Private finance in the social domain

Position paper

November 2026

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Summary

- We discuss the role of private finance in the social domain (think of education, health care, public utilities).
- We demonstrate that private finance can both harm and help the Accessibility, Affordability, Availability and Quality (AAAQ) of services in the social domain, particularly focusing on cases where private finance harms AAAQ.
- We discuss that certain characteristics of the social domain make the risk of private finance harming AAAQ significant. These characteristics include the presence of both public and private actors as well as public funding, and the nature of the goods and services in the domain. Together, these characteristics frequently create a tension between profit-seeking finance and public interests.
- Based on these observations, we outline three conditions under which private finance can strengthen rather than harm the social domain.

Why the social domain is partly public

There are multiple valid reasons why public actors decide to step into the social domain rather than allowing free market outcomes.

Many goods and services within the social domain have both private and public good characteristics. Education is an example. When people receive education, it benefits them directly. That is the private good part of education; the benefits that fall to the person who 'consumes' the education. Yet there are also public good characteristics to education. Education will help people function and contribute to society, which benefits everyone around them. That is the public good part of education. People paying for their own education will, theoretically, pay for the private good part of it. If you recognise the public good value of education, then spending more on it is actually worthwhile. That, in a nutshell, is why most governments pay for education. Private provision alone would lead to lower levels of education than desirable.

Additionally, there are parts of the social domain where a public goal, such as accessibility, is not helped by profit maximization. The best example of this would be a water network. It is expensive to dig and operate a water network. This makes it unlikely that multiple different water companies will dig a water network to the same neighbourhoods, to compete with each other for who gets to sell water. Rather, when there is one water network in place, no other company feels incentivised to build a parallel one, so there is a natural tendency towards monopolies. In a monopoly, a private company might well charge much higher prices than their actual operating costs justify. That would lead to lower accessibility of drinking water than possible. Here, too, a government steps in and takes over part of provision to prevent the price of water rising too far above the actual costs.

There are some more reasons why public actors step in in the social domain. Health care insurance and costs are partly borne publicly because they are high and uncertain. Without mandatory health insurance and low costs at the point of delivery, we would likely see people fall ill without being able to afford their own treatment. To prevent this and spread the costs equitably, the governments of the countries in which Triodos Bank operates as a bank are involved in organising health care (partly) publicly. In addition to the three reasons mentioned above, there might also be a political preference to organise services publicly, based on the view that they are basic rights. Education and healthcare are good examples.

All in all, this means that public actors take a serious role in providing and paying for the social domain. They do so because purely private provision does not serve public interests.

Private companies are present in most parts of the system as well. They might provide (part of) the services based on public funding, or they might provide private alternatives in addition to public systems. The exact public-private mix differs a lot per country and sector.
In some cases, companies that were first fully publicly owned have been privatised, or vice versa. All in all, in the countries in which Triodos Bank operates as a retail bank, most of the services in the social domain are at this point provided through a public-private mix.

Which services do we mean?

In this paper we discuss private finance's contribution to goods or services that

- Serve a public interest
- Are for a significant part publicly funded or organised
- Involve private companies for at least part of provision

Many of these types of goods and services fall within the social domain. This aligns closely with the European Commission's definition of Services of General Economic Interest (SGEI). Some SGEIs are fully provided by governments, such as police, military and justice systems. Those are not the topic of this paper.

How private finance enters the social domain

The private companies in the social domain, in turn, sometimes seek financing. Note here that we do not mean funding, e.g. money that *pays for* services in the social domain. We mean the finance that provides the capital needed to build a house, purchase equipment or start an organization that provides goods or services. This capital might be supplied through a loan, an equity investment or an alternative. The capital provided by (private) finance must be paid back at a later point, with a return in the form of interest (for debt) or dividends / appreciation (for equity). Loans and equity investments ultimately do not *pay* for a dental appointment, a ticket to the opera or the construction of affordable housing. In the end, services in the social domain are always paid for by either or both:

- Public funding (through taxes, social insurance or subsidies)
- Individuals (through fees, rents, donations, etc.)

An example would be a museum seeking a loan. The loan will help it buy its building, and perhaps its collection. Over time, it will sell tickets and receive subsidies to operate the museum. These proceeds are then partly used to pay the loan back.

Yet, in some cases, the involvement of private finance can actually aggravate the tension between public interests and private benefit that we described earlier. Let us take an example to show how this works. Imagine a private equity company takes over a water utility company, with the aim of maximising its returns over the next 7 years. It might well borrow money with the water utility company, whilst at the same time paying out large dividends to its investors. Then, to service the debt and ensure some profitability, it could raise prices for water – they have a monopoly position anyway. Keeping the system safe and functioning would cost money, such as replacing pipes and increasing filter capacity over time. However, since these are costs, the private equity firm might prefer to spend as little as possible on maintenance, even if this leads to some pollution and outages.

Of course, this is no imaginary example, but a fairly accurate description of how Thames Water (UK) fared under private equity ownership. There are more examples where privately financed and privately owned companies within the social domain saw accessibility decline, costs rise, quality deteriorate, or availability shrink. (When discussing essential services, this usually done in terms of availability,

accessibility, affordability and quality, the so-called AAAQ.)[1] This might make you feel like the social domain would be better served without any private financing.

However, the social domain simply needs private financing, given its current public-private mix. If non-public organisations play a role in providing services, they will need access to financing. In most countries, they will rely on the private financial sector to provide that financing.[2] Through providing this finance, the private financial sector can help boost the AAAQ of services in the social domain.[3]

Observations: private finance in the social domain

The public-private mix in the social domain we described above has implications for the dynamics of private finance in that domain. A first observation is that by nature, private finance in the social domain often involves (to a large extent) the conversion of public funds into private profits. The presence of private finance generally depends on the existence of a stable stream of income that can be used to repay the financier. For most goods and services in the social domain, at least part of this income stream comes from public funds.

Whether or not the funding is (fully) public, for most goods and services in the social domain, revenue streams are not completely market-based in the conventional sense. Prices are often regulated and the demand for services such as water, social housing or healthcare is quite stable, meaning the overall market risk is low. The main risks faced by financiers are policy risk (the government can alter the availability or quantity of public funding, for example by restricting the scope of services that is publicly covered) and the remaining credit risk (the debtor can for example go bankrupt due to financial mismanagement or commit fraud and choose not to repay the loan).

A second observation is that the social domain has become increasingly financialized: what were once primarily public services and goods delivered with the occasional involvement of private finance, are now a playing field that is shaped and dominated by financial actors.[4] This shift is closely linked to policy choices over the last few decades. Although large differences between countries exist, governments have generally decreased the generosity and accessibility of their welfare programs and the provision of public services, instead actively encouraging market provision in the social domain.[5] Services were transferred to the market in the hope that this would increase efficiency and cut public expenditures. Along with it, private financial actors and the logic of accumulation entered the social domain.

A third observation is that this financialisation can lead to more frequent or severe tensions between public interests (AAAQ) and private profit. The news frequently reports on private finance achieving (very) high returns, in various forms. Financiers (mostly private equity) engage in creative debt structures,[6] lucrative 'exits'[7] and other financial constructions such as 'lease-backs'.[8] And the increased focus on profits at times erodes the AAAQ of services in the social domain, in other words: the public interest. Large-scale overview studies show that private equity ownership in health care is 'often associated with harmful impacts on costs to patients or payers and mixed to harmful impacts on quality'.[9] Recent noteworthy examples include Covid-mortality rates in private elderly care homes in Spain being twice as high as those in public homes [10], safety concerns raised by whistleblowers at UK mental health care provider Priory Group [11] and widespread allegations of elder abuse at French care provider Orpea which led to the publication of an entire book ('Les Fossoyeurs') on Orpea by an investigative journalist.[12]

These high returns and deteriorating outcomes have attracted a lot of attention and dismay about the presence of and profits earned by private finance (and especially private equity) in these domains. This reflects a growing discomfort with current practices and a need to better define the desired role of private finance in the social domain.

Three conditions for private finance

As stated at the start of this article, we do believe private finance can be a force for good by improving AAAQ in the social domain, given the public-private organisation. Yet, there are clearly cases where

private finance harmed rather than helped AAAQ as discussed in our observations. We suggest three conditions for private finance to play a constructive role.

1. Choose a justifiable financing instrument and return

Much of the social domain is currently financed through a mix of private and public sources, which inevitably comes with some level of private returns. We believe that these returns should be proportionate to the risks incurred by financiers.

This also requires matching the right type of financing instrument to the financing need. We believe that for lower-risk organisations with steady (public) income streams (so with low market risk and essentially only some policy and credit risk), debt financing is often sufficient to meet financing needs. Think of an established elderly care home or water provider. [13] In the absence of public financing, they might seek private finance to expand their operations or supply working capital. For these types of cases, equity financing seems unnecessary and potentially problematic: it adds profit pressures and misaligned incentives (discussed more elaborately in the next section), without there being a high level of (market) risk, which generally warrants equity rather than debt financing.

Higher returns, including instruments like equity shares, can play a justified and constructive role where the (market) risk for the financier is truly higher, for example when financing concerns a new technology or business model that has not yet proven itself. In these cases, a higher return may be justified to compensate the higher (market) risk that is incurred. It may also cause projects and organisations to be financed that would not be available with only debt financing.

Even in these higher risk cases, an ownership and governance structure that prevents profit motives dominating the AAAQ of the services provided could help. If ownership and governance structures put the societal mission first, such as steward-ownership or cooperative models do, this can prevent some of the negative consequences of private finance and its return focus we discussed in the observations section.

For lower-risk activities, we believe not more than a 'fair return' should be made. A useful benchmark may be the interest rate associated with term-equivalent government bonds, increased slightly by a variable risk premium to compensate financiers for the policy and credit risk they take as well as their operational costs. This, and not much more, might be considered a justifiable rate to pay – usually with public money, it is good to remember – in the social domain. [14]

Lastly, in some very specific sectors, the presence of private finance may be undesirable or unethical altogether. This is particularly the case where there is a risk of profit-making conflicting with fundamental public values. For example, Triodos Bank has a strict zero-tolerance policy for investing in the arms industry based on this reasoning. Other examples of 'markets' where private involvement may raise fundamental concerns include the provision of donor organs or the operation of the prison system.

2. Safeguard AAAQ by selecting the right financees

When profit-motivated actors provide services in the social domain, certain tensions can arise in the interaction between profit-seeking incentives and the public interests of AAAQ. Profit-oriented service providers may try to avoid servicing individuals who are more complex, costly or risky. They instead focus on those who are easier or more profitable to serve. For example, a private clinic may only perform routine hip surgeries for low-risk patients while leaving complex (and thus expensive) cases to public hospitals. This practice known as cream-skimming. It is closely related to adverse selection, which describes the resulting outcome: the more profitable patients or treatments end up in specific (private) centres, with public centres left to pick up the unprofitable or difficult treatments.

This undermines the 'cross-subsidization' between more and less profitable treatments that many public institutions rely on to balance their budget. Risk selection can also take subtler forms: a healthcare insurer may be formally required to accept all applicants, yet create practical barriers. For example, by only allowing applications in person on the fifth floor of a building without an elevator. This will result in healthier clients and lower costs.

For private finance to play a constructive role in the social domain, financiers should refrain from financing organisations engaging in the practices described above, which harm AAAQ.

3. Focus on productive financing

Our last condition is not about the level of return, the financing instrument used or the practices adopted by the financier. It is instead about what the additional private finance enables. We know that, over time, the amount of 'finance' has increasingly grown relative to 'economic activity'. This is visible, amongst other things, in the rising debt to GDP ratio on a global level. The social domain financializes, too.

This raises the question when finance actually helps improve AAAQ. In general, when finance is used to *expand* capacity, AAAQ may improve. So, when financing is used to open a new elderly care home, given growing care needs, that will help AAAQ. We call this productive financing. On the other hand, when more financing is used just to keep existing operations going, AAAQ might well decrease. After all, there will be more loans to be paid back or dividends expected, without extra care capacity or expected revenues. We call this unproductive financing.

We think private finance should aim to focus on productive finance. When expanding capacity in the social domain requires financing, there is a clear reason to finance. Of course, there are many grey areas. When an elderly care home switches owners, a new loan might be needed to pay off the previous owner, who might still have a loan themselves. In that case, the new loan might still help AAAQ; the alternative could be an end to the elderly care facility. Yet, if a private equity owner is looking for a loan against an already existing property without a clear link to the operation, this is usually unproductive financing. The loan might primarily serve to pay out dividends, whilst indebting the care home more than it has to be. While sometimes nuanced, we think private finance should critically reflect on whether the finance it provides in the social domain can really be considered productive.

Conclusion

Private providers in the social domain need capital, and private finance can provide it. In this paper we have discussed why the social domain is not a 'normal' market, which risks arise from private companies oriented to profit, and how the presence of (profit-seeking) private finance can aggravate these risks.

We conclude that private finance can have a positive impact in the social domain, but due to the nature of the services provided, its role should be carefully regulated and monitored by the government. Additionally, certain conditions should be met:

- Equity financing should only be done when it is warranted, meaning in cases where the risks for the financier are high. Even in these cases, alternative ownership and governance models would help to prevent profit motives harming AAAQ. In lower-risk cases, financing should take the form of debt, and the financier should earn not more than a 'fair' return;
- Private finance should not finance providers that harm AAAQ through for example cream-skimming;
- Capital should flow primarily to productive purposes; unproductive finance does little to serve the public interest.

Endnotes

[1] Breuer, I. M., & Milbert, A. (2013). Services of general interest indicators: methodological aspects and findings. *Europa XXI*, *23*, 29-46.
[2] In some sectors and countries, public financing exists, such as the 'Bank Nederlandse Gemeenten' who can finance social housing corporations. In these cases, there is less need for private finance.
[3] In our view, private financing in the social domain should not be a goal in itself. In some countries, public banks play a significant role in financing the social domain. This can be a good solution to combine commercial rigour with

public interests; profit made by public banks flow back to the state, so there is in principle less tension between public and private interests.
[4] Christophers, B. (2023). *Our lives in their portfolios: Why asset managers own the world*. Verso.
[5] Lavinas, L., Bressan, L., Rubin, P., & Cordilha, A. C. (2023). The financialization of social policy: an overview. *Handbook on critical political economy and public policy*, 461-475.
[6] A Dutch example is daycare center Estro, which eventually went bankrupt after being forced to take high debts with the private equity firm owning it (against a high interest rate).
[7] A UK example: Advent International sold the largest UK mental healthcare provider (Priory Group) to a different private equity firm (Acadia) after less than five years. The 'exit' earned them more than £500 million in profit.
[8] Acadia financed the £1 billion acquisition of the Priory Group almost entirely through the sale and leaseback of 40 of Priory's hospitals, with the rental costs being approximately £50 million per year.
[9] Borsa, A., Bejarano, G., Ellen, M., & Bruch, J. D. (2023). Evaluating trends in private equity ownership and impacts on health outcomes, costs, and quality: systematic review. *Bmj*, *382*.
[10] CorpWatch. (2022, November 9). *Impact of healthcare privatization on eldercare homes in Spain*. https://corpwatchers.eu/en/investigations/caring-for-profit-en/impact-of-healthcare-privatization-on-eldercare-homes-in-spain
[11] BBC (2023, April 21). *Care home operator under scrutiny after abuse claims*. https://www.bbc.com/news/uk-65335941
[12] Het Nieuwsblad. (2022, April 28). *Onderzoek naar rusthuisgroep Orpea in Frankrijk wegens mishandeling van senioren*. https://www.nieuwsblad.be/buitenland/onderzoek-naar-rusthuisgroep-orpea-in-frankrijk-wegens-mishandeling-van-senioren/54865283.html
[13] We think some examples of private finance in the social domain make this painfully clear. Thames Water is such an example. After being bought by private equity parties led by Macquarie in 2006, Thames Water became known for paying out high dividends whilst chronically underinvesting in the infrastructure it was meant to maintain. In the words of a judge who fined the company for pollution of the river Thames in 2017 "inadequate investment, diabolical maintenance and poor management". (Christophers, 2023)
[14] In our view, private financing in the social domain should not be a goal in itself. In some countries, public banks play a significant role in financing the social domain. This can be a good solution to combine commercial rigour with public interests; profits made by public banks flow back to the state, so there is no real tension between public and private interests.