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MEASURES TO MINIMIZE THE EFFECT OF INFLATION ON INFRASTRUCTURE PROJECT COSTS

Sampatti Goyal*

Abstract

Infrastructure plays an important role in the economy of any country. A lot of projects experience cost overrun and thereby exceed initial contract amount. However, it is difficult to complete projects in the allocated cost and time. Taking into account the scarce financial resources of the country, cost overrun is one of the major problems. Inflation is one of the major factors leading to these cost overruns. Moreover time overruns or delays in project implementation, escalates the effect of inflation. Therefore, this research paper gives suggestions to reduce the effect of inflation as a major factor that causes cost overrun.

Keywords: *MOSPI, KPMG, Infrastructure, Financial Resources, Cost Overruns, Inflation.*

Introduction

Delays in project implementation and the resultant cost overruns have been a regular feature of the infrastructure sector in Rajasthan. Almost all state level projects have been victims of time and cost overruns owing to several avoidable factors, general price rise being singled out as the prime villain. The cost of a project is estimated on the basis of the price level prevailing when the project proposal is made. Thus there is a time element of error involved which represents underestimation in the face of inflation. The cost estimate is generally revised upwards to take account of this when the price level is rising rapidly. Ideally, a revised cost estimate should sufficiently cover the general price rise. Hence, what remains in the revised cost escalation of a project over and above the general price inflationary influences merits serious consideration; it may represent an overestimation due to uncertainty or a deliberate attempt at mismanagement of resources. Each project involves immense cost overrun. The government is not able to implement each project efficiently within the normally expected constraints of time and cost. It could have saved huge resources and hence undertaken many more additional projects. It is not that the government has no more resources for infrastructure development but it is to avoid extra spending. On the other hand this problem lies in the inefficiency of management and political corruption.

In recent years costs of key inputs such as iron and steel, cement, bitumen, concrete, crude oil, etc. have fluctuated sharply. However the volatility in material prices makes forecasting a challenging exercise and leads to inaccurate forecasts. Furthermore, the cost estimate assumes the project completion as per the schedule and does not account for inflation beyond the schedule date. Thus any delay in project completion makes the initial cost estimates obsolete leading to cost overruns. In short run projects, inflation may not create much of difference as material costs can be contractually fixed. But in long run projects and delayed projects, inflation plays a vital role as vendors will be forced to increase their prices from time to time and as such prices cannot be contractually fixed, rather an estimated margin has to be taken into account for the length of the project. In his book Megaprojects and Risk, An Anatomy of Ambition, Flyvbjerg noted a 'calamitous history of cost overrun' in major infrastructure projects worldwide. He observed that the difference between actual and estimated investment cost is often 50 to 100 per cent, and for many projects cost overruns end up threatening project viability. Flyvbjerg writes "A main cause of overruns is a lack of realism in initial cost estimates. The length and

* Department of EAFM, Faculty of Commerce, University of Rajasthan, Jaipur, Rajasthan.