

# Managing in the *public sector for* investment and growth

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This article will focus on the central role played by imperfect or incomplete markets in the spread and perpetuation of recessionary situations. It is a known fact that demand volatility perpetuates such situations, and this can only be mitigated by sustainable economic stimulus policies. Macroeconomic rules, which are important for enhancing the tarnished credibility of State action, need to combine two basic principles: responsibility and stability. This means preserving regulation mechanisms so that excessive macroeconomic fluctuations can be stabilized. The best thing the authorities can do is to use flexible intervention policies to prevent such fluctuations. The new paradigm of public management by results thus entails setting clear fiscal rules with medium-term targets and short-term stabilization capabilities, but it must also involve allocating a larger and larger proportion of public expenditure on a multi-year basis. In seeking to combine stable economic growth with proper implementation of the plans and programmes voted for by citizens, public management faces three essential challenges: adhering to a macrofiscal rule over the cycle, identifying structural deficits as they arise, and correcting the traditional bias against investment. This article will look at some recent efforts to deal explicitly with these serious obstacles by applying legal provisions designed to cope with the uncertainties that surround both the cyclical behaviour of the economy and calculations of its long-term growth potential.

# I

## Introduction

The prevailing economic philosophy regards macroeconomic shocks as essentially transitory and public-sector intervention as perverse. According to this view, stabilization policies are a wholly ineffective way of increasing long-term growth, and actually make fluctuations more pronounced. It is thus better not to interfere with the natural adjustment towards balance; taking action and then reversing it may be more costly than simply doing nothing. According to this rule of non-interference, good policies are ones that confer credibility by remaining aloof from interventionist pressures. In Latin America, accordingly, most public-sector reforms, and recent fiscal responsibility laws, have sought to do away with or curtail the macroeconomic regulation role that the public finances have traditionally been seen as playing.

It is striking, however, how large a gulf separates the confidence with which these recommendations are made from the intensity of the theoretical debate and the tentativeness of empirical analysis. Economic theory is still debating fundamental aspects of the causes giving rise to macroeconomic ills such as inflation, unemployment and fiscal insolvency itself. Again, identification problems are intractable enough to give economists pause; the complexity of the interaction among observable and unobservable variables makes it difficult to identify statistical patterns, and thus arrive at an empirical demonstration of any initial hypothesis. As Greenspan (1996) puts it: "There is, regrettably, no simple model of the American economy that can effectively explain the level of output, employment, and inflation. In principle, there may be some unbelievably complex set of equations that does that. But we have not been able to find them, and do not believe that anyone else has either."

The combination of prolonged recessionary situations, monetary authorities with some degree of independence in setting their own targets and extremely rigid fiscal responsibility laws has produced strange situations in which the monetary authority has concerned itself solely with inflation and the public sector with short-term balance targets, which are of course impossible to meet in an environment of uncertainty. With no coordination of targets and instruments, responsibilities may be diluted, as no

authority has objectives or can be held to account for what happens to output, real stability or unemployment. The combination of policies applied in the region recently has not always been the most appropriate, and this has had major negative effects on overall performance. Fiscal policy also has a considerable part to play in preventing excessive fluctuations, but this aspect has not been taken into account in recent reforms.

The difficulties involved in understanding the structure of the economy and predicting the consequences of change are not an argument for confining macroeconomic management to a purely administrative role. Uncertainty means that the authorities need to address themselves time and again to two problems for which there is no simple solution: the mood swings of macroeconomic agents (such as euphoria and pessimism), which they need to restrain by providing a guarantee of stability that extends the time horizon for decision-making, and systematic conservatism and the loss of opportunities that this entails.

The present article, which synthesizes a more detailed work, consists of three sections besides this introduction. Section II reviews recent publications that have emphasized the role played by imperfect or incomplete markets in allowing recessionary situations to take hold and become entrenched. Demand volatility results in underutilization of the factors of production, which in turn leads to hysteresis and the entrenchment of recessionary situations. Many authors believe that the only effective way of mitigating volatility and uncertainty and coping with persistent weakness in overall demand and the devastating effects this has on aggregate supply is to apply sustainable fiscal stimulus policies.

Section III suggests that macroeconomic rules need to observe two fundamental principles: responsibility and stability. Generally speaking, recent reforms in our countries have aimed only at the former, so that the latter has been largely neglected. Indeed, stability, understood as the maintenance of a high level of output and employment, is not explicitly included as an objective in the fiscal responsibility laws of Latin America. Policies achieve credibility, however, by combining these principles in an appropriate way, which means having intervention mechanisms available to

stabilize excessive macroeconomic fluctuations. Applying countercyclical rules in normal times, while retaining freedom of action to cope with unforeseen situations, may be a way of responding to the challenges posed by the extraordinary volatility of the Latin American economies.

Section IV looks at some issues connected with the new public management model and the link between planning and budgeting, i.e., the need to allocate a growing proportion of public spending on a multi-year basis so that public plans and programmes can be

implemented efficiently. Modern public-sector management has to cope with three challenges: adhering to a macrofiscal rule over the cycle, anticipating the appearance of structural deficits so that sudden adjustments can be avoided, and removing the bias against investment that traditionally emerges when spending is cut back. The task is difficult, but not impossible; we shall be looking here at some recent attempts to deal explicitly with these serious obstacles to the new paradigm of the results-oriented management model.

## II

### Macroeconomic fluctuations and aggregate welfare

*“Economics is a science of thinking in terms of models joined to the art of choosing models which are relevant to the contemporary world.”*

John Maynard Keynes, letter to Roy Harrod, 1938

For some, the main source of macroeconomic fluctuations is the distorting nature of public-sector intervention. The most that monetary policy should seek to do, as Friedman (1968) puts the proposition, is to “prevent money itself from being a major source of economic disturbance”. The market is self-regulating, and fluctuations are necessary to ensure the overall efficiency of the economy. For others, by contrast, these fluctuations are the result of market failures, and are damaging to growth; highly active public policies are needed to restrain them when markets are incomplete. If the right model is to be chosen for today’s world, these two opposing stances need to be explained.

The emblematic economists of the neoclassical schools base their theories on simple market models whose characteristics are perfect information and competition, the absence of transaction costs and the presence of a full range of markets. There is a representative agent, which does away with the problems of asymmetrical information and risk, among other things. To explain macroeconomic fluctuations, theories in the neoclassical tradition focus on technological upheavals, the shifting balance of work and leisure, or real cycles resulting from changes in aggregate supply. Classical economists continue to interpret the economic cycle on the basis of a friction-

free market model in the tradition of Arrow-Debreu. In a pure Walrasian economy, the level of output that prevails when prices are totally flexible is the optimum one.

The inability of those who followed Walras to describe the real world was attacked by Keynes himself (1936) in his *General Theory*: “Our criticism of the accepted classical theory of economics has consisted not so much in finding logical flaws in its analysis as in pointing out that its tacit assumptions are seldom or never satisfied, with the result that it cannot solve the economic problems of the actual world.” Imperfections are the main difference between the actual world and the Walrasian model of Arrow-Debreu. In the words of Greenwald and Stiglitz (1993), “leaving them out of the model is like leaving Hamlet out of the play”.

There are periods, often long ones, when there is an excess supply of labour at the real wage level prevailing. In other words, there is involuntary unemployment. Aggregate economic activity, whether measured by capacity usage, GDP or the unemployment rate, fluctuates sharply, to a greater degree than could be caused by short-term changes in technology, consumer tastes or demographics, for example.

As Tobin (1993) remarks, the great debate between Keynes and his opponents was over how effective the

natural adjustment mechanisms of market economies were in restoring the balance of full employment once some adverse demand shock had disrupted it. Keynes and the Keynesians held that these mechanisms were weak, or perhaps non-existent or perverse, and that public policy action was thus required. Blanchard (1996) argues that during the Great Depression it was irresponsible to expect the economy to return by itself to its natural level, and that trying to balance the public budget was not just stupid, but dangerous. According to this view, entrenched unemployment and economic fluctuations are central, permanent problems. Recessions and depressions are market failures on a grand scale, as Mankiw (1993) puts it.

Many authors dwell on the role that imperfect or incomplete markets can play in creating, amplifying, spreading and perpetuating macroeconomic fluctuations (Greenwald and Stiglitz, 1989 and 1993; Stiglitz, 1999 and Dreze, 1997 and 2000). A common assertion is that in markets that are lacking in automatic regulation mechanisms, quantities vary greatly because prices change too little and too late. These imperfections in market adjustments are at the centre of explanations for prolonged recessionary processes. A variety of factors may explain why markets are not self-balancing: monopoly situations, uncertainty, transaction costs, sunk costs and information costs, among others. We shall concentrate now on the first two explanations.

Macroeconomic fluctuations may be a perverse consequence of uncompetitive conditions (Mankiw, 1985, 1989 and 1993; Blanchard and Kiyotaki, 1987 and Romer, 1993a). In conditions of perfect competition, companies lower their prices in response to a decline in aggregate demand, thus avoiding a fall in output. But it may take no more than small barriers in the price and wage adjustment process to turn modest falls in aggregate demand into costly recessions. The frictions referred to mean that the gains to any individual firm from lowering its own prices are small. In a system of monopolistic competition,<sup>1</sup> companies set their own prices and accept real sales as a constraint. This is in contrast to a situation of perfect competition, where

competing companies that are price takers can decide on their output level.

In a system of monopolistic competition, prices do not change when demand falls, and a recession occurs. Companies do not have much incentive to reduce their prices when the demand for their goods is lower, as their decisions have externalities. As Blanchard and Kiyotaki (1987) suggest, the aggregate demand externality indicates that the decisions of individual firms affect all others through aggregate demand.<sup>2</sup> We can define the aggregate demand externality as the additional welfare that would accrue if a monopolistic equilibrium situation gave way to one of perfect competition, as in the latter state aggregate demand would be higher.

When a situation of monopolistic competition is combined with price rigidities, small (second-order) costs in price adjustments can result in large (first-order) changes in output, in cases where nominal variations occur. Owing to the existing distortions produced by monopoly pricing, the benefits to society from a fall in prices can be large, even if they are small for the company. The microeconomics of price adjustments is crucial to the macroeconomics of nominal rigidities.

The reasons for fluctuations are to be sought in the risk-averse behaviour of companies (Greenwald and Stiglitz, 1993), whose decisions are affected by their perception of the risks, which in turn are associated with uncertainty about the consequences of their actions and the value of their assets. At least three factors influence companies' evaluation of risks.

The first is the situation of the economy as a whole. When expectations are pessimistic, this very perception has real consequences, as it affects all of a company's decisions from pricing to investment spending to employment levels. In other words, expectations have a strong influence on decision-making and generate multiplier effects that can assume large proportions. As Keynes (1936) put it: "Worldly wisdom teaches that it is better for the reputation to fail conventionally than to succeed unconventionally." The development of expectations is an eminently social phenomenon, and their tendency to become self-fulfilling is one of the greatest perils of the modern capitalist system.

<sup>1</sup> The concept of monopolistic competition, which is a contradiction in terms, refers to an economy made up of companies producing goods that are imperfect substitutes for other goods (Blanchard and Kiyotaki, 1987). In this situation, each company has some monopoly power, and thus the ability to set its own prices. The condition is that each firm has an objective function that can be differentiated in its prices. In other words, it can change these marginally in relation to its competitors' without its sales falling to zero.

<sup>2</sup> In the words of these authors: "If starting from the monopolistically competitive equilibrium, a firm decreased its price, this would lead to a small decrease in the price level and thus to a small increase in aggregate demand. While the other firms and households would benefit from this increase in aggregate demand, the original firm cannot capture all of these benefits and thus has no incentive to decrease its price."

Uncertainty means that the economic environment of the future is not known in the present. Complete markets are a utopian state in which economic agents can trade all goods and services in the light of future economic conditions. Markets are incomplete when risk coverage is limited, i.e., in the real world. Thus, a basic macroeconomic relationship, the balance between saving and investment, is constantly disturbed by the degree of uncertainty perceived by economic agents, as it is on this that actual investment spending will depend.

A second factor has to do with companies' liquid asset position. In a world where there is credit rationing and risk-averse behaviour, a company's liquidity takes on great importance. The liquidity position is affected by profits, which represent a residuum from previous decisions on pricing and quantity. To maintain the same cost level at a time of recession, when liquidity is less because profits are lower, companies have to borrow more. But the higher debt that results means there is a greater likelihood of future revenues being insufficient to meet the new liabilities. As a result, lower profits in a context of recession and credit rationing lead companies to invest less and produce less.

A third important factor is the change in relative prices, which has major effects on access to credit, on the interest rates paid and, thence, on companies' liquidity and net wealth. A rise in interest rates very rapidly erodes the net wealth of companies that are already in debt. The high speed at which asset prices and interest rates adjust to shocks, combined with flaws in the capital market that limit the ability of companies to diversify their risks, has profound implications for aggregate supply in the economy.

As different prices are set in different ways, and adjust at different speeds, shocks lead to large changes in relative prices, and these in turn severely exacerbate macroeconomic fluctuations. The aggregate supply curve moves markedly downward if the economy goes into recession. The risk of producing increases and the ability of companies to cope with this risk decreases.

When there is an aggregate demand shock, wage and price deflation, if this occurs, will not cause the economy to return to its full employment level, even in a situation of perfect competition. In the view of Stiglitz (1999), the large, simultaneous falls seen in prices, real wages and economic activity in certain countries during the recent Asian crisis have once again shown that price and wage flexibility in an imperfect market can have adverse effects far worse than those analysed in the traditional literature.

Dreze (2000) claims that "uncertainty and incomplete markets result in demand volatility and price and wage rigidities whose conjunction leads to multiple restricted supply equilibria, reflecting a lack of coordination that may cause weakness to become persistent". The availability of factors of production places an upper limit on output, but there is no lower limit. There are frequently long periods during which resources as important as labour and production capacity are underutilized or wasted.

There is a perfect synchrony between production and investment, which suggests that the volatility of the latter is a factor in the variability of the former. For a company, postponing investment decisions has second-order consequences for the benefits expected, but first-order consequences if overall investment demand declines significantly. The very existence of incomplete markets, then, is enough in itself to produce volatility in aggregate demand. Volatility results in underutilization of existing resources and, if investment is postponed, of future resources.

If there is underutilization, this will persist because of non-coordination until market conditions change. Underutilization leads to the perpetuation of weakness for at least three reasons: weak activity today tends to result in expectations of weak activity tomorrow; a low level of investment today reduces tomorrow's potential supply; and weak activity today tends to worsen tomorrow's financial situation, as price rigidities can prevent recovery in profit margins.

It is important to differentiate the concept of market failures, associated with the existence of imperfect markets (which can be perfected by introducing competition or appropriate regulation), from the notion of incomplete markets, which is explained by the existence of probabilistic expectations in a world where risk coverage is limited. In turn, these probabilistic expectations, which are perfectly rational, are associated with uncertainty about future scenarios. It is a matter not of anticipating situations on the basis of a macroeconomic model that everyone is familiar with, as in neoclassical theory with rational expectations, but of assigning probabilities in a context of uncertainty.

The programme, then, involves not just promoting competition, but also reducing volatility. From what has been said so far, three policy conclusions arise (Dreze, 2000):

- i) Solutions to demand volatility have to be sought. There needs to be constant awareness of the possibility that labour and production capacity may



be underused. The natural way of ensuring that demand stimulus policies are sustainable is to focus them on investments that produce an adequate social return, such as investments in social housing, urban renewal and urban transport. Carrying out such investments in periods when other private investment has temporarily declined is an effective way of dampening volatility, persistent weakness in overall demand and the devastating effects that this has on aggregate supply.

- ii) Wage and price rigidities are inevitable, which makes automatic adjustment policies very costly. The effects of rigidities need to be offset by specific temporary policies, such as *ex ante* wage moderation mechanisms to deal with recessionary situations, taxes on labour that vary depending on the unemployment rate and policies to alleviate the financial situation of SMEs.
- iii) The problems of market asymmetry and coordination cannot be taken lightly. The possibility of insufficient coordination is always present. Coordination problems are characterized by their potential to recur, which suggests that a constant slight demand pressure needs to be kept up, with dynamic supply policies to guard against the tendency to inflation.

As Dreze (2000) puts it: “The economic policy debate has convinced me that the main obstacle to implementing effective policies comes from gaps in macroeconomic theory, particularly its relative disdain for aggregate demand.”

If theories of hysteresis<sup>3</sup> are given any credence, a major challenge for the authorities is to avoid excessively conservative management. If economic policy is not relaxed when the conditions merit it, unemployment may persist and, because of hysteresis, come to bear out excessively high estimates of the structural unemployment rate. Thus, conservatism becomes self-fulfilling (Alsopp and Vines, 1998); structural unemployment is estimated at a high level (and potential GDP at a relatively low level) and a conservative economic policy is followed as a result, leading to entrenched unemployment which then becomes structural.

<sup>3</sup> Strictly speaking, the word hysteresis should be used only when the stationary equilibrium depends on actual conditions (for example, if the actual unemployment rate affects the equilibrium unemployment rate). Very often, the term is used for situations in which current conditions affect equilibrium conditions for an extended period.

In hysteresis models, the natural rate of unemployment is determined by macroeconomic policy and by its own history. Cyclical unemployment, which is produced by a prolonged recessionary environment, may over time turn into structural unemployment. On the labour supply side, the long-term unemployed adapt to their situation, ceasing even to look for formal work. This results in a higher natural unemployment rate, inasmuch as these unemployed do not exert any downward pressure on wages (Blanchard, 1997). On the demand side, employers prefer to hire those who became unemployed recently rather than the longer-term jobless, simply because the former can be easier to fit in. These types of behaviour also tend to raise the natural unemployment rate. When unemployment rates are persistently high, the concept of a natural unemployment rate is a misleading indicator for economic policy.

As Stiglitz (1999) points out, the consequences of action are not just uncertain, but costly to reverse. It is hard to win back a customer who has found another supplier, and even harder to rehire a worker who has found another job. The assumption of hysteresis, understood as the irreversibility produced by negative shocks, has major policy implications.

According to the conventional view of the economic cycle, fluctuations represent nothing but temporary deviations from an output trend. In hysteresis models, where temporary changes (such as movements in aggregate demand in conjunction with slow price adjustments) have persistent effects if a nominal shock in a context of rigid prices leads to a fall in demand, the level of output is going to be lower than it would have been had the shock not occurred, even once prices have fully adjusted. Models that incorporate rigidities thus show very different effects on welfare, as they assume asymmetry between periods of expansion and contraction in demand. The former increase social welfare and the latter reduce it. Asymmetry between expansions and recessions becomes possible when the natural output rate remains persistently below its optimum level, given the assumptions of imperfect competition.

When output falls below its equilibrium level, then, there are large costs for welfare if the decline affects investment decisions, and thence potential output. If this view is correct, countercyclical stabilization policies could mean significant gains in welfare (Romer, 1993a). Thus, the high variability of some prices, combined with the relative rigidity of others, plays an important role in perpetuating and amplifying shocks.

The risks involved in adjusting prices can be greater than those involved in adjusting quantities, and quantities can vary widely as a result. In a context of uncertainty and price rigidities, real volatility is greater than nominal volatility.

In a globalized world, the sources of uncertainty are multiplied and the authorities are faced with many challenges, as they have to combine credibility in their actions with the flexibility needed to cope with unforeseen situations. In the face of this dilemma (credibility presupposes stable ground rules for a prolonged period, while flexibility involves the ability

to respond to changes in conditions external to the system), short-term credibility, to be achieved by establishing rigid budgetary targets and deliberately renouncing any power to respond to adverse events, is often enshrined as the sole objective of economic policy. Given the frequency of shocks that are asymmetrical among countries, regions and sectors, discipline cannot be the sole or even the dominant criterion when the authorities are called upon to cope with a whole range of situations requiring the kind of inherently discretionary and temporary action that is essential if perpetuation phenomena are to be attenuated.

### III

## Macrofiscal rules for investment and growth

In situations of uncertainty, there is no place for strict rules and rigid conceptions, just as there is none for improvisation or ineffectiveness. If the objectives of fiscal policy are to achieve economic growth targets while simultaneously ensuring the sustainability of the fiscal accounts, the rules used need to be informed by complementary criteria of fiscal discipline and budgetary flexibility. Uncertainty means that discretionary action frequently has to be taken in the interests of stability, and that excessively conservative management has to be avoided.

Now as never before, most countries in Latin America have laid the foundations for sound, efficient management of the public finances with the recent enactment of fiscal responsibility laws. But there are still challenges, especially as regards the way the macroeconomic cycle is dealt with in budgetary planning and the stabilizing role of fiscal policy, issues that are vital if public- and private-sector investment are to complement each other as they should. It seems to be the right time to consider medium-term strategies that look beyond short-term conflicts. Despite progress with budgetary planning, and considering the chronic financing difficulties of the public sector, recent fiscal policy rules still tend to focus on short-term goals that look no further than the budgetary cycle and do not include provisions for dealing with the contingencies that are continually cropping up. The Fiscal Transparency Manual itself (IMF, 2001) warns about this. The Manual proposes that any rule adopted by a

government should be clearly specified. If a fiscal rule is to last, there obviously needs to be some flexibility built in for cases when a departure from it is justified by economic conditions.

In some cases targets are quantified by law, which makes it impossible for automatic stabilizers to operate fully, and thus means that the effects of the cycle on the budget are not allowed for. There cannot be any social or external sanctions on budgetary performance because of changes in variables that are outside the control of the public sector. The best thing is to incorporate conservative calculations into planning or, failing this, to provide for explicit divergence mechanisms. The type of management system, so common in our region, in which spending adjustments are continually being made because of deviations from overambitious quarterly balance targets cannot be regarded as an efficient one.

In some countries, the law states that the real rate of increase in primary public spending may not exceed real GDP growth. Given the climate of uncertainty in which the public finances operate, rules of this type seem too rigid. On the one hand, insufficient weight is given to the principle of stability, as the authorities' ability to react to recessionary situations (with extraordinary emergency employment programmes, for instance) is removed. On the other hand, an unrealistic limit is placed on spending growth, as this is related to actual GDP (known retrospectively) and not potential GDP (estimated in advance). It seems more appropriate

to base primary spending growth criteria on potential GDP, thereby eliminating the undesired effects of cyclical fluctuations on the planning and implementation of spending, and introducing a significant countercyclical component.

Spending rules are not risk-free, however, as the size of the public sector depends on factors that are not directly under the control of the authorities, such as demographic and economic variables. For a sample of 125 countries, Rodrik (1998) establishes a positive relationship between the size of the State (measured as the ratio between government consumption and GDP) and the economy's openness to the outside world. In the author's words: "The statistical association between openness and government spending appears to be a robust one. It is not a spurious relationship generated by omitted variables. Nor is it an artefact of the sample of countries selected or of a specific data source. The question is why this relationship exists." The explanation appears to lie in the fact that more open economies are more exposed to the ups and downs of world markets, and that these risks are transmitted more strongly to domestic economies. Governments play a role in insulating the economy from these disturbances, being a "safe" sector by comparison with the internationally tradable sector. External vulnerability can drive the public sector to play a greater role in the economy in transition stages, so it may be difficult to plan primary spending on an automatic basis without taking these mechanisms into account.

Generally speaking, our countries' laws are much stricter than those applying in the developed countries (Martner, 2000). A curious effort is being made to achieve macroeconomic credibility through legislation; but faith in rules or laws is no substitute for responsible policy action. The credibility of policies has more to do with the ability to internalize externalities, i.e., with bodies of law that provide for the consequences of changes in circumstances. The main objectives of fiscal policy should be as follows:

- In the medium term, maintaining sound public finances: i) by setting tax and spending priorities in such a way as to avoid unsustainable rises in the public debt and/or excessive tax rates, and ii) by ensuring, as far as possible, that the costs of the services consumed are met by the same generation as benefits from the public spending concerned;
- In the short term, supporting monetary policy: i) by allowing automatic stabilizers to operate fully

and thus play their role in smoothing out macroeconomic fluctuations when there are variations in aggregate demand, and ii) when prudent and appropriate, by altering discretionary policies to provide further assistance.

Short- and medium-term objectives are interrelated. For example, the scope for helping monetary policy to stabilize the economy during a recessionary phase depends on the strength of the public sector's medium-term financial position.

There is a critical problem with fiscal institutions, however. When events call for a change in the direction of fiscal policy, this is very difficult to achieve quickly, owing to the organizational complexity of the public sector. For example, the tax changes that circumstances require may be the subject of protracted and intense parliamentary negotiations. Various suggestions have been made for achieving greater autonomy in this area. One interesting initiative has been put forward in Australia. The Business Council of Australia (Gruen, 2001) has proposed that the instrument used should be income taxes, both personal and corporate. There would be no need to make short-term changes in the rates laid down by law if use were made of a weighting that varied according to the position of the economy in the cycle. The fiscal parameter would initially be set by the executive in a range of 0.97 to 1.03, giving a tax buffer of no more than one percentage point of GDP.

On the spending side, changes generally require budgetary authorization; furthermore, project design and evaluation take time. In the history of the United States, for instance, many discretionary stimuli have been applied only once recession has technically ended (Gruen, 2001). Another very serious problem is the risk that what are supposed to be temporary fiscal stimuli may prove irreversible. The tendency towards deficit that results from the difficulty of reversing such stimuli is one of the main arguments for establishing binding rules that limit discretionary action of this type.

Despite the risks, note should be taken of Ball's position (1996) regarding the ideal policy combination: "Shorter time lags are the first major advantage of using fiscal policy as a macroeconomic tool... If policy makers used their fiscal tools... they would make fewer mistakes. And mistakes could be corrected more quickly."

The following equation for the public-sector deficit illustrates the dilemma of fiscal policy well:

$$d = d_s - (\alpha + \beta) \text{GAP}$$



where  $d$  is the actual public-sector deficit, while  $d_s$  represents the structural component of the public-sector deficit,  $\alpha$  the marginal sensitivity of the deficit to the GDP gap (or cyclical deficit),  $\beta$  the discretionary reaction of the authorities to the cycle (or discretionary deficit) and  $GAP$  the GDP gap. Any macrofiscal rule needs to make provision for the following three components: a medium-term structural deficit objective, exception and transience clauses for when unforeseen macroeconomic fluctuations occur, and some room for manoeuvre for dealing with persistent recessionary situations (Buti, Franco and Ongena, 1998). This is what has been done in some countries' more recent legislation.

In New Zealand, for example, the Fiscal Responsibility Act of 1994 laid down the criteria of "maintaining total Crown debt at prudent levels by ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues".<sup>4</sup> The definition of a "prudent" level of debt that allows some room for manoeuvre should adverse events occur in future is not specified in the legislation. No one level of debt can be regarded as prudent at all times. All the relevant factors, such as vulnerability to external shocks, the cost of servicing debt, demographic pressures and so forth are likely to change over time.

Governments may depart temporarily from the principle of prudence, but the legislation stipulates that they have to explain why this departure took place and how they propose to return to a prudent level. The aim is to avoid the problems associated with numerical objectives in legislation; the difficulty of anticipating the future means there is a need for some short-term flexibility, provided that deviations are temporary and transparent.

The laws of the United Kingdom are guided by a similar philosophy. The Code for Fiscal Stability, passed by the House of Commons in December 1998, lays down the criteria that are to guide the formulation and implementation of fiscal policy. Government fiscal rules were first set in July 1997 in the Financial and Budget Report and were ratified in the March 1998 budget. It should be noted that they were included not in the Code for Fiscal Stability, but in the annual budget acts.<sup>5</sup> An alternative approach would be to include these fiscal rules in the Act, but this would be excessively restrictive, as the process under way might require that the rules be supplemented. Furthermore, the prevailing view is

that it is up to each elected government to choose and announce its policy rules and objectives, provided they are consistent with the fiscal principles laid down by the Act. The Government lays down two rules for the legislature: i) the golden rule: over the cycle, governments borrow only to invest and not for current spending; ii) the sustainable investment rule: the public debt, as a proportion of national income, is to be kept at a stable, prudent level over the cycle.

The golden rule seeks to achieve fairness between the generations by ensuring that the bill for today's spending, which mainly benefits current taxpayers, will not be passed on to future generations. By contrast, today's investment will benefit future generations as well as present ones. This does not mean that capital spending automatically ranks above current spending; both have a part to play, and both have lasting effects on the economy. The golden rule applies to net investment; it is implemented using a definition of the public-sector current account that is close to the concept of National Accounts, so that the depreciation of public-sector capital is included as a current expense. This ensures that today's taxpayers pay the cost of maintaining the capital stock. The definition of National Accounts is transparent and does not provide any inducement to pass off current spending as capital spending in order to comply with the rule. As for the second rule, the Government stipulates that, all other things being equal, it is desirable for net public-sector debt to be kept below 40% over the cycle. A debt objective that covers the whole cycle makes it possible to take account of the macroeconomic environment, to which this indicator is very sensitive, especially as regards the differential between the growth rate and the rate of interest on the debt.

Other legal provisions of great importance include those of the European Union's Growth and Stability Pact, which lays down medium-term objectives for achieving fiscal balance or surplus and obliges its members to submit three-yearly stability programmes that specify the route they propose to take to achieve these objectives. The Amsterdam resolution assumes that "adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3% of GDP". The time period used to interpret the medium term is the macroeconomic cycle.

To judge the extent to which medium-term objectives are met, in practice it is necessary to evaluate the likely impact of immediate economic conditions

<sup>4</sup> See New Zealand, The Treasury (1996).

<sup>5</sup> See United Kingdom, Her Majesty's Treasury (1998 and 1999).

on the present and future position of the public-sector accounts, in accordance with some method accepted by all Member States. Both the Member States and the Committee of the European Central Bank<sup>6</sup> consider the method used by the Commission services to be appropriate and useful for examining the cyclically adjusted public-sector balances of each Member State.

At the beginning of each year since 1999, all the countries have provided the Council and Commission with three-yearly stability programmes (in the case of eurozone countries) or convergence programmes (in the case of the rest) that meet the criteria of the Pact. According to the first Council Regulation,<sup>7</sup> which has had legal force since 1 July 1998, stability and convergence programmes must include the following information:

- i) The medium-term objective of a budgetary position close to balance or in surplus and the path of adjustment towards this objective for the general government balance, and the expected path of the general government debt to GDP ratio;
- ii) The main assumptions regarding the developments expected and the economic variables relevant to the implementation of stabilization programmes, such as government investment spending, GDP growth, employment and inflation;
- iii) A description of the budgetary or other measures proposed to achieve the programme objectives and, in the case of the main budgetary measures, an estimate of their quantitative effects on the budget;
- iv) An analysis of how changes in the main economic assumptions affect the balance and the public-sector debt.

The information on movements in the public-sector balance, debt and the main economic variables tracked must be provided annually and cover the previous year, the current year and the next three years. Member States are to make their stability and convergence programmes public each year. The Committee has produced a technical report, to serve as a code of good practice, on the format and content of stability and convergence

programmes, with a view to facilitating examination and discussion of these. The main components of these programmes are as follows:

- i) The grounds of assumptions relating to GDP growth and the expected sources of this growth must be explained, with sufficient information to allow the position of the economy in the cycle to be analysed. Technical assumptions relating to changes in interest rates must also be set forth, owing to the impact of these on the public finances. Given the practical difficulties involved in using a common set of macroeconomic projections, the Committee prefers member countries to come up with their own forecasts for the domestic economy and the world situation. Where these differ significantly from the Commission's forecasts, however, the member country will have to justify its assumptions.
- ii) Programmes should include sensitivity analyses estimating how changes in the main economic assumptions would affect the public-sector debt and balance. These analyses are to be supplemented by studies on the impact of different interest rate scenarios on the deficit and debt.
- iii) The information on trends in the general government deficit and debt and the assumptions relating to the main economic variables should cover at least the next three years. Member countries may submit information for a longer period should they so wish.
- iv) The annual updates should show how the variables have behaved in relation to the objectives of the previous programme and, when there are significant deviations from these, state what steps are planned to rectify the situation.

The Pact does, however, allow the balance objective to be interpreted more flexibly, so that larger deficits will be accepted, within certain limits, when they are the result of transitory cyclical factors. The steps to be taken are set forth in the Protocol on the Excessive Deficit Procedure,<sup>8</sup> article 2:

- i) The excess government deficit over and above the reference value will be deemed exceptional when it is the result of an unusual event outside the

<sup>6</sup> See Council of the European Union (1998) for the opinion of the Monetary Committee on the content and format of stability and convergence programmes.

<sup>7</sup> See Council of the European Union (1997a) for the Council Regulation on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

<sup>8</sup> See Council of the European Union (1997b) for the Council Regulation on speeding up and clarifying the implementation of the excessive deficit procedure, effective from 1 January 1999.

control of the member government and has a significant impact on the financial position of the general government, or when it is the result of a severely unfavourable change in the short-term economic situation. The excess will be deemed transitory if the Commission forecasting services judge that the deficit will fall back below the reference value once the unusual event or unfavourable change in economic conditions is over. The excess deficit must be fully corrected within two years from when it arises and one year from when it is identified, unless exceptional circumstances exist. The statistics used to apply the protocol will be provided by the Commission.

- ii) As a rule, the Commission will consider an excess deficit to be exceptional only if there is a year-on-year fall in GDP of at least 2%.
- iii) The Commission will decide if the situation is exceptional in cases where this fall is less than 2% and there is an excess deficit, taking account of the observations made by the member country, in

particular as regards the steepness of the recession and the accumulation of GDP losses in relation to past trends.

The idea is to combine discipline with flexibility by means of multi-year planning with explicit objectives and short-term management that takes more account of macroeconomic fluctuations. These components help to improve the efficiency and effectiveness of public policies by extending the horizon of public-sector management and retaining room for manoeuvre so that unforeseen situations can be coped with. This is possible only where there is transparency and clear reporting mechanisms. The combination of properly explained medium-term goals (a situation of near balance or surplus under normal conditions in the euro zone, balance in the current account over the cycle and stable public debt over the cycle in the United Kingdom) and budget planning that sets out the path to attainment of these objectives allows a proper appreciation to be formed of the situation and direction of the public finances.

## IV

### Managing the public sector for the future

As macroeconomic stability makes it possible to look towards a medium-term horizon, it is becoming more and more feasible and necessary to focus anew on planning as a key public-sector management instrument in Latin America. This process has been proceeding piecemeal, rather than in the form of a preconceived project. Planning should shed light on medium- and long-term prospects for the body of citizens, clarify the public authorities' decision-making choices and explore new economic and social strategies that are feasible and desirable. Planning creates a bridge between the government's overarching political and economic objectives and the implementation of its plans and programmes.

Making an effort to predict the future so that forethought and a long-term horizon can be incorporated into the decision-making process is one of the most crucial tasks of public-sector management. One of the legacies of the adjustments carried out since the 1980s is that the bulk of Latin American countries have very limited time horizons. Notwithstanding this, the State has an inalienable responsibility to prepare

for the future, improve forward thinking capabilities, resist the "destructive tyranny of the short term" and provide far-reaching vision. Forward thinking is a precondition for action, and this cannot become entangled with mere crisis management. The future is not just foreseen, it is constructed; anticipation in order to build a future chosen by free and mutual consent, this is the object of forward planning.

We can distinguish two opposing approaches to such planning. One is of an exploratory nature, setting out from the present to review the gamut of possible futures, while the other is prescriptive, setting out from a vision of the future that is desirable and constructing a road map of the actions needed to attain it. The risk of setting out from present conditions is that one may remain there without changing anything, or changing only at the margins. If the starting point is a vision, the risk is again that one may remain there, weaving fantasies. The natural course is to seek images of the future that are based on the present, but the opposite route, setting out from the vision, is attractive, since the key thing is to break away from inertia and mobilize

energies. The challenge in the latter case is to turn these ideas into new economic and social strategies that can be used to deal with the great problems faced by the region.

Preparing public-sector management for the future involves progress in seven well defined areas (OECD, 2001a): i) macrofiscal rules, ii) multi-year budgeting, iii) zero-base budgeting, iv) relaxation of internal controls, v) accrual-basis accounting and management, vi) result evaluation and vii) performance agreements. Note that this classification entails a sequence. Thus, the evaluation of results only makes sense if the preceding reforms are implemented.

As is well known, public-sector management has moved from programme budgeting to a results-oriented approach. The programme budgeting method sought to establish close links between the budget process, planning and the evaluation of public programmes. In its broadest conception, the results-oriented approach seeks rather to enrich budgetary discussion within a framework of flexibility (see Marcel, 1998). The process of modernizing institutional management is now closely linked to what is known as the management by results model, which involves providing management centres with a degree of decision-making autonomy while simultaneously constructing appropriate evaluation systems. Evaluation should be both internal, involving performance indicators and targets, and external, with evaluation rounds carried out by other bodies. The guiding principles have to do with the strategic planning of public bodies, the type of linkage between resource allocation and institutional performance, the transparency of State action and, as a corollary of this, the quest for change in the organizational culture of public institutions.

This process is not without difficulties, as it is obstructed both by current failings (the shift from a procedure-based culture to a user-oriented results-based one) and by external constraints (continuous restructurings that hinder the emergence of an appropriate organizational structure with specialized human resources). Every experience is unique; the factors specific to each country and institution mean that instruments and procedures must differ from case to case.

It is clear, though, that management by results can only become a day-to-day reality if agencies' capacity for independent action is strengthened by means of performance agreements. Such agreements have a variety of purposes: increasing efficiency/effectiveness, accountability and managerial capabilities, moving

from a rule- and input-based approach to an output- and results-based one, and building trust. In general, performance contracts are not legally binding but are negotiated by mutual consent on the basis of agreements between ministers and executive heads, or between departments and agencies. These contracts are generated on the basis of agreements, which provide the basis for resolving disputes and coping with contingencies or adjustments when unforeseen events arise. Performance contracts are constructed on the basis of a "relational" contractual model rather than a traditional one, and draw their strength not from the threat of legal or financial sanctions but from the need of the parties to have clear relationships and stable agreements (OECD, 1999).

The transformation of public-sector administration can result in incompatibility between the need for central control of operations and the managerial freedom required for performance to improve. Here it is very important that budget offices do not confuse new public-sector management systems with short-term fiscal adjustments, and that managers do not interpret the reforms as a licence to spend as they please (Shick, 2001). Managerial innovation requires new models for the relationship between "spenders" and "allocators" so that an appropriate balance can be struck between the need for flexibility in implementing plans and programmes and the discipline involved in forming part of a public sector with explicit macrofiscal rules.

It is indispensable for policy decisions with a multi-year outlook to be clarified. The implementation of public-sector plans and programmes needs to take place within a multi-year budgeting framework, and this is nothing other than strategic planning. Until a few years ago, multi-year planning of this kind was synonymous with budgetary rigidity, in the sense of an accumulation of sectoral commitments that were radically incompatible with overall objectives. This "bad" type of multi-year planning has given way to a more optimistic view of public-sector financial planning. Today, "good" multi-year planning is the natural consequence of the enhanced role being played by performance agreements and public policy evaluation instruments. There is nothing new about taking a multi-year approach to public-sector management; the innovation consists in achieving growing linkage between the plan, the budget and the evaluation of results, formalizing processes around these instruments so as to ensure consistency over time in decision-making, and designing a chain that makes the results-oriented management model viable.

Public-sector management could facilitate decision-making and arbitration, both centrally and regionally, if it were designed on the basis of forecasting exercises and strategic plans, with medium-term fiscal rules, multi-year budget planning, performance agreements, effective coordination bodies and open systems for the evaluation of plans and programmes. For planning to fulfil its function properly, there is a need to introduce more pragmatism and lay the groundwork for flexible, decentralized management with greater accountability and freedom of action for those conducting it.

If medium-term rules are to be made consistent with public expenditure management, the new planning and control system needs to avoid, on the one hand, the tendency towards short-termism in decision-making and incrementalism in budget management and, on the other, the negative bias that generally affects investment spending. A clear separation between current spending (including depreciation) and capital spending, and the allocation of growing proportions of public spending on a multi-year basis, are changes that can unquestionably make a decisive contribution to the arduous task of creating an institutional environment that nurtures stability and growth.

The creation of an appropriate environment for private-sector investment and the proper administration of the scarce resources available for public-sector investment can only come about if management methods are able to deal with three fundamental challenges: firstly, adhering to a fiscal rule over the cycle, to avoid the economic and political costs of sudden fiscal adjustments; secondly, identifying structural deficits far enough in advance to avoid excessive public borrowing that will place a burden on future generations; and thirdly, removing the bias against capital spending which, by its very nature, is generally more sensitive to fiscal adjustments than current spending. Delaying or cancelling such spending also places a burden on future generations.

As regards the first challenge, that of adhering to the fiscal rule over the cycle, the right approach is to develop instruments that can guide the budget process towards a disciplined, flexible system in which temporary factors are clearly identified and management is consistent with the fiscal pact that is essential for our societies. The right approach seems to be to aim for a financial position that is corrected for fluctuations in the level of economic activity, which is equivalent to planning spending and revenue with a medium-term outlook in the management of the public

finances. When budgetary policies are being designed, it needs to be remembered that the cyclical progression of the economy is inevitably uncertain and that projections for the determinants of revenue and expenditure are necessarily imprecise.

To deal properly with the second challenge, that of identifying structural deficits far enough in advance, the need is to ensure that the multi-year trend of the budget balance is consistent with the fiscal rule. Most multi-year planning errors are attributable to mistakes in forecasting the growth potential of economies, and these errors have permanent effects on the public finances. If actual GDP is below the trend estimated for the period covered by government planning, the result is a structural deterioration in the public-sector financial position.

It is thus important to take explicit account of the position of the economy in the cycle and to use moderate growth assumptions for multi-year planning. With lessons from the past in mind, such as the observation that the main reason multi-year budget planning exercises fail is excessive optimism about medium-term growth, a prudent strategy with the flexibility to cope with macroeconomic fluctuations should be determinedly embarked upon.

It seems necessary to confront this "optimistic bias" (whereby positive episodes are regarded as permanent and negative ones as temporary) if fiscal planning is to become more consistent and transparent. Sensitivity analyses should not be confined to the construction of scenarios incorporating different values for one-year GDP forecasts, but should also include less optimistic scenarios for trend GDP. This will provide a prudent set of multi-year assumptions, which is necessary in an uncertain environment to provide a margin of safety and thus internalize the possibility of unforeseen contingencies and of measurement errors in the budgetary planning process itself.

Orienting fiscal policy by a medium-term structural objective involves much more than just a simple criterion, as it means carrying out systematic measurements of the position of the economy in the cycle, and thus of the factors affecting potential GDP. Public-sector management should contain a large component of macroeconomic analysis; a much larger one, indeed, than is normal in our countries.

As regards the third challenge, that of removing the bias against capital spending, it is important to give explicit recognition in the budgetary planning process to the economic difference between current and capital expenditure. The State has an obligation to create or



maintain the capital stock that the economy needs and to ensure that its public-sector component is kept in good condition. Inadequate public-sector investment can do irremediable harm to the long-term performance of an economy.

Many countries are making great efforts to bring their budgetary processes into line with the objective of stimulating and protecting public-sector investment. To this end, it is helpful to plan and manage current and capital expenditure separately. With the results-oriented management model, spending should be planned, managed and accounted for on an accrual basis whereby capital costs, and likewise depreciation and interest on public-sector investments and other assets, are recorded as and when they arise. This provides a better link between the expenditure planning process and the fiscal rule.

The recent experience of the United Kingdom<sup>9</sup> is particularly intriguing. "Firm" three-year plans are drawn up for all government departments, in the form of the departmental expenditure limits (DELS). The idea is that these limits (roughly half of total spending) should provide a solid basis for planning and a strong incentive for costs to be administered efficiently. The Government is also seeking to improve management by making it more flexible, accepting that agencies are free to shift any proportion of their DEL-mandated spending from one year to another.

When spending cannot reasonably be covered by a three-year plan, it is subject to annual scrutiny as part of the budgetary process, and is known as annually managed expenditure (AME). Most of this spending is for social security, and it is subject to rigorous annual control. Current and investment spending, whether covered by DELS or the AME provisions, are planned and managed separately in a way that is consistent with the fiscal rule.

Since 2000, a new accrual-basis accounting system has been in operation for the public sector, to supplement the existing cash-basis accounts. The use of accrual-basis accounting principles recognizes that the economic effects of capital spending are not the same as those of current spending; in addition, outgoings are recorded when they are incurred and not once they have been disbursed. The objective of resource accounting and budgeting (RAB) is to plan, manage and account for DELS on an accrual basis, recording capital costs and depreciation and interest

on public investments and other assets as and when they arise.

This provides a stronger link between the expenditure planning process and the fiscal rule, with the spending of agencies being accounted for on the same basis as is used for fiscal projections. It is worth noting, however, that the cash system will continue to be important, for example in accounting for the government's financial needs. Furthermore, the cash basis will continue to be used for tax forecasting.

Accrual-basis accounting has been fully implemented in Australia, Canada, Iceland, Italy and New Zealand, and other countries are currently developing such systems (see OECD, 2001b). High-quality information is the basis for good decision-making policy.

Public-sector management thus has to combine transparent design, involving rules that ensure medium-term control of the public finances, with a new budget planning system based on multi-year allocation of a growing proportion of public spending. These two pillars are inseparable; the first of them (fiscal rules) makes the second (multi-year planning) technically feasible by establishing norms that are independent of the macroeconomic cycle, while the second gives agencies greater incentives to manage their budgets more efficiently and thus contribute to the attainment of goals over the course of the cycle.

Strategy thus needs to concentrate on long-term planning, stress outputs more than inputs, distinguish current spending clearly from capital spending and, lastly, be grounded in prudence and stability, with a margin to cope with the inevitable uncertainties. The developments described reveal interesting changes in the way public-sector management is approached. After almost two decades of decline, planning, guided by multi-year plans and programmes, is being used to reverse the policy of administration by sector and by institution. The prescriptive approach is giving way to strategic management and forecasting. This means incorporating the multi-year aspect into investment plans and budgetary frameworks; the challenge is to coordinate public- and private-sector investment in the interests of growth.

In a context dominated by imbalances and a variety of emerging conflicts, the objective is to build new institutional structures with prudential systems designed to internalize positive and negative externalities to the greatest possible degree by means of rules, procedures and exception protocols. The idea is not to legislate for credibility, but to develop long-term strategies whose

<sup>9</sup> See United Kingdom, Her Majesty's Treasury (2000).

guiding aims are accountability, stability and growth. This is about much more than just semantics; our countries need fiscal responsibility laws that give due

weight to the principle of accountability, but consideration also needs to be given to stability and growth laws. The difference is not a minor one!

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