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CAPITAL EXPENDITURES AND THE BUDGET

Davina F. Jacobs

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This note discusses issues related to the integration of capital expenditures into the budget process faced by many low-income countries (LICs).[2] The following main issues are covered:

The definition of "capital."

What are the main characteristics of budgeting for capital expenditures?

What are the critical steps for capital budget planning, prioritization, and implementation?

I. THE DEFINITION OF "CAPITAL"

A. Introduction

The United Nations' System of National Accounts (SNA) and the IMF's *Government Finance Statistics Manual 2001* (GFSM 2001) prescribe how a government's consumption and investment activities should be separately recorded in the government budget and in accounting records and statistics.[3] This note is concerned mainly with capital or public investment. However, some of the most common problems with public sector capital budgeting can arise from its interface with current spending. These are discussed in the next section.

B. Defining Capital

Governments around the world may define "capital" in different ways. *Capital spending is generally about physical assets with a useful life of more than one year.* But it also includes

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[1] This note is largely based on a recent IMF working paper by the author (WP/08/160). It has benefited from useful comments from Messrs. Richard Allen, Marco Cangiano, and Eivind Tandberg (all FAD).

[2] This note does not aim to be fully comprehensive nor cover all aspects of budgeting for capital, such as decisions related to public investment project selection and institutional setup, among others.

[3] Sarraf, 2005, p. 4 also discusses this aspect.

capital improvements or the rehabilitation of physical assets that enhance or extend the useful life of the asset (as distinct from repair or maintenance, which assures that the asset is functional for its planned life).[4]

Capital spending is sometimes associated to *investment* or *development spending*, where expenditures have benefits extending years into the future. Under this definition, governments may include physical assets for government use (for example, office buildings), public good nature that also enhances private sector development (for example, roads and water systems), and intangibles (for example, education and research). It can be quite difficult to distinguish between investment and noninvestment expenditures, and if investment spending receives preferred or special treatment in the annual budgeting process, many types of spending, whether recurrent or not, may end up being classified as investment.

Every government establishes some arbitrary cut-off point to distinguish capital from current expenditures. For budgeting purposes, the relevant distinction is between capital and current (or operating) expenditures.[5] Current expenditures are purchases of assets to be consumed within one year, regardless of expenditure size. Small expenditures (for example, less than US$10,000) are regarded as current, regardless of the fact that it could be consumed over a period longer than one year.

C. The Distinction Between Capital and Current Expenditure

Capital and current expenditures need, in some cases, to be considered separately:

- Capital spending within the budget needs to be clearly identified *separately* in order to highlight certain government priorities.
- Also, given the large amounts usually involved, *capital-specific procedures* are needed for project selection and evaluation, asset procurement and project management, and for subsequent management and disposal of capital assets.

But sometimes, capital and current expenditures need to be considered together:

- For efficient planning and budgeting purposes.

[4] See IMF, *Government Financial Statistics Manual*, 2001: p. 62–78. See also for European countries, the European System of Accounts (ESA) and more generally, the SNA methodology established in 1993.

[5] The 2001 *Government Financial Statistics Manual* uses the concept of "expenses" as a decrease in net worth resulting from a transaction. Governments have two broad economic responsibilities: the provision of selected goods and services to the community on a nonmarket basis; and to redistribute income and wealth by means of transfer payments. These responsibilities are largely fulfilled through expense transactions.

- Investment proposals need to be appraised in terms of *both* capital *and* operating costs.

The structure of a capital budget (both receipts and expenditures) can be illustrated as set out in Table 1 below. The funding of a capital budget can be more than borrowing—although depending on the situation, borrowing may be the most important source of funds. In principle, taxes levied on property, although paid from current income, are considered levies on capital and included in capital receipts. In some countries, income from natural resources (including oil) may be earmarked for capital projects and, therefore, included in receipts. In countries with development plans, surpluses from the current budget (relatively less during recent years owing to the significant growth in current outlays) are yet another source of receipts. Depreciation allowances represent, in accounting parlance, a *contra* or a balancing entry, in that allowances that are charged to the current account are treated as capital receipts under accrual accounting and budgeting. The receipts section includes capital transfers from external sources and proceeds from the sale of property and privatization.

Table 1. An Illustrative Example of the Structure of a Capital Budget

Receipts	Expenditures
1. Estate and death duties • Taxes and property • Earmarked revenues for capital projects	1. Acquisition of existing assets[6] • Plant, property, and equipment • Financial
2. Surpluses from the current account	2. Acquisition of new assets • Plant, property, and equipment • Financial (other than capital transfers)
3. Proceeds of borrowing: • Domestic • Trust accounts maintained by government • External	3. Capital transfers • Transfers to other levels of government • Transfers to state-owned enterprises
4. Depreciation allowances	4. Repayment of loans
5. Sales of property • Regular • Privatization	
6. Capital grants	
TOTAL	**TOTAL**

Source: Premchand in Shah, 2007: p. 94.

[6] The acquisition of existing assets are not considered as “investments” in the SNA because in the SNA, an investment implies the creation of new assets.

It is normal in developed economies for the section in the Ministry of Finance that is familiar with a spending unit's activities to deal with both capital and current spending. For each spending program, the budgeting of capital and current expenditure is developed together.[7]

The annual government budget for all public spending in most developed countries is broken down into several hundred items for approval by parliament. Indeed parliaments often require capital expenditures to be specifically identified in the budget documentation. Program budgets in these countries still have capital and current components, usually with only limited freedom (if any) to vire between them. Capital and current expenditure are also distinguished in the *accounts* of spending units and in *reporting* expenditure. However, presentation and debate in the parliament usually focuses on expenditure programs as a whole.[8]

II. Main Characteristics of Budgeting for Capital Expenditures

A. Why Dual Budgeting?

Dual budgeting (or budgeting separately for current and capital expenditures) originated in European countries in the late 1930s in order to help governments ensure that the resources they borrowed were used only for capital expenditures.[9] [10] In recent years, the use of a "golden rule" (which allows borrowing only for capital spending), could be seen to justify a separate treatment of capital and recurrent expenditures. But over time, it came to be accepted that regardless of their financing sources, government's current spending and capital investment are considered together, and that these two types of expenditures together can produce results.[11]

[7] See Spackman, 2002, p. 9, for more examples on this practice.

[8] For example, the Netherlands had separate capital and current budgets from 1927 to 1976; subsequently, there has sometimes been pressure to return to this arrangement from those who believe that this may lead to more public investment, but these arguments have been resisted (Spackman, 2002, p. 10).

[9] Detailed information on the creation of dual budgeting in the Sweden and the U.K. in the 1930s and 1940s can be found in A. Premchand, *Government Budgeting and Expenditure Controls—Theory and Practice,* International Monetary Fund, 1983, pp. 292–302.

[10] See also Premchand in Shah, Anwar, (ed.), 2007, *Budgeting and Budgetary Institutions,* p. 89.

[11] In the United States, periodic recommendations were made for the introduction of a separate capital budget. But this never materialized, primarily because it might tilt the resource allocation in favor of "bricks and mortar." However, the budget documents presented a special analysis of investment expenditures, which was for information only and had no accounting or other implementation impact for the budget structure. For further details, see A. Premchand, op. cit., p. 302.

For many low-income countries, separate current and capital budgets—i.e., a “dual budget” process—have their origins in the public financial management structures established by colonial administrations.[12] Frequently, finance and development ministries issued their own separate budget circulars, and the dual approach to budgeting also took root in the line ministries. Lack of coordination between the finance and planning or development ministries may also have reflected differences between their ministers and/or heads of state who, in some cases, exercised *de facto* control of investment decisions and their funding. Such settings made it difficult to introduce consolidated budget presentation and classification systems. Moreover, some substantial but unforeseen recurrent costs evolved from the expansion of investment projects.[13]

Some low-income countries have merged their finance ministries with their planning or development ministries. Line ministries have a strong incentive to prepare and defend separate budgets because they can use the opportunity of donor-negotiated projects to demand further complementary financing and to expand their operations without attention to the future cost implications. These projects may include either capital projects or specific and independent recurrent activities. For line ministries, dealing with two separate central ministries for defending their budgets is more advantageous than dealing with one unified central budget authority, because they can take advantage of the two central ministries’ lack of detailed information.

Today more than ever, the integration of recurrent and development budgets in low-income countries has become a necessity:

- government borrowing is no longer limited to capital expenditures;
- only an integrated analysis of recurrent and development expenditures can identify those poverty-reducing expenditures that have an immediate impact (e.g., social transfers and targeted subsidies and some other social expenditures) or an indirect impact through accelerating economic growth; and
- even after several decades of experience, the recurrent costs of capital projects continue to be ignored, due in part to the lack of coordination between two separate budgets.

[12] See Webber, 2007, pp. 1–2 for more discussion on the origins of dual budgeting.

[13] In some countries, although the Minister of Finance may have presided over the planning commissions or planning ministries, the latter were directed from the presidency. For details, see I. Lienert and F. Sarraf, *“Systemic Weaknesses of Budget Management in Anglophone Africa,”* IMF Working Paper, WP/01/211.

B. The Case for Integration of Current and Capital Budgets

Most OECD countries have achieved a high degree of integration of their current and capital budgets. This has usually occurred through a process of development in their public administration and budgetary systems that has taken place over many decades. It is the result of a growing realization by these governments that (i) the distinction between current and capital spending is often quite arbitrary or uncertain; and (ii) better resource allocation and management decisions can often be made within a single, unified (and medium-term) framework for revenues and expenditures.[14] In some developed countries (e.g., New Zealand, Norway, and the United Kingdom), highly sophisticated strategies for managing the government's stock of capital assets and new investment programs have been developed. The switch from cash-based to accrual-based accounting in some countries has also heightened the importance of efficient management of capital assets and new investment.

Although many developed country administrations may not consciously seek to optimize a current/capital spending balance, they nonetheless aspire to achieve consistency and efficiency within the context of their ongoing resource allocation and budget management decisions. In fact, getting the right balance between current and capital spending across the whole range of budget interventions and activities will depend substantially on the quality of budget planning systems and capabilities. While these issues may involve a much wider range of factors than simply the extent of budgetary integration per se, there is no doubt that a unified budget generally makes it easier to develop better systems, policies, and capabilities in these areas.

The budget systems of countries with a high degree of integration between current and capital expenditures exhibit several key features:

- a single (combined) annual budget law and appropriation process;
- clear and unified responsibilities for budgetary preparation and implementation within the relevant public sector institutions;
- the existence of effective and widely employed investment appraisal techniques;
- a unified budget presentation, with supporting classification and accounting systems; and

[14] See further discussion of the development of this process in Webber, 2007, p. 2.

- budget planning and management techniques within individual spending agencies that encourage and enable good use of financial resources.

Most developed countries' budgetary systems incorporate some of these features. However, the full benefits of a unified budget can only be achieved where each of these conditions is present. And although each of these features is important, it is often in the last area—the budget planning and management within spending agencies—where the most challenging reform measures and greatest gains are to be found.

C. A Medium-Term Approach to Capital Expenditures

Above-mentioned characteristics of a sound budgetary system are often strengthened by the use of a medium-term approach to public investment. If the sole focus is on preparing and executing the annual budget, the main reasons for pursuing investment projects will be related to short-term macroeconomic effects, for instance on employment, and short-term political considerations. In such a setting, the potential long-term effects of the investments may be accorded little importance. As a result, the capital budget will tend to be underfunded. In addition, project selection will tend to prioritize high-visibility, fast-track projects, not the projects that give the highest benefits over the given lifetime.

Decisions about allocation of resources to different sectors and investment projects should ideally be based on efficiency. What are the benefits compared to the costs of the projects? In the short term, the main focus will tend to be on static efficiency: what are the expected results of allocating resources to certain sectors based on their current capacity to deliver specific public goods and services? In a longer-term perspective, dynamic efficiency becomes more important: resource allocation should also be governed by the possibilities for improving the capacity of the sectors over time, and investment projects will play a critical role in this regard.

Many efforts to extend the time horizon for investment planning include the introduction of medium-term budget frameworks (MTBFs). Currently, many OECD countries prepare comprehensive MTBFs. Few low-income countries have been able to introduce full-fledged MTBFs so far. Experience shows that this type of reform is conceptually and practically demanding. In particular, it has turned out to be difficult for line ministries to develop credible, multi-year budget estimates.

III. Critical Steps for Capital Budget Planning, Prioritization, and Implementation

A. Introduction

The following benchmarks should be taken into consideration in budgeting for public investment: (i) determining the resource envelope for expenditures; (ii) efficient prioritization and selection of capital projects; and (iii) efficient implementation of capital projects. The section below highlights some of the main recommendations for efficient budgeting, prioritization, and implementation of capital expenditures.

B. Determining the Resource Envelope

- Capital expenditure decisions should be based on a consolidated budget approach, incorporating all revenues and expenditures, in particular foreign-financed projects and extrabudgetary funds with investment activities.

- Capital expenditure decisions should be based on a medium-term budget perspective.

- Decisions regarding capital expenditures should be taken in the context of a hard budget constraint. There should be explicit ceilings for commitments beyond the budget year.

- Governments should have clear policies regarding which types of capital expenditures should be financed by the budget, which may be realized through public-private partnerships (PPPs) and which should be handled by public or private enterprises. These policies should reflect the cost structure of the activities and the possibilities for user-financing, as well as political priorities.

C. Efficient Prioritization and Selection

- The budget calendar and the procedures for integration of capital expenditures in the budget must be clear, transparent, and stable. Development and analysis of capital investment proposals should largely be completed before the budget preparation process starts.

- All projects should be subject to cost-benefit analysis. If the subjection of all projects to cost-benefit analysis is too costly, the focus could firstly be on the larger projects, with using a simplified methodology for smaller projects.

- A public investment agency, with strong links to the Ministry of Finance, should prepare guidelines for project development and analysis. This agency should review project proposals to ensure that they are adequately prepared and analyzed and have the authority to reject projects that do not meet the established technical standards.[15]

- The Ministry of Finance should give the cabinet recommendations for which investment projects should be realized within the available resource envelope. Ministries should compete for investment funds based on the net social value and political priority of their investment proposals.

- The decision to implement an investment project should be independent of the financing and procurement modalities for the project. PPPs can improve risk allocation, but the benefits must be substantial to compensate for increased financing and transaction costs. Decisions regarding PPPs should be an integral part of the budget process, and PPP arrangements[16] should be fully disclosed in budget documents.

D. Efficient Implementation

- Rules for budget adjustments should give incentives for realistic initial capital cost estimates. Cost overruns during project implementation should be partly covered by reallocation within ministries' existing budgets. In the case of real cost reductions, ministries could be allowed to retain part of these for other additional expenditure needs.

- Capital investment project proposals should only be considered when they include a detailed disclosure of the expected operating costs, indicating how these will be accommodated within existing resource envelopes or making an explicit proposal for additional financing of the operating costs.

- Capital investment project proposals should only be considered after the ministry has explained how it will fully cover the maintenance of its existing capital stock.

- Governments should avoid excessive targeting of capital expenditures for budget cuts. Decisions on budget cuts should be based on the medium-term budget and take full account of future expenditure pressures.

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[15] Most Latin American countries have a "National System for Public Investment" (SNIP) whose key feature is an "investment project bank or database," where the information on investment projects that were evaluated and considered economically viable is recorded.

[16] See Schwartz, G., Corbacho, A., and K. Funke, 2008, IMF's PFM Blog at http://blog-pfm.imf.org.

- There should be project completion reports for all capital expenditure projects. These should form the basis for cross-sectoral analysis and methodology development and continuous improvements in the investment process.

IV. Conclusion

The earlier recommendations for achieving optimal budgeting for capital expenditures integration in LICs remain critical for success. However, obtaining the necessary results could take LICs several years. In summary, an effective capital budgeting process should form an integral component of a sound overall budgeting system. A well-designed public financial management system supports each aspect of the system, including capital spending. Good multi-year planning furthermore supports overall fiscal balance, with more stable spending patterns for ministries and programs, and for their capital planning and execution. Good budget execution and procurement will enable timely, within-budget completion of projects (assuming good program and project management). Financial management information systems will support the financial and program management needs of the executive, ministries of finance and economy, spending ministries, and program managers.[17] In addressing these aspects, LICs should continuously aim to improve not only their capital budgeting processes, but also their public financial management systems overall.

[17] See Dorotinsky, W., 2008, IMF's PFM Blog at http://blog-pfm.imf.org.

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