Making Room for Public Investment

Possible new approaches to fiscal accounting

Richard Hemming and Teresa Ter-Minassian

FINDING money to invest in infrastructure and other public projects without jeopardizing fiscal stability has become a hot topic in many countries seeking to boost economic growth. At a recent United Nations conference on hunger and development, Brazil's President Lula da Silva called on the IMF to allow infrastructure investments to be excluded from the fiscal targets countries must meet in order to qualify for financial assistance. President Vicente Fox of Mexico made a similar proposal last year at a Group of Eight summit in Evian, France.

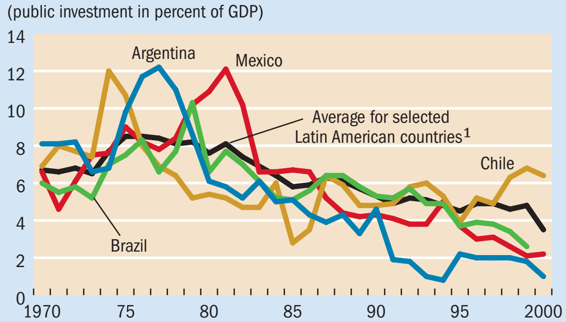
Presidents do not often get involved in the nitty-gritty of fiscal accounting, but Latin America is eager to boost growth after years of near stagnation and, in some cases, crises. Public investment as a share of GDP has sharply declined in the region during the past two decades, taking a bigger hit than in other parts of the world (see chart). While several factors have contributed to this decline—including privatization, which has reduced the role of government in the economy—fiscal adjustment often receives the blame. Since private sector involvement in infrastructure has also been smaller than anticipated, significant infrastructure gaps have emerged that could hurt economic growth in many countries.

While looking for innovative ways to boost the private sector's role in providing infrastructure and other services (see box), countries in Latin America and other parts of the world are also focusing on how to make more room for public spending. In this connection, critics of the accounting methods used by the IMF—who are mainly in Latin America but can also be found in Europe, where fiscal constraints are pretty severe—question its traditional reliance on the overall fiscal balance and gross public debt as key fiscal indicators. Latin American countries also claim that the IMF treats them unfairly compared with the rest of the world

Photo above shows a bridge in western Mexico that collapsed for no apparent reason.

On the decline

Public investment in Latin America has slipped during the past three decades.



Sources: International Finance Corporation and OECD.
[1] Unweighted average for Argentina, Brazil, Chile, Colombia, Ecuador, and Mexico.

when it comes to deciding what should be counted as public spending. In this article, we try to shed some light on the fiscal accounting debate and offer thoughts on possible new approaches to making room for more public investment spending on critical infrastructure needs.

Logic behind IMF's approach

The IMF has chosen to focus on the overall fiscal balance and gross public debt because of these two indicators' well-established links with short-term macroeconomic stability and longer-term public debt sustainability. It is for this reason that these indicators are used not only by the IMF but also by other international organizations, financial markets,

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and most ministries of finance and central banks worldwide. The general approach is to target these indicators—taking other policies into account—so as to meet specific objectives for output, inflation, and the balance of payments, and to ensure that public debt remains sustainable. But in many cases, the room for maneuver is limited: fiscal targets in IMF-supported programs are dictated by financing constraints that emerge when markets worry about a country's large deficit and high debt.

When advising on how to meet fiscal targets, the IMF emphasizes the importance of high-quality fiscal measures that provide lasting savings and minimize the social costs of adjustment. In this connection, it asks whether savings are achieved mainly by compressing capital spending or whether they are the product of lasting reforms that increase revenue and reduce current spending. The IMF also advises on how to improve economic efficiency and income equality, and it offers technical assistance to countries that want to reform their tax systems and restructure spending.

In principle, increasing investment in infrastructure and protecting priority projects when fiscal adjustment is called for could be accommodated under this approach. In practice, however, it has clearly proven difficult. Political pressure makes it problematic for governments to cut major current spending programs during periods of fiscal adjustment because such spending often benefits interest groups that have a lot of political influence. In contrast, it is much easier for governments to cut spending on a few large public investment projects and on investment maintenance, and then resume it when funds become available once again. But this stop-and-go spending creates volatility that undermines efficiency.

Public-private partnerships: treat with care

Public-private partnerships (PPPs) hold the promise of increasing the supply of infrastructure and other services without overburdening a country's public finances. An infusion of private capital and management can ease fiscal constraints on infrastructure investment and boost efficiency. For these reasons, PPPs are taking off around the world, and there are now well-established programs in a number of countries, including Australia, Ireland, Mexico, and the United Kingdom.

But PPPs should be treated with great care. It is by no means certain that they will be more efficient than traditional public investment. Moreover, PPPs can be used to move investment off budget and debt off the government balance sheet, while the government still bears most of the risk and faces potentially large costs that will eventually be borne by taxpayers.

If PPPs are to deliver high-quality and cost-effective services to consumers and the government, there must be adequate risk transfer from the government to the private sector. The quality of services has to be contractible so that payments to service providers can be linked to performance and the risk of costly contract renegotiations can be minimized. There has to be either competition or incentive-based regulation. An appropriate institutional framework characterized by political commitment, good governance, and clear supporting legislation is needed. And the government will have to refine its project appraisal and prioritization skills so it is able to manage a complex PPP program.

Further complicating matters is the fact that there currently is no international accounting standard for reporting PPPs. The lack of a such a standard raises concerns about transparency, especially regarding the longer-term fiscal implications of such schemes.

Looking at public investment differently

What about the proposal to exclude infrastructure investment—or more specifically the borrowing required to pay for it—from fiscal targets by targeting the current balance (which excludes public investment) and net worth instead of the overall balance and gross debt? The argument is that subjecting public investment to the same fiscal constraints as current spending is wrong because it is insensitive to the fact that public investment contributes to a country's growth potential and a government's future revenue stream. In that sense, the critics argue that borrowing to finance public investment should pay for itself over the longer term.

> **"The hope is that countries can increase the scope for productive public investment in infrastructure in a manner consistent with maintaining macroeconomic stability and debt sustainability."**

While it is far from certain that public investment as a whole has been good for growth—the empirical evidence for this is shaky—shortages of essential infrastructure clearly limit growth potential. Thus, the IMF acknowledges that there is a clear need to promote and protect infrastructure investment in many countries, but it worries that the critics' proposal could compromise debt sustainability. For example, the well-known (but little used) variant of the current balance approach—the golden rule, which requires governments to run a current balance or surplus—places no limit on borrowing to finance public investment. Indeed, there is no guarantee that public investment will be productive and yield significant dividends for the budget, or have a higher pay-off than private investment, good quality current spending, and cuts in distortionary taxes. Moreover, the door is opened for creative accounting by masking current spending as capital spending. When the United Kingdom introduced a golden rule in 1998, it supplemented it with a debt rule, strong project appraisal and budget prioritization, a sound framework for private sector involvement, and state-of-the-art fiscal accounting and reporting—precisely to counter such risks.

The reality is, however, that most countries do not have the institutional capacity to adopt the golden rule, making it impractical to use as a basis for setting fiscal targets, especially under IMF-supported programs. Instead, the IMF is proposing to take a more flexible approach by attaching importance to three goals: macroeconomic stability, debt sustainability, and promoting and protecting public investment. This would involve

- helping countries find scope for additional borrowing to finance productive and cost-effective public investment in a way that is consistent with macroeconomic stability and debt sustainability;
- paying more attention to the current balance—in addition to the overall balance and public debt—to ensure that room for additional borrowing is used to increase public investment and that fiscal adjustment is achieved by mobilizing revenue and reducing current rather than capital spending;
- assisting countries with reforms to streamline current spending and mobilize revenue, eliminate wasteful public investment, and protect priority projects;
- focusing on structural or cyclically adjusted fiscal indicators to encourage a buildup of fiscal cushions in good times that can be used to protect public investment in bad times; and
- helping countries strengthen their project evaluation and management capacity to ensure that public investment is both productive and cost-effective.

Unfair data treatment?

How about Latin America's complaint that it is being treated unfairly by the IMF in terms of statistical coverage? Here the argument is that the statistics the IMF uses to assess fiscal policy cover much more ground in Latin America than elsewhere. Whereas the fiscal statistics used by the IMF for European countries is limited to the general government, and in other parts of the world often cover only the central government, the entire public sector in Latin America is covered—including all public enterprises, regardless of whether they are an actual or potential burden on the budget. Latin America argues that this puts the region at a disadvantage because infrastructure investment undertaken by commercially run enterprises is treated as public expenditure. This means that fiscal targets place limits on such investment and fiscal deficits are made to seem larger than elsewhere.

Why does the IMF use fiscal statistics that cover the entire public sector when discussing fiscal policy and setting fiscal targets for IMF-supported programs with Latin American countries? The reason is that many of these countries have a tradition of using public enterprises to undertake so-called quasi-fiscal activities—fiscal activities that are off-budget. Governments have on many occasions allowed such enterprises to build up excessive debt, which they have then had to honor when these enterprises got into financial difficulties—and this often included bailing them out to avoid bankruptcy. Of course, this problem is not unique to Latin America, and may not be at its worst in this region; however, the data are available to achieve broad coverage in Latin America, in contrast to most other emerging market economies and developing countries. But the same cannot be said for European and other industrialized countries where public enterprises are not always commercially run.

The IMF agrees that broad coverage fails to distinguish enterprises that pose fiscal risks from those that do not. For that reason, it is considering the possibility of excluding commercially run public enterprises from the coverage of fiscal statistics when setting fiscal targets in Latin America, on the assumption that commercial orientation provides a good guide to fiscal risk. This means these enterprises would have the freedom to make business decisions as they see fit—including those on investment. At the same time, coverage in other regions should be extended to include public enterprises that are not commercially run. While such a judgment should ideally be made by reference to whether an enterprise undertakes significant quasi-fiscal activities or the government assumes considerable risk in connection with its operations, this is often difficult to determine. The IMF is therefore experimenting with the use of criteria such as managerial independence, relations with the government, financial conditions, and governance structure to make this judgment.

Next steps

The IMF has embarked on a number of pilot studies in Latin America and other parts of the world that are aimed at paving the way for implementing these new approaches—the hope is that countries can increase the scope for productive public investment in infrastructure in a manner consistent with maintaining macroeconomic stability and debt sustainability. Once the results from these studies are in, IMF staff will make a recommendation to the Executive Board on when and how to relax constraints on borrowing to finance public investment, and whether to permanently modify the coverage of fiscal statistics used to define fiscal indicators and targets. ■

Richard Hemming is a Senior Advisor and Teresa Ter-Minassian is Director in the IMF's Fiscal Affairs Department.