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Public Investment and Fiscal Policy—Summaries of the Pilot Country Studies

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I. INTRODUCTION

1. **This paper provides background to the Board paper on Public Investment and Fiscal Policy—Lessons from the Pilot Country Studies (SM/05/118)**. It summarizes the findings of eight pilot case studies prepared by mission teams that visited each of the countries during 2004. The selection of pilot countries—Brazil, Chile, Colombia, Ethiopia, Ghana, India, Jordan, and Peru—aimed to include different regions and levels of development, and to ensure adequate coverage of the issues raised in the earlier Board papers on Public Investment and Fiscal Policy (SM/04/93) and Public-Private Partnerships (SM/04/94). However, the large share of Latin American countries reflects the importance of these issues in the region and the eagerness of the countries concerned to be involved.

2. **Missions were for the most part given considerable latitude in how they organized their work**. In part, this reflected the fact that not all of the issues covered in SM/04/93 and SM/04/94—the analytical framework, the coverage of fiscal indicators and targets, and public-private partnerships (PPPs)—are relevant to every country. In particular, some countries have little experience to date with PPPs, and these were not addressed where this is the case (e.g., in Ethiopia and Jordan). In contrast, the case study for Chile focused largely on PPPs, reflecting the fact that the authorities were most interested in this specific issue, and that Chile's successful experience with PPPs offers valuable lessons for other countries in this area. Reflecting the individual characteristics of the pilot case studies, no uniform structure was imposed on the country chapters in this paper.

3. **The country chapters draw on longer reports.** It is expected that some of these reports will be circulated as background papers to future staff reports for the countries concerned. However, some of the reports will likely remain confidential, where country authorities so requested.

II. BRAZIL

A. Macroeconomic Background

4. **Brazil has made important progress in addressing macroeconomic imbalances in recent years.** Disciplined monetary and fiscal policies have helped to bring about a sharp decline in inflation and a significant strengthening of the public finances. Following the economic crisis in 1998, Brazil managed a successful transition to a floating exchange rate regime, and further strengthened its financial system. Demonstrating the government's commitment to fiscal sustainability, the public sector primary balance improved from a deficit of 1 percent of GDP in 1997 to a surplus of over 4.5 percent of GDP in 2004.

5. **However, significant vulnerabilities remain.** Real economic growth has averaged 2.5 percent over the last decade. A strong economic recovery is now underway, with real GDP growth estimated at over 5 percent in 2004, but sustaining the momentum into the medium term will require further structural reform efforts. The net public debt stock,

although declining, remains sizeable and vulnerable to interest rate and exchange rate shocks.[1] The size of fiscal adjustment has been impressive, but it was largely achieved by increasing the relatively high tax burden,[2] while tilting the expenditure allocation toward current spending. In addition, pervasive rigidities in both revenue and expenditure allocations constrain the government's ability to respond adequately to shocks and improve the allocation of budgetary resources.

6. **The government has continued to emphasize the need for fiscal sustainability.** In this context, it has implemented a fiscal policy strategy aimed at achieving a downward path for the net public debt by maintaining sufficiently strong public sector primary fiscal surpluses. The 2005 Budget Guidelines Law (LDO) emphasizes the government's commitment to continued fiscal prudence by establishing targets of 4.25 percent of GDP for the public sector primary surplus in 2005–2007. Maintaining a primary surplus at a level of 4.25 percent of GDP is projected to allow a decline in the net public debt to 50 percent of GDP by 2007. The 2005 budget, approved at end-2004, is consistent with this objective.

B. Fiscal Adjustment and Public Investment

7. **During the ongoing fiscal adjustment, public investment has continued to decline.** Public investment has fluctuated along a declining trend for the last two decades.[3] More recently, public investment averaged 3.2 percent of GDP during 1996–98, but has dropped significantly since then. It averaged 2.5 percent of GDP during 1999–2004, excluding 2001, when it rose to 3.1 percent of GDP reflecting emergency investments in the wake of the energy crisis.[4] In contrast, during 1999–2004, federal government primary current spending increased by 2.8 percent of GDP to 21.3 percent of GDP,[5] in part due to a rapid rise in spending on entitlement programs, including pensions.[6]

8. **Along with the decline in public investment, infrastructure bottlenecks have emerged that could adversely affect Brazil's long-term growth potential.** Total infrastructure spending declined from an average 5.2 percent of GDP in the early 1980s to

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[1] The public sector net debt-to-GDP ratio declined by over 10 percent of GDP since 2002 to under 55 percent in 2004. Over half of the net debt is indexed, either to the exchange rate or to short-term interest rates.

[2] General government tax revenues increased by about 6 percent of GDP since 1999 to an estimated 35.5 percent of GDP in 2004.

[3] The decline in public investment partly reflects a scaling back of the role of the state in the economy.

[4] These data include investment in nonfinancial assets by the federal government, the states, and the federal public enterprises. Not included are investment spending by municipalities, and by public enterprises owned by the states and municipalities. Note that these data are unadjusted for changes in the scope of the public sector, i.e., some of the decline in public investment reflects ongoing privatizations.

[5] The federal government comprises the central administration; the Central Bank of Brazil; and the social security system.

[6] Similarly, during 1996–2004, primary current spending of the public sector increased by over 6 percent of GDP to more than 37 percent of GDP.

2.3 percent in 1996–2000, i.e., by 2.9 percent of GDP, while total public investment declined by 2.6 percent of GDP. Infrastructure bottlenecks are considered most acute in the transport sector, particularly roads. Road transport dominates the Brazilian transport system, but only 25 percent of the paved federal road network is in good condition, and the last rehabilitation expenditures for more than 80 percent of the network occurred 10 or more years ago. The poorly maintained road infrastructure has increased accident rates, fuel consumption, and travel times, all of which have added to transport costs with adverse effects on Brazil's competitiveness. In addition, road network capacity is low compared to demand even in developed regions. These inadequacies have become particularly acute with the recent boom in Brazil's exports. Also, various high-volume ports (e.g., Santos in São Paulo state, Paranaguá in Paraná state, and Sepetiba in Rio de Janeiro state) are facing capacity constraints.[7] For the rail network, largely operated and maintained by concessionaires, key issues relate to improving the separation of passenger and freight services in the São Paulo metropolitan region, improving the integration of lines with different track types and track widths, and upgrading the rolling stock as well as track security (where illegal land invasion and housing construction in areas immediately surrounding rail tracks have resulted in low average speeds).

C. Options to Increase Public Investment

9. **A sustained increase in public investment will first and foremost require a sustained increase in public saving**. To address infrastructure bottlenecks, it has at times been argued that Brazil should adopt a modified "golden rule" that targets the primary current balance (or public savings) alone, while excluding some or all public investment spending from the fiscal targets. However, the room for reducing the overall primary surplus is limited in Brazil, given its high level of the public debt, the structure of which is still vulnerable to shocks. Following a golden-rule target, as opposed to targeting the primary or the overall balance of the public sector, would imply de-linking budgetary policies from debt sustainability and fiscal vulnerability considerations, with likely deleterious consequences for investor confidence and market perceptions. Hence, there is no alternative to maintaining a cautious overall fiscal stance and seeking increases in public investment primarily through increases in public savings. In view of a relatively high tax burden, this will primarily require reforms that facilitate a sustainable reduction of current primary spending, in particular further reforms of the civil service, the pension system, and revenue earmarking, so as to facilitate selective expenditure reductions.

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[7] Yet, the lack of good statistical data and the absence of a strong regulatory framework make it difficult to identify how much capacity expansion would be needed. The government also argues that, to the extent that physical capacity constraints in various ports have become binding, adding capacity to specific segments of the road network improving access to non-congested ports is a sensible option.

D. Improving the Quality of Public Investment

10. **Even within the current envelope for public investment, there exists much scope for efficiency-enhancing measures to help address pressing infrastructure needs.** Brazil has a strong tradition of planning, and has in place a comprehensive public financial management system that reliably tracks budget expenditures, within an institutional framework emphasizing fiscal responsibility at all levels of government. Still, it has put relatively less emphasis on strengthening systems for public investment prioritization, implementation, and management. In particular, there is a need to build capacity to perform economic and financial evaluations of projects. This should be done in the context of improving the overall systems for project evaluation, prioritization, and management, so as to help ensure that available resources are put to efficient use. In the first place, resources should be concentrated on maintaining and rehabilitating existing infrastructure, and on speeding up the execution of ongoing projects, which often are subject to long delays and in some cases are never completed. It will take time for various investment reform and rationalization efforts to be put in place and start producing fiscal savings.

11. **As a first step in strengthening the framework for public investment and increasing the quality and efficiency of the public investment budget, the government is implementing a three-year (2005–07) pilot program.** The pilot program aims to improve existing systems of appraisal, selection, implementation, and monitoring of public investment projects. The projects included in the pilot program were selected through an improved screening process and focus on high-priority infrastructure and other public investment projects that can be expected to have potentially strong macroeconomic and fiscal payoffs over the medium term. In line with identified infrastructure bottlenecks, over 90 percent of the pilot program amounts are directed toward transportation, particularly for maintaining and rehabilitating the federal road network, expanding key highways, and improving the infrastructure of sea ports. While the authorities recognize that cost-benefit analyses performed for some of the pilot projects remain at an initial stage, they are committed to continue building capacity to perform economic and financial evaluations, including with assistance from the World Bank. To ensure full transparency, the pilot program does not entail any changes to how fiscal outturns are computed, nor does it imply the exclusion of specific expenditures from the fiscal primary balance.

12. **The projects included in the pilot program will be subject to strengthened oversight.** In the context of getting the pilot program underway, the government has created a high-level Coordinating Committee, comprising representatives from the Office of the Chief of Staff of the Presidency, the Ministry of Finance, and the Ministry of Planning. This Committee will establish a special technical unit to process the information required to monitor the projects. Full budgetary funding will be linked to progress in implementing the strengthened management and supervisory functions, thereby providing incentives for completing projects on schedule. The pilot also envisages strengthening existing information systems. The projects will be monitored frequently, and the Committee will have additional discretion to expand or reduce the budget allocation for projects in the pilot, providing more funds to those with more successful implementation. The authorities intend to evaluate the

pilot at the end of 2005, to learn from the experience with the new procedures, and inform the preparation of the 2006 budget. Eventually, the government hopes to extend the new procedures to all public investment projects.

13. **The government's pilot program is consistent with a continued expected decline of the debt-to-GDP ratio over the short to medium term.** If fully implemented, the authorities' pilot program would allow for a modest downward adjustment (of about 0.15 percent of GDP) in the government's primary surplus target of 4.25 percent of GDP for 2005. Full budgetary funding for the pilot projects will be linked to the implementation of the improved procedures. Staff calculations suggest that, ceteris paribus, adjusting the primary surplus target of the consolidated public sector during 2005–07 by no more than 0.1–0.2 percent of GDP per year (or at most 0.5 percent of GDP in total) would be consistent with the government's debt and macro-fiscal sustainability objectives.

E. Coverage of Fiscal Indicators

14. **Brazil has comprehensive fiscal accounts, allowing for fiscal adjustment to be broad based.** Like in many other Latin American countries, Brazil's fiscal accounts cover the public sector, including the federal government, the state and municipal governments, and the public enterprises at all levels of government. Such a broad coverage reflects a recognized need to capture the whole range of fiscal and quasi-fiscal activities carried out by the public sector, including in public enterprises.

15. **Several federal enterprises (FEs) have a strong commercial orientation, but none fully meets the complete set of criteria laid out in SM/04/93. In particular**:

- all FEs are subject to government approval of their wage policies and, with the exception of Petrobrás, their employment policies;
- FE investment plans have to be approved by Congress, as part of the budget process;
- FE top managers tend to be changed whenever there is a change in government, and sometimes by the same government, without clear performance-related reasons;
- several FEs continue to carry out quasi-fiscal operations, including the absorption of companies in need of restructuring, without explicit and formula-based compensation through the budget; and
- several FEs have a history of loss-making and/or noncommercial pricing policies.

16. **Further analysis will be needed to refine this assessment.** Clearly, some federal enterprises, like Petrobrás, have a strong commercial orientation. Nevertheless, they cannot be considered fully commercially run using the criteria set out in SM/04/93. Questions have arisen, also on the basis of the findings of other pilot projects, on the appropriateness of some of those criteria and on their relative importance. In particular, it appears that, in assessing to what extent public enterprises should be constrained by considerations related to the overall

fiscal stance, more emphasis should be placed on fiscal risks posed by a public enterprise, on its economic and financial performance, and on the rates of return on its proposed investments.

17. **In the meantime, it seems appropriate to retain some limited flexibility concerning the treatment of higher-than-budgeted Petrobrás investments.** In particular, the government may wish to retain an option to adjust its public sector primary surplus targets to accommodate some additional high-priority energy investments by Petrobrás that exceed the budget baseline, particularly as they are geared toward further reducing the degree of Brazil's dependence on imported oil. This would seem justifiable in light of the continued strong financial position of the enterprise, and the favorable medium-term outlook for oil prices. Nevertheless, the government should ensure that these additional investments show rates of return significantly in excess of current and foreseeable borrowing costs.

F. Private Investment and Recent Progress with PPP Legislation

18. **Government efforts to strengthen public investment will have to be complemented by steps to increase the attractiveness of infrastructure investments for the private sector.** This will also need to include strengthening and closing gaps in the existing regulatory framework, more actively exploring opportunities for new concession arrangements, and putting in place the necessary conditions for efficient and fiscally sound private-public partnerships (PPPs).

19. **In this regard, the Brazilian congress recently approved a law that governs PPPs at all levels of government.**[8] The December 2004 law complements existing legislation in the fiscal area, including the Concessions Law and the Procurement Law,[9] and creates a new contractual modality where the private partner is responsible for constructing and financing a public asset that supports the provision of a contracted service. The law prohibits the use of PPPs to hire personnel, purchase equipment, or carry out public works. It sets a minimum value for PPP contracts (R$20 million, about US$7.7 million) and limits on their duration to 5–35 years. Government payments will be conditioned to service delivery and based on performance standards. At the expiration of the contract, the asset must be transferred to the public sector, with or without a final payment (depending on the contract).

20. **Federal PPP contracts will be subject to close oversight.** There is a clear need for the public administration to equip itself with the necessary tools and knowledge to strengthen its cooperation with the private sector. In this context, it is urgent to build, in both the sectoral and economic ministries, the capacity to assess, appropriately design, and monitor

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[8] The states of São Paulo and Minas Gerais have approved their own laws governing their own PPP contracts. These local laws are compatible with the federal law.

[9] Under the concessions law the private sector can build and operate infrastructure projects, but the government cannot make payments to the concessionaire. Under the Procurement Law the private sector is a supplier to the public sector, but it cannot charge user fees, and contracts are limited to a maximum duration of five years.

the implementation of PPP contracts, and to evaluate the fiscal costs and risks they entail. For the time being, the government has decided that the federal PPP program will be managed by a council (*Conselho Gestor*) formed by the Ministers of Finance and of Planning, and the President's chief of staff. The council will be in charge of establishing the criteria to select projects and designing the contracts. The authority to tender PPP projects resides in the council. Operating rules for the council have just been issued and need to be implemented.

21. **The law also contains provisions to minimize the exposure of private partners to institutional risk and reduce the implicit financial cost in PPP contracts.** The key provision in the law is the creation of a guarantee fund made up of government assets like equity shares of public enterprises, real estate, and budgetary contributions. The guarantee fund will be managed by a public commercial bank. The initial endowment of the fund will be US$1.9 billion. Regulations governing the functions of the fund are being developed.

22. **The law includes safeguards for public finances by limiting the exposure to PPPs.** Specifically, for all levels of government, it limits total financial commitments undertaken in PPP contracts to a maximum of 1 percent of annual net revenue. If subnational governments exceed this limit, the federal government is authorized to withhold voluntary transfers. The law also limits financing for PPP projects that can be provided by the national development bank (BNDES) and public pension funds.

23. **The institutional framework for PPPs continues to be strengthened.** A PPP unit has been established at the Ministry of Planning to provide support to the *Conselho Gestor* when established, and a working group at the National Treasury is working on macroeconomic issues related to PPPs, including the accounting. Accounting rules for PPPs are being defined, including the valuation of guarantees and their treatment in relation to compliance with the 1 percent of net revenue limit for PPPs.

III. Chile

A. Background

24. **By the early 1990s, sizeable infrastructure bottlenecks had emerged, and major investments were needed to prevent these bottlenecks from becoming obstacles to growth.** Fiscal adjustment under economic stabilization programs during the 1980s had adversely affected public investment in infrastructure and infrastructure maintenance. Rapid growth during the second half of the1980s and into the 1990s then quickly exposed infrastructure inadequacies. Traffic speeds markedly declined, road accident rates increased, and ports and airports became congested. Official estimates suggested that infrastructure deficiencies for the second half of the 1990s were equivalent to over 20 percent of the country's 1993 GDP.

25. **A challenge for the government was to address these bottlenecks while maintaining fiscal discipline to keep public debt on a rapidly declining path.** The solution lay in promoting private sector involvement in the provision of some public

infrastructure through public-private partnerships (PPPs), whereby private firms would be given concessions to build infrastructure assets and operate them for a number of years before transferring the assets to the government. Chile thus embarked on an ambitious concessions program in 1994, centered around a number of projects to develop the highway network.

B. The Concessions Program

26. **The concessions program in Chile covers 44 contracted projects with a total value of US$5.7 billion (about 6¼ percent of the 2004 GDP).** These include: 8 projects to rehabilitate and upgrade the Route 5 highway which runs the length of Chile, with financing from tolls (US$2 billion); 11 other highway projects for connecting roads to Route 5 (US$1.3 billion); 10 airport projects (US$240 million); 6 urban road projects (US$1.8 billion); and 9 other projects (including prisons, public buildings, and a reservoir, for US$360 million).

27. **A key aim of the government is to ensure that the Route 5 project is financially viable, while having similar tolls per kilometer across all segments of the highway.** However, not all segments are equally profitable, with the outer segments being less profitable than the segments near Santiago. The government therefore set up an *Infrastructure Fund*, which is consolidated with the budget, and through which various payments by firms operating profitable highway concessions are used to cross-subsidize operators of unprofitable highway concessions.

28. **The government also provides guarantees to concession operators.** A *minimum revenue guarantee* is provided for highway and airport concessions, under which concession firms are compensated when traffic or traffic revenue falls below an annual threshold. In return for the minimum revenue guarantee, the concession firm enters into a *revenue sharing agreement* in which it shares a percentage of revenue with the government once a threshold is exceeded.[10] Under the terms of the exchange rate guarantee, which applies to debt service payments, the government compensates the concession firm if the *Unidad de Fomento*—a unit of account that is adjusted daily for past inflation—depreciates against the US dollar by more than 10 percent, and the concession firm pays the government if the *Unidad de Fomento* appreciates by more than 10 percent. This guarantee is, in effect, a real exchange rate guarantee.

C. Institutional Framework

29. **Chile has a well-developed institutional framework to support the concessions program. Its key features include:**

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[10] As an alternative to the minimum revenue guarantee, since 2002, highway concession firms have been allowed to switch to a revenue distribution mechanism whereby the concession contract is changed from fixed- to variable-term, with the duration of the contract depending on future revenue. A least-present-value-of-revenue franchising mechanism has also been tried, where the concession ends when the contracted present value of revenue is reached. Only a few concession firms have opted for these alternatives.

- The 1991 *Concessions Law*, which requires competitive bidding for concession contracts, establishes the rights and obligations of parties to contracts, facilitates private property appropriation with full compensation, specifies dispute resolution procedures, and provides for the cancellation and transferability of contracts.

- Thorough evaluation of public investment projects involving the Ministry of Public Works, the Ministry of Planning and Cooperation (MIDEPLAN), the Ministry of Finance, and the Comptroller General. The objectives are to ensure that projects are consistent with a broad infrastructure plan, are subjected to rigorous social cost-benefit analysis, undertaken by the private sector or the public sector depending on which is in a better position to carry them out, and are acceptable from a macroeconomic and fiscal sustainability perspective.

- Project tendering based on detailed design and engineering specifications, a careful assessment of bidders' financial soundness and technical capacity, and flexibility in the structure of concession contracts.

- Recognition that concession firms can run into financial or other difficulties and that contracts may have to be renegotiated. This being the case, the emphasis is on addressing liquidity difficulties of concession firms rather than their solvency problems.

- Clear specification of the risks that are to be borne by the government, and a high level of fiscal transparency about government's exposure to contingent liabilities due to the provision of guarantees. Fiscal transparency practices are especially noteworthy.

D. Fiscal Transparency

30. **In addition to the cash payments to and from concession firms, the government has started to report the contingent liabilities arising from guarantees provided to concession firms.** In 2003, the government commissioned a study from the World Bank that analyses the government's exposure to risk under the concessions program, values some of the main sources of risk, and offers options for managing risks. The study focuses on the minimum revenue guarantee, the revenue-sharing agreement, and the exchange rate guarantee. The value of the guarantees are estimated by modeling the variables that are the underlying source of risk—revenue and the real exchange rate—and then using Monte Carlo simulations in the case of the minimum revenue guarantee and the revenue-sharing agreement, and the Black-Scholes options pricing model in the case of the exchange rate guarantee.

31. **Based on these approaches, the government first reported estimates of the contingent liabilities in the October 2003 *Report on Public Finances*.** These covered not only the guarantees provided to concession firms, but also the minimum pension guarantee.

However, in contrast to the latter, the methodology used to estimate the contingent liabilities associated with guarantees provided to concession firms was not described. Moreover, future subsidy payments were not reported, which made it difficult to get a complete picture of the long-term costs and risks associated with the concessions program. The October 2004 *Report on Public Finances* addresses the first of these shortcomings by providing a detailed description of the analytical approach taken to valuing guarantees. It also reports that the present value of future subsidy payments over the period 2004–2030 amount to 2¼ percent of the 2004 GDP, the net present value of expected minimum revenue guarantee payments (i.e., net of receipts under the revenue sharing agreement) is a modest ¼ percent of 2004 GDP, and the maximum payment is 5½ percent of the 2004 GDP. The exchange rate guarantee is a marginal source of revenue for the government, because the guarantee was offered at a time when the peso was undervalued.[11] In view of Chile's strong fiscal position, commitments under the concessions program are not a significant source of fiscal risk.

E. Assessment

32. **Chile's experience with concessions has so far been successful and contains useful lessons for countries interested in PPPs.** These include:

- **It is important to have in place an appropriate institutional framework before embarking on a PPP program.** The *Concessions Law*, a track record of thorough project evaluation, ensuring the financial and technical capabilities of concession firms, paying attention to the possible need for contract renegotiation, and ensuring appropriate risk sharing are strong points that have contributed to cost-effective additions to economic infrastructure in key sectors.

- **A commitment to fiscal transparency, including explicit recognition and full disclosure of longer-term fiscal costs and risks.** The estimating and reporting of contingent liabilities arising from government guarantees is clearly an example of best practice, and an illustration of the way the disclosure practices recommended in the Board paper on Public Investment and Fiscal Policy (SM/04/93) should be implemented.

33. **There are nonetheless some areas where the concessions program are being or could be strengthened going forward.** These relate to:

- **Conflict resolution procedures.** There is a risk that these procedures is biased in favor of concession firms because the Ministry of Public Works represents the government on conciliatory commissions and yet has a vested interest in the concessions program. Consideration should be given to changing the government representative on conciliatory commissions.

[11] Further detail is provided in the background paper on Government Guarantees and Fiscal Risk (SM/05/120).

- **Project evaluation.** Major projects undertaken to date have been of high quality in the sense that not only are they addressing pressing infrastructure needs, but they also have imposed little cost on the government. However, some high-risk, prestige projects are now being considered, project proposals are focusing increasingly on areas where the efficiency gains from concessions are less clear (e.g., hospitals, schools, public buildings), and resistance to tolls could mount (e.g., for the use of urban roads). This being the case, the authorities are aware of the need to ensure that proposed concessions are evaluated as carefully as all other public projects, and to develop public sector comparators for all proposed PPPs as a means of verifying that concessions offer better value for money than traditional public investment and government supply of services.

- **Design and engineering specifications.** While there are advantages to tendering fully specified projects, there is a risk that this approach stifles private sector innovation and therefore could limit efficiency gains. As the range of concession proposals expands, and in particular as the size of a typical concession declines, concession firms should have a larger say in project design and engineering. This approach is being applied in the case of prison concessions.

- **Publication of concession contracts.** Full information on original and renegotiated contracts should be publicly available. In view of the heterogeneity and complexity of concession contracts, it would be desirable to use a uniform template to summarize their key provisions which could be published on the Ministry of Public Works website and as part of the budget documentation. The Ministry of Finance has recently devised such a template.

- **The Infrastructure Fund.** Given that it is fully consolidated with the budget, it has been used for more than cross subsidization (its intended purpose), and that expenditure is not limited by fund resources, the Infrastructure Fund does not play a clear fiscal policy role. Unless it has some other compelling purpose of a political economy nature (e.g., as a means of disciplining a propensity to award concessions), consideration should be given to discontinuing the Infrastructure Fund.

IV. COLOMBIA

A. Background

34. **Colombia has made significant economic progress in recent years.** In response to the economic crisis of the late 1990s, triggered by a worsening fiscal position, external shocks, and intensified security problems, the authorities have been pursuing disciplined monetary and fiscal policies, which have helped improve macroeconomic performance. A strengthening of public finances has helped foster growth with declining inflation and a stable exchange rate and has improved the environment for private investment.

35. **The authorities have been making efforts to consolidate the fiscal position.** The nonfinancial public sector primary surplus rose by over one percentage point of GDP in 2003 and a further improvement of one percentage point of GDP is estimated to have taken place in 2004. Thus, public debt, which, reflecting fiscal deficits and currency depreciation, had increased substantially in a few years to reach 60 percent of GDP in 2002, has started to decline (a development aided by the appreciation of the currency), but is still relatively high at close to 54 percent of GDP at end-2004.

36. **The government is committed to a fiscal policy aimed at strengthening the long-term position of public finances and protecting fiscal sustainability.** Recently, the authorities reaffirmed their commitment to this objective with the submission to Congress of the Medium-Term Fiscal Framework (MTFF), in accordance with the requirements of the fiscal responsibility law approved in 2003. The strategy aims to reduce the level of public debt, a source of significant vulnerability, to less than 45 percent of GDP by 2010 by achieving primary surpluses on the order of 3 percent of GDP in the medium term.

B. Public Investment and Infrastructure

37. **According to the government's fiscal statistics, public investment has been relatively stable in recent years, although somewhat lower than in the mid-1990s, and compares favorably in a regional context.** The fiscal data show relatively steady levels of public investment in recent years (about 8 percent of GDP). Within the public sector, investment by the central government and public enterprises has declined somewhat, compensated by an increase in investment at the subnational level—the largest component of total public investment. National accounts data through 2001 and preliminary estimates for 2002–03, however, show a lower level of public investment (by about 2 percentage points of GDP) than the fiscal accounts and some decline in the last few years.[12] While differences in the scope of the public sector and in methodologies for the compilation of data suggest the need for caution in making international comparisons, public investment levels in Colombia appear to be higher than in several comparable Latin American countries.

38. **In a recent study of Colombia's infrastructure, the World Bank noted that the country has consistently sustained one of the highest and most stable infrastructure investment levels among Latin American countries.** In particular, Colombia is one of only a few countries in the region that has consistently maintained public infrastructure investment levels above 2 percent of GDP. As a result, access to basic household services such as water and sanitation and electricity is high compared to Latin American peers and relative to the country's economic, social, and geographic conditions. Access to services is relatively equitable across the income spectrum. However, there are some large access differentials

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[12] There are differences in methodology and coverage between the fiscal accounts and the national accounts. In addition, data on subnational public investment should be treated with caution due to some problems in the coverage and quality of the information. The authorities should give priority to the implementation of their program to strengthen the subnational financial information system.

between urban and rural areas. In the water sector, which is fully decentralized, a number of small utilities show weak operational and financial indicators.

39. **On the other hand, Colombia lags behind its peers in some productive infrastructure such as paved roads, and the country's relative position in these areas has been deteriorating since the 1960s.** The World Bank has noted in particular the deterioration in recent years of the paved road network, due to shortfalls in maintenance. More broadly, there is mixed evidence as to the relative quality and efficiency of Colombia's infrastructure service providers, and comparative efficiency indicators suggest that electricity and telecommunications utilities (where public sector participation is still significant) perform below the regional average.

40. **The World Bank has encouraged Colombia to enhance its performance on productive infrastructure, while preserving its achievements in social infrastructure.** Priority should be given to maintenance and rehabilitation to preserve and restore existing assets, as this spending would entail higher rates of return than investments in new assets.

Options to promote high-quality public investment

41. **Under the baseline debt sustainability scenario, public debt remains subject to substantial vulnerabilities.** In particular, this stems from shortfalls of growth from its assumed rate of 4 percent, which is significantly higher than the average of 2¾ percent recorded in 1992–2003. The public debt path is also very sensitive to movements in the exchange rate, interest rates, deviations from the basic primary fiscal surplus scenario, and oil prices. The pension system's high actuarial deficit and sizeable public sector contingent liabilities are additional sources of vulnerability.

42. **Therefore, a cautious fiscal stance is essential to consolidate the gains achieved so far and to reduce the public debt consistent with the targets of the MTFF.** Such a strategy would reduce vulnerabilities and buttress economic stability and the confidence with which markets view the conduct of economic policy. Lower public debt levels would also create room for a less procyclical conduct of fiscal policy than has been the case in recent years. Moreover, by adhering to the objectives and targets publicly stated in the MTFF—a new and visible public statement of policy intentions—the government would take important steps to cement its credibility.

43. **Against this background, adequate priority should be given to productive public investment, given its importance for economic growth and fiscal sustainability.** Within the context of the fiscal objectives of the MTFF, a sustained increase in public investment would depend to a large extent on a sustained increase in public savings. Such an increase could be sought through reforms that would facilitate a reduction in primary current spending (which increased by more that 5 percentage points of GDP between 1994 and 2002), including through measures aimed at enhancing efficiency and reducing significant rigidities in the budget, streamlining subsidies, and pressing ahead with structural tax reform and the

reform of the pension system. Recent government proposals to reform certain taxes and reduce the financial imbalance of the social security system go in this direction.

44. **The authorities are making efforts to improve the efficiency of public spending and have submitted to Congress a reform of the Organic Budget Law (OBL).** This reform would be an important step toward a more flexible and efficient public expenditure management system and would facilitate subsequent efforts to release some resources that could be redirected to priority expenditure, including public investment. The authorities, however, have stressed the need to entertain realistic expectations about what could be achieved in the short run, as a number of rigidities are constitutional and additional legislation would be needed following the passage of the reforms to the OBL. They also noted the political difficulties involved in reducing revenue earmarking.

45. **It will be important to implement the Medium-Term Expenditure Framework (MTEF) envisaged under the proposed reform of the OBL.** The MTEF should be seen as the key instrument to ensure the adequate competition of expenditures for scarce non-earmarked resources and their allocation in an explicit medium-term setting. The success of the MTEF will depend in no small measure on close coordination in the budget formulation and execution processes for the current and capital budgets, which are institutionally assigned to the Ministry of Finance (MOF) and the Planning Department respectively.

Public investment assessment, selection, execution, and control

46. **Project evaluation procedures at the national level seem broadly adequate.** Projects are evaluated by ministries and agencies and, once approved by the relevant unit and the Planning Department, are included in a proposed database of national investment projects. Investments in the annual budget are prioritized and selected from the database in consultation with the relevant ministries. However, the process suffers from some shortcomings, in particular the lack of ex-post evaluation of the performance of completed investments and the occasional inclusion in the budget of projects that have not gone through the due process. The authorities are encouraged to set up a centralized system to assess the results of completed investments and to apply uniformly the project evaluation and selection procedures to all relevant investments.

47. **The quality of project evaluation at other public sector levels is more uneven.** While similar procedures apply in principle to investment by subnational governments, their application is hampered by capacity constraints. A number of local authorities have not set up the required mechanisms, and the process is constrained by institutional limitations and excessive personnel turnover. As regards public enterprises, while project evaluation and selection procedures at some enterprises appear to be satisfactory, significant shortcomings have been observed in a number of enterprises. These include poor economic, technical, and financial evaluation of projects and lack of adequate prioritization.

C. Public-Private Partnerships

48. **Since the early 1990s, Colombia has been one of the most active countries in Latin America in developing public-private partnerships (PPPs) for infrastructure.** All in all, there have been some 150 contracts for private participation in all aspects of infrastructure service provision, leading to estimated investments of the order of US$5 billion. Contractual approaches used have included BOTs, concessions, joint ventures, and licenses. The development of infrastructure through PPPs has been significant.

49. **Colombia's experience with PPPs for infrastructure has gone through two distinct phases.** The first phase, up until 1997, included significant demand guarantees motivated by the need to attract the private sector to provide urgent investments in an unknown market. A number of these guarantees were triggered, partly as a result of the recession of the late 1990s, resulting in cumulative payments of US$2 billion to date. The three most important examples are the Power Purchase Agreements for electricity generation, the Telecom joint ventures, and the first generation of toll roads. The lessons of this experience are reflected in the second generation of PPPs, from 1998 onwards, which have been based on a much more substantial transfer of risk to the private sector, with only sparing use of government guarantees.

50. **The new legal framework established during the last five years requires full accounting and disclosure of contingent liabilities.** The first step was Law 448/98 that requires the MOF to estimate the value of contingent liabilities, and explicitly provide for these in the budgets of the respective public entities so that provisions may be deposited into a centralized Fund for Contingent Liabilities (FCL). Thereafter, Law 819/03 has required all contingent liabilities associated with concessions, sovereign debt guarantees, and legal cases to be reported annually to the Congress as part of the MTFF. This requirement applies retroactively to contingent liabilities incurred before the passage of this law. Contingent liability estimates were included in the first MTFF submitted to Congress in mid-2004.

51. **According to information reported in the MTFF, contingent liabilities from infrastructure PPPs that have been assessed so far are estimated at ½ percent of GDP.** These estimates, however, are incomplete, as there are still a number of past contingent liabilities for infrastructure to be evaluated and included in the estimates. Thus, while the estimation and publication of contingent liabilities in the MTFF is a positive step, the authorities are encouraged to press ahead with their plan to finalize the process of valuation of historic contingent liabilities at an early opportunity.

52. **Policy guidelines have been issued providing detailed principles for the allocation of risks between public and private partners to ensure that the use of guarantees reflects efficient risk transfer standards.** The guidelines require that each risk be carefully analyzed and allocated to the party with the greatest control over that risk, so as to minimize the overall costs of risk mitigation. With few exceptions, the private sector is expected to bear almost all of the risk associated with infrastructure projects, including commercial, construction, operating, financing, exchange rate, regulation, and *force majeure*

risks. Furthermore, it is stipulated that detailed technical, financial, and legal due diligence should precede the award of any infrastructure concession, and that the award process should be transparent and competitive, avoiding use of multiple bidding criteria. There are, however, no statutory limits on the total financial commitments that the government can undertake through PPP contracts.

53. **A sophisticated methodology has been developed for valuing contingent liabilities that remain with the public sector following the risk allocation process.** The legal framework makes the estimation of contingent liabilities arising from PPPs mandatory for all public entities at the national and subnational levels. Any project risks that remain with the public sector are quantified using Monte Carlo simulation techniques. The valuation may be done directly by the entity designing the project, although in practice technical assistance is provided by the MOF. The risks attached to the projects are reviewed every year and the valuation of contingent liabilities is revised accordingly, taking into account estimated changes in the conditional probabilities of various events.

54. **A deposit plan scheme has been set up to allow the project entity to budget for the contingency over time.** Based on the contingent liability estimates, a deposit plan is devised, which among other factors takes into account the entity's cash flow and the risk profile of the guarantee and aims at smoothing out the deposits required into the FCL. The assets of the FCL are managed by a fiduciary. Every year, the General Directorate of Public Credit at the MOF reviews the risks attached to the projects to take into account new information and makes any necessary updates to the contingent liability estimates and associated deposit plan. The deposits are made into individual accounts for each risk within each project proposed by each entity. If the contingency materializes, the FCL will cover up to the total amount of the deposits, and the difference has to be met by the responsible entity. At the end of the contract, and if all risks and projects are completed, the FCL reimburses the amount not used to the entity.

55. **The effective implementation of the system to assess contingent liabilities is relatively new.** The unit responsible in the MOF is still in the process of consolidation and should be supported. Larger resources may be required to process the growing number of contingent liability assessment requests and to provide appropriate training to other public agencies, in particular at the subnational level. In addition, the analysis of contingent liabilities is applied as a final screening in the project assessment process. The methodology could generate greater benefits if it was applied at an earlier stage in the process, since in this case it could be used in the design of the project and in the selection of projects based on their risk profiles and would help identify excessively risky projects at an earlier stage.

56. **Accounting procedures for contingent liabilities are generally clear, but the treatment of guarantees paid by the FCL needs to be defined.** Private investment under PPPs is not recorded in the public sector accounts. Government payments to contractors under PPPs are recorded in the budget as capital expenditure when they are made. The treatment of payments for guarantees depends on the legal arrangements under which the guarantees were contracted. Payments for guarantees issued prior to the new legal framework

that are executed must be recorded as a capital expenditure in the year of payment. For guarantees issued under the new legal framework, the agencies must record the deposits they make into the FCL as amortization in their internal accounts. These deposits have no impact on the consolidated accounts of the public sector, which includes the FCL. The accounting treatment of executed contingent liabilities from the FCL has not yet been clearly established, and no such liabilities have been executed to date. It is recommended that payments to contractors from the FCL in exchange for guarantees called be recorded as capital expenditures. Finally, given the limited information available on subnational PPPs, it would be advisable to establish a centralized inventory of these PPPs.

57. **An important feature of the financing framework for infrastructure in Colombia is the use of future budgetary appropriations.** These are commitments to ring-fence a stream of future fiscal resources for a specific multi-year project. In 2004, reported future appropriations were estimated to amount to 40 percent of projected public investment. Furthermore, a total of US$14.8 billion of investment has already been pre-committed under this mechanism up until the year 2020, of which about two-thirds are associated with infrastructure projects. National future budgetary appropriations are publicly reported when the commitment is made, but data on subnational future budgetary appropriations is limited. The legislation places some restrictions on the use of this mechanism. In particular, it limits authorization to cases that are consistent with the ceilings established in the MTFF.

58. **The authorities plan to step up the PPP program.** Preliminary plans under consideration envisage recourse to PPPs for various strategic infrastructure projects and social investments, including projects in social telecommunications and urban transport systems which could require providing capital subsidies.

D. Nonfinancial Public Enterprises

Commercial orientation of public enterprises

59. **In late 2003, the authorities assessed the commercial orientation of 14 large nonfinancial public enterprises.** They used the preliminary criteria suggested in SM/04/93. The enterprises assessed, which were all included in the public sector, operate in various sectors and generate more than 75 percent of the public enterprise sector operating surplus. The analysis, with which the staff agrees, revealed significant differences in the commercial orientation of public enterprises, particularly with regard to management independence, financial position, and management structure. Only one of the enterprises assessed, ISA (an electricity transmission company), was considered to be managed according to commercial criteria. In consultation with Fund staff, starting in July 2004, the authorities removed the enterprise from the coverage of the consolidated public sector monitored for operational and Fund program purposes. However, the operations and accounts of the enterprise continue to be monitored regularly.

60. **The authorities are implementing a program to reform and enhance the performance of decentralized public enterprises.** The strategy includes restructuring,

changes in budgetary procedures, strengthening follow-up, implementation of codes of good governance, and improvements in the configuration of boards of directors. At this time, no detailed assessment of additional enterprises has been carried out. However, the authorities might wish to assess some additional public enterprises in the future (including some subnational enterprises), particularly with a view toward assessing their commercial orientation and potential fiscal risks.

The national oil company

61. **The operations of the national oil company, Ecopetrol, raise some public investment issues of particular relevance for the pilot study.** The enterprise has made important progress toward improving its commercial orientation in recent years. However, it is not judged to be commercially run according to the suggested criteria. In particular, it carries out quasi-fiscal operations (including by being required to charge prices for some domestic products that are still below international prices, although over the last two years the authorities have been raising these prices faster than inflation) and is not independently managed. In the last few years, the authorities have limited Ecopetrol's investment program relative to the enterprise's proposals in light of overall fiscal constraints.

62. **Ecopetrol is keen to undertake more investment to expand oil production—which has been declining in recent years—particularly in light of the increase in international oil prices.** The enterprise's project evaluation and selection procedures appear to have been broadly satisfactory so far—and it is important to ensure that they remain so. On the other hand, the enterprise's operations make a key contribution to the primary surplus of the public sector, and the authorities did not propose to remove it from the definition of the public sector at this time. However, they are interested in exploring ways to enhance Ecopetrol's investment within the context of their MTFF.

Authorities' comments on the proposed criteria to assess public enterprises

63. **The authorities offered their comments on the criteria to assess the commercial orientation of public enterprises proposed in SM/94/03.** In their view:

- **The criteria do not define clearly the concept of *profitability*.** Some public enterprises operate in noncompetitive markets and it is not clear what profitability criterion should be applied in these cases, or how to make comparisons. Furthermore, profitability depends on the enterprise's type of business activity.[13] The assessment of the enterprise's profitability also requires detailed knowledge of its accounting principles and practices, as enterprises may use different accounting criteria.

- **The criteria should put more emphasis on *transparency*.** For a public enterprise to be considered commercially run, it should have in place codes of good governance in

[13] In this context, some officials noted the importance of assessing the enterprise's operating balance.

line with international standards and outside audits conducted by private firms that also adhere to international standards.

- **The specific characteristics of *subsidies* received by the enterprise matter for the assessment.** Transparent budget subsidies granted to public enterprises with appropriate corporate practices that are properly accounted by the enterprise and recorded in the budget should not be an argument against the commercial orientation of such public enterprises.

- **The medium- and long-term *sustainability* of the enterprise should be taken into account.** In particular, assessments should include the characteristics of its investment (in particular, whether the enterprise might be neglecting or postponing needed investment and maintenance) and its level of debt.

V. Ethiopia

A. Public Investment Trends and Infrastructure Needs

64. **Total investment increased sharply since 2000 and compares reasonably well regionally.** After an initial jump at the end of the socialist regime in 1991, total investment stagnated as a share of GDP at about 15–16 percent. In 2001, at the end of the 1998–2000 border conflict with Eritrea (and the initiation of the PRGF Arrangement), total investment rose strongly to reach some 20–21 percent of GDP currently. This compares reasonably well with similar countries in the region, such as Kenya, Tanzania, Uganda, and Zambia, as well as to the sub-Saharan African (SSA) average.

65. **Public investment mimicked total investment trends, and, on average, was higher in relation to GDP than in any of the neighboring countries.** Public investment averaged about 12 percent of GDP during this period, and was higher than private investment by about 5 percent of GDP. About a fifth of public investment is undertaken by public enterprises, mainly the major utilities.

66. **Still, Ethiopia faces enormous social and physical investment needs.** Human development needs are arguably the greatest of any country in the world. Per capita GDP is only US$100, half the population lives in absolute poverty, and Ethiopia ranks 170th in the 2004 Human Development Index. Road density and access to potable water, electricity, and telecommunications, are extremely low by any standards.

67. **Over the last ten years, growth performance has improved but remains volatile and varies greatly across sectors.** GDP growth per capita has averaged 1.6 percent between 1993 and 2003, which is higher than the SSA average. This was driven by robust growth in the non-agricultural sector. Despite attempts to raise yields by increasing input utilization, agricultural productivity has struggled to improve. Since agriculture employs 85 percent of the population, the national growth strategy hinges on transforming agriculture into the engine of growth.

68. **Significantly higher, and better structured, growth is key for reducing poverty.** Simply projecting current growth rates, given the current income distribution, suggests that in 2015 poverty would be only marginally lower than in 1990. But if this growth were to be much more pro-poor, the headcount measure of poverty could be reduced by almost half.

69. **Infrastructure bottlenecks greatly constrain Ethiopia's growth potential.** Large infrastructure investments are needed not only to support the creation of rural-urban linkages and rural growth, but also to create an enabling environment for private sector development.

B. Fiscal Strategy and Debt Sustainability

70. **A careful balance will need to be struck between ensuring debt sustainability, scaling up public investment, and addressing social investment needs.** External debt has been lowered by debt relief under the HIPC initiative (Ethiopia reached the completion point in April 2004). Nonetheless, debt sustainability remains a concern. The NPV of the public debt is still 55 percent of GDP, 34 percentage points of which is domestic debt.

71. **Under a baseline scenario of high growth and fiscal consolidation, public debt sustainability improves.** This scenario assumes growth increasing to about 5½ percent (significantly above the historical average of about 4 percent), an improving fiscal balance, and external assistance continuing at historical levels. Driven by these factors, the ratio of public debt-to-GDP declines. But sustainability is threatened if growth remains at the historical average, or domestic real interest rates increase.

72. **Increasing foreign-financed development expenditure and structural reform could substantially enhance growth.** A comprehensive costing of the programs necessary to reach the MDGs is currently being conducted by the government. The recent Public Expenditure Review, however, envisaged poverty-reducing spending increasing by around 17 percent of GDP, including spending on roads, rural development, and agriculture.

73. **The impact on public debt sustainability of higher poverty-reducing expenditure will depend critically on the link with growth and the grant component of external assistance.**

- If external financing is provided on concessional terms, and results in substantially higher growth than currently projected, the public debt-to-GDP ratio can be sustainable. If such a growth response does not occur, the public debt-to-GDP ratio may well not be sustainable.
- Higher export growth would make more room for external debt financing.
- Financing the spending by grants sharply improves debt sustainability.
- The scope to substantially increase domestic borrowing is limited, owing to the existing high levels of domestic debt.

C. Impact of Fiscal Restraint and Adjustment on Public Investment

74. **The burden of fiscal adjustment does not seem to have fallen disproportionately on public investment**. Between 1990 and 1997, the overall balance improved significantly. Yet, capital spending increased and current spending fell sharply. Since then, both current and capital spending have increased. Capital spending has also varied less year-to-year than current spending since the early 1990s.

75. **Key sources of fiscal adjustment, such as retrenchment of defense spending, have, however, been tapped already.** Going forward, fiscal consolidation may constrain the extent to which public investment could be scaled up to meet the challenge of the MDGs, though greater structural reforms could unlock more foreign assistance. It is also important to recognize the human capital investment nature of efficient social sector current spending, which contributes to higher growth (and thus improves sustainability).

D. Institutional Capacity to Appraise and Manage Infrastructure Projects

76. **Infrastructure investment is planned and appraised as part of a comprehensive investment strategy.** Federal infrastructural projects are planned on a rolling three-year basis in a Public Investment Program, based on the authorities' poverty reduction strategy (SDPRP) and approved by the Council of Ministers. Regions receive transfers from the federal government intended to cover infrastructure investments in key pro-poor sectors in the framework of the SDPRP. At the ministry level, the government also has control over investment decisions taken by the utilities to ensure consistency with the overall public investment framework. For instance, there are sector-based masterplans that guide medium-term investment decisions.

77. **Project evaluation procedures, at least for external projects, seem adequate.** Most infrastructure projects, which are financed by external assistance, are prepared by sectoral ministries and reviewed by the budget department of the Ministry of Finance and Economic Development (MOFED), and then submitted for approval to the Council of Ministers and to the Council of People's Representatives. Project evaluation is consistent with standard international practice in line with donor requirements. For example, the World Bank requires a minimum 12-percent social rate of return, and an estimate of ex-post project performance suggests that social rates of returns have been around 16–17 percent in most sectors. Projects by public enterprises are mostly appraised by international consultants, while management oversees implementation.

78. **Absorbing large increases in the capital budget can be difficult.** Difficulties with the physical execution of capital works include problems with contracting, managing, and committing resources, delays with construction and design, insufficient capacity of the contractors, and implementation difficulties in remote rural areas or during the rainy season. Substantial delays seem to be caused also by the need to comply with donor requirements for accounting, procurement, and reporting. The latest Country Financial Accountability

Assessments also identified weaknesses in the auditing function, linked to the difficulty in attracting sufficient qualified staff.

79. **Decentralization complicates the management of public investment.** Not only is reporting from regions problematic, the planning, budgeting, accounting, and procurement capacities of the different levels of government need to be reinforced. More generally, there remain regional problems in the limited ability to contract out the supply of services and in private sector capacity to meet these contracts. Local governments have embarked on a comprehensive effort to address these deficiencies with the support of the World Bank's Public Sector Capacity-Building Program (PSCAP). Under the PSCAP, local governments are strengthening expenditure management and control, planning and policy development, procurement policies, and upper management capacity.

E. Coverage of Nonfinancial Public Enterprises in Fiscal Indicators

80. **Public enterprises are numerous and play a large role in the economy.** They operate in all sectors of the economy, but mainly in manufacturing. Public enterprises account for about 6 percent of GDP, and for slightly more than half of manufacturing output. Most of these enterprises are planned to be privatized by 2005 (which is likely to prove optimistic, given past performance). The enterprises to be privatized are currently overseen by the Ministry of Trade and Industry. The major public utilities, including the airline, are not envisaged to be privatized and are overseen by the Ministry of Infrastructure.

81. **Public enterprises, especially those overseen by the Ministry of Trade and Industry, seem fairly tightly controlled.** The government appoints the board; and the board appoints the CEO and senior officers. Enterprises cannot readily borrow abroad commercially, except to support export activities and the government on-lends concessional borrowing to the utilities. Enterprises do not receive subsidies and are generally allowed to reinvest profits. Annual budgets must be approved by the supervisory ministry, and the Ministry of Trade and Industry requires quarterly reporting of financial data with a lag of a couple of months. The Ministry of Infrastructure, however, only receives audited annual accounts from its enterprises, but does follow closely the execution of the utilities' investment projects.

82. **While in principle all public enterprises should be commercially run, in practice they are not.** Indeed, no public enterprise is currently commercially run as defined by the criteria proposal in the Board paper on Public Investment and Fiscal Policy (SM/04/93). To assess the commercial orientation of public enterprises, the operations of the five largest public enterprises were examined (Ethiopian Electric Power Corporation (EEPCO), the Ethiopian Telecommunications Corporation (ETC), the Ethiopian Railways Corporation (ERC), Ethiopian Airlines (EAL), and the Ethiopian Shipping Lines (ESL)). These generated 54 percent of the sales of the public enterprise sector.

83. **EAL, ETC, and EEPCO heavily cross-subsidize their various operations.** EAL's international routes are profitable, but it makes significant losses on domestic routes.

Similarly, ETC makes profits on international and urban calls, but makes losses in rural areas. EEPCO uses profits on industrial, business, and urban residential customers to subsidize rural consumers. While cross-subsidization within a firm may be done for commercial purposes, in the case of these PEs, the cross-subsidization appears to be done for reasons of public policy. A central tenet of government policy is to help the rural poor; and utilities are required to contribute to this goal by exercising their monopoly power in some markets to support development in rural areas.

84. **While public enterprise employees do not have a special status independent of the labor law applicable to private firms, there is excess employment in most public enterprises.** A World Bank study of Ethiopia, using frontier firms (the best performing public and private firms) as a benchmark, concludes that although frontier private firms and Industrial Public Enterprises (IPEs) produce the same amount, frontier IPEs employ 25 percent more workers than private frontier firms. Government officials also generally agreed that public enterprises were characterized by excess employment. Public enterprises may also pay above market wages at the lower end of the wage scale.

85. **Both EAL and ESL have occasionally been effectively exempt from corporate income tax.** The government argued that this is justified as it avoids transaction costs. However, in addition to possibly being seen as a nontransparent subsidy, it is also contrary to the effort to modernize the public finance process by congregating all expenditure decisions in one location (the budget) so that they may be properly prioritized against one another.

86. **EAL is profitable while facing competition in international markets, though still possibly benefiting from some regulatory assistance.** This is no mean achievement. But this has not been achieved without government intervention. Landing rights are negotiated between countries with the result that on many routes EAL enjoys a duopoly with the carrier of the destination country (as is the case in many industrial countries).

87. **Similar considerations apply to ESL.** Like EAL, ESL earns a profit operating in international markets. But as with EAL, the degree of competition in those markets may be questioned. Exports are officially unconstrained, as are private imports (overall, 29 percent of imports go through ESL). However, there is a guideline to use ESL for imports by, or through, government entities.

88. **No public enterprise is listed on any stock exchange and only one (ERC) seems to have minority shareholders**. Since the other shareholder in ERC is the Government of Djibouti, which controls one terminus, its rights are likely to be fully protected.

89. **By law, public enterprises should be audited by outside auditors**. But in practice for the sample, the outside auditor is the Audit Services Corporation (ASC), which is a public enterprise wholly owned by the government. It is not clear if this qualifies as "outside." The reports provided by the ASC are comprehensive by international standards. Only at one firm were the full three-year series immediately available. There is no public registry of company reports.

90. **Consolidating the nonfinancial public sector would not significantly change the recorded fiscal position.** Public enterprises have little external debt (which is already included in the government debt data) and their "overall balance" varies around zero. And while it is clear that public enterprises are undertaking significant fiscal operations, integrating them into the fiscal framework does not seem an immediately pressing need. The impact on the recorded fiscal position is small and the fiscal risk posed seems modest, given the tight government control. Moreover, data and resources needed to properly integrate even just the top few enterprises, combined with the limited capacity to coordinate such an exercise and the authorities' reluctance to consider public enterprises part of the fiscal sector, suggest that integration would be a major challenge for the near term.

VI. GHANA

A. Recent Fiscal Developments, Public Investment, and Infrastructure Needs

91. **While the central government has run relatively large fiscal deficits over the past decade or so, the fiscal position has strengthened in recent years.** During the 1990s, the overall fiscal deficit of the central government averaged about 8–10 percent of GDP, due in part to uneven tax revenue performance, high domestic interest rates, and terms of trade shocks. The fiscal deficit was reduced to about 3½ percent in 2003 and is projected to decline to about 1½ percent of GDP in 2004.

92. **Ghana's debt outlook has improved considerably over the past few years**. Ghana reached the completion point under the enhanced HIPC in July 2004. Assuming full delivery of current debt relief under HIPC at end-2003, the nominal stock of external debt would decline from US$7.5 billion to about US$4 billion. The authorities' macroeconomic strategy, supported by a new three-year PRGF arrangement in 2003, aims to achieve medium-term debt sustainability through prudent fiscal and debt management. This strategy has already begun to pay a fiscal dividend, with nominal interest rates declining sharply since mid-2003 in conjunction with a significant decline of domestic debt.

93. **Total investment in Ghana has been volatile in recent years, with the public sector contributing a declining share of the total.** Total investment has fluctuated from just under 20 percent to 26½ percent of GDP, with both private and public investment each averaging at about 11 percent of GDP during the period 1993–2003. The share of public investment in total investment has declined from about 50 percent in 1993 to under 40 percent in 2003. Foreign-financed public investment in Ghana (funded by either project grants and/or loans) has declined from over two-thirds of total public investment in 1993 to just under half of the total in 2003.

Capital expenditure by the government has been impacted by shortfalls in foreign financing as well as by the lack of flexibility in fiscal adjustments. Two periods of marked decline in public investment (1998–2000 and 2002) were associated with significantly lower foreign financing. The authorities also resorted to cuts in capital outlays in order to undertake fiscal adjustment, given the large share of protected items in the consolidated budget and

further inflexibility due to the earmarking of tax revenues for the extrabudgetary statutory funds.

94. **There are signs of significant infrastructure bottlenecks**. Transmission and distribution losses in the electricity network of 30 percent suggest a need to improve technical efficiency. Access to improved water and sanitation facilities in Ghana lags somewhat compared to low–income countries as a whole. The lack of a telecommunications sector strategy (including a policy for the period of post-exclusivity for Ghana Telecom) has led to low levels of investment in the fixed-line telecommunication infrastructure. While the size of the road network compares relatively favorably to that of sub-Saharan Africa, the quality of the road network is quite poor.

95. **The Ghana Poverty Reduction Strategy (GPRS) delineates the policy priorities of the government, including in terms of infrastructure.** The GPRS is comprised of five pillars: macroeconomic stability, production and gainful employment, human development and provision of basic services, protection of the vulnerable groups, and governance. The total cost of the fully articulated GPRS was estimated at US$5.3 billion for 2003–2005 (about 60 percent of annual GDP). However, recognizing resource constraints and absorptive capacity, a set of prioritized Medium-Term Priority Programs (MTPPs) has been identified, which amounted to about one third of the total GPRS. The budget of the central government as well as the budget guidelines that are provided to the district assemblies are guided by the MTTPs/GPRS. Some 80 percent of the MTPPs in 2003 were expected to be externally funded. In the context of this prioritization process, road infrastructure development gained increased significance.

96. **The GPRS emphasizes the importance of infrastructure in the achievement of the country's development goals.** For water and sanitation, the main target is to meet the specific MDGs. In terms of roads, improving the quality of the existing infrastructure is a priority. At the same time, the GPRS states the need to develop interconnecting roads aimed at opening up the country and harnessing the potential of intra-West African trade. The priority in the electricity sector is to expand access to and improve efficiency of the distribution network.

97. **The World Bank estimates that achieving these targets will cost about US$3.4 billion in terms of new investment and in maintenance costs for the period 2004–2008.** This represents an annual outlay of about 8 percent of GDP (almost three times higher than what has been undertaken in recent years). About 85 percent of the public investment in infrastructure is required to address needs in the water, sanitation, and road sectors. As for maintenance of both existing and new infrastructure, roads account for close to half of all needs.

98. **In addition to capacity constraints in undertaking public infrastructure investment of the magnitude identified above, financing the infrastructure bottlenecks may pose a challenge.** There is room for enhancing domestic resource mobilization over the medium term, both from the private sector (once issues relating to the weaknesses in the

banking sector and the low level of financial intermediation are addressed) and from the public sector (in terms of raising the tax revenue ratio somewhat and further reprioritizing among expenditure categories). While recent debt relief under the enhanced HIPC initiative has freed-up significant resources (about 2–2½ percent of GDP over the period 2004–08), not all of these resources are to be used to finance physical infrastructure. As identified in the GPRS, Ghana also has substantial financing needs in order to meet the MDGs, which will require investment in social (health) and human (education) capital as well.

B. Coverage of Fiscal Indicators

99. **The scope of government activity (including in terms of infrastructure spending) goes well beyond the fiscal coverage under the Fund-supported program, which is limited to the central government.** Fiscal policy is also executed through a number of channels, with more or less control by the center, including by district assemblies (local governments), statutory funds, the social security system, and state-owned financial and nonfinancial institutions. The core of the central government comprises 36 ministries, with some 250 departments and agencies (MDAs) operating under these ministries. In addition, there are five statutory funds that are financed by earmarked funds. The District Assemblies Common Fund (DACF) is used to finance the activities of local governments (i.e., the 130 District Assemblies).[14] The statutory funds are legal entities, which are required to produce annual audited accounts and are subject to oversight by Parliament. Expenditure by these funds is mostly capital-related. The public sector also includes several financial institutions, in particular, the Social Security and National Insurance Trust (SSNIT). In administering the national pension scheme which currently generates large surpluses, the SSNIT invests in financial assets, commercial property, and targeted investments. Ghana Commercial Bank (GCB) is the largest commercial bank and, through GCB, the government has pursued quasi-fiscal activities, such as the financing of the Tema Oil Refinery and other state-owned enterprises.

100. **Many of the enterprises that are wholly owned by the government do not operate on a commercial basis and rely on state support for their activities.**[15] Some of these enterprises serve social policy (culture, communications, media) and other public policy objectives (transportation), while others are engaged in quasi-fiscal activities. In addition, the majority of these enterprises operate at a loss, due to a number of factors, including technical and productive inefficiency, and in some cases, pricing below cost recovery.[16] There is a significant number of additional public enterprises (as many as 200) where the government has a majority interest. It would appear that sectoral ministries are responsible and supervise the operations of these enterprises. However, there is no central

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[14] The other four statutory funds are the Ghana Education Trust; the Road Fund; the Petroleum Fund; and the newly established National Health Insurance Fund.

[15] This assessment uses the criteria developed in the Board Paper SM/04/94 and is preliminary, given the limited data that were available.

[16] The government is now pursuing cost recovery pricing for water, electricity, and petroleum products.

monitoring unit for their operations. The State Enterprise Commission (SEC) is charged with monitoring the performance of 34 wholly government-owned enterprises, but the information made available by the SEC is insufficiently comprehensive and timely. There is no central unit tasked to produce monitorable data on financial operations of all the public enterprises.

C. Analytical Framework

101. **Extending the fiscal coverage to include the district assemblies, the statutory funds, and eight among the largest wholly government-owned public enterprises would result in both a worsened overall and current fiscal balance.**[17] The overall fiscal deficit would shift from an average of 6 percent of GDP for the central government to about 10 percent of GDP for the extended government over the period 2000–2003. The current balance would shift from a surplus of 3.3 percent of GDP for the central government to a surplus of 0.6 percent of GDP under the extended coverage over the same period.

102. **The outcome of debt sustainability analysis (DSA) using an extended fiscal coverage depends critically on the financing assumptions for the increased deficit, but in all scenarios it remains vulnerable to exogenous shocks.** The debt position in the immediate aftermath of the HIPC completion point is sustainable, with the NPV of debt falling to the equivalent of 189 percent of government revenues and 109 percent of exports of goods and services. After taking into account the extended fiscal coverage, a steady strengthening of the fiscal position, in conjunction with strong economic growth, would be required under those scenarios that did not rely primarily on grant financing.

103. **The fiscal target under the Fund-supported program, namely net domestic financing of the central government, provides some room for additional foreign-financed public investment.** This, however, requires that such financing be available, of concessional nature, and consistent with the other macroeconomic objectives, such as containing inflation. Still, there is a need to strengthen the process of project appraisal to ensure that the returns on public investment exceed the cost of financing.

D. Institutional Capacity to Appraise and Manage Investment Projects

104. **There is a need to strengthen the institutions and mechanisms to appraise public investment projects.** While many investment projects are donor-financed and are thus typically subject to international appraisal procedures, as well as sector level cost-benefit, cost-effectiveness, risk, financial, and sustainability analyses, there is a need to develop Ghanaian capacity in this area. The State Enterprises Commission (SEC) has undertaken some value-for-money appraisals of investment projects for public enterprises under its supervision. It is not clear whether sectoral ministries (or any other government agency)

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[17] Given the significant data limitations, this analysis is preliminary and involves eight public enterprises, which are: Tema Oil Refinery, Volta River Authority, Electricity Company of Ghana, Ghana Water Company, Ghana Civil Aviation Authority, Ghana Ports and Harbors Authority, Ghana Airways, and Ghana Cocoa Board.

undertake similar appraisals for other public enterprises. The Ministry of Finance and Economic Planning ought to establish a public enterprise unit responsible for reviewing the financial status and for auditing activities (including relating to investment projects) for all enterprises (or, at least, for those not currently covered by the SEC).

105. **The authorities have recently established policy guidelines for implementing PPPs in Ghana.** The guidelines limit themselves to essentially providing a definition of PPPs, and do so in relatively broad terms, in that they include management contracts, concessions, joint ventures, as well as variations on the standard design-build-finance-operate scheme. Private sector participation in the provision of public infrastructure and services can ease fiscal constraints on such investment and increase efficiency. In operationalizing the recently approved guidelines, it will be important to take explicitly into account a number of important principles, including: (i) giving foreign partners equal access and treatment to PPP projects as domestic partners; (ii) adhering to the requirement of disclosing PPP contracts; (iii) transferring adequate risk to the private sector to obtain the full benefit from the inflow of private capital and managerial expertise; (iv) ensuring that any contingent liabilities stemming from the PPP are disclosed and properly provided for in the budget; and, (v) strengthening the process of project appraisal and prioritization. The guidelines, in their current form, do not reflect these principles.

VII. India

A. Fiscal Developments and Infrastructure Investment Trends

106. **According to conventional criteria, India's fiscal situation is a cause for concern.** After an aborted fiscal adjustment in the early 1990s, general government debt has risen to 81 percent of GDP. The overall deficit of the general government exceeds 9 percent of GDP and the primary deficit amounts to 3¼ percent of GDP. Still, India recorded a small external current account surplus in 2003 (1.4 percent of GDP), as well as a strong capital account surplus built largely on FDI and portfolio flows (3.7 percent of GDP). International reserves exceeded US$135 billion in March 2005, some 13½ months of imports and about six times the level of short-term debt. Net private sector savings have been rising, while the government has been able to finance itself domestically on favorable terms, and at low rollover risk. While the near-term risk of turbulence is low, in the medium term, were the current favorable growth-real interest rate differential to disappear, public debt would be on an unsustainable path.

107. **Fiscal adjustment in the early 1990s contributed to infrastructure problems, but other factors have played an important role as well.** As part of fiscal adjustment efforts, nonfinancial public sector capital spending fell by about 3 percent of GDP in India in the early 1990s, and has not recovered since. An important restraint later in the decade was recurrent spending pressures, especially due to high civil service wage awards. Throughout the period, implementation problems have had an impact on infrastructure (cost overruns still average 20 percent of initial cost estimates and were as high as 60 percent in the early 1990s), as has inadequate maintenance (Planning Commission estimates put the deficiency at

between 30 and 60 percent of needs in the roads and irrigation sectors). Private sector spending was expected to compensate public cutbacks, but has been slow to materialize, largely due to deficient sector policies and regulatory frameworks.

108. **There are many indications of significant infrastructure needs, but measuring precise bottlenecks is complicated by several factors.** The most pressing needs in India are widely felt to be in the electricity, roads, and urban infrastructure areas. The current shortfall in energy peak supply is about 11 percent, which would imply $5–7 billion in needed new upfront investment (plus another $4–6 billion annually to accommodate new growth). In roads, there is widespread congestion and average speeds often so not exceed half the legal limits. It is estimated that over the next 10 years, around 32,000 km of national highways and 25,000 km of state highways will need to be widened, at a cost estimated at $40 billion. Urban infrastructure needs are especially serious: they are estimated to amount to $38 billion for water and sanitation to achieve full coverage of the urban population by 2021; and $46.5 billion for urban transport in cities with a population over 100,000 (over the next 20 years). However, these estimates are affected by pricing—without heavy price subsidies the electricity shortfall might not exist—and by uncertainties about the pace of urbanization.

109. **The government has argued that raising India's GDP growth rate may require significant new infrastructure investment.** During the last 10 years, growth averaged about 6½ percent. The government would like to accelerate this by 2 percent per annum to help create jobs and improve living standards for the poor, especially in rural areas. While it is difficult to exactly pin down the relation between infrastructure and growth, the government estimates that to raise the growth rate by 2 percent will require about 4 percent of GDP per annum in *new infrastructure investment.* At the same time, a significant increase in expenditure on maintenance, possibly around 1 percent of GDP, appears needed.

B. Public Investment Options

110. **High fiscal deficits and the possibility of adverse debt dynamics limit options for India to borrow to finance additional public investment.** Even with unchanged budgetary policies, public debt, currently at 81 percent of GDP, is likely to continue to increase relative to GDP. To stabilize the debt ratio over the next five years would require a reduction in the primary deficit from 3.3 percent to 1.4 percent of GDP (assuming GDP growth of around 6½ percent, and a gradually declining real interest rate). Reducing the deficit by a further 1 percent would reduce the debt ratio to close to 75 percent of GDP. In both cases, the evolution of debt is quite sensitive to underlying assumptions about growth and the real interest rate, and even short-lived shocks can create unstable debt dynamics. Nor is there a convincing case that borrowing to achieve higher infrastructure investment-led growth would solve the sustainability problem: if the primary deficit is not reduced and it leads to extra investment averaging around 1 ¼ percent of GDP per year over five years, both growth and the real interest rate would likely rise relative to the baseline, and it is far from clear what the net effect of this would be on debt sustainability. In fact, assuming that the real interest rate is at the average level of 2002–04 (rather than falling, as projected in the baseline), an

implausibly low incremental capital output ratio (of around 1) would be needed to secure the extra growth necessary to stabilize the debt.

111. **Alternative methods for financing higher public sector investment also raise some issues:**

- Given the Government of India's extensive equity holdings (including in marketable oil and energy companies), there is much potential for disinvestment. However, new investment funded from this source should earn at least a similar rate of return, to preserve public sector net worth. More importantly, it would be important to ensure that this easy financing does not delay a needed adjustment of the current fiscal balance (to the detriment of medium-term debt dynamics). India's nascent medium-term spending framework can help to this end, but measures to achieve fiscal targets also need to be clearly identified ex-ante.

- An alternative that is being discussed is to create off-budget funds to finance infrastructure. Although the precise modalities are still being worked out, it appears that these funds will borrow domestically with government guarantees to finance commercially viable projects with private participation. They would draw down foreign exchange reserves only to finance imports for these projects. While such schemes could mobilize additional funds, it is important that their operations are undertaken in a fully transparent manner, and take into account the debt-sustainability constraint. There is less potential for using foreign exchange reserves directly to finance infrastructure, another option that has been debated. While India's reserves have grown rapidly in recent years, and are adequate by many measures of coverage, their use by the government could have adverse implications for the fiscal adjustment targets and credibility of the monetary policy framework.

112. **Public savings will need to be raised to fund sustainably higher investment, and this will require both revenue adjustment and expenditure reorientation.** India's general government revenue, at 18¾ percent of GDP, is low by international standards, suggesting an adjustment strategy focused on revenues. In fact, the Kelkar Commission has already examined options and noted the need to overhaul sales taxes, broaden the tax base (especially to better capture services), and improve tax enforcement. Still, revenue measures would likely be insufficient in the short run to both meet fiscal targets and fund higher investment and maintenance spending. Indeed, tax administration improvements would need to play a large role, and it is notoriously difficult to predict their yield. There are, however, many options for expenditure restraint and reorientation, including rationalizing subsidies, which are poorly targeted. India's experience in the late 1990s also demonstrates the importance of continued restraint of the wage bill.

113. **Encouraging state governments to raise their savings will be vital for achieving higher public investment.** In India, almost 60 percent of public investment is implemented at the state level, much of it by constitutional mandate. Yet states face binding fiscal constraints: high debt, a high overall deficit, and a significant current deficit (about

2½ percent of GDP). In some states, the situation is dire, with interest to revenue ratios approaching 90 percent. As in the case of the central government, options for adjustment start with revenue reforms (and in particular the introduction of a VAT), but expenditure restraint is also crucial. Some states have already begun to tackle wages (through attrition), subsidies (through higher user charges), and pensions (through parametric changes). Appropriate fiscal responsibility legislation could help maintain the effort, and a model law is being developed by the Reserve Bank of India. However, sanctions for non-performance are needed, in view of experience to date. The central government could also help by closing off-budget borrowing loopholes which states have in the past exploited (e.g. special purpose vehicles), and by increasing the proportion of conditional transfers (with conditions set to take account of states' fiscal adjustment efforts).

114. **Revenue and expenditure assignments need to be reviewed at the municipal level of government, to ensure responsibilities are matched by adequate resources.** Like the states, municipalities are also in a dire fiscal predicament, with high expenditure needs, a low revenue base, and little organizational and technological capacity. Given the expected continued sharp growth in urbanization in India, the fiscal framework for municipalities urgently needs review, and measures need to be taken to secure more reliable sources of financing, including via higher user charges for municipal services.

115. **There are significant potential gains from improving the management of the public investment program.**

- Improvements in the system of project appraisal, selection, and monitoring at the central government level in India have already led to a dramatic reduction in cost overruns, from 60 percent in the early 1990s to about 20 percent now. Key remedial actions in the 1990s included establishing more rigorous project appraisal and a two-stage approval process, weeding out unviable projects, reprioritizing, appointing an officer responsible for each project, establishing a computerized monitoring database, establishing a standing committee in each ministry to address time and cost overruns, and focusing more attention on selected high implementation-risk projects. In some cases, the authorities have also set up semi-autonomous agencies to manage the construction, maintenance, and use of infrastructure assets (e.g., the National Highway Authority of India). These have been fairly successful, but consolidation of their activities into general government accounts would strengthen fiscal management.

- Still, there remain areas for improvement. Planning coordination can be improved, with project sequencing taking better account of spillovers (e.g., through transportation connectivity). Budget processes have also not captured the recurrent implications of capital spending, in part due to a focus on annual budgets (a new multi-year rolling budget is being piloted in the MOF, but only a handful of states have implemented such a framework to date).

116. **Criteria for the commercial operation of public enterprises have been successfully applied in India as conditions for more management autonomy.** In 1997, India's central government began to grant a substantial degree of management autonomy to public enterprises, which meet key commercial criteria. The authorities' "Navratna and Mini-Ratna" schemes allow selected companies more autonomy to invest, hire employees, and restructure operations, provided they have a track record of good financial performance, do not have any subsidies or guarantees from the government, and have upgraded their corporate governance (e.g., by appointing outside directors to their Boards and audit committees). The companies involved (mainly in the energy sector) have indicated that the scheme has been helpful to their operations. However, the degree of appropriate autonomy needs to be regularly reviewed: at present it may be desirable to provide more latitude for joint ventures, for mergers/acquisitions, and for revenue-hedging operations. Companies may also, at some point, require more flexibility in remuneration for highly skilled staff than that afforded by the civil service pay scales.

117. **Non-commercially oriented companies need to be better integrated into fiscal planning to help manage their fiscal impact.** In India, the budget presented to parliament does not contain a consolidation of general government and public enterprises, even for public enterprises which fall far short of most or all the criteria in SM/04/93, and are involved in, or have a history of, quasi-fiscal activity. Fertilizer producers, the railway, and state electricity boards (SEBs) have been the greatest problems. SEBs have in fact created substantial fiscal stress for the states, and have incurred annual deficits as high as 1½ percent of GDP. In part, the issue is a deeper one of reforming public subsidies (to ensure adequate cost recovery), and the ability of governments to hide costs off-budget has clearly not helped to adapt public attitudes. But there are also clear operational improvements that can be made in non-commercial enterprises if attention is directed towards them. Indeed, state electricity regulators and the Committee for Restructuring Public Enterprises (at the central government level) have helped encourage operational improvements (especially reductions in overstaffing).

C. Private Sector Participation

118. **Given limited options for higher public investment, especially in the near term, greater private sector involvement in the provision of infrastructure investment including through public private partnerships will be needed to help realize investment and growth targets.** While this has been recognized in India at least since the early 1990s, private participation has been slow to materialize, and has been absent entirely in some sectors.

119. **There has been much experimentation with PPPs across Indian states, but they have not proved possible in all circumstances.** Much has been already achieved, for example in telecommunications and ports. Other successful sectoral examples include the projects to expand national highways being implemented by National Highway

Administration of India (NHAI), both tolled and based on the so-called Annuity Scheme[18]; the electricity distribution privatization in Delhi, and a small number of water projects, such as Tirrapur, built around sales to consumers with a high willingness to pay. However, state governments have had extreme difficulty in attracting interest in rural projects in any sector, notwithstanding efforts to bundle these with urban infrastructure concessions or to offer higher public risk bearing. The government has indeed explicitly recognized the different roles that public and private sectors can play by setting up two separate high-level committees, one for infrastructure that may be commercialized, and another for rural infrastructures where the public sector will be largely responsible.

120. **Financing is readily available to the private sector, but capital market imperfections have nonetheless restricted financing to private infrastructure projects.** Domestic savings have been high enough in India to ensure a small current account surplus, despite high government dissavings. Moreover, foreign savings have been readily available, and India has run a capital account surplus averaging almost 3 percent of GDP over the last three fiscal years. As a result, many financial institutions have the capacity in their portfolios to undertake additional finance of infrastructure projects. However, the long-term finance needed by most infrastructure projects is held back by cautious banking practices (reflecting in part underdeveloped risk assessment capabilities in banks), and excessive maturity mismatches in banks (whose long-term assets are already dominated by government paper). Outside banks, there are restrictions on long-term institutional investors (pension funds and life insurance companies), and the corporate debt market is underdeveloped. The dearth of products and players in the interest rate derivatives market further limits the ability of the financial system to transform maturities. As a result, project developers face financing hurdles and high refinancing risk. High ex-ante rates of return must be achieved, and the number of bankable projects is correspondingly lower. Recent deals to securitize receivables (in the road area) may, however, signal some expansion of refinancing opportunities.

121. **Regulatory risk has been a major impediment to private participation, and has several dimensions.** Many regulatory frameworks in India have only recently been set up, and there remain bottlenecks which need to be addressed. For instance, many existing regulators still lack control over their expenditure and staff compensation, and suffer from a public impression that commissioners are insiders, thus leading to questions about their objectivity and independence. Secondly, excess discretion has been an issue, both in terms of setting the level of tariffs and the timeliness of decisions. Finally, investors have faced long and uncertain delays in project approvals and clearances. Openness to feedback and a good process of public hearings have helped earlier frameworks mature over time and gain credibility—the Telecom sector provides an example—and more recent frameworks, for instance for electricity, are trying to follow this path.

[18] The concession is given to the developer/builder who bids for the lowest grant. The government pays the grant in installments, and the concessionaire builds and maintains the facility for the specified period. The grant is financed by an excise tax on gas.

122. **Political risk has also undermined PPPs, and a number of mechanisms have evolved to help minimize it.** Changes of government have often led to renegotiations, while vested state interests have also blocked reforms. More generally, a populist political culture undermines political support for necessary user fees. Several strategies have been employed in India to overcome vested interests. Most prominently, sector policy frameworks have promoted competition. In the power sector, the pending creation of a power market, and the opportunity to on-sell power to a range of players, have already spurred private sector interest in investing in new generating capacity. Second, the government has compensated those who will lose from reform. Again in the power sector, the central government has given states incentives to improve the performance of SEBs (ahead of the negative impact that opening the market will have on their balance sheets). Third, some infrastructure projects have given a prominent role to stakeholder management, to the extent of including consumers, landowners, and trade unions in the Board charged with implementing the project. The assumption has been that if they can see costs and benefits, they will be more willing to help overcome obstacles. Fourth, contracts have provided for dispute resolution mechanisms and have in some instances set out explicitly the cost the government would bear in the event of policy reversal. Finally, there have been broad efforts to improve transparency about subsidies and costs in some states, including by requiring that these be printed on consumers' bills.

123. **Governments in India have also perceived there to be risks in PPPs, and this may have reduced the supply of potential PPPs.** The capacity to negotiate and implement PPPs has been especially lacking at lower levels of government in India, making them wary of entering into such commitments. Moreover, while there are many experts in India on PPPs, there are few mechanisms to disseminate their experience. Some states have created infrastructure development agencies, and these have interacted with specialized central government financial institutions to gain knowledge. Specialized government financial institutions have also loaned staff to state governments. However, the authorities view a more systematized approach as desirable, including, perhaps, the creation of a central clearing house for good practice. This could also be a source for template or model contracts and for sound auction and procurement practices which ensure competition.

124. **Both supply and demand factors have limited the recourse to government guarantees.** To date in India, central and state governments have granted various types of guarantees, including on minimum revenue, non-competition, and tariff and legislative changes. Nonetheless, individual guarantees have in general not been large. Good government audit procedures have helped to limit risk undertaken in individual cases. At the same time, private sector demand for large guarantees has also been restrained by concerns about their value (i.e., in view of the difficult fiscal position of governments, especially at the state level). In general, the private sector would much rather have a transparent and consistent regulatory framework, allowing it to undertake rational cost benefit analysis for projects. In some sectors, indications are that as investors become more comfortable with the projects and the regulatory frameworks, the demand for guarantees is falling (for instance, the roads board has been able to reduce its exposure over time).

125. **The lack of a comprehensive management framework for contingent liabilities presents an important future fiscal risk.** While central and state governments are required to report guarantees on loans, no comprehensive information on other guarantees giving rise to liabilities is available at the state or central government level. Moreover, not many states explicitly account for likely future commitments in their budget document. A few states have set up guarantee redemption funds and are charging a guarantee fee, but the funds are not fully funded. Rules on exposure are also lacking (for instance, explicit limits or ceilings on contingent liabilities in terms of tax revenue).

126. **Direct government support to projects (e.g., in the form of procurement) is increasingly done in a transparent and competitive way, but some problems remain.** The "viability gap" funding facility, set up by the government in August 2004, is a positive step towards transparent support. It provides limited and conditional support to projects with private participation based on the bid with the lowest present value of required funding. The NHAI private roads projects based on annuities also represent a good model for situations where the government is the purchaser of infrastructure services, but capacities need to be developed to account and report the debt-like obligations that arise under such schemes. One problem area is in-kind grants of land and other public assets as part of a support package. These have not always been transparently accounted for.

127. **The central government has yet to work out a consistent, balanced, and transparent tax treatment of private infrastructure investment.** The high license fees paid by the telecom sector in India, while helping with fiscal adjustment, certainly delayed the sector's full emergence. The authorities have conversely given broad tax incentives by creating special economic zones, but these have created a threat of growing fiscal drag (and there is a risk that they may become a substitute for addressing underlying problems). Standard tax incentives exist in India (e.g., accelerated depreciation), but have occasionally been passed on to consumers by regulators, undermining their effectiveness.

VIII. JORDAN

A. Background

128. **This study was conducted in the context of Post-Program Monitoring, in place since Jordan graduated from Fund-supported programs in July 2004.** Post-Program Monitoring is expected to run through end-2005. The study focuses on the coverage of fiscal indicators, including coverage of public enterprises, and the analytical framework for conducting fiscal policy. Investment needs are covered briefly and in general terms.

129. **An evaluation of sectoral investment needs could not be carried out, also as the World Bank declined to participate in the study.** The authorities' immediate concern is clearly to reduce public debt.[19] Increasing public investment, which they view as adequate at

[19] Public debt is defined as government and government-guaranteed debt net of deposits in the banking system. It includes the debt of own-budget agencies and subnational governments.

this point, was not seen as a priority. The authorities viewed increased private sector participation, including through PPPs, as the best way forward for increasing infrastructure spending, including in health and education. Therefore, the main lessons of this pilot study relate to (i) the complexity of widening the coverage of the fiscal sector for a country like Jordan; and (ii) the practicability of the suggested criteria for assessing the commercial orientation of public enterprises.

B. Public Investment Trends and Infrastructure Needs

130. **Public investment has been relatively stable over the past five years, with central government investment gaining a higher share in total investment.** Gross domestic investment was declining until 1998, then stabilized at about 22 percent of GDP in the past five years. While other investment (including that by public enterprises) declined from 27 percent of GDP in 1993 to about 14 percent of GDP in 2003, central government investment has been fluctuating between 5 and 7.5 percent of GDP over most of the decade.[20] Central government investment, however, has increased substantially in the past three years from just over 5 percent of GDP in 2000 to almost 9 percent of GDP in 2003, following the introduction of the Plan for Social and Economic Transformation (PSET), entirely funded by grants.

131. **The lack of data and of World Bank involvement precluded the analysis of infrastructure bottlenecks.** This limited the capacity of the pilot to assess the magnitude of outstanding investment needs. Discussions with the authorities, however, confirmed that overall investment priorities were human resource development (education and health) and water supply. The authorities felt that the physical infrastructure base was relatively adequate, and argued forcefully that further investment in infrastructure (including in the social sectors) should involve private sector participation and PPPs. This would largely relate to water and railroads, but also education and health. They viewed this in line with the government's priority of reducing public debt. The authorities also noticed that there was scope for improving the efficiency of investment expenditures within the overall spending envelope.

132. **Jordan's physical infrastructure compares favorably with countries in the region or of similar levels of development.** In terms of communications (telephones per capita), Jordan is more connected than most countries in the region, although not as much as the new entrants to the EU, which mostly have higher levels of income per capita. The same is true for indicators of electricity or energy consumption. With respect to the transport infrastructure, while Jordan has 100 percent of paved roads, one of the highest rates among developing countries, the quality of roads has been deteriorating and may require higher

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[20] "Other investment" is defined as gross domestic investment minus budgetary government investment and includes both private investment and investment by public enterprises. Available data did not allow to fully disaggregate investment by public enterprises from gross domestic investment prior to 2001.

maintenance spending. The access to clean water and sewage systems is nearly universal in Jordan. There are uncertainties, however, over the sustainability of water supply.

C. Institutional Capacity to Appraise and Manage Investment Projects

133. **The Ministry of Planning together with line ministries, is responsible for developing the government's capital investment plan.** The plan is described in rolling three-year investment plans approved by the cabinet. The newly developed national plan for 2004–2006 also includes and replaces the PSET, which is expected to be fully integrated into the budget as of 2005. Previously, regular capital budget and PSET projects were evaluated and prioritized separately. The prioritization model developed for the PSET with support from the World Bank will now be used for all projects. The model takes into consideration economic, social, and capacity implementation factors, as well as priorities within and between sectors to derive an overall ranking of projects. At present, the budget department has little input into the investment evaluation beyond its influence in the context of the yearly budget negotiations, but the planned integration of the PSET into the 2005 budget should improve the role of the Ministry of Finance in determining investment priorities.

D. Coverage of Fiscal Indicators

134. **Currently, the fiscal sector coverage in the budget law and program monitoring is limited to central government finances.** There are 39 autonomous agencies that are fully owned by the government, and whose budgets are approved by the cabinet and are readily available for public scrutiny.[21] The remaining enterprises are either fully or partially owned by the government directly, or through the Jordan Investment Corporation (JIC), or the Social Security Corporation (SSC). The pilot identified a preliminary list of 183 nonfinancial entities outside the central government budget, including the autonomous agencies.

135. **The mission assessed the commercial orientation of key enterprises in which the government holds a participation.** There are three broad categories of enterprises:

- Enterprises operating under the own-budget category do not qualify as commercial enterprises because employment is governed by civil service regulations, and, in most cases, management is appointed by the government;[22]

- Enterprises in which the sole government ownership is via the SSC are tentatively assessed to meet most of the criteria for being considered commercially run, as set out in SM/04/93;

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[21] These so-called own-budget agencies represent a hybrid group, which includes proper public enterprises as well as small government bodies such as regulatory commissions. Their number may vary from year to year.

[22] The most important enterprise in this category is the Water Authority, which accounts for over half of total investment by these agencies.

- Enterprises that do not fall in the previous categories need to be dealt with on a case-by-case basis. The pilot focused on macroeconomically relevant public enterprises (mainly in the infrastructure and utilities sector) to assess their commercial viability.[23]

136. **Specifically, the mission believes that two state enterprises—Jordan Telecom and Arab Potash Company—are commercially run on the basis of the criteria set out in SM/04/93.** Jordan Telecom is held at 40 percent by the Joint Telecommunications Company (JITCO), a strategic investor (mostly consisting of France Telecom); 41.5 percent by the government, 13 percent by the SSC, and 5.5 percent privately. The strategic investor has full management control. The Arab Potash Company is owned by the government through JIC at 26.8 percent and SSC 3.2 percent; 26 percent is owned by a Canadian strategic investor, 21 percent by the Arab Mining Company; and the remainder by various Arab governments. The Jordanian government does not intervene in investment decisions. Both companies met the criteria for commercially run enterprises, with the following caveats: they are listed only on the Amman stock exchange; and, while they do not currently contract any government-guaranteed debt, they may carry old loan guarantees on their books that were extended when they were fully controlled by the government. A third company, the Jordan Phosphate Mining Company, met most criteria but was excluded from the set of commercially run enterprises because the company has excess employment of about 25 percent, and both the chairman and the general manager are appointed by the government.

137. **Switching to a consolidated public sector definition would require significant preparation and technical assistance to ensure data consistency and timeliness.** Currently, the government does not produce general government statistics, although the ministry of finance is in the process of developing such data. Efforts are made more difficult by the absence of legal reporting requirements. In addition, there is no single government agency in charge of monitoring public enterprises, and thus the mission had to analyze the financial statements of individual enterprises for consolidation purposes. The mission's work was further complicated by the absence of public officials familiar with converting data in enterprise accounts into a format suitable for fiscal analysis.

E. Analytical Framework

138. **Consolidating the public sector accounts would result in a larger overall deficit and a smaller primary surplus, but a higher current surplus.** An attempt was made to create fiscal accounts for the consolidated nonfinancial public sector to include own-budget agencies and selected public enterprises.[24] Whereas the central government fiscal deficit was 1.1 percent of GDP in 2003, the consolidated nonfinancial public sector is tentatively estimated to have incurred a deficit of 2.5 percent of GDP; similarly, at 1.9 percent of GDP,

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[23] The Zarqa oil refinery was not covered. Despite minor government ownership, it would likely not qualify as commercially run, given the extensive government intervention in pricing and financing.

[24] Namely, Central Electricity Generation Company, Electricity Distribution Company, National Electric Power Company, Royal Jordanian Airlines, and Jordan Phosphate Mining Company.

the primary fiscal surplus of the consolidated nonfinancial public sector would be lower by 1 percentage point of GDP. At the same time, the current surplus of the consolidated nonfinancial public sector would post an improvement of 2.7 percent of GDP, to reach 10.1 percent of GDP.[25]

139. **Reducing the large public debt burden remains a key priority for fiscal policy.** While Jordan made significant progress in reducing its public debt as a ratio of GDP during the past decade, the reduction was mainly attributable to the pick-up in economic growth. Moreover, the DSA shows that the debt dynamics remain vulnerable to exogenous shocks, implying that sustaining the recent improvement in the debt profile would require a steady reduction in the overall fiscal deficit and maintaining strong economic growth. Fiscal measures of about 2 percent of GDP per year for 2005 and 2006, combined with an ambitious privatization program with receipts used for debt reduction (4.5 percent of GDP cumulatively) will be required to achieve the public debt target of 80 percent of GDP at the end of 2006, as set out in the 2001 Public Debt Law. Structural reforms on both the revenue and expenditure side of the budget are needed to achieve the desired fiscal adjustment, improve budget flexibility, and free up resources for more productive spending, including investment.

140. **Extending DSA to the consolidated public sector would make little difference for government and government-guaranteed debt, which is monitored by the public debt law.** Due to large bank deposits of the public enterprises that largely offset their gross debt, the initial net debt ratios in 2004, at about 92 percent of GDP, are largely the same under the two baselines. The baselines are based on the Post-Program Monitoring medium-term macroeconomic framework, where the government is assumed to abstain from short-term and commercial borrowing. Under the new fiscal funding strategy, external borrowing is expected to decline as domestic capital markets are being developed. Both baselines imply a steady decline in the debt-to-GDP ratios to under 65 percent of GDP by 2009, with the consolidated public sector debt declining marginally faster.

141. **Two scenarios were prepared to consider the impact of an increase in public sector investment by 2 percentage points of GDP in 2005–07.** The first scenario assumed no effect on real GDP growth, while the second scenario considered a more favorable outcome, where higher investment in 2005–07 generates higher real GDP growth in 2006–08.[26] Under both scenarios, the debt ratio initially increases, but the medium-term public debt remains on a downward trend. However, under the first scenario, the medium-term deviation in the debt ratio from the baseline outcome is markedly higher than under the second scenario. While the first scenario implies a debt-to-GDP ratio in 2009 which is 5.5 percent of GDP higher than under the baseline, the second scenario produces a much smaller deviation

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[25] Integrating the SSC would result in an improved fiscal balance on account of the surpluses in the order of 2 percent of GDP that this young social security system is generating.

[26] Higher investment implies real GDP growth which is 0.7 percentage points higher in 2006–2008, assuming constant ICOR equal to the average of the baseline ICOR in 2005–2007.

of about 2 percent of GDP. Neither scenario poses a significant threat to longer-term debt sustainability.

F. Conclusions

142. **The overall fiscal deficit of the central government, monitored under past Fund-supported programs, has served Jordan well in view of its high level of public debt.** The current balance could receive more attention, however, if certain conditions were met. In particular, greater reliance on the current balance as a fiscal indicator would require strengthening of the present system of assessment, prioritization, and selection, as well as budget classification, execution, monitoring, and ex-post evaluation of public investment programs.

143. **PPPs could be a useful tool to promote efficient investment in infrastructure.** However, before embarking on PPPs, the authorities will need to develop the appropriate legal and institutional frameworks, in line with international best practice.

144. **For Jordan, the operational policy question is whether to extend fiscal coverage to include over one hundred state enterprises.** This is different from the question of whether or not to *exclude* some public enterprises from fiscal analysis in countries with an existing broad coverage. Extending the coverage would allow for a more comprehensive assessment of Jordan's fiscal policy stance and provide more consistent monitoring across Fund-supported programs. But it would also entail a significant cost in data collection and analysis. At present, no single agency maintains a complete list of public enterprises, let alone data. To include these enterprises, the government would have to introduce this new responsibility at the Ministry of Finance. Setting up such a unit would require significant capacity building. Given that the preliminary results show that the extended DSA is not significantly different from the narrower one, the costs are likely to exceed the benefits. Moreover, such an extension should await the completion of the privatization program.

145. **Consideration might be given to monitoring only the enterprises which represent a fiscal risk.** In Jordan, a few large enterprises generate most of the revenues and could pose such a risk.[27] This approach would yield most of the benefits at a modest cost. For other enterprises, the focus should be on improving transparency, publishing accounts, tightening fiscal controls, and access to borrowing so that they do not create contingent liabilities.

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[27] While, in the event of a systemic crisis, a simultaneous failure of many small enterprises may also result in substantial fiscal pressures, such an event is relatively unlikely in Jordan's stable macroeconomic environment.

IX. Peru

A. Public Investment Trends

146. **Public investment fell during the last decade from about 4½ percent of GDP in the mid-90s to 3 percent of GDP in 2003.** This reflects various factors, some of which may be difficult to quantify: (i) through privatization, the government has withdrawn from some sectors (e.g., telecommunications, where *total* investment has gone up); (ii) since 2000, a new quality control system allows redesigning public investment projects so they can pass an internal-rate-of-return test, which is sometimes accomplished by scaling down the initial design; (iii) the operation of this system has resulted in the narrowing of the definition of investment; and, (iv) in the last few years, the need to reduce the deficit in the context of a narrow revenue base and pressures to increase current spending.

147. **Public investment in infrastructure has been relatively low during the last decade.** Initially rising to a peak of 0.9 percent of GDP in 1997, it has fallen back to under ½ percent of GDP after 2000. In the case of infrastructure, however, it appears that the rise in private investment that was made possible by privatizations has more than offset the decline in public investment activity.

148. **Over the last 15 years, a main factor reducing public investment has been the decline in public saving,** which took place in spite of a reduction in the interest bill associated with a successful debt restructuring in the mid 1990s. The primary current balance of the public sector fell from an average of 3.5 percent of GDP in 1993–1999 to 1 percent of GDP in 2001–2003, with the decline reflecting developments both in the central government and the public enterprise sector. For the central government, data show an almost continuous increase in current noninterest spending, which rose by 3 percent of GDP between 1993 and 2003, twice as much as government revenues did.

149. **In part reflecting the decline in public investment, but also due to chronic deficits for maintaining existing facilities, significant infrastructure needs persist.** About one-quarter of all households do not have access to drinking water, sewage, and electric power, and only 15 percent of households have phones. Some widespread indicators of infrastructure endowments, such as measures of paved roads and power generation capacity, place Peru below a broad sample of Latin American comparator countries. In particular, Peru's ports are viewed as relatively inefficient (presenting a clear bottleneck to the export-oriented growth strategy), and about a third of the national road network is said to be in poor condition (with only one-quarter being in a good state of repair). Summary estimates of the size of existing "infrastructure gaps" are usually large, but often based on inadequate methodologies (e.g., based on catching up to a regional leader). Also, the magnitude of these estimates varies considerably. Moreover, they provide little guidance for action. Instead, in key sectors such as energy, the government plans its investment with the objective of staying ahead of projected demand growth. In the same spirit, the government has been preparing a master transportation plan. However, the implementation of those plans is vulnerable to disruption created by the emergence of politically attractive projects.

150. **Despite the decline in public investment, economic growth has remained fairly strong, with the economy growing at 4 percent or more in each of the last four years.** This reflects in part the fact that total investment, after a boom in the early- and mid-1990s (at the height of privatization) has remained stable at about 20 percent of GDP.

151. **Growth has been supported by improved macroeconomic management during the last decade, including an effort to reduce the public debt.** As a result, interest rate spreads have remained well below the average for the region for several years. Under the 2002–03 Stand-by Arrangement (SBA) the combined public sector deficit was reduced from 2.2 percent of GDP in 2002 to 1.7 percent of GDP in 2003. To maintain macroeconomic stability and further reduce vulnerabilities, a precautionary 26-month SDR 287.3 million SBA for Peru was approved in June 2004, which focuses on fiscal consolidation, including lowering the public debt-to-GDP ratio from 47.7 percent in 2003 to about 40 percent in 2006. The program envisages a further reduction of the annual overall deficit of the combined public sector to 1 percent in 2005–06 (this deficit fell to 1.1 percent in 2004)—consistent with the Fiscal Responsibility and Transparency Law (FRTL).[28] While reinforcing robust debt dynamics, the new SBA aims at creating room for infrastructure and social spending.[29]

152. **In the view of the mission, it would not be advisable at this point for Peru to raise public investment by increasing public debt.** A key element of Peru's success has been the improvement in macroeconomic management, and these gains should be preserved and increased by continuing observance of the fiscal responsibility legislation. For many years now, the public finances have been managed prudently to help improve sustainability; however, the public debt is still too high for comfort: it was estimated at 270 percent of government revenues, 360 percent of tax revenues, and 44.5 percent of GDP at end-2004.[30] Moreover, the debt is largely denominated in foreign currency, making it a source of vulnerability to exchange rate shocks, which further argues for its reduction, since in the short run the conversion of debt into local currency could only happen on a small scale and at the price of shortening maturities and increasing interest rates.[31] For these reasons, financing additional public investment will require an effort to increase public savings.

153. **The public investment process has improved in the last few years with the introduction of the National Public Investment System (SNIP).** The main purpose of the

[28] The FRTL puts a ceiling of 1 percent of GDP on the overall deficit of the combined public sector starting in 2005 (with deficits of 2 percent of GDP and 1.5 percent of GDP for the transition years 2003 and 2004). The combined public sector deficit is the sum of the deficit of the nonfinancial public sector and the cash-flow deficit of the central bank; the latter is sometimes called the "quasi-fiscal deficit" of the central bank.

[29] A structural PC is to grant concessions for the construction and maintenance of two major roads. In support of the involvement of the private sector in infrastructure, the limit on the contracting and guaranteeing of public debt included in the SBA can be adjusted upward by up to US$400 million (0.6 percent of GDP).

[30] Government revenues exclude grants from abroad; tax revenues include collections at the central and other levels of the general government.

[31] The government is also pursuing a market-based strategy to improve the maturity profile of its debt.

SNIP, in which the Ministry of Economy and Finance plays a central role, is to ensure that individual projects are viable in the sense of having a sufficiently high internal rate of *social* return. As a result, the ability of the government to weed out poor public investment projects has been enhanced. There is, however, room for improving the SNIP by strengthening its capacity to evaluate and monitor projects through the various stages of their development and execution, including at the subnational level.

154. **Some limitations in the conception of the SNIP keep it from making a fuller contribution to increasing the efficiency of public investment.** The main limitation is its lack of input into the setting of priorities among and within sectors. Indeed, the SNIP does not rank investment projects, but instead certifies the viability of individual projects. This process results in a large number of viable projects being approved, which are then difficult to accommodate within the limits of the annual investment budget. The priorities among SNIP-approved projects are negotiated in an ad hoc fashion in the Council of Ministers, without systematic consideration of the social/economic returns of new and ongoing projects. In the face of well-defined fiscal limits, the direct results of this bottom-up investment planning process, which lacks central prioritization, are the inadequate maintenance of existing infrastructure and the proliferation of projects, leading to delays in project execution and completion dates to the point where the projects' internal rate of return may be significantly lowered. Improving budgetary and planning practices would help accord ongoing projects and maintenance of existing infrastructure the high priority they deserve, and, in turn, enhance the contribution from public investment to growth within the current resource envelope.[32]

155. **Additional execution delays were experienced in 2004 as a result of the decentralization process.** Subnational governments (both regions and municipalities) are beginning to take on public investment responsibilities including the authority to test the viability of relatively small projects. These governments' limited implementation capacity to design and execute investment projects resulted in execution delays and deterioration of the quality of investment projects.

156. **Lastly, politically attractive projects may bypass the evaluation system at the heart of the SNIP.** This is because the law permits a project to go ahead without a proper viability assessment when it is approved by a special presidential decree co-signed by the Minister of Economy and Finance and the minister sponsoring the project. While this exclusion clause protects the integrity of the system from the pressures created by politically attractive projects, the approval of these projects sometimes leads to an overturn of established investment priorities. Furthermore, projects approved by the exclusion clause may be awarded in concession even though such projects do not often lend themselves to this approach. Indeed, despite transferring these projects to the private sector, the government

[32] The government is considering the introduction of a System for Monitoring Public Investment, which would support adequate execution of a project once it is selected. The Ministry of Finance is also exploring practical ways to protect key maintenance expenditure.

would still bear most of the risk involved and face potentially large fiscal costs, thus raising concerns that such concessions are used mainly to circumvent spending controls. To mitigate some of these problems, the Ministry of Economy and Finance is working toward a fuller disclosure of detailed information on the projects approved by the exclusion clause.

B. Public Enterprises

157. **Peru's central government retains over 30 public enterprises, mostly in the energy sector and managed through a holding company, FONAFE—itself a public enterprise.** FONAFE's directory is chaired by a representative of the Ministry of Economy and Finance. Subnational governments have public enterprises too; the most important are utilities owned by the municipality of Lima. The fiscal responsibility law mandates the consolidation of the accounts of public enterprises with those of their associated governments for the purposes of calculating the balances of the public sector. The authorities expressed the view that the coverage of public enterprises in the fiscal accounts is adequate.

158. **FONAFE establishes annual targets for the enterprises' operating surpluses and approves both the operational and investment budget of each enterprise.** In addition, the enterprises' individual investment projects must be approved by the SNIP, and their purchases must comply with the government procurement law. In these circumstances, some enterprises would desire more autonomy to borrow funds in order to make additional investments, and to be exempted from the evaluation of their projects by the SNIP.

159. **No public enterprise currently meets the commercial-orientation test based on the preliminary criteria proposed in the Board paper on Public Investment and Fiscal Policy (SM/04/93), and thus the mission did not recommend the exclusion from the fiscal accounts of any enterprise.** There were some criteria which were not met by the enterprises because of the public enterprise management framework based on FONAFE. In particular, enterprises must follow FONAFE's guidelines for the management of their wage bills. The guidelines seek to address the singular situation in which these enterprises find themselves due to government ownership. In fact, these enterprises have the most vigorous labor unions in the country, and in the absence of external limits, an excessive expansion in the wage bill would be likely. Most enterprises also showed losses or what appeared to be very low profit rates, although the mission did not obtain long enough data series to verify that the losses are chronic. It was also difficult to find relevant comparators for assessing profitability in relative terms. It was found, however, that most enterprises are almost free of debt and those which have borrowed recently have done so on favorable terms.

160. **On the other hand, public enterprises exhibit many features which reveal an effort to pursue efficiency.** All are subject to periodic outside audits, and most do not receive any subsidies. Most display a market-oriented price setting behavior to the extent that they are free from regulation; and those subject to regulation do not receive treatment different from that given private firms in the same activity.

161. **The authorities also offered their views on improving the criteria for excluding public enterprises from the public accounts**. In general, they argued that, being in the public sector, public enterprises cannot be run autonomously from their main shareholder, nor can they be expected, even when well run, to show the same rate of profit observed among their less encumbered private rivals. Specifically, they felt that three issues needed to be addressed in revising the criteria: (i) price-setting policy may be a highly complex issue in regulated sectors; (ii) some "transfers" from enterprises to the government are in kind and do not show in flow accounts; and (iii) interference of the government with wage-bill related decisions in enterprises might be a response to the risks arising from public ownership rather than constituting a deviation from efficiency benchmarks represented by the idea of "commercial orientation."

C. Public-Private Partnerships

162. **Despite early ventures, Peru has relatively limited experience with PPPs.** Since the early 1990s, Peru has used *concessions* as a mechanism to promote private investment in infrastructure. Following the granting of the first concession for the operation, maintenance, and construction of the Arequipa-Matarani road in 1993, the authorities have awarded a number of concession contracts, notably in the electricity sector and transportation (including ports, airports, roads, and railways).[33]

163. **In general, Peru's PPP program has operated in a lax legal environment.** There is no proper legal framework regulating PPPs, nor a registry for the liabilities associated with them (including contingent liabilities). The work related to the design of PPPs is carried out by a capable but reduced outfit, and their main efforts are devoted to contract drafting and awarding of concessions. There are no guidelines or institutional procedures for deciding which projects could be implemented as PPPs. No resources are available for carrying out risk analysis of the projects in a systematic fashion, although in the case of certain high-profile projects, externally financed consultants perform some limited work in this area. There is no recording in the public accounts of contingent and even firm liabilities associated with PPPs.

164. **PPPs give rise to various types of liabilities, which can be complex.** The government may directly guarantee loans, offer minimum revenue guarantees, and/or commit to making fixed periodic payments for extended periods. Sometimes a concatenation of guarantees takes place, such as when private partners do not feel that a direct contractual commitment by the government has sufficient weight. This prompts them to seek partial or full guarantees from third parties—financial intermediaries and MDBs—which would be activated if the government were to fail to honor its commitments. In their turn, these third parties demand explicit commitments from the government. This can give rise to differential

[33] Concessions have more often been used to allow the private exploitation of mineral resources. This is clearly a different type of activity, and was not the subject of the mission's work.

treatment in the fiscal accounts of otherwise similar PPP arrangements, because the debt limits do include guarantees issued to financial intermediaries and MDBs.

165. **Although limited, Peru's experience with PPPs offers lessons to improve project and business design models.** In particular, there is a tendency to accept aggressive offers that too often lead to subsequent renegotiations, which then take place by necessity in a situation where the private operator has acquired an incumbent's advantage. Also, contracts incorporate specific monetary targets for investment, instead of targets for the quality of deliverable services. Some contracts do not fully reflect the issues brought up during the awarding process, which often results in litigation when issues discussed but not formally incorporated in contracts materialize.

166. **Peru has relaunched the concession program.** The authorities view PPPs as a useful option to address some infrastructure needs without jeopardizing fiscal consolidation. They also expect that this approach may help correct some public management failures observed in the past, notably in the maintenance of infrastructure. Calls for bids for the concession of five roads amounting US$600 million were issued in the second half of 2003, and bid submission and award dates are scheduled for the second half of 2004.

167. **The mission agreed with the idea of using PPPs, but gave some views on how best to take advantage of this approach**, with the goal of both protecting the fiscal strategy and nurturing PPPs by choosing projects that have a high chance of success. The mission expressed the view that PPPs were potentially most beneficial when they helped mobilize significant revenue and/or could operate without ongoing subsidies from the public sector, because in those circumstances it was possible meaningfully to transfer risk to the private partner. In this connection, it would be important to require an assessment by the SNIP of all PPP projects for which the government extends guarantees. The mission further noted that PPPs involved very long-lived commitments, and thus should not be entered into hurriedly. Moreover, to guard against costly renegotiation, it is useful to create dispute resolution mechanisms, and set performance criteria for the private operator in terms of measurable indicators of quality and level of service. In this connection, strong and independent regulators are crucial to the successful monitoring of PPPs. This will require an effort to build up regulatory capacity in the transportation sector and to strengthen the regulatory framework applying to the water and sewage sector. Lastly, while much information on PPPs in Peru is available on the internet, increased transparency is required in reporting them in budget documentation, including in the debt dynamics projections which are part of the multi-annual macroeconomic framework.

168. **The mission noted that the development of broadly accepted accounting standards is still an ongoing effort.** However, on a provisional basis, the mission suggested that, for clearly unprofitable PPPs and when the government makes a firm commitment to make payments aimed to allow the private partner to recover the construction costs fully, the present value of such payments should be counted as debt. The authorities felt that they would need to study the issue further before taking a decision, also with a view to improving the norms regulating the granting and reporting of government guarantees.