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Economic Commission for Latin America and the Caribbean

THE FISCAL COVENANT

• strengths • weaknesses • challenges •

SUMMARY

UNITED NATIONS

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THE FISCAL COVENANT
STRENGTHS, WEAKNESSES, CHALLENGES

UNITED NATIONS
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CONTENTS

PREFACE

The Fiscal Covenant. Strengths, Weaknesses, Challenges is the latest in a series of documents produced during the 1990s on the theme, “Changing production patterns with social equity”. Like the other documents in the series, it offers guidelines for the present and future development of Latin America and the Caribbean. This time the issue addressed is that of public-sector finances.

The purpose of the present publication is to disseminate more widely the first chapter of **The Fiscal Covenant. Strengths, Weaknesses, Challenges**. This chapter summarizes the main arguments of the document and provides a general idea of its contents and proposals. The fiscal covenant is understood as being the basic sociopolitical agreement that legitimizes the role of the State and establishes the areas and scope of government responsibility in the economic and social spheres. Five main aspects of it are analysed: fiscal consolidation, improved productivity of public expenditure, transparency of public expenditure, safeguarding social equity and strengthening the institutional framework of democracy.

A. INTRODUCTION

It is a well-known fact that the debt crisis brought about profound changes in the development strategies of the Latin American and Caribbean countries. As it became clear that this was no transitory event, but instead represented a lasting change in the macroeconomic climate, emergency measures rapidly evolved into structural adjustment programmes designed to promote economic reforms compatible with the new conditions.

Beginning in the 1980s, then, the Latin American and Caribbean economies, with varying degrees of intensity, undertook wide-ranging structural reforms, among them trade liberalization and economic integration; opening the economy up to foreign investment; price deregulation; financial deregulation; greater labour market flexibility; privatization, divestiture and capitalization of public enterprises; a change in the model for financing social security pensions; and fiscal decentralization, especially in the provision of social services in the areas of health care and education.

To a great extent, the crisis of the 1980s represented a turning point in the view of the State as an actor in the development process. As a result, the reorientation of regional development has centred on the revision of the role assigned to the State, entailing a fundamental re-shaping of the fiscal regime. In many countries, for example, privatization and modernization have brought in an extraordinary level of revenues in the short term and reductions in public expenditure and public-sector employment in the long term, while intensifying calls for an adequate system for regulating the privatized services. Decentralization has altered the distribution of resources and responsibilities among the various levels of government and, hence, the structure of intra-governmental transfers. Trade liberalization has necessitated a shift in the tax structure towards domestic taxes (primarily on consumption, in the form of a value added tax). Meanwhile, deregulation of the financial system —designed to promote the development of national capital markets— has, in some cases and to varying degrees, facilitated a change in the social security funding model from pay-as-you-go to funded systems, incidentally expanding the sources of domestic financing for both government and the private sector, including, potentially, private infrastructure projects.

The new external context created by globalization and the striking increase in subregional trade agreements has added new challenges without eliminating those already in evidence. Globalization has accentuated the integration and interdependence of markets, imposing a certain discipline on macroeconomic policy and public finances in response to the increased mobility of short-term financial capital. Moreover, the sharp increase in subregional integration and commercial complementarity agreements generates certain constraints with regard to tariff levels, obliging forcing countries to adjust gradually to lower customs revenues and to deal with new challenges in administering tariffs and rationalizing the resulting levels of effective protection.

These two trends taken together —a conjunction that has given rise to the approach known as “open regionalism”[1]— have tended to reduce the autonomy of national authorities in making and carrying out decisions, particularly in the realms of domestic economic policy and fiscal policy. Recently, as the Asian financial crisis has underscored the disciplinary effect of the market, national economic authorities have been forced to pay ever closer attention to the kind of signals they are sending out in terms of stability and consistency through their chosen mix of fiscal, monetary and foreign-exchange policies and their management of the public debt.[2]

Now, some 15 years later, it can be unequivocally stated that the region has made significant progress in terms of its public finances. For most of the countries, government finances are no longer the cause of imbalances, but actually contribute to macroeconomic stability. Indeed, the magnitude of the fiscal adjustment undertaken in the region and the speed with which it has been accomplished constitute a striking achievement. Fiscal adjustment has been a major contributor to the current state of macroeconomic stability, absent for many decades, and a key factor in the region’s relatively strong performance in the face of the external turbulence that began in late 1997. In addition, progress has been made in the institutional arrangements for fiscal management, and this has eased the countries’ adjustment to the demands of globalization by paving the way for forms of public debt and deficit management that are more compatible with international patterns of budgetary discipline.

Nevertheless, it cannot be said that the region has resolved its fiscal problems and need only persist in its current approach for a reasonable period of time. On the contrary, myriad economic problems and crises —in many cases limited in intensity and ultimately brought under control, but crises nonetheless— have created an overall impression of fragility and suggest that fiscal balance and its contribution to general macroeconomic equilibrium are still constantly at risk, and that recent achievements in this regard must be firmly consolidated before there are any grounds for complacency. Another cause for concern are the banking crises which are becoming more frequent as the volatility of capital flows increases in the absence of adequate prudential regulation and whose costs are potentially much greater than those of traditional fiscal crises.

It is clear, moreover, that because of the exigencies of the crisis, most of the countries’ efforts have gone into reaching and maintaining financial equilibrium, and scant attention has been paid to other possible objectives of fiscal policy, including some on which there is considerable consensus. Social equity goals, for example, generally received short

[1] ECLAC (1994).

[2] The drastic fiscal adjustment undertaken by Brazil in November 1997 in response to the serious instability and domestic stock market slump caused by the Asian crisis in October and November of that year is an example of the limits imposed on the autonomy of economic authorities by the discipline of financial markets. The purpose of adjustments like Brazil’s, which was to some extent preventive, is to build up a reputation for solvency, prudence and budgetary discipline, thereby establishing credibility in financial markets, in order to avoid speculative attacks on the local currency and ensure continuity in the pace and terms of net capital inflows.

shrift during the 1980s in the design of the tax structure and the composition of public expenditure, although the present decade has seen significant improvements in the latter respect. Moreover, efforts to improve the transparency of public accounts, to develop a new style of results-based government management and to promote a fuller debate of the budget within a democratic framework have been insufficient, to say the least.

These considerations form the basis for the underlying thesis of this document, namely, that the strength or weakness of public finances reflects the strength or weakness of the “fiscal covenant” that legitimizes the role of the State and the scope of government responsibilities in the economic and social spheres. The absence of a generally accepted model of what the State’s goals should be undercuts any possibility of consensus on the amount of resources it should manage, the sources of its revenues and the rules for allocating and utilizing them. An explicit or implicit political agreement between the various sectors of society as to what the State should do, on the other hand, helps to legitimize the amount, composition and orientation of public expenditure and the tax burden necessary to finance it.

The success of the profound transformation of the economy that is now taking place, as outlined in general terms in the foregoing paragraphs, will falter if the State is not in a position to make its essential contribution. Privatization of public utilities, for example, must be accompanied by effective regulation; accumulated human capital and quality infrastructure are essential to economic growth; and equity in the distribution of the fruits of development is necessary to the political and social stability required for stable growth. But the State cannot systematically and efficiently carry out its functions if the fiscal covenant is not operative. There is a tremendous need, then, to reconstruct and renew the fiscal covenant. This is undoubtedly an enormous task politically and technically; but, as this analysis attempts to show, the elements required to undertake it are at hand, and it is therefore not only necessary but possible.

Indeed, an understanding and debate of many of the components of a new fiscal covenant are already in evidence, and the main effort required is to push ahead with the task and articulate it clearly, on the technical front, and to build a social consensus, on the political front. The section that follows offers some thoughts on the most important components, while the remainder of the chapter delineates the inroads that has been made in each of these areas and the policies that might be conducive to further progress.

B. MAIN ELEMENTS OF A NEW FISCAL COVENANT

Despite the significant steps many countries have taken in reforming their fiscal institutions, policies and administrative procedures, in general it is fair to say that they have not gone far enough to enable the Governments of the region to deal confidently with the challenges they face both internally and globally as the century comes to a close. Consolidating the notable fiscal progress made in recent years will require a lasting consensus on a fiscal system capable of harmonizing macroeconomic stability with other public responsibilities in terms of growth and distribution. That, in turn, requires a consensus on the scope, composition and orientation of public expenditure and taxation over the medium term. In the absence of solid agreement on these points, equilibrium can be undermined by the reappearance of destabilizing fiscal, and ultimately macroeconomic, pressures, which may sometimes manifest themselves through non-transparent mechanisms. Hence, **fiscal consolidation** is the first element in any new fiscal covenant. It should also be mentioned at this point, both because of its intrinsic importance and because the State is the main social agent in a position to do something about it, that fiscal consolidation should allow for the possibility of action in the face of fluctuations in economic activity caused by domestic or external factors. Private economic agents will benefit if the macroeconomic environment does not undergo sudden shifts or shocks, and fiscal policy has some useful instruments to offer in that regard.

This effort must be undertaken in an environment in which civil society demands that when the public sector acts, it should in principle be as efficient as market forces in the allocation of resources. It follows that **raising the productivity of public expenditure** is an essential ingredient of the type of fiscal covenant that would be satisfactory to society. Some of the approaches that are being developed to respond to society's demands are: reassigning the functions of various public institutions; introducing clear criteria to improve the efficacy, efficiency and quality of the civil service; and involving new agents, subject to appropriate regulation, in providing infrastructure and social services traditionally considered the purview of the State.

The success of any attempt at macroeconomic adjustment —and this point is closely related to the others just discussed— depends on the capacity to account in detail for the revenue and expenditure involved. Another reason for close monitoring is to ensure that expenditure is productive. Accountability is therefore essential to the democratic agreements that underlie sound fiscal practice. In this regard, as will be examined in some detail in subsequent sections of the document, the recent history of the public sector in the region, providing as it does many examples of a lack of transparency in public finances and in government action in general, inspires serious concern. Not infrequently, quasi-fiscal operations that were inadequately reported or accounted for have caused hidden fiscal imbalances to explode in the authorities' faces. Society has been left with the impression that some social groups have unjustly benefited and others have been wronged by operations conducted behind the scenes which have, moreover, exacerbated the inefficiency of public agencies. It would therefore be difficult for a new, operative fiscal covenant to take shape unless it reflected the explicit intention, and was equipped with definite mechanisms, to endow fiscal action with the utmost **transparency**.

Although the countries of the region have almost universally opted for a market-based system of production, in which individuals can fully realize their potential and exercise their initiative, the notion still strongly persists in all of them that the type of progress that is truly worthwhile is progress as a society, that is, the simultaneous advancement of individuals united by common civic values and a relationship of solidarity, who understand that collective progress is not antagonistic to individual progress, but rather complements and reinforces it. One of the most important manifestations of solidarity is the idea that at any given point in the life of a nation there is a certain minimum level of equity that society is responsible for ensuring. Society usually entrusts the State in particular with a crucial role in the **promotion of social equity**, and a fiscal covenant would be incomplete and unsatisfactory if that role were not provided for or were ignored or inadequately performed. Important aspects of that role are the promotion of equal opportunity, as expressed, for example, in education, health care and employment, and the task of protecting vulnerable members of society; nor should equity in the Government's collection of the resources it needs to perform these and other tasks be left out of the reckoning.

Lastly, it should be recalled that the countries of the region are becoming increasingly committed to the values of democracy, and strengthening those values is a concern shared by virtually all social sectors. The fiscal covenant not only needs democratic institutions in order to work; it is also an essential contributor to the strength of those institutions. The norms of democratic coexistence can only be benefited by a process of debate from which commitments emerge that represent a broad consensus as to the scope and composition of public expenditure and its funding and provide for proper controls on public management. This exercise in democracy must involve the real —and not just the formal— participation of the legislature and the branches of the national Executive, the authorities of subnational levels of government, and civil society as a whole, through the channels appropriate for each.

A new fiscal covenant that consolidates the reforms now in progress, thus promoting a stable macroeconomic environment; that commits government to using resources efficiently; that provides for transparent mechanisms of public action; that makes social equity a priority objective; that strengthens democratic institutions —such a covenant is a prerequisite if the region is to make further progress towards its goal of changing production patterns with social equity. The remaining sections of this chapter, as well as the rest of the report, seek to contribute to the debate on the nature of this new covenant.

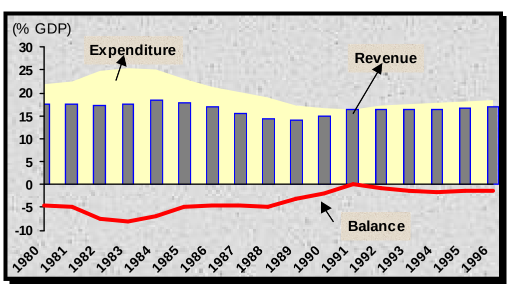
C. FISCAL CONSOLIDATION

It is well known that large fiscal deficits on the accounts of the central government and non-financial public sector in the first half of the 1980s created inflationary pressures and external imbalances in many countries of the region. For that reason, fiscal consolidation has constituted the centerpiece of the stabilization and later the adjustment plans adopted by Latin American and Caribbean countries over the past two decades.

Progress in this area has been considerable. For the region as a whole, public finances are on a far sounder footing than they used to be, and this is reflected in substantially smaller deficits and much more careful deficit and debt management. In the 1980s, adjustment essentially took the form of reduced spending. In the 1990s, it has tended to involve revenue enhancement in the Latin American countries, allowing for a return to higher levels of spending; this recovery is not yet evident in the Caribbean countries, however, which have generally maintained a tendency to reduce spending (see figure I-1).

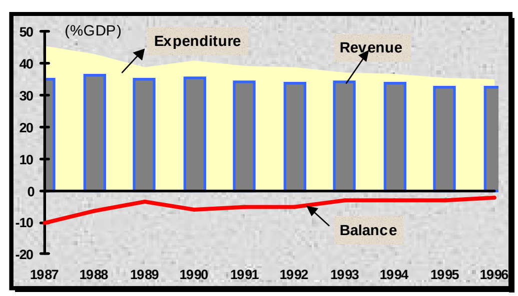
Figure I-1
OVERALL BALANCE OF THE CENTRAL GOVERNMENT
(*Percentage of GDP*)

1.a Latin America



Source: ECLAC, on the basis of official figures.

1.b Caribbean



Source: ECLAC, on the basis of official figures

The need to place such a high priority on the fiscal component of macroeconomic stabilization meant that other objectives of public finance were put on the back burner. The most seriously neglected aspect of all was undoubtedly the distributive function of government.[3] In effect, the objective of equity —chiefly vertical equity— was largely left out of consideration in the design and implementation of public policy in general and fiscal policy in particular. In recent years, many Governments have adopted measures, particularly in the area of social expenditure, that reflect a growing awareness of the seriousness of the social problems that have built up over many years, especially since the 1980s. As will be discussed later, that awareness has resulted in a marked resumption of social spending in Latin America, a trend not shared by the Caribbean countries.

The favourable trend in public accounts obscures, however, a number of phenomena that suggest that the achievement is still fragile. By recording proceeds from privatization above the line even though they are, strictly speaking, non-recurrent revenues, some countries have tended to overestimate the solidity of their adjustment. Another problem is that public finances have become more dependent on the economic cycle, a tendency that makes for instability in expenditure and threatens the durability of the fiscal adjustment. An expansion in spending based on a transitory swelling of tax revenues and easy access to external financing during an upswing of the economy is followed by sharp spending cuts when the revenues and financing evaporate. Inadequate regulation of quasi-fiscal operations has resulted in sharp imbalances in a number of countries, the outstanding examples in this decade being those associated with banking crises. Decentralization has brought new challenges and in some countries has become a major source of fiscal imbalance. Lastly, despite deficit reduction, the public debt burden remains high.

In the following pages, two aspects of fiscal consolidation are analysed: first, the trend in public revenues and, second, government deficits and debt. Trends in expenditure are analysed in section D.

1. Public revenue: incomplete progress

Since the mid-1980s, all Governments in the region have to some degree made substantial reforms in their tax and tariff regimes, supplemented by other reforms aimed at modernizing tax administration. Despite major differences between one situation and the next, in general it can be said that their extraordinary efforts to implement tax reforms have contributed to an — as yet modest— increase, in the tax ratio in Latin America (though not in the Caribbean) and to substantial improvements in tax structure and administration. There is, to be sure, great variety in the level and composition of public revenues from one country to the next, owing to differences in income levels, production structures, trade integration and tax policies and administration (see chapter III).

The average size of the public sector in the region, as measured by revenues, is moderate and clearly smaller than in the OECD and Asian countries. Average total central government revenue in Latin America increased slightly from a little less than 15% of GDP in

[3] Evidence of increasing inequality in income distribution in most countries of the region, particularly in urban areas, is presented in ECLAC (1997a), chapter I.

1990 to 17% in 1996 (see figure I-1); most of the countries fell into the 15%-20% range, and only Haiti and Guatemala collected less than 10%. Including the non-financial public sector, total receipts rose from 25.5% of GDP in 1990 to nearly 28% in 1996, and the countries' convergence towards levels above 20% of GDP increased. In the Caribbean, average total central government revenue fell slightly in the 1990s but, even so, held at over 30% of GDP. In this context, the national government tax take (excluding social security contributions) increased from 11.8% in 1990 to 13.6% in 1996 in Latin America, while dropping from 29.5% to 27.2% in the Caribbean. Although the average tax ratio for Latin America as a whole exceeded the figure for 1980, half the countries in the region had a tax burden lower than in 1980.

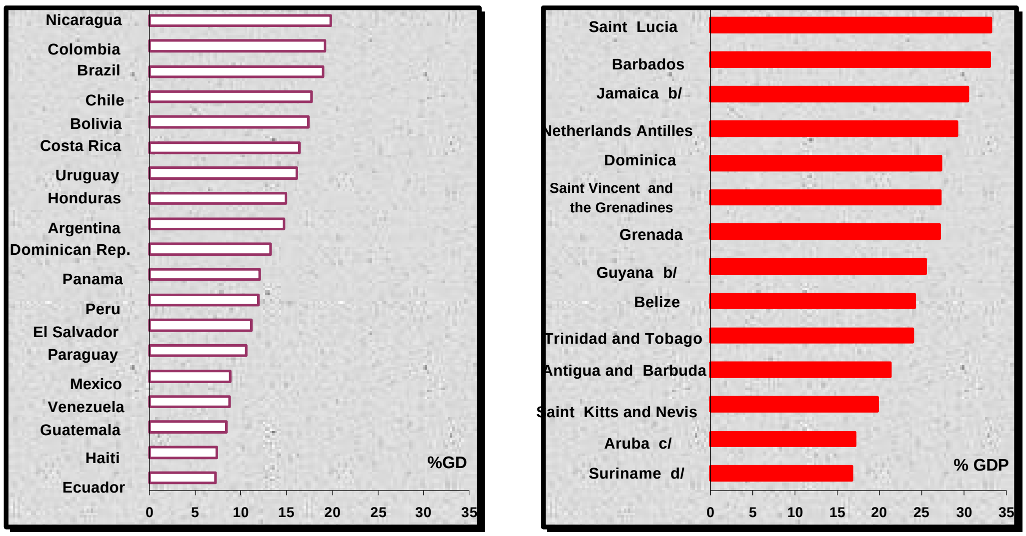
The level of social security contributions makes a big difference in comparisons of the tax burden across regions. The tax burden in the OECD countries was 38% of GDP in 1995, of which social security contributions accounted for nine points, so that the effective tax burden, net of social security contributions, was somewhat over 29% of GDP. Social security contributions average 2% of GDP in Latin America, and, as just indicated, the tax take net of these contributions averages 13.6% of GDP. In any case, social security is only one of many factors contributing to the heterogeneity in tax levels characteristic of the region, which reflect, among other elements, the effectiveness of tax systems, decisions as to the size of government and the option open to some countries of financing public expenditure with oil revenues (see figure I-2). These comparisons also reveal the great potential that exists in many countries, particularly in Latin America, for increasing taxation without affecting their competitiveness.

With respect to the structure of trade, liberalization and integration have drastically reduced the mean level and variance of tariff revenues and hence the importance of foreign trade taxes to government financing, especially in the large and medium-sized countries of Latin America. These phenomenon is a source of fiscal concern to the small Caribbean economies, however, which derive roughly one third of total revenues from foreign trade. To a lesser extent, this trend is also observable in Central America; consequently, in both these areas the prospects for subregional economic integration depend heavily on the consolidating of new sources of fiscal revenue.

Tax systems have changed considerably since the early 1980s in many other respects as well. The number of tax bases has been reduced, and there has been a shift in the territorial and functional basis of taxation away from tariffs and towards domestic taxes, and away from direct taxes and towards indirect taxes. The tendency to rely increasingly on value added tax (VAT) not only favours allocative neutrality, but allows for an increase in the sectoral coverage of indirect taxation, thereby reducing exemptions and making it easier to control evasion. With respect to income tax, the threshold limit of income subject to tax has been raised, the number of brackets have been reduced and the maximum marginal tax rates have been lowered for both individuals (from 47% to 28% on average) and companies (43.3% to 35.5%). In addition, there has been more widespread use of presumptive criteria for taxation in some industries in order to reduce evasion.

Figure I-2
CENTRAL GOVERNMENT TAX RECEIPTS[a] : 1996
(Percentage of GDP)

2.a Latin America **2.b Caribbean**



Source: ECLAC, on the basis of official figures.
[a] Net of social security contributions.
[b] Figures from 1995.
[c] Figures from 1992.
[d] Figures from 1993.

The tendency to abandon direct taxes as means of revenue has, however, been carried somewhat too far in Latin America. In OECD countries, for example, 65% of tax receipts come from direct taxes (fourth fifths of that from personal income tax), while in Latin America direct taxes account for only 25% of tax receipts (most of that from corporate income taxes). Most countries in the region collect only between 20% and 30% of their tax revenues from direct taxes. Only Colombia, Mexico and Panama have a more balanced structure, with direct taxes accounting for between 40% and 50% of all tax revenues. The tax structure in the Caribbean is closer to the OECD pattern than to Latin America's: on average direct taxes account for 40% of tax revenues in this subregion, and a number of countries (Aruba, Barbados, Guyana, Jamaica, Netherlands Antilles, Suriname and Trinidad and Tobago) have exceeded that percentage in the last 15 years.

Proceeds from privatization since the end of the 1980s have brought the region some US$ 76 billion at 1990 prices. The extent of privatization has varied from one country to the next, but the pattern has been the same: a flood of privatization at the start and subsequent slowing as the number of enterprises available for sale drops off. The sales proceeds constitute only the short-term fiscal impact, however. The long-term effects, which are discussed in chapter IX, have not been adequately quantified.

Tax evasion, tax avoidance and tax expenditure continue to be the weak points in revenue collection. They cannot easily be explained as the result of excessive taxation, since there appears to be a positive correlation in the region between higher tax rates and tax collection efficiency. In the case of VAT, in particular, countries with comparatively high rates, such as Brazil, Chile and Uruguay, also have relatively high rates of tax efficiency, while the opposite is true in countries with low rates, such as Bolivia, Ecuador and Paraguay. This suggests two things: first, that the quality of tax administration is a critical determinant of collection levels, and, second, that good administration can more than compensate for any disincentive to comply that might result from higher rates. Hence the prime importance of strengthening tax administration in programmes to control tax evasion and avoidance.

Reforms of the tax administration apparatus have been directed towards raising its place in the bureaucratic hierarchy and increasing the technical autonomy of the tax and customs services. There has also been a tendency to concentrate the regulatory functions in the national tax bureau, while decentralizing the operational functions of collections and auditing to subnational units or governments. Although there is also a tendency to merge tax and customs offices, and even one instance (Argentina) in which the revenue service is also responsible for social security contributions, this trend is somewhat less marked. Lastly, there have been widespread efforts to streamline administrative rules and procedures and to incorporate modern information technologies into the processing and auditing of tax returns and tax collection and refund procedures in an effort to reduce collection costs and improve the productivity of revenue services.

To sum up, while important steps have been taken in the area of tax reform, in most countries they fall short of meeting the classic objectives of revenue adequacy, the streamlining of rules and procedures, neutrality in resource allocation and equitable distribution of the tax burden. Overall, tax performance indicators reveal a marginal improvement in terms of revenue adequacy, but high rates of evasion, avoidance and tax expenditure persist, and the issue of vertical equity has faded from the tax debate. There is thus a need to persevere in reforms aimed at boosting public revenues. Some possible courses of action are briefly sketched below:

(a) Place priority on four key approaches to boosting revenue: combat evasion, increase direct taxation, introduce green taxes and tax some financial transactions

International comparisons show that the mean tax ratio in Latin America is low — this is not the case in the Caribbean— and that many countries have ample margin for raising public revenues. For both economic and political reasons, in this regard priority should be given to a strategy to combat various forms of tax evasion by improving tax administration capabilities. This will send out a clear signal to economic agents and to society as a whole that, just as obeying the law is a requirement of life in a democracy, so full compliance with the tax code is essential if the fiscal covenant underlying economic and political governance is to work. In addition, the above analysis suggests that there is ample margin for increasing direct taxation (especially personal income tax) in most Latin American countries. Just as combating evasion would increase horizontal equity, the latter reform would improve vertical equity. Another possibility is to expand the use of “green taxes”, that is, taxes that promote environmental protection, an innovation that has only recently begun to be introduced in the region. In addition to these sources of revenue, another option is to tax certain financial transactions, especially those of a speculative nature; such taxes should, however, be applied within a framework of international procedures and institutional arrangements that call for similar tax burdens to be imposed on such operations in all countries, so that they will not cause a diversion of capital flows. For any of these measures to be politically viable, revenue enhancement must be closely tied to greater productivity in expenditure and to institutional practices that minimize opportunities for corruption.

(b) Persist in efforts to streamline the tax system and its administration in order to minimize evasion and avoidance

By reducing the number of tax bases, some of which have a low yield, Governments can reduce the compliance costs to taxpayers and hence the incentive to avoid or evade complying with their obligations. A tax regime characterized by broad bases and uniform rates is less vulnerable to evasion —chiefly because it is easier for the tax office to monitor— than a system that features multiple exemptions, deductions or differential rates. Moreover, simplifying the tax system cuts down on the amount of information required and the need for complicated tax procedures, which tend to encourage avoidance or evasion. Streamlining should also be accompanied by a consolidation of jurisdictions with regard to any given tax base, since when responsibilities are divided between different levels of government (as happens in Brazil), control becomes more difficult.

(c) Reduce the welter of tax incentives and thus the amount of tax revenue foregone (“tax expenditure”)

Tax incentives introduce opacity into the design and implementation of fiscal policy, since Governments generally lack good, current estimates of the volume of tax revenue they are foregoing and are unaware of who primarily benefits. The lack of transparency that characterizes “these tax expenditures” is closely linked to the considerable discretion Governments have in allocating tax concessions, a circumstance that tends to turn them into vehicles for rent-seeking and corruption. Hence, the use of tax incentives not only undercuts revenue adequacy, but may often jeopardize the principle of equity as well. The potentially regressive nature of such mechanisms can, in fact, neutralize the redistributive efforts the Government is making through other policy instruments, whether these are tax measures or fiscal actions in general.

The classic argument for such exemptions is that they bias the allocation of resources towards selected sectors or regions with the economic authorities wish to promote. Since, however, Governments generally do not know what amount of resource is being channelled towards the beneficiaries and do not evaluate the results of the exemption programme, it is generally unclear whether or not their objectives are being accomplished. If the aim is justified, it would usually be more efficient to pursue the same objective by explicitly allocating resources in the budget, an approach that also makes it easier to evaluate the efficiency of the expenditure. In the absence of such a decision, at the least an estimated tax-expenditure budget should be drawn up along with the regular budget for the consideration of the legislature; this has the added virtue of ensuring greater transparency in fiscal management (see section E below on transparency in public expenditure).

(d) Do not make the generation of public revenues the chief goal of privatization

Because they are non-recurrent, the public revenues generated by privatizations should not be the main objective of the process. It is essential, in particular, to avoid using privatization proceeds to finance current expenditure. The region's experience shows that the most efficient use of the proceeds is to buy back public debt at a discount on secondary markets, whenever possible.

2. Deficit, debt and new macroeconomic challenges for fiscal policy

For the first seven years of the current decade, the average central government deficit for 19 countries of the region never exceeded 2% of GDP. This is proof of a remarkable exercise in fiscal restraint, especially in comparison with the period prior to the debt crisis, when the average deficit was close to 8% of GDP (see figure I-1 and chapter V). This is a spectacular achievement at the international level and one that surpasses the record of much of the industrialized world over the same period.

All the traditional indicators —borrowing requirements, primary deficit and current saving— have shown further improvement in the 1990s, especially in those countries which were in a weaker position at the beginning of the decade. With the exception of Chile, however, they have not managed to sustain overall surpluses; and in some cases their fiscal position remains precarious (Brazil, Colombia, Costa Rica, Haiti and Honduras), despite attempts by the authorities of most of these countries to address the problem in recent years. Moreover, in the last few years, public accounts have tended to deteriorate somewhat. In 1996, for example, 15 out of the 19 countries for which information was available recorded a deficit.

This points to a disturbing procyclical trend in public finances within the region, which has tended to intensify rather than moderate the business cycle. In a number of countries, the combined effect of a drastic reduction in the rate of inflation, the resumption of growth and of external financing, and proceeds from privatization have generated a temporarily more favourable fiscal situation than the longer-range scenario for public finances. At times, this process has been fueled by adjustment programmes, monitored by multilateral finance agencies, which overemphasize deficit indicators without allowing for the impact of the economic cycle. This practice leads to a relaxation of fiscal discipline in the upswing of the cycle and requires drastic adjustments when international conditions take a turn for the worse, such as occurred with the Mexican crisis at the end of 1994 and the current Asian crisis. Estimates presented in chapter IV of this report suggest that the behaviour of government expenditure in the region is much more procyclical than in the OECD countries and South-East Asia.

No less important are the problems associated with the costs of poorly managed financial cycles at a time when globalization has tended to contribute to increasingly volatile capital flows. In many cases, these crises have been associated with the liberalization of financial variables (interest rates, bank credit or the balance-of-payments capital account) unaccompanied by a simultaneous effort to strengthen prudential regulation and supervision of banks and other intermediaries in order to deal with the levels of risk that can affect the lending and investment processes in freer financial markets. A deficient prudential standard during economic booms or deregulation processes allows financial entities to assume an excessive level of risk; this leads to subsequent bankruptcies and costly rescue programmes, which include loans to illiquid banks, portfolio buyouts, loan reschedulings at preferential interest rates or, in the case of foreign loans, at preferential exchange rates, among other measures. In a few cases, the Treasury has assumed the losses outright, but in others the central bank has resorted to quasi-fiscal operations. Delayed intervention in such cases has tended to increase the losses. The most costly were the bank crises in Argentina and Chile in the early 1980s, where losses amounted to between 40% and 60% of GDP. The main financial crises of the current decade (Mexico, Paraguay and Venezuela) have generated fiscal or quasi-fiscal obligations equivalent to between 8% and 18% of GDP (see chapter V).

Decentralization has also given rise to considerable macroeconomic difficulties for four basic reasons: (a) a greater emphasis in the decentralization process on revenues than on expenditures in some countries (Brazil and Colombia); (b) the generalized use of revenue-sharing systems which reduce the degree of freedom of tax policy, since increases in revenue collections automatically generate higher expenditures through increases in transfers; (c) the absence of controls on borrowing by subnational levels of governments; and (d) the lack of incentives for regions to generate their own funds. Excessive dependence on national transfers is one of the unfortunate features of decentralization in Latin America: these transfers usually finance over half of local expenditures compared with one third in the OECD countries. Given this state of affairs, efforts to improve public management through the decentralized administration of services must be accompanied by a solution for these macroeconomic problems, which could otherwise ultimately defeat the whole process (see chapter VIII).

Trends in public debt also reveal significant progress, thanks mainly to the debt-reduction programmes adopted since the late 1980s. The public debt-to-GDP ratio fell from 50% in 1988 to 30% in 1992 and then leveled off, although with major differences among countries and significant increases in some cases. The external debt problem is far from being resolved, however, as can be seen from the level of the region’s debt service, the high ratio of public debt to total external debt and the fact that in many countries, both this ratio and the external debt-to-GDP ratio are higher than in the pre-crisis years. In a few countries, domestic debt has started to play an important role (Brazil, Colombia, Costa Rica and, to a lesser extent, Argentina); this gives domestic financial markets a boost, but also at times exerts pressures on those markets.

In recent years, there has been a growing awareness in the region of an element of public debt that is generally overlooked, namely pension liabilities. This has led to the introduction of social security reforms that limit and redefine government participation in that sphere. The impact of such reforms on public finances is considerable in terms of both the size of the debt involved and the fiscal requirements imposed by the transition to a different kind of pension system (see chapter VII).

A total, immediate changeover to mandatory individual savings accounts entails recognizing two components of pension liability: (a) the present value of the pensions of people who are already retired when the reform takes effect (pension obligations to retirees) and (b) the present value of the contributions (or the entitlements to which they give rise) which have been made (or accrued) up to the time the reform takes effect by those who are still working (pension obligations to active contributors). The sum of these two values, less the amount of reserves in the old system, gives an approximate estimate of the total implicit pension liabilities.

Pension liabilities are high in the countries with relatively older labour forces and populations, high contribution and replacement rates and a high participant-to-wage earner ratio. For one group of countries, whose pension liabilities are estimated to be over 200% of GDP (Argentina, Brazil and Uruguay), the total and immediate substitution of one system for another would demand fiscal resources equivalent to over 6% of GDP over a 40-year period (assuming straight-line amortization and a 5% discount rate). For another group of countries (Chile, Costa Rica, Cuba and Panama), with pension liabilities equivalent to between 90% and 200% of GDP, fiscal resources equivalent to 2.8% and 4.6% respectively of GDP would have to be allocated for this purpose. Other countries (Bolivia, Colombia, Dominican Republic, Guatemala, Mexico, Nicaragua, Paraguay, Peru and Venezuela) are in a better position to finance their total pension liabilities, which range between 20% and 50% of GDP, and would have to allocate fiscal resources equivalent to between 0.7% and 1.4% of GDP annually.

The feasibility, from the standpoint of public finances, of carrying out a total, immediate pension reform must be weighed by the competent authorities in each country. A case frequently cited in the region is the Chilean experience, where financial responsibility for the total cost of reform was assumed by the State. This cost includes: payment of the operating deficit (to amortize obligations to retirees and pensioners); payment of recognition bonds (to amortize liabilities accrued through past contributions made by workers who were active contributors at the time of the reform as they arrive at retirement age or begin to draw their pensions); payment of subsidies for minimum pensions to those who, having contributed for the required period, still have not accumulated enough to finance the minimum pension; and payment of welfare pensions for the indigent. These commitments have, up to now, made far greater demands on the public purse than originally projected, and part of their financing at the time (1981-1987) required a major adjustment in the structure of public social expenditure, including cutbacks in the amounts available for education, health and housing programmes. Apart from these fiscal considerations, account should be taken of the distributional effects, especially with respect to the prorating of the fiscal cost among the different generations of contributors and pensioners.

In order to address the problems mentioned, four major courses of action are proposed:

(a) Moderate the cyclical nature of public finances

The excessively procyclical management of public finances must be corrected by restoring a stabilizing approach which focuses on medium-term trends in the economy and fiscal variables themselves. Certainly, the validity of a countercylical approach to public finances depends on consistency, i.e., on its operation during both phases of the cycle, saving the excess available during boom periods in order to have reserves to fall back on in hard times. For this purpose, it is necessary to have certain rules on expenditure and an institutional plan that ensures fiscal symmetry throughout the cycle.

With respect to budgetary rules, it has been suggested that the growth in current expenditure should be kept at stable levels not exceeding the trend rate of growth of the economy by letting taxes play an active role in attenuating the fluctuations in the economic cycle. At the institutional level, in addition to the well-known stabilization funds for the prices of coffee (Colombia) and copper (Chile), it has been suggested that it would be appropriate to set up a tax stabilization fund in which short-term revenues would be recorded and accumulated during boom periods to avoid excessive cutbacks in expenditure during the subsequent downswing. This form of management should be complemented by other countercyclical measures for handling the public debt, particularly in relation to external borrowing.

In this regard, Governments of the region need to pay more attention to the distinction between the cyclical component and the structural component of the public deficit, as in the OECD economies. For one thing, the high income elasticity of imports is an indicator of the strong cyclical component characteristic of the current pattern of growth. Since the tax structure has become increasingly dependent on indirect taxes, the fluctuation in revenues from customs duties and VAT on imports suggests that traditional methods of calculation may underestimate the importance of the cyclical component.

Careful monitoring of the cyclical and structural public-sector deficits on the basis of standardized and timely information will facilitate fiscal debate on medium-term policy, thus avoiding traumatic adjustments in response to cyclical variations. It would also be a means of ensuring more stable social programmes, since public revenue or public investment could serve as adjustment variables for the economic cycle. This approach would help to improve the impact of social programmes, since, once the sharp fluctuations in social spending were rectified, it would be easier to evaluate the results of these programmes and to make the necessary corrections to enhance their effectiveness.

(b) Prevent banking crises and, if they do occur, dilute shareholders' equity in the institutions involved and assume losses fiscally

Given the high fiscal and quasi-fiscal costs of banking crises, prevention efforts are highly cost-effective for society. Experience both within the region and around the globe suggests that a combination of a less volatile macroeconomic environment and strong prudential regulation is particularly effective in preventing such crises. The first may be encouraged by financial measures designed to raise the cost of short-term capital inflows (reserve requirements on foreign liabilities) or the cost of attracting shorter-term deposits into the financial system (higher reserve requirements on short-term deposits) and by less procyclical fiscal management. Prudential regulation should prevent excessive exposure of lending institutions during an upswing and ensure adequate coverage of the risks assumed by setting even stricter requirements than those proposed by the Basel Committee on Banking Supervision (given the greater financial volatility of the region) and by extending the scope of regulation to branches and subsidiaries abroad and to the group of financial conglomerates that make up the business unit. When crises do arise, it is essential that shareholders' equity in the institutions involved should be diluted in proportion to the accumulated losses and that steps should be taken to avoid, at all costs, bailing out debtors who have engaged in fraudulent or legally dubious practices. Governments should provide funds directly to capitalize institutions in distress if they see fit, or to cover the quasi-fiscal losses of the central bank, and in the latter case they should ensure that such losses do not lead to an expansion of domestic credit.

(c) Manage the macroeconomic effects of decentralization carefully

Regional experience has shown that the first prerequisite for managing the macroeconomic effects of decentralization is to distinguish clearly between the functions of the central and the regional and local levels of government and to make a precise estimate of the costs of financing them. The transfers arranged for this purpose should be de-linked from the collection of national taxes, and preference should go to arrangements that reconcile criteria of equity in terms of the different areas within a country, efficiency and tax effort. To that end, four variables need to be taken into account and their relative importance weighed on the basis of the situation in the country: target population, cost of providing decentralized services, efficiency and effectiveness of service delivery, and level of the regional or local tax effort. Experience also suggests that mechanisms should be set up for strict monitoring and control of borrowing and the use of transfers. It is also important to strengthen revenue collection capacity at the local level and technical capacity for administrative and financial management at the regional and local levels.

A number of recent initiatives in the region have resulted in a more responsible and coordinated management of subnational government borrowing designed to minimize adverse macroeconomic effects and promote a better use of savings, as in Colombia, for example. Other relevant experiences include the implementation of restructuring and fiscal adjustment programmes at the subnational level in some provinces of Argentina and states in Brazil and those recently launched at the departmental level in Colombia. Under these programmes, targets have been set for reducing the fiscal deficit by strengthening and modernizing subnational tax bases, cutting operating costs and establishing payment commitments. There have been successful efforts to strengthen local tax systems (property and valuation taxes). This process must be reinforced by granting subnational governments sufficient autonomy in administering their revenues.

(d) Monitor the fiscal impact of social security reforms

Even in the absence of financial crises which could affect the minimum guaranteed return on pension funds, it is possible that the conversion of pension liabilities into explicit obligations and the necessary transfers for paying minimum and welfare pensions will require inputs of additional fiscal resources. The Chilean experience confirms this view. Hence, the main lesson to be drawn from that experience is that the transition from one pension fund system to another makes an enormous demand on the public purse.

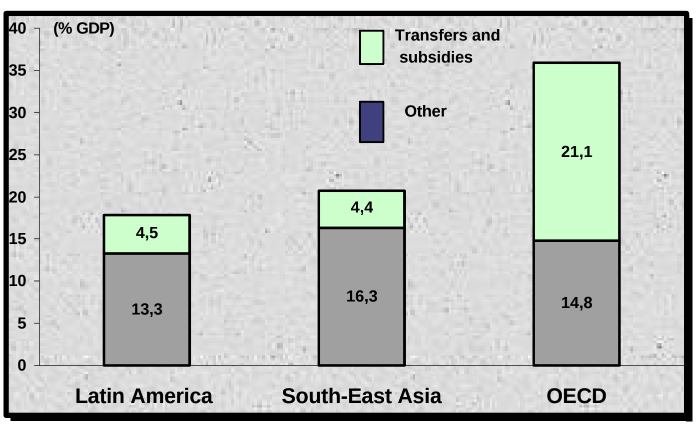
Alternative reform models have been devised which combine four strategies to take advantage of the virtues of capitalization, or funded, systems, while minimizing explicit pension liabilities. The first strategy seeks to reduce the system's future financial commitments by modifying eligibility requirements and benefit formulas. The second strategy entails only a partial changeover to a funded system by allowing a pay-as-you-go system and a funded system to operate concurrently, dividing participants between the two systems on the basis of fiscal or other considerations (Argentina, Colombia, Uruguay). The third strategy consists in designing an incentive mechanism, at the lowest possible cost, to attract individuals or cohorts to the new system. The fourth strategy entails continuing with the pay-as-you-go system, but administering it as a notional defined-contribution system, that is, one where each contributor has a hypothetical individual account, which is capitalized at a rate of return roughly equal to the growth rate of the average wage on which contributions are collected (Italy, Latvia and Sweden are using this strategy, and Costa Rica and Poland are considering it). The information presented in chapter VII shows that in general the countries of the region have tended to adopt a combination of the first three, as in the cases of Bolivia, Brazil, Colombia, Mexico, Peru and Uruguay. The fourth strategy should be the subject of increased attention in the future.

In most cases, the type of funding is not predetermined but may consist of a combination of current taxes, public borrowing and privatization receipts. If taxation is the only source of financing, it places a heavy burden on most members of the generations currently working; debt-financing, on the other hand (through government bonds), relieves the burden on present generations and shifts the cost of the transition onto future generations.

D. IMPROVED PRODUCTIVITY OF PUBLIC EXPENDITURE

The average size of the State's share in the economy differs considerably between subregions; in the 1990s, it went as high as 36% of GDP in the Caribbean (central government) and 27% in Latin America (non-financial public sector). Trends in public expenditure in the two subregions have also diverged during the current decade. While in the Caribbean countries the size of the central government has continued to decline, approximating OECD levels (35% of GDP), in Latin America it has tended to increase, but still remains well below OECD and South-East Asian levels (see figure I-3). In Latin America, a rising trend in government spending has appeared in countries where starting levels were relatively low, whereas the reverse has occurred in countries where the levels had been higher. Considered in conjunction with trends observed in the Caribbean, these observations reveal some convergence in the scale of public expenditure in the various countries of the region. It is also noteworthy that, in those Latin American countries for which figures are available, rising expenditure has not been accompanied by increased public-sector employment, which has actually decreased as a proportion of non-agricultural employment during the current decade from 15.3% in 1990 to 13.0% in 1996 (see chapter IV).

Figure I-3
COMPOSITION OF TOTAL CENTRAL GOVERNMENT EXPENDITURE
(Regional averages, 1990-1996)



Source: ECLAC, on the basis of official figures and data from the International Monetary Fund (IMF).

International experience shows that public expenditure tends to increase with the level of development, which suggests that it is a "superior good". This pattern is strongly associated with the development of social security. If we consider how expenditure patterns have changed in the OECD countries and in Latin America, a clear trend can be seen towards an increase in the relative importance of transfers and subsidies —largely associated with social insurance— as per capita income increases. However, even after adjustment for that factor, the central government is smaller in Latin America than in the OECD countries and South-East Asia (see figure I-3).

In terms of the composition of public spending, the most noticeable trend is certainly the upturn in social expenditure in Latin America, a trend which unfortunately has not been seen in the Caribbean, where social expenditure still shows a slight downward trend (see below). Similarly, while public investment has been showing signs of recovery in a number of Latin American countries during the 1990s, it has continued to decline in the Caribbean. On the other hand, during the current decade, most countries have seen a drop in relative level of interest payments and spending on functions not directly related to productive and social activities.

Military spending represents, on average, 10% of central government spending in Latin America, or 1.9% of GDP. Both percentages are the lowest of any developing region. Spending on public order and safety, which averages 1.3% of GDP, then needs to be added to the above figures. It should be noted that reductions in military spending have not kept pace with the growth of democracy and the restoration of peace in the region, which therefore does not yet appear to have benefited from a "peace dividend". In fact, Latin America is the region where military spending as a percentage of GDP has fallen least during the 1990s. This is a substantial item of expenditure, then, which for various reasons is not transparent, tends not to be budgeted in accordance with competitive criteria, and is not subject to adequate levels of reporting or evaluation.

Efforts to implement policies to improve the efficiency of public expenditure, while promising, have generally proved insufficient. There is still a tendency to emphasize the size of appropriations, rather than the efficiency, effectiveness and quality of expenditure. Despite some pioneering attempts, efforts to encourage productivity by shifting the administrative culture in the direction of results-based management have hardly begun. There has, however, been some success with a number of institutional restructuring measures aimed at improving spending efficiency through the more efficient management of public enterprises; decentralized management of government spending, especially in the social arena, and the design of mechanisms to enable new actors to participate in areas which have traditionally been the preserve of the State. Progress in all these areas is a major component of the so-called "second-generation reforms" undertaken in the countries of the region.

Growing governmental interest in the microeconomic impact of public finance has been observed during the current decade. It is generally agreed that public spending programmes should meet clearly-defined objectives, at the least cost and with the highest quality possible. Consequently, new public-sector management paradigms, which incorporate results-based administrative criteria are gaining increasing acceptance. These paradigms are based on recognition of the right of citizens —as taxpayers and as users of public services— to be treated as valued customers. This new management culture is associated with the design of innovative schemes whereby government oversight agencies in a particular sector set out the goals and results expected from the service provider concerned, sometimes in the form of a written contract, and the attainment of the established goals is evaluated periodically. The oversight agencies, in turn, are subject to the same process of goal-setting, in contracts concluded with the Head of Government or the fiscal or planning bodies. In some cases, the beneficiaries of public expenditure (such as parents, in the case of education) are involved in the decision-making and monitoring process. Under another method still in the experimental stage, the remuneration of government officials has in a few cases been linked to the fulfilment of the proposed goals and objectives. Such schemes began with pilot projects in a number of OECD countries and have begun to be introduced in the region. Progress in that respect has been made in Chile, Colombia and Costa Rica (see chapter X).

In the case of public-sector enterprises, there has certainly been some progress in the rationalization of rates and charges. These improvements have helped to reduce the usual lags in price increases caused by short-term tactics aimed at slowing inflation or easing a distributional conflict, tactics that have invariably led to abrupt rate hikes that have a negative impact in terms of governance. Although there are notable examples in the region of the economically sound management of public-sector enterprises, there have been a great many cases in which political motives have predominated in the appointment of directors and managers and in the day-to-day running of the enterprises, and in which management has not been transparent, thereby opening the door to various types of corruption. All the countries of the region, including those where privatization has gone furthest over the past two decades, have kept a number of major enterprises under State control; as a result, the administration of those enterprises will continue to weigh heavily in terms of the efficient management of government resources.

Fiscal decentralization has progressed in the region in response to such political imperatives as the consolidation of democracy, by bringing government closer to the people, and the objective of improving the efficiency and effectiveness of public expenditure, particularly on social and other services whose provision does not enjoy economies of scale. The degree of decentralization has depended not only on political decisions, but also on the size of the country. It is a complex process, involving delicate political and economic balances. As we have seen, some of the main difficulties have to do with the adverse macroeconomic consequences of imperfectly designed schemes for dividing functions and resources, inadequate transfer systems, lack of efficient control over subnational public borrowing and the absence of opportunities or incentives for local governments to generate their own revenues. As a later section will show, there is also the risk that decentralization could adversely affect equity among the territorial subdivisions of a country (see chapter VIII).

In the area of improved service delivery, it is still too early to judge, but indications are that potential improvements are constrained by two basic factors: excessive reliance on national resources, and over-centralization of human resources management, leaving insufficient leeway for local authorities to manage and be accountable for services or to take advantage of the full potential of community participation. The information available on changes in the efficiency of expenditure —measured on the basis of indicators of cost, impact and changes in service quality— is somewhat ambivalent, revealing both successes and setbacks. There have been successful experiments in creating channels for citizens' participation in budgeting and in the provision or monitoring of local services, but this approach is still relatively undeveloped in the region as a whole.

Experience in the region suggests that privatizing public-sector enterprises leads to improvements in management and productivity, both during the preparatory stage before the sale and after private agents take over. However, there are no truly comprehensive evaluations of the sectoral effects of privatization that would make it possible to assess the benefits to consumers in terms of the cost and quality of the privatized services. In sectors where there are significant market failures, improvements are closely dependent on regulation (see chapter IX).

In many countries, privatization has been accompanied by the development of schemes to promote private-sector participation in new infrastructure projects. Apart from regulatory issues, such schemes involve important decisions regarding Government guarantees.[4] By granting such guarantees, the Government acts as an insurer regulatory risk force majeure, commercial risk (guarantee of minimum sales or profits) or financial exposure (guarantee of availability of resources), and assumes contingent liabilities which may become effective at any time. The design of such schemes determines the way in which costs are shared between the private agent involved and the Government, and therefore influences the distribution of the net return on the corresponding investment between that agent and the community as a whole.

In the case of social services, there are already established mechanisms for the participation of the private sector in social investment and emergency funds. In this area, there are notable cases of transparent, efficient, swift and flexible management in response to specific social needs. These funds have proved efficient in mobilizing external resources, although there has been insufficient evaluation of the actual impact of programmes financed by these means. It is therefore a matter of concern that most of their actions have been oriented towards temporary relief for a limited number of vulnerable groups, rather than towards overcoming the structural problems facing the poor, particularly the lack of the human capital required for entry to formal labour markets. The coordination of these funds with broader social programmes has also tended to be insufficient (see chapter VI).

In recent years, there has been increasing scope for the participation of private-sector, charitable and community organizations in ongoing social programmes. This sphere of activity entails the redesign of social security systems and a variety of mechanisms for participation in the provision of education, health-care, nutrition and low-cost housing services, among others; considerable opportunities exist for complementarity between public- and private-sector actions that could help to upgrade such services, particularly in cases where competition in the provision of those services is a possibility. The response of private agents tends to be greater when the services are intended for middle- and upper-income brackets, and are provided in cities rather than in provincial towns or rural areas. This indicates that the public sector is not entirely substitutable as a service provider and that in order to reach poorer segments of society, mechanisms are needed which are specifically designed to encourage the supply of services to them, particularly through the promotion of community organizations. In addition, the existence of proper regulatory standards is particularly important in this area in order to avoid equity problems, as we shall see in a later section. Problems of user information and quality control are also particularly acute in such cases and are generally attributable to the absence of institutions to provide the necessary information and appropriate regulatory systems for the provision of the services concerned.

[4] Such guarantees are also provided in cases where existing enterprises are privatized, although much less frequently.

On the basis of these considerations, the following courses of action are recommended:

(a) Promote a public management culture based upon two fundamental concepts: the scarcity of public resources and the achievement of results

The tendency of many, perhaps most, public agents to try to solve problems in their sectors through increases in funding shows that the concept of the scarcity of public resources is underdeveloped. Constant attention must therefore be given to the prioritization of items of expenditure, both across and within sectors, and to the efficiency, effectiveness and quality of public-sector services. The shift in expenditure towards social programmes and infrastructure should be intensified, and spending should be focused on areas where it can make the greatest contribution to equity and growth. Consideration should be given to possible reductions in military spending in order to take greater advantage of the "peace dividend".

The new results-based public management paradigm should be brought into wider use. This requires not only institutional changes that allow for the establishment of formal mechanisms requiring public agencies to set management objectives and goals regularly and assess their results periodically, but also changes in informal institutions (standards, values, customs and usages). This process is essentially an evolutionary one, and therefore requires persistent efforts by Governments so that it will take root in the day-to-day practice of public management. Obviously, this process must be accompanied by policies for the training of public-sector technical personnel, within a broader policy of modernizing the State that includes the establishment of appropriate performance incentives.

(b) Strengthen efficiency criteria in the administration of public-sector enterprises

All Governments have to judge whether, in order to achieve their goals —in the areas of equity, resource allocation and economic growth, among others— it is preferable in particular sectors to use State-owned enterprises to produce goods and services or to leave that function up to the private sector, subject to indirect regulatory mechanisms. If a Government opts for the first approach, its enterprises should be models of managerial efficiency and transparency, in accordance with current international best practice in the modern management of both human and financial resources. Public-sector enterprises are therefore prime candidates for the application of the new results-based public management paradigms and for the introduction of management contracts and periodic public evaluations of their performance either by the regulatory agencies for the sector in question, or by a highly specialized public-sector enterprise unit. Their managers and directors should be selected according to criteria of professional excellence and should be subject to a regime of incentives and sanctions based on the fulfilment of performance agreements.

An essential part of the administration of State-owned enterprises is correct management of their prices and charges. If it is considered desirable to grant subsidies to a particular sector, region or social group, the subsidies should be transparent and included in the public budget, so that they can be explicitly evaluated by the elected representatives of society. Another alternative is to design transparent systems for the management of cross-subsidies, such as the scheme now being developed in Colombia, under which the most affluent social strata are required to pay to legally defined contributions, in addition to a charge that covers the costs of providing the service; the contributions are paid into a solidarity fund that finances the subsidies, which are also explicitly defined, for poorer social groups.

(c) Decentralize services effectively, when deemed advisable

The major challenge of decentralization is how to combine the design of a good funding system that will correct the above-mentioned macroeconomic problems with the actual transfer of administrative responsibility for services to subnational levels of government. Administrative autonomy should be extended to service providers (health centres, schools, and the like) so that they can be accountable for their results. Regional experience indicates that an excessively rigid system, in which subnational levels of government and service providers do not have the necessary autonomy in terms of financial administration or employment-related matters, does not allow for the improvements in efficiency expected from decentralization.

Hence, institutional structures need to be designed which, in addition to furnishing that autonomy, provide for guidance, follow-up and consistency between the decentralization process and other governmental policies and programmes. The national Government should strengthen its role in regulating and guiding the process, while subnational levels of government should improve the financial administration of their resources and their technical capacity to provide basic services more to promote community participation. This institution-building process must be accompanied by training programmes for public employees at various levels and a proper information system to allow for monitoring and evaluation of transfers between levels of government and, in general, the achievement of the goals set out in the decentralization programmes.

(d) Manage the privatization process properly

Experience in the region suggests that privatizations should be undertaken primarily for the purpose of improving efficiency in the sectors in question. Therefore, apart from the need for a clear definition of goals and transparency in the process, there is also a prior need to strengthen the State’s regulatory and competition-promoting roles, particularly when the enterprises undergoing privatization are natural monopolies or when there are significant imperfections in their markets; this course of action prevents the improved internal efficiency of the enterprise from being achieved at the cost of a deterioration in the operation of the market or in consumer well-being. This requires both lowering entry barriers, whenever possible, and avoiding transfer modalities that may lead to vertical or horizontal integration.

In the case of public-sector enterprises operating in imperfect markets, it is sometimes feasible to restructure the enterprises beforehand, identifying the potentially competitive sectors and privatizing them. In those which remain under State control, private investors can be allowed to acquire minority interests as a means of encouraging improvements in the firms' management.

The problem of contingent liabilities generated by government guarantees offered under recent schemes for private-sector participation in infrastructure projects requires that the authorities should take responsibility for monitoring, evaluating and budgeting for the risks assumed by the State. In the first place, schemes for private-sector participation should be designed in such a way as to limit the provision of government guarantees to those risks which cannot be covered in the market and cannot effectively be controlled by the private sector, thus discouraging demand for guarantees in such cases and limiting the risks to the State. Those guarantees which are provided must be assigned a value, with an estimate of their cost should they be called in and the degree of probability that this will occur. These estimates, although only approximate, must be taken into account in the annual budget debate. Furthermore, the budget should preferably include the annual cost of such liabilities, that is, the cost of the "insurance" coverage provided to the investor by the State, and the corresponding reserves should be transferred to the entities providing the guarantees or deposited in a central fund administered by the Ministry of Finance. This would also tend to cut down on the excessive use of guarantees, which are attractive because they involve the replacement of a very costly item of government expenditure (the equivalent investment, if it were made by the public sector) with another item having no apparent cost (the guarantee).

(e) Develop a pragmatic approach to encouraging private-sector, charitable and community participation in the execution of social programmes

Social investment and emergency funds have proved to be an efficient mechanism for complementary action between the public and private sectors. The promotion of such funds should be accompanied by mechanisms to ensure their long-term financing, periodic evaluation of the impact of their programmes and reorientation of their activities towards overcoming structural poverty.

Regular social programmes also offer many opportunities for participation by private enterprise and charitable and community organizations. In many cases, however, there is no substitute for the provision of services by the State. Mixed systems with participation by various types of agents must therefore be developed on a pragmatic basis. They must be subject to common, appropriate regulation and to user information requirements and quality control of the services provided. This approach takes advantage of the opportunities offered by the competitive provision of social services, while at the same time creating instruments for State action which have not been developed to any great extent in the past. In particular, the design of such systems must avoid the concentration of service delivery to the most affluent groups, with the consequent equity problems. It may be necessary to develop appropriate systems to ensure that services do indeed reach the poorest segments of the population; this could be done in various ways, including the promotion of community organizations for that purpose.

E. TRANSPARENCY OF PUBLIC EXPENDITURE

National budgets fail to fully recognize certain government activities which have effects analogous to the collection of taxes or the granting of subsidies yet are not subject to debate or approval by the legislature. Such activities, known as “quasi-fiscal” operations, lead to considerable opacity in public-sector finances and hinder efforts to determine the real magnitude of public expenditure, its sectoral distribution and, hence, the distributional effects stemming from government action. They also conceal the true magnitude of the tax burden and any distortions it may cause. Consequently, quasi-fiscal operations violate the principles of budgetary unity and universality and thus make it harder for the fiscal authorities to exert macroeconomic control. They also contravene the principles of good governance (transparency, responsibility and predictability) and may create an environment more conducive to corruption (see chapter II).

The lack of transparency with which the Governments of the region conduct their fiscal activities is largely due to political considerations. Given the absence of a widely accepted fiscal covenant with respect to the role and size of the State and its modes of intervention, Governments have an incentive to replace politically “costly” instruments —taxes and the on-budget expenditures that taxes finance— with other “cheaper” tools that operate through administrative channels and thus are not subject to the same degree of scrutiny or opposition in the legislature. In this way, explicit subsidies are replaced by tax concessions, lines of credit on easy terms or foreign-exchange subsidies; social expenditure targeted at particular groups is replaced by mandatory regulations that oblige the private sector to take on that role; and explicit budgetary assistance is replaced by government guarantees that will be called upon in the future if certain contingencies arise. Hence, the "price" of more transparent practices is related to the degree of difficulty the Executive may face in establishing a political consensus with respect to the size of the tax burden or the suitability of undertaking certain expenditures; the scope of the quasi-fiscal realm, then, depends on the strength or weakness of the fiscal covenant.

Some prime examples of quasi-fiscal practices include rescue operations or bail-outs in the face of exchange-rate crises and the granting of guarantees to private investors. Tax expenditure and mandatory regulations are also common practices. Tax expenditure refers to tax concessions of one sort or another —exemptions, preferential rates, deductions or payment extensions— granted in consideration of expenditures undertaken by the private sector. Because they are financed through a reduction of tax liability, they constitute indirect subsidies or indirect public expenditures. Mandatory regulations refer to the replacement of public expenditure with the legal obligation for private agents to provide or directly finance the supply of a particular good or service, generally some form of social benefit for workers or environmental protection measures. In contrast with tax expenditure, in this case an additional tax is levied on the private agent, and the expenditure stipulated by law is charged against it.

Mention should also be made of an additional factor that tends to generate considerable opacity in fiscal accounts: the lack or poor quality of information (see chapter V). Many countries have made substantial progress, particularly in response to macroeconomic crises, but much still remains to be done on this front. The problem affects not only quasi-fiscal items, but also the fiscal accounts *per se*. Among the many shortcomings observed in this area, the chief problems are inadequacies in the coverage, consistency and intertemporal comparability of the available statistics; a tendency to measure expenditure on a cash basis rather than an accrual basis; inadequate public debt accounting; and an almost total absence of estimates of national wealth (assets, liabilities and net worth).

In order to enhance the transparency of public finances, two courses of action are recommended:

(a) Cut down on quasi-fiscal practices by incorporating most operations of this nature into the government budget or preparing supplementary budgets for tax expenditure, mandatory regulations and guarantees

Reducing the scope of quasi-fiscal practices by including them in the government budget is one means of improving the transparency of public finances. This approach allows for greater macroeconomic control, proper analysis of the sectoral and distributional effects of fiscal policy, suitable democratic controls and an overall view of the costs of the many activities carried out by the State and the resources required to finance them. Once the fiscal assistance that a given social, productive or regional sector receives is made explicit, it becomes clearer whether it should be eliminated or provided by means of another policy instrument. In this way, conferring greater transparency on these operations and refraining from those for which there is little justification clears the ground for a debate on the financing of those operations deemed legitimate, a debate that considers the technical efficacy of the instruments chosen to pursue a specific public policy objective.

An alternative to the full integration of such operations in the budget is to prepare supplementary budgets that can be submitted to the legislature as annexes. Such supplementary budgets would cover three areas:

Tax expenditure: This would entail applying the practice adopted in Germany and the United States in the late 1960s, and subsequently emulated by many OECD countries, whereby the legislature is informed of the amounts, rationale and purposes of “tax expenditures” generated through exemptions, preferential rates, deductions and deferment of tax obligations. This procedure would also make it possible to rationalize these concessions. They should, in any case, be authorized only under strict conditions and for limited periods; they should not be automatically renewable, but subject to an evaluation of results.

Mandatory regulations: Bearing in mind that it is possible to achieve public policy objectives not only through direct budgetary provision of public goods and services, but also through private action mandated by regulation, it is appropriate to estimate the cost of the latter to the private sector and record it as public expenditure financed out of earmarked contributions. This procedure also facilitates an explicit analysis of the benefits that a variety of social, productive or regional sectors receive directly or indirectly from public action and the consideration of how to rationalize them.

Guarantees: As mentioned above, estimates of the guarantees granted by public entities in relation to infrastructure projects should be made regularly, and, where possible, the actual amount of the equivalent "insurance" should be explicitly budgeted for. In addition to the specific case of infrastructure projects aside, all public guarantees should be estimated on a regular basis. In this regard, there is a particular need to estimate the value of contingent liabilities associated with pension systems on a regular basis. While the practice of calculating the actuarial values of pensions provided by the State has been given a boost by the social security reforms currently under way, this practice has not been extended to estimates of contingent liabilities assumed by the State in connection with such reforms, especially in the case of minimum pension guarantees.

It is worth emphasizing that the principle that the legislature should debate the full range of fiscal policies implies that the Executive should submit with a breakdown of all public finances, including the financial implication of actions taken by autonomous entities, whether State-owned enterprises, or regional or local governments. Accordingly, this practice should be adopted by those countries which have not yet done so.

(b) Redouble efforts to improve fiscal information

This task has immense public significance, since it underlies not only macroeconomic control, but also the efficacy and efficiency of government action. It is a tribute to the strengthening of democratic values that there is a demand for the State to present an accurate, transparent and timely accounting of its activities to the community. As explained above, this accounting should encompass both fiscal and quasi-fiscal activities and include not only income statements, but also the public-sector balance sheet (assets, liabilities, net worth). Of course, as a complement to this, the agencies responsible for producing such information should be endowed with suitably qualified staff and technological resources; in addition, there is a need to encourage academic debate on the major conceptual issues underlying fiscal estimates (use of cash versus accrual accounting; measurement of the value added by government activities; selection of indices to deflate expenditure series; precise definition of certain types of expenditure, such as military spending; alternative definitions of the deficit and estimation methods; method of reporting privatizations in fiscal accounting; methods of estimating assets, liabilities and net worth; and, in that context, methods of estimating contingent government liabilities).

F. SAFEGUARDING SOCIAL EQUITY

As was mentioned earlier, the need to assign top priority to the goal of macroeconomic stabilization has, in recent decades, led to a relative neglect of other fiscal policy objectives, particularly that of fostering social equity. As this study will show, efforts have to some extent refocused on this objective in the 1990s, and this has been reflected in an upturn in social spending in Latin America. However, this issue poses an enormous challenge to the region, and will need to be tackled with greater determination in the immediate future.

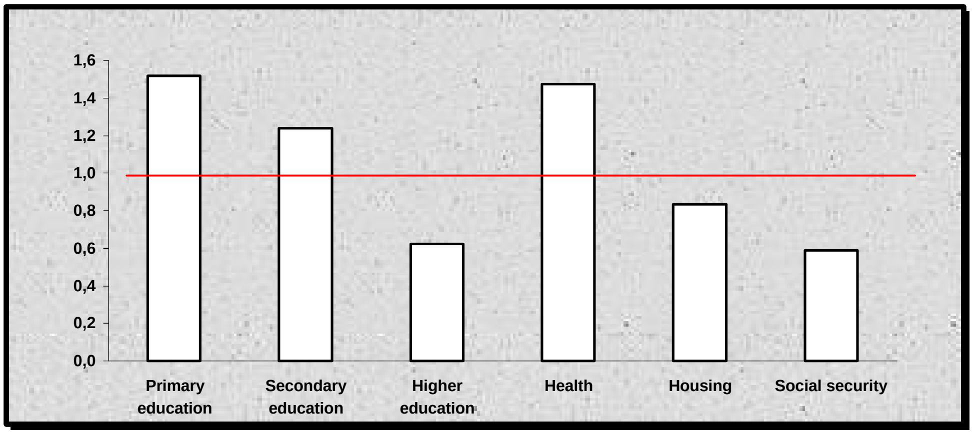
Social expenditure is undoubtedly the most important tool used by Government to influence income distribution (see chapter VI). There is, in fact, a great deal of evidence to suggest that social expenditure has a significant impact on the secondary distribution of income. In addition, over the long term, greater investment in human capital makes it possible to influence one of the structural factors of income distribution. Studies indicate, in particular, that allocating greater resources to education permits a better distribution of human capital in society and may have a far greater impact on equity than has been estimated in studies of short-term distributional effects.[5]

The data available on the secondary distribution of income in Latin America indicate that, in absolute terms, higher-income groups are benefiting more from social expenditure. However, as a proportion of the income of the various social strata, the subsidies channelled through social expenditure to the poorest segments of the population are higher than for the other segments. This overall pattern obscures the widely varying distributional effects of different types of expenditure. As figure I-4 shows, spending on health care, primary education and, to a lesser extent, secondary education achieves a high level of targeting of the poor (i.e., the proportion of spending that benefits the poor in relation to the proportion of the poor to the total population). In contrast, spending on social security and higher education tends to be regressive. Spending on housing falls somewhere in between, as it chiefly benefits middle-income strata. These data suggest that there is ample room for improving income distribution through social expenditure, as well as for better targeting.

The means of financing such expenditure are not distributionally neutral, either. Financing through direct taxes tends to be more progressive than financing through VAT, for example. Just as importantly, inadequate revenues and consequent borrowing, by causing inflation to accelerate, may cancel out any favourable redistributional effects. The effects of revenue structure on income distribution, while less important than used to be thought, are by no means negligible; nonetheless, they have come in for little scrutiny in academic circles in recent decades. In this regard, the sharp decline in the relative importance of direct taxation in Latin America, and especially of personal income tax (which quite possibly has the most significant distributional effects), is cause for concern.

[5] For more information, see recent editions of the "Social Panorama of Latin America and the Caribbean"; see also Inter-American Development Bank (1997).

Figure I-4
TARGETING OF SOCIAL EXPENDITURE ON THE POOR (INDICES)



Source: Prepared on the basis of table VI-4.

Unfortunately, consideration of these topics is hampered by the dearth of studies on the distributional effects of fiscal policy. While budgets are often prepared with an eye to sound macroeconomic criteria, rarely is that exercise supplemented by calculations of the distributional impact of various budget options, in part, no doubt, because of the technical complexity of the task and the lack of information or studies on the subject. Almost no country in the region has prepared sufficiently complete and up-to-date studies on tax incidence, and only a few have conducted analyses of the incidence of expenditure, either at the sectoral or aggregate levels. Consequently, there are still fewer studies on budget incidence which measure the net distributional impact of fiscal policy.

Figure I-5 presents an outline of trends in social expenditure in Latin America and the Caribbean over the past two decades. The 1980s were notable for a sharp reduction in social investment. The decrease in the proportion of GDP devoted to social expenditure, coupled with a decline in per capita income, led to a 24% drop in per capita social expenditure in Latin America. During the 1990s, both these indicators have moved upward; by 1995 per capita social expenditure in Latin America was already 18% higher than in the early 1980s. It should be noted that the Caribbean has not shared in this positive trend in social expenditure; there, such spending has fluctuated at around 9%-11% of GDP since 1987, with the trend being slightly downward, and per capita spending has continued to drop. Nonetheless, as a general rule, public spending by the Caribbean countries remains higher than the average for Latin America. This positive picture for Latin America must be viewed with some reservations, however, for three reasons. First, the priority given to social expenditure still varies widely from one country to the next and, in many, social spending is still too low. Second, a very substantial portion of the growth in social expenditure —especially in countries where such spending is high— goes to social security, and specifically to pension payments, which is the component with the least progressive distribution. The increase in expenditure on human capital has also been lower than the above-mentioned figures suggest. In the case of education, for instance, by 1995 real per capita expenditure in Latin America as a whole had barely recovered to 1980 levels and in a number of countries was still below those levels. Third, the sharp reduction in social expenditure in the 1980s and its rebound in the 1990s is largely a reflection of the region's macroeconomic cycle and thus is symptomatic of the procyclical pattern of trends in social spending.

Some of the reforms designed to increase the efficiency of social expenditure have had worrisome distributional effects that need to be examined closely. There is, in fact, evidence that when decentralization is carried out without adequate safeguards, the process can have a serious impact on equity among subnational units. Thus, in some of the cases for which comparable data are available (for example, education in Argentina, Brazil and Mexico), there is evidence that dispersion of service quality has tended to increase (see chapter VIII).

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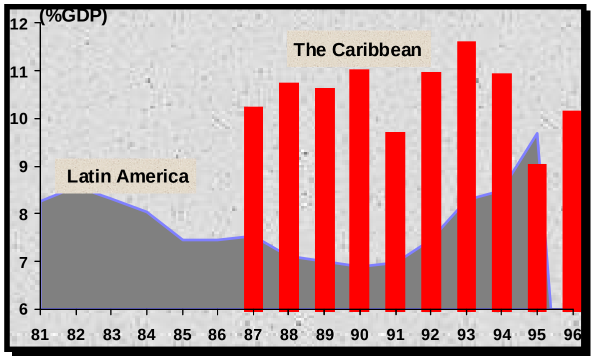
Similarly, reforms designed to increase the opportunities for private management of service delivery may have adverse effects if they are not accompanied by appropriate altruistic, or "solidarity", mechanisms; an example of this is Chile's private health-care system. Under these conditions, such reforms may encourage "skimming", or adverse selection of users; this occurs when users with higher incomes and lower age-related health risks are concentrated in the private system, while people of lower incomes and high-risk age groups are concentrated in the public system. Such a scheme, far from reducing the demand for public resources in the sector, may actually increase it (see chapter VII).

Figure I-5
TRENDS IN PUBLIC SOCIAL EXPENDITURE: CENTRAL GOVERNMENT
(As a percentage of GDP)



Source: ECLAC, on the basis of official figures.

In line with these observations, the following courses of action are recommended:

(a) Encourage studies and regular estimates of the distributional impact of fiscal policy

The reasonable concern for ensuring the non-inflationary balancing of public accounts needs to be complemented by a similar interest in the impact of public policies on social equity. This entails special attention to analysis of the distributional impact of fiscal policy through up-to-date studies on tax incidence on different socio-economic strata and a wider diffusion of studies that examine the effects of public expenditure, both in the aggregate and, in particular, with respect to programmes specifically targeted at lower-income groups. Such studies should provide the basis for estimates of budget incidence, i.e., the net distributional effects of the budget. Just as Governments and many analysts calculate the macroeconomic effects of fiscal policy, so too its distributional effects should be estimated on a regular basis. This exercise is especially necessary when the legislature must take important decisions in this sphere, i.e., on major changes in the tax structure or the composition of public spending. Analysis of the distributional impact should be one of the main criteria for taking the decision. Such analyses should also consider all areas of quasi-fiscal activity, especially tax expenditure and mandatory regulations.

(b) Consolidate the upturn in social spending, improve its targeting and stabilize its funding

In view of the importance of the distributional effects of social expenditure, the recovery in the levels of such expenditure in Latin America should be consolidated and the negative trend seen in the countries of the Caribbean should be halted. Social expenditure should be accorded higher fiscal priority in quantitative terms, while a drive should be undertaken to rationalize expenditure by eliminating or reducing unnecessary administrative expenses and improving the targeting of its benefits. The latter requires not only emphasizing expenditure that has greater redistributional effects, but also designing mechanisms that make it possible to minimize or even reverse the regressive nature of some types of expenditure. Just as importantly in terms of avoiding the trauma caused by the procyclical pattern of social expenditure, such spending needs to be given special priority in initiatives aimed at stabilizing public expenditure.

(c) Restore emphasis on the importance of direct taxation, especially personal income tax, for reasons of equity as well as other motives

For reasons of both revenue enhancement and social equity, greater emphasis should be placed on direct taxes (especially personal income tax), which are more progressive in their distributional impact. The negative effects of indirect taxation in terms of the simplicity of the tax system and its administration have been analysed in detail elsewhere. With respect to equity, the possibility of applying differential rates for indirect taxes —with lower rates on some staples prominent in the basic shopping basket of the poor— should not be ruled out, so long as technical and administrative safeguards are in place to avoid linkage or marked distortions in resource allocation. Another option that should at least be considered is the transparent use of cross-subsidies on public services, provided they do not generate distortions in the setting of the basic price of the service or cause any considerable substitution effect that would increase the consumption of goods and services that are more socially costly.

(d) Monitor the effects of decentralization on social equity

Explicit redistributional criteria should govern the design of schemes for transferring the funding of social expenditure to subnational levels of governments. Moreover, in providing institutional support to local governments and monitoring decentralization, care should be taken to ensure that the process does not lead to greater dispersion in coverage and quality among different areas of a country.

(e) Incorporate specific altruistic mechanisms in the design of schemes for private-sector involvement in social services

In designing schemes for private-sector involvement in the delivery of social services, special emphasis should be placed on altruistic mechanisms in order to prevent adverse selection. Systems for informing users about the alternative service available and mechanisms of quality control are also needed to protect lower-income groups, in particular.

G. STRENGTHENING THE INSTITUTIONAL FRAMEWORK OF DEMOCRACY

Public finances are at the heart of the democratic process. It is a well-known fact that legislatures arose in the modern era out of a desire to curb the power of the monarch to levy taxes and control the revenues collected. That historical consideration aside, there is perhaps no issue that galvanizes citizens' interest more than knowing how they will be taxed and what use will be made of their contributions.

In an era where democracy is fortunately taking firm hold in the region, fiscal institutions must also evolve within an institutional framework imbued with the principles of participation and the separation of powers. There are understandable reservations concerning the democratic system's ability to meet expectations regarding public spending without generating macroeconomic imbalances; there are numerous cases in the region that appear to justify those reservations. However, it is also clear that the lack of a democratic consensus regarding the fiscal covenant usually leads to undesirable practices: an increase in quasi-fiscal operations which reduce the transparency of fiscal policy, with the consequences already noted (see chapter II); and budgetary rigidities stemming from earmarked rents, demanded by groups unhappy with the Executive or the legislature, in order to force the fiscal authorities to undertake specific actions (see chapter IV).

In designing fiscal institutions, three considerations need to be taken into account. First, institutions should meet multiple objectives, with the following as a minimum: (i) they should provide for levels of revenue and expenditure that are compatible with macroeconomic balance and growth; (ii) they should ensure that resources are used in accordance with plans of government resulting from the democratic process; and (iii) they should offer incentives for suitable resource use. Second, they should take into account all the social actors involved: the national Executive, subnational levels of governments, autonomous public entities, the legislature, regulatory agencies and civil society. Third, it is also important to consider informal institutions, i.e., patterns of behaviour, implicit rules and customs. Unlike formal institutions, which can be modified by law or administrative reform, informal institutions are necessarily the result of a lengthy process of evolution.

The institution-building process undertaken in the region in the last few decades provides only a partial response to these multiple requirements. In general, the emphasis has been on strengthening the formal institutions of the national Executive, on which responsibility for achieving the first of these objectives has been placed, that is, the achievement of macroeconomic equilibria through the management of public finances. This has been the aim of efforts to strengthen departments or ministries of finance and autonomous central banks, tax offices, integrated financial administration systems and private research centres or similar institutions which monitor macroeconomic management. However, since these efforts are not part of a broader process geared to generating consensus on the value of such practices, they rarely trickle down to informal institutions and indeed even encourage counter-productive practices: constant confrontations within the Executive and between the Executive and the legislature, attempts by dissatisfied elements in the Executive or the legislature branches to find quasi-fiscal loopholes for escaping controls, and the creation of earmarked rents or revenues specifically in order to tie the hands of the fiscal authorities. Measures to create autonomous fiscal authorities, rather than providing a solution, have merely added to the problem.

The emerging trend in institution-building which seeks to foster a results-based public administrative culture relates to the third objective mentioned above, i.e., offering incentives for suitable resource use; unlike the previous objective, it chiefly concerns informal institutions. Paradoxically, however, this trend coincides with the maintenance of formal fiscal oversight institutions still employing antiquated methods that run counter to this aim, and with the virtual dismantling of most national public investment systems; as a result, the emphasis is on efficiency in terms of current rather than capital expenditure (see chapter X). As pointed out earlier, decentralization also tends to promote fulfilment of this objective, but when the process is poorly designed, it can upset the macroeconomic balance. On the other hand, a decentralization plan that maintains excessive central control in order to avoid this problem may end up undermining the autonomy necessary for efficient management.

The dismantling of national public investment systems is part of a generalized emasculation of the planning agencies that used to administer them and is reflected in the paradoxical lack of institutions to oversee the attainment of the second of these objectives: consistency between budget appropriations and government priorities. If this function is assigned to the Ministry of Finance, i.e., to the institution whose basic purpose is, by definition, to achieve the first objective, then the second objective may be treated as a matter of lower priority. The preferred option in some cases is to assign this role to the Office of the President or the Office of the Prime Minister, but in this case the political functions of such offices must not be allowed to obscure this specifically fiscal role.

The problems are even more acute when other actors are involved. With very few exceptions, there is a marked asymmetry between the fiscal structure of national and subnational levels of governments. Moreover, the lack of qualified technical support for the legislature prevents it from functioning as an effective counterpart to the fiscal authority and the Executive in general, and hence from fulfilling its role with respect to the above three objectives. This and the fact that civil society’s potential for fiscal analysis remains largely undeveloped (except for the handful of centres for macroeconomic analysis referred to earlier) reduce the budget debate to a mere formality, lacking any real substance, which thus contributes little to deepening the social consensus on which a solid fiscal covenant and a stronger democracy may be built.

In addition to the foregoing, the obvious bears repeating, namely, that the budget exercise is a dynamic process, in which decisions are adopted at different stages as new information emerges and new problems come to the attention of authorities. Apart from the necessary flexibility that this demands, the importance of an appropriate information system for the proper functioning of any budgetary institution cannot be overemphasized. There is nothing, in fact, so disruptive from the institutional standpoint as major surprises resulting from a deficient information system —as finding out, for example, that certain (quasi-fiscal) expenditures or hidden liabilities (unreported debts, uncalculated contingent liabilities or unestimated pension liabilities) have thrown the accounts so out of balance that the political agreements that are the foundation for any budget at any given time must be rebuilt all over again.

The above analysis leads to the conclusion that it is necessary to:

(a) Promote the development of balanced and democratic fiscal institutions

The institutions to be developed should fulfil the three objectives identified above, permit the participation of all the actors involved and attempt to influence informal norms and practices. This entails, as initial steps, strengthening the Executive agencies that monitor consistency between the distribution of fiscal, resources and government plans, and instituting practices that contribute to proper resource management. Second, it entails providing more technical support to the weakest actors in the budget process: subnational levels of governments, legislatures and civil society. Lastly, attention should be paid not only to formal institutions, but also to the host of informal rules and practices, a sphere in which public debate and democratic consensus-building are indispensable.

(b) Improve the information flows essential to the proper operation of fiscal institutions

The above-mentioned initiatives for enhancing fiscal information resources are thus essential in order to ensure not only transparency of public action, but also the proper operation of fiscal institutions.