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The public sector's role *in Latin American* development

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The public sector's role in the development of the Latin American countries is undergoing a big change. The system of State action and intervention which arose after the Second World War came to an end in the early 1980s, when the debt crisis forced the end of a cycle and the beginning of a process of adaptation to new circumstances. This article seeks to outline the main changes that have taken place in the State's role and to analyse the causes giving rise to the public sector's new operating model. The availability and reactions of the financial markets were of decisive importance both in the external adjustment process and in the phase that followed it, when the region regained its access to credit. The conduct of investors and suppliers of funds –both domestic and external– has helped to delineate the space open for the formulation of policies which, after various attempts and in manners which vary from one country to another, have considerably changed the mechanisms of the public economy. The author concludes that the basic attributes of the new system are as follows: the private sector is now the main factor in the mobilization of saving and investment, while the provision of social services –albeit under different forms of management and financing– remains the responsibility of the public sector, but with increasing decentralization of taxation and public expenditure and with different assumptions regarding the design of the tax system. The configuration which is thus emerging has not yet taken on its definitive form, but the parts that make it up include some elements that seem likely to endure in the medium and long term. There has undoubtedly been a profound change in the type of public economy with which the world was familiar up to the 1980s.

I

The need to take a backward look

The functions and role played by the public sector in the development of the Latin American countries, particularly from the end of the Second World War to the early 1980s, are currently undergoing far-reaching changes. These are easy to see and are reflected almost every day in the issues and news items that keep alive the ongoing discussion on public policies in the various countries. The fact that the changes are so great and obvious does not mean that we do not need to try to interpret the phenomenon which is under way, however. A phenomenon like this, which goes beyond

the globalization of economic trends and tends to eliminate the intrinsic elements and special features of countries, is reflected in a particular way in the case of Latin America.

In order to appreciate the nature of the current changes in the role of the public economy in the region, it would seem desirable to begin with a backward look, not in order to make a historical retrospect, but simply to clarify the differences and also try to determine what has caused the changes in the functions of the public sector in the Latin American economies.

II

The public sector: the mobilization of saving and investment and its effects on growth

For a start, and as a point of reference for our analysis, it is worth recalling Musgrave's classification of the functions of the public sector: allocation, distribution and stabilization. These three categories are usually used to justify from the economic standpoint the way resources are absorbed and their subsequent application through public expenditure. In analysing these three dimensions, the question arises as to which of them seems to have predominated in inspiring the guidelines and policies which shaped the public sectors of the region from the end of the Second World War onwards. The hypothesis put forward in this article is that none of the three provides a satisfactory explanation. Indeed, it could be asserted that the scheme underlying Musgrave's classification is

not the most suitable one when analysed in retrospect.

The concept that gradually shaped the actions and dimensions of the Latin American public sectors actually had quite a different starting point: the challenge faced was invariably the pursuit of development and the speeding-up of the processes of growth and industrialization. The weak point in the efforts to attain these objectives was the external fragility of the economies, which became the dominant concern in the economic policy of the region from the 1930s onward. There were many factors influencing this external dependence: financing cycles, the fluctuations in prices and demand affecting exports of natural resources, the backwardness of agriculture—where the land tenure structure encouraged rent-seeking— and the draining-off of resources through the transfer of profits abroad. Within this general context, the public sector gradually acquired an increasingly important role in the mobilization of saving for, on the one hand, the formation of basic capital in those economies and, on the other, the broader provision of pub-

□ The views expressed in this article are of a personal nature and do not necessarily reflect those of the institution for which the author works.

erably broader and were seen in more dynamic terms. Fiscal policy instruments, which were used in different ways and to different extents, went beyond the mere correction of market flaws or the desire to correct inequalities in income distribution through the supply of socially desirable goods or through taxes and transfer payments. As already noted, the backdrop to the vigorous growth of the Latin American public sector was the challenge of promoting growth in spite of markets whose flaws derived not so much from the traditionally accepted reasons as from the inherent features of underdevelopment.

This public sector task of mobilizing saving and acting as the main motive force for investment was carried out through the use of various instruments. Thus, public sector surpluses were generated by using sources which had been found to be effective: collection of monopoly rents (generally channeled through State enterprises engaged in the exploitation of natural resources); use of the current saving generated by the production of those public services (electricity, rail transport, etc.) which could continue to take advantage of the initial investments made (generally foreign) and did not yet require major expansion or renewal; social security funds –pensions and health insurance– which benefited financially from horizontal expansion and the ongoing incorporation of new members; and the attraction of external saving in periods like the 1950s and 1960s, when the few resources available to the region came from official sources.

The resources thus collected were put to different uses: significant expansion of various social programmes in such areas as health, housing and secondary and higher education; the establishment of enterprises in various sectors of industry, or majority equity participation in branches which –according to criteria which did not always agree with each other– were considered to be of key importance (iron and steel, petrochemicals, cement, etc.). In many cases, the new public enterprises or government agencies were also made directly responsible for promoting the development of whole regions and building up new infrastructure (communications, highways, energy generation, etc.). Public resources also served to assist private investment: directly, through industrial promotion systems, and indirectly (by way of relative prices), through the financial system and tariff protection.

If judged by its main objectives mentioned above and its performance from the post-war period up to the end of the 1970s, this strategy gave by no means insignificant results. The public sector eventually became an important factor in capital accumulation, aided industrial development, and promoted the establishment of a broad system of social services. The usual reservations are called for, of course, regarding the pronounced differences between the individual countries of the region. This description undoubtedly fits the larger Latin American economies better, where industrialization policies were applied to a fuller extent.

III

Sources of tension: the constraints affecting the region

In addition to outlining the evolution described above, however, mention should be made of some features which, when judged with hindsight, are seen to be elements of growing tension which were to become critical constraints in the 1980s.

Firstly, little importance seems to have been given to the role of fiscal policy as an anti-cyclical instrument. The fiscal variables were not generally approached with the degree of flexibility and freedom of action needed to allow them to serve as a corrective to economic cycles. This is partly due to

the circumstances and manner of generation of cycles: in most countries, these were associated with external shocks, which reduced the possibility of offsetting them through fiscal instruments. At all events, the role assigned to the public sector in the saving and investment process meant that the macroeconomic restrictions to which it had to adapt itself were frequently forgotten. The clear inflationary syndrome suffered by a number of Latin American economies in those years is partly associated with the laxity of fiscal policy. This laxity, in turn, arose from

the concurrent –and excessive– demands simultaneously weighing on the public sector. The impossibility of meeting all these demands, which led to heavy fiscal imbalances, was not a recurrent or uniform feature, however. It is no accident that fiscal deficits got worse in the mid-1970s. In the years before this, there was a certain degree of balance between the cost of dealing with the multifarious functions covered by the government budget and the availability of the various sources of State revenue. When this balance was broken on one side or the other, the public sector suffered from financial imbalances. In some countries these gave rise to severe difficulties in short-term macroeconomic policy, leading ultimately to episodes of inflation.

Secondly, little importance tended to be given to the distortions in resource allocation associated with the various forms of State intervention. There are any number of examples of this: the tax system pursued various contradictory objectives, often against a background of unsatisfactory tax administration (industrial promotion, incentives for the self-financing of enterprises, complex regulations of dubious effectiveness in taxes on consumption, etc.); there was misuse of cross-subsidies in connection with the prices and charges for public services, and financial resources which were supposed to form reserve funds to guarantee rights granted by the public sector itself simply evaporated (pensions systems are the clearest example of this).

Thirdly, the whole public intervention model was applied in a highly centralized manner, even in

countries with federal-type institutions. Here, too, various kinds of factors may be identified which help to explain these tendencies. The way the territory was occupied and the institutional legacy on which the State was built were undoubtedly important factors in this. Centralism was also favoured, however, by the recurrent presence of military governments which, because of their own political concepts and the circumstances in which they acted, tended to place obstacles in the way of local-level institutions and forms of democratic participation.

Finally –although the above list could be made considerably longer–, the accumulation of public capital and the various forms of intervention involved losses of productivity, mainly because of shortcomings in State management itself. These losses were not seen as costs that could be avoided, however, for the public sector was often the only actor and participant in many areas and sectors of production of goods and services. There was a lack of a private sector which could serve as a yardstick and comparison for the public sector economy and act as a source of competitiveness and efficiency. There was another reason for playing down the importance of possible losses of productivity, however: resources (savings) were effectively available and the limitations imposed by the overall public sector budget did not endanger the strategy as a whole. In short, although the progress made in expanding the area of State activities was accompanied by losses in terms of resource allocation, these did not represent a source of concern for economic policy.

IV

The 1982 crisis. The end of a cycle, and the need to adapt to new circumstances

Almost without exception, the model described above ceased to be applied in the region in 1982. It came to an abrupt end which was associated with the external payments crisis which began in Mexico and subsequently spread to the rest of the region. The exception, of course, was Chile, whose evolution was only partly affected by this situation. Like the rest of Latin America, Chile felt the real and financial impact of the debt crisis, but that country had already

begun its economic reforms –especially those concerning the role of the State– in the second half of the 1970s.¹

¹ The experience of other Southern Cone countries in those years is not as important for the present analysis of the economic functions of the public sector, because although their reforms were concentrated on trade and financial aspects they did not alter the main lines of the public economy.

Although the events which took place from 1982 onward put a sudden full stop to the functions which the public sector had carried out up to then in the economic and social development process of the countries of the region, this change did not take place instantaneously. As we shall see below, the new elements making up the model have been taking shape gradually since then, at rates and in forms which differ from one country to another. Before dealing with this new configuration, it is worth emphasizing three aspects regarding the circumstances and factors fostering the change.

Firstly, it should be noted that, as in the earlier cycle of the 1930s, it was the impact of external shocks which set off the change. There is no counterfactual intention in this assertion. It is impossible to surmise how the model in force up to then would have reacted if the debt crisis had not occurred. As already noted, the public sector had been running into difficulties on the financial level, in the macroeconomic context, and in aspects of a sectoral nature in various countries of the region. It cannot be ruled out that these conflictive dimensions might have led to the application of corrective policies. However, this is a conjecture which is not open to analysis and the known facts indicate that what promoted the mobilization and change was not an awareness of the problems that had been building up in the public sector but a substantial change in external financial flows and the need to adapt rapidly to the new circumstances.

Secondly, it is noteworthy, at least in a first analysis, that the policies adopted by the Latin American countries after the debt crisis followed a more or less parallel course to the changes taking place in the developed world. In the first half of the 1980s, neoliberal type approaches had gained force, especially in the United States and Great Britain. Under these approaches, radical measures were formulated and applied in various spheres of economic management. The increased inflation, recession and unemployment that followed the two bouts of oil price rises in the 1970s shaped the basic context in which this revision of the model in force up to then took place. This broke a tendency which had been in effect since the postwar years and which consisted of the combination of Keynesian instruments for managing aggregate demand with the development of the Welfare State. The conception of expenditure and taxation adopted reflected this model in its macroeconomic and microeconomic design.

The change in course that took place in the developed countries was accompanied by a debate on the efficacy, economic cost and social consequences of the model which had been followed up to then. It is hardly surprising that in the new context, where the real facts did not readily fit in with the assumptions and results of economic analyses, a fundamental change was proposed in the role of the public sector. The debate invaded and enlivened academic circles, but it also went beyond them, entering strongly into the midst of the political discussions.

Because of the severity and magnitude of the crisis in Latin America, the sequence of events there was very different from that observed in the developed countries. The debate was more pragmatic and offered fewer incentives for a discussion in depth of the limitations of the path followed up to then and the new conceptual foundations of the changes which needed to be made. The fiscal accounts, which were already registering heavy imbalances in the early 1980s, suddenly came up against severe credit restrictions. The policies applied now had to cope with the new external financing conditions, and domestic spending and the domestic absorption of goods and services had to be adapted to the new situation. For this reason, the policies were dominated by the macroeconomic priorities associated with adjustment and stabilization, and their instruments were conceived and ordered as a function of those objectives. Analysis of the fundamental issues was more or less inhibited, because other criteria were being applied in the appraisal of the solutions in question. The Latin American countries sought to ride out the storm by trying to adapt their domestic economic conditions to the external financing conditions. For this reason, a number of the heterodox economic policy measures taken in the region in those years differed little, especially as regards the fiscal policy instruments used, from the traditional neoliberal proposals, since they coincided with them on the need to bring the fiscal imbalance down to a level in keeping with the rest of the aggregate budgetary restrictions. The differences observed lay in the intensity and speed at which the adjustment measures were to be applied, or were due to the possible social rejection of such a process.

Thirdly, the foregoing naturally has implications for the macroeconomic effects of the process. To the extent that the external debt was contracted by the public sector or incorporated in the public budgets, fiscal policies not only had to act as means of secur-

ing domestic balance and stabilization but were also a prime instrument for reducing aggregate expenditure, thus making it possible to increase the foreign trade surplus. Moreover, as well as fulfilling this function, fiscal instruments had to bring about the domestic transfer of income required by the adjustment process. Because of the large amounts involved (depending on the particular situations that the various economies faced at the beginning of the crisis), this redistribution of income and assets was a complex process which took on highly conflictive characteristics in a number of countries: high inflation, stagnation, destruction of the domestic financial markets, and a reigning climate of economic uncertainty.

As already noted, the duration and the severity of the crisis were not the same all over the region. There were countries like Costa Rica and Chile which received relatively more external finance in critical periods, and others which had not incurred excessive indebtedness, such as Colombia. Argentina, Brazil and Mexico, however, passed through more difficult circumstances. For these reasons, the adjustment process was marked by episodes of unequal duration. Apart from these disparities and the differing reactions of national policies to the new context, however, the public sectors of the region all showed, now quite explicitly, that they were in a phase of exhaustion. The symptoms were not only to be seen in sectoral aspects or in relatively limited areas of expenditure or tax policies. It is quite true that investment in public infrastructure, pension systems, social services and tax systems were shaken by the crisis and clearly showed their limitations, but the element which caused all the countries to react in a similar manner and has become an important factor of change, especially since the 1990s, was the loss of creditworthiness of the public sector.

This loss must be interpreted in the broad sense, because it was reflected both in very limited use of the capacity to collect the inflation tax and in the very limited access to credit markets. In this respect, we could speak of a certain symmetry between the point of origin and the subsequent continuation of the

process. The initial disturbance which upset the economic functions of the Latin American public sector was of a macroeconomic nature. In recent years, even though the external finance flows to the region have been restored, credit markets—both local and international—have shown that the pressures the public sector can exert on them have clear limits. This limitation, which is of an aggregate nature, has been the dominant factor in shaping and defining the leeway left open for tax and public expenditure policies.

Thus, public sectors are now not only obliged to maintain a fiscal balance or at least a modest imbalance. Even if they adopt financially prudent positions, fiscal policies must display structural ingredients which unmistakably show that they are aiming at a profound redefinition of the economic role of the State. It would therefore be wrong to suppose that these demands for change are only the result of new guidelines and conditions imposed by the international agencies, or, more vaguely, external factors in general. The element that lies at the heart of this process is the radical change that has taken place in the manner of operation of financial markets. In a way, the leeway of public policies in general, but very particularly those concerning the fiscal system, is delimited by the degree of willingness of the financial markets to accept the content of those policies. The markets have shown that they are willing to give credit to the private sector even if there is a risk of imbalance in the external trade accounts, but on the explicit condition that the countries undertake reforms in various fields, and especially those connected with the public sector. The indebtedness and investment behaviour of the domestic private sector have also been affected by similar considerations. Obviously, this manner of operation of the markets—including their reactions, the processing of the information they receive, etc.—has become increasingly prominent with the globalization of financial flows. It has also been favoured for some time past by the replacement of debt paper with equity as a result of the privatization process.

V

The elements making up the new model

As we saw in the previous section, during much of the 1980s the situation was dominated by the need to carry out the adjustment process; structural reforms of the wide range and variety now being applied in most of the countries of the region had to wait for better times. The favourable turnaround in the situation has been due to various elements. The changes in the institutional arrangements on the renegotiation of long-term debt represented important progress, aided by the support of the multilateral credit agencies. Another positive factor has been the restoration of the flow of capital to the region which began in 1990 and has been maintained up to the present, in spite of the episodes of late 1994 and 1995 which affected in particular the Mexican and Argentine economies. This massive access by Latin America to international credit has made possible economic recovery and growth, although it has once again highlighted the fragile situation of some of the economies of the region. From now on, national macroeconomic policies must adapt themselves to the new context with the instruments at their disposal. The availability of external financing and the possibility of partly reversing recent trends will necessarily condition economic performance in the immediate future.

Whatever the options offered by these new developments in the future, we consider that the interpretation outlined in the previous section continues to be valid and that, from this angle, there are no grounds for expecting a reversal of the path followed so far. The restrictions on public credit continue to prevail and have had some effects which will make themselves felt in the medium and long term. Structural reforms have already been applied in a number of areas of the public economy –privatization of public services and infrastructure, redesign of pension systems, reforms in tax systems, etc.– and represent an appreciable departure from past trends. Moreover, the new pieces in the scheme cannot easily be substituted in economic and political terms, so that it seems likely that the countries which have embarked on this process will continue to intensify it. Other countries, such as Brazil, whose reforms initially lagged behind

the rest of the region, are now showing signs of advancing in the same direction.

In short, in most of the countries of the region the public sector is witnessing a profound redefinition of its functions. The extent and diversity of the reforms under way, which are essentially connected with the execution of those functions, vary widely in the region. Although they all point in similar directions, these reforms show important instrumental differences which affect their economic and social effects. What we wish to highlight here, however, are the elements which strike a common note and therefore indicate that we are witnessing a change in the model that represents a veritable watershed with respect to the past. As we see it, the main features of the new model are those described below.

1. Redefinition of the public sector's role in the saving and investment process

After having been a central factor in the mobilization of saving and investment, the public sector is now witnessing the emergence of a new actor: the private sector. An appreciable part of the economic activities with the greatest profitability and growth potential have been transferred to private enterprise, so that these sources of income are now private property. Moreover, particularly in those countries where the changes in ownership have extended to important areas of infrastructure which were traditionally under State control –such as road and rail systems, ports, electricity generation, drinking water supply and sanitation, communications, etc.– the decisions and actions on investment in them are also in private hands. Natural resources have also been transferred in the same manner and systems have been introduced to permit heavy private investments in this field. The old mechanisms for the transfer of income which existed in their day through tariff protection, subsidized credit or the appropriation of financial surpluses are no longer available. A clear example of the latter is the appearance of pension funds as a result of the reform of social security systems: the use of these resources for long-term investments rep-

resents a new area for private decisions in a field where they had previously been prohibited.

The foregoing does not mean, of course, that because of these new sources of saving and new uses of resources there will no longer be any need for the public sector. The role of the latter has diametrically changed, however: direct management and decisions by it have now been replaced by responsibilities in terms of regulation and the application of indirect instruments. This calls for new State capacity for planning and administration, which is now beginning to be developed. The process is not instantaneous; it tends to advance through successive approximations and may be considered as the natural field for the design and execution of public policies in the new areas opened up by the reform of the public sector economy.

2. Increased concentration by the public sector on the provision of social services

After having transferred to private hands the activities associated with the production of public goods and services and infrastructure, the public sector tends to concentrate much more on the provision of social services. The reforms in the machinery for the provision and financing of these services have not shown a comparable degree of dynamism, however, even bearing in mind that the problems which have built up in the countries of the region are long-standing and have been further aggravated by the impact of the recent changes, especially those associated with the restructuring of production activities and the labour market in economies which have increased their degree of openness.

Except in the case of pension systems, the forms of public sector intervention in these areas still take place in line with well-known patterns. This does not mean, of course, that there have not been any innovations at all. If we take a detailed look at the recent experience of the countries of the region, there is clear evidence of sectoral policies—in education, health, housing, programmes to combat poverty, etc.—which seek to correct some of the most obvious difficulties and make innovations in other aspects. The effective results of the public programmes connected with social reform seem to be slow in coming, however, partly because they run into more complex obstacles and the design of new means of action and financing requires changes in terms of organization,

administration and human resource structures within the public sector. This naturally implies that the changes will be slower.

3. The trend towards decentralization

Another reason which we think explains the more limited progress registered in this area is the trend towards decentralization. Just as we noted earlier that a functional element of the previous public sector operating model was its marked centralism, so the present stage is marked by a tendency in the opposite direction. The decentralization of government activities and administration has a clear corollary in the division of powers within the national public financing structures. This process is marked by the transfer to local levels of government of greater responsibilities for the provision of public services, especially those of a social nature.

With regard to the tax and financial resources needed to support this new division of powers, the lines of action being taken by the countries of the region are not so clear. In some cases, they are promoting policies to strengthen local taxation powers, which are running into the well-known kinds of difficulties: in their economic aspects, there are problems due to the limited or very unequal tax bases of the regions, provinces or communes, and in their political and institutional dimension they run into resistance to assuming the political costs of imposing higher taxes or confrontations with local economic powers. Because of this, in most of the countries decentralization seems to be accompanied by a reformulation of the systems of financial transfers between the different levels of government. One way or another, however, the process of geographical re-deployment of the public sector is displaying, perhaps more so than in the past, a regional dimension in terms of the struggle for the distribution of public income and expenditure. Although the foregoing refers to the fiscal aspects associated with decentralization, it may be added that the dynamics of the decentralization process are very much dependent on factors whose logic and rate do not always coincide with those of that process. The main elements affecting this process are of a political and institutional nature and take different forms depending on the different national conditions. Therefore, although the general direction of the process is towards greater intervention by subnational levels of government, the

forms and instruments of that intervention cannot readily be generalized.

4. The role of tax policy

In this field, the recent reforms applied in the countries of the region appear to reflect an appreciable change in objectives. Until recently, the prevailing tax systems in the region incorporated—at least in their normative design—ambitious income redistribution objectives combined with equally ambitious aims regarding the promotion of various production activities or regions. The new policies, however, have departed from these objectives. There is greater reluctance to grant special tax benefits, and more emphasis is placed on horizontal equity, together with

simpler and more universal rules for the taxation of consumption. On the one hand, these changes would seem to indicate some abandonment of the objectives of tax progressiveness and the generation of indirect incentives for increasing capital formation, but on the other hand it may also be considered that the traditionally discouraging distribution profile in Latin America can only be corrected to a marginal extent through more progressive income tax. There is also less propensity to apply tax exemptions, because of a more prudent assessment of the cost-benefit aspects of the mechanisms applied in the past. The current trends in tax policies in the region therefore seem to emphasize the objectives of more effective tax collection, simplification and horizontal equity, together with the expansion of the bases for taxes on consumption.

VI

By way of conclusion

Three essential arguments may be identified in the above interpretation. Firstly, we have noted that the operating model and role of the public sector underwent substantial changes after the debt crisis of the 1980s. Secondly, we noted that both during the external adjustment process and in the subsequent phase in which the region recovered its access to credit, the reception and reactions of the financial markets to the general lines and content of public sector reform policies were of decisive importance. The behaviour of suppliers of funds and investors—both domestic and external—helped to define the leeway open for policies which, after various efforts and in different ways in the different countries, have altered the mechanisms of the public economy. Thirdly, we stated that the basic features of the new scheme are the following: redefinition of the role of the State in

the saving and investment process, concentration by the public sector on the provision and financing of social goods and services, decentralization, and new bases for tax design.

The configuration emerging from these elements has not yet assumed its final shape: the process is not yet complete and is still underway. The individual elements have a degree of permanence in the medium and long term, however. It may therefore be assumed that future policies will be aimed mainly at solving shortcomings and making corrections in an established course of action which seems unlikely to be altered much in its essential aspects. It may therefore be asserted that the public economy model applied up to the 1980s has undergone profound and lasting changes.

(Original: Spanish)