

BUDGETING FOR CAPITAL – OECD EXPERIENCES

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Agenda

- **Conceptual Issues**
- **Capital Allocation Decisions**
 - Role of Feasibility Studies
- **Asset Management Practices**

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- Asset Management Practices

Defining Capital is Difficult

- **Investments**

- Yielding a benefit beyond one year

- **Traditional view: Physical assets**

- Property, plant and equipment
 - Monetary thresholds

- ***“21st Century view”*: Human capital**

- Education
 - Science and technology

Arguments Used for Special Treatment of Capital Expenditure

- **Capital expenditure is “neglected”**
 - Perceived bias against capital expenditure
- **Capital expenditure is profitable**
 - Analogy to private sector return on investment
- **Inter-generational equity**
- **Capital expenditure is appropriately debt-financed**

Distinct Characteristics of Capital Expenditure

- **One-off projects**
 - Spikes in funding levels
 - Appropriations over multiple years
- **Cost over-runs more common**
- **May imply higher operating costs in future years**
- **Requires funding for maintenance in future years**

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“Capital Budgeting”

- **Usually not a separate legal document**
- **Refers to special presentation on capital expenditure in regular budget**
- **Refers to special decision-making processes for capital expenditure**

Financing Rules

- **“Golden Rule”**

- Borrowing for capital expenditure (Germany, UK)

- **Earmarked taxes for capital expenditure**

- Gasoline taxes for highways (common)

- **Other dedicated revenue sources for capital expenditure**

- Non-renewable gas receipts (Netherlands, Mexico)

- Privatisation proceeds (Finland)

Budget Allocations (1)

- **Varying degrees of centralisation in OECD countries**
- **Project-by-project involvement of budget office**
 - For very large scale projects only
- **“Top-down” global allocations by budget office**
 - In context of multi-year capital acquisition plans
 - True “top-down” for very small projects only

Budget Allocations (2)

- **Long-term capital acquisition plans**
 - Often sector-based rather than whole-of-government
 - *e.g.*, highways, schools
 - 10 years' time horizon common
 - Project-by-project listing
- **Ranking of projects (feasibility study)**
 - Objective criteria
 - Political criteria
- **Budget allocation**
 - Equal to total in capital acquisition plan for respective year, or
 - Budget is stand-alone decision and whatever funds are allocated fund projects by their respective ranking

Funding Modalities

- **Up-front funding authority for total project cost**
 - Cash outlays may span several years
 - Carry-over of unused appropriations to next year
- **Annual funding for each phase of project cost**
 - Often too late to reverse decision

Role of PPP's

- **Bypasses traditional allocation process**
 - Speeds up projects
- **Private sector borrowing costs higher than government's**
 - By definition
 - But it should reflect the risk of the individual project
- **Difficult to demonstrate efficiency gains / risk transfer as outweighing higher cost of capital**

Role of Accruals

- **Funding through accumulated depreciation**
 - Initial balance sheet values are critical
 - Is depreciation a valid proxy for new capital requirements?
 - Ring-fencing accumulated depreciation
 - Supplemented by new appropriations in practice

Role of Internal Loan Funds

- **Central fund at budget office lends money to agencies to fund capital expenditure**
 - For equipment purchases (IT)
 - For large projects
- **Smooths out spikes in funding**
 - Loan paid back by appropriations over useful life of asset
- **Agencies may have borrowing limits in budget, or is based administratively on baseline ability to repay**
 - Swedish government agencies have “credit ratings”
- **Interest rates on loans reflect government’s cost of capital**

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A focus on existing stock rather than only on new acquisitions

- **Asset registers**
 - **Maintenance in capital acquisition plans**
 - **Capital charges**
 - **Asset Management Agencies**
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- **...but political preference for new projects**
 - **...but assets often “owned” and managed by lower levels of government**

Asset Registers

- **A key benefit of the introduction of accruals**
- **Previously, governments were not aware of their portfolio of assets on a central basis**
- **This has had an immediate impact on the disposal of surplus assets**

Maintenance in Capital Acquisition Plans

- **Not Neglecting Maintenance**
 - Regular assessments of quality of capital stock against formal benchmarks
- **Maintenance and new acquisitions on level-playing field**
- **A possible benefit of PPP's**
 - Required maintenance is part of PPP contract

Capital Charging

- **Reflects government's cost of capital in the budgets of agencies**
- **Promotes the disposal of excess assets**
- **Internal charge between budget office and agencies; no net effect**
 - ✓ **Budgets increased to reflect capital charge at first**
- **Capital charge goes down with disposal of assets**
 - ✓ **Agencies permitted to keep the difference, in part or in full**
- **Capital charge goes up with acquisition of new assets**
 - ✓ **Agencies do not receive additional appropriations to pay it**

Asset Management Agencies (AMA's)

- **Assets transferred to AMA's**
- **AMA's receive no direct appropriations**
- **AMA's act as landlord to agencies and charge rents**
- **Rent includes depreciation, cost of capital**
- **Agencies receive appropriations to cover rent at first**
- **Agencies free to seek alternative accommodations**

- **Most appropriate for offices and similar non-unique assets**
- **AMA's can be left with (temporary) excess assets**

Conclusion

- **Capital expenditure is different from other expenditure**
 - But not inherently better or worse
- **Capital budgeting practices vary widely**
 - Capital acquisition plans are the foundation
- **A focus on existing stock rather than only new acquisitions is a major theme today**

For further information

- *OECD Journal on Budgeting*
- www.oecd.org/gov/budget
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