Capital Budgeting

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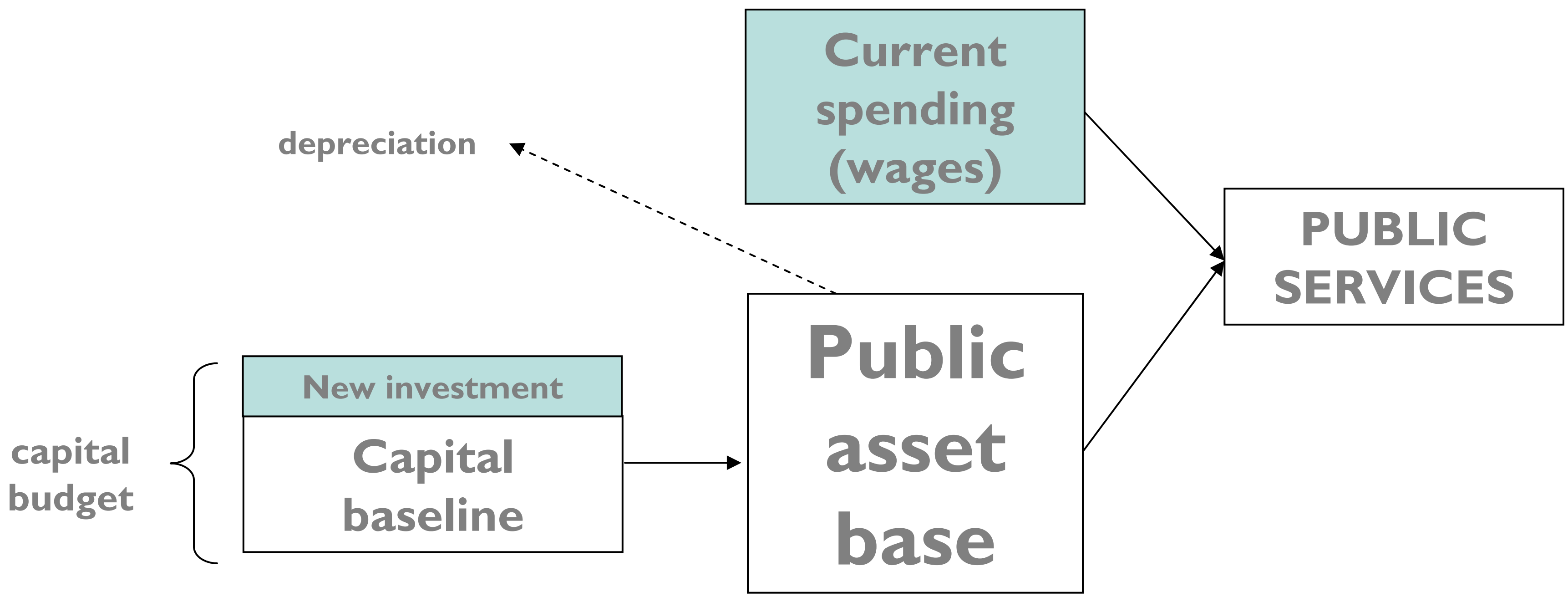
What we'll cover

- Why is capital different?
- Should we budget for capital differently?
- Modalities of budgeting for capital
- Getting value for money from capital spending
- Policy issues to consider

What is investment?

- Spending that improves public services in the long-term: expects a long term return, creates public assets
- In layman’s terms, spending on durable goods that will contribute to the provision of public services over a number of years
- E.g. Building Hospitals, buying IT systems
- Not e.g. training teachers, redundancy costs
  - Why not?

Where capital fits in?



- Conventionally, we think that recurrent spending plus capital spending delivers a service
- This is wrong
- Public asset base plus recurrent spending delivers service

Theoretical issues to consider

- Think of a continuum of spending to impact
  - If I hire a teacher, I get an output immediately
  - If I budget to build a school I get a school in say two years time
  - If I budget to build a power plant, I get power in seven years time
  - If I under-maintain an asset, I see a deterioration in public services in ten to fifteen years time
- This introduces an inherent bias against capital spending
  - Benefits not visible immediately
  - … or costs of not investing only visible in the long term
  - Tougher to cut recurrent spending
    - Easier to cut maintenance spending than fire teachers

Should you budget separately for capital?

- Case for
  - It counters the bias against capital spending
  - It allows government to ‘direct’ the increase in the capital base towards priorities
  - It allows for more robust cost-benefit analysis
- Case against
  - Returns to capital not always the same
  - Links between capital and the related recurrent costs are harder to secure
  - What about different policy options:
    - More police or close circuit TV cameras
    - More police or more vehicles
  - Surely these decisions cannot be taken centrally

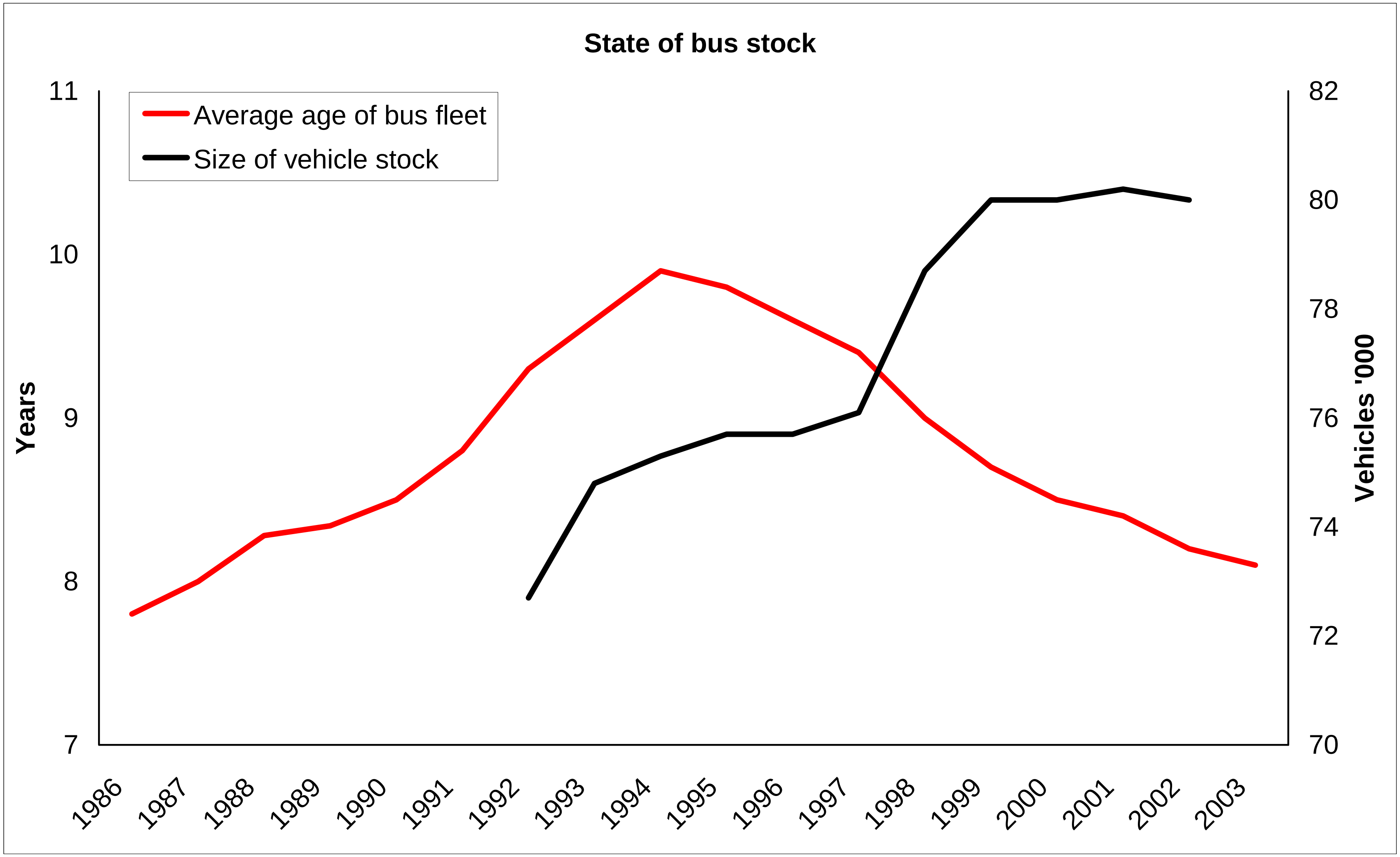
Modalities of capital budgeting

- Centralised
  - Treasury appraises all capital projects and decides which ones to spend on
  - Advantage: high benefit projects are favoured
  - Disadvantage: not easy to measure benefits and well organised departments capture too much resources
- Decentralised
  - Allocate money to for capital to police
  - They decide which police station to build
  - Advantage: closer alignment between allocations and priorities and between need and spend
  - Disadvantage: departments may do high profile – low benefit projects

Measures of performance

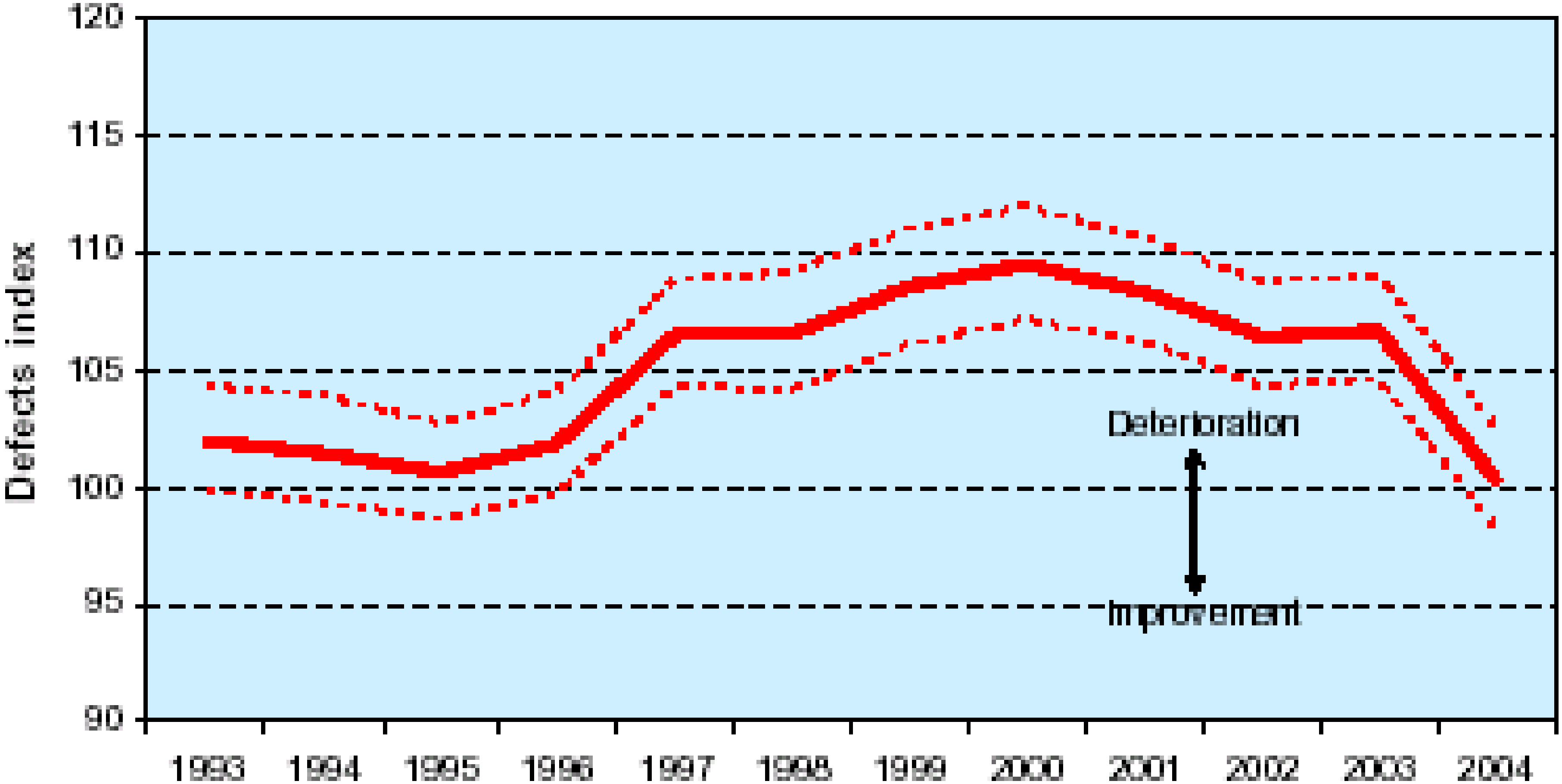
- People generally look at spending numbers
- Must shift focus to look at outputs
  - Houses built, new electricity connections, kms of roads built or resurfaced
- Also look at outcomes
  - Capacity constraints, congestion
- Most importantly, but not easy to do objectively
  - Focus on the state of the stock
- Tension between need to maintain infrastructure (which is often in richer areas) and build new capacity in poorer areas

It’s the state of the stock that matters



It’s the state of the stock that matters

(road defects index)



Capital budgeting in South Africa

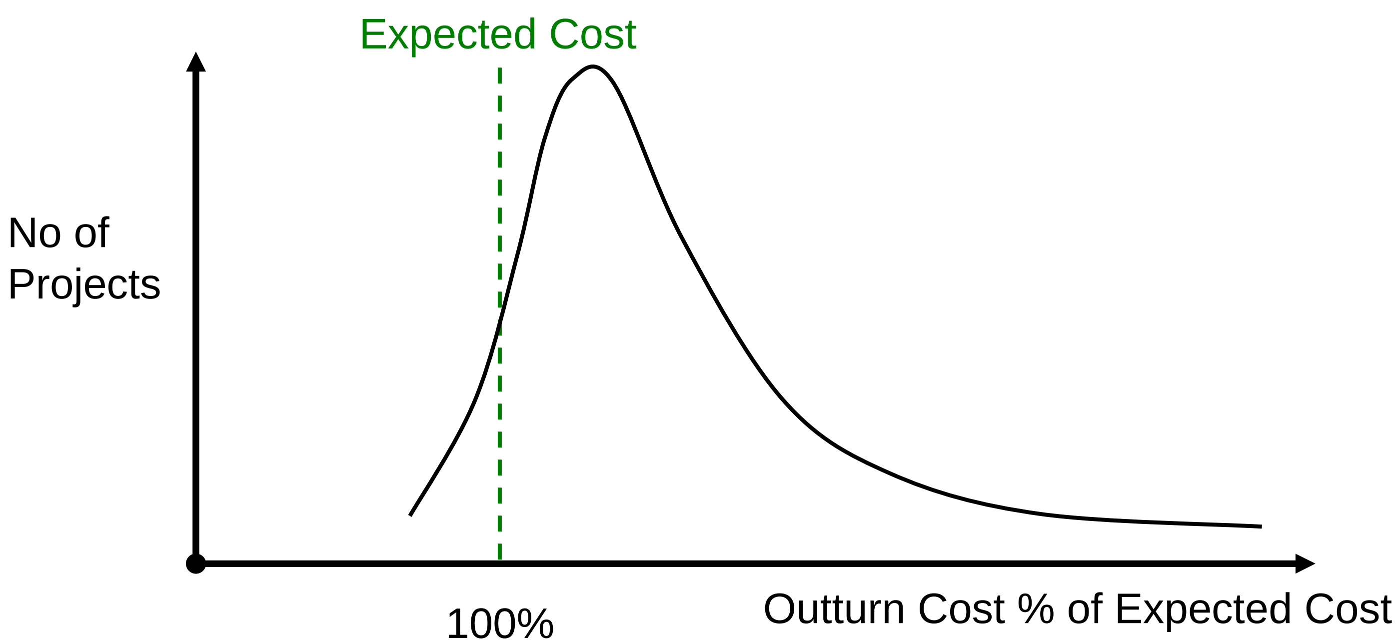
- We generally have a decentralised system
  - Police, education, health, roads agency receive a budget
  - They decide which project to implement
  - Treasury tries to raise the bar on cost benefit analysis
- For large projects over R1.2 billion, treasury does evaluation and allocates money directly
- 95% of capital spending is done through conventional budgeting
- 5% through PPPs

How does PPP or PFI work?

- Government specifies exactly what we want
- Private sector raises capital, builds and then maintains
- Government pays a unitary charge consisting of capital portion and maintenance portion
- Key thing is to pass some risk onto the private sector
- Do they work?
  - If the specs are good and the department has the capacity to manage the contract, then we get value for money
  - If not, its often more costly

Optimism bias

- Departments under-budget for costs because they think that if they are honest with the costs, money will not be allocated
- Project overruns are a nightmare for spending control, yet they are endemic in the public sector



Examples of optimism bias

Green point stadium budget: R1.7 billion

Revised estimate: R3 billion

Freedom park budget: R400 million

Revised estimate: R1 billion

Automated fingerprint ID system

Budget: R700 million

Outturn: R2 billion

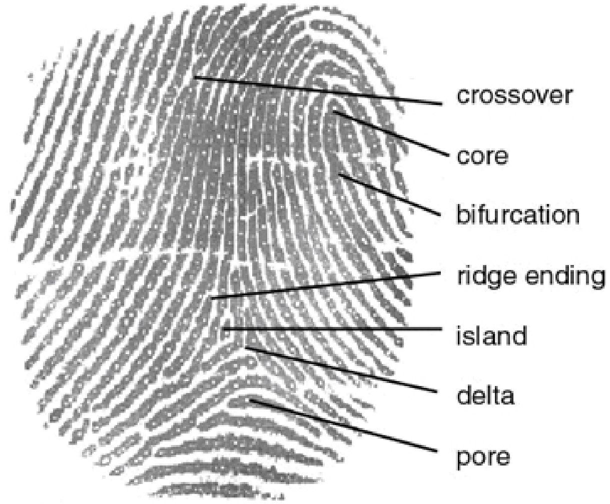
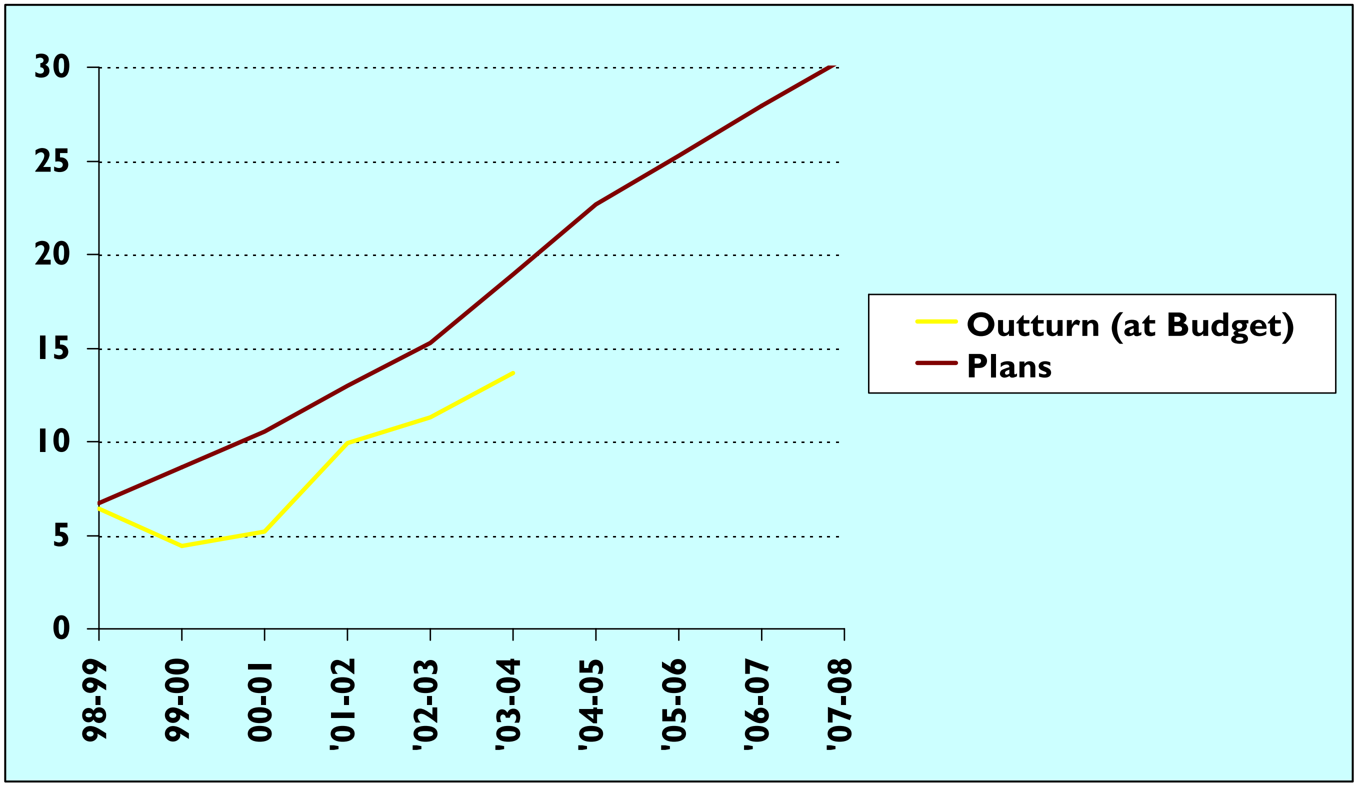


Figure 1

Under-spending on capital



- Why?
  - Failure to cascade 3 year budgeting
  - Longer lead times for complex procurements
  - No capacity and expertise to deliver

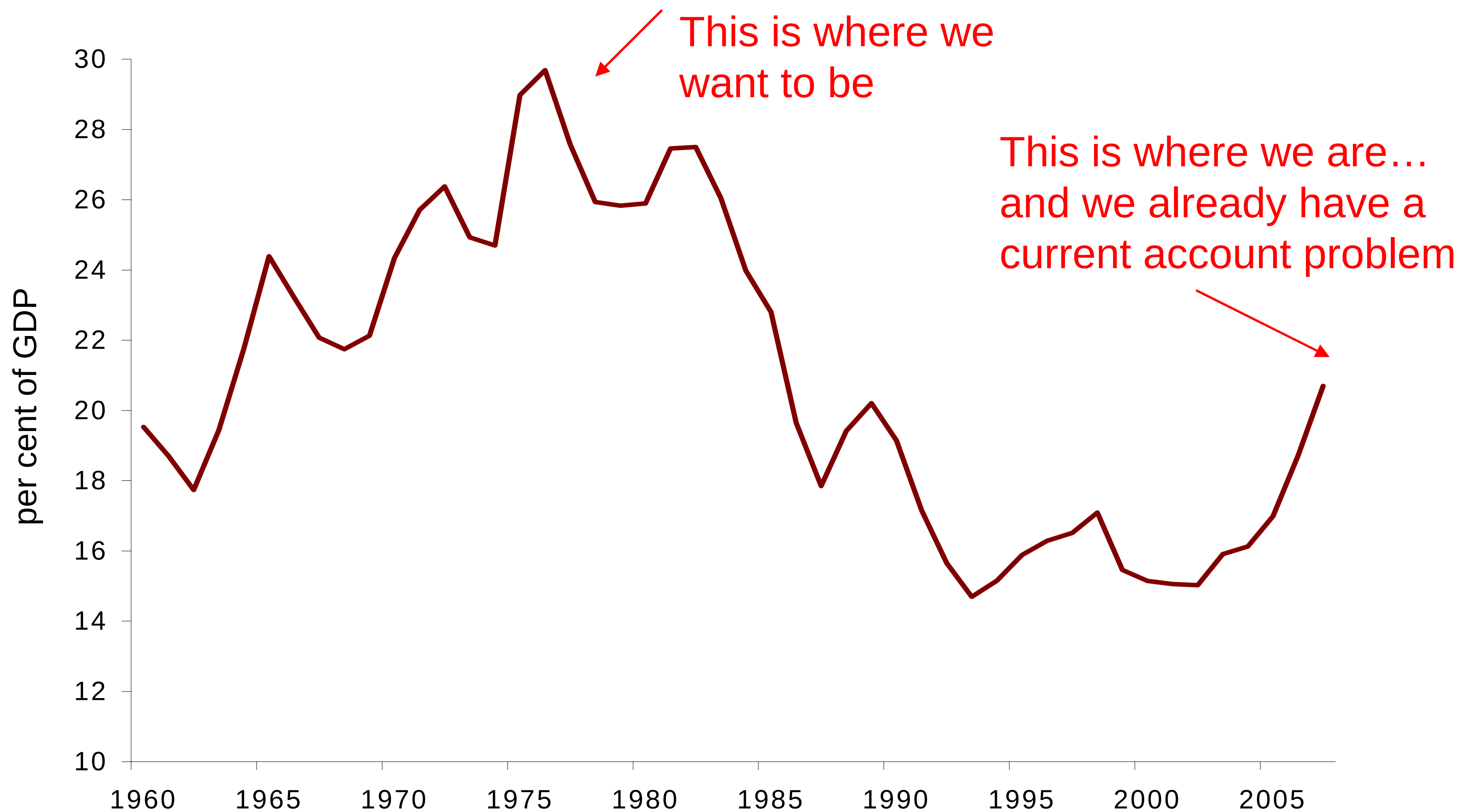
What might be happening?

- Why the underspending?
- Some ideas:
  - Failure to cascade 3 year budgeting
  - Longer lead times for complex procurements
  - No capacity and expertise to deliver

Infrastructure bunching

- Typical scenario
  - Commodity prices rise, exchange rate appreciates, interest rates fall
  - Domestic demand increases
  - Higher domestic investment in non-tradables
    - E.g. telecomms, retail space, housing, banking
  - Construction boom
  - Prices rise due to capacity constraints
  - Imports rise, current account deficit widens
  - Interest rates rise
  - Boom turns to bust
- It is critical for the public sector to avoid ‘bunching’
- Rather save and smooth infrastructure spending growth

Gross fixed capital formation



- **Strong investment will increase domestic capacity and raise potential growth in the economy, but pressures on inflation and current account must be managed**

Any questions?