The Performance of Public Investments During Fiscal Consolidation in Albania

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Public Investments are generally accepted as one of the main factors which contribute in the economic growth of a country, despite that several studies bring evidences that these variables are not always strongly correlated to each other. However, the sensitivity of economic growth to Public Investments (PI) and the high level of budget funds spent from governments for capital expenditures have made the issue on PI in general and moreover the factors that influence on PI very important to researchers and public as well.

This paper gives a broad insight of public investments performance in developed or developing countries over time, underlining several factors that have assessed this performance, focusing especially on the impact of fiscal consolidation. It brings the views of many authors over the fact whether the governments during fiscal consolidation, in order to control debt stock and the budget balance prefer to cut current expenditures or capital expenditures. Furthermore, it analyses how

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Albania has reacted during its periods of fiscal consolidation and which has been the behavior of different governments toward PI.

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I. FACTORS AFFECTING PUBLIC INVESTMENTS

Government's behavior toward public investment and especially the reasons for the ups and downs of the public investment funds during different periods have always been a very interesting issue for the researchers. However, the main focus of the studies was on the decline of the productive government services as a percentage of GDP which hypothetically led in productivity growth decline. This hypothesis raised by Aschauer (1989) has received great attention ever since, but few studies have been conducted to find out the factors that affected capital spending over time, across different countries, in order to explain why public capital spending declined in so many countries. Most of them analyze the case of given country for a certain period, such as: Aubin et al. (1988) for France, Herenkson (1988), Kirchgassner and Pommerehne (1988) for Germany and Switzerland, Sorensen (1988) for Norway. While De Haan, Sturm and Sikken (1996) used panel data sets for 22 OECD counties and Sturm (2001) for 123 less developed countries for the period 1970-1998. All the above studies use as dependent variable measures of total public investment, expressed as percentage of GDP, as growth rates or just in real levels.

According to Kirchgassner dhe Pommerehne (1988) there are three sets of variables that can help to explain Public Investments: Structural Variables; Economic Variables and Politico-Institutional Variables.

The group of structural variables consists of: level of urbanization and growth of population. This kind of variables is usually used in studies that try to explain government's size, especially in testing Wagner's law (Lybeck 1988). But Sturm (2001) included them in his model to measure their impact in Public Investment and to explain the demand for public capital. It was expected that a large degree of urbanization will lead to a smaller demand for public investment. A growing population could have the same effect as well. In the study of 123 less developed countries Sturm found o negative correlation between the level of urbanization and public investment, which mean that rural economies needs higher public expenditures, especially in infrastructure, than urban economies. However, he didn't find a strong correlation for the variable of growth of population. He pointed out that this variable is never important in explaining PI demand, despite the model used.

Kirchgassner dhe Pommerehne (1988) defined many economic variables, such as: real economic growth, government debt, private investment, government budget deficits, interest payment; openness; foreign aid and foreign direct investments. Each variable influences on Public Investment funds, but not all of them are significant (Sturm, 2001). The economic variables are one of the most important groups that explain the public capital demand, especially the variable of budget deficit that can bring fiscal illusion and private investment. High levels of budget deficit usually lead to restrictive fiscal policy and high level of interest payments. In order to offset increases in debt interest payments, countries may cut back PI, because it is politically easer to postpone investment spending than current expenditure (Oxley and Martin, 1991). This hypothesis is supported by Roubini and Sachs as well. According to them "in periods of restrictive fiscal policies and fiscal consolidation capital expenditures are the first to be reduced (often drastically) given that they are least rigid component of expenditures" (1998b, pp 108-109). De Haan et al. (1996) bring the same evidence for a large group of OECD countries, followed by Sturm (2001) for 123 non-OECD countries.

Private investment is another important factor which influences government capital spending, because both investments are substitutes. In fact, Sturm (2001) found that there is a strong negative correlation between them.

The variables of the last group (political-institutional variables) are: ideology; electoral cycles; coalition variables; economic and political freedom and political instability. There may seem little connection between this group and economic research, but many studies have been conducted to measure the influence of political-institutional variables on public investment. A special attention is devoted to the possibility that socialist governments tend to spend more than rights governments. Roubini and Sachs (1989b) and De Haan and Sturm (1994) tried to bring evidence about this hypothesis. In fact, socialist governments are expected to be more willing to favor social welfare spending and cut back investments and vice versa for right governments. Even though, Sturm (2001) in his model found out that the government ideology didn't matter to public capital spending. Furthermore, according to Sturm none of the political institutional variables seem to matter to capital spending. Very interesting are the studies that test the electoral cycle influence on government behavior. Schuknecht (2000) in his research on 24 developing countries pointed out that public investments are a strong instrument, used to influence elections results. The same result was reached by Van Dalen and Swank (1995) for the Netherlands, where elections cycle can help to explain investment carried out in infrastructure. It is also found out (Herenkson 1988, Sturm et al. 1996) that governments use public investment as a tool to improve employment indicator.

II. PUBLIC INVESTMENT DURING FISCAL CONSOLIDATION

The decline of public investment as percentage of GDP has been a tendency since the 70s for the EU countries, and also for other developed economies. According to Oxley and Martin (1991) there are two main factors: a shrinked public sector and the need to adjust public expenditures as a response to high public debts. In the last 30 years, public investments have been below 5% of GDP. However, countries didn't react in the same way. The decline in EU and USA continued during the whole 70s till mid 80s, while Japan followed a completely different magnitude. At the beginning of the 70s, the share of PI in Japan was in the same level as in EU (4.3%), but higher than the US (3.2%). After the 90s, Japanese PI share is almost the double of the EU and US (5.5% against 2.9% for the US and 2.4% for the EU). During the 90s, the PI share increased in the EU and US as well (Turrini 2004).The same picture comes from the study of Sturm (2001) with his panel data set of 123 and 37 less developed countries. Since 1970 there seems to be a clear decline in the share of capital expenditures.

The downward trend of public investment happened because of several factors, but the fiscal consolidation during 1970-1990 as a measure to control public debt and the high deficit was underlined as one of the most important. World Bank, in its World Development Report (1988) found out that during fiscal consolidation of the 80s, governments cut down capital expenditures three times higher than current expenditure. Furthermore, Roubini and Sachs (1989) note that in periods of restrictive fiscal policies, capital expenditures are the first to be reduced in the OECD countries. Another evidence comes for the euro zone from Turrini (2004) who supports the view that during budget consolidation, especially after mid 80s, PI was reduced proportionally more than other expenditure categories in EU countries. But as in the 90s governments started to increase their expenditures, it became necessary to take some fiscal reforms for a more controlled budget spending and deficit management (Tanzi and Schuknecht, 2000). The EU states signed the Stability and Growth Pact in 1996, which constrained their budget deficit and debt level, while the US enacted the Balanced Budget Amendment. In his empirical analysis for the impact of EU fiscal framework on Public Investment, Turrini (2004) found out that after phase II of EMU, public investment was more negatively affected by debt levels, which was consistent with the idea that in the run up to Maastricht Treaty the budgetary adjustment implied a significant decline in public investment, especially in high-debt countries.
In fact, the reductions of the public sector and of budget spending not necessarily affect all the kind of expenditures in the same proportion. They can be selective, affecting some categories more than others. Despite the predominant idea that budget consolidation will mainly

lead to PI cuts, researchers are separated in two opposite groups regarding this issue. The first group protects a negative correlation between PI and fiscal consolidation, while the second group defends the hypothesis that budget consolidation will give a bigger effect on social spending, including education, health and social expenditures.

Representatives of the first strand indicate that fiscal regulation will protect social expenditures. This happens because public investment are the least rigid component of expenditures (Roubini and Sachs, 1989) and it is politically easer to reduce or postpone PI than current spending, which mainly consist of wages and social welfare (Oxley and Martin, 1991). Cutting jobs, reducing salaries or pension's payment means losing votes and no political party would be ready to take this risk. Sturm (1998) has another interesting point of view on the matter. He suggests that in need for budget reduction, myopic governments will cut off the less visible and long term projects. In 2001 this author tested through his model the impact of budget deficit on PI, because most of the PI is deficit financed. It is often agreed that governments should be allowed to raise that debt stock, as long that it serves to finance PI, because it helps for a redistribution of the effects among generations. But high debt levels lead to high interest payments, which reduce the budget for the other categories. In fact, Sturm (2001) found out that budget deficit of previous periods lowers capital spending in the future.

The second group suggests that budget cuts will firstly affect social expenditures rather than productive expenditures. Aubin et al. (1998) for instance says that a decline in investment has more political consequences than salaries reduction or public consumption restriction because they are more visible. Ghate and Zak (2002) created a model to test what happens if government is driven in budget allocation depending from social welfare and output growth as well. Evidence showed that at the first stage, social welfare leads to governments growth, but after a certain point, to obtain a positive growth in long run when a threshold may have emerged, governments have to cut back social spending and at least maintain a same level of productive expenditures. In this line are researches that think governments have to invest if they want be more competitive and take advantage of globalization. According to Tanzi (2000) globalization will reduce revenues and spending capacities of the governments because of the factors mobilization. In this situation governments need to protect capital spending as the only alternative to be more competitive or attract Foreign Direct Investment. If something needs to be cut, most probably it would be social spending, preserving capital outlays.

III. THE PERFORMANCE OF PUBLIC INVESTMENT IN ALBANIA

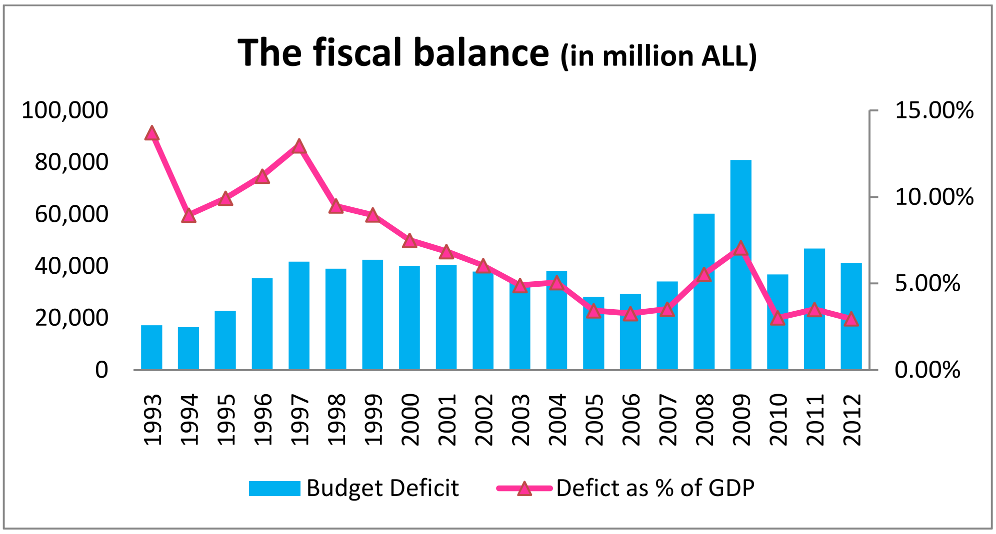
The general theory that usually prevails, despite all, is that in periods of fiscal consolidation or during reforms to reduce the deficit and cut costs, governments are expected to reduce public investment funding. This reaction is even more high lightened after periods of aggressive fiscal policy, when funds are mainly financed through debt. This happens because the growth of debt stock leads to higher interest payments in the upcoming periods, making these payments the main expenditure financed by the State Budget. Since the public audience is more sensitive to current expenditure, especially those destined for social welfare, governments tend to reduce capital expenditure in order to keep public's votes safe.

This way of addressing funds gets more emphasized through electoral years, when budget cuts in pensions, salaries or public employment becomes even more difficult. This chapter tries to explore the behavior of the Albanian government to public investments policy in the past 20 years, in order to understand if during periods of financial consolidation and expenditure cuts, Albanian governments prefer to slash capital spending while protecting current ones, or vice versa.

The Fiscal Balance

A consistently negative budget balance leads to steadily growing debt stock, reason for which, governments react to set deficit under control. Reduction of the deficit can be accomplished either by increasing the incomes, or by reducing expenses. Increasing the revenues would be translated to changes in tax policy, in which governments prefer not to have tough variations because, among other things, it creates confusion. That's why public consolidation can be pursued, generally through expenditures cuts.

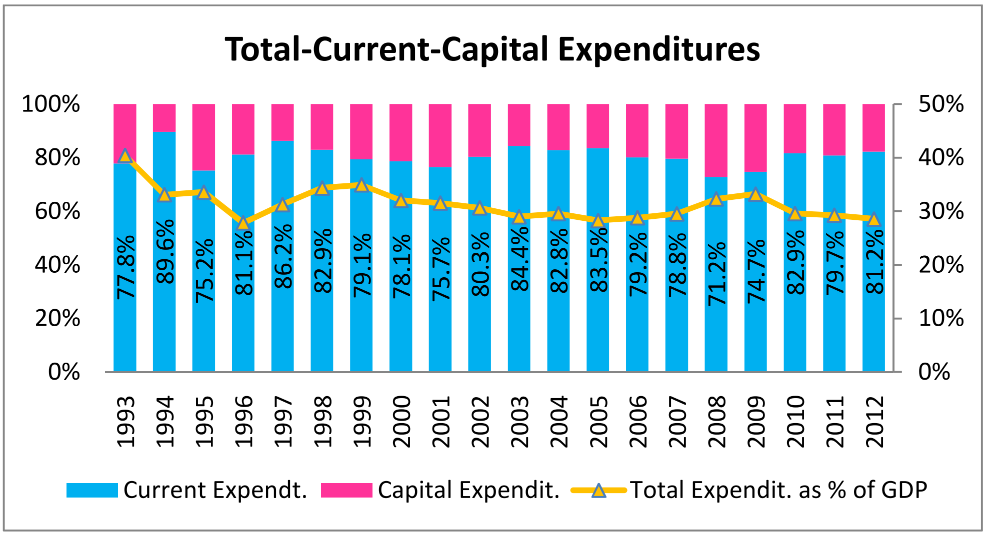
The following chart presents the performance of budget balance since 1993, in million lek and as % of GDP.



Source: Ministry of Finance

The fiscal balance of the budget, for the period taken in consideration, has always been negative. Years 1993-1997 are characterized by a high level of deficit as a percentage of the GDP, although in comparison to the absolute value levels of it, we can say that the deficit of year 1993 was much less then ¼ of 2008 balance. Growth rates continued until 1997, when the deficit reached almost 12.9% of the GDP. For this reason the government decided to take immediate action to reduce it, trend which is observed up to 2005. The fiscal goal set was to lower the deficit to 5.8% of the GDP within 2005. In 2003 there is a higher reduction of the fiscal deficit, as a result of a higher revenue growth rate compared to the spending one. Meanwhile, any failure to reaching forecasted revenues would be accompanied by a strict control of costs, to not overpass predicted deficit. Situation changed after 2006 as a result of the implementation of an aggressive fiscal policy. The deficit peaked in 2009 (round 7% of GDP) as a result of a borrowing to

finance a big project in transport. A constantly negative budget balance made the debt stock grow, approaching the limit rates (60% of GDP).
For this reason, the government was trying to be careful, to have a deficit no higher than 3% for the year 2012. Any shortfall of income would be backed up with expenditure contraction (revised budget).
One of the problems generated by a high level of debt is the high level of interest payments, which dry up funds available for other items of the budget. Thus, in 2012, interest payment (Zilja, 2012) is the second most funded function by the State Budget (COFOG Classification). In the context of a limited budget and deficit level defined, governments are forced to cut spending in other items of the budget, whether current or capital expenditure.
Government expenditures: Capital and Current
The weight of the total budget expenditures to GDP has varied over the years. After an upward trend in the years 1996-1999, a downtrend is noticed. In 2000-2005, the government tried to reduce the budget deficit, eventually there was a decrease of the total expenditure to GDP, but that was about to change during 2005-2009. Of great interest, is the way in which composition of expenditures has changed over this time. For further analyze we review the current and capital expenditures budget classification in fiscal tables. Their proportion to the total expenditures is shown below.



Source: Ministry of Finance

It is noted that there is not a certain solid behavior toward current and capital expenditure. Despite the measures to reduce the budget deficit (since 1997), the reduction of the rate of recurrent expenditure to total expenditure is alternated with increased capital expenditures and vice versa, without creating a multi-year trend. However, during 2000-2003 period when stronger measures were taken to reduce the deficit, it can be observed an increase in current expenditure weight, what means that the deficit reduction was accomplished by virtue of reducing capital expenditure. Trend breaks in 2004, first, because of the growth of the deficit as a % to GDP compared to the year 2003, and second, because it was a year before the elections, reason for which the government chose to increase public investments. The facts high lightened the influence that elections continuously had over the budget allocations. Years 2005-2009 are characterized by the simultaneous growth of the deficit and the weight of public investments. This means that the debt was taken to finance capital expenditures. The reduction of the deficit after these years was accompanied at the same time with a decrease in the weight of public investments, while current expenditure was reaching the highest level since 2004. There are two important elements to these developments. First, the year 2009 marked the completion of the "Rreshen Kalimash" project, which was the major cause of the parallel growth of the deficit, the debt and PI for the 2008-2009 period. The completion of the above mentioned project brought the decrease of PI and caused the budged to return to its normal trend. Second, insurance and social security expenses are the main function financed by the state budget over the years, this function is also one of the most important elements of current expenditure.

The position of this function is not affected by the government's attitude on the deficit or debt and is less likely to be affected as long as the pension scheme is highly depending on the budget. Payments for this item are fixed liabilities for the government, which must be paid so their decline is almost inevitable, conclusion which is reinforced by the past trends, as well as expected ones, of the government to increase pensions. The same treatment can be done to wages, despite all efforts made for a small government. If all these elements were added the cost of debt, then current expenditure would be framed in a static position. Maybe evidence shows they are not growing, however they are so not likely to be reduced.

This conclusion is encouraged by the revised budget analyses that can be made. So, in year 2011, total expenditures in the Revised Budget decreased by 4.5%, as a result of 3.2% reduction in current expenditures and 10.4% in capital expenditures. Furthermore, in year

2011, total expenditures in the Revised Budget were 9.4% less than the Budget approved earlier that year. In the same time, current expenditures fell by 5.7% while capital expenditures fell 22.4%, almost than five times more than current expenditures.
Because of the recent economic developments in and outside the country and high debt levels, starting from year 2012 the Albanian government has announced that will be very prudent in public expenditures in order to maintain the level of debt stock under 60% of GDP and a deficit up to 3% of GDP. This means that public finance is entering to a fiscal consolidation phase. In these circumstances, it would be very interesting to see if the government will accomplishing its macro framework by cutting off current spending more than capital one or vice versa.

IV. CONLUSIONS

In a great majority of countries, studies show that capital spending as % of GDP has declined since 1970, relating this performance with fiscal consolidation which characterized fiscal policy of many countries after the 70s. In their studies Roubini and Sachs (1989), De Haan et al. (1996), Tanzi and Schuknecht (2000), Sturm (2001) and Turrini (2004) protect the hypothesis that during fiscal consolidation governments prefer to cut public expenditures, supporting the idea of Oxley and Martin (1991) that it is politically easer to cut PI than current expenditures. However, other authors suggest that budget cuts will firstly affect social expenditures rather than productive expenditures, leaving room for discussion if fiscal consolidation gives the greater impact on PI or current spending.

During the last 20 years, Albania has always had a negative fiscal balance of budget. However, evidence shows that the level of deficit as % of GDP has generally decreased, especially in years 1997-2005 and 2010-2012. A constant negative balance has led to a continuous increase of debt stock, reaching in 2012 the assessed limit of 60% of GDP. In order to not surpass the allowed and recommended level of debt stock, but also to decrease the interest payments, the Albanian governments have try to keep under control their total expenditures, whether current or capital.

In order to assess if the restriction of total expenditures were characterized mainly by current spending fall or capital funding decrease, an analysis of the proportions of current and capital expenditures to total budget's expenditures was carried out. It shows that there is not a specific behavior of the Albanian governments toward one or another kind of expenditures. There have been periods of time during which the decrease in total expenditures was accompanied by current expenditures increase, but in some cases, PI incline have been present as well. This means that the governments didn't have a pre-assessed aim to control the debt through PI cuts. It could be as a result of the developing phase of the country which demands high level of investment especially in infrastructure.

However, there are some periods of time during where there seem to be a strong correlation between fiscal consolidation and PI shortfall, such as 2000-2003 or 2010-2012. This attitude is also conditioned by the high level of social welfare expenditures, the most financed function from the State Budget. The social pension scheme is very depending from the budget and payments for this item are fixed and inevitable liabilities and for the government. Despite the total expenditures level, these payments have to be done and very unlikely will decrease. This conclusion is encouraged by the analysis of budget review after years 2007. It showed that during this process, PI cuts are higher than current expenditures cuts.

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- Data Sources:
- Ministry of Finance
- The data used in the chart belongs to the Fiscal Table of Budget Laws for 1993-2012 periods.
- The data of 1993-2010 are extracted from the *Factic Budget.* The data for year 2010 belong to the Revised Budget. The data for years 2011-2012 belong to the budget approved at the beginning of the year.