **public sector**, is characterised by **predictable and steady real returns which are usually attractive for investors**. Therefore, economic infrastructure and social infrastructure have similar features, although they differ in some relevant characteristics, offering investors opportunities to diversify.

- However, we still don't have the conditions to make these investments operative – we need to **make infrastructure investment more attractive** and we need to **resolve the "Infrastructure Bottleneck"**[2]

- **Public-private Partnerships (PPP)** represent an alternative for public procurement. PPPs are cooperation agreements between a public body and private-sector body under which the parties' respective skills are pooled to build public works or carry out projects of public interest for the management of the related services. When properly structured and well controlled, PPP can benefit both the public authority and the private party with positive spillovers to the final beneficiary of the infrastructure or of the service. However, the recourse to PPP is <u>still quite uncommon</u>:

    - **Allocation of risks** is essential for a successful PPP. The main risks identified are: **(1) <u>Construction</u>** risk: events related to the construction and completion of the PPP assets (e.g. non-compliance with specified standards) which **trigger compensation** payments to third parties; **(2) <u>Availability</u>** risk: situations where, during the PPP operational phase, an **underperformance** results in **services being partially or wholly unavailable**, or where these services fail to **meet the quality** standards specified in the PPP contract; **(3) <u>Demand</u>** risk: it relates to the **variability of demand** (higher or lower than expected when the PPP contract was signed); **(4) <u>Financial</u>** risk; **(5) <u>Context</u>** (political, country, etc.) risks.

    - The process of classification of a PPP usually takes a **very long time** and the **classification itself is often subject to change** during the lifetime of the PPP contract, thus <u>increasing uncertainties</u>.

Mobilising Private Capital

Social Infrastructure has some distinctive features that attract investors:

1. **The role of the public sector**: the cashflow to repay the financing of social infrastructure comes from public budgets, this means that social infrastructure investment risk is only slightly higher than sovereign bond's risk, thus a stable investment.
2. **Local focus**: Traditionally social infrastructure is designed, developed, procured and operated and realised by local bodies and SMEs.
3. **Common and extensive recourse to traditional public procurement**: Public procurement is a strategic instrument, extremely valuable in spreading innovation and digitalisation.
4. **Small average size of capital expenditure (capex) and great opportunity for portfolio diversification**: 99% of existing social infrastructure projects in Europe entail an investment of less than 1 billion EUR and the great majority is below 30 million EUR. This is good for spreading risks (portfolio diversification).
5. **High level of operating expenses related to capex**: The hard infrastructures are enablers but only represent a small portion of the total costs in producing public services.

[2] An *Investment Bottleneck* is any systematic market failure, structural impediment, shortfall of capacity or other barrier to the effective and efficient development and implementation of high quality investment projects.

6. **Bundling of projects:** to overcome the potential small capex size 'bottleneck'; while preserving the portfolio diversification, a solution can be the "bundling" of similar social infrastructure projects – this can save design and construction costs and create the opportunity to save on long-term maintenance.
7. **Low volatility of returns**: Predictable and steady real returns from the public sector are attractive to the investors (especially long-term investors).
8. **Low correlation to other assets**: its "public" nature often makes social infrastructure investments less exposed to market risk.

However, it is important to consider two points:

a. **Importance of financial intermediaries**: The small size makes direct investments unattractive due to high active management costs; financial intermediaries are key for channelling investors' money.
b. **Uncertainty related to regulatory and political risks**: Political and regulatory risks, often interlinked, are a key issue of social infrastructure investment. Governments may renege on their commitments and regulators may change the regulatory framework.

In Europe, the investment landscape is dominated by three large investor segments: insurance companies, pension funds and mutual funds. Institutional investors typically invest over a long investment horizon. Life insurance companies and pension funds usually have an investment horizon of over 10-15 years and 20 years respectively and constitute a large segment of the institutional investor landscape.

Therefore, these institutions play an important role in fixed income markets, especially as major providers of long-term funding to banks and the public sector.

- **Lack of pipelines & the role of Technical Assistance**

  One of the main investment 'bottlenecks' is the difficulty of establishing a reliable pipeline of projects (an adequate supply of suitable, infrastructure assets open to investment).

  Appropriate **advisory and technical assistance services** can help public administration expand its **capacity to prepare, develop and implement projects**, sometimes constrained by lack of skills. Technical assistance could provide appropriate services in project identification and preparation, financial structuring, procurement and state aid, project implementation, capacity building, communication and awareness raising and advice regarding accounting treatment for European purposes (in case of PPP and PFI[3] schemes) or advice on the use of European Structural Funds and other EU grant schemes, as well as on blending.

  Institutions and/or agencies that provide technical assistance already exist at European, national and regional level in most EU countries. However, all EU countries have stated that these are not sufficiently effective or large enough to cover the growing demand for assistance, being this especially problematic at local level.

  This report advices that technical assistance providers should have a strong link with the

[3] PFI – Private Finance Initiative

European Invertment Advisory Hub building on an efficient network including national promotional banks and institutions; they should be independent institutions with highly-skilled staff, large enough to be able to provide a personalised approach to every client.

Funding Sources: Blending Funds and Investment

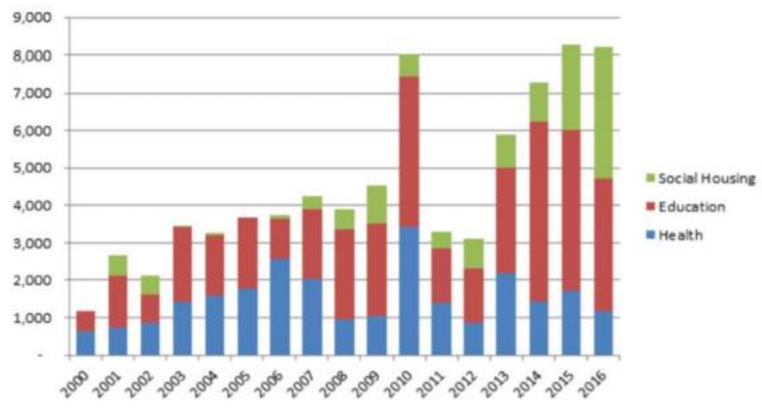
EU grants can be combined with other grants, and, especially, financial instruments (loans, guarantees or equity) from public and private financiers through a mechanism known as **'blending'**. The intuitive rationale for this instrument is to make a project more bankable by reducing risk exposure of potential investors for projects considered strategically important. Blending a grant with another financial instrument (or budgetary guarantee) may enable a previously economically nonviable project to be implemented, when it might have faced difficulties in securing financing. However, blending has been, so far, relatively little used, due to problems as: inflexibility of grant procedures, risks associated with the impossibility of extending EU grant funding beyond the ongoing programme period, lack of certainty about the level of the grant, among others.

EIB's Role

Social infrastructure investment in the three sectors examined in this report (health, education and social housing) represents a key share of the **Bank's total infrastructure investment**. Investment in these sectors **has risen** since the beginning of the century, especially in social housing. Still, **we don't see the same with social care.**

In 2016, the EIB provided EUR 19,7 bn to support infrastructure investment.

Figure 21: **EIB lending to HLTF priority sectors, 2000-2016**



Source: EIB Group (2017)

- **The European Fund for Strategic Investments (EFSI)**

  The European Fund for Strategic Investment (EFSI) is an initiative set up jointly by the **Commission and the EIB Group** (EIB and EIF) under the Investment Plan for Europe to help bridge the EU's current investment gap by mobilising private investment in infrastructure, innovation and SMEs.

  Social infrastructure is one of the EFSI's priority sectors. A broad range of projects are eligible for support, such as the construction, expansion or refurbishment of schools and

universities, clinics and hospitals, and affordable and social housing.
EFSI financing is generally **demand-driven**, and the Investment Plan for Europe establishes no fixed sector quotas. However, **currently only 4 % of approved EFSI financing supports social infrastructure projects in the EU**, which is still relatively low compared to needs.

EFSI investment platforms could be an appropriate tool to improve the pipeline of projects in the social infrastructure sector. The Regulation establishing the EFSI specifically provides for the use of investment platforms. **Investment platforms are not set up by the European Investment Bank (EIB), but by sponsors or project promoters**, which may be public authorities or national promotional banks and institutions (NPBIs), or social sector organisations and private investors or partners. The EIB can advise on setting up platforms through the European Investment Advisory Hub (EIAH). It can also support such platforms financially through the EFSI. These are public-private co-investment arrangements, structured in such a way as to catalyse investment in a portfolio of projects (as opposed to individual projects) with a thematic or geographic focus. Investment platforms can be useful for blending resources and bundling projects.

CEB's Role

The Council of Europe Development Bank is a multilateral development bank with a social mandate, promoting social cohesion by providing financing and technical expertise. CEB lending totalled EUR 14 bn in 2000-2016 in the areas covered by this report: in social housing (6.2 bn), education (4.4 bn) and health (3.2 bn).

Conclusion

The gap in **social infrastructure investments is significant** and it has **widened since the 2007 financial crisis**. The High-level task force presented strategies that fight this tendency, allowing investment in education and lifelong learning, health and social and long-term care as well as affordable and energy efficient housing. It reiterated the importance of a strategy in rebuilding trust with the public and recreate a momentum of upwards convergence.
The group has also reflected on possible ways of increasing and improving the current financing instruments of social infrastructure investments. All the proposals intend to help:

- Implementing policies and instruments designed to expand the achievements of the European social welfare state, adapting it to the knowledge economies of the future and to ageing societies in a globalised world;
- **Incentivise reforms and boost investment in innovations**;
- Build an **even more efficient partnership between public and private participants** in investment;
- Establish a new asset class and financing instruments that are adapted to needs in the social field.

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