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Fiscal policy, *cycles and growth*

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In Latin America, macroeconomic fluctuations have been more frequent and more serious in recent decades than in other parts of the world, and this volatility has adversely affected the development processes of the countries of the region. This article looks at the desirability of establishing economic policy rules, particularly in the fiscal area, to reduce the frequency and size of these imbalances. The interactions between fiscal policy, the economic cycle and growth are reviewed, and the difficulty of establishing a convincing numerical relation between public expenditure and long-term growth is demonstrated. The theories proposing the reduction of public expenditure as a means of improving macroeconomic performance do not have solid empirical bases. "Fine tuning", which should in principle make it possible to reduce the effects of disturbances and hence reduce the impact of this negative relation between volatility and growth, require the existence of flexible instruments for explicitly dealing with the adverse disturbances that frequently arise. It is therefore necessary to adopt policies that will make it possible to overcome the dilemma between credibility and flexibility. The way of tackling this volatility set forth in the article has to do with the political and institutional factors that lie at the basis of the expectations of the private agents and encourage them to save and invest in a long-term economic horizon, rather than with the imposition of rigid rules that tend to impede intervention by the authorities in the economic cycle. In the fiscal area, the article analyses the dilemma between sustainability and regulatory capacity and posits the need to make more intensive use of fiscal instruments for stabilization in order to ensure a better macroeconomic performance.

I

Introduction

In the short and medium term, the economic authorities have four simultaneous objectives: i) to reduce unemployment or keep it to a low level, ii) to control inflation, iii) to keep a wary eye on potential imbalances which may arise on the fiscal side, and iv) to keep a similar watch on those that may arise in the external sector. The "art" of economic policy is to reconcile the four corners of this magic square, while the "mission" of policymakers is to minimize the social losses due to fluctuations in the aggregates, anticipating future sources of instability and taking today the measures that are going to be needed to deal with them tomorrow. This means highlighting the importance of the interactions between fiscal policy, the economic cycle and long-term growth: a matter which is dealt with in section II below.

Fiscal policy influences long-term growth in different ways: through its direct participation in capital accumulation, through the crowding-out effect that the financing of public activities can have on private saving and investment, through the negative externalities that unproductive public expenditure causes on aggregate productivity, and finally, through what might be called the quality of public policies. The transmission mechanisms are thus highly complex, so that it is impossible to find a simple linear relation between fiscal policy and long-term growth in the empirical literature. The currents of thought that advocate the absence of public intervention and the reduction of public expenditure as mechanisms for improving global macroeconomic performance therefore do not have any sound empirical bases.

In Latin America, the variability of external and domestic conditions has led to recurrent imbalances which have had negative effects on the development processes of our countries. If we take the GDP as a reference point, macroeconomic fluctuations (with a few notable exceptions) seem to be more frequent, bigger and more dramatic than in the industrialized countries. If such cycles are harmful because they affect the average growth rate of the economy through the uncertainty that they generate, then there is ample justification for the adoption of strategies to

reduce their effects. In Latin America, according to the recent economic literature, there is a negative relation between the average GDP growth rate and its standard deviation.

In this article, the analysis is centered on the desirability of establishing economic policy rules in the monetary, fiscal and external sectors, in order to keep the four corners of the magic square under control. The need for "fine tuning" means that flexible instruments should be available for explicitly tackling the negative upsets that often arise. It is therefore necessary to adopt policies based on the idea of "discretionality within the rules" which make it possible to solve the dilemma between credibility and flexibility which has been so marked in the 1990s (*credibility* means that there should be stable rules for a long period of time, while *flexibility* means that there should be capacity to respond to changes in the external conditions affecting the system).

If fiscal and monetary policies have an anti-cyclical component relating to the terms of trade and inflow of capital, there is a better chance of addressing the objectives of medium-term stability and, ultimately, bringing the economy as close as possible to its production frontier. This means intervening energetically in the economic cycle, both in respect of the aspects due to domestic fluctuations and those coming from outside.

Since the excessive use of monetary policy as a means of regulating conjunctural situations may lead to cases of macroeconomic inefficiency, greater emphasis needs to be placed on fiscal policy instruments, especially the role of the automatic stabilizers in the cycle and an increase in the degree of discretion (within certain limits) for fixing taxes in the light of stabilization objectives.

In section III, fiscal policy design criteria are examined, the dilemmas between sustainability and regulatory capacity and between discretionality and established rules are analyzed, and it is suggested that greater use should be made of fiscal stabilization instruments in order to ensure a better macroeconomic performance.

II

The interaction between the economic cycle, fiscal policy and long-term growth

In macroeconomics, long-term growth and short-term fluctuations are usually analyzed separately. Thus, it is implicitly suggested that the two are completely independent, so that temporary upsets do not have lasting effects on growth. On the one hand, the debate on the neutral nature of money or the effectiveness of fiscal policy concentrates on describing short-term fluctuations around a given trend and on the desirability of eliminating or alternatively of maintaining such cyclical movements. On the other hand, long-term growth is considered as a phenomenon which is independent of economic fluctuations; the prime objective of researchers is therefore to discover the factors that determine it and the policies that affect it. This reasoning is based on two main assumptions: i) that the cost of fluctuations in terms of well-being is not significant and ii) that macroeconomic intervention/stabilization policies do not make much sense in this context.

In this respect, Lucas (1988) has suggested that the value of understanding cycles is only trivial compared with that which could be expected from understanding long-term growth ("the implications that this kind of question holds for human well-being are simply tremendous: once one begins to think about them, it is difficult to think about anything else"). He reaffirms with deep conviction and in dramatic terms the standard dichotomy in macroeconomic studies and asserts the preponderance of economic growth theories over debates on fluctuations. In the words of Sala-i-Martin (1994), "short-term cyclical movements are like tiny and almost irrelevant little variations compared with the immensity and force of the long-term growth rate".

The empirical literature on the determinants of growth was given a strong impulse with the publication of comparable per capita GDP data for more than 130 countries (Summers and Heston, 1991). Barro (1991) used this set of data to analyze the empirical determinants of growth rates, and since the publication of his article over 50 variables have been found which have a significant correlation with per capita

GDP (Sala-i-Martin, 1994). Within those variables, various fiscal policy indicators undoubtedly have a leading role.

1. Empirical analysis of the impact of fiscal policy on growth

Fiscal policy affects long-term growth in four main ways. The first is its direct participation in capital accumulation, especially infrastructure. The second is the crowding-out effect that the financing of public activities can have on private saving and investment. The third is connected with the size of the State and the negative externalities produced by excessive State intervention on aggregate productivity. Finally, the fourth concerns mechanisms which could be grouped together under the title of the quality of public policies.

In regressions like those carried out by Barro, a positive relationship is usually identified between public investment and growth. Thus, for example, on the basis of disaggregated information for a set of developing countries, Easterly and Rebelo (1993) found a solid and significant relationship between public investment and growth, especially in the transport and telecommunications sectors. These authors also report a positive direct influence of public investment on private investment. Devarajan, Swaroop and Zou (1993) identify a non-linear influence of expenditure on infrastructure, consistent with decreasing yields to scale: at low levels of expenditure, its marginal contribution to aggregate productivity is very high, but it rapidly declines and tends to disappear for high values of the ratio between public investment and GDP (inverted U-curve).

Public expenditure in general and the taxes needed to finance it have a negative effect on private investment and growth, however. Mendoza, Milesi and Asea (1995) observed significant effects of the level of taxes on long-term growth, although they were quite small and had coefficients which were fairly weak in relation to other alternative specifica-

tions. De la Fuente (1997), for his part, considers that in the member countries of the Organization for Economic Co-operation and Development (OECD), for every dollar that public investment increases, private investment goes down by 32 cents. The impact is smaller in the case of transfers to households, probably because these represent a redistribution of income among private individuals.

Many studies have also found a partial negative correlation between growth and the size of the public sector, with the latter measured as the ratio of government consumption to GDP (Barro, 1991) or public expenditure as a proportion of GDP. The argument in support of this, which is extremely well known, is that the externalities generated by unproductive public expenditure give rise to distortions in the economy which reduce the growth rate of productivity and income. De la Fuente (1997), for example, calculates that a 5 per cent reduction in total public expenditure (keeping investment and transfers constant) would increase the average growth rate of the OECD economies by two-thirds of a percentage point per year in the medium term. Some authors, however, have highlighted the relatively weak statistical basis of these results, showing that when other relevant variables are added the negative influence of public expenditure disappears (Levine and Renelt, 1992; Easterly and Rebelo, 1993; Andrés, Doménech and Molinas, 1993). There are few empirical proofs, then, of the negative impact of public expenditure on GDP, when an effort is made to measure it systematically.

Finally, some studies try to measure the impact of the quality of public policies on long-term growth. Thus, for example, the report by the World Bank (1997) includes in its multiple regressions a measurement of "good government" in which a public policies variable, defined as a synthetic indicator which includes measurements of the openness of the economy, price distortions (difference between domestic and international prices) and over-valuation of the exchange rate represent a factor for explaining differences of income between developing countries.

The conclusions are not free from the classical problems of multi-collinearity and endogenous elements displayed by this type of regression. In fact, the effects of fiscal policy are not distinguishable from the spurious correlation between fiscal structure and per capita income. Moreover, it is hard to rule out the existence of a spurious correlation among the variables due to the problem of inverse causality. Thus, for example, the interaction between public

expenditure and the growth rate would make it necessary to carry out sensitivity analyses and tests for weak exogenous influences in order to verify the soundness of the results.

Two useful lessons for our purpose may be drawn from this summary examination of the empirical evidence on the impact of fiscal policy: i) it is very difficult to identify a clear causal relationship between government policies and growth, both because of the complexity of the mutual interactions and also because of the difficulty of measuring the multiple actions of the State in the area of the economy, and ii) in line with the foregoing, the international data do not allow a convincing numerical relationship to be established between the size of the State and economic growth, although of course "the measure of our ignorance" should not lead us to underestimate the importance of "good government" in development processes.

2. Volatility, irreversibility and macroeconomic regulation

The sinusoidal image of growth already mentioned earlier, in which the fluctuations twist about a pre-determined trend, seems an excessively mechanical view of the process. It is hard to believe that the magnitude or duration of cycles do not have lasting effects on the economic system. The assumption of hysteresis, understood as the irreversibility caused by negative upsets, has important policy implications: one of the requisites for increasing the long-term growth rate of a country is to reduce its real volatility.

In theory, there are linkages of different signs between short-term instability and long-term growth of the product. This relation may be positive in the context of a Schumpeterian process of "creative destruction". Recessions are a "necessary evil" which makes it possible to eliminate obsolete techniques and activities and increase global productivity. The alternation of phases of recession and reactivation is therefore positive for long-term growth. Models of real cycles highlight the essentially transitory nature of random upsets of technological origin in the economic cycle and consequently ignore the possible adverse effects of fluctuations on the long term.

The negative relation between volatility and growth has two main explanations in the economic literature. The first, and undoubtedly the dominant, explanation is connected with the adverse impact that uncertainty has on private investment expenditure. If

TABLE 1

Latin American countries: Growth rates and volatility

Country	Period:	Average (%)		Standard deviation	
		1981-1996	1985-1996	1981-1996	1985-1996
Argentina		1.3	2.0	0.054	0.056
Bolivia		1.6	2.8	0.031	0.023
Brazil		2.1	2.8	0.039	0.036
Chile		4.5	6.3	0.054	0.023
Colombia		3.9	4.5	0.016	0.014
Costa Rica		2.9	3.8	0.038	0.020
Ecuador		2.4	2.7	0.031	0.031
Mexico		1.9	1.9	0.038	0.034
Paraguay		3.1	3.5	0.029	0.018
Peru		1.4	2.1	0.073	0.072
Uruguay		1.8	3.6	0.048	0.035
Venezuela		1.3	2.5	0.048	0.048

Source: ECLAC data; the volatility of GDP is calculated as its simple standard deviation for both periods.

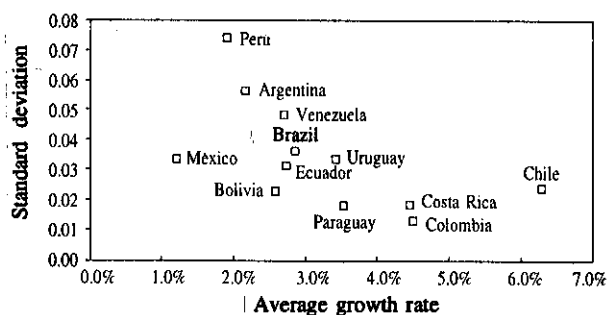
investment is irreversible, then greater volatility (which gives rise to uncertainty in future demand) may cause the agents to be reluctant to carry out their medium-term projects. The second argument is connected with the process of "learning by doing", and indicates that part of long-term growth is due to the faculty of learning and the experience accumulated on the job. Consequently, recessions (and the unemployment they cause) represent episodes of disaccumulation of physical and human capital which strongly affect future growth. The mechanisms of creative destruction, irreversibility and learning by doing may exist side by side in reality, and the predominance of one or another of them is an empirical matter.

It is considered that in general there is a significant negative relation between volatility and growth. Ramey and Ramey (1995) show that a smaller standard deviation of GDP is associated with a higher average growth rate, both for a sample of 92 countries and for the OECD member countries. These studies take as their starting point the regressions of Barro (1991) and Levine and Renelt (1992), which seek to explain the differences in growth rates between countries by the usual empirical factors: the initial level of per capita GDP (conditional convergence effect), initial human capital (measured by the average number of years of schooling of the population over 25, or the rate of secondary education in the case of the OECD countries), and the average investment rate. When, in addition to these variables, the indicator of volatility (measured as the standard deviation of the annual growth rate) is introduced into the regressions

for the period 1960-1988, the coefficient is negative and significant (as also occurs when the short-term volatility is measured by the standard deviation of the rate of unemployment). According to these calculations, a reduction of one standard deviation of volatility leads to an increase in the growth rate of between 0.3% and 0.6% per year. In terms of magnitude, volatility comes second among the growth factors, after the initial level of GDP and above the investment rate. It should be noted that the estimated impact is independent of the indirect effect of volatility on physical investment, since this latter variable is included in the regressions. All other things being equal, the countries in this sample which have had higher rates of volatility have grown less since 1960.

It seems important, then, to analyze the repercussions of the extraordinary real volatility which has existed in our countries on development. These big fluctuations have led to low average growth rates in most of the Latin American economies. Cotler (1997) made estimates for 17 countries of the region for the period 1960-1995 and showed that there is a significant and quite solid negative relationship between the growth rate of GDP and its standard deviation, similar to the correlation observed between investment and an indicator of unexpected volatility. Table 1 shows details of the average growth and standard deviation for 12 countries of the region between 1981 and 1996 and between 1985 and 1996. In many countries, if the transitory external debt upset –i.e., that observed in the first half of the previous decade– is eliminated, the average growth rate increases and the standard deviation decreases. The two problems still remain,

FIGURE 1
**Latin America: Volatility and performance of
 selected countries, 1985-1996**



however: generally speaking, the Latin American economies have grown little on average, with many ups and downs.

Without going into a quantitative analysis, the negative relation between growth and economic cycles seems quite clear when we compare the growth rate of GDP with its standard deviation over the period 1985-1996 (figure 1); the countries with the highest average growth (Chile, Colombia, Costa Rica) are also those with the smallest variability. Moguillansky (1996) shows that the factors of variability are important determinants of private investment in the Latin American countries and hence of the potential growth of their economies. Although this is not the only or even perhaps the main explanatory factor, it seems reasonable to identify a positive connection between long-term growth and macroeconomic stability in the Latin American countries.

Thus, the benefits of stabilization may be considerable if declines in the product from its equilibrium level give rise to major costs in terms of well-being. This can happen if the aggregate variability has major effects on decisions affecting production capacity (investment) and, hence, the potential product. If this point of view is correct, counter-cyclical stabilization policies could mean significant gains in well-being (Romer, 1993). There would thus be a kind of symmetry between the episodes of expansion and contraction of demand. If there is an awareness that major fluctuations in the level of activity have harmful effects, then monetary, exchange-rate and fiscal policies must be very active in order to "insulate" the economy from external upsets and cushion the domestic ones. In this context, it is no longer a question, as Friedman (1968) says, of preventing the policies themselves from being a major source of upsets, but rather of designing policies,

instruments and institutions which minimize both the causes of the fluctuations and their consequences.

3. The magic square, fine tuning and virtuous circles

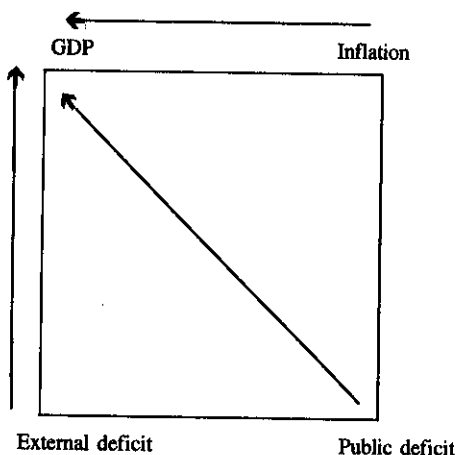
The imposition of rules and the development of institutions aimed at solving the problem of the inconsistency of growth and preventing pressures in the design of economic policies seem to be quite generalized approaches at the present time. It would therefore be desirable to formulate intermediate objectives—for example, a stable growth rate of the money supply or a ceiling on the fiscal deficit—as a way of imposing restrictions on the discretionary powers of the authorities. A system under which governments seek to attain their final objectives (in terms of inflation and unemployment) without laying down rules for the intermediate objectives could be a source of potential errors. Policymakers may genuinely have the aim of maximizing social well-being, yet in spite of this (or perhaps because of it) they commit systematic errors. Thus, for example, the authorities may give too much weight to the short-term costs of higher unemployment as compared with the long-term costs of higher inflation. This can happen if there are strong political pressures or there is not a clear knowledge of the way the economy operates. In this context, the procedure which seems to be a maxim of our times is applied: if we know little, then we had better do little, since taking measures and then having to reverse them may be more costly than not doing anything at all.¹ As the effects of decisions are uncertain, it is reasoned that more active policies would lead to still greater uncertainty.²

In the same direction, Lucas (1994) holds that, since only surprise measures can have some effect, the most that can be expected from economic policy is that it should be neutral, with two clear rules: i) a balanced fiscal budget (which refrains from using economic policy for regulatory purposes), and ii) a monetary policy which maintains a growth rate of the money supply in keeping with the potential growth of activity (thus preventing the use of monetary policy as an anti-cyclical instrument). It may be noted that this argument is consonant with the assertion that short-term fluctuations are irrelevant.

¹ For an interesting analysis of the importance of intervention at the macroeconomic level, see Blanchard (1996).

² The classic article by Brainard (1967) introduces the idea of multiplicative uncertainty.

FIGURE 2
The Magic Square



Emphasis is often placed on the desirability of watching over the macroeconomic balances as a necessary condition for ensuring growth. It is essential to keep inflation and the external and public balances under control in order to create suitable conditions for growth (figure 2). But the problem is that the relations between the four corners of the magic square are multiple and interdependent. There are short-term dilemmas which are by no means insignificant between inflation and growth, between the external balance and GDP, between the public deficit and GDP, and between inflation and the external sector, and the way they are tackled conditions future growth. It is not possible, therefore, to reduce the role of macroeconomic policies simply to "maintaining the balances", since both what is done and what is not done have significant effects on the evolution of an economy.

Macroeconomic efficiency diminishes volatility and reduces the magnitude of the cycle, bringing the level of activity increasingly close to the production frontier and transforming the magic square into a virtuous circle. Macroeconomic regulation therefore takes on great importance in development processes; the State is responsible for safeguarding the "common good" that stability represents in a market economy. The announcement of explicit medium-term objectives for the four corners of the magic square can help in this respect. But the rules must also be flexible, in order to give the authorities the discretionality they need to forestall the generation of harmful fluctuations. Explicit rules form a sound basis for the "structural" credibility of economic policies, but discretionality is also needed in order to ensure the capacity for regulatory intervention.

It is not really necessary to "choose" in the dilemma between credibility and flexibility; it should be possible to achieve institutional arrangements which allow both concepts to be reconciled. The credibility of policies does not depend so much on respect for rigid rules as on the simultaneous fulfillment—within reasonable limits—of the four objectives of the magic square. If fiscal and monetary policies have an anti-cyclical component regarding the terms of trade and inflow of capital, there are greater possibilities of achieving medium-term stability objectives and, ultimately, coming as close as possible to the production frontier. This means intervening energetically in the economic cycle, both in that generated by domestic fluctuations and in that due to external forces. All options are legitimate for this purpose: the best policy for withstanding a negative upset tomorrow is to develop the necessary institutions and introduce today a set of measures which will make it possible to accumulate reserves to cope with the bottom part of the cycle.

The application of rules of this type, understood as the definition of instruments and selection of objectives (Fontaine, 1995), gives credibility to macroeconomic policy and makes it possible to achieve its objectives. If the intervention in the economy by the authorities is in line with more or less well-known rules, this will help to put the expectations of private agents on a steady basis. These rules are not numerical, but rather normative, however. When we speak of well-known rules, for example, we nevertheless mean that there should be some flexibility in the targets regarding the public balance (if the public deficit is greater than expected in an environment which is more recessionary than was anticipated, it is desirable to activate the automatic stabilizers rather than fulfill the goals strictly) or that if there is an excessive increase in aggregate demand there should be a reaction by the Central Bank.³ Flexible rules (exchange rate fluctuation bands, ranges of inflation, and ranges of external and public deficit) provide the degree of discretionality that the economic authorities need in order to avoid the generation of harmful fluctuations. In other words, there must be semi-automatic rules, if

³ In this respect, the agents' internalization of the Phillips curve and of the reaction of the Central Bank is noteworthy. In the United States, for example, an excessive increase in employment immediately gives rise to expectations of a rise in interest rates. Inflation may be very low, but the agents already know that the Central Bank will react even before a possible outbreak of inflation takes place.

possible anti-cyclical, in order to achieve objectives under normal conditions, but the authorities should reserve full capacity to intervene in possible situations of external or internal disturbances which may distort the growth path and increase real volatility.

Rules cannot be completely mechanical in an increasingly complex world. In this respect, rules laid down by decree or law, or institutions with too much independence, are not only undemocratic but can also accentuate the fluctuations if an attempt is made to achieve a single objective at any price. In reality, there is not much point in establishing excessively precise goals in respect of inflation or the public deficit. The important thing is to achieve a certain degree of relative stability, to smooth down expectations, rather than to precisely fulfill the announced goals. What improves the business climate is not the reduction of the public deficit or of inflation in themselves, but the steadying of expectations that takes place when the macroeconomic policy is seen to be effective in influencing private sector decisions.

There is a much better chance that the goal in terms of inflation will be fulfilled if the combination of exchange-rate, monetary and fiscal policies respects a current account objective and, in addition, can help increase domestic saving. If it were necessary to establish an order of precedence among the four economic policy objectives, then first of all it

would be necessary to set a current account objective, and then objectives in respect of inflation, the level of activity, and finally the public deficit. The current account objective should be in real terms, in order to take account of changes in relative prices with the exterior and introduce a reference situation; it should be sustainable, with an external debt/GDP ratio that will not increase, and it should be of a medium-term nature (it is better to establish ranges of values rather than precise goals).⁴ This means controlling aggregate demand, through all the relevant policies, as a function of the external results. This way of approaching the problem makes it necessary to establish a certain order of objectives, which can always prove to be dangerous, unorthodox, rather arbitrary and perhaps impossible to achieve. It is also the way in which the authorities have had to act when there is a pressing external constraint. Clearly, under normal conditions, fulfilling the external balance objective (in terms of the current account deficit) will make it possible to obtain results with regard to inflation, growth, unemployment and the public balance. The purpose of fine tuning is to establish suitable conditions for giving rise to virtuous circles within the magic square, with the clear objective of reducing aggregate fluctuations through a wide range of instruments, of which fiscal policy is particularly important.

III

Fiscal policy design criteria

Let us assume, in order to simplify the analysis, that fiscal policy has two macroeconomic objectives: i) sustainability of the deficit, defined in technical terms as the public balance that keeps the public debt/GDP ratio stable, and ii) macroeconomic stabilization, defined as the combination of expenditure and income which will ensure a suitable level of aggregate demand. In Latin America, more than in other parts of the world, governments have concentrated their efforts on reducing the deficit and public debt, leaving the regulatory role, if it exists, to monetary policy. In order to achieve these objectives, two ways may be chosen: i) the application of discretionary measures, with the authorities using all the instruments available to them as they see fit, or ii) the

establishment of explicit rules, with restrictions being imposed on public intervention in order to make its actions more transparent and credible. In the following sections, the various fiscal policy criteria will be discussed as a function of these four concepts.

1. Sustainability or macroeconomic regulation?

The evolution of the public debt in Latin America and the big changes displayed by it in the 1980s and 1990s raise the question of the sustainability of fiscal

⁴ Held and Szlachman (1997) make a more detailed analysis of the importance of establishing a conservative sustainable deficit objective and the desirability of basing the definition of this objective on a number of domestic and external indicators.

policy. Long and irregular episodes of –sometimes explosive– growth of indebtedness were followed by short and very violent adjustments. It has often happened that the fiscal budget has been involved in an unstable pattern of sudden growth (“snowballing”) of indebtedness in which the servicing of that debt absorbs a growing proportion of fiscal revenue. Apart from the fact that there may be excessively expansionary policies, this perverse pattern is generally exogenous to the public sector and those responsible for it. Thus, if the (domestic or external) interest rate increases and growth falls, the sustainability of fiscal policy is immediately brought into question. Even when there are no discretionary decisions by the authorities, the persistence of a situation of this type gives rise to an explosive pattern of growth of the debt.

Thus, a restrictive monetary policy increases the public deficit, especially if the exchange rate appreciates and public indebtedness includes a significant external component. It is by no means hard to imagine this kind of situation, in view of the abundant examples observed in the region in recent years. It is worth wondering if, in these conditions, the excessive use of monetary policy is an efficient way of stabilizing the economy. Although managing interest rates may help to correct excessive movements of private expenditure, it can also generate, maintain or aggravate a potentially destabilizing movement on the fiscal side. Although these situations may be only transitory, their effects on the budget may become permanent, giving rise to the persistence of deficits and debts. If there were some automatic stabilization mechanism, these debts and deficits would be absorbed in the economic cycle, if the exogenous variables returned to their medium-term path. In general, however, these self-regulating mechanisms are insufficient, so that the deficits become persistent.

The sustainability of the public deficit, which is no more nor less than the long-term solvency of the government, depends on the observance of its budgetary restrictions over time, which is expressed in the form of two equivalent identities: i) the public debt is equal to the updated value of the anticipated future primary surpluses, and ii) the updated value of the debt for a horizon tending to infinity is zero. Sustainability may be defined as a condition of stability of the public debt in a determinist world, or one of being stationary in a stochastic world (Hamilton and Flavin, 1986). In the latter case, the State is solvent if the public debt/GDP ratio is stationary. What this latter property tries to reflect is that the solvency of the

government is endangered not so much by the existence of deficits as their persistence at an excessively high level.

a) *Balanced budget laws*

Many authors maintain that public deficits are the cause of high real interest rates and stagnation of production. Reduction of the public deficit may be painful in the short term, but it has very favourable effects in the future, since it reduces interest rates because of the greater availability of private saving and stimulates investment, consumption and production. This view assumes the adoption of specific rules, according to the particular case, for reducing the deficits to “reasonable” levels or securing completely balanced fiscal accounts. One of the most hotly debated reforms at present is the introduction of constitutional laws demanding a balanced budget, or measures to limit the government’s power to run up deficits. It is argued that, even if it is accepted that this is a second-best policy, a balanced budget law would have the merit of doing away with second-best solutions of political origin which may lead to much greater problems than those arising from the failure to cyclically adjust the budget (Alesina and Perotti, 1995).

The most radical supporters of this view hold that the budget should be balanced at all times. In theory, the benefits of having a numerical target for the balance are clear, both for strengthening fiscal discipline and for stimulating long-term economic growth. A law that makes a balanced budget compulsory would eliminate the sources of imbalance generated by opportunistic politicians and short-sighted views. There are no actual cases where such a rule has legal force, but in some countries the maintenance of a budget which is balanced or even shows a surplus is indeed a prime objective. It seems fair that it should be the beneficiaries of public services who should pay for them and that the costs should not be placed on the shoulders of future generations, but only in the case of current expenditure which does not give rise to future income.

In the literature on this subject, two main arguments are put forward against the use of strict numerical targets. The first is that a rule of this type increases the incentive to use accounting practices which are “creative rather than transparent” (Alesina and Perotti, 1996), since there are innumerable accounting tricks which make it possible to apparently

respect the objectives but reduce the transparency of the budget; in the medium term, lack of transparency becomes a serious impediment to controlling expenditure and achieving the institutional consolidation of budgetary procedures. The second argument is of an economic nature. Quite apart from the contractionary consequences of an adjustment process of this type, balanced budget rules turn the public sector into an amplifier for economic fluctuations. Their strict application means that exogenous upsets must be instantly absorbed by the public sector, thus leading to the programming of public income and expenditure on a sub-annual basis. Immediate regulation of the deficit represents a radical break with the principle of using fiscal policy for macroeconomic stabilization purposes. It is also at variance with the rules that state that the level of public expenditure should be guided by structural objectives and should be as foreseeable as possible.

Thus, for example, if there is a recession public income goes down more than proportionately to the reduction in GDP (the elasticity of revenue collection is generally greater than unity if there is some degree of progressiveness in the tax system). The balanced budget rule would entail the immediate reduction of expenditure by an amount equal to the loss of revenue, which would certainly aggravate the recession and reduce tax income still further. Procyclical policies can turn the economy into a bottomless pit. On the other hand, a situation of expansion would provide room for reducing taxes, which would mean speeding up the growth of demand, with the consequent risk of increasing inflation. In this respect, a rule demanding a strictly defined balance would be a second-best solution. To sum up, balanced budget laws are probably not a good idea, since they introduce incentives to reduce budget transparency and also lead to excessive fiscal rigidity.

In view of the foregoing, it is extraordinarily difficult, if not impossible, to put forward a practical constitutional amendment in this respect. As Musgrave (1997) suggests, the establishment of rules governing the procedures to be followed does not require such a constitutional amendment, nor can faith in rules take the place of the implementation of responsible policies. In our classification, this policy would be sustainable and would have a high normative content, but it would leave little or no room for the regulatory role of fiscal policy and would also prevent discretionary intervention.

b) *The sustainable deficit*

When the real interest rate is lower than the real growth rate of GDP, a certain amount of deficit can be financed through public indebtedness, without increasing the public debt burden. In this case, it is possible to handle primary deficits on an ongoing basis, while respecting the criterion of debt sustainability (Bohn, 1995). When the interest rate is higher than the growth rate of GDP, however, the persistence of a primary deficit gives rise to explosive growth of the debt and of interest payments, which sooner or later endangers the solvency of the public sector. In order to stabilize the debt, then, it is necessary to achieve a primary surplus which will make it possible to pay that part of the interest commitments which is not absorbed by the growth of the economy. This primary surplus is proportional to the prior total debt and to the difference between the interest rate and the growth rate. In highly dynamic economies marked by a positive differential in this respect, of course, the sustainability of fiscal policy is ensured because the debt is gradually eroded by growth.

If the objective pursued is to stabilize the public debt and there is a lack of monetary financing, a situation of stagnation and high interest rates makes it necessary to generate surpluses proportional to the relative weight of the debt. In view of the extreme sensitivity of the public accounts and the size of the adjustments required in a situation of stagnation of the economy, short-term goals for the deficit are impracticable. This perverse mechanism explains the explosive growth of public indebtedness in most of the countries of the region in the situation of recession and high interest rates which prevailed in what has been called the "lost decade".

The obligation to respect goals in respect of the public balance in conditions of high real interest rates leads to the short-term adaptation of the level of public expenditure to the level of income, in order to maintain the annual goal. In a policy of this kind, the government must manage public expenditure on almost a monthly basis, in view of the sensitivity of public income to the level of activity. This kind of management of the budget, which entails multiple revisions of public expenditure plans in the course of the year, increases the uncertainty of the environment in which private decisions are taken. In their efforts to anticipate this policy in a rational manner, the agents would tend to act in a procyclical manner, since the reduction of public demand would announce a reduction in private demand, and vice

versa. The question of the sustainability of public indebtedness and of the solvency of the public sector thus becomes a central issue in the formation of the agents' expectations, but it would appear to be ill-advised to establish rigid rules regarding the sustainable debt or deficit in such changeable conditions of the macroeconomic environment.

When a public balance target fixed *a priori*—whether it refers to the surplus, balance or the deficit—is maintained regardless of the evolution of the level of activity and the other macroeconomic variables, the role of the public finances as automatic stabilizers disappears. When these rules are explicit, budgetary policy plays a markedly procyclical role. In our classification, as in the previous cases, the sustainable deficit rule reduces the flexibility of fiscal policy and prevents its use as a regulatory instrument.

c) The golden rule for the public finances

In the European countries, the debate can be set forth in different terms. A fundamental aspect of the Maastricht Treaty is the adoption of explicit restrictions on fiscal policy for the countries which are going to form part of the European Monetary Union. The justification for these limitations is that overindebtedness of a member country could lead to monetary destabilization. The rules adopted are more flexible than in the case of the balanced budget law. Since the historical rate of public investment in Europe has been 3% of GDP, a reference value of 3% of GDP for the deficit is something like a golden rule for the public finances: indebtedness is permissible subject to limitation by capital expenditure (Corsetti and Roubini, 1996).

If public sector investment is profitable, future flows of current income for covering the costs of indebtedness are ensured. The Maastricht criterion may be interpreted, then, as an implicit rule for the current account balance of the public accounts. This golden rule, which is more flexible than those of the balanced budget and sustainable deficit criteria, is based on a macroeconomic logic: the budget must be neutral with respect to private agents' consumption and saving decisions. In its strictest version, the golden rule would mean, for example, that subsidies to enterprises would not be financed from taxation but from credits and that the income from privatization operations would not be available for financing current expenditure. With regard to short-term stabilization policies, the Maastricht Treaty itself and the recent arrangements in connection with it allow the target balance to be interpreted more flexibly, accept-

ing higher (although limited) deficits due to temporary cyclical factors. The idea behind the establishment of these numerical targets would appear to be to ensure a balanced current account budget position in the medium term. Although this rule is more flexible than the foregoing examples, it is still within the area of normative criteria basically aimed at ensuring a sustainable fiscal policy, even to the detriment of the regulatory objective and of flexibility in the authorities' interventions.

d) Optimum fiscal policy

Optimum fiscal policy (Barro, 1979) means that the budget deficits and surpluses are used in the best possible manner to minimize the distorting effects of taxes for a certain given behaviour of expenditure. Consequently, the public balance is used as a shock absorber; there are deficits when expenditure is momentarily higher, and surpluses when it is low. If public expenditure has to be high today and low tomorrow (if there is a war, for example), a balanced budget policy means that there must be high tax rates today, followed by a reduction of taxes tomorrow. Optimum fiscal policy suggests rather the application of constant tax rates, however, accepting a deficit today; obviously, the surplus tomorrow will have to make up for the present deficit in terms of its present value. This policy is preferable to that of the balanced budget, because in the latter policy the additional tax distortions of today more than outweigh (in terms of utility) the social advantages of the lower tax rates of tomorrow, because of the decreasing marginal profits. Optimum fiscal policy means not changing tax rates to cope with a momentary deficit situation.

This simple principle has far-reaching consequences for fiscal policy.⁵ The principle of optimum fiscal policy is very clear: fiscal deficits and surpluses are used in the best possible way in order to minimize the distorting effects of taxation. An important extension of this policy refers to cyclical fluctuations in tax revenue: tax rates should remain approximately constant during the economic cycle, thus accepting deficits during periods of recession, which will be offset by surpluses during periods of expansion. The optimum nature of the policy assumes a balanced budget rule which is adjusted for cycles; deficits should be allowed during wars and recessions if they are offset by equivalent surpluses in periods of peace and expansion.

⁵ For an analysis of this question, see Alesina and Perotti, 1995.

Curiously enough, although with different arguments, old Keynesian and new classical economists advocate similar fiscal policy rules, although assuredly with different levels of public expenditure. It should be noted that we are not talking about Keynesian stabilization policies, because we are dealing with a supply-side model. Compared with the previous rules, optimum fiscal policy seeks medium-term sustainability, thus leaving room for the accommodation of the public balance as a function of macroeconomic circumstances. The normative component is more flexible: a constant rate of taxation is preferred to a rule fixing a target balance. There are no reasons for adopting discretionary regulatory policies, since the tax rate is fixed once and for all as a function of permanent expenditure.

e) Active regulatory policies

For traditional Keynesians, fiscal policy should ensure surpluses in situations of full employment and accept deficits in recessions, giving a zero average balance for the cycle as a whole. If the objective of fiscal policy is to obtain an average balance independently of the cycle, then the annual balance is allowed to vary as a function of domestic conditions, allowing the spontaneous mechanisms of the automatic stabilizers to act. Deficits are perfectly legitimate and even necessary in periods of crisis, but the suggestion that there should be surpluses at times of full employment has met with a cooler reception. As Tobin (1993) emphasizes, Keynesian macroeconomic policies apply to both sides of the medal. The fiscal surplus is a fundamental instrument for containing excess expenditure. Macroeconomic stabilization calls for reasonably symmetrical countercyclical regulation of demand.

Efficient macroeconomic management also involves the achievement of increasing degrees of tax consensus among the economic agents, however, especially when there are upsets of various types. The tax consensus means reducing private and public expenditure in situations of excessive demand through taxes on households and enterprises and through the fiscal adjustment itself. A more active fiscal policy can help to improve the effectiveness of short-term regulation. In order to use tax instruments designed to check oscillations in private expenditure, however, the authorities need a certain amount of freedom to fix tax rates, which they do not have at present.

In this respect, there are some interesting proposals for establishing by law certain ranges of tax rates within which taxes can vary according to the prevailing conditions. There is a danger, of course, that the

authorities might be tempted to keep those rates always at the highest levels in order to cover their expenditure more easily. The experience in this respect shows that it has been very difficult to come to an agreement between the Executive and the Legislature for the efficient use of tax rates for stabilization purposes. Although this is the most powerful means of directly managing the evolution of private expenditure, it is very little used in the Latin American countries.

In our classification, active intervention policies are classed as discretionary (and therefore run the risk of being somewhat arbitrary) and are concerned basically with the aim of regulation. There may be a bias towards excessive intervention, exaggerated public expenditure or an insufficiently controlled deficit. At some point, the regulation of aggregate demand through fiscal policy comes into conflict with sustainability, giving rise to the well-known consequences in terms of economic-political cycles and/or the accumulation of imbalances. Whether for intellectual reasons or on account of the lessons of experience, many analysts tend to reject the discretionary intervention model because of the dangers of arbitrary action, populism and fiscal irresponsibility that it involves. The fixing of external limits or the exertion of control by Congress or other State organs to prevent excesses in the management of public expenditure and tax rates would appear to be advisable in order to avoid potentially destabilizing fiscal cycles.

f) Automatic stabilizers and rules on expenditure

In periods of expansion, public revenue grows rapidly and the expenditure associated with unemployment benefits tends to go down, thus temporarily easing the management of the public finances. At times of recession, in contrast, the low level of activity seriously affects the budgetary balance. The types of public income and expenditure whose evolution is linked to the economic cycle are called automatic stabilizers.

The "rule" for fiscal policy cannot be the deficit itself, but its discretionary component, which is independent of the economic cycle. The programming of income and expenditure as a function of a discretionary target in terms of the deficit would allow a medium-term approach to be taken in the management of the public finances, thus avoiding continuous fluctuations in policy formulation and execution. With economies as volatile as those of Latin America, the public sector cannot be allowed to become a sound-

ing-board for short-term fluctuations. In the case of recession, for example, the public sector must accept a certain amount of cyclical deficit if it does not want to make the crisis still worse. If fiscal policy wants to avoid becoming an agent for the propagation and amplification of macroeconomic upsets, then medium-term budgetary rules should be adopted with the aim of controlling the discretionary or permanent component of the deficit.

It is thus a question of seeking fiscal policy indicators which are independent of the economic cycle. This is the methodology of the OECD (Giorno and Suyker, 1997), in which the deficit is broken down into a cyclical component and a structural component. A variation in public income or expenditure is of a cyclical nature when it is produced by the difference between the observed product and the trend product. The cyclical position of the economy leads to fluctuations which are reflected in the budget, especially in tax revenue and expenditure on unemployment benefits. In contrast, when it is a question of variations which are due to decisions by the public authorities, then these are of a discretionary nature.

For the OECD countries as a whole, the cyclical balance has ranged between +0.8 and -0.5 points of GDP between 1985 and 1996, although it has reached peaks of +2.6 points of GDP in the United Kingdom and +1.4 points in Japan and minimum levels of -2 points in Canada and -1.8 points in France (Giorno and Suyker, 1997). As table 2 shows, a breakdown of the global fiscal balance of the Latin American countries reveals a cyclical component of the deficit which has been very significant in the 1990s, fluctuating between -1 point of GDP in Argentina (1996) and Brazil (1992) and +1 point of GDP in Argentina and Uruguay (1994) (Martner, 1997).

The relative size of the cyclical deficit depends on two factors: the gap between the effective and potential GDP (that is to say, the distance between the effective growth of the economy and its medium-term path) and the weight of taxes (i.e., the revenue directly linked with the level of activity) in total public income. Obviously, the cyclical component has been greatest in the most volatile countries, such as Peru, Argentina, Venezuela, Mexico and Brazil in the 1990s. In the more stable countries, in contrast, the cycle of the level of activity has had less influence on their public accounts (Paraguay, Bolivia, Colombia, Ecuador and Chile in the 1990s). The second determining element – the weight of tax revenue in total

public sector resources – is very significant in some countries (90% on average in Argentina, 80% in Peru, 70% in Chile, 60% in Brazil, Colombia and Mexico, and 50% in Costa Rica, Paraguay and Uruguay), but in others it is not outstandingly important (23% in Venezuela, 29% in Ecuador, 30% in Bolivia).

If we combine these two elements, we see that it is in Argentina, Peru, Brazil, Chile, Colombia, Costa Rica, Mexico and Uruguay that the influence of the economic cycle is of fundamental importance for evaluating the public accounts. In Bolivia, Paraguay and Ecuador, in contrast, the cyclical component is no more than 0.1 points of GDP. In Venezuela, the cyclical component has amounted to only 0.4 points of GDP in the 1990s, in spite of big fluctuations in the level of activity and the public accounts balance. This is because of the decisive influence both of variations in oil prices and rescue programmes for the financial system.

The above breakdown leads in some cases to a radically different interpretation of the results of the public accounts. Generally speaking, the cyclical component is seen to be important in the improvement in the public accounts in the early 1990s. In many countries, the reactivation of the economy at rates higher than the medium-term trend values led to fiscal results which were positive, but which were partly obtained on the basis of transitory resources. In this respect, it is essential to identify a sustainable medium-term path and to formulate fiscal policy as a function of the permanent incomes generated when the economy is located on its trend path. Moreover, the deterioration of the public accounts in some situations may be due to factors of a conjunctural nature rather than to deliberate actions by the authorities. In this case, the position within the cycle conceals a structural effort to improve the public accounts.

The use of indicators of fiscal discretionality is very useful for the analysis, formulation and design of budget policies. By giving a measure of the public deficit independent of the economic cycle, this makes it possible to identify more clearly the decisions of the fiscal authorities and to calculate the size of the deficit which has to be corrected through discretionary measures. In this respect, a rule on the discretionary deficit would be rather of a passive nature, since it would allow the automatic stabilizers to act. If the effective GDP were below the trend GDP, the cyclical component of the deficit, attributable to higher expenditure on unemployment benefits and smaller tax

TABLE 2

Latin American countries: Fiscal performance

	1990	1991	1992	1993	1994	1995	1996
Argentina							
Observed balance	-3.8	-1.6	-0.1	1.4	-0.2	-0.6	-1.9
Structural balance	-3.1	-1.5	-0.7	0.6	-1.5	0.1	-1.1
Cyclical balance	-0.7	-0.1	0.6	0.8	1.3	-0.7	-0.8
Bolivia							
Observed balance	-4.5	-4.3	-4.4	-6.1	-3.0	-2.0	-1.9
Structural balance	-4.5	-4.4	-4.3	-6.0	-3.0	-2.0	-1.9
Cyclical balance	-	0.1	-0.1	-0.1	-	-	-
Brazil							
Observed balance	1.4	-0.2	-1.8	-0.8	1.1	-4.9	-3.9
Structural balance	0.8	-0.3	-1.1	-0.4	1.0	-5.2	-4.2
Cyclical balance	0.6	0.1	-0.7	-0.4	0.1	0.3	0.3
Chile							
Observed balance	0.8	1.5	2.2	1.9	1.7	2.5	2.2
Structural balance	1.0	1.7	1.8	1.6	2.1	2.6	2.4
Cyclical balance	-0.2	-0.2	0.4	0.3	-0.4	-0.1	-0.2
Colombia							
Observed balance	-0.5	-	-0.1	0.3	2.6	-0.5	-1.1
Structural balance	-0.8	0.2	0.2	0.6	2.5	-0.8	-1.1
Cyclical balance	0.3	-0.2	-0.3	-0.3	0.1	0.3	-
Costa Rica							
Observed balance	-2.5	-0.1	0.7	0.6	-6.6	-2.0	-2.7
Structural balance	-2.4	0.3	0.6	0.2	-7.0	-2.1	-2.1
Cyclical balance	-0.1	-0.4	0.1	0.4	0.4	0.1	-0.6
Ecuador							
Observed balance	0.1	-1.0	-1.7	-0.4	-0.2	-1.5	-3.1
Structural balance	0.2	-1.0	-1.8	-0.4	-0.3	-1.5	-3.0
Cyclical balance	-0.1	-	0.1	-	0.1	-	-0.1
Mexico							
Observed balance	-2.8	3.5	4.8	0.8	-0.7	-0.8	-0.5
Structural balance	-2.5	3.5	4.6	0.6	-1.3	-0.4	-0.4
Cyclical balance	-0.3	-	0.2	0.2	0.6	-0.4	-0.1
Paraguay							
Observed balance	5.2	2.9	0.1	1.2	2.4	-	-
Structural balance	5.1	2.9	0.2	1.2	2.4	-0.1	-
Cyclical balance	0.1	-	0.1	-	-	0.1	-
Peru							
Observed balance	-2.1	-1.4	-1.5	-2.3	1.8	-1.6	2.2
Structural balance	-2.4	-1.5	-1.0	-1.7	-1.6	2.1	2.2
Cyclical balance	0.3	0.1	-0.5	-0.6	0.2	0.5	-
Uruguay							
Observed balance	0.3	1.3	1.5	-0.8	-2.5	-1.3	-1.2
Structural balance	0.5	1.6	1.2	-1.0	-3.3	-0.8	-0.9
Cyclical balance	-0.2	0.3	0.3	0.2	0.8	-0.5	-0.3
Venezuela							
Observed balance	0.1	-2.2	-5.9	-1.3	-13.8	-5.9	7.5
Structural balance	0.4	-2.3	-6.2	-1.6	-13.7	-5.9	7.9
Cyclical balance	-0.3	-0.1	0.3	0.3	-0.1	-	-0.4

Source: Prepared by the author. See Martner, 1997.

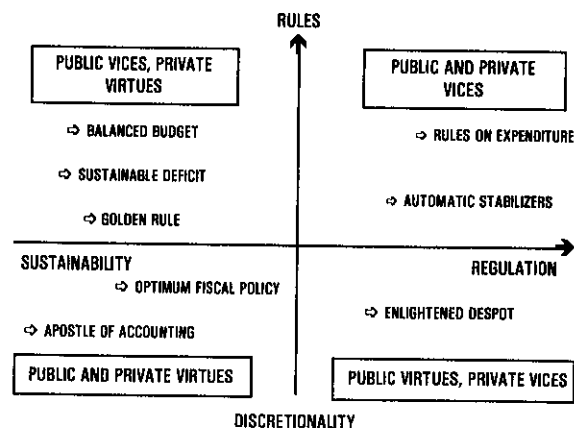
revenue receipts, would be financed through indebtedness. When the GDP returned to its medium-term trend path, this deficit would be automatically eliminated. The amount of debt contracted during the low part of the cycle would be absorbed in its high part. Both the balance and the total debt would be constant on average during the cycle, provided that the real interest rate was on average either equal to or not very different from the growth rate of the economy. A policy of this type is based on controversial assumptions, however, such as the need for a certain symmetry in the cycle and the absence of lasting effects of the latter. Realism calls for the maintenance of a certain amount of flexibility in economic policy in order to maintain the possibility of intervention in an uncertain environment.

In economies with a high degree of variability like those of Latin America, with periodic financing constraints and difficulties in establishing active fiscal policies, it would seem desirable to have explicit public expenditure rules throughout the cycle to make it possible to keep up growth when the economy is in the low part of the cycle and reduce the public debt when it is in the high part. For normal conditions, a prudent practice would be to allow expenditure to grow at a similar rate to the trend GDP and income to rise like the effective GDP. If the condition of the medium-term convergence of these two values is fulfilled, then obviously the average balance would be zero for the cycle. A programming criterion of this type presupposes strict control over certain types of expenditure (on health, for example), which tend to grow faster than the trend GDP. In our classification, these policies would have a certain normative component, but like all policies aimed at fulfilling the regulatory role of the public sector, they bring with them a tempting bias towards slacker fiscal discipline.

2. Discretionality or rules?

Figure 3 shows the position of the policies analysed above in the classification which we adopted. The position of each of these policies in the different quadrants of the area is relatively unimportant. In the lower left quadrant, the approach which we have called *apostle of accounting* has much to do with the way fiscal policy is currently carried on in our countries. Very often, decisions follow an accounting logic rather than a macroeconomic one, with the discretionary adoption of expenditure priorities which

FIGURE 3
Fiscal policy criteria



give preference to the fulfilment of strict targets regarding the balance. This is a perspective based on the idea of *public and private virtues*, in which the authorities trust in the self-regulating mechanisms of the market and the agents believe in the good judgement of public decisions. If, in contrast, the agents do not have confidence in what the public sector is doing, we enter the world of *public vices and private virtues* (upper left quadrant), where priority is given to the establishment of explicit rules to ensure the sustainability of fiscal policy. There, within the combination of sustainability and rules, we have placed balanced budget laws and, below them, the idea of a sustainable deficit (a little less normative) and the golden rule of public finances (in which the objective of sustainability is a little more flexible).

Others, however, may tend to mistrust the market, and may advocate much more active regulation of aggregate demand, with discretionary intervention. These active policies, which we have symbolized with the image of the *enlightened despot*, are located in the world of *public virtues and private vices* (lower right quadrant). In this view of the world, the self-regulation mechanisms of the market are either non-existent or perverse, and it is therefore necessary to have flexible intervention mechanisms for controlling excessive (or insufficient) expenditure and insufficient (or excessive) saving in the private sector. It is important to note that here we are contrasting the criteria of regulation and sustainability, because of the potential tensions that may arise between them. If the effective GDP is less than the potential level, the criterion of regulation (which calls for anticyclical fiscal policy intervention) comes into contradiction

with the criterion of sustainability (which favours a procyclical form of behaviour). Although there are situations where the two objectives are compatible (in the expansionary phase, anticyclical policy means increasing public saving, which obviously improves the financial position), the important thing in this classification is that it highlights the potential dilemmas that exist when establishing policy criteria.

In this respect, the impact of the automatic stabilizers on the level of activity has been the subject of intensive empirical evaluation but, as usually happens, the results have not been very enlightening. Weise (1996), for example, calculates that in the case of the United States, if the anticyclical reaction of the public balance were eliminated, the size of the recessions would increase by between one-third and half a percentage point of GDP. There would thus be a real conflict between the objectives of stabilization and short-term sustainability of fiscal policy. Other studies, however, show that the size of the cycle and the action of the automatic stabilizers are relatively independent of each other. It is estimated that for the OECD countries, the impact of variations in the public balance on the gap between effective and potential GDP is a good deal weaker (Hénin, 1997), thus considerably weakening the significance of the foregoing dilemma in this case. It is important to note that our classification refers basically to the more common definition of sustainability (understood as the annual and even monthly numerical goals for the balance imposed on governments in stabilization programmes). This criterion, if carried through to its ultimate consequences, would have a negative effect on the economic cycle and also, through the transmission mechanisms already referred to, on long-term growth.

Finally, the upper right quadrant shows us the combination of regulation and rules in which the automatic stabilizers and rules on expenditure may be located. In these cases, the normative component is more of an implicit nature and takes the form of a criterion rather than a strict rule. Policies involving automatic stabilizers refer more particularly to income, whereas rules on expenditure also try to limit the growth rate of expenditure, so that their normative and regulatory components are greater. Although these criteria are not of a mandatory nature for the public sector, they do represent clear guidelines for fiscal policy action, imposing maximum and minimum levels on expenditure and income. It may be recalled that we defined the rule on sustainable expenditure as the practice, in normal conditions, of

allowing public expenditure to grow like the trend GDP and income like the effective GDP.

As we already noted, one of the most important questions in fiscal policy matters is the clear separation of the transitory from the permanent components of public finances. Economic trends in the 1990s in our countries have shown once again, however, that fluctuations associated with events which are transitory or not sustainable in the medium term have played a leading role in the evolution of the public accounts. In this respect, indicators of discretionality can help to highlight the medium-term problems of public finances, by promoting an informed discussion and strengthening fiscal discipline in economic boom periods.

Mention may be made here, by way of illustration, of the kind of analysis carried out in the Ministry of Finance of France (referred to in Hénin, 1997), in which the criteria used in the definition of fiscal policy are the following:

- i) The sustainability of fiscal policy must be ensured, so that the rules adopted must comply with the requirements that the public sector must meet over time. The biased application of the action of the automatic stabilizers, involving excessive optimism in periods of expansion, may endanger the solvency requirement;
- ii) Only if sustainability is assured is it possible to permit the action of the automatic stabilizers, defined in the strict sense, i.e., as a symmetrical mechanism;
- iii) Only if the leeway for action is clearly identified can it be advisable to go beyond the automatic stabilizers, especially through expenditure of a transitory nature on public investment, whose effect on demand is both strong and rapid.

Although there is no intention here of trying to establish criteria of universal applicability, this way of formulating fiscal policy rules is obviously more flexible and hence more realistic than a mere requirement for balanced budgets. In a world of constant changes and uncertain situations, economic policies must be very active in their task of reducing excessive fluctuations, and fiscal policy obviously has a major role to play in fulfilling this objective. Leaving aside "good" or "bad" policy prescriptions, the challenge is to progress towards greater fiscal governance by developing instruments to guide the budgetary process towards a scheme in which expenditure is adapted to the ongoing availability of resources, by clearly identifying the transitory factors and ensuring that a medium-term view is taken in fiscal policy decisions.

IV

Conclusions

In economies like ours, periods of volatility are multiple, of great magnitude and frequent. If the authorities aim to reduce this volatility, which can lead to losses of social well-being, economic policy must be extraordinarily active and vigilant on all fronts. Laissez-faire in these matters has led in all the countries of the region to extreme situations; the State can hand over many of its powers to the private sector, but it cannot renounce its duty to watch over common goods like stability in a market economy.

A number of studies have shown the negative correlation that exists between volatility of the economic aggregates and long-term growth. In these conditions, stability would lead to gains of well-being in the medium term, thus giving grounds for the adoption of an approach which is more highly committed to the need for macroeconomic regulation. In their deeds, although perhaps not in their words, most of the industrialized countries currently practice Keynesian-type policies, i.e., policies which are more or less of an anticyclical nature. Policies designed to reduce the volatility of the real sector of the economy can have important beneficial effects. Macroeconomic regulation thus assumes great importance in development processes.

If the authorities act in accordance with more or less generally-known rules in their interventions in the economy, this helps to put private agents' expectations on a steady basis. Such rules, which are normative rather than numerical, must preserve the

degree of discretionality that the authorities need in order to forestall the generation of harmful fluctuations, however. Since the excessive use of monetary policy as a short-term regulation instrument can lead to situations of macroeconomic inefficiency, it is necessary to give much greater weight to fiscal policy, strengthening in particular the role of the automatic stabilizers in the cycle and increasing the discretionary capacity –within set limits– to fix tax rates for stabilization purposes.

In the interplay between the private agents and the public sector, a cooperative solution calls for a guarantee of stability, in order to lengthen the time horizon of decisions. A virtuous cycle is formed when forward-looking economic calculations become feasible, when the perceptions of future demand are stable, and when the agents do not pursue windfall gains caused by abrupt changes but profitable projects in the real sector of the economy. What is needed is to create, through active policies within the magic square, suitable conditions for a virtuous circle in which enterprises invest because there is demand and consumers consume and save because there is employment. The well-known maxim of supply-side theories ("today's profits are the investments of tomorrow and the jobs of the day after tomorrow") curiously enough converges today with an approach calling for macroeconomic policies which are much more active in regulating aggregate demand.

(Original: Spanish)

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