



Public sector finance for investment in infrastructure – some recent developments

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1. Introduction

This note looks at two recent developments which show a revival of the role of the public sector and public finance for investment in infrastructure and other public services: Brazil's 4-year plan for growth, known as the PAC; and the recommendations of the World Bank's review of public expenditure in Indonesia.

It also discusses the political pressures placed on the IMF and World Bank by a number of developing countries, and the recent papers from international organisations which show a new interest in public financing of public services.

2. Brazil

In January 2007 Brazil announced a new 4-year programme for economic growth, the "Programa de Aceleração do Crescimento"(PAC), based on investment of USD\$236 billion (504 billion reais) in infrastructure, especially in roads and electricity, but also water, sanitation and housing.¹

This is largely financed through the public sector, and is expected to stimulate economic activity through subsequent investment by the private sector: "Extra spending has been earmarked for roads and electricity generation, drivers of economic growth which, it says, will bring extra private investment in their wake. Private-sector investment will also be stimulated by tax breaks for construction..."²

The programme is an explicit attempt to correct the under-investment in the last decade: "In recent years, with the government desperate to stabilise its accounts in order to control its debt burden, public investment has declined markedly.....capital investment has totalled less than 3 per cent of GDP, well below the commitments being made by more rapidly growing countries in Asia."³

It is also seen as a way of reducing regional and social inequalities: "development of infrastructure as a crucial instrument for reducing regional imbalances...We are working to reduce social imbalances in Brazil".

The financing mechanisms include:

- Direct funding from taxation (about 13% of the total)
- Increased investment by state owned companies, including Eletrobras, the state electricity utility
- Use of state pension and social welfare funds to invest in infrastructure
- strengthening the role of the national development bank BNDES, e.g. by extending the maximum period of its loans from 14 to 20 years, and increasing the percentage of a project that can be financed by the BNDES to 80 per cent, from 60 per cent previously

Table 1. Financing of PAC 2007-2011

	TOTAL investment		Federal Budget		Government Enterprises and Other Sources	
	US\$ billion	as % of GDP	US\$ billion	as % of GDP	US\$ billion	as % of GDP
Logistic (transport and roads)	27.3	0.58%	15.4	0.33%	11.8	0.25%
Energy*	128.6	2.71%			128.6	2.71%
Social and Urban Infrastructure	79.9	1.69%	16.3	0.34%	63.6	1.34%
Total	235.8	4.97%	31.7	0.67%	204.1	4.30%

*Note: Nearly two-thirds of the energy programme relates to oil and gas development.

The financing of investment in electricity falls partly under social and urban infrastructure and partly under energy. The "Luz para Todos" (Light for All) policy for connecting more people to electricity supply falls under the social and urban infrastructure heading of the overall PAC. It is overwhelmingly financed from federal and regional state funds (as is the similar South African programme of rural electrification).⁴ Brazil

has already connected an extra five million people between 2003 and 2006, and intends to reach another 5.3 million people from 2007 to 2010 – a rate of 1.3 million new connections per year.

About 1/3 of the energy programme consists of USD \$37 billion investment in electricity, with USD \$31 bn to be invested in generation and USD \$6 bn in transmission.⁵ All of this is to be financed by state enterprises – notably Eletrobras – or other sources. Eletrobras plans to invest USD \$2.3 billion in 2007 alone - \$1.3 billion in generation and \$1.0 billion in transmission - a 75% increase over its investment in 2006.⁶ Other sources include private schemes: for example, Cess, a Brazilian subsidiary of Suez, is constructing a 241 MW greenfield hydro power plant in São Salvador, financed by a USD \$274.5 million dollars loan from BNDES and secured by 30 year power purchase agreements (PPAs) with distributors. The PPAs are reported to have been fixed not by negotiation but “at the Brazilian power auctions in Brazil on October 10th 2006”, so implicitly in competition with other sources of power.⁷ Eletrobras holds about 40% of the generation capacity of Brazil.

Table 2. Financing electricity investment under the PAC in Brazil 2007-2011

	Luz para Todos (distribution)	Transmission	Generation
	USD \$ Billion	USD \$ Billion	USD \$ Billion
Federal government	3.0		
Regional state	0.6		
Government Enterprises and Other	0.5	6	31
TOTAL	4.1		

Source: Latin America News Digest January 23, 2007

The sanitation investment programme, which aims for a great increase in the proportions of households connected to sewerage systems, is half financed by federal and regional state finance, and half by loan finance from the savings funds and pension funds.

Table 3. Financing sanitation investment in Brazil 2007-2011

	USD \$ Billion
Federal government	5.6
Regional state and municipal budgets and operating surpluses	3.7
Workers' savings fund (FGTS) & federal workers protection fund (FAT)	9.4
TOTAL	18.7

Source: Business News Americas April 27, 2007⁸

The government is also providing tax relief for small businesses, for private investment in construction, and for personal income tax, to stimulate private sector activity. Existing concessions, especially in roads, are being reviewed to reduce the rate of return guaranteed to the private companies: “They are being reviewed because of the rate of return on capital [guaranteed to concession holders]. The values that are in the formula reflect a different Brazil with different interest rates. As interest rates are falling it isn't appropriate to have a rate of return of 26.6 per cent. We are reviewing this as we think it is a bit excessive.”⁹

The programme involves new policies on public spending and taxation.

Firstly, investment in infrastructure is being excluded from the government's own targets for public borrowing: “we are doing something a little similar to what was done in the UK, if I'm not wrong, by Gordon Brown, on the treatment of investment and current expenditure. We consider that only specific investments, to be approved by the president of the republic, can be deducted from the primary budget surplus [before debt repayments]. No current expenditure can be discounted in this way.”¹⁰

Secondly, public spending is being diverted away from debt repayments towards infrastructure finance: “The government plans to divert the equivalent of up to 0.5 per cent of gross domestic product away from debt repayment and into infrastructure investment. It argues that even with a reduction in its primary budget

surplus it will be able to continue to reduce the ratio of net public debt to GDP, currently at about 50 per cent.”¹¹

The government presents the policy as justified by and consistent with orthodox criteria of sound public finance. The finance minister emphasised that Brazil was able to do this because of the favourable conditions of a trade surplus, low inflation rate, high budget surplus, and a declining public debt/GDP ratio: “The fiscal conditions allow an increase in public investment without compromising macroeconomic stability and the reduction in the ratio of net public debt to GDP.”¹²

Table 4. Brazil: Fiscal deficit/surplus, public debt, and inflation 2002-2006

Factor	Ratio used	2002	2003	2004	2005	2006
Fiscal deficit/surplus	Government primary surplus as % of GDP	+3.89	+4.25	+4.59	+4.83	+4.37
Public debt	Public sector net debt as % of GDP	55.5	57.2	51.7	51.5	49.5
Inflation	Consumer price index annual % change	12.5	9.3	7.6	5.7	3.1
External debt and trade	Net external debt as % of annual exports	2.7	2.1	1.4	0.9	0.6

Source: The Brazilian Economy in 2007 Guido Mantega, Finance Minister London, January – 2007

<http://www.fazenda.gov.br/portugues/documentos/2006/p290107.pdf>

The PAC includes other policy commitments consistent with these orthodoxies:

- Continued reduction of public debt as a percentage of GDP, from 48.3% in 2007 to 39.7% in 2011
- A commitment to keep social security expenditures stable as a percentage of GDP (at 8.1%)
- A commitment to reduce expenditure on federal government personnel from 5.3% of GDP in 2007 to 4.7% of GDP in 2011 – the lowest figure since before 1997.

3. World Bank on Indonesia

In January 2007 the World Bank published a report on public expenditure in Indonesia: “Spending for Development: Making the Most of Indonesia’s New Opportunities. Indonesia Public Expenditure Review 2007” <http://siteresources.worldbank.org/INTINDONESIA/Resources/Publication/280016-1168483675167/PERReport.pdf>

The review contains recommendations for increased public spending on services and infrastructure which are unusual compared with most WB reports in recent years. Much of the report repeats familiar WB themes – the need to create a climate friendly to investors, the desirability of ending subsidies, the need for full cost recovery, the emphasis on private healthcare, the need for fiscal discipline etc. – but amongst all this are some recommendations for increased public spending both on infrastructure and social services. These are justified by reference to Indonesia’s success at reducing inflation, public borrowing and public debt, and the consequent scope for increasing spending (through the “fiscal space” created by these policies)

The report describes the potential for increased spending in terms of a ‘great opportunity’:

“Indonesia’s post-crisis period is over: the country now has enough financial resources to address its development needs. Prudent macroeconomic policies, particularly the extremely low budget deficits, were instrumental in this recovery. Now is the time to build on the achievements of the past few years and to spend Indonesia’s financial resources effectively and efficiently to improve the quality of education, expand healthcare, close critical infrastructure gaps, in order to reduce poverty and build a competitive economy. (p.i)

..... This is a moment of great opportunity. With a stable macroeconomic environment and sufficient fiscal resources, the Indonesian government can further reduce poverty and improve quality and access to basic services. (p.viii)

The report identifies a particular problem with infrastructure investment, which has fallen far too low. The key cause identified is the failure of the private sector to invest:

“Annual infrastructure investment is around 3.4 percent of GDP.... The level of infrastructure investment is low by regional standards, especially compared with countries such as China and Vietnam, which invest around 10 percent of GDP in infrastructure, or less-developed countries such

as Laos and Mongolia, which invest 4 to 7 percent of GDP, respectively.Expenditure in infrastructure has declined mainly due to the continuous decline of private investment....” (p.79)

So the public sector is expected to take the lead:

“....Large increases in public investment are needed to make up for low public investment in the past five years and to stimulate private investment. Overall investment levels have still not recovered to pre-crisis levels. The recovery of public investment to 6.5 percent will increase total investment to 23 percent of GDP in 2006 public investment has been low for many years and needs to catch up. ” (pp. 2, 6, and 79)

The report recommends an increase in investment on the same scale as Brazil’s PAC (and argues that it is affordable for similar reasons):

“Scaling up infrastructure investment will require at least 2 percent of GDP, or US\$6 billion per year. While this would amount to a return to pre-crisis investment levels, it would still not make up for the ‘lost decade’ in infrastructure investments since then..... At the central level unutilized fiscal space is estimated at 1-1.5 percent of GDP for the period 2001-05”.

A WB strategy paper on electricity in Indonesia, “Energising the economy” published at the end of 2006, contains similar mixed messages.¹³ For example, it recognises that: “The public sector will maintain its key role in advancing the sector in the near future” - but still complains against the constitutional court ruling which annulled a 2002 law which provided for break-up and privatisation, supports reduction in subsidies and imposition of cost recovery pricing, and calls for a new law to encourage PPPs.

4. IMF and World Bank under pressure

The World Bank report on Indonesia is one symptom of changing pressures on the international financial institutions. Since the 1980s the IMF and the World Bank have tried to cut public spending and borrowing, and to introduce privatisation in infrastructure and public services, as a condition of loans to developing countries.

The impact of these policies of the IMF and the World Bank is now being weakened for two reasons :

- Firstly, a number of southern countries, including Brazil, have deliberately acted to reduce their dependence on loans from the IMF and the WB, and so can no longer be subject to conditions.
- Secondly, IMF and WB policies of cutting public spending and promoting privatisation have failed to deliver private investment (and have encountered strong resistance), and so there is greater pressure from donors, international institutions and NGOs to use the public sector and public finance to support donor commitments to the Millennium Development Goals (MDGs).¹⁴

4.1. Political initiatives by developing countries

Some countries in the south have deliberately paid off loans from the IMF and the World Bank in order to reduce their vulnerability to conditionalities. These include Asian as well as Latin American countries, as shown in the table below. There are similar moves to reduce dependency on the World Bank. In April 2007 Venezuela repaid all its loans from the World Bank, five years early,¹⁵ and in the same month Ecuador expelled the World Bank representative because the Bank had “suspended a 100-million-dollar loan for Ecuador in 2005 in retaliation for [president Correa’s] reform of the country’s oil sector”.¹⁶ A number of Latin American countries – Argentina, Venezuela, Bolivia, Brazil, Ecuador and possibly Paraguay - have agreed to create a ‘Bank of the South’, which is explicitly seen as an alternative to the World Bank and IMF in the context of south America.¹⁷ Other reactions against the policies of the IMF and WB include a decision by Kyrgyzstan to withdraw from the HIPC programme, as a result of public concerns that it “would allow foreign companies to gain control of the country’s energy sector”.¹⁸

The pressures on the IMF and WB have been increased by disagreement over whether the IMF should be given a new wider policy role, and pressures on the president of the WB, Paul Wolfowitz, to resign, over his

favouritism towards a WB employee with whom he has a relationship, and loss of confidence in his policies especially in relation to corruption.

Table 5. Countries which have accelerated final repayment of IMF loans

Country	Date of final repayment to IMF/pledge of non-renewal of relations
Thailand	August 2003
Brazil	December 2005
Argentina	
Bolivia	
Serbia	March 2007
Indonesia	May 2008
Uruguay	
Philippines	December 2006
Venezuela	1999
Possible further repayer:	
?Turkey	?November 2007

Source: Soren Ambrose "The decline (& fall?) of the IMF or, chronicle of an institutional death foretold" 02 April 2007
http://www.focusweb.org/index2.php?option=com_content&do_pdf=1&id=1172

4.2. Failure of private investment forces discussion of public sector investment

The failure of privatization to deliver investment in infrastructure has created problems for international agencies, as investment in public services is crucial to achieving many of the MDGs, but the public sector now has to be recognized as the vehicle for such investment. A series of reports from the World Bank have recognized the failure of privatization,¹⁹ and papers have been published by authors working for the World Bank, other development agencies, such as UNDP, and development NGOs, including Oxfam, on the need to recognize the central role of the public sector and public finance in development. These reports include:

- a World Bank policy paper in April 2006 reiterates the official line that government spending and borrowing needs to be limited for the sake of economic "stability", and that private sector investment is the best way for all investment, but reluctantly acknowledges that this "is often not forthcoming" and so "for a broad range of countries, public financing remains the principal means to provide public goods and services needed for growth and poverty reduction." A later WB research paper painstakingly re-discovered that public spending on investment and maintenance of infrastructure and services can increase productivity and growth in many ways, including the fact that roads make it easier for children to get to school, clean water makes people healthier, and that reliable electricity supplies enhance domestic and industrial activities.
 - World Bank, Development Committee, "Fiscal Policy for Growth & Development (FPGD): An Interim Report," April 23, 2006.
[http://siteresources.worldbank.org/DEVCOMMINT/Documentation/20890698/DC2006-0003\(E\)-FiscalPolicy.pdf](http://siteresources.worldbank.org/DEVCOMMINT/Documentation/20890698/DC2006-0003(E)-FiscalPolicy.pdf)
 - Pierre-Richard Agénor and Blanca Moreno-Dodson. Public Infrastructure and Growth: New Channels and Policy Implications. World Bank Policy Research Working Paper 4064, November 2006. http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2006/11/08/000016406_20061108161655/Rendered/PDF/wps4064.pdf
- a paper published by UNDP for the G-24 technical meeting in Singapore, September 2006, criticizes the WB paper for only allowing public investment to be justified where the benefits can be shown to reduce borrowing overall. It argues that there needs to be a new framework to assess the positive developmental impact of public expenditure on investment in services – not only in infrastructure, and not only in terms of fiscal restraint – and that the ideology and the practice of the IMF and the WB are obstacles to such a framework.

- Rathin Roy, Antoine Heuty, and Emmanuel Letouzé. “Fiscal Space for Public Investment: towards a Human Development Approach” September 2006
<http://www.g24.org/rroy0906.pdf>

There is no clear ‘institutional’ position emerging from the UNDP, however. While some authors, such as McKinley and Roy, are advancing powerful arguments for development through the public sector, the recent 600-page publication from the UNDP on “The New Public Finance”, edited by Inge Kaul and Pedro Conceição,²⁰ shows an unquestioning devotion to neo-liberalism, including the necessity for relying on private sector finance and for continuing to impose conditionalities on developing countries. The book’s title is thus extremely misleading.

- a series of reports from Oxfam call for a recognition of the key role of public services in development, emphasise the need to build public sector systems for delivering services, and the importance of establishing aid and public finance mechanisms which enable a country to pay long-term salaries for the workers needed to maintain and develop services:
 - “In the Public Interest: health, education, and water and sanitation for all” September 2006
http://www.oxfam.org/en/policy/briefingpapers/bp_public_interest
 - “Serve the Essentials: What Governments and Donors must do to improve South Asia's Essential Services” October 2006 http://www.oxfam.org/en/policy/briefingnotes/bn061023_essential_services
 - “Paying for People: Financing the skilled workers needed to deliver health and education services for all” April 2007 http://www.oxfam.org/en/policy/briefingnotes/bn061023_essential_services

5. Notes

¹ Government launches PAC economic growth programme 25 January 2007

www.brazil.org.uk/newsandmedia/pressreleases_files/archive-10.html

² Jonathan Wheatley and Richard Lapper: Left turn ahead? How flaws in Lula's plan could condemn Brazil to lag behind its peers. Financial Times 21 February 2007

³ Jonathan Wheatley and Richard Lapper: Left turn ahead? How flaws in Lula's plan could condemn Brazil to lag behind its peers. Financial Times 21 February 2007

⁴ See D. Hall “Electrifying Africa” January 2007 PSIRU <http://www.psiru.org/reports/2007-01-E-Africa.doc>

⁵ Gazeta Mercantil (Brazil) January 25, 2007: Após 2010, infra-estrutura energética terá mais R\$ 189 bilhões; Infra-estrutura energética terá mais R\$ 189 bi após 2010

⁶ Latin America News Digest April 5, 2007: Brazil Eletrobras To Invest \$2.313 Bln 2007

⁷ NoticiasFinancieras (Latin America) March 23, 2007: French Suez signs USD274.5 million financing contract for hydro plant in Brazil

⁸ Business News Americas April 27, 2007 Cities ministry pre-selects 669 sanitation projects for PAC funds

⁹ Jonathan Wheatley: Interview: Dilma Rousseff, chief of staff to Brazil's president Financial Times 22 February 2007

¹⁰ Jonathan Wheatley: Interview: Dilma Rousseff, chief of staff to Brazil's president Financial Times 22 February 2007

¹¹ Jonathan Wheatley and Richard Lapper: Left turn ahead? How flaws in Lula's plan could condemn Brazil to lag behind its peers. Financial Times 21 February 2007

¹² “The Brazilian Economy in 2007” Guido Mantega, Finance Minister. London, January – 2007

<http://www.fazenda.gov.br/portugues/documentos/2006/p290107.pdf>

¹³ World Bank “Energising the Economy” December 2006

¹⁴ This section has greatly benefited from the invaluable information services of the ITUC provided by Peter Bakvis and Molly McCoy, and from the article by Nancy Alexander “The elusive quest for ‘fiscal space’: the World Bank, the IMF and the UNDP” 2nd April 2007 published by the Bretton Woods Project

<http://www.brettonwoodsproject.org/art.shtml?x=552326>

¹⁵ AFX International Focus April 14, 2007: Venezuela pays off multilateral loans

¹⁶ Agence France Presse April 27, 2007: Ecuador expels World Bank representative

¹⁷ Global Insight April 16, 2007 Brazil Keen to Join Venezuela-led Regional Bank Plan

¹⁸ Dow Jones 20 February 2007 Kyrgyz Govt Votes To Quit HIPC Debt Relief Program

¹⁹ For a review of some of these reports see D. Hall “Electrifying Africa” January 2007 PSIRU

<http://www.psiru.org/reports/2007-01-E-Africa.doc> and D. Hall and E.Lobina “ water as a public service” January 2007

PSIRU <http://www.psiru.org/reports/2007-01-W-waaps.pdf>

²⁰ The New Public Finance - Responding to Global Challenges. Inge Kaul and Pedro Conceição (eds.)

Oxford University Press , 688 pages Feb 2006.