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GOVERNMENT INVESTMENT IN THE FRAMEWORK OF ECONOMIC STRATEGY

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I. INTRODUCTION AND SUMMARY

This communication is a follow-up to the debate - relaunched by the European Council meeting at Pörtschach - on infrastructure investment in the context of the broad discussion on economic growth, competitiveness and employment in the European Union.

This discussion underlines the fact that government investment in infrastructure has a strong impact on the economy, but is usually one of the first categories of government expenditure to suffer cut-backs in case of budgetary constraints or unfavourable developments in business cycles.

The Commission considers that the budgetary adjustment pursued by Member States in the run-up to the third stage of EMU put the public finances onto a sustainable path, which led to improved economic conditions encouraging the investment needed for further growth. However, government expenditure restraint has had a disproportionate impact on government investment, which fell from around 3% of GDP at the beginning of the 1990's to 2.1% in 1998. Budgetary discipline in line with the requirements of the Maastricht Treaty and the Stability and Growth Pact must be maintained, but there is a need for a restructuring of government expenditure in favour of government investment. This document deals with promoting public investment spending compatible with budgetary discipline, and public private partnership.

II. ECONOMIC STRATEGY FOR GROWTH AND INVESTMENT

The economic policies pursued in preparing for the third stage of EMU improved the conditions for sustainable growth of output and employment. During the last few years, the fundamental conditions for investment also improved as a result of these policies: inflation has been stabilised at a low level, interest rates both long and short-term have come down, profitability has increased, and the financing of government current spending no longer crowds out the financing of investment in the domestic capital market.

After considerable weakness at the beginning of the 1990s, private investment, which is eight times larger than government investment, is now on a recovery path. The Commission services' Autumn 1998 Forecasts project that private investment in real terms will increase by 4 to 5% in both 1998 and 1999. However, for private investment to be fully effective in generating output growth and employment, it must be accompanied by an appropriate development of infrastructure.

Even though government investment is showing a systematic downward trend in practically all mature industrialised economies, it has been reduced significantly in EU countries over the last few years. In the European Union as a whole, it fell from around 3% of GDP at the beginning of this decade to 2.1% in 1998. In Belgium, Denmark, Germany, Sweden and the United Kingdom, government investment is at present below 2% of GDP, while it is above 3% only in Greece, Luxembourg and Portugal. In most other Member States, it lies around 2.5% of GDP (see table).

Table

Government investment expenditure

(General government gross fixed capital formation, as % of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
B	1.4	1.4	1.3	1.5	1.6	1.4	1.2	1.4	1.5*
DK	2.0*	1.9	2.3*	2.2	2.0	1.9	2.1*	2.0*	1.8*
D	2.2*	2.5	2.8*	2.5	2.4*	2.2	2.0	1.8	1.8
EL	2.8	3.2	3.5	3.1	3.0	3.2	3.1	3.4	3.8*
E	5.0*	4.9	4.0	4.0	3.9	3.7	3.0	2.9*	2.9*
F	3.3*	3.4*	3.4	3.3	3.2	3.1	2.8	2.8	2.7
IRL	2.1	2.2	2.0	2.2	2.3*	2.4*	2.4*	2.3*	2.5*
I	3.3	3.3	3.0	2.6	2.3	2.2	2.3	2.3	2.5
L	5.4*	4.9*	5.5*	5.4*	4.4*	4.7*	4.8*	4.7*	5.4*
NL	2.7	2.7	2.8	2.7	2.7	2.7	2.6*	2.7*	2.6*
A	3.2*	3.3*	3.3*	3.2	3.2	3.0	2.8	2.0*	2.0
P	3.4	3.5	3.9*	4.0	3.6	3.7	4.1*	4.2*	4.2*
FIN	3.6*	3.7*	3.5	2.8	2.8	2.6	2.7	2.8*	2.5*
S	3.0*	3.0*	2.9	1.1	3.1	2.9	2.1	2.5*	1.4*
UK	2.3*	2.1	2.1	1.9	1.8	1.8	1.3	1.1	1.2*a)
EUR11	3.0	3.0	2.9	3.0	2.8	2.7	2.5	2.4	2.3*
EUR15	2.9	3.0	3.0	2.8	2.7	2.6	2.4	2.2	2.1*

* Denotes that government investment expenditure is greater than or equal to the government deficit, i.e. the golden rule is met.

a) Financial year

Source: Commission services.

This reduction is partially due to the fact that, during the recent period of budgetary adjustment, a disproportionate share of spending cuts fell on government investment expenditure. In addition, a part of infrastructure investment is being shifted into the private sector.

Indeed, much infrastructure investment – for example, on telecommunications and other utilities and to a lesser extent transport – is now carried out by private sector enterprises or by free-standing publicly-owned enterprises. Recently, part of the infrastructure investment which traditionally was implemented by government – both at the central and local level – is being provided by the private sector in co-operation with the government. For example, around one quarter of the reduction in government investment in the United Kingdom over the period 1993-1997 can be explained by the shifting into the private sector – via the so-called "Private Finance Initiative" – of spending that was previously classified as government investment.

However, the government retains a major role in setting the regulatory framework and in the direct provision of certain kinds of infrastructure, for example roads, schools and hospitals. It should also be noted that some elements of current government expenditure, such as spending on research, education or on labour training programmes, can be considered as investment in human capital and can thus also have beneficial supply-side effects.

This analysis shows that, even allowing for the shift of investment activity into the private sector, government investment has borne a disproportionate share of spending cuts in recent years. While government expenditure as a whole has declined as share of GDP, government investment has fallen relatively more sharply from close to 3% to only just over 2% of GDP since the early 1990's, though this masks very considerable differences between national performances.

Increased public investment is therefore necessary for the competitive performance of the European economy. The question is therefore how to give public investment sufficient prominence while maintaining budgetary discipline.

III. BUDGETARY DISCIPLINE

Budgetary discipline must not be put into jeopardy by the current drive to increase the priority given to government investment because it will ensure low interest rates and a better allocation of savings which both contribute to enhance investment and employment. Given the low level of government investment spending there is however a case for action in favour of government investment in compatibility with the Stability and Growth Pact.

It is important to underline that the case for greater government investment is not as a form of counter-cyclical budgetary policy. Spending on investment projects cannot be used as a stabilisation tool in view of inflexibilities in the timing and implementation of such types of spending. The underlying logic of the golden rule, under which borrowing should not exceed the level of government investment, is that current generations should not build up debts for future generations by failing to pay for current spending, but that investment for the benefit of succeeding generations can be financed from borrowing. It is encouraging to note from the table that in 1998 for the first time the EU in the aggregate (both EUR 11 and EUR 15) respects the golden rule and that 11 Member States do so individually. Four Member States while meeting the 3% ceiling, do not respect the golden rule in 1998, their deficit being greater than government investment thus causing government dissaving.

The Treaty states that the Commission shall take into account whether the government deficit exceeds government investment expenditure when assessing the budgetary position of a Member State. Member States report data which have to be of reliable quality on government investment in line with the provisions of the excessive deficit procedure, following the definition laid down in secondary legislation. These data have always been taken into account by the Commission in its reports under Article 104c(3) when initiating the excessive deficit procedure.

In line with this approach, the Commission will ensure it makes an assessment of the adequacy of public investment, and the implications of the programme with regard to the objectives of the Stability and Growth Pact, in its recommendations for the Convergence and Stability programmes, and will invite the Council to take a similar approach. If a "golden rule" - which allows governments to run deficits in order to finance government investment - were to be applied in the current situation as the sole criterion of budgetary discipline, Member States might feel encouraged to halt the ongoing reduction in their underlying structural deficit in conflict with the requirements of the Stability and Growth Pact. Allowing government investment to be fully deficit-financed even above the deficit ceiling implied by these requirements would take off the pressure from the necessary restructuring of government expenditure.

A satisfactory implementation of the "golden rule" raises a number of other difficulties as well. The problems related to the splitting of the budget into a current and a capital section may create incentives for governments to classify current expenditure as capital spending. As a result, budgetary positions would become even more difficult to monitor under the "golden rule" than is currently the case. Moreover, when investment projects do not generate sufficient returns to pay back the debts incurred to finance these projects, excessive borrowing may arise. In sum, respect of the "golden rule" does not guarantee that the public finances are sustainable and that the government debt ratio is controlled. Clearly, the golden rule must not be used as an excuse for breaching budgetary discipline. But equally, the Stability and Growth Pact should not be applied in a way that discourages investment that is consistent with sustainability. The room to finance the necessary increase in government investment spending will have to be found through a structural correction of current government expenditure. This commitment to budgetary discipline will ensure that the current favourable conditions enhancing investment will be maintained.

This general approach is in line with the positions taken by the Community institutions so far. The Council on several occasions endorsed the Commission's advice to the Member States to bring their budgets towards a position of "close to balance or in surplus" by the year 2002 at the latest and to increase investment spending on infrastructure as well as on other productive activities, such as on human capital and active labour market initiatives, without threatening the necessary further reduction in the deficit.

As well as making room within government budgets for additional direct spending on infrastructure investment so as to reverse the decline of recent years, there is considerable scope for expanding the provision of infrastructure investment through greater use of public-private partnerships. The nature of these arrangements and some initiatives which could be taken at Community level to encourage their more effective use are explored in the following sections of this note.

However, it must be recognised that most schemes of this kind are likely to involve some costs to government budgets, in the form of capital or operating transfers, etc., in order to generate a sufficient financial return to secure private sector involvement. Moreover, there can be some dangers in shifting activity of this kind off the government balance sheet; if there is no genuine risk-sharing between the private and government sector and the financing of projects is wholly covered by government guarantees, then the contingent liabilities assumed by government can result in large unpredictable costs to government budgets in future years. However, well designed PPPs can both reduce the need for government grant finance and result in an appropriate transfer of risk to the private sector.

IV. NEW FORMS OF INFRASTRUCTURE FINANCING

In recent years Member States have shown an increased interest in public-private partnership structures to finance major infrastructure. Such partnerships are generally based on the principle that infrastructure services are no longer only provided directly by governments using government-owned assets, but are now being supplied also by the enterprise sector against some form of revenue[1]. However, public private partnerships are not only a source of complementary financing, but also an instrument for introducing private sector efficiencies into infrastructure projects throughout their planning and operational stage.

In the construction and operation of large infrastructure projects, the private sector can only perform its role if there is some form of government involvement. The government creates the framework and the incentive system that determines whether or not private sector participation in the provision of infrastructure is feasible. Private sector involvement is directly related to the prospect of an acceptable level of profitability and a suitable revenue stream, subject to an acceptable level of uncertainty. It is the government that has the power to take measures to reduce the technical and financial uncertainty of projects to a level acceptable to the private promoter, be the project in question a new project based on direct user charges or relying on shadow tolls, or even a transfer to the private sector of a mature project or portfolio of projects. Member States have adopted this approach in various ways, illustrated by the following examples:

The Finnish Main Road 4 – shadow tolls. This stretch of a Finnish motorway is to be constructed and maintained by a private company owned by Swedish and Finnish companies. The private concession company is responsible for the planning and the construction of the motorway and for its maintenance over 15 years, and shall be compensated by shadow tolls for the construction and maintenance on the basis of traffic flow after the motorway has been opened for traffic.

The Second Tagus bridge – example of a transfer of an existing upfront revenue stream. This Lisbon bridge was funded and realised by a special purpose vehicle fully owned by private investors on the basis of a concession to operate the existing First Tagus Bridge together with the new bridge and raising tolls on both for 33 years. The first bridge therefore helped to fund the second one. Additional finance has been provided by the EIB on the strength of a completion guarantee, commercial banks and the Cohesion fund.

The Öresund fixed link bridge – direct user charges in the form of tolls. This bridge project linking Copenhagen with Malmö is built on the basis of an unlimited concession for a consortium of the Danish and Swedish governments, established in the form of a special purpose company, and based on direct user charges, i.e. tolls raised from motorway operations and fixed annual payments from the railway companies. The special purpose company financed the bridge by raising loans under government guarantees.

The PBKAL High Speed Line Netherlands – user charges and commercial exploitation of real estate. This high-speed rail connection, linking Amsterdam, its Schiphol airport and Rotterdam to the Belgian border is to be built largely by the government. Ways to most effectively involve private capital in the project have been investigated, and the project is intended to be privatised as a special purpose project company. Revenues from operations on the basis of user charges and commercial exploitation of real estate assets including stations will provide the revenue stream for this company.

[1] See COM(97) 453 final of 10 September 1997.

However, the capacity to generate revenue differs significantly between different kinds of infrastructure projects. Telecommunications, energy and water projects are usually either strongly cash-generative from the beginning of operations or enjoy an accurately predictable cash-flow. Conversely, transport projects may encounter significant obstacles in raising finance, usually because their capacity to generate future cash-flow may be fraught with uncertainty. Irrespective of the way the government chooses to create a revenue stream for the project, transport projects in particular will continue to require public funds in the form of grants or, in a recoverable form as risk-capital. Therefore, public-private partnerships are not appropriate for all types of infrastructure and cannot always replace grants, in particular for transport infrastructure.

As has been illustrated above, there are many alternative ways for the cooperation of governments with the enterprise sector. The choice of the appropriate mechanism for transfer of investment risk may be purely financial, but would usually be expected to reflect the national circumstances including the acceptability of user charges. The choices would also reflect the type of investment made, with for instance water works and road projects likely to be perceived differently by the general public.

V. CHOICE OF MEANS FOR PROMOTING INVESTMENT IN INFRASTRUCTURE

Public-private partnerships thus have an important role to play in accelerating implementation of essential infrastructure. The Commission encourages the undertaking of infrastructure investment through public-private partnerships. But there are two areas where "financing gaps" can be identified. First, in many cases, implementing a project through a public-private partnership can reduce but by no means eliminate the need of public grant finance, and the size and duration of some of the larger infrastructure projects involve risks which the private sector is not in a position to take on fully. There are four areas where action by the Community or Community institutions combined with Member State action would lead to a more integrated approach to dealing with the financing problems of public private partnerships:

- Adequate provision of grant or similar finance, to bring a project to financial viability. A major step in this respect would be to endorse the Commission proposal in Agenda 2000 for 5.5 Becu for trans-European networks in the period 2000 to 2006.

- Use of the Community budget to encourage the development of instruments for channelling private sector risk capital into infrastructure projects.

- Development of European Investment Bank lending instruments to better fit the features of long-term infrastructure projects allowing the Bank to take more risk in line with its support for small and medium-sized enterprises under the Amsterdam Special Action Programme of 1997.

- Exploration of the possibility for the EIF to provide risk capital for TEN's, and to extend its activities to accession countries, together with a clarification or extension of its eligibility rules, so that it can make the most effective possible contribution to infrastructure development.

Given the capacity of the European capital markets, there is no shortage of loan finance at European level for infrastructure projects. The issue is rather more to ensure that the lending is available on suitable terms, and that, where appropriate, it is accompanied by grant-type finance to complete the financial package. In order to expand the scope that exists for using existing sources of finance in a complementary manner, greater synergy between the Member States, the European Investment Bank, the European Investment Fund and Structural Fund instruments therefore needs to be developed.

Using grant finance effectively

The Commission under Agenda 2000 foresees a substantial increase in funds for infrastructure (under the TENs budget lines, the ERDF and the Cohesion Fund). These funds will be a significant source of grants and other forms of finance for infrastructure investments in the European Union. Grant finance normally is provided in the early stages of a project, since this is when the major costs arise, with revenue accruing only at a later stage. There are numerous ways of avoiding paying the grant contribution upfront, thus easing the immediate adverse budgetary impact. This could take the form of putting together financing packages which include revenue streams from existing projects to achieve overall financial viability (this approach has for instance been used for the Tagus bridge in Portugal or the Second Severn bridge in the U.K.), or of providing grant or similar finance at a later stage of the construction process. It is also desirable, where possible, to provide government contributions to projects in a recoverable form of risk capital, which would allow the funds to be recycled to new projects when they have helped previous ones on their way.

Promoting public private partnerships also raises important legal and administrative issues, which were already identified by the Commission in its communication on public private partnerships in transport TENs[2]. The involvement of private finance in infrastructure projects can usually best be achieved through the creation of dedicated special purpose project vehicles for the ownership, construction or financing of infrastructure. The lack of relevant legislation may act as a barrier for increased use of public-private partnership structures, notably for the railway sector.

Promoting risk capital

The amounts of funds in the hands of pension funds and life assurance companies are increasing steeply in line with the trend towards funded pension schemes and increased demand for pension-type products from life companies. In the next few decades these assets will provide increasing liquidity to the European capital markets. At present these funds can only be harnessed for public infrastructure investment by way of government bonds, i.e. the government borrows from pension funds and life companies and invests the moneys in infrastructure. The creation of mechanisms to allow institutional investors to participate directly in infrastructure projects would reduce the necessity to cycle these funds through government accounts and involve participation in the project risks.

The Commission, in the follow-up to its Green Paper on supplementary pensions in the single market is exploring ways of alleviating the burden of restrictions on pension funds without threatening the prudential soundness of the funds[3]. The channelling of funds into infrastructure projects by institutional investors could be

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2 COM(97) 453 final of 10 September 1997.

3 See COM(98) 625 final of 28 October 1998.

facilitated by supporting investment funds specialised in infrastructure. Such funds are comparable to venture-capital funds, and the Commission, in the current review of the TEN Financial Regulation, has put forward the possibility for Community support in the form of risk-capital participations for investment funds focusing on trans-European network projects. The Commission invites the Member States to support this proposal.The small amount allocated by Council to this initiative at the moment, however, is only adequate for a limited pilot action.

Lending more suited to project needs

The European Investment Bank is the principal source of loans at Union level, but it does not normally provide loans without commercial or Member State guarantees. It would be appropriate for the Bank to intensify its efforts in involving the enterprise sector in the financing of infrastructure. To this end, it should develop acceptable forms of risk-taking for infrastructure, by itself becoming, alongside the national governments, a risk-sharer in the implementation of infrastructure projects. Similarly to its SME support under the Amsterdam Special Action Programme, the Commission invites the Bank to set up a special window for risk-sharing activities. Drawing on its experience, the EIB should develop the instruments which would allow it to efficiently complement financing available from commercial sources; it could for example consider expanding its lending to infrastructure without third party guarantees, the development of a better capability to provide loans during the construction period of projects, the tailoring of its loan products to better suit the cash-flow profile of projects, or the provision of technical assistance for special projects.

The European Investment Fund has an important complementary role to play in facilitating the financing of projects of the enterprise sector by the provision of loan guarantees. Since its creation in 1994, the Fund has steadily built up its underwriting skills and project-structuring expertise. At the end of September 1998 the Fund had issued guarantees in favour of 24 TEN projects to a value of Ecu 1.67 bn. Support for TENs should remain the top priority for the EIF, with an increasing contribution to be expected over the coming years. It could develop in the way suggested above ways to support more efficiently the general development of infrastructure, e.g. by clarifying or extending its eligibility rules. At the same time, the Fund should explore the possibility of extending its operations to future accession countries with particular reference to cross-border projects with EU Member States.

VI. CONCLUSIONS

The budgetary adjustment pursued by Member States in recent years to prepare for the third stage of EMU has been essential to put the public finances onto a sustainable path and has already led to a much improved climate encouraging the investment needed for faster growth. However, government expenditure restraint has had a disproportionate impact on government investment, which has been cut back relative to GDP in most Member States and fallen to very low levels in several of them.

Safeguarding of budgetary discipline in line with the requirements of the Treaty and the Stability and Growth Pact must be maintained, but there is a case for a restructuring of government expenditure in favour of government investment, especially in infrastructure.

In line with this approach, the Commission will ensure it makes an assessment of the adequacy of public investment, and the implications of the programme with regard to the objectives of the Stability and Growth Pact, in its recommendations for the Convergence and Stability programmes, and will invite the Council to take a similar approach.

There is clear scope for further development of new methods to provide infrastructure through private sector involvement. The Commission therefore favours actions aiming at increasing the possibilities of putting together viable financial packages for projects undertaken through public private partnerships by private sector promoters and free-standing public enterprises. This means ensuring instruments to take on risk, but also adequate grant finance.

As far as grant finance is concerned, the Commission invites the Council to join the European Parliament in endorsing the financial envolope of 5.5 Becu for trans-European networks put forward for the period 2000-2006 under Agenda 2000, and to look at ways of ensuring that this finance can be used most effectively.

In order to encourage the development of private sector risk capital instruments, the Council is invited to agree to the Commission proposal on risk-capital under the TEN Financial Regulation.

As far as instruments to take on risk are concerned, the Commission invites the European Investment Bank to step up its efforts in supporting the implementation of infrastructure projects by creating a special window for risk-sharing activities in line with its support for small and medium-sized enterprises under the Amsterdam Special Action Programme of 1997. The Bank should study and develop such instruments as to allow it to efficiently complement financing available from commercial sources.

The Commission also invites the European Investment Fund, in co-ordination with its shareholders, to explore the possibility to provide risk capital for TENs, and to extend its activities to accession countries, together with a clarification or extension of its eligibility rules.

The Commission finally invites the Member States while maintaining budgetary discipline in line with the requirement of the Maastricht Treaty and the Stability and Growth Pact to restructure at the same time government expenditure in favour of government investment.

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