
macroeconomía del desarrollo

Rigidities and fiscal space
in Latin America: a comparative
case study

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Abstract

Despite the macroeconomic and fiscal bonanza experienced by the region from 2003 until mid-2008, the spread of the international crisis necessitated a fiscal response to the challenges it created. This situation has put the increased fiscal-policy space achieved in previous years to the test. An important aspect to consider in this context is the limited flexibility of public budgets in the region.

The emergence of fiscal rigidities (which affect budget flexibility) cannot be explained by any single factor, but is rather a reflection of societal decisions about the role of the State, numerous public-policy priorities and their means of financing. This paper proposes that determining the degree of budget flexibility is less critical than understanding the type of rigidity inherent in a given budget, its origin and the reasons behind it.

The paper begins with a conceptual overview and comparative analysis of the cases studied. First, there is an analysis and review of the theoretical justifications and arguments used in the political debate which underlies the emergence and persistence of rigidities in countries of the region, following a typology which allows for the classification of the reasons for rigidities.

Based on the case studies, which include countries in Central America (Costa Rica, Guatemala and Honduras) and the Andean Region (Colombia, Ecuador, Peru and the Plurinational State of Bolivia), the potential effects of fiscal rigidities on public budgets and their impact on fiscal-policy management are evaluated. The ultimate goal of this comparative study is to provide a set of recommendations to help guide future improvements in the management of public budgets.

I. Introduction

In the period 2003-2008, a unique combination of international economic circumstances, a favourable macroeconomic situation and fiscal-policy management resulted in increased “fiscal space” in the public accounts of Latin American countries. The need for a fiscal response to the crisis which unfolded in mid-2008 necessitated using the fiscal latitude achieved in previous years to face the challenges posed by the crisis. Given this fact and the need to assess how best to exploit this new margin of manoeuvrability, the limited flexibility of public budgets in the region must be recognized, as demonstrated by several recent studies. The analysis of fiscal rigidities in Latin America –including various legal, contractual, institutional and public-sector obligations that impact budgets– has become a relevant topic to the region’s fiscal agenda. These are usually presented as a major constraint on economic-policy management in general and on fiscal policy in particular.

However, there remains an ongoing debate about how much freedom (or discretion) tax authorities should have, versus the level of rigidity from existing regulations (rules), and there would appear to be no single, universal solution. If stakeholders are not confident that governments will act in a particular way (depending on the fiscal-policy objectives in question) they will have incentives to limit the discretion of policymakers, and tend to press for the establishment of various types of rules or fiscal rigidities.

The existence of rigidities in public budgets is often seen as having two sides: one negative, associated with the limitations on fiscal-policy action; and one positive, which relates inflexibility with the need for an institutional framework to help achieve fiscal-policy objectives.

This paper attempts the difficult task of balancing the arguments for and against the various modalities that give rise to rigidity in fiscal-policy management.

Recent literature seems to have been focused on one of those two sides: the constraints on and the decrease in the degree of freedom for fiscal-policy action. It is, however, difficult to find studies that analyze the reasons for these constraints and how they relate to fiscal-policy objectives in each country. This is precisely what this paper shall attempt to do.

It may be initially speculated that this concern has evolved over time. In fact, it should be noted that the discussion of fiscal rigidities or inflexibilities is closely linked to the macroeconomic cycle and macroeconomic turmoil. The establishment of budget rigidities during a period of crisis is not usually the result of appropriate financial design, but is rather of intense disputes over financial resources in the context of severe budget cuts (such as in an economic downturn). In times of insolvency, the debate over rigidities highlights the difficulties inherent in developing adjustment measures with impacts on the availability of fiscal space.

Conversely, in a context of economic growth –and thus increasing revenue– the budget-rigidities discussion will center on the difficulties they pose for achieving new objectives, as noted above. An acceptable consensus regarding the content and form of these rigidities could help to forge a new fiscal pact (both socially and politically) regarding public-sector responsibilities. Absent this, such rigidities become a clear reflection of the opposing interests among different sectors or groups of power regarding the direction of fiscal policy and government agendas.

In practice, the emergence of fiscal rigidities cannot be traced to any single factor, but is rather a reflection of societal decisions about the role of the State, public-policy priorities and their means of financing. Determining the degree of budget flexibility is less critical than understanding the types of rigidities present in a given budget, their origins and justifications, in order to contribute to a democratic debate and help public sectors and their budgets meet the goals set by the societies of our region. In this sense, rigidities could be seen as “desirable”, to the extent they help society achieve the agreed upon public-policy objectives required by their chosen mode of development.

As argued by Crispi and others (2004), the existence of increasingly rigid expenditures is not an evil in and of itself; in many cases it reflects the gradual expansion of economic and social rights and in others, such expansion is the product of the gradual implementation of major social reforms.¹ In this way, the development of various fiscal inflexibilities can be seen as a reflection of the roles and functions that the public sector has assumed over time. While a certain amount of budget inflexibility can be justified on both theoretical and practical grounds, excessive rigidity in spending and resources can have a number of negative effects. Thus, the literature has begun to address both the rationale for fiscal rigidities and their effects.² A distinction is often made between fiscal rigidities that manifest themselves as obstacles in the structure of expenditures (“spending rigidities”), as opposed to the predetermined allocation of resources (“income rigidities”). This paper argues that the relevance of these rigidities cannot be examined without discussing the objectives and functions that produce them. Based on these definitions, a discussion can be had regarding which rigidities serve to further the stated policy objectives. As emphasized by Cetrángolo and Jiménez (2007), one should not lose sight of the fact, again, that each statement has its own conceptual base that responds to specific concerns (one might even say there could be a justification for each of them). This debate is particularly relevant when examining the fiscal measures taken by the countries of the region to address the crisis and the budget reformulation that will be needed when the crisis ends.

Therefore, and taking into account the importance of fiscal rigidities in budget management in the countries of the region, the theoretical and applied analysis offered in this paper focuses on assessing the comparative experiences of a group of Latin American countries on the basis of seven case studies,

¹ Crispi and others, 2004, p. 14.

² Allier (2006) calculates the degree of budget rigidity in four countries: Argentina, Brazil, Chile and Ecuador. Echeverry, Navas and Clavijo (2009) study the origin and scope of budget rigidities in Argentina, Colombia, Mexico and Peru.

covering Central America (Costa Rica, Guatemala and Honduras) and the Andean Region (Colombia, Peru and the Plurinational State of Bolivia).³ These case studies look at the conceptual justifications for and arguments regarding the political struggle behind the emergence and persistence of rigidities, following a typology for the classification of the reasons for the existence of rigidities. Based on these studies, an assessment is made of the possible effects of fiscal rigidities in public budgets and their impact on fiscal-policy management in countries. The ultimate goal of this comparative study is to provide a set of recommendations to help guide future improvements in the management of public budgets.

With this goal in mind, the paper is organized as follows: an introduction of the main characteristics of the case studies is followed by a presentation of the different types of rigidities found in the countries studied. Section II provides a necessary introduction to the basic concepts behind and effects of rigidities. This initial work concludes with a section that reviews the most salient points, makes a set of policy recommendations organized according to the different types of rigidity and, finally, refers to the role played by the various branches of government in managing budgets rigidities.

³ The authors of the studies are: Maynor Cabrera and Juan Alberto Fuentes for the cases of Costa Rica, Guatemala and Honduras; María Dolores Almeida for the cases of Ecuador and the Plurinational State of Bolivia and Juan Carlos Echeverry, Verónica Navas and Andrés Clavijo for Colombia and Peru. These works have been published in Cetrángolo and Jiménez, compiladores, Santiago de Chile, LC/W.269 (2009).

II. Fiscal rigidities: conceptual framework for analysis and measurement

1. Main characteristics

Fiscal rigidities are essentially institutional constraints that limit the ability to change the level or structure of public budgets in a specified period. The institutional arrangements which limit the discretion of budgetary authorities often arise out of a desire to ensure compliance with a specific fiscal-policy objective when it is feared they will not be handled properly by the authorities. It would therefore be possible to argue that rigidities stem from the distrust of some public policymakers by others.

Such institutional constraints may have different regulatory roots and involve various legal, contractual and institutional public-sector obligations that have budgetary impact. One of the classifications chosen in some of the studies refers to “levels of rigidity,” in terms of the regulatory or institutional arrangement that leads to their emergence. Regulations at the constitutional level generally lead to a higher level of rigidity than Executive Branch rules or regulations. Although this classification is extremely useful for the study of individual cases, it does not appear to provide much context for the comparison of cases.

In each country there are important reasons why rules of various kinds lead to more or less rigidity.⁴

It is of utmost importance to note that the definition of rigidities refers to a specific period of time. In the short term, the vast majority of budget components are rigid, whereas in the long term, the entire budget may be more flexible. In particular, Echeverry, Navas and Clavijo (2009) postulate that all components whose inclusion in the budget are not subject to the discretion of political authorities in the short term must be considered as “inflexible”.

As previously suggested, rigidities tend to arise from different interpretations of public-sector objectives and functions. In addition, budget decisions are the result of a collective process involving a wide range of political actors who are competing for scarce resources according to their own motivations and incentives. Thus, public-sector budgets are a product of these conflicts of interest and the way in which they are resolved.

It would appear that the only way to overcome the many obstacles arising from such conflicts is to build a solid and sustainable consensus, to give legitimacy to the required policies of reform and to allow them to be funded by the sectors of society with greater resources. Promoting and supporting public policies that help build a new fiscal pact is critical to achieving increasing levels of social cohesion and economic development in the countries of Latin America. Given that this requires promoting certain public policies and implementing major reforms in several areas, the desirability of incorporating varying degrees of rigidities in the budget must be understood as part and parcel of this challenge. Thus, while each case must be analyzed and implemented with great caution, their consideration should not lead them to be seen as isolated aspects of government strategy. On the contrary, even though the specifics of each case must be examined, it is essential to highlight the systemic nature of public policy.

Reforms require not only strong political will and consensus, but also institutional and administrative capacity to ensure high quality in public spending. These two aspects have traditionally posed major challenges for the governments of Latin America. Whatever the prevailing scenario in the future, it will be essential to ensure the quality of actions taken without compromising economic competitiveness.

In sum, funding must be secured to improve citizens’ access to social benefits, with efficiency (at lower cost and according to quality standards), solidarity and in a timely manner, taking into account the level of government that is most suited to the task. This is the crux of the new fiscal pact needed. It is not merely an agreement reached at a particular historical moment, or the mere drafting of a document to be endorsed by society. While this could be an important aspect in some specific cases, it is more a question of ongoing work aimed at achieving a growing consensus in each of the areas involved. Modern fiscal policy requires continuous learning and constant updating of the types of policies necessary to increase fairness and a sense of belonging for growing economies.

Unfortunately, it is not always possible to build such a consensus, especially when the needs far outweigh the claims of different sectors of society. Indeed, in a context of scarce resources, including a new issue on the public agenda implies rearranging existing priorities. For some, participation in planning the institutional agenda is limited, because “certain groups and interests often lack representation in the process of creating it,” so control over the agenda remains in the hands of the authorities and a relatively predictable number of players (with greater resources and organizational capacity), which form a “sub-government”.⁵ The establishment of budgetary rigidities might then be seen as a response to the dispute over scarce resources, and they serve to demonstrate how different actors manage to “defeat” or “defend themselves” from other actors involved in the struggle over the distribution of resources in society. In very general terms, the problem of inflexibility, as is the case with budgets in general, is essentially a question of politics. This fact leads some authors to believe that

⁴ In fact, it would appear that in some countries it would be easier to reform some aspect of the constitution than to pass legislation. In addition, among the factors which contribute to the degree of rigidity are the performance and relevance of budget oversight agencies as well as the judiciary’s role in monitoring and enforcing the laws that result in budget rigidities or inflexibility.

⁵ See Cobb and Elder (1993), p. 88.

political conflicts often result in the adoption of policies or institutions that are “inefficient from an economic standpoint” (Echeverry, Navas and Clavijo 2009).

Similarly, the *Public Choice* theorists emphasize that it cannot be assumed that the objective of policymakers is to achieve social welfare. Thus we arrive at the notion that the strategic behaviour of government officials and bureaucrats who seek to serve their own interests leads to excessive and inefficient budgets. This is because the benefits of higher spending –and the continuation thereof through mechanisms which increase “rigidity”— would be felt solely by the bureaucrats themselves, who would in turn have incentives to promote such spending.⁶ This cycle is reinforced by the continuation over time of bureaucratic structures and those involved in them, which helps shed light on the persistence of fiscal rigidities. This would partially explain the idea that government salaries are considered an inflexible cost item.

Putting aside this extreme scenario, under which bureaucracy would inevitably lead to an undesirable situation, consideration should be given to idea that the absence of bureaucracy could lead to an even worse situation. It is argued here that the solution to the dilemma of coexistence in a society that seeks increasing levels of cohesion in democracy calls for significant state intervention. It is, in any case, a question of seeking out better means of state intervention when required and in that sense, the analysis of fiscal-policy dynamics and rigidities is an unavoidable topic. In fact, according to Musgrave, “Public policy enters, not as an aberration to the “natural order” of private markets but as an equally valid or natural means of addressing a different set of problems. The visible hand of budgetary processes, in short, is no less “natural” than the invisible hand of markets” (Musgrave, 1999, p.31).

2. A few reflections on the effects of fiscal rigidities

From a fiscal-spending management point of view, the greater the degree of rigidity in public budgets the more difficult it is to manage fiscal policy in response to changes in the macroeconomic environment. However, to the extent that the policy objectives of the various rigidities are aligned with these instruments, they are more likely to be achieved. Thus, in order to analyze the effectiveness of fiscal policy –including the identified rigidities—one must evaluate all of its objectives. For this reason, the proposed review does not imply a value judgment on the establishment of rigidities.

In the conventional literature on the subject, one of the general consequences related to the presence of fiscal rigidities is the lower quality of fiscal-accommodation measures implemented to address a fiscal crisis. Thus, even in a context of economic expansion, the presence of a relevant set of budgetary rigidities which lead to rigid (and expansive) public expenditure will result in the increased tax revenues not being fully available to fund new public-policy programmes or actions.

Moreover, fiscal rigidities promote a bias towards more spending and higher taxes and generate other problems such as distortions in the design of tax policy, difficulties in pursuing countercyclical fiscal policy and loss of incentives to improve efficiency in public spending (due to resources being guaranteed regardless of performance).

The quality of fiscal measures taken in times of crisis is undermined by the presence of rigidities; the authorities tend to adjust capital spending first, but the effectiveness of these measures is relative when they are insufficient for achieving fiscal equilibrium and other spending items are “rigid”.⁷ At the same time, budget rigidities could limit the ability to reallocate resources towards social safety nets in times of socio-economic crisis.

⁶ Moreover, one could even assert that government officials seek to secure funding, thereby promoting rigidities, but at the same time they seek greater flexibility and discretion for the funding they receive.

⁷ In addition, the adjustment of capital expenditure is not always desirable, when its long-term contractionary effects on aggregate demand are taken into account.

It is also possible to consider that “during an economic slowdown, when there is a drop in tax revenues, the government is obliged to assume these expenses, which become unavoidable, in detriment to the health of public finances. Therefore, in periods of fiscal austerity, “mandatory” expenditures do not necessarily coincide with government spending priorities” (Echeverry, Navas and Clavijo, 2009).

Another way in which the quality of fiscal accommodation to unexpected shocks would be adversely affected by public rigidities is by amplifying the effect of contractionary fiscal policies based on tax increases. The existence of specific allocations of additional revenue results in higher tax increases than those required in their absence (along with increased spending which is not necessarily desirable in a time of adjustment), or increased pressure to raise taxes with fewer appropriations, regardless of how reasonable are the increases (Podestá, 2007).

Allier (2006) argues that budget rigidities can lead to overspending in some sectors at the expense of others, and cites the case of public investment in Latin America where the reallocation of resources was difficult due to the emphasis placed on social spending by the democratic governments in the eighties, who reflected their priorities through various laws to protect such spending.

The points reviewed thus far regarding the effects of fiscal rigidities on fiscal-policy autonomy refer to the notion of “fiscal space” and the ability of governments to create it. Following Fanelli and Jiménez (2009), the breadth for this dimension of fiscal policy available for governments to pursue their objectives is a function of three factors: the amount of available fiscal resources, the number of independent tools available to meet the proposed objectives and the degree of competition among policies vying for resources and tools.⁸ In this sense, the impacts that rigidities cause on fiscal space can change rapidly in the presence of macroeconomic turmoil. Macroeconomic shocks alter fiscal space not only because they influence resources, but also because they determine the degree and intensity with which policies compete with one another.

It is interesting to review the period 2002-2008, which was characterized by significant and increasing primary surpluses and a sharp decline in public debt. In this sense, the region had been gaining “fiscal space” since the beginning of the decade, mainly explained by the growth of income, however, this did not result in a *pari passu* and simultaneous growth in expenditures. As noted in ECLAC (2008), “primary surpluses enabled countries to pay off substantial portions of their public debt ... and allocate more resources to capital and social spending”.⁹

Conversely, in the case of a negative shock such as that felt in late 2008 and early 2009, not only do resources and access to financing shrink, but the demands coming from those sectors most affected by the crisis grow and competition intensifies for both resources and policy instruments (which are structurally limited in the region), with a more than proportionate reduction in available fiscal space.

Another potential consequence of budget rigidities is that they can contribute to the procyclicality of government spending. First, excessive earmarking reduces the ability of governments to implement discretionary countercyclical fiscal policy by limiting the capacity for public savings during economic expansions. Second, the allocation of resources weakens the tax system’s role as automatic stabilizer, because while taxes reduce disposable income and therefore demand, the specific allocation of this tax revenue to finance certain expenditures boosts aggregate demand, which may partially counteract the first effect.

It should be recognized, however, that the quality of fiscal accommodation in situations of macroeconomic shocks is lower in the presence of budget rigidity or inflexibility, and it should also be noted that in conditions of acute socio-economic crisis, the public sector tends to redefine their role and functions (often abruptly), which leads to disregarding, modifying and questioning various fiscal

⁸ For more details regarding the definition and evolution of “fiscal space”, see ECLAC (2008) and Fanelli and Jiménez (2009).

⁹ See Chapter I, Regional Overview in ECLAC (2008).

rigidities.¹⁰ In this sense, it could be argued that in “normal” contexts, the capacity for modification and removal of budget rigidities will be smaller (and therefore the changes tend to be marginal) than in crisis situations where the redistribution of “resources” and organizational capacity that takes place changes the roles of the various political and institutional players.

3. Reasons for rigidities: an attempt at typology

3.1 Main characteristics of the cases studied

Beyond the conceptual considerations presented in the previous section, the study of the rigidities in the cases selected for this project had to take into account not only the ambiguities of any categorization and the difficulties inherent in applying them to concrete cases, but the limitations of the information used. This is linked to the public-sector coverage that might be considered as a function of the availability of data, and differing definitions used in different budgets, where in some cases, debt payments are considered part of the public budget. Decisions had to be made in each case regarding the time period covered by the studies. Table II.1 provides details of coverage and the period analyzed in each case.

TABLE II.1
FISCAL RIGIDITIES IN LATIN AMERICA:
COVERAGE OF THE CASE STUDIES

	Bolivia (Plurinational State of)	Colombia	Costa Rica	Ecuador	Guatemala	Honduras	Peru
Government Coverage	General Government ^a	Central Government	Central Government	Central Government	Central Government	Central Government	Central Government
Fiscal year / period analyzed	Annual/2001- 2006 ^b	Annual / 2006 ^c	Annual/ 2006	Annual/ 2001- 2006 ^b	Annual/2006	Annual/ 2006	Annual / 2006 ^c
Budget Coverage includes debt payments	Yes	No	Yes	Yes	Yes	Yes	No

Source: Prepared by the authors on the basis of Almeida (2009a and b), Echeverry, Navas and Clavijo (2009), and Cabrera and Fuentes (2009).

^a ^b ^c Information from 2005 is presented for some analysis.

Carrying out a comparative analysis of fiscal rigidities in the countries of the region requires developing some form of typology of the different fiscal rigidity phenomena that can be applied to the cases being studied in order to compare and analyze them. This will have a bearing on the characterization of justifications for or dominant features of the rigidities presented above.

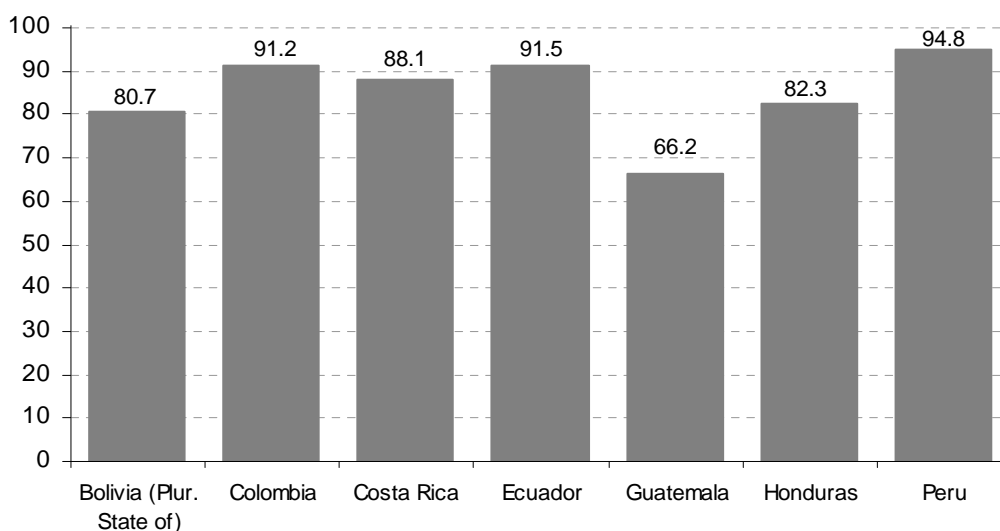
Given the initial need to classify the various phenomena that arise in situations of budget rigidities, a distinction is usually made between rigidities stemming from spending policy and those derived from the allocation of tax revenues. While this distinction may be useful, it should also be recognized that significant ambiguity exists in this classification, which results in a number of hybrid situations where expenditure rigidity is manifested through the earmarking of tax revenues. Nevertheless, the cases studied made use of this first classification which helps introduce the topic and

¹⁰ One example of this is the introduction, during times of crisis, of macrofiscal regulations in several countries of the region, which sought to establish for fiscal results and levels of public debt (that is, establish rigidities), for which the removal of other rigidities such as specific earmarking or wage-adjustment clauses was promoted. An extreme example was the Zero Deficit regulation established in the Fiscal Responsibility Law in mid-2001, in the prelude to the crisis early this century.

found a relatively high proportion of the rigidities associated with public sector expenditures to be the first common pattern found in the cases studied. Figure II.1 illustrates this fact for the countries studied.

The main conclusion regarding the relative weight of the expenditure-based rigidities is the high level of rigidities which, except in the case of Guatemala in 2006, was found in over 80% of the universe of expenses considered. It can also be seen that three Andean countries had the largest percentage of spending inflexibility. It is difficult, however, to make comparisons with indicators whose criteria are not entirely homogeneous.

FIGURE II.1
RIGID EXPENSES: SELECTED LATIN AMERICAN COUNTRIES
(Percent of budgetary universe considered)



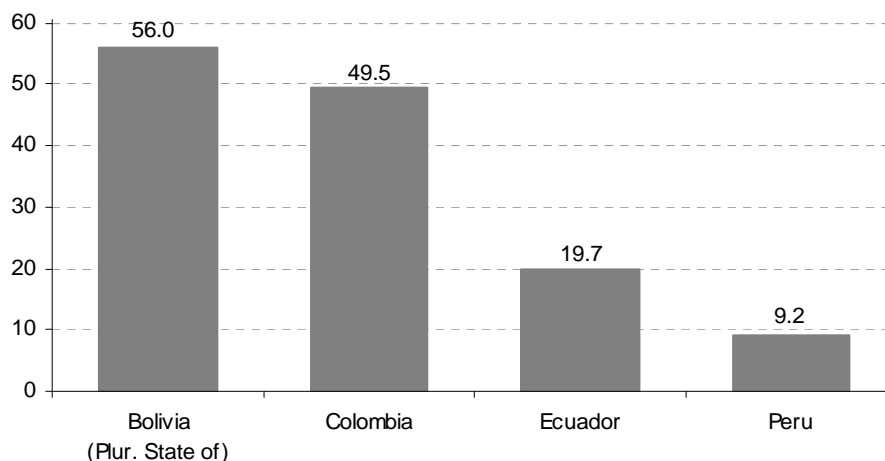
Source: Prepared by the authors on the basis of Almeida (2009a and b), Echeverry, Navas and Clavijo (2009), and Cabrera and Fuentes (2009).

In the case of the Plurinational State of Bolivia, inflexible components have risen from two thirds of the expenditure budget of the non-financial public sector (total expenditures plus debt payments) in 1990, reaching a maximum of 95.4% in 2004 and then dropping to 80.7% in 2006 (Almeida, 2009a). For the same budget universe, in 2000-2006, rigid spending in Ecuador averaged 88.5% (Almeida, 2009b). Meanwhile, in the cases of Colombia and Peru, inflexible expenditure items amounted to 91% and 95% respectively in 2006 (Echeverry, Navas and Clavijo 2009).¹¹

Within these rigidities, the most important in relative terms are those associated with the payment of public salaries, interest payments on public debt and transfers (to other levels of government and social security systems, which are constitutionally mandated in many cases).

In considering the various countries, the Plurinational State of Bolivia can be seen to have had a high level of earmarking of revenues, which in 2006 amounted to 56% of all income sources (Almeida, 2009a). In the case of Ecuador, both the growth of specific resource allocations until recently (from 13% to 20% of total tax revenue between 1994 and 2006, equivalent to 2.4% of GDP), and the recent total elimination of earmarking of oil revenues, which accounted for 1.7% of GDP in 2006 should be noted (Almeida, 2009b). An opposite situation exists in Colombia, where specific revenue allocations dropped from 72% to 50% between 1998 and 2006 (10.4% of GDP in 2006). Finally, we have a noteworthy situation in Peru, where only 9.2% of total revenues were specifically earmarked in 2006.

FIGURE II.2
SPECIAL REVENUE ALLOCATION: SELECTED LATIN AMERICAN COUNTRIES
(Percentages of total revenue)



Source: Prepared by the authors on the basis of Almeida (2009a and b) and Echeverry, Navas and Clavijo (2009).

3.2 An attempt at typology

Clearly, determining the origin of budget rigidities is not always possible. Moreover, fiscal rigidities are likely to have several different simultaneous causes. It would be helpful, however, to clarify some significant differences regarding the dominant features of each case, in hopes of constructing a typology that is useful for the discussion of fiscal policy in the region.

As noted, the degree of relevance of the different fiscal-policy rigidities should be evaluated based on their priorities and requirements. These necessarily change over time, just as social values and priorities change. For this reason, state budgets contain many components that reflect past agreements and decisions –and there are cases of earmarking taxes that respond to questions that no longer have the same “importance” as they once did– and do not reflect the budget debate where these decisions are made each year (Abuelafia and others, 2005, p. 12)¹² This point should be borne in mind when assessing the relevance of certain budget rigidities and inflexibilities.

It can be argued that many budget rigidities are the product of disputes or struggles over the distribution of resources among different groups or classes. This may relate to the struggle over pursuing differing objectives and is particularly important when fiscal adjustments are needed.¹³ Under these circumstances, the various interest groups attempt to transfer the adjustment costs to others. This view would also explain why budget rigidities remain over time, since they can be a way to protect against loss of income at a time when fiscal accommodations are necessary.¹⁴ Seven groups of rigidities, and the explanations for them, are presented below.

¹¹ Figures for Peru are official.

¹² A related example would be the case, in Chile, of earmarking for defence spending from copper income.

¹³ One way in which this dispute unfolds is the phenomenon of the so-called “waiting wars” between opposing interest groups, which are essentially aimed at avoiding the costs of fiscal adjustments (Alesina and Drazen, 1991, cited in Echeverry, Navas and Clavijo, 2007).

¹⁴ An interesting idea relating to fiscal rigidities is that posed by Schick (1990) (cited in Cabrera and Fuentes (2009)), who introduced the term “sticky” to refer to the fact that fiscal rigidities that favour a particular group or sector are “sticky” for other groups, leading to their propagation.

First, with a long tradition in fiscal policy and with very clear explanations, we have rigidities associated with programmes or policies designed under the *benefit principle*. To the extent there are public policies designed to benefit those who contribute to their financing, it is reasonable that the resources provided are rigidly assigned to these programmes. Indeed, the taxation benefit principle, which stipulates that every individual should help finance government expenditure according to the benefits they derive from public goods and services, is the classic argument to justify the allocation of revenue to certain expenses. Thus, taxes act as quasi-prices and are expected to improve efficiency in resource allocation. The financing schemes of social security systems in the region are an example of the application of this principle. These schemes are contributory because, in theory, only those who contribute benefit from them.¹⁵

Social security systems with tax allocations linked to payment of benefits, which follow the benefit principle –to a greater or lesser extent in each case– are likely the rigidities that have the most profound impact on the budgets of many of the countries in the region. In some cases, they should be understood as deferred salaries (social security) and in others, as wages in kind (health insurance). However, depending on the terms of proportionality set forth in each case and the solvency of individual pension schemes, their use can have significant redistributive effects among taxpayers and those who contribute to the regimes.

The need to redefine the traditional concept of social protection to reach those segments of the population that have difficulty meeting the threshold for receiving contributory benefits, also requires redefining the scope of fiscal rigidities associated with social protection and their redistributive impact. In some cases, pension system crises create rigidities that affect the availability of traditional tax revenue, which, among other things, should be used to finance social welfare benefits for those not covered by social security.

These rigidities also reflect differences between countries in terms of the level of coverage and benefits of these systems, reflecting both the make-up of the labour market in each country and the “maturity” of the systems themselves. For example, in Honduras the rigidities associated with retirement and pensions account for 0.7% of GDP, in Ecuador and Guatemala they account for approximately 1% of GDP, in Costa Rica they amount to 3.2% of GDP and in Colombia they account for 4.1%.¹⁶

A relevant point regarding the fiscal rigidities associated with social security systems can be found in the case of the Plurinational State of Bolivia. In 1996 the country embarked on process of reforming its pension system, moving to a system of individual capitalization. Although one of the objectives was to reduce the system’s tax burden, pension expenditure (which in 1997 accounted for 3.2% of GDP) reached 3.7% in 2006 (up from 4.5% in 2002) and still represents 80% of the NFPS deficit, despite the elimination in recent years of various indexation mechanisms. (Almeida, 2009a)

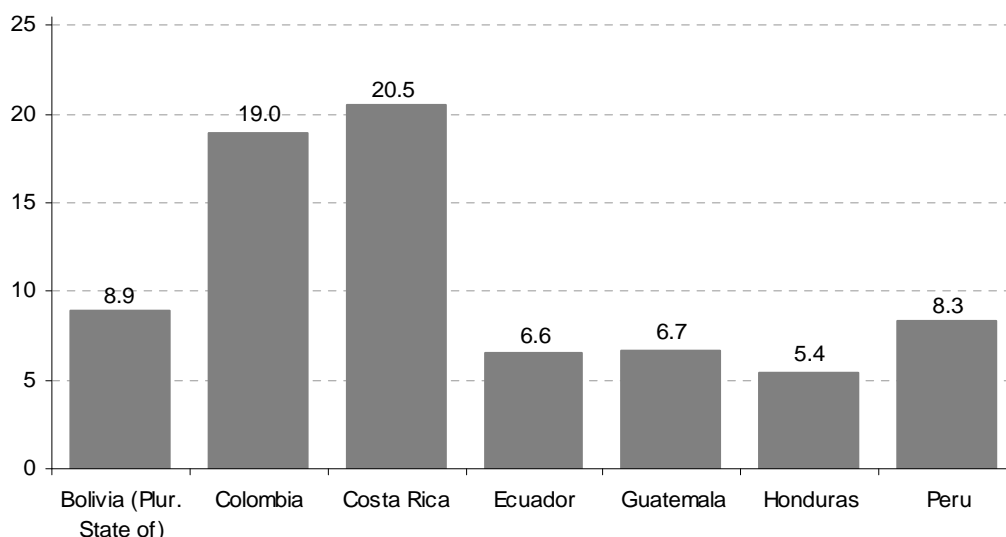
Another case worth mentioning is Colombia, where the social security system –administered by the Social Security Institute– has exhausted the reserves available to meet the shortfall between contributions and benefit payments, such that this responsibility has fallen on the central government, whose contributions are estimated to reach 4.8% of GDP between 2011 and 2014.¹⁷

¹⁵ Though it should be noted that not all social security systems are based on the benefit principle.

¹⁶ The case study of Ecuador reveals the low level of earmarking of tax revenue for the social security system.

¹⁷ See Echeverry, Navas and Clavijo (2009).

FIGURE II.3
LATIN AMERICA (7 COUNTRIES): BUDGET RIGIDITIES AND SOCIAL SECURITY
(Percentage of total spending)



Source: Prepared by the authors on the basis of Almeida (2009a and b), Echeverry, Navas and Clavijo (2009), and Cabrera and Fuentes (2009).

Another case in point of a rigidity related to the benefit principle is when funding for infrastructure costs are paid by those who benefit from the work (such as roadways or power generation) through tax revenue derived from the sale of fuel. Finally, other examples can be found in the funding of certain public services (waste collection services) and payments to specialized agencies, such as regulatory entities.¹⁸

The second category of spending rigidities includes those which address *rights and guarantees established by various types of rules*. In some cases, earmarking based on various legal rules, even the Constitution itself, can be justified using the “merit good” argument.¹⁹ Also, budget rigidities have been justified as a solution to problems of inconsistency over time, which arise when public policies chosen in the past are no longer a priority. In this context, budget rigidities act as rules which limit the discretion of the authorities, thus avoiding an inadequate supply of high-priority goods or services which would benefit society in the long run and represent an expression of social preferences. This argument is used to justify minimum spending requirements and specific resource allocations for social spending, such as in health and education.

Such allocations may be focused on one sector –as an absolute value or as percentage of the budget— or be specific to a particular purpose. The introduction of explicit guarantees of assured supply merits particular attention. In much of the new literature on rights and social policy reforms, such guarantees are considered an important step towards the consolidation of the State, which becomes a guarantor of individual rights, but they simultaneously introduce new rigidities into the budget. Along

¹⁸ Somewhat different in nature, yet related in their operation, are taxes whose rigid allocation to a specific line item acts as a rationale to convince members of parliament to pass them and citizens to pay them. While not exactly the same as income defined by the benefit principle, the two are related, as long as taxpayers feel their preferences for where their tax money is going are being heeded. (See Sevilla, 2004, cited in Podestá, 2007).

¹⁹ The definition of meritorious or priority good is related to the notion that individuals, when left to follow their own preferences, do not always act in a way that society considers to be in their own interest (even if they have complete information, “they act in their best interest”) so that society or government decides which public goods or services should be provided or funded, according to societal preferences that are supposedly above individual preferences (Stiglitz).

these same lines, the definitions of “priority expenditures” or “protected spending” have been introduced in some countries.

Third, we have fiscal rigidities arising from the *relationship between different levels of government*, or the operation of fiscal federalism in each country. In particular, these rigidities stem from allocations included in mechanisms for the transfer of resources between levels of government to cover vertical imbalances. In these cases, even when the recipient government is totally free to use such resources as they fit, different degrees of rigidity exist within each jurisdiction's budget.²⁰ A classification of the basic systems of intergovernmental transfers in the region is presented to illustrate this diversity.²¹ They include:

- Transfers between the Central Government and intermediate governments (Argentina, Bolivarian Republic of Venezuela).
- Transfers between the Central Government and different levels of subnational government (Brazil).
- Systems that include resources derived from natural resources (Mexico, Peru).
- Systems with exceptions (port cities in Honduras).
- Horizontal transfers (Chile).
- Transfers to entities other than subnational governments (universities in the Plurinational State of Bolivia).
- Distribution of funds from debt relief (Plurinational State of Bolivia)

There are also cases, however, of allocations of transfers between levels of government that have some specific sectoral allocation or when new incentive schemes for shared responsibilities are introduced.

The degree of this type of inflexibility partially corresponds to the level of fiscal decentralization, and none of the case studies come from countries with federal structures. While rigidities associated with transfers from the national level to subnational or local levels total 0.5% in Honduras, 1.4% in Guatemala and 2.7% in Ecuador, in the Plurinational State of Bolivia (where significant fiscal decentralization has occurred), such rigidities amount to 10.7% of GDP, with considerable amounts of social expenditure (which denotes the transfer of functions by the Central Government). Conversely, these rigidities are much smaller in the case of Costa Rica.

Another important case regarding fiscal decentralization is Colombia, where despite the fact that rigidities associated with decentralization total 4.9% of GDP (less than half that of the case of the Plurinational State of Bolivia), the transfer of resources began with the 1993 Constitutional reform and is stated to grow, which has led to various negotiating processes to “loosen” the fulfillment of this rigidity, despite its constitutional status.²²

In the case of Ecuador, the progressive degree of decentralization, particularly after the passage of the 1998 Constitution, has been reflected in increased allocations to regional governments, which went from about 17% of current revenues in 2001 to almost 32% in 2007.²³

Another case that highlights the constitutional status of allocations to local governments (municipalities) is Guatemala, where “constitutional contributions” are accompanied by the earmarking of the so-called “Peace” Value Added Tax (IVA-PAZ) which resulted from the peace processes in the early nineties.²⁴

²⁰ The consolidated public-sector accounts are not considered.

²¹ This classification was taken from Cetrángolo (2007).

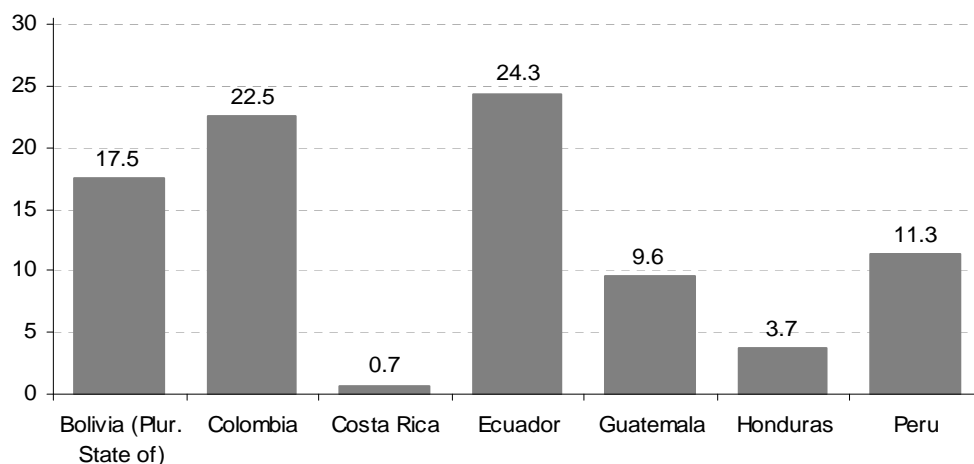
²² See Echeverry, Navas and Clavijo (2009).

²³ See Almeida (2009b).

²⁴ See Cabrera and Fuentes (2009).

Figure II.4 demonstrates the differing weight of transfers to subnational governments in the various cases considered.

FIGURE II.4
LATIN AMERICA (7 COUNTRIES): BUDGET RIGIDITIES
AND INTERGOVERNMENTAL FISCAL RELATIONS
(Percentage of total spending)



Source: Prepared by the authors on the basis of Almeida (2009a and b), Echeverry, Navas and Clavijo (2009), and Cabrera and Fuentes (2009).

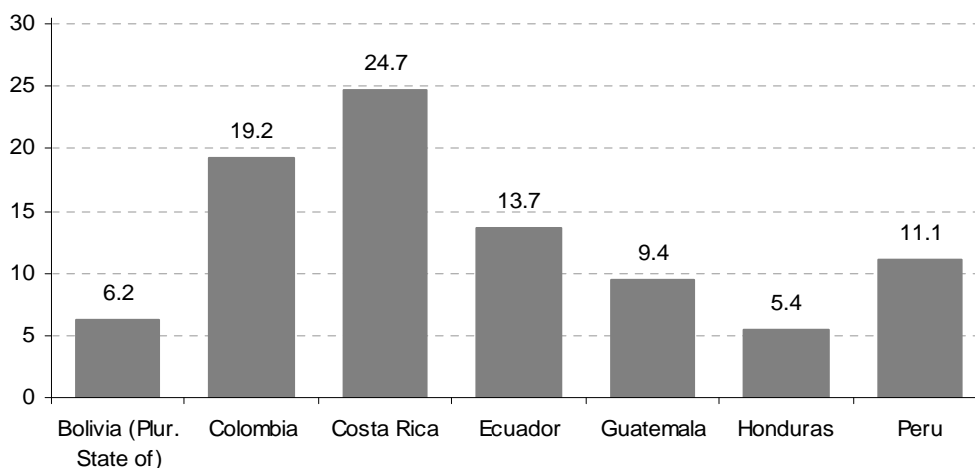
Fourth, consideration should be given to fiscal-policy rigidities associated to *macroeconomic dynamics*. This general category includes several specific modalities. First, we have the pressure exerted by debt-servicing payments on the public accounts of the countries of the region. Debt servicing is usually considered an expenditure of the highest priority. It could be argued that this issue involves an intergenerational conflict, in that rigidities arising from debt servicing could be understood as a way of prioritizing the consumption of the current generation over that of future generations.

From 2003 to 2008, the burden from interest payments declined in the countries of the region in line with the reduction in the ratio of public debt to GDP (which reached about 32% of regional GDP) (ECLAC, 2007) easing this type of rigidity. It has not, however, ceased to have an impact on the countries' fiscal management. In Ecuador, public debt service represented 11.2% of GDP in 2006, while it reached 4.2% of GDP in Colombia. In the Plurinational State of Bolivia, debt service has been falling over time, reaching 8% of GDP, and has been accompanied by a declining share of foreign interest (which can be attributed to multilateral debt relief).

A country where the weight of this constraint has declined over time, as a result of fiscal health in recent years along with various changes to public debt management, is Peru, where public debt service makes up only 1.8% of GDP.

Finally, in the case of the Central American countries considered, the weight of public debt interest also shows important differences: while in Honduras, interest payments make up only 0.7% of GDP (reflecting a situation that is similar to but more intense than the case of the Plurinational State of Bolivia); Costa Rica's debt-service burden is very high, exceeding 8% of GDP. Thus, according to Cabrera and Fuentes (2009), this expenditure constitutes the principal budgetary rigidity in these two countries.

FIGURE II.5
LATIN AMERICA (7 COUNTRIES): BUDGET RIGIDITIES AND DEBT INTEREST
(Percentage of total spending)



Source: Prepared by the authors on the basis of Almeida (2009 and b), Echeverry, Navas and Clavijo (2009), and Cabrera and Fuentes (2009).

In addition, budgetary constraints arising from the existence of inflation-adjustment clauses for various expenditures (especially wages and pensions) must be considered.²⁵ These mechanisms have varying degrees of legal force and, even when they are not legally binding, there may be political rigidities that are as or more difficult to reverse.

Finally, in relation to the macroeconomic situation, it is conceivable that if solvency problems are caused by the presence of “excessive” spending rigidities in quantitative terms, their existence –which is often justifiable for distributive reasons– would be in conflict with other fiscal-policy objectives such as stabilization or solvency. Thus, there are fiscal rigidities that respond to different fiscal-policy objectives.

Therefore, the list of causes of fiscal rigidities must include the loss of flexibility due to the necessary relationship between fiscal policy and the economic cycle. As has been clearly seen in recent years in the region, the high degree of volatility of the macroeconomic variables that underlie public sector financing (GDP, consumption, commodity prices and foreign savings) requires the design of acyclical fiscal policies, whose aim should be to dissociate fluctuations in revenue –heavily influenced by the economic cycle– from actual expenditures, which undoubtedly means a lower degree of freedom in fiscal policy.

The countries of the region have sought different solutions to this dilemma, from discretionary fiscal-policy decisions to more institutionalized mechanisms, such as tax rules and stabilization funds. In addition, coinciding with the rise in prices for non-renewable goods and their consequent impact on tax revenues, many countries have recently discussed different mechanisms to regulate the use of surpluses generated. The importance of this rigidity and the ability to meet fiscal-policy objectives that address such cycles will vary according to the policy itself and the institution that implements it. Stricter regulations do not necessarily ensure they will be effectively implemented.

The preceding overview of rigidities and differences between different fiscal-policy objectives is related to the existence of “conflicts” between different types of rigidities within a single fiscal-policy objective: there are some who, in promoting the achievement of fiscal solvency, would challenge the

²⁵ See Cetrángolo, Jiménez and Ruiz del Castillo (2009).

rigidities associated with adjustment clauses in social spending, while at the same time defending the establishment of fiscal regulations, that is, another kind of rigidity.

Fifth, there is a consensus that when a country receives *extraordinary income* no particular allocation should be mandatory and, the use of such income to finance current expenditures should be especially avoided. This is precisely where space is created to discuss the allocation of such revenue, which often involving some kind of rigidity. For example, in some countries we have the case of revenue derived from the exploitation of non-renewable goods (which deserves particular attention because of its volatile and exhaustible nature); of extraordinary resources derived from the privatization of public enterprises; of income generated through multilateral debt-cancellation initiatives (heavily indebted poor countries (HIPC) y Multilateral Debt Relief Initiative (MDRI) and in general, numerous programmes developed with assistance from multilateral lending institutions which attempt to ensure the proper use of funds by building rigidities into their use.

The first case, according to Almeida (2009b), is relevant in Ecuador, where in the period 1994-2006 oil revenues accounted for an average 6.4% of GDP and 27.7% of total revenue. In addition, out of total oil revenues, on average between 2004 and 2007, only 46.8% remained within the state-owned firm Petroecuador, and 29.2% was allocated directly to various agencies and special allocation funds. In particular, most of these resources are allocated to regional governments (57.4% of the total or 0.3% of GDP) and the Armed Forces (27.6% of the total distributed or 0.1% of GDP). In April 2008, legislation was passed that eliminated all earmarking and routed all resources of this nature to the Central Government budget. The main argument for this decision, which translates into a significant reduction in the rigidity of income, has been the underutilization of resources in the oil funds involved, which has put limitations on fiscal management.

In connection with the assistance programmes of multilateral lending institutions, resources may be used for purposes that Governments consider relevant or necessary according to their own public-policy agendas and with significant “external” constraints, as in the cases of the Plurinational State of Bolivia and Honduras. In particular, in the Plurinational State of Bolivia, in the period 1994-2006, half of public investment came from external funding sources (up to 66% in 2004, although this figure has declined as tax revenues have recovered in recent years). A similar situation has occurred with funding from international cooperation resources, particularly in the cases mentioned above.²⁶ Thus, the case in Ecuador is also worth mentioning, where there is a significant dependence on infrastructure investment based on foreign credit (nearly 20% of total capital expenditure).

Sixth, there is a diverse group of rigidities associated with *disputes within the public sector itself*. While it is true that all rigidities are, to a greater or lesser extent, manifestations of conflicts between groups that exert pressure on public budgets, there are some cases in which the dispute is not a product of the justifications linked to the groups described above. Rather, justifications are made based on the mere understanding that certain spending objectives are more important than others –which requires the relatively explicit establishment of such priorities– or the need to focus on certain specific expenditures.

As a result, the first subgroup consists of explicit budget rigidities that have been justified as a means of ensuring adequate and timely funding for priority expenditures, such as various types of social, judiciary, legislative or defence spending. The struggle over the establishment of this type of rigidity can become particularly intense during times of financial difficulty or insolvency. It becomes, in essence, a question of each sector attempting to keep their neck off the budgetary chopping block.

In Ecuador, since 2004, this type of rigidity has accounted for approximately 4.3% of GDP. In Costa Rica, in 2006, ear-marking for the judiciary reached 6.4% of current expenditures. In the case of the Plurinational State of Bolivia, these values have gradually decreased from a high of 4.6% of GDP in 2001 to 3.3% of GDP in 2006.

²⁶ In fact, in the case of the Plurinational State of Bolivia in 2006, international cooperation funds exceeded US\$ 200 million, or 2% of GDP. See Almeida (2009a).

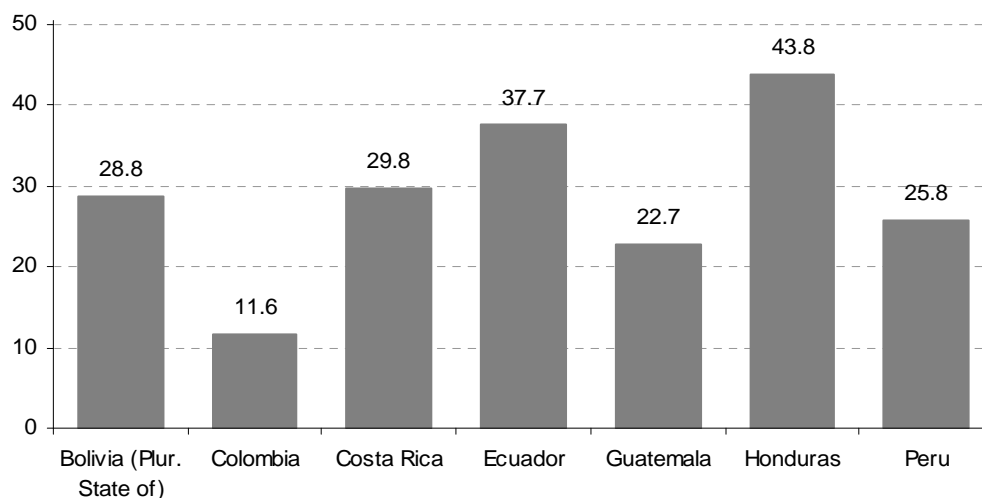
Within this subgroup we also find the specific allocation of resources which are justified as a way to improve the efficiency of certain state agencies, such as earmarking a small fraction of tax revenues to the tax authorities (Allier, 2006). We could also include the cases mentioned above, where various agencies are partially self-funded.

The Internal Revenue Service in Ecuador receives 1.5% of the taxes it collects; in the Plurinational State of Bolivia this percentage is 1%. The case of Honduras is notable in that 2.5% of all tax revenues are earmarked to the tax authority itself.

The second subgroup refers to rigidities that are less explicit but at times just as severe owing to the political difficulty inherent in modifying certain earmarks. These, essentially, are civil servant wages, since other government operating expenditures (such as consumer goods and services) tend to be modifiable in times of fiscal difficulties despite the need to carry out any number of operational functions.

As previously mentioned, the importance of rigidities associated with public sector operations (which are essentially public wages) should be highlighted. Among others, we have the case of Honduras, where this line item accounts for 43.6% of spending,²⁷ while in Costa Rica and Guatemala, the figures are 29.8% and 22.7%, respectively. Similarly, in Colombia they make up 19.7% of total Central Government expenditures, while the figure is 25.8% in Peru (28.9% if regional governments are included). Clearly, in the case of Honduras, public wages constitute the principal budget rigidity.

FIGURE II.6
LATIN AMERICA (7 COUNTRIES): BUDGET RIGIDITIES AND WAGES
(Percentage of total spending)



Source: Prepared by the authors on the basis of Almeida (2009a and b), Echeverry, Navas and Clavijo (2009), and Cabrera and Fuentes (2009).

One important consideration would be the level of capital-spending rigidity found in the cases of Colombia and Peru. In particular, a high degree of flexibility could be expected in both cases, however, in Colombia, the Ministry of Finance and Public Credit itself considers 65% of all investment expenditures inflexible, while in Peru the estimate reaches 76.3% (Echeverry, Navas and Clavijo, 2009).²⁸

Lastly, a seventh group of rigidities has been identified and included in this category even though they are not traditionally a part the budgetary structure. This category includes rigidities that are *implicit*

²⁷ In the case, salaries in the field of education are particularly important.

²⁸ In the cases of the Plurinational State of Bolivia and Ecuador, all capital expenditure is considered inflexible.

in fiscal policy through incentive programmes for specific sectors or productive activities by means of tax breaks. Since they are what are known as “tax expenditures”, they must be treated as rigidities that are not clearly spelled out in budgets.²⁹

According to available and documented official estimates, in the case of Guatemala, tax expenditures accounted for 63.5% of current income in 2006. In the case of Ecuador, official estimates for 2005 reveal that tax expenditures corresponding to VAT reached 2.6% of GDP, while that of income tax was 1.2% of GDP for the same year. Peru’s total tax expenditure equalled 2.6% of GDP in 2006, whereas in Colombia, the official estimate shows a fiscal cost of 1.4% of GDP in connection with income tax.

In summary, seven categories of rigidities have been described and are summarized in Table II.2. This classification has allowed for a differentiation in each case study of the causes of the rigidities and their main characteristics. It is possible, however, that the reasons or justifications may overlap in some cases.

TABLE II.2
CLASSIFICATION OF FISCAL RIGIDITIES ACCORDING TO MAIN CHARACTERISTIC

Main characteristic	Specific types found
1. Benefit principle	Social Security Infrastructure funding Funding of specialized government agencies
2. Rights and guarantees established in various kinds of regulations	Meritorious goods More or less generic rights Guarantees of assured supply Priority or protected spending
3. Intergovernmental relations	Basic transfer systems Transfers with sector-specific allocations Other transfers between levels of government
4. Macroeconomic dynamics	Payment of debt service Clauses for wage adjustment, assets and others Countercyclical fiscal policy
5. Extraordinary income	Non-renewable resources (royalties, etc.) Privatization of public enterprises Debt-relief programmes Loans from multilateral lending institutions
6. Other disputes within the public sector	Explicit priorities (Judiciary, Legislature, spending priorities, etc.) Politically inflexible expenditures (wages and other operating expenses)
7. Implicit in fiscal policy	Tax expenditure

Source: Prepared by the authors.

4. Recommendations and final thoughts

This paper has attempted to provide a comprehensive overview of fiscal rigidities in several Latin American countries. Beginning with a presentation of the concept of fiscal rigidity or inflexibility, an attempt has been made to evaluate the various reasons for their appearance and persistence over time, followed by a typology of budgetary rigidities that would allow for a comparative analysis of the experiences of seven countries in the region that were selected as case studies.

In addition, the possible effects of fiscal rigidities were reviewed, bearing in mind the importance of analyzing rigidities not only in terms of how they limit the autonomy of fiscal-policy management, but also by taking into account the objectives that these rigidities are created to address (which are related to the

²⁹ For additional details regarding the difficulties in measuring “budget expenditures”, see Jiménez and Podestá (2009).

reasons for their emergence). In this sense, it has been pointed out that rigidities should not be assessed only in terms of their limitations on freedom in discretionary decision-making by fiscal authorities.

We have seen that the countries of Latin America and the Caribbean were able to create more fiscal space at the beginning of the decade (until the outbreak of the international crisis), which was reflected in increasing primary surpluses and the reversal of overall deficits and steady declines in public debt/GDP ratios, driven by the growth of Latin American economies and greater relative increases in tax revenue.

4.1 Some recommendations with respect to different types of rigidities

When reviewing fiscal rigidities according to their main characteristics, clear differences emerge between countries indicating which fiscal-policy objectives were sought in each case, and which sectors, groups and levels of government tended to prevail. Particular attention has been paid to the relative weight of some pertinent rigidities, as is the case of rigidities associated with public-sector operations (wages), those related to transfers to social security systems and to other levels of government, and those associated with debt service.

Bearing in mind that fiscal rigidities should be evaluated or classified in light of a broad group of public-policy objectives, a more complete understanding of them could help identify the challenges inherent in fiscal policy when attempting to better meet these objectives which, along with the necessary fiscal pacts, must be constructed and consolidated in our countries.

The typology presented here provides some insight as to how to shape fiscal-reform policies to address this type of rigidity in public budgets. The classification of rigidities according to their main characteristics allows for a discussion that goes beyond mere numbers, which reflects the difficulty of modifying a specific budget line-item and shifts the discussion to the conceptual framework most appropriate in each case. Thus, a set of recommendations broken down by type of rigidity can be found below.

First, in the case of rigidities arising from earmarks related to the “benefit principle”, it would be inappropriate to consider any constraints arising from the rigidity in and of itself. Rather, those sectoral policies that include rigid allocation of resources should be redefined. This is particularly true in reference to the reforms to and modernization of social security systems to achieve social protection schemes that are more suited to the new challenges that our societies face.³⁰ In contrast, in the case of funding for infrastructure projects, particular care should be exercised in defining the use of funds and the duration of the rigidities.

Secondly, the existence of rigidities associated with different types of rights and guarantees – whether or not they are related to “merit” goods– calls for an explicit definition of guaranteed rights, so they can be effectively enforced. Of course, this will require a discussion about the funds available to finance such guarantees in a clear and accessible way, and will, at the same time, result in a complex debate about the limits of such guarantees. There are many examples in the region of rights that are broadly defined and are inevitably not clearly enforced by States.

The third group of rigidities comprises those associated with the financial relationship between different levels of government. In this case, there is no shortage of literature on the reforms required although, clearly, there is no broad consensus either. Suffice it to say that the issue of fiscal federalism and processes of decentralization have more to do with the political organization of each nation than with economic theories. However, efforts must be made to improve the impact of decentralization and to ensure that transfers are as efficient and equitable as possible.³¹

³⁰ See ECLAC (2006).

³¹ See Cetrángolo (2007) for a debate on the decentralization processes in Latin America.

Fourthly, the existence of rigidities associated with macroeconomic factors calls attention to the need to redefine the operation of such rigidities to ensure long-term fiscal solvency. In particular, the institutionalization of countercyclical fiscal mechanisms (either in the form of structural balance laws or contingency funds), although they are understood as an additional rigidity, is increasingly necessary given the high volatility of tax revenue.

Rigidities associated with the presence of extraordinary income (the fifth group) lead to three types of comments. First, it is clear that, to the extent possible, resources should not be used to finance current expenditures that would be difficult to sustain once the revenue shrinks or disappears. Second, the region has significant experience with the need to establish some sort of stabilization fund for these resources. Finally in the case of resources provided by multilateral lending agencies, States should not undertake projects that already have funding, but rather fund those policies that are understood to be most reasonable.

The last two groups are undoubtedly the types of rigidities that should be eliminated most quickly. The sixth group includes, essentially, rigidities stemming from defensive public-sector policies in the face of encroachment from rigidities linked to other functions. Only a frank discussion of public-budget priorities will enable these to be acceptably managed.

Let us not forget one relevant fact: whenever a sector manages to introduce a rigidity to protect its budget over other line items, efforts will be made to make the “protected” item as flexible as possible within that sector. In extreme situations, when fiscal adjustment is looming, each area will fight hard to make their budget externally rigid and internally flexible. However, the justification used to “stiffen” a particular line-item may end up introducing constraints on the budget of its own sector, generating a new source of disputes and inefficiencies.

Finally, any attempt to make explicit the effects of public policies that are now implicit in the tax structure will be an indispensable step towards rethinking the rationality of all earmarks.

4.2 Final note on the role of the State in addressing fiscal rigidities

When evaluating the establishment and maintenance of fiscal rigidities, the dynamic of the budget process itself should be considered. In particular, attention should be paid to the interaction between the Executive and Legislative branches (the institutional actors involved in the process), and to a lesser extent, the judiciary. Understanding how this interaction takes place, that is, the role of these two branches of government in the formulation, approval, modification and implementation of government budgets, helps to identify, at least in part, the source of budget rigidities. While not attributing the formation of fiscal rigidities to different branches of government, it is still important to understand that rigidities will emerge in different ways, depending on how the budget process game is played and on the institutional actors involved.

Based on how these roles or powers are defined, it is possible to speculate on the relationships involved in the “subgovernment” of the budget process, a critical issue for understanding what the institutional agenda is and how it is reflected in the public budget. In terms of the existence and persistence of fiscal rigidities, understanding who has more or less ability to influence the budget process (where such rigidities are reflected) is critical. In essence, knowing who has more power in the budget process also reveals who has more “discretionality” to establish fiscal rigidities, and allows for a qualitative assessment (meaning the degree) of their “rigidity.”

The stages of the budget process can be summed up as the development, approval, implementation and monitoring and evaluation of income and expenditures. In the budget formulation stage, the Executive and Legislative branches have different roles. The Executive is essentially tasked with budget formulation, and while the legislature may become involved at this stage, the fact is that the

Executive and the Legislature branches have vastly different analytical and technical capabilities. In fact, these differences impact the role of Congress in the remaining phases of the budget process.

The majority of budgetary changes are made during the implementation stage by the Executive, which, depending on the circumstances and powers conferred in each case, tends to give more power to this branch of government. There are several reasons for this. First, discretionary use of the budget instalments (quotas) system³² and underestimation of resources, which allows more resources than budgeted to be left to the Executive Branch, can lead to large discrepancies between the public budget actually implemented and the budget approved by Congress.

Second, due to different rules regarding the pre-budgetary process (which clearly differs between countries), parliaments have a limited role in budget reallocations which are handled mainly within the Executive Branch. In addition, extra-budgetary funds of various kinds are often created, in order to “liberate” the management of a portion of public funds.

Thus, there are various indications that there could be major discrepancies between an approved budget and what is eventually implemented. Therefore, the ability of ministries and agencies to protect their budgets (a function of the technical quality and expertise of their bureaucracy) becomes quite relevant (Abuelafia and others, 2005). This point is linked to the notion of “subgovernment” in the budget process discussed above, and in fact becomes important for understanding the “discretion” available to establish or eliminate fiscal rigidities in practice and to understand how they are maintained over time.

An important point to consider in the formation of rigidities in the routine budget process is that allocations and cuts for future fiscal years are usually based directly on usage during the current fiscal year (Molinas and Perez Liñán, 2005). This often leads public agencies to utilize resources for programmes or activities that may not be public-policy priorities rather than “lose” funding through fiscal adjustments, with the expectation that they will be able to reallocate those resources in future years.

The next stage in the budget process is evaluation and monitoring. In this stage agencies tasked with budget oversight play a critical role. Their ability to effectively do their job –which consists, inter alia, of reviewing the allocation of resources in accordance with the budget (which also implies monitoring the “fulfillment” of budget rigidities)– depends on several factors, including: their legal status and charter, the mode of appointment and renewal of their members, the scope of their jurisdiction, whether or not they have budgetary self-sufficiency, their authority to investigate and sanction and others.

In short, the situation of the countries of Latin America in relation to the powers of allocation or reallocation of budget items is characterized by the fact that the Executive Branch handles budget formulation in a particular fiscal year, while approval of the budget falls to Congress. In this case, the powers of the legislature to make changes to both the total level of resources and expenditure and the composition of the budget vary between countries: while the former is possible in some countries, the level of expenditures budgeted by the Executive cannot be modified in others.³³

It is also relevant to consider how budget reallocations are treated and how potential additional resources (primarily as a result of higher than estimated tax revenue) are handled. In this case, the alternatives are that Congress play a role in allocating the additional resources, or that the Executive has complete freedom of allocation.

Several studies on the subject have yielded conflicting results regarding the weight of the Executive and Legislative powers in the budgetary process. For example, in the case of Peru, Echeverry, Navas and Clavijo (2009) emphasize the predominant role of the Executive in the budgetary process, based on the

³² The system of budget instalments (quotas) is an operational system which regulates the pace of budget implementation. Essentially, existing budget loans are divided into quarters, thus allocating resources according to public sector financial planning. In practice, determining which agencies receive their entire budget instalment (quota) (an Executive power, usually through the Treasury or the Ministry of Finance) is a de facto method of budget allocation.

³³ See Rodríguez and Bonvecchi (2004). Likewise, for a broad overview of the most important experiences and reforms in the budgetary processes in the region, see Martner (2008).

powers conferred by the Constitutions of 1979 and 1993. Meanwhile, Cabrera and Fuentes (2009) refer to the greater role or weight of the Congress in the budgetary processes in Costa Rica, Guatemala and Honduras. A similar point was made for the case of Paraguay by Molinas and Pérez Liñán (2005), who highlighted the “fuzzy” role of the Executive Branch, associated with institutional changes at the beginning of the decade.³⁴ Although understanding why one branch has more power than others in different countries is relevant, it is beyond the scope of this work.

A final point to consider regarding the management of the budget process and the “effective” level of fiscal rigidities is the role of the judiciary. As noted in Eslava (2006), this issue has not been sufficiently addressed in the literature. However, the ability of the courts to define the constitutionality or legality of various tax and spending initiatives, as well as their ability to demand other branches of government take actions to guarantee various constitutional rights, demonstrate the importance of the role of the judiciary. In this regard, it is very interesting to note the point made by Cabrera and Fuentes (2009) regarding the importance of judicial oversight in various fiscal rigidities in the case of Costa Rica. Future lines of study should comprehensively address to what extent the level of fiscal rigidities depends on the scope and power of the judiciary in each country.

³⁴ For the case of Argentina, both Bonvecchi and Rodríguez (2004) and Abuelafia and others (2005) mention the relatively smaller role of congress in the budget process. Alston and others (2008) refer to the greater role of the Executive in managing the budget process, while also highlighting the interaction between Executive Branch initiatives aimed at fiscal stability (through new or higher taxes) and the “concession” to congress to create partial earmarks (i.e. fiscal rigidities).

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