If you build it, will productivity increase?

Diario Expansión (Spain)

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In the film "Field of Dreams”, there is a line which can be read as a simple but compelling reason for investing in infrastructure: “if you build it, he will come." Cause and effect. In Spain, an important part of the growth in the pre-crisis years was driven by accumulated physical capital. In recent years, however, investment has had to adjust to the prevailing economic climate. Moreover, although the level of capital is not relatively low in Spain, it has been inefficiently distributed between sectors and regions and has not done much to increase productivity. So now that public administrations have put the focus back on investment, measures to ensure a more efficient use of resources in the next cycle are sorely lacking.

During the expansion period prior to 2008, around 50% of Spain's GDP growth stemmed from the accumulation of physical capital. Investment accounted for 30% of GDP, much higher than in the rest of Europe. In fact, public investment, in particular, reached 4.4% of GDP on average over the 1990-2010 period, compared to 3.3% in the EU12. However, since the onset of the crisis, this investment has fallen to 2.0% of GDP in order to correct the imbalance in public accounts and to prioritise other types of expenditure. It is important to point out that other developed economies also share the trend towards less public capital accumulation, and this could be due to other factors besides fiscal consolidation. On the one hand, the recession itself led to less demand for infrastructure. On the other hand, changes in the economy have prompted less focus on large-scale physical capital/infrastructure projects and more on investments in "intangible assets". Lastly, if public and private spending go hand in hand, then they would both be constrained by the lack of reforms to draw investment. At this point, and regardless of what the reason might be, it is worth asking whether the current level of public capital may be a burden on the competitiveness of the Spanish economy going forward.

When one compares, for example, physical capital to GDP, a lack of infrastructure does not appear to be the reason for the lack of convergence in living standards between Spain and more advanced EU countries. Although capital levels are high, the adjustment in investment to below the level of asset depreciation, suggests that public capital may already have been falling since 2012 in key sectors such as education, health and social protection. Moreover, the fact that so much has been invested does not mean it has been done so efficiently. For example, a recent study by the BBVA Foundation and the Valencia Economic Research Institute (Instituto Valenciano de Investigaciones Económicas, or IVIE) points to great variations in the distribution of public service capital endowments (per inhabitant) per Autonomous Community. In fact, some of the regions with the greatest deficiencies in this regard reported some of the highest falls in total factor productivity (TFP). Whatever the causality at play here, what is clearly observed is that in general, increased investment in Spain did not go hand in hand with an increase in TFP. This is important because public resources will become increasingly scarce in the future, and they should be allocated in a way that is consistent with economic and social profitability criteria. If we believe that growth can only be sustained with a higher level of public investment than is currently observed, we will need to find the resources to finance it. Moreover, if the solution is to raise taxes, taxpayers will have to be shown that public money is being well spent. Unfortunately, despite the excesses committed in the past, there are not enough independent institutions to assess the profitability of the projects proposed, or to pinpoint investment needs in the Spanish economy. This shortcoming may become evident now that political decisions point to an imminent recovery in public investment.

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