Fiscal Space for Investment in Infrastructure in Colombia

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For the evaluation of macroeconomic policies Colombian authorities rely heavily, if not exclusively, on the operational framework known as the Financial Programming Model developed by the IMF in the 1950s. Based on this static framework, the formulation of fiscal policy in the country, just as in various Latin American countries, focuses primarily on fiscal deficit and gross debt targets. However, the type of fiscal policy advice derived from it is not useful for understanding the asset-creating nature and the intertemporal trade-offs involved in public investment decisions. This paper develops a perfect foresight, dynamic small open economy model to provide an alternative framework for fiscal analysis and policy purposes. It is shown that the two competing frameworks deliver differing paths for the expected behavior of the Colombian economy. The proposed framework is then used to study the likely consequences of using public capital spending to achieve deficit targets since, in addition to an already high public debt, in the years ahead unfunded pension obligations will put an enormous pressure on the Colombian government’s solvency. The results indicate that public capital compression is costly, in terms of foregone growth, and very ineffective in achieving fiscal consolidation. The adoption of fiscal rules such as the golden rule or the permanent balance rule to protect public investment from undue budgetary pressures makes little sense in the presence of sustainability concerns. The redefinition of the public sector to exclude commercially-run public enterprises from deficit targets or the exclusion of particular investment projects are feasible initiatives. But independently of the adoption of any of these public investment protection schemes, policymakers should recognize the fundamental importance of public investment to ensure the country’s economic future as well as the danger of focusing on deficit targets without worrying about how those targets are met.