Public Investment–

virtue or vice?

British Road Federation

PUBLIC INVESTMENT - VIRTUE OR VICE?

The following is the text of a talk given in February 1985 by Mr A P de Boer, CBE, Chairman of the British Road Federation to members of the Economic Research Council

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The Government's negative approach to investment

The question of whether public investment in the infrastructure should be increased has aroused great passions. The cut and thrust of debate between the Government - especially the Chancellor and the Prime Minister - and its critics has led to some strange charges. The Chancellor has accused those who support more public investment of resorting to a "voodoo witchcraft" means of promoting economic prosperity. I think that the links between an improved infrastructure and a better economic performance are more intelligible than the Chancellor would have us believe. However, the Government's obsession with controlling total public expenditure and not its composition means that Ministers have a very negative attitude to public investment compared with the way in which a company would view its investment programme.

Just imagine how you would react if the chairman of a company in which you were an investor made a statement at the AGM along these lines:

"As you know, we attempt to control our budgets by concentrating on just one figure - the company's total expenditure each year. In 1984-85 we planned to spend £126.4 billion. Now during the year we have given our staff pay increases which are 50% higher than planned. We have also had some industrial relations problems with one of our subsidiaries - involved in mining - although that should soon be over. Due to these developments we are going to overspend our £126.4 billion target, but by some creative accounting we have kept the apparent overspend down to £1.7 billion.

"Another thing which kept the overspend down was a 3.5% cut in the real value of our capital expenditure. Next year we are going to cut capital spending again, this time by 6.5% in real terms. In the 2 subsequent years there will be cuts of 3% each year.

"By cutting back our investment programme like this we should be able to keep our total spending under control - even if our plans for holding down wages or reducing subsidies to unprofitable subsidiaries continue to be thwarted. It should also enable us to reduce our bank borrowing."

As shareholders, I do not think that you would be very impressed by this company's way of controlling costs or its criteria for a successful financial performance. Yet this is the sort of analysis which was presented for the public sector in the 1985 Public Expenditure White Paper.

Thank goodness that companies do not determine their investment programmes in such a way.

Increase in private sector investment not matched by the public sector

One of the encouraging features of the economic scene in 1984 was the increase in private sector investment. Although full year figures are not yet available, the indications are that private fixed investment has risen by about 8% in real terms compared to 1983 with manufacturing industry being particularly buoyant. When it is remembered that private investment only rose by 2% in 1983, the 1984 performance looks particularly encouraging. In 1985, investment surveys undertaken by both the Department of Trade and Industry and the CBI indicate continued growth, at a very similar rate.

By way of contrast, 1984 marked the beginning of a period of retrenchment in public sector investment. After a 13% real increase in fixed investment in 1983, real cuts were made in 1984. A glance at the new public expenditure plans for 1984-85 suggests that the decline in investment in the public sector is across-the-board. It is true of expenditure on new construction, which accounts for most of the fixed investment undertaken by central and local Government. From 1985-86 onwards, the White Paper shows that further substantial real cuts will be made.

Construction expenditure a 'soft target' for cuts

I would like to concentrate on one aspect of public investment - expenditure on construction and on roads in particular. Construction accounts for the greater part of the fixed investment undertaken by central and loca. government, if one excludes defence spending.

Such investment has declined considerably in real terms in recent years due to cutbacks by central and local government. For example by 1983 Government investment was only 44% of its 1973 level in real terms, mostly due to less spending on construction. During the same period, current expenditure by central and local government continued to expand.

The Government are quick to point out that the construction expenditure figures do not include repair and maintenance. Precise figures are not available, but the Treasury estimates that in 1983 the public sector spent about £6 billion on repair and maintenance. However, a recent, well publicised study by the National Economic Development Office concluded that present levels of spending on repair and maintenance were not high enough in the public sector and that there is a potentially costly backlog of essential work to do.

Both new investment and repair and maintenance have been 'soft targets' when Governments - both Labour and Conservative- have sought to cut public expenditure. Some attempt must be made to shield this type of capital expenditure from further cuts and indeed to examine whether increased public sector construction would be justified. The British Road Federation believes the starting point must be to distinguish more clearly between capital and current expenditure and to recognise that increases in many types of current spending would be detrimental to the Government's economic strategy but selective increases in capital spending would not.

More construction expenditure would not threaten the Government's strategy for the economy

There are four major reasons why the overall objectives of economic policy would not be threatened by increased public sector construction, for example:

* The State would not be depriving the private sector in construction of real resources. As the civil engineering industry can testify, public spending cuts have simply resulted in lower workloads and employment levels. Obviously, companies have attempted to find alternative work, but have not been able to fill the gap left by the public sector.

* This leads to the second reason why the Government should not be afraid to spend more on construction -there is enough spare capacity in the industry to ensure that a carefully phased public investment programme would not create inflationary pressures. In road construction, for example, the degree of competition for work among contractors has been so fierce that construction prices have been rising at little more than 2% per annum.

* The resulting improvements to the nation's infrastructure would, by reducing costs and improving competitiveness be of direct assistance to industry, as the CBI pointed out last year in its report entitled 'Fabric of the Nation.'

* My final point in defence of more public investment is that the programme could be of finite duration. Public expenditure would not, therefore, be running out of control since there would be little permanent commitment of resources. Any borrowing which was necessary to finance the programme should be presented to financial markets in these terms, preferably by separating it out, together with the resulting investment expenditure, in the national accounts. If the Government has a problem of controlling public expenditure, it is with current spending. It is increases in the real value of current expenditure which have proved to be permanent in the past, leading to a growing absorption of national resources by the public sector; and it is borrowing to finance current expenditure which should therefore be of concern to the Government and the financial markets.

As I said earlier, the Government is obsessed with controlling total expenditure and is not looking closely enough at the relative merits of different expenditure programmes. So its attitude to public investment seems so unadventurous when compared with the way in which a company would view its investment.

The need for new infrastructure in a changing society

The keynote of the boom in private sector investment is "planning for change." The emphasis has been on saving labour with the result that productivity has risen rapidly in recent years. The Government does not seem to have the same approach to its own investment. Ministers have argued that much of the post-War investment in infrastructure was a "one-off" affair, because the forces which led to the need for the new towns, for more schools and hospitals and for motorways are no longer operating. This is a great oversimplification. Society is continuing to change and so create the need for new infrastructure. New developments include the decline of traditional manufacturing and the rise of new service and high technology industries in new geographical locations, the problem of inner city decay and the shift in our pattern of trade to the east coast ports. Meanwhile some of the post-War forces for change are still with us - such as the continuing growth of car ownership. Like industry, the Government should be "planning for change" in its investment policy.

Take roads for example. It is true that within a few years Britain will have the basic motorway network planned for it in the '50s and '60s, but even taking existing roadbuilding plans, there is much more than this to be done. After a thorough survey of existing road plans, especially at local government level and taking account of the likely growth of traffic by the year 2000, the British Road Federation has identified projects with a works cost of £20,000 million. To get these projects completed by the year 2000, they need to be started during the next 10 years. To do this demands an increase in annual road construction expenditure of £800 million above today's level. This would be an increase of 27% over present road expenditure of £3,000 million. It would only be 8% of the £10,000 million paid each year in motoring taxation.

It is far too simplistic to argue that increases in this type of investment expenditure are bad whereas the surge in private sector investment is to be applauded. The new methods of operation and economic growth promoted by private investment place demands on the infrastructure which require public investment. The two types of investment complement each other: it is not true to say that one is virtue and one is a vice.

Roads provide an obvious example. Economic growth and, on a local scale, changed business methods and techniques generate traffic. I was recently told by a member of Hampshire County Council that - despite all the financial constraints which the Council faces - it is maintaining intact its £51 million capital expenditure programme. This is because the Council recognises that this expenditure is vital to the development of the local economy. The message seems to be clear at local government level but not in Whitehall. Yet Ministers have no excuse for deliberately turning a blind eye: the growth of traffic in recent years has caused the Department of Transport to revise its forecasts upwards. Traffic is now expected to exceed current levels by between 25% and 50% by 2000.

Better roads bring cost savings for industry

If the road network is modernised to cope with the increasing demands being placed upon it, the benefits to industrial costs can be highly significant. Although there is a cost-benefit appraisal system for roads, this does not pretend to capture the true benefits to commercial operators of a good quality road network It only measures saving in time and vehicle operating costs for the users of specific sections of road. The British Road Federation tackled the problem from a different angle by asking major fleet operators to compare the cost of running lorries on motorways and the most convenient parallel 'A' roads which the motorways had been built to relieve. Without motorways, they would be impossibly congested and so our tests must have heavily understated the cost of using these roads had there been no motorway.

Even so, the cost advantages of using motorways were startling. Ford Motor Company conducted the test on runs between its factories at Halewood (Merseyside), Dagenham (Essex), Leamington (Warwicks) and Bridgend (Glamorgan). On average, the cost of operating on 'A' roads was 54% higher than on motorways. Despite the higher speeds attained on motorways, fuel consumption was cut due to the absence of stop-start motoring. Ford were also able to eliminate the need for overnight stops by using motorways, which saved on labour costs and which increased vehicle utilisation. Lucas Electrical produced similar savings in time and fuel consumption by using motorways instead of 'A' roads. Their costs per vehicle were reduced by £4,500 per annum.

In national terms, the savings to industry from the use of existing motorways must sum to hundreds of millions of pounds each year. This is why it is important to press ahead with the completion of the planned motorway and high-standard dual carriageway network and to increase the capacity of that network as traffic volumes grow.

Can the nation afford more public investment?

Even if a strong case can be made for more public investment, we then have to face the question often put by the Government - <u>can the nation afford it?</u> First of all we should remember the point made in a recent Financial Times leader that while debt is a burden for future generations, run-down infrastructure could be a bigger burden. In all too many areas of public investment this kind of assessment is not made. We make no attempt to discover what policy provides the best value for money.

This argument was made forcefully in the recent study by NEDO on the planning and control of public sector capital and maintenance expenditure.

Clearly, there is not enough investment appraisal in the public sector - what is even worse, there does not seem to be enough basic information about the state of the existing capital stock. No wonder capital expenditure has consistently lost out to current expenditure.

Perhaps the private sector could do these jobs much better if it were allowed to have a greater role in areas of investment which the public sector has until now reserved for itself. Some providers of infrastructure are trading bodies and could therefore offer a profitable return on private injections of capital. For example, 13% of the public water supply in England and Wales is provided by private water companies. This figure could be enlarged. There may also be scope for privatising investment in our airports. Indeed the Government is known to be considering various options for introducing private capital into the British Airports Authority, which is becoming increasingly profitable.

Because roads are provided out of tax revenue or by public borrowing, and not by charging users directly, the provision of private capital is not so easy to arrange.

It could be done, however. A viable scheme for privately financing road building was drawn up by West Midlands County Council as the highway authority, Tarmac Construction and National Westminster Bank. West Midlands County Council would have borrowed the money - initially from an affiliate of National Westminster, but later the loan would have been converted to bonds floated on the stock exchange. The return to the private investors paid by the Council would have been based on the amount of traffic using the road together with the amount of industrial development alongside it. Because the road was to link the depressed Black Country area with the M6, there would have been considerable potential to develop derelict industrial sites along the route.

Naturally enough, the private investors would have been offered a risk premium in their expected return, since traffic volumes and economic development could not be predicted with certainty. The risk premium aroused the objections of the Treasury who effectively sabotaged the proposal. The road is now to be financed by public sector borrowing but of course at the expense of some other road which could not have been privately financed. To the Government, infrastructure investment seems to be a vice whether it is undertaken by the public or private sectors.

Private finance is not a panacea for roadbuilding.

Most of it would have to continue being financed by the Government or local authorities directly. So there is a limit to what can be done due to the need to strike a balance between more investment and maintenance expenditure and the containing of public sector borrowing. At the British Road Federation, we have suggested such a compromise. Public borrowing has now been reduced to under 3% of GDP, which is low by recent historical standards. In the mid 1970s the PSBR was over 9% of GDP. The Government should now concentrate on stabilizing the Public Sector Borrowing Requirement at 2% of GDP instead of 1.25% as suggested in its medium term financial strategy. This would release around £2,000 million each year for the next 4 years which could be devoted to capital expenditure. That would still leave available the sums which the Government has earmarked for tax cuts.

Tax cuts versus public investment: a sterile debate

While tax reductions are an essential part of the Government's programme, there is no empirical evidence to suggest that these will have a greater impact on employment than public investment, despite recent statements by the Prime Minister to the contrary. While the case for more public expenditure on construction does not rest on the employment argument, it does add weight.

To summarise - a carefully planned and modest increase in public expenditure on new and existing capital assets is necessary to meet the demands of a growing economy: there would be an added bonus of job creation and no need to forego tax cuts if the planned reductions in the public sector borrowing requirements were scaled down.

The case for more public expenditure on construction does not rest primarily on the direct employment that could be generated. It is a pity that recent political debates have concentrated on the employment aspect and have degenerated into a dispute about whether tax cuts or public investment would do most to create jobs.

The Government should attempt to achieve something on both fronts but in assessing the need for more investment, job creation should take second place to an assessment of the wider economic benefits. Of course, the fact that more jobs could be generated is important, but greater economic efficiency will eventually guarantee higher levels of employment anyway.

In fact, in seeking an increase of £800 million a year in national and local government investment to bring forward outstanding highway improvement projects, BRF estimates that this could produce up to 81,000 new jobs for the 10 year period of the proposed programme. It has also been sad to see the Prime Minister misled by information which seeks to suggest that investment in construction projects would stimulate more imports than an equivalent reduction in general taxation. This just isn't true. 10 Downing Street seems to be just as confused about the value of public investment as it recently was about the value of the £.

In fact the true position is that while the Prime Minister may be correct in estimating that '30% of all investment spending leaks into imports,' the import content of total materials used in house building is estimated to be 7% of total costs, and for road construction, materials with a significant import content account for only 13% of total costs. These compare with the Prime Minister's estimate that 21% of consumer spending goes into imports.

Government will only make the right economic judgement if it gets its facts right and interprets them correctly.

The longer term contributions to economic efficiency from a sensible programme of additional investment in public infrastructure projects would be significant - indeed vital - if Britain is to regain sufficient competitiveness to attract enough multi-national investment to achieve the brighter future which all of us would like to see. We do not believe that it necessarily has to be a choice between more investment or more tax cuts.

The fact that BRF is not alone in regarding more investment in highways of vital importance to this country's future economic efficiency has been supported and confirmed by the CBI report 'Fabric of the Nation' and by the continued emphasis which CBI places on the need for further and more urgent action to improve our highway system. The BRF call for an extra £800 million a year reflects an attempt to assess realistically what needs to be done in order to compete more effectively with the road systems and related efficiencies which nations such as West Germany, the Netherlands and the United States already enjoy. The CBI is calling for somewhat less, since its total capital spending package is only £1,000 million a year for 10 years. However, we are fully agreed on the need to do more than the Government presently plans.

It ought to be possible to make tax cuts and invest more in our infrastructure by means of the more realistic view of the present scope for PSBR reduction that I have suggested. For this to happen in practice

would however require the issue of infrastructure investment to be looked at more objectively <u>not</u> just in the context of economic dogma or the pursuit of political arguments about how to reduce unemployment.

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