



Fiscal decentralisation and public investment

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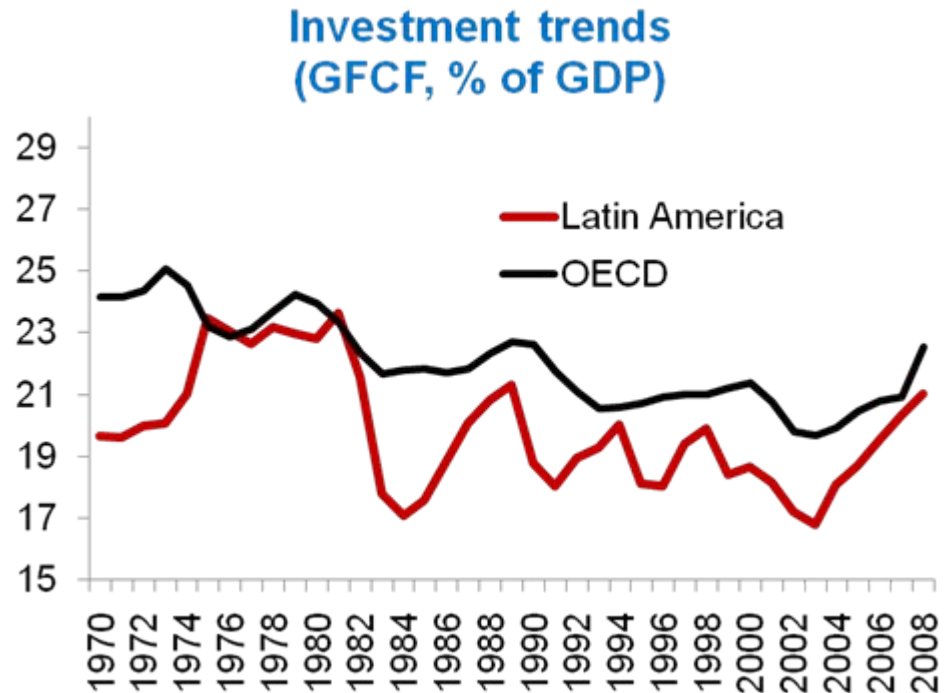
Santiago de Chile,
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A talk in three parts

- **Basic indicators: How does Lat Am compare with OECD countries?**
 - Investment ratios and output indicators, what holds back private participation
- **The role of sub-national governments**
 - Intergovernmental relations, financing options, empirical evidence, effects of the global financial crisis
- **Main policy challenges**
 - How to better equip sub-national governments to narrow (hopefully close) the region's infrastructure gap

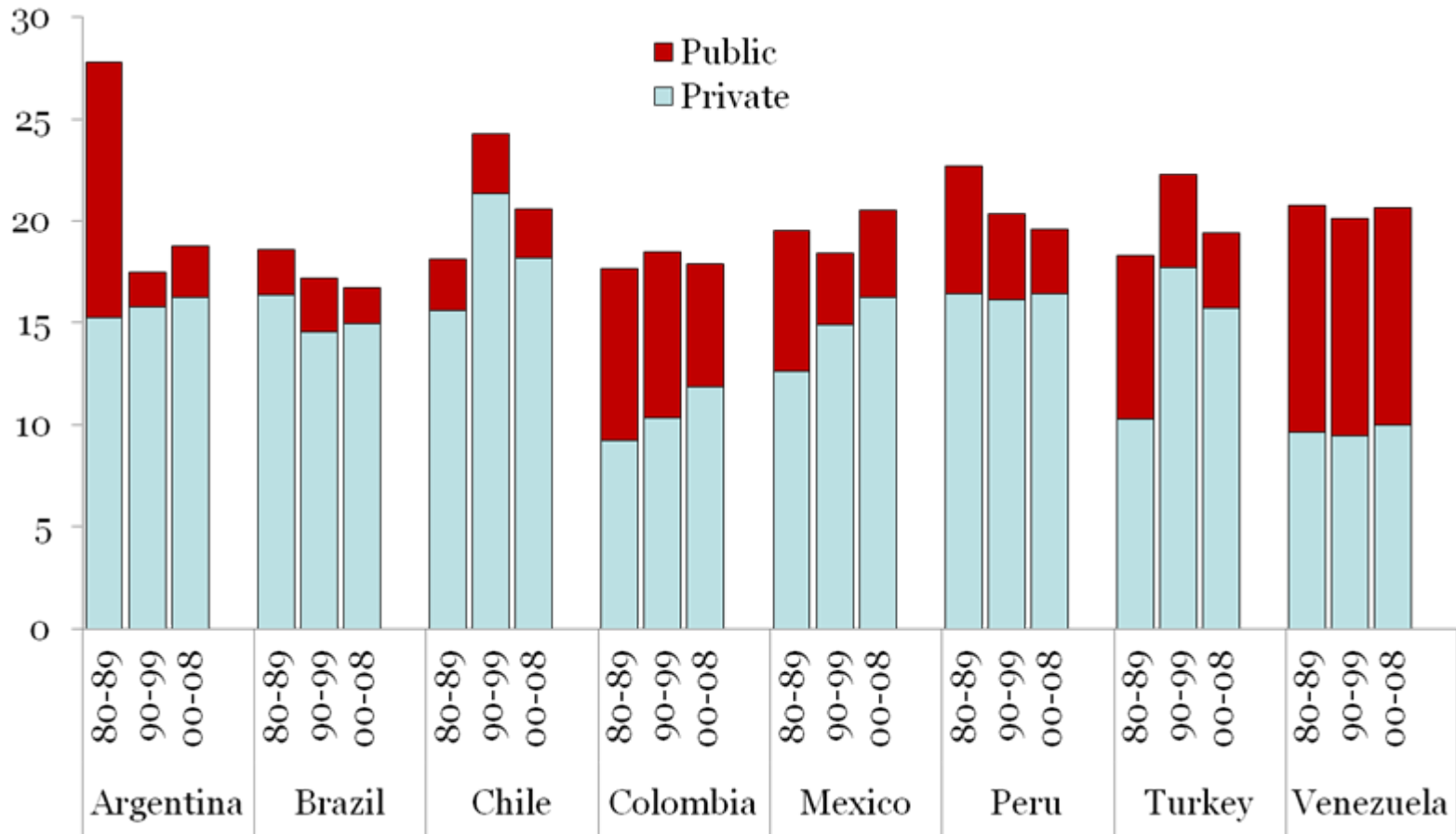
Investment inputs: International comparisons

- Lat Am invests relatively little by international comparison
 - Falling GDP share until 2002 (macro turmoil, fiscal crises, etc.)
- Government investment spending
 - About 4.4% of GDP in Latin America in 2006 based on national accounts (Lucioni, 2009)
 - How much on infrastructure alone?



Source: WDI.

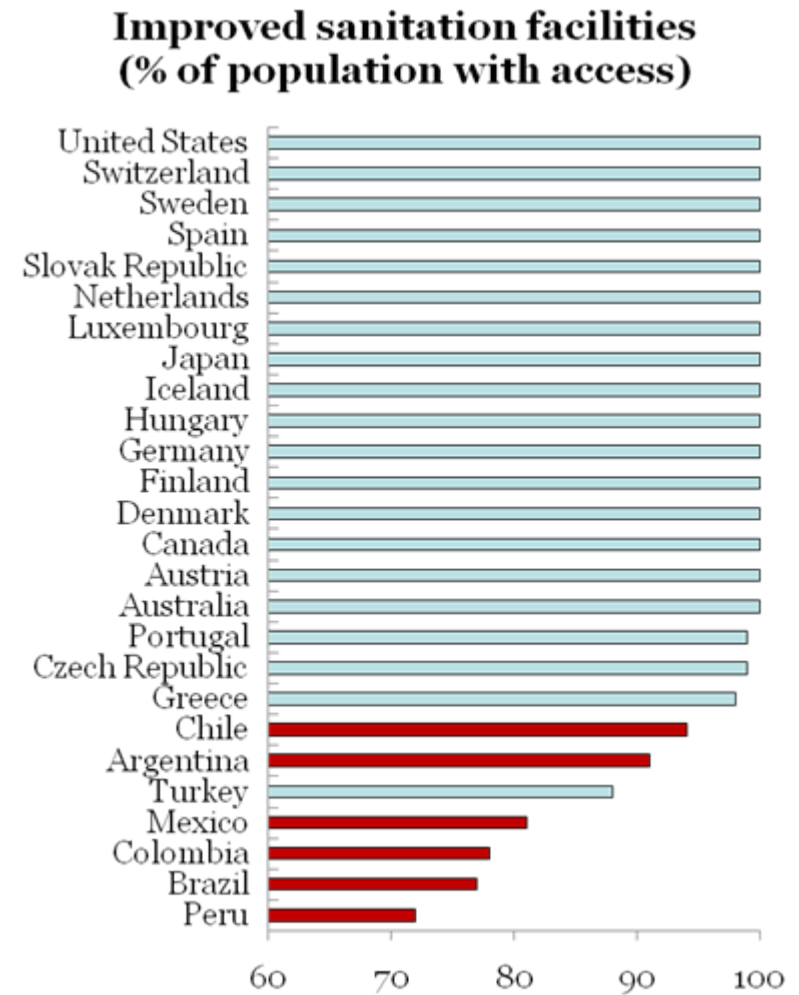
Investment trends (GFCF, % of GDP)



Source: WEO.

Investment outputs

- Outputs correlate strongly with income level across countries
- There are important deficiencies in Lat Am in areas that have a bearing on social development
 - Water and sanitation
- Infrastructure deficiencies are worse for vulnerable social groups
 - Spending is often tilted to the non-poor

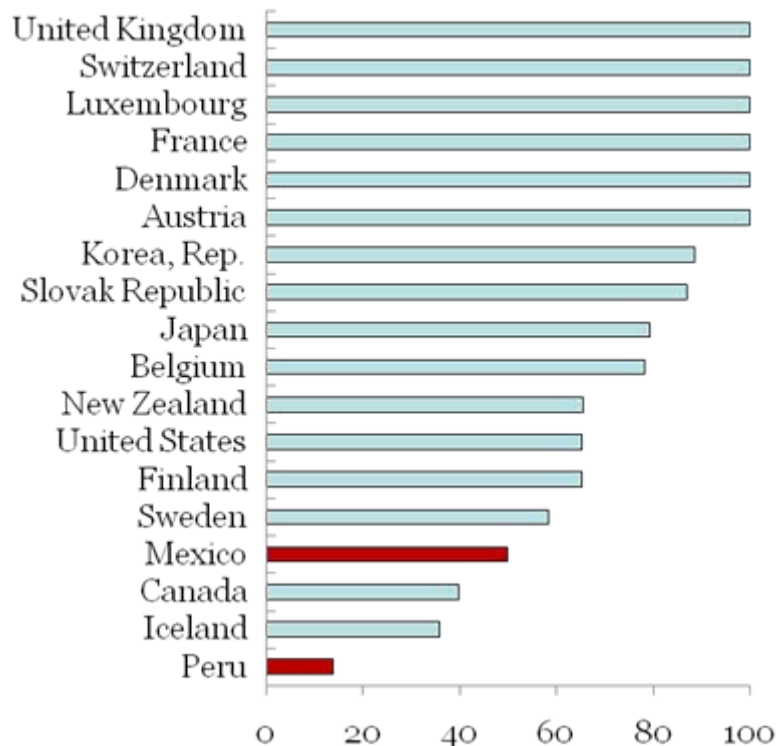


Source: WDI.

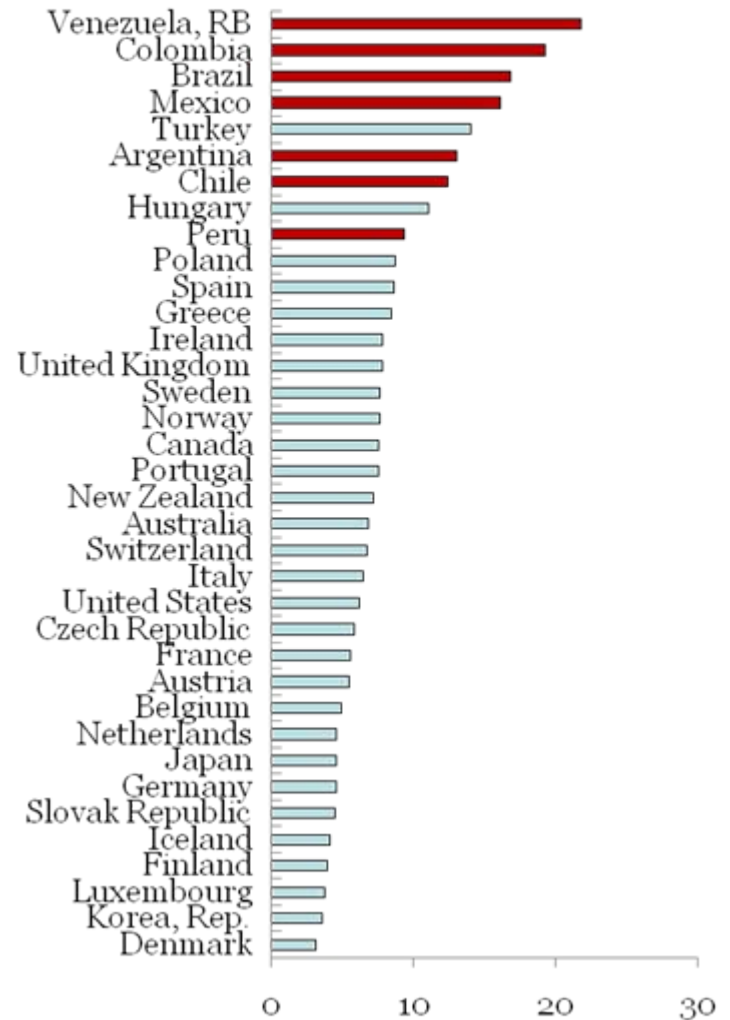
Implications

- Poor infrastructure affects the business environment
 - Transport, telecoms, energy

Paved roads (% of total)



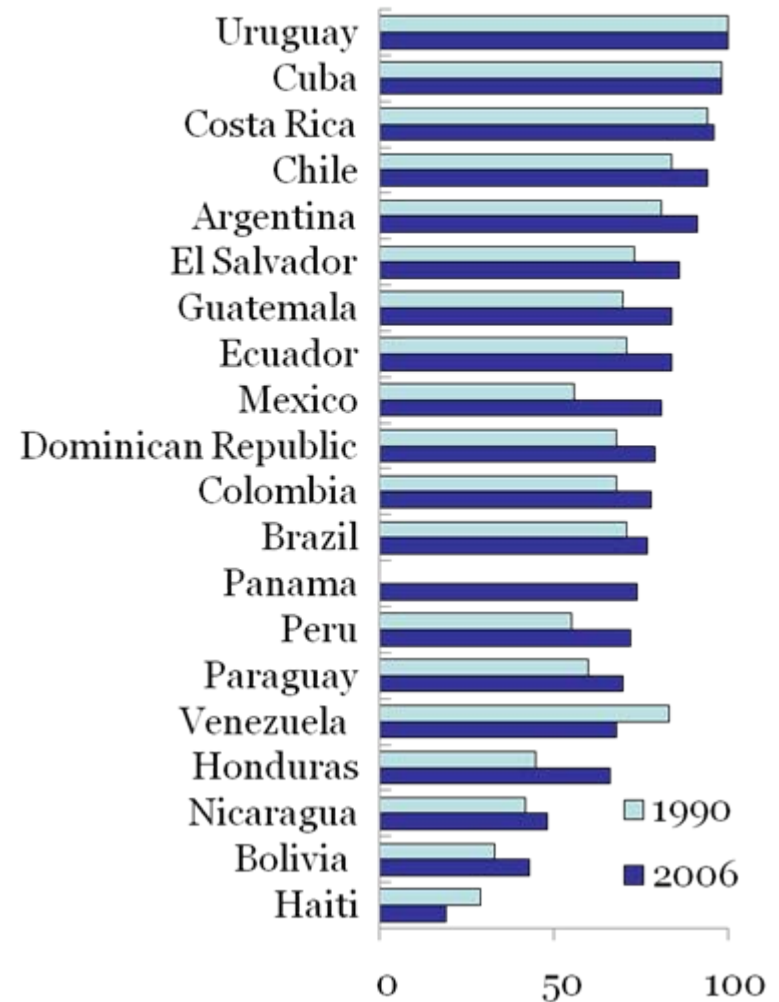
Electric power transmission and distribution losses (% of output)



Source: WDI.

- Investment deficiencies may compromise longer-term development targets, including attainment of the MDGs
 - Incentive to monitor progress
- Effect on long-term growth is difficult to establish
 - Empirical evidence is inconclusive, but growing agreement on causality via efficiency and reduction of production costs (Estache and Fay, 2007)
 - Unit roots and causality: GDP growth → infrastructure

MDG: Population with access to improved sanitation (%)

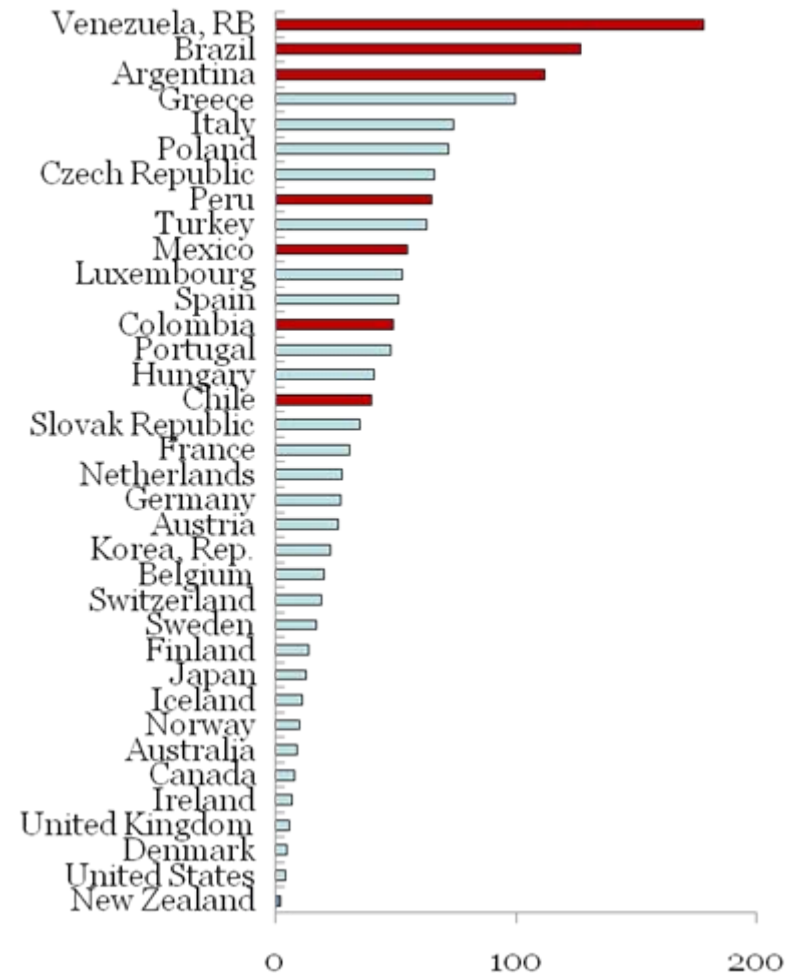


Source: CEPAL.

The regulatory environment

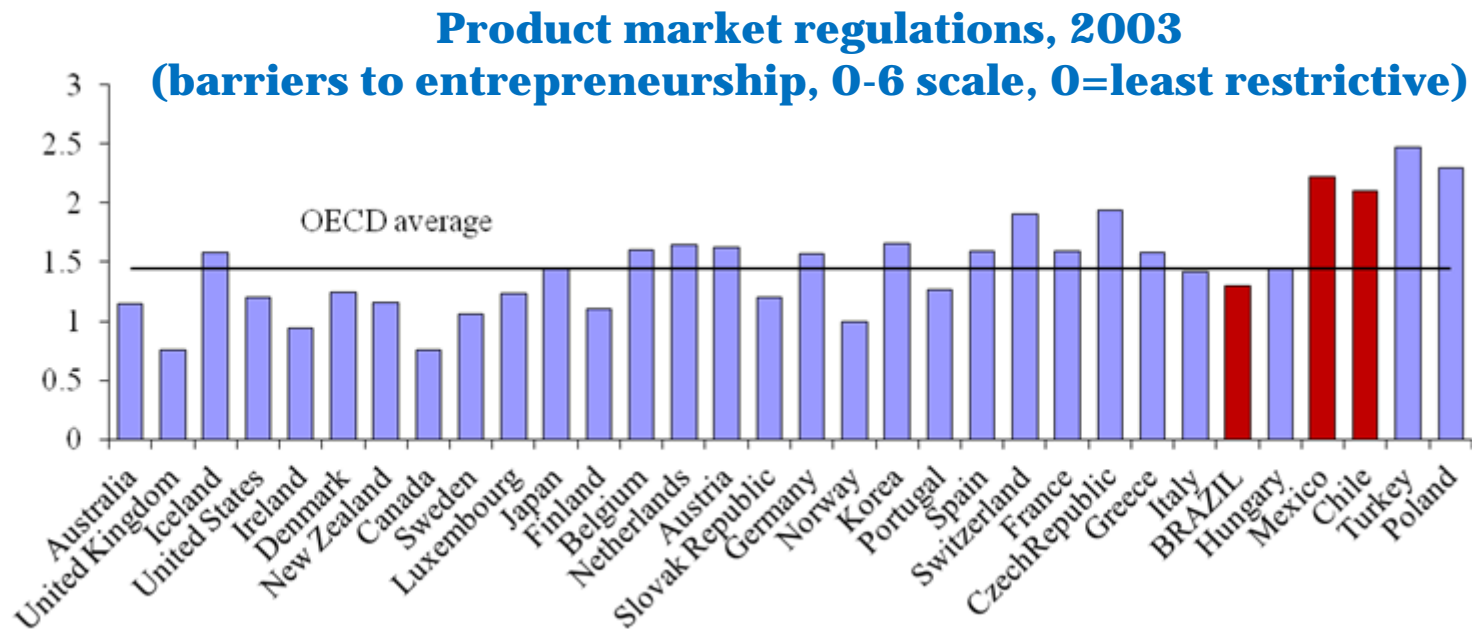
- Private investment is held back by burdensome product market regulations
 - Often under the purview of sub-national governments
- Regulatory uncertainty also plays a role
 - Grey areas (commonplace), overlapping or undefined functions across levels of administration (i.e., water in Brazil)

Ease of doing business index
(1=most business-friendly)



Source: WDI.

- Barriers to entrepreneurship are particularly burdensome in Latin America
 - Regulatory and administrative opacity, administrative burdens on start-ups
- Property rights and security of contracts



Source: OECD.

The role of sub-national governments

- Sub-national governments may implement investment programmes on behalf of higher levels of administration
 - Disincentives for provision arising from externalities and economies of scale
 - Agency problems and design of intergovernmental transfer system to internalise externalities and reduce unit delivery costs
 - Experience of inter-jurisdictional ventures are more numerous in service delivery and O&M (hospital administration in OECD and Brazil), water/sanitation in France)

- But, if sub-national governments have their own investment programmes and financial autonomy, then:
 - How to finance provision out of own revenue or unconditional transfers?
 - Direct investment or alternative modalities: PPPs (risk sharing), concessions (subsidy level), fiscal incentives (Jiménez and Podestá, 2009)
 - Untapped revenue sources: underutilised tax bases (property tax), user charges for infrastructure services (distributional/political economy considerations)
 - Scope for reprioritisation of spending: “hidden” fiscal space?
 - Indebtedness (domestic and/or foreign): consistency with macro fiscal stability and budget rules, where applicable
 - How to deal with administrative/capacity constraints?
 - Deficiencies are most common in feasibility studies, project appraisal, project management, procurement, environmental licensing

Public spending on investment across levels of government

(acquisition of fixed capital, accrual, % of GDP, avg. since 1990s)

	General		Central		State		Local	
	Invest	Total	Invest	Total	Invest	Total	Invest	Total
	outlays	outlays	outlays	outlays	outlays	outlays	outlays	outlays
Argentina	1.3	29.6	0.2	19.5	0.8	11.0	0.3	2.4
Chile	1.4	20.5	1.2	20.5	0.2	2.6
Colombia	1.9	35.9	0.6	33.6	0.4	4.5	0.9	6.1
Mexico¹	0.5	15.9	..	7.0	..	1.4
Peru¹	2.4	19.0	1.2	18.3	0.4	3.2	0.8	2.3
Venezuela¹	1.7	25.7
Italy	0.6	47.8	-0.2	39.0	0.8	15.0
Japan	1.1	37.8
Spain	1.9	38.6	0.4	27.3	0.8	13.6	0.7	6.1
France	0.7	52.6	0.1	45.5	0.6	10.4
United Kingdom	0.5	42.0	0.0	38.9	0.5	12.1
Australia	0.6	34.5	0.1	25.3	0.4	13.9	0.2	2.3
Germany	-0.1	46.5	0.0	30.9	0.0	13.1	-0.1	7.2
Switzerland¹	2.2	37.4	0.1	20.1	1.1	14.6	1.0	9.6
United States	1.2	36.3	0.1	21.0
Canada¹	2.3	40.7	0.3	18.7	1.0	21.4	1.0	7.4

1 = cash. Source: GFS.

Some empirical evidence

- Limited theoretical guidance on the link between decentralisation and public investment (tax competition and composition of spending)
- Higher spending on infrastructure could be due to rationing under centralism or higher delivery costs due to loss in economies of scale?
 - Fiscal decentralisation boosts public investment (notably infrastructure) in Europe to the detriment of less productive investment (i.e., recreational facilities) (Kappeler and Vålilä, 2008)
 - Reallocation of spending away from investment towards social development in Bolivia and Colombia (Faguet, 2004)
 - Greater sensitivity of investment in roads and human capital to local needs after decentralisation in Spain (Esteller and Solé, 2005)
- Governance (link with corruption)? Inconclusive evidence
- Effect on private sector involvement? Positive according to Ghosh Banerjee (2006).

A word on the financial crisis and sub-national financing

- Responses to the crisis have been neutral or counter-cyclical in Latin America
 - Counter-cyclical activism in many places: Chile (2.8% of GDP), Brazil (0.6% of GDP) (see CAPAL and IMF)
 - How sensitive are sub-national finances to the business cycle?
 - Sensitivity is low even for the central government in the region. Brazil (0.35) and OECD average (0.45)
 - What are the magnitudes of the multipliers associated with public investment?
 - For OECD: working assumption of 1 for spending (higher for capital spending) and 0.5 for revenue (both may have fallen with the crisis)
 - Problems of implementation of investment programmes included in fiscal packages

- OECD experience: A few points of interest
 - Public investment hikes account for most of the spending programmes to be implemented during 2008-10 in Czech Republic, Finland, Germany, Netherlands, Poland and United Kingdom (OECD, 2009a)
 - Investment programmes financed predominantly through conditional grants to sub-national jurisdictions
 - Credit crunch for sub-national governments that have access to capital markets (tighter supply, risk aversion, costlier borrowing)
 - Turmoil in the relevant market segment (*Kommunalkredit Austria AG, Dexia*)
 - Exposure of local governments to problematic assets (e.g., United Kingdom and Norway to Iceland banking crisis)
 - Post-crisis retrenchment and impact on sub-national finances: the sub-national role in exit strategies

Key policy challenges

- **How efficient is public investment in Latin America?**
 - Most empirical literature focuses on social spending (health care and education) and on consolidated spending. Only few studies focus on sub-national level (de Mello and Pisu, 2009, for Brazil)
 - Data constraints on both inputs and outputs
- **How much investment is needed to close Latin America's infrastructure gap?**
 - Fay and Yepes (2003) estimate needs at 3.1% of GDP during 2005-15 for upper-middle income countries (incl. 1.4% of GDP in maintenance)

- What are the longer-term trends shaping demands for infrastructure?
 - Demographic developments, increasing constraints on public finances (maintenance, upgrading and rehabilitation), environmental factors, technological progress (OECD, 2007)
- How to create fiscal space to boost public investment and preserve public investment in times of fiscal duress?
 - Inclusion of public enterprises in fiscal targets (criteria for exclusion), PPP financing (risk sharing and accounting/reporting standards), pros and cons highlighted in IMF (2004)
 - Embedding investment programmes in medium-term expenditure frameworks (budget institutions and public financial management systems)

- What's the role of public financial institutions in supporting/financing investment?
 - Financial depth and market failure (long maturities, high sunk costs), market creation vs. destruction
- How to strengthen the regulatory environment to foster private investment/involvement in investment programmes?
 - Regulatory regime, agencies and instances for conflict resolution, “business models”
 - How much support through fiscal incentives?
 - *OECD Principles for Private Sector Participation in Infrastructure, Sectoral Checklists*

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Thank you!