THE FISCAL COVENANT
STRENGTHS, WEAKNESSES, CHALLENGES

UNITED NATIONS
ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN
Santiago, Chile, 1998

LC/G.1997/Rev.1-P
November 1998

This document was prepared by the ECLAC secretariat for presentation at the twenty-seventh session of the Commission (Oranjestad, Aruba, 11-16 May 1998). The executive officers were José Antonio Ocampo and Gert Rosenthal, Executives Secretaries, during their respective terms of office, and Reynaldo Bajraj, Deputy Executive Secretary, assisted by Osvaldo Rosales. The officer responsible for technical coordination was Juan Carlos Lerda. ECLAC experts collaborating on this text were: Gabriel Aghón, Jorge Bravo, Rossella Cominetti, Emanuela Di Gropello, Trevor Harker, Günther Held, Keiji Inoue, Felipe Jiménez, Eugenio Lahera, Ricardo Martner, Rossana Mostajo, Carlos Mussi, Igor Paunovic, Juan José Pereira, Daniel Titelman, Andras Uthoff, Vivianne Ventura-Dias and Jurgen Weller. The following acted as assistants: Gloria Bensan, Javier Carranza, Susana Gonzales, Susanne Hofmann and Jorge Montesinos. External consultants who also collaborated on this document were: José Carlos de Oliveira, Paulo Fontenelle e Silva, Dominique Hachette, Mario Marcel, Felipe Ohana, Jorge Puchet, Federico Torres and Miguel Angel Vizzio.

Explanatory note

The figures for 1996-1997 are provisional

LIBROS DE LA CEPAL

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UNITED NATIONS PUBLICATION

Sales No. E.98.II.G.5

ISBN 92-1-121225-1

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PREFACE

Since the start of the present decade, ECLAC has produced a series of documents on the theme, "changing production patterns with social equity", which have offered guidelines for the current and future development of the region. Continuing this process, the Commission has chosen the theme of Latin American and Caribbean public-sector finances for consideration at its twenty-seventh session.

For the proposals that ECLAC has been formulating to be viable, public finances must first be put in order to ensure that the State can act effectively. In effect, both consistent macro-economic management, which makes accelerated growth possible by raising savings and investment rates, and the ability to respond to demands for better distribution of the fruits of that growth and for environmental conservation are issues that are clearly linked to public-sector management and the institutional mechanisms through which that sector, private agents and society as a whole interact. The secretariat has therefore considered it opportune to turn its attention to public finances and fiscal management, centred around the concept of the "fiscal covenant". By this is meant the basic socio-political agreement that legitimizes the role of the State and establishes the areas and scope of government responsibility in the economic and social spheres. The new fiscal covenant, it is suggested, has five basic aspects: consolidating the ongoing fiscal adjustment process, raising the productivity of public management, making fiscal activity more transparent, promoting social equity and encouraging the development of democratic institutions.

The document is in three parts. Part one summarizes the strengths, weaknesses and challenges presented by the new fiscal covenant. It also analyses the fiscal and quasi-fiscal aspects of public action, advocating that greater efforts need to be made to achieve transparency and proposing various courses of action to limit the quasi-fiscal component of public policies. Part two reviews progress and changes in the areas of public-sector revenue, expenditure, deficit and debt. Part three considers what has been achieved and what remains to be done in key areas of public management with major fiscal implications: social

spending, social security reform, fiscal decentralization, privatization and the modernization of the State. On each of the issues examined, proposals are made, with the aim of consolidating progress and meeting the challenges that await by attempting to learn from the best practices observed in the region and in other parts of the world.

PART ONE:
THE OVERALL FRAMEWORK

I. Strengths, weaknesses and challenges of the new fiscal covenant

II. Transparency in public finances: the fiscal and quasi-fiscal spheres

I. STRENGTHS, WEAKNESSES AND CHALLENGES OF THE NEW FISCAL COVENANT

A. INTRODUCTION

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

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

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

cases and to varying degrees, facilitated a change in the social security funding model from pay-as-you-go to funded systems, incidentally expanding the sources of domestic financing for both government and the private sector, including, potentially, private infrastructure projects.

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

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

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

Nevertheless, it cannot be said that the region has resolved its fiscal problems and need only persist in its current approach for a reasonable period of time. On the contrary, myriad economic problems and crises —in many cases limited in intensity and ultimately brought under control, but crises nonetheless— have created an overall impression of fragility and suggest that fiscal balance and its contribution to general macroeconomic

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[1] ECLAC (1994a).

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

equilibrium are still constantly at risk, and that recent achievements in this regard must be firmly consolidated before there are any grounds for complacency. Another cause for concern are the banking crises which are becoming more frequent as the volatility of capital flows increases in the absence of adequate prudential regulation and whose costs are potentially much greater than those of traditional fiscal crises.

It is clear, moreover, that because of the exigencies of the crisis, most of the countries' efforts have gone into reaching and maintaining financial equilibrium, and scant attention has been paid to other possible objectives of fiscal policy, including some on which there is considerable consensus. Social equity goals, for example, generally received short shrift during the 1980s in the design of the tax structure and the composition of public expenditure, although the present decade has seen significant improvements in the latter respect. Moreover, efforts to improve the transparency of public accounts, to develop a new style of results-based government management and to promote a fuller debate of the budget within a democratic framework have been insufficient, to say the least.

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

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

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

B. MAIN ELEMENTS OF A NEW FISCAL COVENANT

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

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

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

unless it reflected the explicit intention, and was equipped with definite mechanisms, to endow fiscal action with the utmost **transparency**.

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

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

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

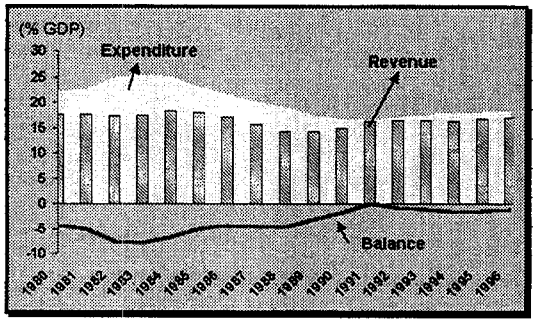
C. FISCAL CONSOLIDATION

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

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

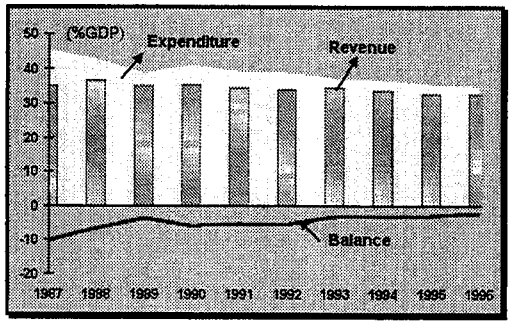
Figure I-1
OVERALL BALANCE OF THE CENTRAL GOVERNMENT
(Percentage of GDP)

1.a Latin America



Source: ECLAC, on the basis of official figures.

1.b Caribbean



Source: ECLAC, on the basis of official figures

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

The favourable trend in public accounts obscures, however, a number of phenomena that suggest that the achievement is still fragile. By recording proceeds from privatization above the line even though they are, strictly speaking, non-recurrent revenues, some countries have tended to overestimate the solidity of their adjustment. Another problem is that public finances have become more dependent on the economic cycle, a tendency that makes for instability in expenditure and threatens the durability of the fiscal adjustment. An

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

expansion in spending based on a transitory swelling of tax revenues and easy access to external financing during an upswing of the economy is followed by sharp spending cuts when the revenues and financing evaporate. Inadequate regulation of quasi-fiscal operations has resulted in sharp imbalances in a number of countries, the outstanding examples in this decade being those associated with banking crises. Decentralization has brought new challenges and in some countries has become a major source of fiscal imbalance. Lastly, despite deficit reduction, the public debt burden remains high.

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

1. Public revenue: incomplete progress

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

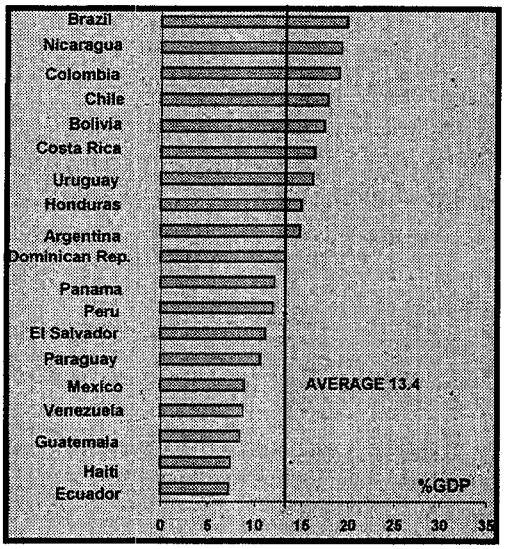
The average size of the public sector in the region, as measured by revenues, is moderate and clearly smaller than in the OECD and Asian countries. Average total central government revenue in Latin America increased slightly from a little less than 15% of GDP in 1990 to 17% in 1996 (see figure I-1);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

The level of social security contributions makes a big difference in comparisons of the tax burden across regions. The tax burden in the OECD countries was 38% of GDP in 1995, of which social security contributions accounted for nine points, so that the effective tax burden, net of social security contributions, was somewhat over 29% of GDP. Social security contributions average 2% of GDP in Latin America, and, as just indicated, the tax take net of these contributions averages 13.6% of GDP. In any case, social security is only one of many factors contributing to the heterogeneity in tax levels characteristic of the region, which reflect, among other elements, the effectiveness of tax systems, decisions as to the size of government and the option open to some countries of financing public expenditure with oil revenues (see figure I-2). These comparisons also reveal the great

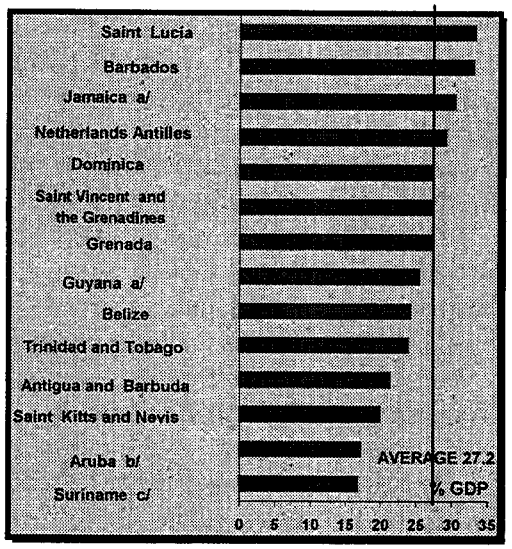
potential that exists in many countries, particularly in Latin America, for increasing taxation without affecting their competitiveness.

Figure I-2
CENTRAL GOVERNMENT TAX RECEIPTS, NET OF SOCIAL SECURITY CONTRIBUTIONS, 1996[a]
(Percentage of GDP)

2.a Latin America



2.b Caribbean



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

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

Tax systems have changed considerably since the early 1980s in many other respects as well. The number of tax bases has been reduced, and there has been a shift in the territorial and functional basis of taxation away from tariffs and towards domestic taxes, and away from direct taxes and towards indirect taxes. The tendency to rely increasingly on

value added tax (VAT) not only favours allocative neutrality, but allows for an increase in the sectoral coverage of indirect taxation, thereby reducing exemptions and making it easier to control evasion. With respect to income tax, the threshold limit of income subject to tax has been raised, the number of brackets have been reduced and the maximum marginal tax rates have been lowered for both individuals (from 47% to 28% on average) and companies (43.3% to 35.5%). In addition, there has been more widespread use of presumptive criteria for taxation in some industries in order to reduce evasion.

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

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

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

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

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

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

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

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

By reducing the number of tax bases, some of which have a low yield, Governments can reduce the compliance costs to taxpayers and hence the incentive to avoid or evade complying with their obligations. A tax regime characterized by broad bases and uniform rates is less vulnerable to evasion —chiefly because it is easier for the tax office to monitor— than a system that features multiple exemptions, deductions or differential rates. Moreover, simplifying the tax system cuts down on the amount of information required and the need for complicated tax procedures, which tend to encourage avoidance or evasion. Streamlining should also be accompanied by a consolidation of jurisdictions with regard to

any given tax base, since when responsibilities are divided between different levels of government (as happens in Brazil), control becomes more difficult.

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

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

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

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

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

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

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

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

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

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

Decentralization has also given rise to considerable macroeconomic difficulties for four basic reasons: (a) a greater emphasis in the decentralization process on revenues than on expenditures in some countries (Brazil and Colombia); (b) the generalized use of revenue-sharing systems which reduce the degree of freedom of tax policy, since increases in revenue collections automatically generate higher expenditures through increases in transfers; (c) the absence of controls on borrowing by subnational levels of governments;

and (d) the lack of incentives for regions to generate their own funds. Excessive dependence on national transfers is one of the unfortunate features of decentralization in Latin America: these transfers usually finance over half of local expenditures compared with one third in the OECD countries. Given this state of affairs, efforts to improve public management through the decentralized administration of services must be accompanied by a solution for these macroeconomic problems, which could otherwise ultimately defeat the whole process (see chapter VIII).

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

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

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

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

The feasibility, from the standpoint of public finances, of carrying out a total, immediate pension reform must be weighed by the competent authorities in each country. A

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

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

(a) Moderate the cyclical nature of public finances

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

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

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

Careful monitoring of the cyclical and structural public-sector deficits on the basis of standardized and timely information will facilitate fiscal debate on medium-term policy,

thus avoiding traumatic adjustments in response to cyclical variations. It would also be a means of ensuring more stable social programmes, since public revenue or public investment could serve as adjustment variables for the economic cycle. This approach would help to improve the impact of social programmes, since, once the sharp fluctuations in social spending were rectified, it would be easier to evaluate the results of these programmes and to make the necessary corrections to enhance their effectiveness.

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

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

(c) Manage the macroeconomic effects of decentralization carefully

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

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

(d) Monitor the fiscal impact of social security reforms

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

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

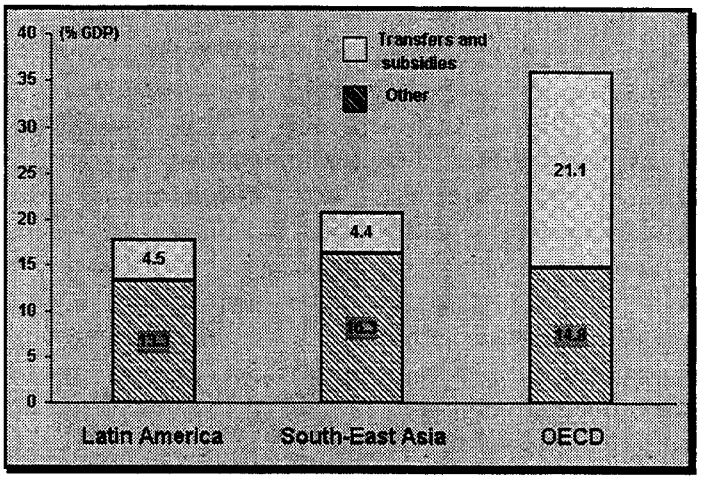
In most cases, the type of funding is not predetermined but may consist of a combination of current taxes, public borrowing and privatization receipts. If taxation is the only source of financing, it places a heavy burden on most members of the generations currently working; debt-financing, on the other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

D. IMPROVED PRODUCTIVITY OF PUBLIC EXPENDITURE

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

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

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



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

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

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

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

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

schemes began with pilot projects in a number of OECD countries and have begun to be introduced in the region. Progress in that respect has been made in Chile, Colombia and Costa Rica (see chapter X).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

charge that covers the costs of providing the service; the contributions are paid into a solidarity fund that finances the subsidies, which are also explicitly defined, for poorer social groups.

(c) Decentralize services effectively, when deemed advisable

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

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

(d) Manage the privatization process properly

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

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

The problem of contingent liabilities generated by government guarantees offered under recent schemes for private-sector participation in infrastructure projects requires that

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

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

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

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

E. TRANSPARENCY OF PUBLIC EXPENDITURE

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

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

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

Mention should also be made of an additional factor that tends to generate considerable opacity in fiscal accounts: the lack or poor quality of information (see chapter V). Many countries have made substantial progress, particularly in response to

macroeconomic crises, but much still remains to be done on this front. The problem affects not only quasi-fiscal items, but also the fiscal accounts *per se*. Among the many shortcomings observed in this area, the chief problems are inadequacies in the coverage, consistency and intertemporal comparability of the available statistics; a tendency to measure expenditure on a cash basis rather than an accrual basis; inadequate public debt accounting; and an almost total absence of estimates of national wealth (assets, liabilities and net worth).

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

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

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

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

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

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

Guarantees: As mentioned above, estimates of the guarantees granted by public entities in relation to infrastructure projects should be made regularly, and, where possible, the actual amount of the equivalent "insurance" should be explicitly budgeted for. In

addition to the specific case of infrastructure projects aside, all public guarantees should be estimated on a regular basis. In this regard, there is a particular need to estimate the value of contingent liabilities associated with pension systems on a regular basis. While the practice of calculating the actuarial values of pensions provided by the State has been given a boost by the social security reforms currently under way, this practice has not been extended to estimates of contingent liabilities assumed by the State in connection with such reforms, especially in the case of minimum pension guarantees.

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

(b) Redouble efforts to improve fiscal information

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

F. SAFEGUARDING SOCIAL EQUITY

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

Social expenditure is undoubtedly the most important tool used by Government to influence income distribution (see chapter VI). There is, in fact, a great deal of evidence to suggest that social expenditure has a significant impact on the secondary distribution of income. In addition, over the long term, greater investment in human capital makes it

possible to influence one of the structural factors of income distribution. Studies indicate, in particular, that allocating greater resources to education permits a better distribution of human capital in society and may have a far greater impact on equity than has been estimated in studies of short-term distributional effects.[5]

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

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

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

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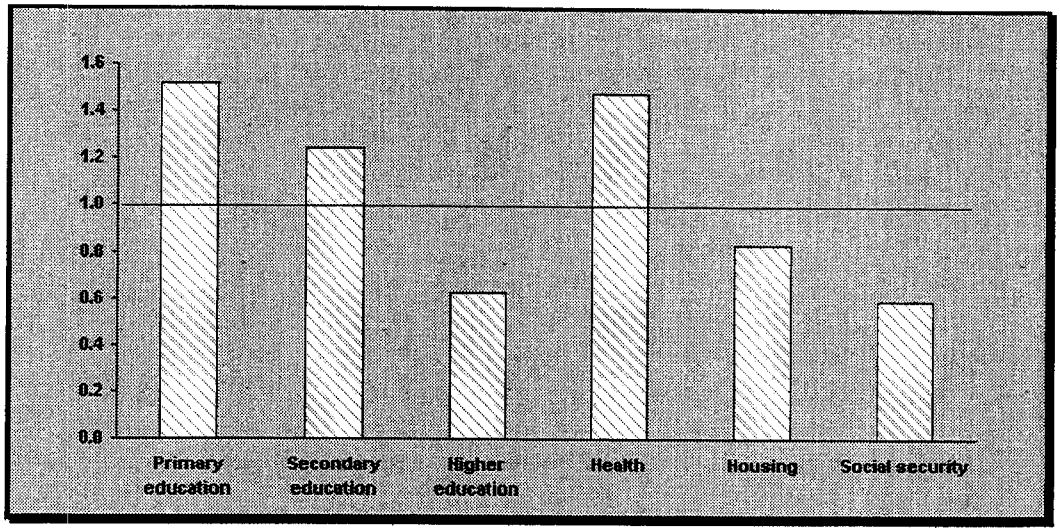
[5] For more information, see recent editions of the "Social Panorama of Latin America and the Caribbean"; see also IDB (1997).

Figure I-4
TARGETING OF SOCIAL EXPENDITURE (INDICES)[a]



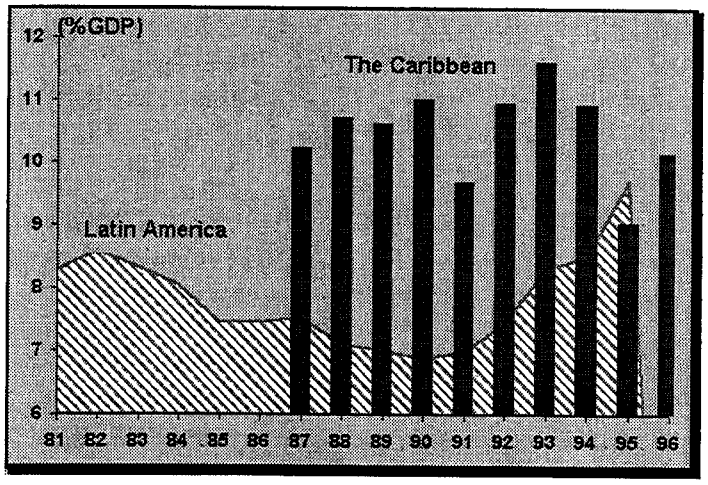
Source: ECLAC, on the basis of José Rodríguez, "Educación y distribución del ingreso en el Perú", *Gestión pública y distribución de ingresos: tres estudios de caso para la economía peruana*, Working Paper, No. 115, Washington, D.C., Inter-American Development Bank (IDB), 1992; I. Santana and M. Rathe, "El impacto distributivo de la gestión fiscal en la República Dominicana", Working Paper, No. 107, Washington, D.C., IDB, 1992; J.C. Navarro, "El impacto del gasto público en educación en Venezuela", *Gestión fiscal y distribución del ingreso en Venezuela*, Caracas, Programas para la Red de Centros de Investigación Económica Aplicada, IDB, 1991; G. Márquez, "El sistema de seguros sociales en Venezuela", *Gestión fiscal y distribución del ingreso en Venezuela*, Caracas, Programas para la Red de Centros de Investigación Económica Aplicada, IDB, 1991; R. Urriola, "Incidencia del gasto público social en Ecuador", Política fiscal series, No. 97 (LC/L.1027), Santiago, Chile, ECLAC, 1997; M. Urquiola, "Inversión en capital humano y focalización del gasto social: análisis de la asistencia y cobertura de servicios sociales por quintiles", Documentos de trabajo series, No. 8, La Paz, Unidad de Análisis de Políticas Sociales (UDAPSO), 1993; M.C. Vargas de Flood and M. Harrigue, "Impacto distributivo del gasto social en Argentina", document presented at the Workshop on methodological issues regarding measurement of public social expenditure and its distributional impact, Santiago, Chile, 1993; C.E. Vélez, "La incidencia del gasto público social en Colombia", Bogotá, Departamento de Planeación Nacional, 1994; Ministerio de Planificación y Cooperación (MIDEPLAN), *Programas sociales: su impacto en los hogares chilenos*, Santiago, Chile, 1990; I.H. Petrei, "Distribución del ingreso: el papel del gasto público social", document presented at the seventh Regional Seminar on Fiscal Policy, Santiago, Chile, 1995.

[a] Targeting index = percentage of social expenditure received by the target population/percentage of total population represented by target population.

Figure I-5 presents an outline of trends in social expenditure in Latin America and the Caribbean over the past two decades. The 1980s were notable for a sharp reduction in social investment. The decrease in the proportion of GDP devoted to social expenditure, coupled with a decline in per capita income, led to a 24% drop in per capita social expenditure in Latin America. During the 1990s, both these indicators have moved upward; by 1995 per capita social expenditure in Latin America was already 18% higher than in the early 1980s. It should be noted that the Caribbean has not shared in this positive trend in social expenditure; there, such spending has fluctuated at around 9%-11% of GDP since 1987, with the trend being slightly downward, and per capita spending has continued to drop. Nonetheless, as a general rule, public spending by the Caribbean countries remains higher than the average for Latin America. This positive picture for Latin America must be viewed with some reservations, however, for three reasons. First, the priority given to social expenditure still varies widely from one country to the next and, in many, social spending is

still too low. Second, a very substantial portion of the growth in social expenditure — especially in countries where such spending is high— goes to social security, and specifically to pension payments, which is the component with the least progressive distribution. The increase in expenditure on human capital has also been lower than the above-mentioned figures suggest. In the case of education, for instance, by 1995 real per capita expenditure in Latin America as a whole had barely recovered to 1980 levels and in a number of countries was still below those levels. Third, the sharp reduction in social expenditure in the 1980s and its rebound in the 1990s is largely a reflection of the region's macroeconomic cycle and thus is symptomatic of the procyclical pattern of trends in social spending.

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



Source: ECLAC, on the basis of official figures.

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

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

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

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

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

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

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

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

For reasons of both revenue enhancement and social equity, greater emphasis should be placed on direct taxes (especially personal income tax), which are more progressive in their distributional impact. The negative effects of indirect taxation in terms of the simplicity of the tax system and its administration have been analysed in detail elsewhere. With respect to equity, the possibility of applying differential rates for indirect taxes —with lower rates on some staples prominent in the basic shopping basket of the poor— should not

be ruled out, so long as technical and administrative safeguards are in place to avoid linkage or marked distortions in resource allocation. Another option that should at least be considered is the transparent use of cross-subsidies on public services, provided they do not generate distortions in the setting of the basic price of the service or cause any considerable substitution effect that would increase the consumption of goods and services that are more socially costly.

(d) Monitor the effects of decentralization on social equity

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

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

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

G. STRENGTHENING THE INSTITUTIONAL FRAMEWORK OF DEMOCRACY

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

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

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

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

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

The dismantling of national public investment systems is part of a generalized emasculation of the planning agencies that used to administer them and is reflected in the paradoxical lack of institutions to oversee the attainment of the second of these objectives: consistency between budget appropriations and government priorities. If this function is assigned to the Ministry of Finance, i.e., to the institution whose basic purpose is, by definition, to achieve the first objective, then the second objective may be treated as a matter of lower priority. The preferred option in some cases is to assign this role to the Office of

the President or the Office of the Prime Minister, but in this case the political functions of such offices must not be allowed to obscure this specifically fiscal role.

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

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

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

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

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

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

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

II. TRANSPARENCY IN PUBLIC FINANCES: THE FISCAL AND QUASI-FISCAL SPHERES

A. INTRODUCTION

The point of departure of this study is the conviction that government programmes and State policies must be implemented within the framework of a sound fiscal structure. This is because any programme of public policy involves operations of a fiscal nature —such as tax collection, purchases of final goods and services, payments of subsidies and transfers— consistent with the goals and objectives set. In pluralistic and democratic societies, such operations are included in the Executive's plan of expenditure and revenue and have to be approved by the legislature, pursuant to rules and procedures established by the budgetary institutions in each country. The outcome of the debate on this plan obviously depends on forces at work within the legislature and, not infrequently, on public opinion in other spheres of national life as well.

When these forces permit the development of lasting political majorities or coalitions and a stable basic consensus on the role of the State in the economy, on the forms, scope and degree of government intervention and, above all, on the way in which such intervention should be financed and distributed among the various components of society, then the necessary conditions exist for the State to function effectively and for government programmes to be implemented.

When, on the other hand, the consensus is weak or is not expressed through legislative majorities or coalitions with converging viewpoints on the level, composition and trends of public expenditure and tax revenue, then it is only to be expected that public finances will be chronically fragile. This implies an ongoing shortage of resources to fund current spending programmes and to expand the country's physical and human capital. Chronic or recurrent fiscal shortfalls translate into poorly paid public-sector jobs, civil servants who lack motivation or a sense of purpose, and inadequately equipped workplaces, among other things. All this, in turn, leads to ineffective, inefficient government action that

is a source of discontent to users of public services and further undermines the fiscal covenant.

The causes of this vicious circle have their roots in the political arena, from which they radiate outward, compounding the initial fragility of the fiscal covenant. In such circumstances, those in charge of running the economy —who are frequently not in a position to increase the tax burden or reduce spending— have no way out other than to take advantage of the scant freedom offered them by an inadequate fiscal regime which has become entrenched over a period of many years through a lack of basic political agreements.[1]

B. SUBSTITUTION OF POLICY INSTRUMENTS

This search for a way out constitutes an obvious incentive for the economic authorities to attempt to replace politically costly measures (for example, a capital gains tax, an increase in the VAT rate, monetary subsidies to agricultural producers or increased transfers for social security purposes) with other "cheaper" measures (such as the under-indexing of government debt paper or civil servants' salaries, delayed payment of government suppliers' accounts, raising reserve ratios for banks far more than is needed to manage liquidity).

It is easy to see that the "price" referred to in this case is linked to the degree of difficulty the Executive encounters in arriving at a political agreement on the use of a given measure to achieve a particular end, and the predicted extent of its use. This degree of difficulty depends, of course, on the transparency, or opacity, of the measure in question. When it is very visible and can be blocked in the legislature, it may be considered to be potentially "expensive". On the other hand, if its implementation remains outside the scope of the legislature, because it operates through non-transparent bureaucratic and administrative mechanisms, it may be considered a politically "inexpensive" measure.

Since the economic authorities pay a price for the use of the instruments they select, must choose from among numerous alternatives and do not have unlimited political capital at their disposal, but instead have to adapt to budget constraints just like any consumer, it can be posited that they will react to changes in "relative prices" by altering the mix of instruments they select.[2, 3]

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[1] See Lerda (1996) and Carciofi (1990) for background to the ECLAC analysis of the fiscal covenant.

[2] Possible differences in the quality of the instruments that may be selected are not taken into consideration, since this effect can be incorporated in some way into the price (the less effective the instrument, the higher the price).

[3] Substitution of instruments is resorted to very frequently in the formulation and design of economic policies in various fields. For example, with respect to foreign trade policy, as the average import tariff level was lowered in successive rounds of GATT negotiations, and in the face of the implied increase in the price of this instrument as the result of international agreements on tariff reductions, Governments responded by replacing the traditional form of trade protection by non-tariff barriers, such as import quotas, voluntary export restraints, foreign exchange controls, minimum local content requirements and rules on public sector acquisitions. See Deardorff (1987) and the comments of McCulloch (1987).

In the fiscal sphere, there are many instances in which the authorities prefer to replace potentially costly instruments by others that, though of lower technical quality, carry a lower political price in the short term. This has given rise to ingenious solutions, with more or less practical significance over the course of time. Thus, when it is not possible to include explicit subsidies for a certain group of agents, a certain sector or a certain region in the public budget, transfers can be effected through the tax expenditure associated with fiscal incentives and other schemes to promote industrial development, lines of credit with preferential interest rates or repayment terms, and the sale of foreign exchange at below-market rates for the purchase of imported inputs and capital goods.

Similarly, if the Government has difficulty including certain expenditure, for example for technical education, in the budget, it can induce the private production sector to provide intermediate-level technical training in exchange for tax incentives available to those businesses that can prove that they have allocated a certain amount of resources to specified areas and programmes or can oblige this sector to undertake expenditure in those areas and programmes. In the latter case, mandatory rules are established under which, for example, any industrial firm with more than 100 workers must offer a certain number of intermediate technical training courses.

Hence, if the economic authorities consider that raising taxes to carry out a programme of direct public spending is costly, they may opt for an indirect form of public spending. It can be deduced from this that the substitution of visible instruments and policies that are considered politically costly with others that are indirect and less transparent —and apparently less costly but assuredly of poorer quality— can turn budgetary policy into a mere adjunct of fiscal policy.

C. FISCAL POLICY: BUDGETARY POLICY AND QUASI-FISCAL POLICY

Whether for reasons of political or practical convenience, the truth is that not all channels through which fiscal policy is expressed are reflected in national budgets. In fact, many forms of fiscal action —apart from the expenditure, tax, subsidy and transfer operations normally included in the budget— usually pass unnoticed because their outward trappings tend to disguise their true nature and even, in some cases, conceal their very existence.

This is in marked contrast to the description of government-sector budget constraints normally to be found in models of macro-fiscal analysis, which assume that the components of the deficit above the line reflect a unified and consolidated version of all the Government's fiscal activities. Actual practice, in all countries, tends to be quite the contrary.

During the 1980s, even more than at present, the adoption of fiscal measures outside the purview of the budget was so common in the region that, in some cases, the budget became an instrument of little more than symbolic value, the ritual approval of which had more to do with legal formalities than with the real requirements of planning public action. The significant role played by certain large public enterprises and government agencies with responsibility for foreign trade was a contributing factor in this situation, combined with the more or less general acceptance of selective price, wage, and interest- and exchange-rate

controls. In situations of less than perfect democracy, all of this created a climate in which fiscal policy, as reflected in the budget, remained an incomplete exercise lacking in rigour. In the past few years, considerable progress has been achieved in Latin America in the area of unifying and consolidating the budget; nevertheless, we should not lose sight of the fact that activity in the sphere of fiscal policy continues to extend far beyond what is recorded in the official budget.[4]

In the transition economies, for different reasons than those that apply in Latin America, the exclusion of typically fiscal operations from the government budget reaches almost extreme proportions. As is well known, in these economies State enterprises execute a major portion of operations of a fiscal nature, so that the activities recorded in the budget do not adequately reflect their actual degree of fiscal activism.[5]

In the industrialized economies, government budgets provide a more accurate picture of the set of measures and initiatives that comprise fiscal policy.[6] This does not mean that the budget of a representative OECD country takes account of all the channels through which fiscal policy is transmitted. In any case, because of statistical and conceptual limitations, it would probably be difficult to demonstrate the existence of a positive correlation between the degree to which such instruments and channels are covered in the budget and a country's degree of economic development.[7]

It is obvious from the above that two sets of indicators must be taken into consideration in order to evaluate a country's fiscal stance accurately. The first is conventional and relates to the expenditure, taxes, subsidies and transfers provided for in the government budget; this constitutes the visible aspect of fiscal policy and is the one normally referred to. The second consists of a broad range of instruments and channels for the transmission of effects of a fiscal nature that are by definition excluded from the budget; this is what is termed "quasi-fiscal policy". The latter, as already indicated, is the counterpart to the official budgetary policy set out in the budget.

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[4] In the case of Latin America, the quasi-fiscal deficit is a well-known example of the management of fiscal matters by alternative methods. In this respect, see ECLAC *Politica fiscal* series, which presents studies relating to Argentina (Giorgio, 1991); Bolivia (Central Bank of Bolivia, 1991); Brazil (Queiroz and Nabão, 1991); Chile (Eyzaguirre and Larrañaga, 1991); Costa Rica (Delgado and Vargas, 1991); Ecuador (Abril, 1991); Mexico (Baqueiro, 1991); Paraguay (Otazú, 1991); Peru (Choy and Dancuart, 1991); Uruguay (Banda and Onandi, 1992); and Venezuela (Velásquez, 1991). Needless to say, the problem of the quasi-fiscal deficit has resurfaced with a vengeance since the Mexican crisis in 1994, owing to rescue operations for the private banking sector, which was seriously affected by the phenomenon known as the "tequila effect". On these topics, see also González del Valle (1997), MacKenzie (1997), Gamboa (1997) and Biasotto and Mussi (1997). This subject will be taken up again in chapter V in relation to the public deficit and debt.

[5] In this regard, see Tanzi (1993) and the collection of studies published in Tanzi (ed.) (1992 and 1993). See also, for an analysis of quasi-fiscal activities, Kopits (1993). The case of Cuba is considered in ECLAC (1997b).

[6] For example, in the context of OECD, several countries submit annual reports, which supplement their proposed budget, containing estimates of the cost to the Treasury of tax expenditure linked to the principal fiscal incentive programmes. See OECD (1996).

[7] Bennett and Di Lorenzo (1982 and 1983) present the argument that in the United States economy, historically the local, state and federal governments have tended to evade the legislative controls that impose limits on the growth of their expenditures by disguising them under various forms of quasi-fiscal policy.

This supplementary role can be interpreted as corresponding to the component of fiscal policy that, for technical or political reasons, the authorities cannot and/or do not wish to incorporate in the budget. This not so visible component of fiscal policy covers a vast and complex conceptual sphere, which may be classified in various ways depending on the aim of the analysis. For the purposes of the present document, the following main areas are considered:[8]

(i) **Extrabudgetary activities.** An unspecified percentage of total public spending occurs outside the budget, through decentralized agencies whose items of income and expenditure are approved by bodies that are relatively independent of the legislative power. Notable in this category is the use of extrabudgetary funds established for specific or general purposes;[9] the proliferation of this practice during the 1970s and part of the 1980s led to strong opposition to it use at the beginning of the current decade.[10]

(ii) **Tax expenditure.** As was pointed out in section B of this chapter, the public authorities can meet certain needs of the private sector (households and firms) directly or indirectly. In the example already used, to provide intermediate-level technical education they can effect spending under the expenditure items authorized for the Ministry of Education in the regular budget, or they can authorize firms that provide such instruction for their employees to deduct the related costs from their taxes. Although this simple example demonstrates that the same objective can be reached directly by means of public expenditure, or indirectly through tax expenditure, without the level of the public deficit being affected, this formal equivalence is rarely verifiable in Latin America and the Caribbean for want of empirical statistics on the overall magnitude of such tax expenditure.

(iii) **Contingent and conjectural liabilities**. A Government can replace immediate public expenditure with a promise of payment in the future, provided that certain conditions are met. An example of how this mechanism functions would be a possible reduction in current public expenditure (to fulfil agreements with international financing institutions or as part of a policy of real exchange rate recovery), in exchange for which some of those harmed by the adjustment process are offered loan guarantees for use in international credit markets. As can be appreciated, given the almost complete lack of information on the amount of the guarantees granted by the public sector, or on the probability that some of these

[8] The legislation of several industrialized countries requires that some of these areas be at least partially reflected in the budget. Therefore, if a fraction of total tax expenditure is included as a deduction in estimates of tax revenue, it is to be interpreted as part of the visible aspect of fiscal policy.

[9] The funds may be budgetary or extrabudgetary and for earmarked or discretionary use. Reference is made in the present case to extrabudgetary funds exclusively, that is to say, to accounts corresponding to the financial sector (often administered by the central bank) in which funds are deposited whose origin is independent of budgetary provisions. For example, a certain percentage of the price paid for fuel is allocated to an oil-price stabilization fund.

[10] This topic will be taken up again in chapter VI.

guarantees will be called in during a given fiscal period, not much can be known about the actual fiscal stance of the Government during this period.[11]

(iv) **Implicit fiscal policy**. This consists in the management of selected aspects of public policies, including the regulatory framework in force, for the purpose of achieving results akin to those that would be obtained using conventional taxes and subsidies. Resorting to the use of instruments conceived and designed to achieve objectives in other areas is generally a political expedient to meet requests for subsidies; it minimizes the opposition that conventional tax-raising provokes. Although not always intentionally, fiscal policy is often concealed behind price, monetary, banking, exchange, wage, social, industrial and, in general, regulatory policies.

This transformation of measures of a fiscal nature may be in the hands of various institutions, such as sectoral ministries, regulatory bodies, government agencies, the central bank and other entities of the State financial sector. It may reflect a strategic vision of how society and its public accounts should be organized, as occurs in the centrally planned or transition economies, or a tactical decision on the part of economic authorities wishing to avoid the political costs of imposing new taxes and granting subsidies, as happens when minimum wages or maximum rents are set. In any event, the fiscal aspect of many measures whose economic effects are the equivalent of conventional taxes and subsidies may pass unnoticed because they are off budget. Consequently, the size of the fiscal component included in public and regulatory policies is often underestimated.[12]

D. PATTERNS OF INDIRECT PUBLIC EXPENDITURE

The substitution of indirect mechanisms for explicit fiscal instruments can be illustrated by means of the concepts of tax expenditure, or foregone revenue, and mandatory regulations. Although in recent years some countries of the region have succeeded in reducing tax expenditure as a proportion of GDP, much remains to be done in this area. Little is known about the use of mandatory regulations as an alternative to public expenditure in Latin America and the Caribbean; although not a new issue, it has been explored relatively little. Since both practices reduce the transparency of public accounts, we should consider what has been done by some countries in this area.

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[11] Contingent liabilities can arise from a wide range of operations whose common denominator is the fact that the public sector grants some type of guarantee to the private sector. This topic will be examined again in chapter IX.

[12] Among the pioneering studies along these lines are those of Posner (1971) and Prest (1985). A similar analysis of the non-industrialized countries can be found in the collected studies edited by Bird (1991). The idea that these systems of implicit taxes and subsidies correspond to a "hidden or invisible budget" was put forward by Fernández-Ordóñez and Ocaña (1997).

1. Tax expenditure

Tax expenditure is a fiscal instrument that serves as an alternative to monetary subsidies or direct spending programmes. By definition, it decreases the revenue coming into the Treasury as a result of preferential treatment under the tax laws.

Tax expenditure leads to considerable opacity in the system of taxation, since estimates of the revenue thus forgone are frequently unavailable. Tax expenditure may take various forms, including: (i) *exemptions*: income or other items excluded from the tax base; (ii) *deductions*: sums deducted from the gross amount in calculating the taxable amount; (iii) *credits*: deductions from the amount of tax payable; (iv) *preferential rates*: lower rates depending on the type of taxpayer, industry, activity or location; and (v) *extensions*: extensions of the payment period, which are equivalent to interest-free loans.[13]

All Governments recognize the need for quantitative information regarding tax expenditure, but there is no agreement on the best way of disseminating that information or on how it should be used or incorporated into particular budgetary accounts. In this regard, it should be noted that tax expenditure reports and estimates are major topics of public policy debates in the OECD countries, although the issue has seldom loomed large in the formulation of tax or budgetary reforms.[14]

The purpose of a system of information for monitoring and calculating tax expenditure (see boxes II-1 and II-2) is to provide greater transparency in public accounts, reducing possible political bias and administrative discretionality in the distribution and enjoyment of such benefits. At the same time, an attempt is made to estimate the budgetary implications of the corresponding loss of tax revenue and, in particular, to compare that loss with the direct expenditure which it replaces. Additionally, to the extent that it is possible to disaggregate tax expenditure information according to the types of tax applicable in different sectors of activity and geographical areas, it becomes possible to identify the "winners" and "losers" from such a policy and hence its possible distributional effects.

Another reason why such a system of information is needed is that tax expenditure can serve various policy objectives. It should therefore be subject to the same results-based evaluation procedures as subsidies financed directly out of the budget. In order for reviews of public policy to be more effective, they should cover all the mechanisms of State intervention, and the same cost-benefit analysis techniques should be applied to tax expenditure as to direct expenditure.

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[13] For other purposes, it may be useful to distinguish between tax expenditure and tax shelters. See, for example, McLure and Zodrow (1994).

[14] See Daly (1995).

Box II-1

PREPARATION OF REPORTS ON TAX EXPENDITURE IN THE OECD COUNTRIES

In 1984 and 1996, OECD published information on the practices of 14 countries that prepare periodic reports on their tax expenditure. Germany and the United States were pioneers in this field in the late 1960s. They were followed some 10 years later by Austria, Canada, Spain and the United Kingdom and in the early 1980s by Australia, Belgium, Finland, France, Ireland, Italy, the Netherlands and Portugal. The nature of the reports varies considerably from one country to another:

- **Periodicity**: The authorities in half of the countries concerned are legally bound to present such reports. In most of the countries, the reports are annual; the exceptions are Germany (biennial reports) and Italy and the Netherlands (sporadic reports).
- **Coverage of tax expenditure**: All the countries report tax expenditure in relation to taxes on personal and business income (with the exception, in the latter case, of the Netherlands) and indirect and direct taxes including taxes on capital (with the exception of Ireland and the Netherlands). In the case of the United States, the reports consider taxes on assets and inheritance and gift taxes, but neither indirect nor payroll taxes. Germany and Austria produce reports on subsidies on a broader basis, including all direct expenditure and tax expenditure.
- **Method of estimation**: All the countries use *ex post* measurements of tax expenditure, which makes it possible to calculate the amount by which tax revenue is reduced as a result of particular provisions. The use of other methods, such as the calculation of receipts *ex ante*, which measures the expected amount of revenue if the exemption were to be abolished, and of equivalent expenditure, which measures the cost of providing the same monetary benefit through direct expenditure, poses problems of calculation and of uncertainty about how the behaviour of agents might change. The United States is the only country which reports the figures for both revenue foregone (tax expenditure) and equivalent expenditure.
- **Inclusion in the budget**: In some countries, these reports are presented separately, but in Belgium, Finland, France, Portugal and Spain they are an integral part of the budget formulation process. In the United States, reports on tax expenditure are prepared as part of the elaboration of the government budget, even though they are not integrated into the budget process.

Source: Organisation for Economic Co-operation and Development (OECD), "Tax Expenditure: Recent Experience", Paris, 1996.

Box II-2
TAX EXPENDITURE IN BRAZIL

The proliferation of fiscal incentives in the form of tax, financial and credit measures in the 1970s and early 1980s led to a situation in the late 1980s in which the scope that should in future be given to such instruments, as well as the monitoring and information system to be adopted in that area, had to be radically reconsidered. The importance that was attached to the issue is reflected in the provisions of article 165 (6) of the Federal Constitution of 1988, according to which the Executive branch must attach to the annual appropriations bill a report showing the effects of exemptions, tax amnesties, subsidies and other tax, financial and credit concessions.

The report on tax concessions which has been attached to the appropriations bill since 1986 includes detailed estimates of the losses of potential receipts through the various taxes and fiscal contributions administered by the Federal Internal Revenue Service, broken down among the major regions.

In 1998, such tax expenditure is expected to amount to 1.85% of GDP and 14.07% of the revenue administered by the Service. It is broken down as follows: income tax, 60.0%; taxation of manufactures, 20.5%; import taxes, 14.5%; other, 4.4%.

Source: Brazil, Secretaria da Receita Federal, "Demonstrativo dos benefícios tributários: 1998", Brasilia, Ministry of Finance, March 1997.

In addition to the above considerations of a basically domestic nature, there are others that concern the link between the fiscal realm and foreign trade. It is well known that, in parallel with the growing deregulation of markets, liberalization of international trade and globalization of the world economy, there has been a resurgence of protectionist tendencies in all economies. As tariff barriers become less significant relative to other forms of trade protection which are less visible and less likely to be challenged by GATT and WTO, tax policy, especially tax expenditure, are seen as attractive choices for modifying the effective protection of particular domestic industries. For that reason, detailed estimates of tax expenditure are essential in order to increase transparency in both fiscal and trade policy.[15]

2. Mandatory regulation

Another instrument that is being used increasingly is mandatory regulation. It is certainly no more mandatory than other legal instruments, but it differs from them in that it seeks to achieve public policy objectives by demanding of private agents that, in certain circumstances, they themselves should directly provide and finance particular goods or services. This saves the Government the trouble of making budgetary appropriations for those purposes, as used to be done, or as some countries with comparable institutional

[15] See Daly (1995) and OECD (1996) for details of measurement problems and the ways in which tax expenditure is registered in certain developed and OECD countries.

traditions and arrangements still do, and at the same time releases it from actually financing those expenditures.[16]

It is thus possible for the State to eliminate certain direct expenditures by substituting mandatory regulations, which —at most— only need to be submitted once for legislative approval, for budget appropriations which have to be voted upon each year by the legislature. The growing use of this approach as an instrument of implicit fiscal policy and the difficulty of estimating the benefits and costs of applying it undoubtedly obscure the effects of fiscal policy on the economy or on public finances.

In recent decades, much importance has been attached to mandated benefits as a tool of social policy. Mandatory provision of employee benefits by employers is a subject of increasing interest, and a number of the proposed mandates are specifically intended to benefit certain target groups.[17]

The appeal of mandatory regulations can be explained in budgetary, political and efficiency terms. Their budgetary advantage lies in the resource savings they imply for the public purse, because a part of the political agenda is financed by passing on the costs to the private sector, resulting in an improvement in the fiscal balance. In political terms, the use of such instruments in place of direct provision causes less controversy, given the hidden nature of their costs, in obvious contrast with the transparency of direct provision financed, for example, through taxation or borrowing

On the other hand, the efficiency argument as a justification for adopting mandatory regulations in place of government expenditure to finance expansion in public services has been a matter of controversy. Its advocates argue that imposing a mandate can be an efficient means of correcting a market failure in the provision of a particular benefit. Publicly financed services require an increase in government revenue, which is typically achieved through increased taxes, with a consequent loss of social efficiency.[18] Mandated benefits, on the other hand, are financed through an implicit tax, create less distortion, and therefore involve less loss of efficiency, provided they are valued by the beneficiaries.[19]At the limit, they can be as efficient as lump-sum financing of the expansion of the corresponding benefit. The efficiency argument is weakened, however, because it cannot be

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[16] Mandatory regulations vary widely, as do the cases in which they can be applied. Traditionally, funds have been appropriated in the government budget to cover the expenditure needed for achieving a particular policy goal, and taxes of equivalent value have to be collected to cover the appropriations. It is then decided that the private sector should be responsible for the expenditure. It could be said that the total government expenditure in respect of the objective concerned is the sum of the budget appropriation plus the private-sector expenditure necessary to comply with the relevant regulations.

[17] Two such examples are mandatory maternity leave, with full pay or with a health-insurance plan under which childbirth is fully covered, which increases the relative cost of insuring women of childbearing age; and mandatory health-insurance benefits, for which insurance coverage must be provided by the employer.

[18] Summers (1989), pp. 177-183.

[19] By way of illustration, the obligation for employers to provide employee benefits increases the supply of labour, since individuals will seek to enjoy those benefits, and also tends to lower average salaries, inasmuch as the employer will pass on a part of the increased cost. This last is what Summers describes as an implicit tax. In the extreme case in which the benefits are fully valued by employees, wages will fall to a level at which the cost of the benefit borne by the employer is fully offset, in which case there is no efficiency cost.

generalized. In particular, it may not apply to some popular policies, as in the case of group-specific mandates that benefit a certain demographic group within the market for the mandated service, which cannot assume the costs of the increased benefit.[20]

In addition to the aforementioned limitation, there may be equity problems.[21] The goal of a mandate may be to channel resources towards a certain group in society, but group-specific shifting of the costs may counteract the redistributive policy. This type of problem may arise in the labour market, for example, if most of those who benefit from the provision are earning close to the minimum wage. In such a situation, the employer has little margin for passing on costs to them via their wages, so he will be strongly motivated to avoid hiring employees in that category, and even to dismiss any that he has. Mandatory provisions can also be a regressive means of financing increased benefits. Under certain conditions, the application of a tax on all labour to finance a benefit expansion will be more progressive than a mandate, if income distribution is sufficiently unequal.[22] [23]

In practice, experience to date shows that mandatory rules should be adopted with caution, since they can impose substantial costs on the regulated private sector without those costs generally being considered as consequences of government action.[24] In addition to all the costs involved in compliance with the rules, there are others, not quantified but possibly great, such as losses of productivity. Regulation absorbs resources which could be used for other purposes, so that excessive regulation can be quite harmful for the economy. Evaluation criteria are therefore needed to permit precise measurement of the costs imposed by regulation, so that Governments will not resort to them as if they were cost-free.

The solution usually proposed is cost-benefit analysis, which is increasingly used in various developed countries (see box II-3). It is thought that real economic improvement can be achieved by expanding those regulatory programmes whose benefits significantly outweigh their costs. However, this method is difficult to apply, owing to the huge gaps in the available information on regulatory costs and benefits.[25] Reliable, valid information is particularly scarce and highly dispersed in the case of benefits, which are sometimes almost impossible to measure; how, for example, could racial equality be quantified? As a result, more progress can be made by comparing costs. This requires an estimate of the

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[20] See Gruber (1994), pp. 622-641.

[21] Gruber (1994).

[22] Vergara (1990).

[23] The case of maternity health-care benefits illustrates how correcting one market failure can exacerbate another. Economists specializing in the health sector have demonstrated that full insurance may lead to considerable losses, owing to the overuse of medical resources.

[24] Some studies, such as Hopkins (1996), estimate that the cost of compliance with United States federal regulations during the 1990s was equal to nearly half the federal budget. Other countries face similar problems. Although the Japanese model involves great fiscal moderation, regulations have imposed considerable indirect costs on the country in recent years, leading to a broad consensus on large-scale regulatory reform.

[25] The main limitations include: (i) technical difficulties involved in quantifying data or expressing them in monetary terms (for example, the problem of establishing a basis for comparison in order to measure costs and benefits, or of pricing non-market factors); and (ii) significant "cultural" or "philosophical" barriers to reducing values such as equity or justice and physical and emotional effects into a common measure, such as dollars and cents.

Box II-3

COSTS AND BENEFITS OF FEDERAL REGULATION IN THE UNITED STATES

The following table summarizes the global estimate of the costs and benefits of federal regulation in the United States. The information is taken from a study by the United States Office of Management and Budget, which refers to the Hopkins classification of regulations and groups them into three types:[a] (i) **social regulations**, including environmental regulations and regulations designed to protect and improve the health and safety of consumers and workers, to advance social goals such as equal opportunity, and to provide protection against fraud and deception; (ii) **economic regulations**, which directly restrict the primary economic activities of firms (such as their pricing and output decisions) and also restrict entry or exit of firms into or out of certain types of business; and (iii) **paperwork and disclosure regulations**, relating to the administrative cost of compliance with government requirements and consumer protection provisions.

ESTIMATED COSTS AND BENEFITS OF REGULATION, 1997
(In millions of 1996 United States dollars)

Category	Benefits		Costs	
	Value	% of GDP	Value	% of GDP
Social regulations	298	4	198	2.6
Environmental	162	2.2	144	1.9
Other	136	1.8	54	0.7
Economic regulations	**	**	71	0.9
Paperwork/disclosure regulations	**	**	10	0.1
TOTAL*	>298	>4.0	279	3.6

Source: United States of America, Office of Management and Budget (OMB), "Report to Congress on the Costs and Benefits of Federal Regulations", Washington, D.C., Office of Information and Regulatory Affairs, 30 September 1997.

* Does not include regulations relating to financial security and soundness.

** Indicates that significant benefits have not been quantified, including the benefits of regulating local telephone monopolies and of requiring information disclosure to banking and capital-market regulatory agencies.

Despite the considerable limitations of the calculations, most of which are due to the fact that they are based on estimates taken from studies which do not take into account the full range of regulations or all indirect costs and benefits, it is worth noting that the estimated annual costs (US$ 279 billion) are less than the annual benefits (more than US$ 298 billion) generated by all regulations established since 1988 and still in force by 1997. Social regulation is the most important component, accounting for a total cost of about US$ 200 billion and all the estimated (quantified) benefits. Next in importance is economic regulation, the cost of which is approximately US$ 70 billion, representing a high proportion of the benefit; it is generally recognized that the benefits of such regulation well exceeds its costs, although the difference has not been systematically quantified. Regulations concerning administrative paperwork and disclosure, mostly related to consumer protection, entail a not inconsiderable cost of US$ 10 billion.

The total costs and benefits of regulatory programmes give an approximate idea of their economic impact. Also, the total cost can serve as a basis for calculating the scope of regulation. Some earlier estimates, for example, put the cost of regulation at about 4% of GDP, a level which has remained fairly constant in recent years, according to estimates by the Office of Management and the Budget; it could therefore be argued that the cost has not grown significantly over the past decade in relation to the size of the economy. This estimation exercise confirms that regulation has considerable costs and benefits, and it also suggests that social regulations have had the greatest net benefits.

It should be borne in mind, however, that these are global estimates, which do not differentiate between good and bad practices. According to some studies, most of the benefits of the "other social regulations" category are produced by highway safety regulations.[b] Moreover, although the 53 regulations issued between 1990 and 1995 generate considerable net benefits, only 23 would pass a cost-benefit test. All of the above demonstrates the necessity of estimating the marginal costs and benefits of individual regulations. In addition, if the aim is to reduce the burden of regulation in the environmental, health and safety fields, steps should be taken to determine how firms would react to the removal of the corresponding regulations.

[a] Thomas Hopkins, "Statement before the Subcommittee of National Economic Growth, Natural Resources and Regulatory Affairs", Committee on Government Reform and Oversight, Congress of the United States, House of Representatives, Rochester, Rochester Institute of Technology, May 1996.

[b] Robert W. Hahn and John Hird, "The costs and benefits of regulations: review and synthesis", *Yale Journal on Regulation*, vol. 8, No. 1, 1991.

value of the resources expended by private agents in complying with mandatory regulations, in order to compare it with those explicitly included in the budget. Greater transparency in the fiscal activities of the Government would result.

In broader terms, consideration should be given to elaborating a "regulatory budget", taking into account mandatory regulations, as a supplement to the traditional revenue and expenditure budget. This could force the Government to take more care in evaluating the advantages and benefits of mandating enterprises and households to spend on certain items versus those of direct government expenditure financed by tax receipts.

E. QUASI-FISCAL ACTIVITY AND SOCIAL POLICY

In any country, the operations of the various levels of government have myriad distributional effects, which are transmitted through: (i) the body of laws which provides a framework for economic activities, i.e., constitutional, civil, commercial and tax laws; (ii) regulatory measures of various sorts; (iii) the decisions Governments or government-related entities make as employers; (iv) macroeconomic policies pursued by central governments (with regard to monetary, foreign exchange, wage and other matters); (v) budget policy; and (vi) quasi-fiscal policy.

In view of the complexities associated with the study of these factors, attention generally centres on the analysis of the distributional effects of fiscal operations provided for in the public revenue and expenditure budget. Social policy analyses tend to focus on this aspect of the issue. However, the other aspects mentioned are also clearly important; these concern the quasi-fiscal sphere of social policies associated with extrabudgetary mechanisms and other means of transmitting social subsidies, which beneficiaries receive both directly, as in the case of monetary transfers or transfers in kind, and indirectly.[26]

Budgetary mechanisms include recognized monetary transfers and transfers in kind, the provision of public services and producer subsidies. While beneficiaries receive direct subsidies, they may also benefit indirectly or from a cross-subsidy. Thus, a worker may receive an additional benefit by selling his food stamps or transferring them to another person. In another example, guaranteed prices for certain agricultural products are a direct subsidy to the producer, but if lower prices result, consumers also stand to benefit.

Pricing policies and regulations are extrabudgetary mechanisms that have an impact on the family shopping basket. Examples of pricing policies include controls on prices and public rates and charges,[27] subsidized or differential interest rates, managed or regulated prices, guaranteed prices or price supports, subsidies on inputs and/or for the adoption of technologies, and subsidized or preferential loans. The regulations in question are basically mandatory in nature and apply to the labour market and production sectors. Lastly, mention should be made of other mechanisms, such as illegal hook-ups to the electrical power grid, which confer benefits on those who do not pay for consumption, or the non-payment of

[26] See Mostajo (1997).

[27] One example is the regulation of utility charges, as Peru has done in the telephone, electricity, water and transport sectors. This in turn leads to cross-subsidization between sectors and households, the degree of which varies according to income bracket and geographic location. See Urrunaga (1997).

housing loans in the expectation of partial or complete forgiveness of the debt at some future date.

In order to evaluate the true scope and impact of social policy, it is necessary to look beyond what is included in social expenditure and to analyse and make explicit a range of quasi-fiscal activities. Due to their implicit and extrabudgetary nature, it is no easy task to quantify such activities. An important first step consists in identifying and categorizing them.[28] The experience of Brazil with regard to the provision of fuel, health-care services, and water and sewerage services provides a good example of the many kinds of subsidies and subsidy mechanisms that can be applied; they also illustrate the complexity of a qualitative and quantitative analysis of the quasi-fiscal components of social policy. In the case of fuel, a cross-subsidization scheme has operated as part of pricing policy; people who purchase petrol for their own motor vehicles finance a subsidy for consumers of propane gas for household purposes, as well as consumers of diesel fuel (public transport). The rate schedule for water and sewerage services has resulted in a web of direct and cross-subsidies, in which it is possible to identify the following: (i) subsidies between or within localities, as a consequence of the use of a flat-rate policy in any given state and progressive charges per consumption bracket; (ii) direct subsidies in the form of free consumption as a result of illegal hook-ups, meter-tampering or underbilling due to faulty metering; and (iii) direct subsidies deriving from regulatory mechanisms, by virtue of which the Government covers the deficit of State-owned enterprises. The health-care system features three types of subsidies: (i) a direct subsidy in the form of free comprehensive health care; (ii) an indirect subsidy in the form of deductions for medical expenses (contributions to health plans and spending on private health care) for purposes of personal income tax; and (iii) a subsidy in the form of tax expenditure represented by the deduction of medical insurance payments from corporate taxes.

Tax expenditure in the form of foregone revenue constitutes a hidden subsidy that implies a transfer between taxpayers. In this regard, tax expenditure has a cost in terms of horizontal equity.[29] In Argentina, for example, tax expenditure is the most important element of quasi-fiscal policy. In fact, tax expenditure plays a role in many social sectors (see table II-1); assessing its true impact in terms of social equity is a pending task that should be tackled in two stages: (i) analysis of the distributional profile, in order to determine its social effects —determining for example, whether such expenditures directly or indirectly benefit the most vulnerable groups or whether they benefit only the direct recipients, i.e., the intermediaries or providers of social services; and (ii) quantification of the level of tax expenditure in order to measure its impact on public finances and its distributional effects on each income group.

[28] In the case of Chile, most social policy mechanisms are recorded in the budget, but there are other governments mechanisms with distributional and social impacts that exceed those of traditional social programmes. See Puentes (1997).

[29] See González Cano (1989).

Table II-1

ARGENTINA: TAX EXPENDITURE IN SELECTED SOCIAL SECTORS, 1997

SOCIAL SECTOR	TARGET	TYPE OF TAX CONCESSION
Education	Foundations (private universities)	Special treatment
	Training activities	Tax relief
	Private schools, and textbooks	VAT exemption
	Non-profit associations	Treatment of profits
	Social benefits for workers (training courses and seminars, school supplies)	Deduction from corporate profits
Health	Aid societies, mutuals, cooperatives and private health insurance plans ("prepagas")	VAT exemption
	Medicines	VAT exemption (exempt in final stage)
	Social benefits for workers (reimbursement of medical expenses)	Deduction from corporate profits
	Non-profit associations	Treatment of profits
	Health insurance contributions	Deduction from profits
Nutrition	Water, bread and milk for the final consumer, the State and non-profit associations	VAT exemption
	Social benefits for workers (company canteens and lunch vouchers)	Deduction from corporate profits
	Lunch vouchers	Special treatment of contributions
	Non-profit associations	Treatment of profits
Social well-being	Social benefits for workers (supply of work clothes, day-care costs, burial of dependent relatives)	Deduction from corporate profits
	Non-profit associations	Treatment of profits
	Burial provided by social funds	VAT exemption
	Mass transit	VAT exemption
Social insurance	Private retirement funds and life insurance policies	Deduction on income tax
Housing	Rent and interest payments	VAT exemption

Source: M. Cristina Vargas de Flood, "El caso de Argentina: primeros ensayos para la identificación del gasto cuasi-fiscal", document presented at the workshop on "Reduction in public expenditure and how to minimize its negative impact on poverty", held in Brasilia in December 1997.

F. SOME IMPLICATIONS

The preceding analysis can be summed up by using the image of an iceberg (see figures II-1 and II-2). The iceberg represents all fiscal activity engaged in by the State (fiscal policy), comprising a visible portion (budget policy) and a submerged, hidden or invisible portion (quasi-fiscal policy). Using this conceptual framework, it is possible to make a number of interesting observations.

(i) The debate that has taken place in recent years concerning the modernization of budgetary institutions should be supplemented by more in-depth study and discussion of the rationale, modalities and quantitative aspects of quasi-fiscal activities and the policy measures that would facilitate their incorporation into budget policy.

When policy makers focus their efforts on improving the rules and procedures that govern the preparation, approval and implementation of the government budget, they lose sight of what is happening with the hidden portion of the iceberg, which by its very nature is difficult to measure.[30] Indeed, the lack of quantitative data on the extent of quasi-fiscal activity opens up an interesting, as yet unexplored area of empirical research on fiscal issues in the region.

However, it is possible to gauge the relative importance of this phenomenon using available estimates of the fiscal cost of banking crises in Latin America and the Caribbean. Concentrating exclusively on this component of quasi-fiscal policy, it is possible to conclude that such crises, which are apparently becoming more frequent and intense, entail a very high fiscal cost, often equivalent to several times a country's annual health and education budget (see chapter V). This underscores the importance of broadening the scope of analysis in order to obtain an overall picture of each country's fiscal position, including the aforementioned phenomenon of policy and policy-tool substitution.

(ii) Measuring the "size of the State" using the explicit tax ratio underestimates the true level of the gross tax burden

Since there are many ways in which public policies can have effects similar to those of conventional taxes, any analysis of the tax burden that is restricted to conventional taxes will obviously underestimate the effective burden. One alternative is to use as a proxy the

[30] Measuring the magnitude of quasi-fiscal activity is hampered by the lack or inadequacy of records. This situation is frequently encountered even in preparing national accounts, which focus on the registered portion of economic activity. Many attempts have been made to measure production activities in the underground economy (smuggling, drug trafficking, money laundering and the like), but there is as yet no consensus as to the precise magnitude of such phenomena. Whether this is due to differing opinions on conceptual and methodological issues or to a lack of basic information, there is a definite need to conduct more research on the issue in the countries of the region.

Figure II-1
VISIBLE AND HIDDEN SEGMENTS OF FISCAL POLICY

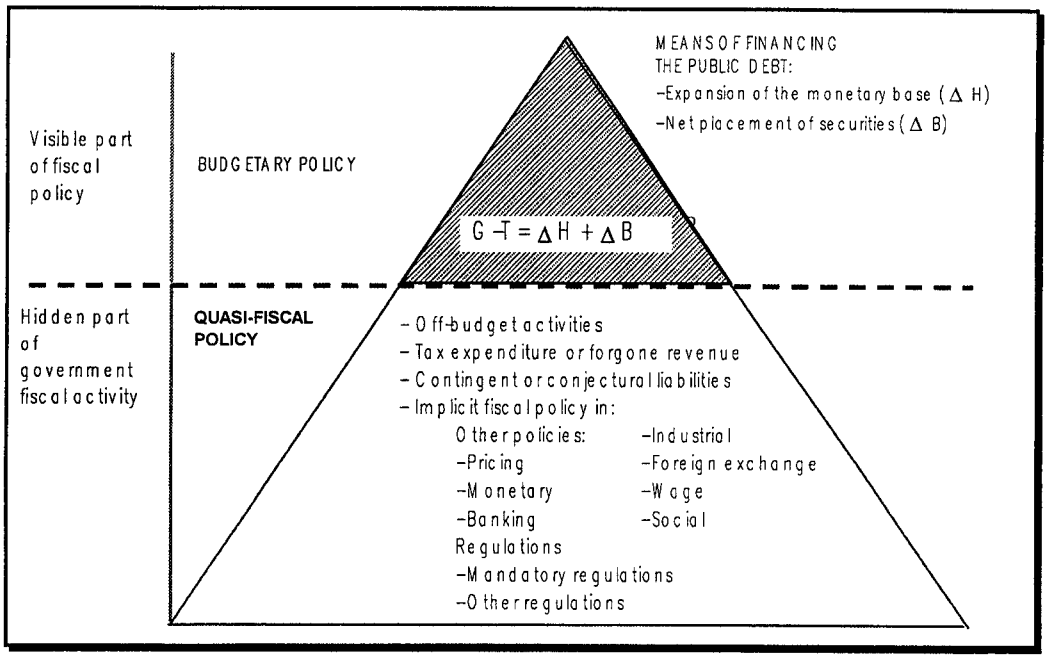
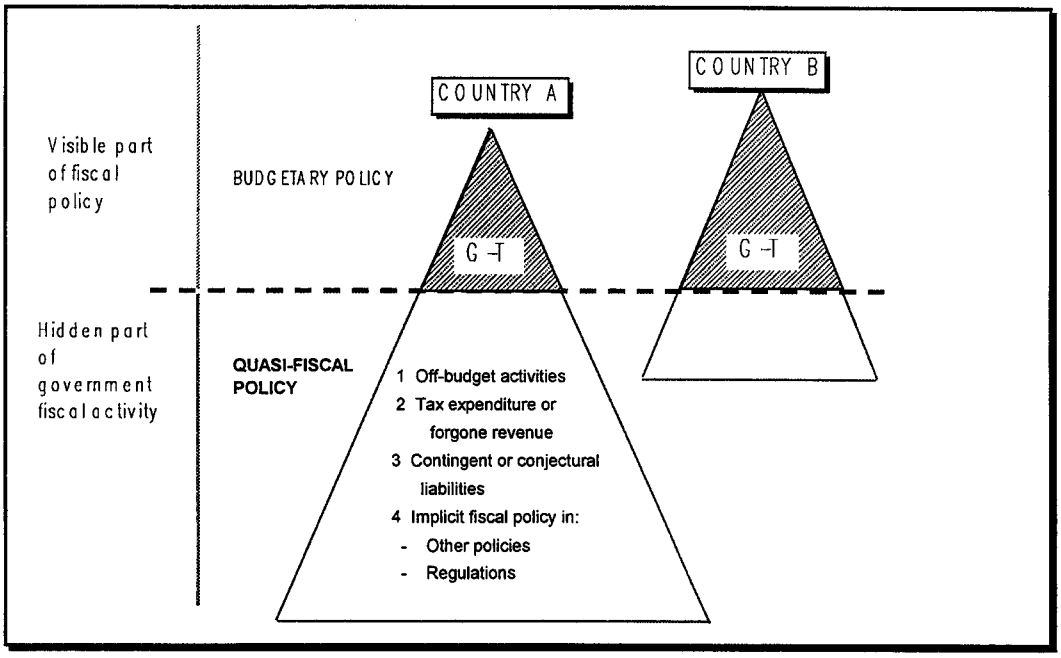


Figure II-2
DEGREE OF TRANSPARENCY IN FISCAL POLICY BETWEEN COUNTRIES



level of public expenditure included in the visible portion of the iceberg in relation to GDP (g/y). Limiting our observation to this part of the iceberg, we note that expenditure can be financed by explicit taxation (t_e) or implicit taxation (t_i), where the latter, for the sake of this argument, refers only to the inflation tax that has a bearing on net government debt (monetary base plus securities of various types).[31] Thus we see that a Government may keep public expenditure constant while selecting different combinations of explicit and implicit taxation, depending on its political assessment of the fragility of the underlying fiscal covenant.

Consequently, two countries with the same effective tax burden (g/y) may differ with respect to the composition of their tax structure, i.e., the proportions of explicit taxation (t_e) and implicit taxation (t_i). Thus, a comparison of countries A and B (figure VII-2), using regularly published tax revenue statistics, shows that country B, which is representative of the industrialized world, is characterized by a higher tax burden than country A, representative of a typical economy in the Latin American and Caribbean region. Assuming that the ratio g/y is the same in both countries, it is clear that this conclusion as to the differences in the level of the tax burden mainly reflects the fact that the analysis fails to take into consideration the implicit taxation component alluded to above. This sort of optical illusion would disappear if international comparisons took into account the differences between countries in terms of the implicit tax burden.

(iii) Bringing the submerged part of the iceberg up to the surface and integrating it into regular budgetary policy is one of the main items of unfinished business on the agenda of State reform

It is essential that all information of fiscal interest be brought together and consolidated, so that economic authorities can adequately assess the scope and possible effects of proposed policies. However, re-prioritizing the classic principles of budgetary unity and universality, which is vital if economic policy makers are to have a complete view of the framework in which they are operating, is by no means an easy task, not only because of the inherent technical difficulties, but also because it runs up against the very factors that originally led to budgetary fragmentation and the substitution of implicit policies for explicit ones, a process that Governments are now trying to reverse.

In the final analysis, these sorts of obstacles must be overcome by attacking the causes of the fragility of the fiscal covenant, which, as indicated, are essentially political in nature. Otherwise, quasi-fiscal policy mechanisms will continue to generate anomalous situations, such as the tacit redistribution of income embodied in implicit taxation, the allocation of subsidies not provided for by law and the veiled forms of corruption promoted by *sui generis* institutional and administrative arrangements.

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[31] The implicit taxation referred to in the text is limited to the effect caused by the inflation tax with respect to net public-sector obligations held by the domestic private sector. Of course, there are many other forms of implicit taxation which are outside the scope of this analysis, but which should be taken into account in any study devoted to measuring the total tax burden. Consequently, the elements considered in figure II-1 represent only one part of the complex reciprocal relationship which exists between the visible portion of fiscal policy and quasi-fiscal policy.

G. QUASI-FISCAL POLICY AND CORRUPTION

To return to the image used earlier, the invisible or hidden part of the iceberg of State fiscal activity can be said to be directly related to the weakness or fragility of the fiscal covenant on which the governance of the country depends.

The lack of transparency characteristic of the submerged portion of the iceberg is related to a fundamental asymmetry of information flows between the principal (citizen, elector and taxpayer) and the agent (elected or appointed politicians and bureaucrats in general). The consequences of this asymmetry are reinforced by the following: (i) less formal demand for the setting of goals and deadlines, disclosure of information and mechanisms for independent evaluation of results and the agent's performance; (ii) insufficient demands placed on the agent in terms of accountability to the principal or to supervisory bodies that oversee or monitor its actions; (iii) limited technical or political capacity on the part of regulatory agencies to carry out detailed audits or enforce existing legal regulations across the board.

This set of conditions inevitably leads to the endogenous development of a system of incentives that encourages corruption. As a by-product, there is also a constant stream of accusations of abuse of public office for personal ends within different agencies and levels of government. Therefore, it is reasonable to postulate that the greater the relative and absolute magnitude of quasi-fiscal policy, the lower the probability of satisfying the criteria of good governance, that is, transparency of laws, regulations and procedures; accountability of agents (politicians and bureaucrats) *vis-à-vis* principals (citizens, electors and taxpayers) and before the law; predictability of the law and legal validity of contracts.

While corruption on the part of public officials is not a new phenomenon, its increasing international visibility proves that it has taken on unsuspected proportions. This explains why interest in this area has already transcended the national arena and is now high on the agendas of international organizations and academic centres throughout the world.[32]

Corruption is one of the most serious ethical, political, economic and social problems of the late twentieth century. Indeed, it may be considered to be a glaring example of government failure, one which leads to grave problems in the sphere of governance.[33] It comes as no surprise, therefore, that this issue should arouse the interest of entities such as

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[32] For example, on 21 November 1997, the 29 countries of the OECD and 5 other countries, including Argentina, Brazil and Chile, adopted a Convention on combating bribery of foreign public officials "in order to obtain or retain business or other improper advantage in the conduct of international business". The preamble of this convention recognizes that "bribery is a widespread phenomenon in international business transactions, including trade and investment...". OECD (1997a).

[33] Although the expression "government failure" is commonly used, there is no widely accepted definition of the concept. Krueger (1993) offers various possible interpretations and describes the limitations of each. In the present document, the expression is used to refer to modes of public intervention which are typically less effective or efficient than best practice. For example, the systematic payment of above-market prices to government suppliers is not only alien to best practice but can also arouse suspicions that the difference corresponds to a bribe or inducement.

national commissions on State reform, legislative committees on ethics, political parties, academic research centres, employers' associations and trade unions.

Although corruption is found in all latitudes, cultures and countries irrespective of their level of economic development, there is no doubt that it is a response to certain objective conditions in the working environment of public officials.[34] According to the literature on the subject, the factors associated with its appearance are as follows:

(i) The complexity, obscurity or lack of transparency of institutional arrangements, administrative models, legal systems and regulatory bodies in general, and of administrative rules and procedures, above all when, at the same time, public officials are granted broad discretionary powers in the exercise of their duties;

(ii) Complex tax codes and unstable regulations that entail high compliance costs and are hence difficult to enforce;

(iii) Complex or unstable regulations governing public contracts for purchases from State suppliers, service concessions or competitive bidding for public works in general;

(iv) Lack of adequate oversight mechanisms and use of outmoded and inefficient supervisory methods together with a lack of mechanisms for the periodic evaluation and monitoring of public officials' performance with respect to ethics and quality.

Beyond the challenge that public corruption poses for the development and consolidation of an ethical framework consistent with a free and democratic society, the use or abuse of public office for personal ends has come to be recognized as an obstacle on three different levels. In the first place, it is an obstacle to fiscal consolidation and hence to non-inflationary financing of the government budget; for example, corruption on the part of government officials helps to increase the evasion of taxes, customs duties and social security obligations and leads, among other things, to unnecessary acquisitions, payment of above-market prices, acceptance of poor quality inputs from government suppliers and the approval of wholly or partially overlapping investment projects. Secondly, government corruption is an obstacle to the efficient allocation of public resources (since it results in funds being diverted for uses that are of less benefit to society) and private resources (since the prospect of large gains often lures more talented and creative employees into activities that are not only illegal but also bring less benefit to society). Lastly, corruption is a hindrance to the equitable distribution of income and wealth, insofar as various sources of income remain concentrated in the hands of a small number of economic agents at the expense of the vast majority of taxpayers.

In short, corruption is a problem that affects both fiscal consolidation and macroeconomic equilibria, undermines good governance and restricts economic growth. This chapter suggests that quasi-fiscal instruments and procedures tend to create an environment conducive to various types of corrupt practices, rent-seeking and, in general, the pursuit of unproductive activities.[35]

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[34] See Tanzi (1997); Chand and Moene (1997).

[35] See Bhagwati (1982).

H. CONCLUSIONS AND FINAL OBSERVATIONS

- Fiscal consolidation in the region requires agreement on a fiscal covenant that is in keeping with the political and institutional structure of the society and legitimizes the role of the State and its scope of action in the economic and social spheres; in particular, it should reflect a stable consensus with respect to the level, composition and trend of public expenditure, and the taxation required to fund it.
- Until such a fiscal covenant is firmly in place, there will be a strong temptation to substitute poorer-quality instruments (indirect, lacking in transparency) which are considered "less costly" from the political point of view for more "expensive" instruments (direct, visible and explicit). Such substitution obscures the manner in which the government budget is managed, so that it ultimately fails to provide a picture of all the channels through which fiscal policy is expressed. In this way, the extrabudgetary content of many measures whose economic effects are equivalent to those of conventional taxes and subsidies often goes unnoticed (or is underestimated) despite the substantial political, economic and social effects that it may have.
- The less transparent fiscal operations are, the less chance there is of satisfying the criteria of good governance (transparency, accountability and predictability). Moreover, a lack of transparency is more likely to lead to corruption, which adversely affects both fiscal consolidation and macroeconomic equilibria, while at the same time undermining political governance and restricting economic growth.
- In view of this situation, the debate on the modernization of budget institutions must be complemented by further research and discussion of the quasi-fiscal dimension. In particular, an accurate assessment of the fiscal situation demands a high degree of transparency in fiscal activities; therefore, the information usually found in the official budget (*the visible part of the iceberg*) must be supplemented by and integrated with information on the whole range of fiscal instruments (extrabudgetary activities, tax expenditure, contingent liabilities, implicit fiscal policy) not included in the budget (*the submerged part of the iceberg*). Greater fiscal transparency is also a good way of combating corruption.
- The extent of quasi-fiscal activity in the countries of the region is reflected in the importance attached to certain indirect forms of government expenditure, such as tax expenditure and mandatory regulations, which have rarely been quantified. Estimation of the actual extent of social spending is of special importance because of its relevance to social equity. In this regard, it is necessary to account for the quasi-fiscal elements of social policy (subsidies granted through pricing policy, mandatory regulation, incentives in the form of tax exemptions and concessions, and illegal and informal operations, among others) in order to assess its true scope.
- In general, bringing the submerged part of the iceberg up to the surface and integrating it into the regular budget is one of the main items of unfinished business on the agenda of State reform. Lack of information, technical capacity and political will are chronic problems in the region which limit the results to be expected from reforms. Therefore, an effort must be made to create an awareness of the strategic

importance of applying the principles of budgetary unity and universality. Furthermore, steps should be taken to improve the flow of information in terms of its quality, quantity and timeliness.

- One basic recommendation emerging from the above is the need to prepare supplementary budgets in certain important quasi-fiscal areas, such as tax expenditure and mandatory regulation, in the light of the experiences of countries that have developed more advanced estimation methodologies. Supplementary budgets should gradually be incorporated into the legislature's annual budget debate so that the actual extent of State action can be assessed and so that of the costs and benefits involved in the substitution of policy tools can be compared.

PART TWO:
THE PROCESS OF FISCAL CONSOLIDATION

III. Government revenues

IV. Public spending

V. Deficit and debt

III. GOVERNMENT REVENUES

A. INTRODUCTION

During the 1980s and 1990s a majority of the region's economies have embarked upon efforts to reform their tax and tariff policies and to modernize their administrative structures in these areas.[1]

These reforms have been designed to pursue the classic objectives of revenue adequacy, the streamlining of rules and procedures, neutrality in resource allocation and equitable distribution (particularly in horizontal terms) of the tax burden. A parallel aim has been to bring about a functional adaptation of the tax base and tax rates in line with the demands of the stabilization and structural reform programmes launched during the 1980s.

As is only to be expected, the extent to which these objectives have been achieved differs from one country to the next. While no definitive studies on the subject are available, it appears that progress in the area of revenue adequacy has been slow and politically costly for those Governments that have attempted to increase the tax burden. Although some countries have made quite a bit of headway in streamlining their tax laws, rules and procedures, much remains to be done in this respect, since complexity increases compliance costs and creates incentives for tax evasion and avoidance. Efforts to achieve greater tax equity have been hampered, on the one hand, by the disillusionment that has followed what were the probably unrealistic expectations of the 1970s as to the tax system's redistributive capabilities and, on the other, by the fact that the highest-yield taxes are regressive. In any event, it is clear that this is an issue that will need to be addressed by future tax reform initiatives in the region.

With regard to the objective of more efficient resource allocation, the widespread adoption of value added taxes (VAT) having a simpler rate structure and broader tax base may have helped to reduce the distortions that had been created by the use of traditional cascading sales taxes. In addition, the increasingly widespread use of the VAT in both

[1] See Shome (1998), Carciofi, Barris and Cetrángolo (1994), Tanzi and Pellechio (1995), Radano (1996), IEF (1992), Cosulich (1998) and Castilla (1998).

absolute and relative terms may be viewed as a development that helps to prevent decision-making from being skewed in favour of personal savings since, although the goods being taxed cover a wide spectrum, the only direct impact of this type of tax is on consumption.

B. PUBLIC REVENUES

After a decade of fluctuations that failed to coalesce into any clear trend, the mean total revenues of the central governments of Latin America have climbed steadily during the 1990s, rising from somewhat less than 15% of GDP in 1990 to 17% by 1996 (see figure III-1). The dispersion of this ratio has also diminished, with total revenues being concentrated in the 15%-20% range by 1996. Only Guatemala and Haiti had coefficients below 10%; Chile's revenues have held steady at around 23% of GDP while, thanks to higher transfer payments from abroad, Nicaragua's are over 25%. The Caribbean countries' total revenues have fallen slightly during the 1990s but, even so, are still over 30% of GDP.

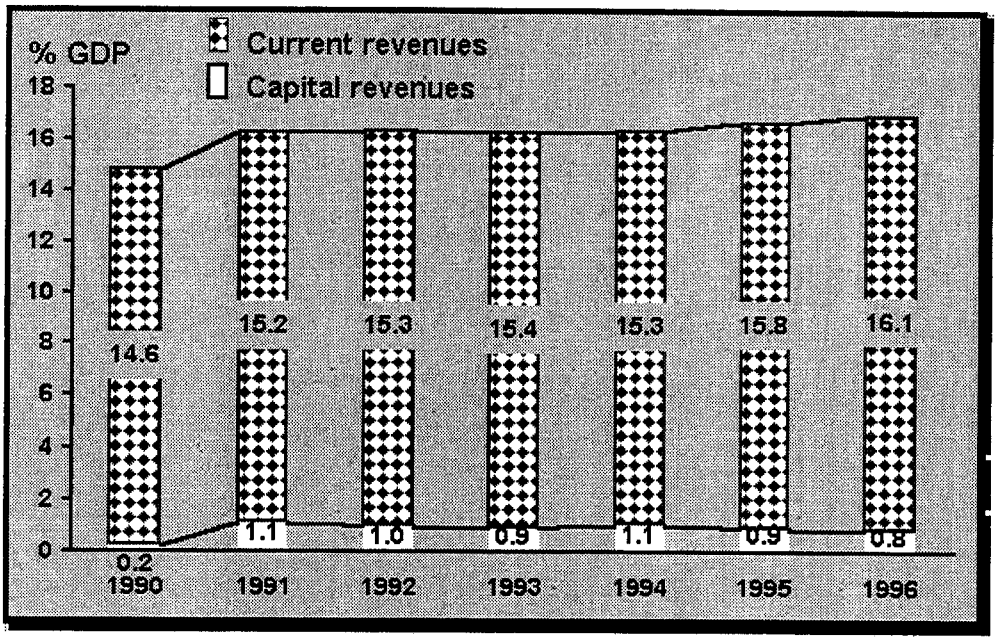
An examination of the figures for the non-financial public sector (NFPS) as a whole shows that its total revenues have followed much the same pattern as those of the countries' central governments. NFPS revenues averaged between 25% and 26% of GDP at the start of the decade and had risen to almost 28% by 1996. The statistics for countries with NFPS data also indicate that revenue levels have tended to converge. At one end of the spectrum, NFPS receipts in Venezuela amounted to 37% of GDP in 1996, thanks to an upsurge in the State oil company's earnings. At the other, the only country in which NFPS revenues totalled less than 20% of GDP was Argentina, whose low coefficient was attributable to the reductions made in employer contributions in order to stimulate labour demand.

Total central government receipts are composed chiefly of current revenue, which increased from an average of 14.6% of GDP in 1990 to 16.1% in 1996. Capital revenue has hovered around 1% of GDP for the last seven years and is expected to trend downwards as privatization and divestment programmes proceed (see figure III-1).

Tax revenues account for the bulk of current revenues and have exhibited an upward trend that had carried them to 13.6% of GDP by 1996 (see the following section). The next largest component is social security contributions (see section 2), which average[2] slightly more than 2% of GDP, followed by non-tax revenues (about 1.5%). Social security contributions held fairly steady in the first half of the decade, but their share of the total has shrunk slightly during the past three years (from 13% to 11% of total current revenues). Such contributions make up 33%, 29% and 28% of the current revenues of the Governments of Colombia, Brazil and Argentina, respectively, but account for a more modest share of current income —between 12% and 13%— in such countries as Ecuador, Mexico and Peru. In another group of countries, which includes Chile, Bolivia, Honduras, Paraguay and Venezuela, this source only makes up between 5% and 7% of total current revenues. In addition, State-owned companies provide significant oil revenues in Ecuador, Mexico and Venezuela, as does the copper industry —to a somewhat lesser extent— in Chile.

[2] Average for 11 countries on which data for 1990-1995 are available: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Honduras, Mexico, Paraguay, Peru and Venezuela.

Figure III-1
LATIN AMERICA: CENTRAL GOVERNMENT REVENUES, 1990-1996
(Percentages of GDP)



Source: ECLAC, on the basis of official figures.

1. Tax revenues

The central government's average gross tax take —defined as its tax receipts as a percentage of GDP, net of social security contributions— has been edging upward since the start of the decade, rising from 11.8% in 1990 to 13.6% in 1996. This increase of around two points of GDP represents the average of widely differing figures for the individual countries, since this ratio rose much more than that in some and fell in others. Be that as it may, it should be noted that the average tax burden in 1990 was slightly lower than it had been in 1980 (see figure III-2a).

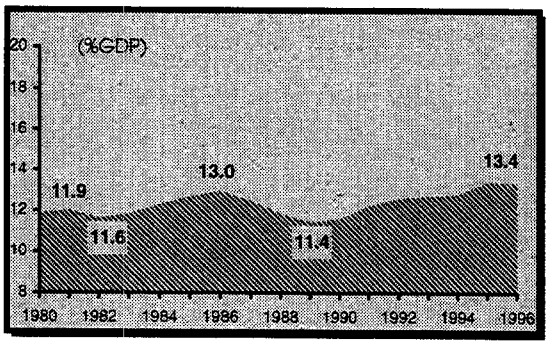
These promising developments are not wholly attributable to the tax reforms of the 1980s and 1990s; other factors have been at work as well. The contributing factors can be broken down into three main categories: (1) policy reforms (the elimination of exemptions, cuts in deductions, the broadening of the tax base, and reductions in the number of income brackets and in the mean marginal rate); (2) improvements in tax collection capabilities (creation and updating of tax rolls, technical training of tax officials, measures for motivating employees and boosting their morale, ranking of tax bureaus and prioritization of auditing functions, computerization); and (3) direct and indirect effects of economic growth and changes in the institutional, political and social environment. In the absence of any in-

depth studies on the relative importance of each of these categories, it would seem somewhat rash to give the first type of factor sole credit for these achievements.[3]

To return for a moment to the question of the central government's average gross tax take, it should be noted that most of the countries in the region have tax burdens ranging between 10% and 20% of GDP. Oil-producing countries such as Mexico, Venezuela and Ecuador have tax ratios below 10% because they are able to rely more heavily on earnings from this commodity (see figure III-3a).

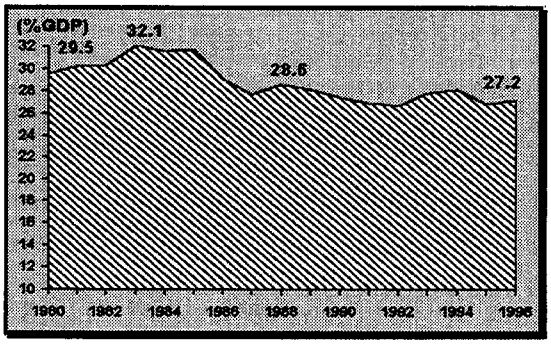
Figure III-2
TAX RECEIPTS NET OF SOCIAL SECURITY CONTRIBUTIONS: CENTRAL GOVERNMENT, 1980-1996
(Percentages of GDP)

2.a Latin America



Source: ECLAC, on the basis of official figures.

2.b The Caribbean



Source: ECLAC, on the basis of official figures.

The situation is quite different in the Caribbean countries, where average tax ratios are twice as high as they are in the rest of the region. This is primarily because they have higher receipts from taxes on foreign trade and from direct taxes on corporate and personal income. As shown in figure III-2.b, the average tax take of the Caribbean countries' central governments held at around 30% of GDP during the 1980s but has fallen to 27% over the course of the present decade. This trend is the net result of widely varying ratios in the different countries, however, as may be seen from figure III-3.b (in 1996, for example, the ratios of individual countries ranged from 17% to 35% of GDP), and the decline seen over the course of the 1980s and 1990s (see figure III-2.b) has mainly been attributable to a reduction in direct tax revenues (see section 1b).

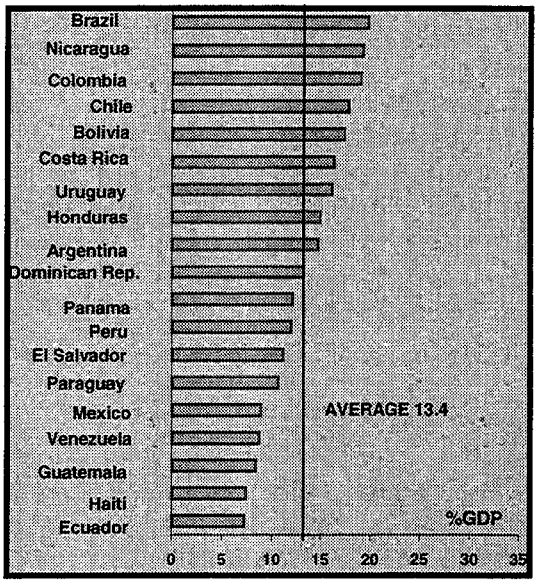
The smaller Caribbean islands exhibit a high degree of fiscal vulnerability, as is illustrated by the case of Aruba.[4] The tax take as of 1986 was approximately 25% of GDP (70% of which was accounted for by direct taxes), but over the next four years it decreased by about seven points of GDP. Since then, the tax ratio has held fairly steady at an average of around 18% of GDP (with direct taxes accounting for 56% of the total). This level of vulnerability is associated with these countries' highly specialized production structures,

[3] See, for example, IDB (1996) and Shome (1995).
[4] IMF (1997).

which are based on commodities in some cases, the refining and export of petroleum products in others (e.g., Aruba up to 1985) and services (mainly finance and tourism) in still others.[5]

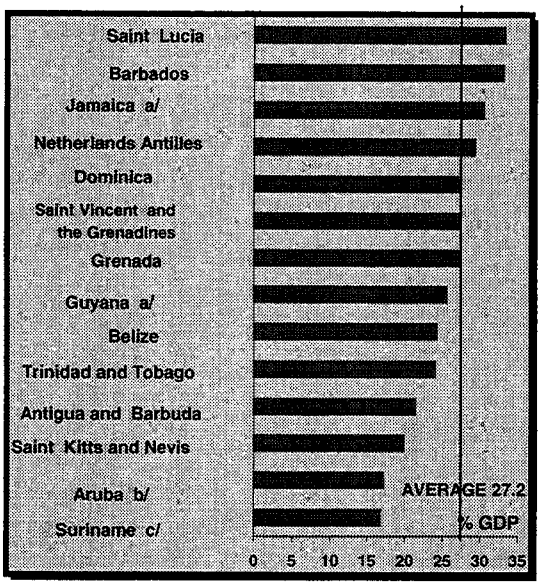
Figure III-3
TAX RECEIPTS NET OF SOCIAL SECURITY CONTRIBUTIONS, BY COUNTRY: CENTRAL GOVERNMENT
1996
(Percentages of GDP)

3.a Latin America



Source: ECLAC, on the basis of official figures.

3.b Latin America



Source: ECLAC, on the basis of official figures.
[a] 1995. [b] 1992. [c] 1993.

(a) Indirect taxes

Under the trade liberalization programmes launched by Latin American countries in the 1980s and carried forward during the 1990s, the region's average level and range of tariff rates have both decreased considerably. As a result, the share of tax revenues accounted for by foreign trade operations has shrunk substantially, especially in the

[5] From the 1920s until the first half of the 1980s, Aruba's economy was heavily dependent on the refining and exportation of petroleum products. When the bottom fell out of this market in 1981-1985 and Venezuela slashed its petroleum output by over 20%, the huge Lago Refinery was closed down. In 1982, this refinery provided more than 40% of the Government's total profit tax receipts, not to mention the revenues from its payroll taxes. Despite its rapid and successful move to switch its production structure over to tourism, Aruba's public finances have felt the effects of this unmistakable change in its fiscal regime, since its income and expenditure levels are now substantially lower than they were prior to 1985.

countries that have made the most progress in opening up their economies to international trade and in concluding bilateral and/or multilateral trade agreements. As "open regionalism" gains sway in Latin America and the Caribbean, a deepening of this trend can therefore be expected.[6]

These policies have shifted the tax mix of many countries' away from cross-border operations (imports and exports) and towards domestic transactions (see figure III-4).

The greater the Treasury's reliance on tariffs as a source of income, the more keenly the Ministry of Finance will feel the pressure represented by the potential tax expenditure associated with tariff rollbacks. This is particularly true of the small Caribbean economies, which generally obtain one third of their total revenues from foreign trade activities (two thirds of their total receipts from indirect taxes) and, to a somewhat lesser extent, of the Central American economies. In these two subregions, the mere prospect of future tariff reductions impedes the progress of negotiations on economic integration (see figures III-4.b and III-4.c).

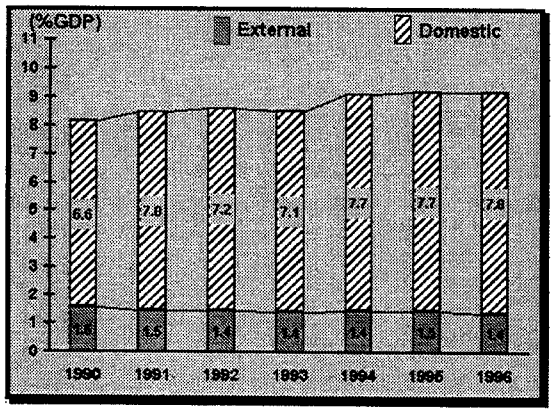
The drop in revenues has been smaller than expected, however, because of a widespread surge in imports (including purchases of inputs for the Caribbean's tourism industry) and the introduction by some countries of other types of taxes on foreign trade. This pressure is also felt in relatively larger, more open economies —such as Chile's—when there is talk of instituting unilateral tariff reductions as a way of improving the country's competitive position in international export markets and of lessening the trade diversion generated by agreements with partners that are not as strongly committed to free trade. It is therefore important to bear in mind the trade-offs between revenue adequacy (the concern of the Revenue Service) and subregional integration and linkages with the world economy (a matter to be addressed by the Ministries of Trade and Foreign Affairs) (see box III-1).

As a complementary development, the 1990s saw the consolidation of the shift in the Latin American economies' tax structure —a trend that had begun decades ago and had strengthened in the 1980s— towards indirect taxes in general and consumption taxes (VAT), in particular. Most of the countries have raised the base rates for this tax (see table III-1). In fact, the average percentage of income derived from indirect taxes has leveled off at around 73% of tax receipts during the 1990s. Almost all the Latin American countries obtain between 70% and 80% of their tax receipts from indirect taxes. The only countries that have a more balance mix of direct and indirect taxes are Colombia, Mexico and Panama, where indirect taxes provide between 50% and 60% of the total. As a whole, the Caribbean countries also have a less skewed distribution than their Latin American counterparts, with approximately 60% of total tax receipts coming from indirect levies.

[6] The complex web of reciprocal concessions provided for under these subregional trade agreements give rise to a welter of exceptions that poke holes in this safety net of nominal tariff protection, thereby further reducing the average effective tariff rates of each country. The tax expenditure occasioned by tariff reductions could be partially offset by a devaluation of the local currency. Nevertheless, tariff cuts have often been associated with a revaluation of the local currency instead.

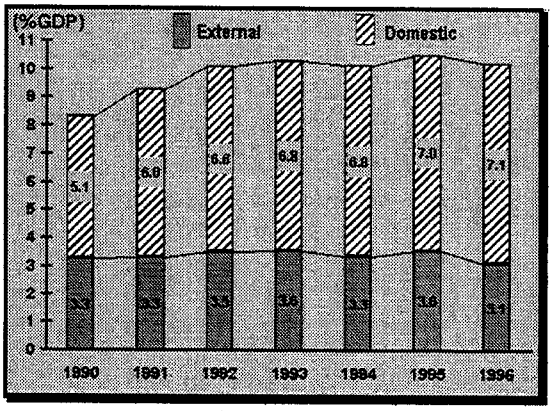
Figure III-4
LATIN AMERICA AND THE CARIBBEAN: CENTRAL GOVERNMENT INDIRECT TAX RECEIPTS
(Percentages of GDP)

4.a South America



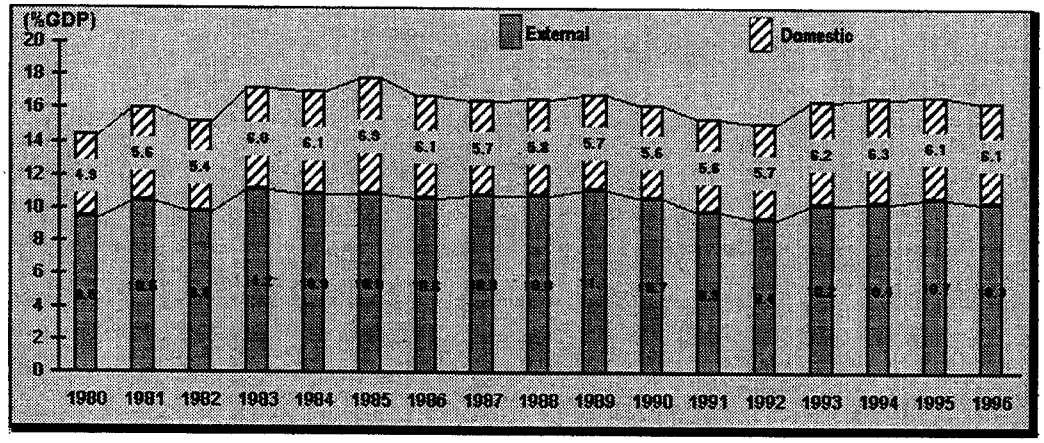
Source: ECLAC, on the basis of official figures.
Note: Averages for Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru and Venezuela.

4.b Central America



Source: ECLAC, on the basis of official figures
Note: Averages for Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras and Panama

4.c The Caribbean



Source: ECLAC, on the basis of official figures.
Note: Averages for Antigua and Barbuda, Aruba, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Netherlands Antilles, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, and Trinidad and Tobago.

Box III-1

RELIANCE ON TARIFF REVENUES

For many of the smaller countries in the region, trade liberalization and the associated reduction of import duties has the effect of sharply reducing fiscal revenues since the level of total tax receipts is heavily influenced by trends in imports and exports. This is especially true of some Central American and Caribbean countries, where revenues from import duties represent a significant percentage of total tax receipts (generally over 15% and, in some cases, as much as 50% or more). As a rule, tariffs are easier to collect than other consumption or income taxes, and although some countries have adopted reform measures aimed at reducing the effect of tariff revenues on the fiscal budget, these efforts have not always proved successful.[a]

Brazil is the only member of Mercosur in which the percentage of total central government tax revenues that comes from taxes on foreign trade is on a par with the levels seen in industrialized countries, where the average is below 2% (except in the cases of Ireland and Switzerland where the figure is between 5% and 7%). In the small Central American and Caribbean economies, tariffs and other taxes on foreign trade account for over 22% of fiscal revenues on average, and the figures are substantially higher in Anguilla (77%), Antigua and Barbuda (66%), Dominican Republic (45%), Bahamas and Barbados (53%).

RECEIPTS FROM TAXES ON INTERNATIONAL TRADE AND OTHER TRANSACTIONS AS A PERCENTAGE OF TOTAL REVENUES, 1994

Mercosur		Central American Common Market (CACM)		CARICOM (cont.)	
Argentina	7.26	Costa Rica	14.89	Belize	52.39
Brazil	1.50	El Salvador	14.70	Cayman Islands	42.16
Paraguay	12.46	Guatemala	21.17	Dominica	56.50
Uruguay	4.12	Honduras	23.40 [b]	Dominican Republic	44.80 [c]
Chile	*9.31*	Nicaragua	20.94	Grenada	16.77
				Jamaica	14.00 [c]
				Montserrat	52.50 [c]
Andean Community		**CARICOM**		Netherlands Antilles	39.16
				Saint Kitts & Nevis	55.20 [c]
Bolivia	6.66	Anguilla	77.00 [c]	Saint Lucia	58.70 [c]
Colombia	8.44	Antigua and Barbuda	66.10 [c]	Saint Vincent & the Grenadines	40.80
Ecuador	11.27	Bahamas	59.98	Suriname	41.70 [c]
Peru	9.71	Barbados	8.60 [c]	Trinidad & Tobago	10.74 [c]
Venezuela	7.33				
MEXICO	6.00				

A dependence on tariffs is a reflection of more deeply rooted structural problems, however, and it is these problems that are the true obstacle to greater openness. In the case of the small economies of the Caribbean Community, the limited size of the subregional market, the similarity of their production structures and their relative lack of diversification appear to provide a more satisfactory explanation for the difficulties standing in the way of regional integration.[d] Intra-regional trade (excluding petroleum) has ranged between 5% and 8% of CARICOM members' total trade flows. Caribbean countries that have a fairly undiversified economic base rely heavily on exports of a limited number of commodities and basic services. For example, in 1994 banana exports represented nearly 50% of Saint Lucia's and Dominica's total merchandise exports. Jamaica's and Trinidad and Tobago's dependence on bauxite and petroleum, respectively, is even greater. These countries are also heavy importers of both consumer and production goods and, in every case, merchandise trade amounts to over 50% of GDP. If trade in services is included, then the proportion of GDP represented by foreign trade in 1994 ranged from nearly 153% in Antigua and Barbuda to 62% in Trinidad and Tobago.[e]

Source: [a] ECLAC, *Economic Survey of Latin America and the Caribbean, 1996-1997* (LC/G.1968-P), Santiago, Chile, 1997, United Nations publication, Sales No. E.97.II.G.2.

[b] Manuel Castilla Domingo, "La armonización tributaria en la integración de las economías pequeñas", in "Compendio de documentos" papers presented at the ninth Regional Seminar on Fiscal Policy, organized by ECLAC and UNDP and co-sponsored by IMF, World Bank and IDB, under the auspices of the Ministry of Finance of Chile, Santiago, Chile, 27-29 January 1997.

[c] T. Harker, Sidya Ould El Hadj and L.V. Souza, "Los países del Caribe y el Área de Libre Comercio de las Américas", *Revista de la CEPAL*, No. 59 (LC/G.1931-P), Santiago, Chile, August 1996.

[d] The total population of the CARICOM countries (prior to Haiti's membership) is slighly over six million.

[e] Some small economies —such as Singapore, the Chinese province of Taiwan, Hong Kong and Luxembourg— have promoted efficient forms of interaction with the international economy. See Harker, El-Hadj and de Souza (1996).

Table III-1
BASIC VALUE-ADDED TAX RATES [a]
(Percentages of GDP)

Country	Introduction/proposal of VAT		Rates		
	Year	Month	Original Rate	March 1994	October 1997
Argentina	1975	January	16	18	21
Bolivia [b]	1973	October	10	13	13
Brazil (intra-state) [c]	1967	January	15	11	17
Brazil (inter-state) [d]	1967	January	15	17	17
Chile	1975	March	20	18	18
Colombia	1975	January	10	14	16
Costa Rica	1975	January	10	8	15
Ecuador	1970	July	4	10	10
El Salvador	1992	September	10	10	13
Guatemala	1983	August	7	7	10
Haiti	1982	November	7	10	10
	1976	January	3	7	7
Jamaica	1991	October	10	12.5	15
Mexico	1980	January	10	10	15
Nicaragua	1975	January	6	10	15
Panama	1977	March	5	5	5
Paraguay	1993	July	12	10	10
Peru	1976	July	20	18	18
Dominican Republic	1983	January	6	6	8
Venezuela [e]	1993	October	10	-	16.5

Source: ECLAC, on the basis of official figures and data from the Fiscal Affairs Department of IMF.

[a] The rates vary from country to country; only the most commonly used rates are included in this table. The rates are the statutory values (te) for calculating VAT "on the outside" (except in the cases of Bolivia and Brazil) and apply to goods and services not subject to very high or very low rates. Some countries use a zero rating for certain products and exports.

[b] The 13% rate (ti) is the statutory value (Act 843, art. 15) for calculating VAT "on the inside". For purposes of comparison with the rest of the table, the effective rate (equivalent to its computation "on the outside") can be estimated: $te = ti/(1 - ti)$, from which we can deduce that $ti < te$.

[c] Like Bolivia, Brazil legislates rates (ti) for the calculation of VAT "on the inside".

[d] The states are divided into Group 1 (the southern and south-eastern regions except Espirito Santo), on which a 12% rate is levied, and Group 2 (the rest of the states), which is subject to a 7% rate.

[e] Soon after its introduction the VAT was abolished; it was later re-introduced on a permanent basis.

(b) Direct taxes

The above-mentioned shift represents the consolidation of a symptomatic trend towards the abandonment of direct taxation as the financial basis for government operations in Latin America. This tendency sets these economies apart from those of the Caribbean —although, as will be discussed later, the level of direct receipts has recently been declining in this subregion as well— and the Organisation for Economic Co-operation

and Development (OECD), whose revenue collection patterns attest to a relatively greater reliance on direct taxes (the Caribbean and OECD countries draw 40% and 66%, respectively, of their total tax receipts from direct levies whereas this source of revenue provides only 25% of the total in Latin America). A more detailed breakdown shows that between 60% and 80% of these revenues come from corporate tax payments, while only between 10% and 15% come from private individuals.

Two inferences that can be drawn from the above are that Latin American taxpayers are strongly averse to paying personal income taxes and that Latin American fiscal authorities display an equally strong preference for indirect taxes. This deepening and increasingly entrenched tendency to rely on indirect taxes (especially VAT) is the result of a combination of technical and political factors.[7] The relevant technical factors include the well-known advantages of VAT, such as its domestic, international and inter-temporal neutrality and the fact that it is largely a "self-monitoring" tax. It is therefore no surprise that VAT has become the tax base of choice for the region's fiscal authorities.[8] With regard to the political factors at work in this regard, it can be argued that the more affluent socio-economic groups have been able to pressure the Government into granting numerous income tax exemptions, credits and deductions which have significantly reduced the impact of this form of taxation.

Fiscal authorities' preference for indirect tax bases is clearly reflected in the decline of personal and corporate income tax rates during the 1980s and 1990s. On average, the high-end marginal corporate income tax rate in the region dropped by nearly 10 points between 1986 and 1994 and the marginal personal income tax rate for the highest bracket fell from 47% in the mid-1980s to 28% by 1994 (see table III-2). At the same time, the marginal rate for the lowest income bracket has risen slightly, which means that, during this same period, the range of tax rates has narrowed to almost half of what it used to be.

As noted earlier, the general shift away from the use of direct taxes in Latin America has not been emulated by a majority of the Caribbean countries. Receipts from direct taxes have stood above the subregional average of 40% for the past 15 years in Aruba, Barbados, Guyana, Jamaica, Netherlands Antilles, Suriname and Trinidad and Tobago, and actually make up around two thirds of total tax revenues in the last three of these countries. Direct tax receipts have been diminishing for the past three years, however, as policy-

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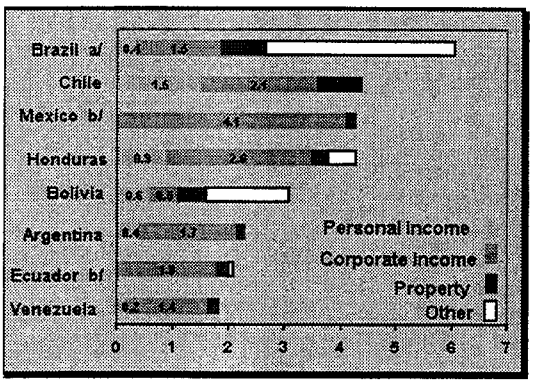
[7] The specialized literature on public finance does not offer any theories regarding the determinants of the direct/indirect tax mix. Ramsey's approach to minimizing the welfare loss associated with taxation does not include direct taxes, and is therefore a theory dealing with the optimum tax structure rather than the tax mix. For a discussion of this subject, see Boadway, Roberts and Shah (1994).

[8] The VAT is the fastest-growing type of tax in the world, and its spread has been especially rapid during the last two decades. After France introduced the VAT on a trial basis in 1954 (and adopted it on a system-wide basis in 1968), Brazil and Uruguay pioneered its use, incorporating it into their tax structures in the 1960s. Argentina, Chile, Costa Rica, Ecuador, Honduras and Panama followed their example in the 1970s, Mexico, Nicaragua, Peru, Colombia, Guatemala, Haiti, Dominican Republic and Bolivia adopted it in the 1980s, and Paraguay, El Salvador and Venezuela did so in the 1990s. Currently, every single Latin American economy levies some form of VAT except Cuba. Cuba's Act. No. 73 of August 1994 does not provide for the use of a VAT but the new sales tax, which is to be used as a partial substitute for the existing turnover tax may be converted into a value-added tax in the future.

makers have moved to lower tax rates in response to widespread concerns about the possible adverse effect of such taxes on business competitiveness. The direct tax payments collected by Caribbean Governments during the 1990s have averaged about 10% of GDP, which is three points below the average figure for the 1980s.

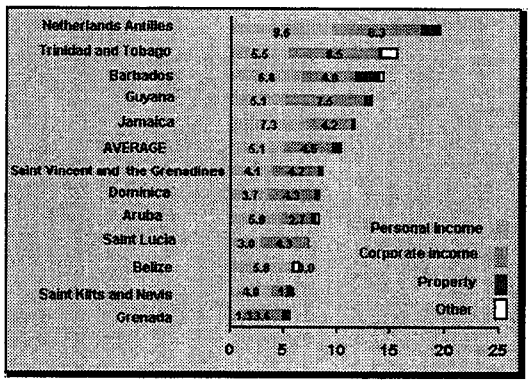
Figure III - 5
CENTRAL GOVERNMENT DIRECT TAX MIX
(Percentages)

5.a Latin America, 1995



Source: ECLAC, on the basis of official figure.
[a] "Other"includes income taxes deducted at the source.
[b] Corporate income taxes also cover personal income.

5.b The Caribbean, 1996



Source: ECLAC, on the basis of official figures.
[a] The figures for Aruba are for 1992; the figures for Guyana and Jamaica are for 1995.

These receipts are split fairly evenly between corporate and personal income taxes, with a slightly larger share being accounted for by payments from individuals, although this distribution varies markedly from one country to the next (see figure III-5.b). Corporate tax receipts were particularly high in the Netherlands Antilles in the early 1980s, when financial services were playing an especially important role in Curaçao's economy, but they were generally far higher than the subregional average. By the same token, Trinidad and Tobago's revenues were extremely high in the early 1980s when the oil industry was booming, but then started to taper off when the liberalization of this sector was begun in the second half of the decade.

Table III-2
PERSONAL AND CORPORATE INCOME TAX RATES[a]
(Percentages)

COUNTRIES	CORPORATE INCOME			PERSONAL INCOME		
	1986	1992	1994	1985 or 1986	1991	1994
Argentina	0 - 33	2	30	16.5 45 -	6 - 30	11 - 30
Bolivia	0 - 30	0 [a]	0 - 40	n.a.- 30	13	13
Brazil	29 50 -	25 40 -	25 40 -	0 - 60	10 - 25	15 - 35
Chile	10 37 -	15 35 -	15 35 -	0 - 57	5 - 50	5 - 48
Colombia	40	30	30	n.a.- 49	5 - 30	5 - 30
Costa Rica	0 - 50	30	30	5 - 50	10 - 25	10 - 25
Ecuador	0 - 59	0 - 44.4	0 - 44.4	19 - 40	10 - 25	10 - 25
El Salvador	0 - 30	0 - 25	0 - 25	3 - 60	10 - 50	10 - 30
Guatemala	0 - 42	12 34 -	25	11 - 48	4 - 34	15 - 25
Honduras	0 - 55	0 - 40.2	15 50 -	3 - 40	3 - 40	12 - 55
Mexico	5 - 42	0 - 35	17 34 -	3 - 55	3 - 55	3 - 35
Nicaragua	0 - 45	0 - 35.5	0 - 30	15 - 50	6 - 50	7 - 30
Panama	0 - 50	2.5 45 -	2.5 42 -	13 - 56	2.5 56 -	4 - 33
Paraguay	0 - 30	0 - 30	0 - 30	5 - 30	0	0
Dominican Republic	0 - 49.3	0 - 49.3	0 - 26	2 - 73	3 - 70	15 - 26
Peru	0 - 40	0 - 30	0 - 30	2 - 56	5 - 56	15 - 30
Uruguay	0 - 30	0 - 30	0 - 30	0	0	0
Venezuela	18 67.7 -	20 67.7 -	20 67.7 -	12 - 45	4.5 45 -	10 - 30
Regional average	**3.4 43.3 -**	**8.6 36.5 -**	**11. 35.5 6 -**	**7 - 47[b]**	**5 - 36**	**9 - 28**

Source: Parthasarathi Shome, "Latin American Advancements in Tax Policy: Looking to the 21st century", *Pensamiento iberoamericano*, No. 32, vol. 32, Madrid, in print. (Special issue on public finance and fiscal policy in Latin America and Spain: Invited editor: Juan Carlos Lerda).

[a] In 1991 the corporate income tax was replaced by a 3% tax on net worth.

[b] Average for both years.

This recent move away from direct taxation is a cause of concern not only because it means that an important source of revenues is being neglected but also because it means that policy-makers are spurning what is a potentially useful distributional tool.[9] In any event, the redistributive power of tax policy should not be overestimated; efforts need to be undertaken in three different areas in order to maximize fiscal policy's positive effect on equity: (a)

[9] ECLAC (1992).

increasing the incidence of direct taxation by broadening the tax base and achieving better taxpayer coverage (with the exception of low-income groups) in order to attain greater vertical and horizontal equity; (b) reducing tax evasion in order to improve horizontal –and perhaps—vertical equity; and (c) improving the design of social expenditure programmes to reduce poverty and inequality in income distribution.[10]

(c) Withholding taxes on outgoing remittances

Generally speaking, the countries of the region have chosen to reduce (and, in many cases, eliminate altogether) tax provisions that discriminate against foreign capital. This decision may be interpreted as an implicit recognition of the fact that the globalization of the world economy is eroding the degrees of freedom enjoyed by tax authorities in selecting policy designs independently of the market and of what other tax bureaus are doing.[11]

Looking at this trend from a different angle, one might say that the globalization of the world economy gives national Governments incentives to prefer competition over cooperation in taxation-related matters. The mounting competition among tax bureaus seeking to boost their receipts while minimizing the risk that their tax bases will "migrate" to other, more attractive tax jurisdictions is reflected in a growing tendency to refrain from differentiating the tax provisions applying to: (a) the profits of local firms versus those of foreign-owned enterprises; (b) regular profits versus capital gains; (c) profits distributed within the country versus remittances being sent out of the country; and (d) other categories of profits, interest and royalties.

As in the case of other direct taxes, the rates for withholding taxes on outgoing remittances have been lowered a great deal during the past decade. The withholding tax on dividends being sent out of the country has been cut by over one half, while the reductions in the rates levied on interest payments and royalties have been somewhat smaller (see table III-3). Nonetheless, the countries of the region still show a preference for taxing remittances of royalties.

In 1986, two thirds of the 18 countries in the sample taxed remittances of dividends at rates of 20% or higher. In 1996, only four countries —Chile, Dominican Republic, Ecuador and Uruguay— still had rates of between 25% and 35%, and six others had eliminated the tax on outbound dividends altogether. On average, withholding taxes on interest payments are five percentage points lower than they were a decade ago. Although the range of rates has not changed significantly, the number of countries with rates of 20% or more has dropped from 11 in 1986 to 7 in 1996. Reductions in withholding taxes on royalties have been smaller.

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[10] For a more detailed discussion of the distributional impact of public expenditure, see chapter VI, section C.

[11] Coelho (1998), Lerda (1996), Tanzi (1995).

Table III-3

WITHHOLDING TAX ON OVERSEAS REMITTANCES TO COUNTRIES NOT COVERED BY AN INTERNATIONAL AGREEMENT[a]

(Rates)

COUNTRIES	1986			1992			1996		
	Dividends	Interest	Royalties	Dividends	Interest	Royalties	Dividends	Interest	Royalties
Argentina	18	16	36	20	14	25	0	4.5	18
Bolivia	25	25	25	10	10	10	12.5	12.5	12.5
Brazil	25	25	25	25	25	25	0	15	15
Chile	40	40	40	35	40	40	35	4	35
Colombia	40	40	0	19	30	0	7	7	7
Costa Rica	15	10	20	15	15	25	15	15	25
Ecuador	40	0	40	36	0	36	25	0	33
El Salvador	22	22	22	0	20	30	0	20	20
Guatemala	13	10	25	13	25	34	12.5	20	30
Honduras	15	5	10	15	5	35	15	5	35
Mexico	55	25	32	0	20	25	0	10	25
Nicaragua	20	18	18	0	35	35	5	30	30
Panama	10	20	10	10	6	16	10	6	16
Paraguay	10	30	30	10	30	30	5	35	35
Peru	30	40	55	10	37	28	0	30	10
Dominican Rep.	20	20	20	35	35	35	26	26	26
Uruguay	30	0	30	30	0	30	30	0	30
Venezuela	20	30	30	0	5	25	0	5	18
Simple average	**25**	**21**	**26**	**16**	**20**	**26**	**11**	**15**	**23**

Source: Parthasarathi Shome, "Latin American Advancements in Tax Policy: Looking to the 21st century", *Pensamiento iberoamericano*, No. 32, vol. 32, Madrid, in print. (Special issue on public finance and fiscal policy in Latin America and Spain: Invited editor: Juan Carlos Lerda).

[a/] Each category presents the most representative tax rate or corresponding average. For the sake of brevity, no variations or special rates have been included.

2. Social security revenues

As has already been mentioned, social security contributions have become the second most important component of current revenues. Table III-4 shows the trends in this source of revenue for 11 countries, using the averages for 1988-1989 and 1995-1996 as periods of comparison. The figures indicate that, these contributions have remained stable throughout the region during the period in question, both as a percentage of output (around 2% of GDP) and in relative terms share (between 13% and 14% of total current revenue). Social security receipts vary considerably, however, from relatively modest levels in many Latin American countries to substantial sums in Argentina, Brazil and Colombia (see table III-4).

In fact, trends in social security revenues in the various countries have been quite uneven, partly because of changes in their pension systems.[12] Thus, the share of current revenues derived from these contributions has increased in some countries (Colombia, Mexico and Paraguay), held steady in others (Venezuela) and dropped in still others (Argentina, Bolivia, Brazil, Chile, Ecuador, Honduras and Peru).

In most countries, social security contributions are considered to be earmarked revenues, i.e., they are reserved for a specific purpose. Since their use is subject to restrictions that do not apply to other types of tax revenues, a more sophisticated indicator of the effective tax take is required; this can be achieved, by deducting social security contributions from current revenue. An examination of the estimates given in table III-4 shows that the increase of roughly two points in average current revenues as a percentage of GDP between 1988-1989 (15.8%) and 1995-1996 (17.7%): (i) is not the result of changes in social security contributions (in fact, they are actually declining, although only slightly, as a percentage of total current revenue); and (ii) can be attributed to an increase in unearmarked tax revenues (current revenue net of social security contributions), which have risen from 13.5% to 15.3% of GDP.

On the other hand, social security contributions *are* responsible, on average, for most of the variation in tax takes across the countries of Latin America. A comparative analysis reveals that, if such contributions are excluded on the grounds that they are earmarked revenues, then cross-country differentials in fiscal performance are substantially reduced and, in some cases, even reversed. It is thus clear that social security revenues are the main reason for the differences observed in the countries' tax efforts in recent years.[13]

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[12] In recent years, a number of Latin American countries have switched from a traditional pay-as-you-go system to an individual or collective funded system, under varying types of administrative schemes (public, private or mixed), depending on whether the system is based on defined contributions or defined benefits. For a more detailed discussion of this question, see chapter VII. It should also be pointed out, however, that yields may vary even within the same kind of system, due to differences in the proportion of the population covered, contribution rates, average wage levels, the efficiency and effectiveness of the administrative machinery responsible for tax collection, and other factors.

[13] In fact, if we extend the analysis to include a comparison between OECD and Latin America, we find that social security contributions are becoming an increasingly important part of the reason for the gap in tax performance between the two regions. On the one hand, the difference between the two groups is significantly reduced if we look at tax revenues net of social security contributions as a percentage of GDP. And on the other, this difference has tended to decline over time (from a gap of 7% in 1989-1990 to one of just over three percentage points in 1995-1996), which indicates that the net tax effort of both regions are tending to converge. This observation supports the hypothesis, as formulated in chapter IV (see table III-4), that social security can be considered to be a superior good.

Table III-4

LATIN AMERICA: SOCIAL SECURITY CONTRIBUTIONS AND CURRENT REVENUE OF THE CENTRAL GOVERNMENT

(Percentages of GDP)

Group	Country	Social Security contributions (SSC)	Current revenue net of SSC	Current revenue (CR)	Share SSC/CR (percentages)
1988-1989					
SSC > 2%	Brazil[a]	8.8	10.4	19.1	45.8
	Argentina	4.5	12.6	17.1	26.3
	Ecuador	2.5	15.0	17.4	14.1
	Mexico[a]	2.1	15.0	17.1	12.3
	Average	**4.5**	**13.2**	**17.7**	**24.6**
SSC < 2%	Chile	1.7	20.1	21.8	7.6
	Colombia	1.6	10.0	11.6	13.8
	Peru	1.3	7.1	8.4	15.6
	Bolivia[b]	0.9	13.0	13.9	6.5
	Honduras	0.9	15.5	16.3	5.2
	Venezuela[b]	0.7	20.6	21.3	3.3
	Paraguay	0.5	9.2	9.7	4.7
	Average	**1.1**	**13.6**	**14.7**	**8.1**
AVERAGE		**2.3**	**13.5**	**15.8**	**14.1**
1995-1996					
SSC > 2%	Colombia	6.1	12.4	18.5	33.0
	Brazil	4.6	13.5	18.1	25.4
	Argentina	4.0	12.7	16.7	24.0
	Ecuador	2.4	17.1	19.4	12.1
	Mexico[c]	2.3	12.9	15.2	15.1
	Average	**3.9**	**13.7**	**17.6**	**21.9**
SSC < 2%	Peru	1.7	12.2	13.8	12.0
	Chile	1.4	20.7	22.1	6.1
	Paraguay	1.1	14.1	15.1	7.0
	Bolivia[c]	1.0	17.6	18.6	5.4
	Venezuela	0.7	18.2	18.8	3.5
	Honduras	0.6	17.6	18.2	3.3
	Average	**1.1**	**16.7**	**17.8**	**6.2**
AVERAGE		**2.3**	**15.3**	**17.7**	**13.3**

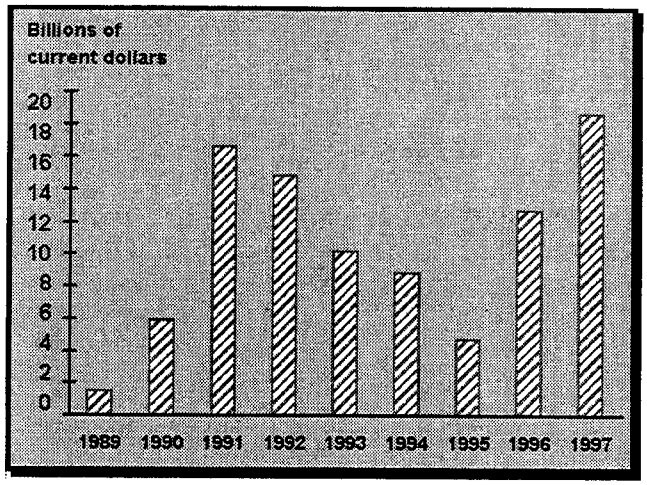
Source: ECLAC, on the basis of official figures.
[a] 1990, [b] 1989, [c] 1995

3. Privatizations

Since the end of the 1980s, ambitious programmes for the privatization of public-sector enterprises have been carried out, as part of the series of structural reforms undertaken in most of the Latin American economies. To date, privatization operations have totalled US$ 76 billion (in 1990 dollars).

This process has gone through several phases since it began. Privatization activity was intense between 1989 and 1991, chiefly as a result of the reforms implemented in Mexico and Argentina. In 1992-1995, the flow of privatization revenues slowed as this process tapered off in both of these countries. Then, in 1996, privatization revenues began to rebound sharply thanks to the momentum generated by Brazil; over the next few years, privatizations in Brazil are expected to bring in some US$ 80 billion (see figure III-6). Chapter IX contains a detailed analysis of the fiscal effects of the privatization process.

Figure III-6
LATIN AMERICA: VALUE OF PRIVATIZATIONS
1989-1997
(Billions of current dollars)



Source: ECLAC, on the basis of official figures.

4. Grants

Total revenue also includes remittances received from Governments and international agencies for specific projects or programmes, the general budget or other purposes (grants in kind are not included, however). Grants are not a major item in the public finances of the larger economies in the region, but they are sometimes a significant component of the public accounts of the smaller economies or those saddled with a heavy external debt burden. As table III-5 indicates, the level of grants in Latin America and the Caribbean has differed from one country to the next and over time.

Table III-5
LATIN AMERICA AND THE CARIBBEAN:
GRANTS RECEIVED BY THE CENTRAL GOVERNMENT
(Percentages of GDP)

Country	1990	1991	1992	1993	1994	1995	1996[a]	Average
Suriname	3.3	1.8	8.2	20.5	17.5	13.3	15.5	11.4
Nicaragua	15.3	11.6	4.3	7.3	4.8	n.a.	n.a.	8.7
Dominica	5.7	5.1	2.7	2.8	2.1	5.3	6.6	4.3
Grenada	2.6	3.6	1.7	2.7	3.1	2.6	n.a.	2.7
SaintVincent and the Grenadines	4.7	5.0	2.8	0.3	1.0	0.4	n.a.	2.4
Bolivia	1.5	1.6	2.4	1.3	2.4	1.32	n.a.	1.8
El Salvador	2.1	2.0	1.9	2.0	1.4	0.8	n.a.	1.7
Guyana	3.5	0.8	1.3	0.6	1.7	n.a.	n.a.	1.6
Belize	1.6	3.7	2.0	0.7	1.2	0.1	n.a.	1.6
Saint Lucia	n.a.	0.4	0.0	4.2	1.3	0.4	n.a.	1.5
Jamaica	1.1	1.4	1.2	0.5	n.a.	n.a.	n.a.	1.1
Dominican Republic	0.8	0.7	0.9	0.8	0.3	n.a.	n.a.	0.7
Saint Kitts and Nevis	0.8	1.1	0.6	0.3	n.a.	n.a.	n.a.	0.7
Antigua and Barbuda	n.a.	0.3	0.7	0.5	0.2	0.0	n.a.	0.3
Panama	0.1	0.0	0.1	0.0	0.0	0.1	n.a.	0.05
Peru	0.0	0.1	0.0	0.1	0.0	n.a.	n.a.	0.05
Bahamas	0.0	0.0	0.0	0.0	0.1	0.1	n.a.	0.03
Barbados	0.0	0.0	0.0	0.0	0.1	0.1	n.a.	0.03
Paraguay	0.0	0.0	0.0	0.0	0.0	0.2	n.a.	0.03
Haiti	0.0	0.0	0.0	0.0	0.1	0.0	n.a.	0.02
Average	**2.4**	**2.0**	**1.5**	**2.2**	**2.1**	**1.8**		**2.0**

Source: International Monetary Fund (IMF), "Country Reports" , Washington, D.C., various years.
[a] Preliminary figures.

In relative terms, the grants received by the central governments of the 20 countries of the region for which information is available have decreased slightly during the 1990s. Grants stood at an average of 2.4% of GDP in 1990, but by 1995 this figure had fallen to just 1.8%. Only Saint Lucia and, in particular, Suriname recorded rises; in the latter, grant receipts jumped from 3.3% of GDP in 1990 to 15.5% in 1996. A total of 11 countries registered no change during the period, while seven experienced a marked reduction; Nicaragua in particular showed a steep decrease.

The countries that are most dependant on grants as a source of income are concentrated in the Caribbean and Central America, while in South America, Bolivia is the

country that relies the most heavily on these receipts. Of the 20 countries examined, only three (Dominica, Nicaragua and Suriname) received grants averaging more than 3% of GDP over the period in question. Eight countries (six Caribbean countries, Bolivia and El Salvador) received the equivalent of 1%-3% of GDP and nine countries (six Caribbean countries, Peru, Paraguay and Panama) received grants totalling less than 1% of GDP.

The 1990s have seen a fairly small yet nonetheless encouraging decline in the region's dependance on grants; it is important to point out, however, that the situation varies considerably from one year to the next. Because of its volatility, this source of revenue can have an enormous impact on the fiscal performance of some of the countries in the region, which continue to rely on large annual transfers of foreign aid. Of course, this state of affairs is both a cause and consequence of the fiscal fragility of these economies, which live with a veritable sword of Damocles hanging over their precarious fiscal and macroeconomic balances.

Since internationally accepted standards for calculating the public deficit stipulate that grants should be recorded "above the line" as a supplementary source of income, the public finances of economies that are heavily dependant on such transfers tend to appear more solid than they would otherwise.[14] Accordingly, it is advisable —and in some cases more realistic— to supplement the analysis of these economies' public accounts with an examination of how the situation would look if grants were regarded as a *source of funding*, i.e., if they were recorded "below the line". This would provide a more realistic picture of the true state of these countries' public finances and thus make it possible to anticipate the need for fiscal consolidation efforts in the future in cases where adequate provisions have not been made for such eventualities.[15]

C. TAX ADMINISTRATION SYSTEMS

The execution of fiscal policy requires highly specific institutional and administrative arrangements that are geared to their established functions and objectives. In particular, the collection of taxes, contributions and various other types of charges calls for an extraordinarily sophisticated administrative apparatus whose importance for fiscal governance and the efficient operation of State machinery should not be underestimated. What is being referred to here is tax administration services in a broad sense, involving the collection of internal tax revenues, customs duties and social security contributions.

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[14] A similar situation occurs in the case of privatization revenues. For a discussion of the subject, see chapters V and IX.

[15] Such transfers are also often linked to international policy considerations on the part of donor countries. Hence, this procedure may well be of interest to economies that rely on these voluntary transfers year after year to in order to close out their fiscal accounts and preserve macroeconomic equilibria, since it would enable them to weigh the available options in the event of a unilateral suspension of grants.

1. Institution-building for tax administration systems

Tax authorities, like other government services, require certain minimum conditions —both internal and external— if they are to perform as expected. When their performance is consistently found wanting, it seems reasonable to suppose that one of the reasons may be that they are operating within a fragile institutional framework. Thus, for example, if the level of receipts collected by the tax bureau depends on the political abilities and connections of the officials in charge, rather than on the regular implementation of the rules, standards and procedures set out in the tax and customs code, then it is clear that the institutional framework in question is deficient. In such circumstances, the principle of impersonalism which is upheld by rational bureaucracies is disregarded. In fact, rectifying this situation is a *sine qua non* if the organization is to achieve satisfactory results.

Weak institutional arrangements expose a tax bureau to the risk of being co-opted by special interest groups ("risk of capture"), or of falling prey to corruption or other types of problems. In addition, very fragile institutional frameworks are frequently characterized by the absence of generally applied rules, since the very legal norms under which the rules are established usually allow for exceptions that make it possible to sidestep their effects by means of eminently discretionary actions.[16] Moreover, in such cases, rules tend to be changeable or to be enforced inconsistently or selectively. Understandably, this sort of environment generates legal uncertainties and undermines the efficacy of the tax authority, thus jeopardizing the fiscal covenant.

These observations underline the importance of safeguarding tax bureaus from the serious institutional weaknesses that often beset government agencies. In view of the key role played by the tax authority in government operations, special care is warranted. Recognition of this situation in recent years has led to the adoption of administrative reforms whose effect has been to upgrade the status of tax bureaus by placing them under the authority of officials with the rank of deputy minister (Costa Rica and Cuba), under-secretary (Mexico), departmental director (Argentina and Brazil) or superintendent (Peru and Venezuela). Institution-building efforts in this area have also been furthered by the creation of legal structures that accord tax bureaus varying degrees of functional, administrative, technical and/or financial autonomy (e.g., Argentina, Colombia, Cuba, Ecuador, Honduras, Mexico, Panama, Peru and Venezuela).[17]

2. Recent trends in organizational models

In addition to the enhanced status and greater autonomy conferred on tax authorities in the region in recent years, there have been other important developments which are worthy of mention:

(a) Consolidation of organizational structures based on principal functions (e.g., information services, taxpayer assistance, regulatory and technical/legal functions,

[16] Of course, this practice exacerbates the familiar problem of inconsistency over time, which arises when rules are established but not consistently enforced.

[17] CIAT (1996), Cosulich (1998).

collections, auditing, etc.) and secondary or support functions (e.g., data processing, internal control, training and research). As a result, there are very few countries left whose tax bureaus are organized on the basis of the different types of taxes (Dominican Republic) or which use some sort of hybrid organizational model (Netherlands Antilles, Guatemala, Jamaica and Suriname);

(b) Concentration of regulatory functions at the central level, complemented by a marked degree of operational decentralization (except in small Caribbean countries, where there are no objective grounds for decentralization);

(c) Streamlining of rules and procedures applied by the tax bureau in order to increase its effectiveness;

(d) Reduction of the unit costs of tax collection by transferring responsibility for the receipt of tax returns and tax collection to the banking sector and by switching over from traditional manual methods of verification and auditing to the use of information technology (IT) and consolidated tax rolls; design of special presumptive assessment systems for micro-enterprises, small businesses and other taxpayers who are difficult to monitor;[18]

(e) Complementing the above, the reduction of compliance costs, both for individual taxpayers and for micro-enterprises and small businesses by simplifying tax forms and reducing the number of taxes; upgrading information systems and customer service; simplifying tax returns and reducing the number of supporting documents that must be attached to the form; and offering the option of filing tax returns electronically and even over the Internet;

(f) Efforts to enhance the efficiency and effectiveness of the tax authority through the provision of more and better human resources and suitable careers opportunities (with well-defined mechanisms for hiring, evaluation, assignment of duties, training and skills development, remuneration and promotion), complemented by equally suitable physical and IT resources;

(g) Adoption of modern management techniques and prioritization of strategic planning as a means of positioning the tax bureau among the top-ranking government agencies; conclusion of management contracts between the tax bureau and higher levels of authority (e.g., the relevant minister or the President) with the aim of institutionalizing a results-based system of public management subject to periodic outside evaluation;

(h) The recent emergence of a trend —each country's individual administrative arrangements notwithstanding— towards the integration of internal revenue and customs administration services (Aruba, Brazil, Colombia, Honduras, Mexico, Netherlands Antilles, Paraguay, Suriname and Venezuela are among the countries concerned). The process has been carried the furthest in Argentina, where a federal bureau of public revenue has been placed in charge of domestic taxes, customs duties and social security contributions (CIAT, 1996).

Nevertheless, the countries of Latin America still have a long way to go in their drive to increase the efficiency and effectiveness of their tax bureaus, especially in comparison to more developed countries. This situation is reflected in the fact that, the region's tax bureaus are run on smaller budgets and have fewer human resources but nonetheless have higher collection costs than their counterparts in the more developed countries (see table III-6).

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[18] González (1995).

3. Tax evasion, tax avoidance and tax expenditure

The fragility of a fiscal covenant is generally reflected in frequent failures on the part of taxpayers to fulfil all or part of their obligations with regard to taxes, customs duties or social security contributions. Such behaviour is not limited to individuals, but is regularly indulged in by private firms and other organizations (both local and international) as well. Even worse, agents of the State itself at the national, provincial, state and municipal levels frequently do the same. For example, it is not unusual for government agencies to fall behind in the payment of their employees' social security contributions. Clearly, this is an extremely delicate matter, not only because of its adverse effects upon sectoral government accounts, but also because of its political and legal implications in terms of governance.[19]

Table III-6
COMPARATIVE INDICATORS OF INLAND REVENUE SERVICES, 1994

Country	Budgetary resources (% of GDP)	Collection costs (hundreds of dollars	Number of inhabitants per official	Number of officials per % of GDP collected
LATIN AMERICA				
Argentina	0.22	1.2	2 567	754
Bolivia	0.06	1.0	14 852	88
Brazil	0.10	1.2	n.a.	n.a.
Chile	0.07	0.4	5 183	146
Colombia	0.23	1.3	9 636	185
Mexico	0.04	0.3	3 036	1 970
Peru	0.14	1.3	9 899	219
Uruguay	0.07	1.2	2 558	225
Venezuela	0.08	0.7	5 461	343
Average	**0.11**	**1.0**	**6 649**	**491**
OTHER COUNTRIES				
Canada	0.29	0.9	1 284	624
France	0.15	0.7	1 324	1 881
Spain	0.16	0.7	1 965	850
United States	0.1o	0.5	2 767	4 478
Average	**0.18**	**0.7**	**1 835**	**1 958**

Source: Internal Revenue Service (SII) of Chile; computed average.

[19] Failure by government officials or agencies to comply with legal provisions, the tax code or other rules is particularly serious because of the image that it creates in relation to the rule of law in a given society. Regrettably, such practices are not unknown in the countries of the region, which certainly does not help to rectify the lack of transparency in some government accounts.

From the standpoint of government accounting, the importance of overcoming these problems lies in the fact that improving the efficiency, effectiveness and ethics of tax and customs bureaus offers the best prospect both for boosting government revenues and for reducing current levels of —mostly vertical, but also horizontal— inequity.

Tax bureaus may fail to collect tax payments, for three main reasons. The first is basically a matter of a decision by the taxpayer not to declare, either totally or in part, particular transactions or taxable income, which constitutes tax evasion. The second is a matter of taxpayer ability to interpret the tax code and make it fit their interests as best they can in order to reduce the amount of tax due, which constitutes tax avoidance. The third involves a decision by the economic and fiscal authorities to refrain from collecting all or part of a tax by granting exemptions to particular sectors, regions, or taxpayers.[20]

Although there are few reliable estimates of the losses caused by tax evasion, and those that do exist primarily concern VAT, the available figures indicate that the best chance of effectively increasing the tax take in future lies in the full enforcement of tax provisions already in force.

Table III-7 shows estimates of a coefficient of tax-collection efficiency for VAT which, quantifies the levels of tax evasion, tax avoidance and tax expenditure.[21] The inclusion of the latter causes this indicator to overestimate the relative importance of evasion and avoidance, but it has the advantage of being based on variables which are more homogenous than those used in other methods of estimating these phenomena. Countries such as Brazil, Chile and Uruguay show relatively high or at least moderate efficiency levels, which demonstrates that high VAT rates do not necessarily lead to adverse results, provided that the administration of the tax is efficient. By the same token, the application of low rates, as in Bolivia, Ecuador and Paraguay, does not necessarily diminish the problem of evasion and avoidance.

Government studies in Chile show a reduction in VAT evasion over the past eight years as a reflection of the cumulative positive results of determined enforcement efforts (see table III-8). As can be seen in table III-9, income tax evasion exceeded VAT evasion by 60% in 1995, which partially accounts for the country's low income tax receipts.

In the light of this information, the question arises as to whether evasion is a small-scale phenomenon or whether, on the contrary, it is a problem of such magnitude that it should be considered in future as one of the major potential "sources" of additional revenues.

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[20] The most well-known forms of tax expenditure for reasons of public policy (basically in order to promote greater equity or to encourage the development of an activity, sector or region) include exemptions, deductions, credits, deferrals and rate reductions. Tax amnesties are a form of tax expenditure that is mainly used for the purpose of increasing current and future revenue. Since tax expenditure is an indirect form of government spending, this subject will be discussed further in chapter IV.

[21] The theoretical difficulties involved in formulating an unambiguous definition of tax expenditure are well known, as discussed by Daly (1995). For our purposes here, it includes all types of tax exemption deductions or incentives granted for reasons of equity or as a means of promoting sectoral, regional or other interests.

A simple calculation can shed light on this question. Assuming that the total evasion rate for Chile in 1996 was 26% of potential receipts (i.e., actual receipts plus those lost through evasion), and bearing in mind that the tax burden in 1996 totalled 18.7%, then tax vasion amounted to about 6.6% of GDP. This means that, in the absence of tax evasion, the tax burden could reach 25%, a level which would be more in tune with the levels observed in more advanced economies, such as those of the OECD countries.

Obviously, it would be unreasonable to imagine that the phenomenon of evasion could be completely eradicated; this has not been accomplished even in economies where tax bureaus have much better means of inspection and control. For example, supposing that the average aggregate rate of evasion in the OECD area were 15% of potential receipts, if that parameter is applied to the previous example, then the evasion rate in excess of that level, would be approximately 3.3% of GDP.

Table III-7
VAT COLLECTION EFFICIENCY, 1995

Country	Effective receipts [a] (Er)	Consumption (C)	Rate (r)	Efficiency index (β)
	(Percentage of GDP)		(Percentage)	
Ecuador	3.3	79.3	10	42
Paraguay	4.1	92.5	10	45
Bolivia	5.1	90.8	13	43
Mexico	2.9	83.1	15	23
Colombia	4.7	80.9	16	36
Peru	5.6	79.2	16	44
Venezuela	3.9	78.8	16.5	30
Brazil	9.2	82.1	18	62
Chile	8.5	70.7	18	67
Argentina[b]	5.8	82.4	21	34
Uruguay	8.5	86.8	23	43
Average	**5.6**	**82.4**	**16**	**43**

Source: ECLAC, on the basis of official figures.

[a] Effective receipts (Er) are a fraction ß of total consumption (C) multiplied by the VAT rate (r): Er = ß*C*r; where ß = 1, effective receipts are equal to those which would be obtained if there were no tax evasion, or avoidance or tax expenditure in connection with VAT.

[b] 1994 figure.

Table III-8
CHILE: ESTIMATED VAT EVASION, 1989-1996
(Percentages)

Rate of Evasion	1989	1990	1991	1992	1993	1994	1995	1996
Gross VAT[a]	23.9	23.9	19.7	19	18.2	18.9	18.2	18.2
Net VAT[a]	31.9	32.4	26	24	23	23.8	23.5	23.1

Source: Internal Revenue Service of Chile.
[a] Amounts of evasion as a percentage of posited gross receipts (including VAT reimbursements).
[b] Amounts of evasion as a percentage of posited net receipts (excluding VAT reimbursements).

Table III-9
CHILE: ESTIMATE OF VAT EVASION, 1995
(Percentages)

Type of tax	Rent	VAT	Specific	Other	VAT return	Total
Rate of evasion	37.5	23.5	3.4	18.8	6.1	26.0

Source: Internal Revenue Service of Chile.

This hypothetical calculation demonstrates the advantages of seeking to bring evasion rates into line with the levels observed in the industrialized countries, as a means of boosting the income tax receipts of the great majority of Latin American countries. Further increases could also be obtained by reducing tax avoidance and tax expenditure.

Given the scale of the problem, it would seem that a high priority should be placed on strategies for reducing various forms of tax evasion. Such an initiative would have a number of advantages. First, it would send a clear message to economic agents and to society as a whole that full compliance with the tax code is a necessary condition for the fulfilment of the fiscal covenant, which is one of the cornerstones of governance. This is a fundamental political decision which is essential for the true modernization of the societies and economies of the region. The counterpart of the safety and protection under the law which the State must provide to citizens and economic agents in each country is compliance by them with the laws of the land in general and with their fiscal obligations in particular.

Second, it would constitute a legitimate means of mobilizing development resources that could not only yield a higher rate of return but would also be politically less costly than the alternative of creating new taxes or of making drastic changes in existing ones. Although, by its very nature, tax evasion tends to go relatively unnoticed, and the economic authorities themselves frequently have no reliable or up-to-date estimates as to its scale, the available evidence, although fragmentary, suggests that reducing current levels of evasion could provide substantial additional resources.

Third, high levels of evasion not only have a negative impact on macroeconomic stability but can also undermine the ethical environment in which public —and private— sector agents interact, increasing transaction costs and reducing both the markets and the Government's allocative efficiency, all of which sets up unfavourable conditions for sustainable or equitable economic growth (see box III-2).

Box III-2
EVASION AND EQUITY

Tax evasion is a major cause of horizontal and vertical inequity, creating a much greater effective tax burden for those who do comply with their obligations. Obviously, this generates discontent and prompts more and more taxpayers to become tax evaders. To illustrate this point, let us suppose that within a group with the same level of income (or consumption, or wealth or whatever is the tax base) there are two groups whose tax burdens are "high" (H = T/Y) or "low" (L = T/Y) due to different levels of compliance. The first group is represented with a weighting of "a" and the second with a weighting of "(1-a)", for a mean tax burden for the entire group of m = a* H + (1-a) L.

It is not very hard to show that, for a given aggregate level of T/Y, the larger the group of those who evade (1-a), and/or the lighter the latter's tax burden, the greater the effective tax burden of the "high" group. At the end of the scale at which burden L tends to zero (meaning that group L evades its obligations completely), the effective burden on group H will be equal to H (effective) = m/a. Thus, if the mean burden is m = 15% (which in theory does not seem too high if it is compared with levels in industrialized countries) and the proportion of those evading their tax obligations is 50%, then the effective burden on those who are in compliance will be exactly double, i.e., 30%. In such circumstances, it is not surprising that the motivation for complying with tax obligations is considerably diminished, and that this is reflected in a progressive weakening of the fiscal covenant.

Source: On the basis of J.C. Lerda, "La política tributaria en América Latina", Santiago, Chile, ECLAC, Cooperation programme between ECLAC and the Government of the Netherlands on fiscal policy, efficiency and equity in Latin America and the Caribbean, 1997, unpublished.

D. AN AGENDA FOR FUTURE TAX REFORMS

It is well known that the numerous tax reforms implemented in the Latin American countries during the 1980s and 1990s were preceded by equally numerous reformulations of their tax codes during the 1960s and 1970s.[22]

1. Four decades of tax reform: the fragility of the fiscal covenant and the influence of a rapidly changing environment

How are we to interpret so many movements and changes in what is one of the basic parameters of every country's legal and economic system? To what can we attribute the widespread and repeated modifications of national tax systems over the past four decades? Two hypotheses can be formulated whose validity varies from country to country according to the circumstances.

First, the greater the fragility of the fiscal covenant, the greater the probability of unsatisfactory results in terms of stability, distribution, allocation and/or growth. Consequently, as happens when a contract is concluded which none of the parties consider to be satisfactory, the less support there is for a fiscal covenant, the greater the need to renegotiate it. Indeed, if a system's results are not only suboptimal but are also persistently untenable (for example, in cases where tax receipts continually fall short of the level needed to fund expenditure, where the tax burden on similar economic activities differs arbitrarily, or where an excessive share of the burden is borne by groups having a limited ability to pay), endogenous political initiatives for the renegotiation of the covenant, are bound to arise that will eventually lead to reforms of the tax system. Clearly, the frequency with which certain countries have had to implement such reforms in recent decades can be interpreted as an indication of the structural fragility of their fiscal covenants and of the poor quality of the political solutions arrived at through the renegotiation processes. This situation suggests that there will have to be further renegotiations and, ultimately, further tax reforms.

Second, the faster the pace of change in the domestic and international environment in which the taxation system operates, the greater the probability that it will have to undergo

[22] Tax system reforms since the 1960s have not been limited to the Latin American countries. As Owen (1997) states, the industrialized world has also seen major public debates and numerous reforms in the area. The report of the Carter Commission in Canada (1967), the Asprey Committee for Australia (1974), the Treasury I and Treasury II reports for the United States of America (1977 and 1984), the Meade Commission for the United Kingdom (1978), the McCaw Commission for New Zealand (1982), the Irish Commission (1982-1985), the Australian White Paper (1985), the White Paper on tax reform in Canada (1987) and the report of the Ruding Commission (1992) are among many examples of seminal thinking which has given rise to tax policy reforms in the industrialized countries. For instance, the above-mentioned Treasury reports eventually led to the Tax Reform Act of 1986, which was undoubtedly the most significant tax reform adopted by the United States of America since 1941 and decisively influenced later tax reforms in Latin America and the other OECD countries. See Boskin and McLure (eds.) (1990) and Shoven (1990).

reforms in order to adapt to new circumstances. For example, by reducing the unit cost of transport services as well as the costs involved in the storage and transmission of information, the rapid acceleration of technological change in the post-war period has paved the way for a striking expansion of the role of multinational corporations in worldwide trade and in foreign direct investment. This, in turn, has affected the taxation of capital gains (which are now, in most cases, subject to the same tax rate regardless of the investment's origin) and the rules governing the monitoring and control of transfer prices.[23] Also, the profound changes in political and economic thinking that began to emerge in the 1980s (regarding, for example, the roles of markets and of the State in the economy) are reflected in the objectives of most of the tax reforms undertaken over the past 20 years and in the tax structures which countries have endeavoured to create.[24]

Tax reforms in the region in recent decades undoubtedly reflect the combined effects of these two factors. Although it is clearly impossible to determine whether one of them has had a stronger effect than the other, there is little doubt that the extraordinary activity which has been observed in the area of taxation in Latin America and the Caribbean has not yet come to an end.

2. Elements of a reform agenda for the early twenty-first century

Contrary to expectations, the profusion of tax reforms in recent decades has not brought us to a point where we can speak of completed tasks, goals achieved or satisfactory results.[25] In fact, no satisfactory solution has yet been found for many of the problems that prompted the earlier reforms, and in some cases the baseline situation has actually worsened. In addition, there are various other backlogged, deferred or emerging priorities which are awaiting their turn for appropriate fiscal treatment. As can be seen in box III-3, the situation in Latin America improved between 1990 and 1996 in terms of financial stability, the tax take and tax compliance but in respect of the last two of these factors, the region still falls far short of best practice. In terms of equity, the situation differs substantially not only from that of the OECD countries, but also from what had been the region's own historical pattern before the debt crisis.

Since the list of possible goals and issues to be included in a reform agenda for the early twenty-first century is exceedingly long and, moreover, varies from country to country, it is best to select a limited number of issues that may be of interest to most of the countries of the region. In doing so, issues which are clearly interconnected are dealt with separately, for the sole purpose of placing stronger emphasis on certain crucial aspects of the future agenda.

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[23] Lerda (1996).

[24] Shoven (1990).

[25] This situation can also be illustrated by reference to the 1986 tax reform initiative in the United States, whose objectives were to promote: (1) efficiency and neutrality, (2) economic growth, (3) fairness, and (4) simplicity. Shoven (1990) graded the results achieved in each of those four areas as follows: B or B- for (1), F for (2), B for (3) and a generous C for (4). Taking into account the meaning of those grades in the United States educational system (A=excellent, B=good, C=fair, D=poor, and F=fail), Shoven obviously feels that the most important and far-reaching tax reform of the post-war period has fallen far short of expectations.

(a) Additional resources. The search for non-inflationary sources of financing will continue to be the highest short-term priority for the public sector in many of the countries of the region. Consequently, future tax reforms will be guided mainly by the criterion of adequacy, in order to: (i) compensate for relatively large revenue losses; (ii) balance government accounts within the context of stabilization plans and agreements with multilateral agencies such as the IMF; (iii) provide additional resources to strengthen social spending and anti-poverty programmes; (iv) increase domestic savings rates; or (v) more simply and generally, deal with chronic shortfalls in the financing of government expenditure. Regarding the first of these aspects, it should be borne in mind that once privatization revenues have reached their peak, they will tend to taper off. Equally, the implementation of further tariff reductions in the future as part of subregional liberalization and integration processes will result in diminishing resources for the Treasury, unless they are accompanied by compensating increases in the domestic tax burden and/or in fiscal savings. Also, the relative importance of social security contributions as a source of revenue can also be expected to diminish as pension schemes change their financing models from pay-as-you-go systems to individual or collective funded systems. As a result, future tax reforms will tend to focus on increasing the tax burden, or at least on preventing it from decreasing.

(b) Greater equity. Given the serious problems of poverty and income concentration observed in the region over the past two decades, it can be anticipated that future tax reforms will reflect a greater concern for income distribution and for issues of equity, particularly vertical equity. It can be expected that personal income tax will once again be regarded as a valid instrument for reintroducing an acceptable degree of progressiveness into the tax structure. It will also be necessary to restore the role of income tax as a source of government revenue, in the light of the currently low yield of this tax in most Latin American countries. Increasing the nominal graduation of personal income tax and improving tax administration procedures could make the tax effectively more progressive. However, it does not seem wise to revert to a situation in which income tax, or the taxation system as a whole, is expected to solve society's income distribution problems.[26] Since the latter result from the interaction of multiple determinants, the taxation system should not be made less effective by overburdening it with unrealistic objectives. In any case, issues of vertical equity in the tax system should be approached from an integral perspective taking into account not only income tax but also other taxes such as those levied on all forms of property (urban and rural real estate, livestock, etc.) as well as taxes on inheritances, gifts, and donations *inter vivos*. In addition to enforcement measures, the decrease in equity generated by tax evasion can be reduced through the collection of minimum taxes from taxpayers that are difficult to monitor (such as self-employed workers, members of the liberal professions, and small businesses), and through an appropriate use of

[26] Engel and others (1997) quantify the direct impact of changes in the tax structure on income distribution in Chile and conclude that: (i) the scope for direct redistribution through taxation is very limited; (ii) a proportional high-yield tax can have a better net distributional effect than a low-yield progressive tax; and (iii) to reduce inequalities in income distribution, it is important to focus on the amounts to be redistributed, on appropriate targeting of public expenditure, and on the relative efficiency of the various taxes (rather than on the progressiveness of the tax system as a whole).

presumptive taxation. Taxes on income and capital gains should also be carefully assessed in the light of the mobility of this factor.[27]

(c) Greater efficiency. This objective should continue to be of primary concern to those responsible for tax reforms for a number of reasons: first, because of the increasing openness of national economies, their exposure to external competition and the resulting need for the export sector to become more competitive; second, because of the increasing participation of multinational corporations in trade and foreign direct investment in each country; third, because of the growing number of subregional trade integration agreements; and fourth, because of the increasing globalization of the world economy. To achieve this objective, a number of initiatives in the following areas will be required: (i) further efforts to achieve a more neutral tax system, by eliminating forms of discriminatory treatment against given factors or characteristics thereof and by reducing the relative importance of "special" sectoral or regional regimes; (ii) a reduction in the multiple rates still used for some taxes; (iii) cutbacks in the scope for deductions, preferential rates, credits, deferrals and other special treatment in personal income taxes or other taxes; and (iv) a reduction in compliance costs (one of the invisible costs in the tax system).[28]

(d) Increased domestic savings. In addition to the contribution that tax collection may make to public savings, various proposals exist for using the tax system to boost the private savings rate of households and companies. In general, most of these proposals seek to skew the tax base towards consumption. This idea —frequently the topic of debates in the industrialized countries and particularly in the United States, where proposals have been made for replacing personal income taxes with a consumption tax— has already been put into effect in Latin American economies, where the tax system has been veering towards indirect taxes on consumption, mainly through the almost universal adoption of the VAT. However, the savings rate of private businesses in the formal sector is often higher than the household savings rate.[29] Since the savings of companies are equal to their retained profits (net of taxes), i.e., profits not distributed to households as dividends, the appropriate tax treatment for such profits can clearly play an important role in increasing domestic savings. Given the inadequate levels of the latter in most of the economies of the region, and the need for non-inflationary financing to meet the substantial demand for investment in the local market, it is highly advisable that due attention be given to this matter in future tax reform initiatives.

(e) Harmonization of the tax structure with first- and second-generation structural reforms. It is important to proceed with the harmonization of tax bases with the new economic realities created by the structural reforms applied since the 1980s. First, as a result of trade liberalization, tax bases associated with foreign trade operations need to be replaced by others more closely related to domestic economic activities. Second, a key element of fiscal decentralization should be the strengthening of state, provincial and municipal tax collection capabilities. In the case of the latter, in particular, this calls for a

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[27] Shome (1993).

[28] Compliance costs are those costs incurred directly or indirectly by the individual or corporate taxpayer in meeting the requirements of the tax code. According to estimates for the United States for 1995, such costs are equivalent to approximately 7% of income tax receipts. See Hite and Sawyer (1997) and Sandford and others (1989).

[29] Ocampo and Tovar (1997); Banco de la República (1997).

revision of the urban property tax structure as a source of local revenues. Lastly, the growing flexibility of today's labour markets will certainly result in losses of tax receipts which will have to be offset by increasing the effective burden of other sources of revenue. In other words, future tax reforms will be applied in a much more demanding context in terms of the quality of the policy-making, one of whose foremost aspects is the interactions between individual policies.

(f) The greening of the tax system. The grave environmental problems being experienced in the closing years of this century suggest that there will be an enormous amount of work to be done on this front in the next few decades (especially in urban centres and, above all, large metropolitan areas). Hence, an increase is to be expected in the demand for fiscal tools —including both tax instruments and measures relating to government expenditure— capable of addressing these problems. Some countries in the OECD area and, more recently, some Latin American countries have already started to apply "green taxes" (that is, instruments that incorporate environmental concerns), although the receipts are still fairly negligible.[30]

(g) Taxation of financial operations and institutions in a global economy. In this regard, attention should be paid to the following factors: (i) the extraordinary development experienced in recent years by domestic and international financial markets; (ii) the problems that this trend has caused in the real sector of national economies; (iii) the long-standing practical difficulties involved in collecting taxes from the financial sector, especially given the worldwide trend towards the globalization of financial operations; and (d) the extremely high volumes traded on these markets daily (a high percentage of which is in many cases —as on foreign exchange markets— of a purely speculative nature). In response to this situation, various steps are now being taken at the international level to establish institutional arrangements and procedures for changing the former order of things and ensuring the inflow of valuable tax resources from such markets into national treasuries. Economic and legislative authorities in the region will surely be paying closer attention to this problem when designing future tax reforms.[31]

(h) Taxation, international trade and foreign direct investment. Fiscal issues as they relate to international trade and foreign direct investment (FDI) will assume greater importance in the countries of the region. The main reasons for this are as follows: (i) an increasing number of trade disputes between industrialized and developing countries are arising based on allegations that government subsidies are being given to industries in the South that export to the North (a variation on this type of allegation refers to the implicit subsidy represented by the lack of adequate environmental regulations in the South); (ii) in general, countries actually do seem to be using different types of tax benefit arrangements to take the place of the protection that used to be provided by tariffs; and (iii) the principal agents of these trade flows and foreign direct investments are multinational corporations, which —without appropriate legislation and timely and efficient monitoring— can use transfer pricing in a manner contrary to the interests of the Treasury. Future tax reforms should therefore include a built-in response to this type of problem.[32]

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[30] OECD (1997).

[31] OECD (1994, 1997), Tanzi (1995).

[32] See Clements and others (1995), Daly (1995), Jackson ( ), OECD (1993) and Qureshi (1996).

Box III-3
TAX PERFORMANCE INDICATORS

Four tax performance indicators which are of particular relevance here are the tax take, tax compliance, tax equity and financial stability.

1. Tax take: The average figure for total tax revenues as a percentage of GDP has been chosen as an indicator of the level of tax revenues available to the State for performing its functions; this level increased by 2% of GDP between 1990 and 1996.

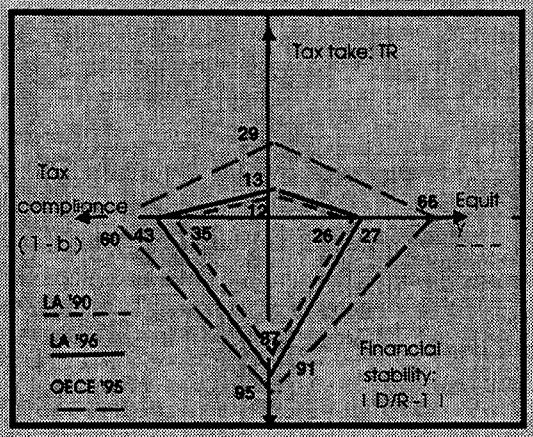
2. Tax compliance: VAT compliance refers to the revenues effectively collected as a percentage of the absolute level of potential receipts, which is equivalent to total consumption multiplied by the VAT rate (see the section on tax administration systems).

3. Tax equity: Since direct taxes are relatively more progressive than indirect taxes, the contribution of the former to total tax revenues (Dir/TR) gives a preliminary indication of the degree of equity in the tax system.

4. Financial stability: The deficit over revenues (D/R) indicates the extent of financial requirements in terms of the sum actually collected by the Treasury. The higher the level of revenue collected (R) in relation to the deficit (D), the higher the level of this stability indicator | D/R-1 |.

At first glance, all these indicators show at least a slight improvement between 1990 and 1996 (see the figure below). However, these proxy performance figures also reveal certain shortcomings in tax collection efforts. The performance coefficients of OECD Governments may serve as a reference point or target. It should be noted that the average tax take, net of social security contributions, is only half as much as that of OECD countries, which collect the equivalent of 38% (1995); this figure includes the income from social security contributions (close to 9% of GDP). The figures indicate that there is a great deal of scope for boosting VAT revenues while still leaving room for a simultaneous increase in the proportion of direct taxes and improvements in terms of the level and progressiveness of the tax system. Direct taxes account for 66% of revenue collections in OECD countries (with personal income taxes providing 52%, corporate income taxes 8%, and property taxes 5%). Even in terms of the deficit as a proportion of total revenues, much higher levels are observed than in the OECD countries. The levels of the same performance indicators for the South-East Asian countries are also higher than the levels recorded in Latin America. The tax take is approximately 17%, three points higher than in that region; direct taxes account for approximately 45% of this figure, while the stability indicator is estimated to be 25 points above that of the OECD, since all these countries, except the Philippines, posted a surplus on their accounts (1994 averages for Indonesia, Republic of Korea, Malaysia, Philippines, Singapore and Thailand).

TAX PERFORMANCE INDICATORS LATIN AMERICA: 1990 AND 1996; OECD: 1995
CENTRAL GOVERNMENT
(Percentages)



Source: Keiji Inoue, "Reconsiderando la tributación directa en América Latina", Santiago, Chile, 1998, unpublished.

In short, there are still many outstanding issues to be addressed by the tax codes of the region. The tax reform process generally incorporates technical and political considerations in addition to tactical and strategic visions. Often, the final result falls far short of the expectations created at the time when the need for reforms was being justified. However, the stakes are so high that taking on new risks is well worthwhile.

E. CONCLUSIONS AND FINAL OBSERVATIONS

- The tax performance of central governments in Latin America improved by approximately two points of GDP between 1989 and 1996. However, this significant advance appears less impressive if one takes into account the fact that the period under consideration corresponds to an economic upswing compared with the preceding decade.[33] Moreover, if we look at the results achieved over a somewhat longer period, for example between 1980 and 1996, it can be seen that: (a) the gross tax take of these central governments fluctuated widely around a relatively low mean (slightly above 12%); and (b) the increase between the first and last years of this period is somewhat smaller than the increase registered for the shorter period (one and half points of GDP). These results already reflect the beneficial effects of numerous tax policy and administrative reforms which, needless to say, were aimed at increasing revenues. In the light of these facts, the question arises as to why further progress has not been achieved.
- Although the gross tax take of the central governments of the Caribbean subregion in any given year between 1980 and 1996 was more than twice as high as the figure for Latin America, a downward trend in these receipts is to be noted, mainly as a result of lower direct tax collections. This trend —which reflects, at least in part, a significant slowdown in the subregion's growth rate in the first half of the 1990s—.[34] is brought out by a comparison of the figures for the beginning and the end of the period in question or, more recently, for 1989 and 1996. In any event, it is clear that this subregion suffered a very sharp loss in tax receipts towards the middle of the 1980s from which it has yet to recover.
- Notwithstanding significant differences between countries, the above conclusions are not altered in any significant way when the analysis is extended to the average change in public revenues (tax and non-tax revenues), or when it is shifted from the central government to the non-financial public sector. The overall picture emerging from these results suggests that, despite some significant progress in this area, the average figures for the Governments of Latin America and the Caribbean leave no room for complacency in terms of the adequacy of the funds at their disposal. Indeed, their

[33] The real (simple annual average) growth rate in 1991-1995 was 3%, compared with barely 0.9% in 1981-1990. See ECLAC (1997).

[34] The Information available for nine countries (Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Jamaica, Saint Kitts and Nevis, Saint Lucia and Saint Vincent and the Grenadines) indicates that real average annual GDP growth has been halved, falling from 4.7% (1981-1990) to 2.3% (1991-1995). If Guyana and Trinidad and Tobago are included, the decline is reduced to a drop from 3.4% (1981-1990) to 2.3% (1991-1995).

revenues are fairly limited, especially when compared with the possible alternative uses, and are subject to wide fluctuations.

- It should be borne in mind that some sources of income —especially in the case of central governments— are essentially temporary in nature (e.g., privatizations and grants). Moreover, emerging trends suggest that further declines in revenues are to be expected in the future. These include the loss of potential revenues associated with foreseeable tariff reductions and changes in social security funding schemes. In addition, increases can be expected in transfers to subnational levels of government together with a shift in tax bases from the central government to these other levels. If this is combined with a higher demand for public expenditure, which may also be expected in the future, it may reasonably be concluded that revenue adequacy will remain one of the fundamental objectives of tax authorities in the region for a long time to come and will therefore, remain a priority consideration in the formulation and design of future tax reforms.
- The fiscal vulnerability of small economies, especially in the Caribbean subregion, will surely need to be addressed in the next few years. The decline in tax receipts since the 1980s and the fact that these economies generally remain heavily dependent on taxes accruing from foreign trade operations are major obstacles to the progress of trade liberalization and economic integration efforts at the subregional level. In other words, government budgetary constraints may continue to be an obstacle to open regionalism in the Caribbean.
- Whereas high expectations were created in the 1960s and first half of the 1970s with respect to the tax system's potential as a vehicle for income redistribution, this perception was reversed in the 1980s and early part of the 1990s and has given way to an equally high degree of scepticism in this regard. As the century draws to a close, a more balanced view is, fortunately, emerging, in keeping with the growing tendency to move away from fundamentalist positions regarding the advantages and drawbacks of market economies and the State. As these two institutions come to be seen as essentially complementary agents rather than as substitutes for one another, it becomes possible to formulate a number of propositions: (a) the tax system should not be exempt from, nor overburdened with, responsibility for the distributive function of the State; (b) debate on the relationship between taxation and equity should focus on concrete proposals relating to particular taxes (e.g., income, payroll, property, inheritance or transfer taxes), rather than on general proposals —which often cannot be assessed on the basis of empirical evidence— relating to the tax system; (c) it is necessary to restore the traditional role of personal income tax as a source of revenue and as an automatic stabilization mechanism. This tax can also be used as an instrument for the counter cyclical management of fiscal policy and as a redistributive tool (for which the support of an effective and efficient tax bureau is vital).
- Although not a single instrument operating in isolation can be expected to overcome complex, deep-seated problems of distribution, there is no doubt that the gravity of the situation with respect to vertical equity and poverty that has built up in Latin America and the Caribbean —especially since the early 1980s— demands an integrated approach which cannot work without appropriate tax instruments. Regrettably, the scepticism of the 1980s and early 1990s with respect to the redistributive capacity of taxation has resulted in an almost total lack of up-to-date, detailed empirical studies on the

implications and distributional effects of various taxes or combinations thereof in countries of the region. After almost two decades of intensive and far-reaching reforms of the tax, tariff and social security systems, there is not enough data to permit an informed assessment of such issues. The knowledge that indirect taxes account for approximately 75% of tax revenues in most of the countries of the region is definitely significant, but insufficient for a technical evaluation of the differentiated distributional incidence and impact of an increase in the tax burden equivalent to 1% of GDP through an increase in the average VAT or personal income tax rates. This is a crucial issue, on the region's economic research agenda and, in circles where these matters are discussed and decisions taken on a daily basis, the lack of such information is keenly felt. It is to be hoped that the more favourable environment for an exploration of these issues that seems to be emerging in the region will make it possible to develop a regional research programme on the distributional incidence and impact of taxation, with effective support from the Governments concerned.

- Modernization of the fiscal institutions responsible for tax, customs and social security administration should continue to be treated as top priorities in the formulation, design and execution of fiscal policy in the countries of the region. In order to satisfy the criterion of adequacy of government revenues, one of the many things that must be done is to work on an on-going basis to improve the efficacy, efficiency and quality of such services. Progress in reducing the extremely high levels of evasion of taxes, customs tariffs and social security contributions which are still widespread in various countries of the region depends to a great extent on such improvements. Of course, in order to achieve these objectives, tax authorities must be given sufficient human, financial, and technical resources, along with the necessary leadership and political support for the development of strategies, procedures and operational modalities. Lastly, it is vital for political and economic authorities to be perceived by all social agents —both within and outside the organization— as committed to enforcing the applicable regulations. Strengthening State institutions must be treated as an urgent priority and one which takes on special importance in the case of tax bureaus responsible for providing the government sector with non-inflationary funding.
- Tax reforms will remain on the government agenda for some time to come; first, because of the fragility of the fiscal covenants on which they are usually based; second, because of the unsatisfactory quality of the solutions usually devised in the course of the political renegotiation of such agreements; third, because the framework within which tax legislation is applied is a rapidly changing one which requires periodic adjustments to new conditions. This includes the need to incorporate emerging issues and to address others which, for various reasons, have been postponed or unsatisfactorily dealt with in the past.

IV. PUBLIC EXPENDITURE

A. INTRODUCTION

The adjustment mechanism most commonly used in economies of the region in response to the 1982 debt crisis was to cut public expenditure. The extent of the contraction and the circumstances in which it occurred explain, to a large extent, why this adjustment mechanism has had such adverse effects on the economies of Latin America and the Caribbean.

The inevitable urgency with which the adjustments were made ruled out the provision of effective safety nets to protect the most vulnerable groups. The social costs were significant in terms of higher unemployment and underemployment levels, lower real average wages, cuts in subsidies and a reduction in the supply of public goods in the social sector. To make matters worse, such costs were insidiously magnified by the marked loss of efficiency and effectiveness in the functioning of the State administrative apparatus caused by these budget cutbacks.

The changes seen in public expenditure since the first half of the 1980s have occurred in the context of —and, of course, have been brought about by— numerous stabilization and structural adjustment programmes aimed primarily at reducing fiscal outlays. These programmes have taken a variety of forms, including: conventional ministerial budget cuts; wage policies oriented towards reductions in the real wages of public-sector employees; elimination of government agencies; privatization of State-owned enterprises; transfer of responsibility to the private sector for delivery of services; reform of the model of social security funding; decentralization of fiscal responsibilities and functions to subnational levels of government; and various initiatives for the reform of the civil service.

As may well be imagined, in the long run the lack of overall coordination in such diverse cost-cutting mechanisms adversely affected public-sector management. The deterioration manifested itself in a number of ways, the most notable being the loss of

highly qualified senior public officials, who moved to the private sector in search of better working conditions; a loss of motivation among public-sector employees in the fulfilment of their statutory responsibilities; an increase in corruption, with the resulting erosion of the ethical foundation of the civil service; understaffing, shortage of working materials and lack of coordination in the flow of factors of production and inputs. Under these circumstances, it is hardly surprising that government departments should have fallen into a vicious circle of disincentives and poor results, to the detriment of the quality of government services.

Furthermore, owing to the urgency of the fiscal adjustment required in the 1980s, many central governments in the region were obliged to make greater sacrifices in government expenditure than would have been necessary had they been able to rely on greater inputs of fiscal revenues. Public revenues declined between 1984 and 1988, demanding further adjustment efforts in spending and delaying the achievement of fiscal balance longer than would otherwise have been necessary. Only towards the end of the decade, in fact, did this variable begin to make a positive contribution to fiscal adjustment.[1] It was at this point that tax ratios began to recover from their earlier decline, without, however, attaining the levels recorded in the first half of the 1980s.

Public spending will undoubtedly continue to demand priority attention from Governments in the region in the short and medium term. First of all, there is no reason to anticipate a trend in fiscal revenues capable of sustaining a steady, moderate rate of growth in real per capita expenditure in the next few years. The experience of the last two decades suggests that there are definite limits to how much the tax burden can be increased in the short and medium term. As a result, the prospects for non-inflationary financing of government expenditure will continue to be a cause of concern for economic authorities in the region.

Second, the pressing need to address the grave problem of poverty in the countries of the region, combined with the constraints on social spending, means that it will be necessary to set priorities in terms of appropriations and to improve the quality of spending. One thing is certain: harmonious and democratic social coexistence and the potential for stable economic growth are being undermined by the acute, accumulated problems of poverty and social equity, which will require a thorough reassessment of the issue of social spending in the region.

Third, the quality of government services to the private sector is not up to the level of efficiency and performance necessary to enable production structures to confront the competitive challenges of an increasingly globalized world, nor to satisfy the basic needs and demands of low-income members of society.

Fourth, the trend towards real exchange-rate appreciation in many countries of the region, as a result of large capital inflows and anti-inflationary programmes that use the

[1] In this connection, see chapter III.

exchange rate as an anchor, will intensify political pressures on the Governments of many of these countries to reduce the rate of increase in public spending.[2]

The four reasons advanced —problems of financing, social equity, efficiency and macroeconomic stability— provide sufficient grounds for the conclusion that public expenditure will remain a priority issue on political and technical agendas of Governments of the region in the short and medium term. However, the past experience of industrialized countries suggests that as economic development progresses, government services will increasingly be perceived as superior goods. Political demands for increases in the amount spent on the most vulnerable economic and social groups will intensify.[3]

B. LEVEL AND CHANGES IN PUBLIC EXPENDITURE

1. General trends

The structural adjustments and reforms referred to in the introduction have brought about changes in the level and mix —both in economic and functional terms— of public expenditure and its distribution among the various levels of government. On the basis of available information, some salient comparative trends can be discerned.

In the 1990s, average State participation in the economy was higher in the Caribbean than in Latin America. Between 1990 and 1996, whereas the average size of the central government in the Caribbean was 35.9% of GDP, in Latin America, non-financial public-sector spending was 27.1% of GDP (see figure IV-1).[4]

In the case of the Caribbean, central government expenditure showed a marked downward trend to 1995, when it was equivalent to 34% of GDP (10 points lower than in 1987). In 1996, it rebounded for the first time in some years (see figure IV-2.b).

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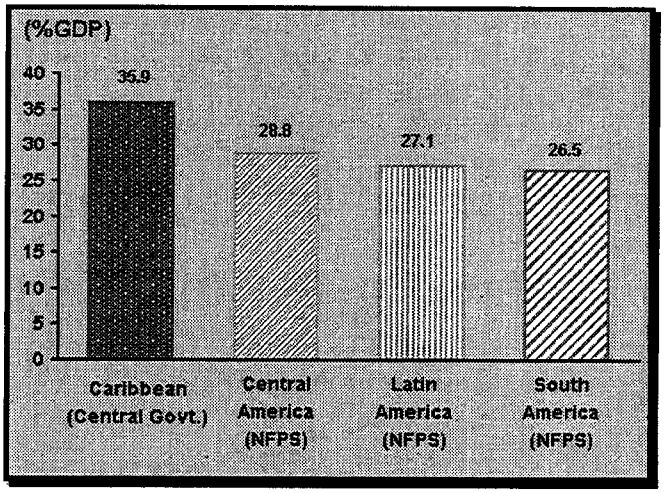
[2] The conventional argument is based on the assumption that public spending largely involves non-tradable goods and services. If one defines the real rate of exchange as the ratio between the average prices of tradable and non-tradable goods, then increasing public expenditure faster than average aggregate expenditure in the economy would lead —other things being equal— to a disproportionately high rise in the price of non-tradable goods and services, which would cause a fall in the real exchange rate. This is why, in economies where the exchange rate is appreciating, there are often calls for a reduction in the rate of growth in public spending even when the latter is clearly lower than the rate of growth in private spending. This clearly poses the problem of deciding to what extent fiscal adjustment should compensate for private-sector disequilibria.

[3] On the topic of long-term trends in public spending and public finances in industrialized economies, see Tanzi and Fanizza (1995), Tanzi and Schuknecht (1995) and (1997), Masson and Mussa (1995) and Tanzi (1997).

[4] Information on non-financial public-sector (NFPS) spending in the Caribbean is not available; however, the size of the central government in the subregion was, on average, 35.9% of GDP, a higher level than for the NFPS in Latin America; therefore, a similar relationship may be expected to exist between the levels of NFPS in the two subregions.

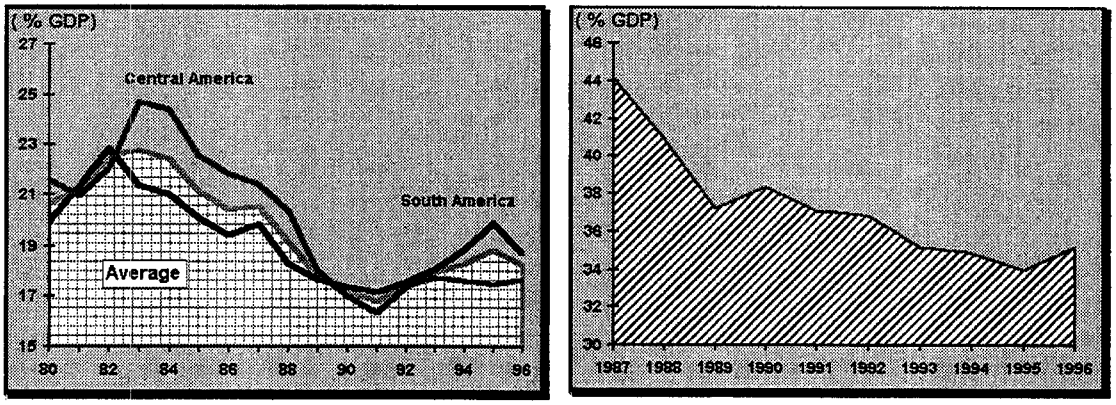
Figure IV-1
TOTAL EXPENDITURE: LATIN AMERICA AND THE CARIBBEAN
(Average 1990-1996, as a percentage of GDP)



Source: ECLAC, on the basis of official figures.

Figure IV-2
TOTAL CENTRAL GOVERNMENT SPENDING
(As percentages of GDP)

2.a Latin America: 1980-1996 **2.b The Caribbean: 1987-1996**



Source: ECLAC, on the basis of official figures.

In contrast with this trend, patterns of public spending in Latin America have been mixed and, in some countries, have differed from those observed throughout the past decade. In 1996, average outlays recorded for Latin America (28.9% of GDP for the non-financial public sector and 18.2% for the central government) were slightly higher than at the beginning of the decade, although they did not exceed the averages recorded in the

1980s (see figure IV-2.a). They were comparable to 1988 levels and 11% lower than those of 1980 in the case of central government. However, the upward trend reflects the pattern in countries not actively engaged in privatization, while those with such programmes have sharply reduced public spending in the course of the 1990s.

Within Latin America, Central America[5] has shown higher average non-financial public-sector expenditure levels (28.8% of GDP) than South America (26.5%). However, the latter experienced relatively faster growth in central government spending between 1991 and 1995. Since 1995, this trend has reversed, narrowing the gap in levels of expenditure between the two subregions (see figure IV-2). Moreover, if countries are classified on the basis of the level of central government expenditure as a percentage of GDP,[6] it can be seen that those that have made the largest spending cuts in the 1990s are high expenditure (over 30%) and mid-to-high expenditure (20%-30%) countries. On the other hand, mid-range expenditure (15%-20%) and low expenditure countries (less than 15%) have recorded increases. Thus, the current decade has seen a convergence in the relative level of public spending in the region.

It is interesting to note that, whereas the size of the central government in countries of the Caribbean has converged towards the levels typical of the countries of the Organisation for Economic Co-operation and Development (OECD), in Latin America the central government continues to be smaller than in OECD or South-East Asian countries (see table IV-2). Nevertheless, the growth in central government expenditure in Latin America in the 1990s is matched only by that of the OECD countries. The contrast is even greater in the case of **public demand** as a percentage of GDP, which has been decreasing in all regions except Latin America (see table IV-1), where the most dynamic component of growth in public demand has been gross capital formation. In the case of the Caribbean, cutbacks in capital expenditure (30% between 1987 and 1996) have been the determining factor in the decline in public demand.

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[5] For a more detailed analysis of fiscal policy in Central America, see Torres (1997).

[6] This classification is based on the level of total central government expenditure as a percentage of GDP in 1990-1996. **High expenditure** (over 30%): countries of the Caribbean; **mid-to-high expenditure** (20%-30%): Bolivia, Chile, Ecuador, Honduras, Nicaragua and Venezuela; **mid-range expenditure** (15%-20%): Argentina, Brazil, Costa Rica, Mexico, Panama and Uruguay; and **low expenditure** (less than 15%): Colombia, the Dominican Republic, El Salvador, Guatemala, Haiti, Paraguay and Peru.

Table IV-1
TRENDS IN GOVERNMENT PARTICIPATION IN THE ECONOMY
1990-1996
(Regional averages)

Type of participation	CARIBBEAN (High level of expenditure)	LATIN AMERICA				OECD	SOUTH-EAST ASIA
		By level of expenditure					
		Mid-to-high	Mid-range	Low	Average		
Central government expenditure	Decreasing	Increasing	Increasing	Increasing	Increasing	Increasing	Stable
Public demand	Decreasing	Increasing	Incr.1994[a]	Increasing	Increasing	Decr.1992[a]	Decr.1992[a]
Consumption	Stable	Decreasing	Incr.1994[a]	Increasing	No trend	Decr.1992[a]	Decr.1992[a]
Investment	Decreasing	Increasing	Decreasing	Increasing	Increasing	No trend	Decr.1992[a]
Subsidies and transfers	Increasing	Decreasing	Increasing	Increasing	Increasing	Increasing	Increasing

Source: ECLAC, on the basis of official figures and IMF data.
[a] Refers to the year when the increasing or decreasing trend began.

Subsidies and transfers are acquiring an increasingly important role in all regions (see tables IV-2 and IV-3). During the 1990s, their levels as a proportion of central government expenditure have increased on average by between 4% (Caribbean) and 26% (South-East Asia). In Latin America, they have expanded by around 18%, since their share of total central government expenditure moved from around 23% in the 1980s to 27% in the 1990s.

The size and dynamic growth of this variable could explain the significant inter-regional differences in levels of central government expenditure. In fact, in Latin America, total expenditure net of transfers and subsidies reflects levels of State intervention in the economy that are much more comparable to —although still a bit lower than— the patterns typical in OECD and South-East Asian countries (see table IV-4).

Table IV-2

SELECTED INDICATORS OF GOVERNMENT EXPENDITURE

Central government

(Regional averages)

Indicators	Unit of measurement [a]	Latin America		Caribbean		OECD		South-East Asia	
		1985-1989	1990-1996	1987-1989	1990-1996	1985-1989	1990-1995	1985-1989	1990-1994
Total expenditure	% GDP	19.8	17.8	40.7	35.9	33.1	35.4	22.5	20.7
Current expenditure	% GDP	16.1	14.5	30.4	28.3	30.7	33.2	15.7	14.8
Breakdown by economic type									
- Interests	% GDP	2.7	2.2	2.1	1.5	3.5	3.4	3.3	2.3
- Subsidies and transfers	% CGE	22.6	26.8	13.6	14.2	57.8	58.2	15.2	19.2
- Wages	% GDP	5.2	4.8	14.1	12.6	4.2	3.8	5.2	4.8
- Wages	% EGS	86.1	88.5	71.1	70.8	47.1	40.4	55.4	55.6
Breakdown by function									
-Social expenditure	% CGE	37.9	42.3	26.5 [c]	28.0 [c]	56.7	59.3	28.2	31.8
Capital expenditure	%GDP	3.7	3.3	10.3	7.6	2.0	1.9	5.6	5.1
Real investment [b]	%CE	55.3	60.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: ECLAC, on the basis of official figures and IMF data.

Note: The selected countries for each region are as follows: **Latin America**: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela. **The Caribbean**: Antigua and Barbuda, Aruba, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Saint Kitts and Nevis, Saint Vincent and the Grenadines, Saint Lucia, and Trinidad and Tobago. **OECD**: 10 countries of Europe, Canada and the United States. **South-East Asia**: Indonesia, Malaysia, Republic of Korea, Singapore and Thailand.

[a] CGE: central government expenditure; EGS: expenditure on goods and services; CE: capital expenditure.

[b] Selected sample of countries.

[c] Excludes social expenditure on housing. Limited selection of countries.

[d] Values adjusted for different countries and years.

Table IV-3
SECTORAL AND ECONOMIC BREAKDOWN OF CENTRAL GOVERNMENT EXPENDITURE
(As a percentage of total expenditure)

Breakdown of expenditure	Latin America		Caribbean	
	1985-1989	1990-1996	1987-1989	1990-1996
Breakdown by sector				
Economic sector [a]	8.3	8.6	n.a.	n.a.
Infrastructure [b]	8.3	9.1	n.a.	n.a.
Social sectors [c]	37.9	42.3	n.a.	n.a.
- Human capital	23.5	25.0	23.6	25.0
Other sectors [d]	27.5	24.6	n.a.	n.a.
Interest payment	18.0	15.5	4.2	3.5
Total	100.0	100.0		
Breakdown by economic type				
Current expenditure	81.2	81.7	74.7	78.9
- Goods and services [e]	40.6	39.4	56.2	59.6
- Interest	18.0	15.5	4.4	3.8
- Subsidies and transfers	22.6	26.8	14.1	15.5
Capital expenditure	18.8	18.3	25.3	21.1
- Fixed gross capital formation	10.1	11.1	n.a.	n.a.
Total	100.0	100.0	100.0	100.0

Source: ECLAC, on the basis of official figures and IMF data.
Note: Breakdown adjusted for different samples of countries and years.
[a] Agriculture, fishing and hunting, forestry, mining, manufacturing and construction, etc.
[b] Fuel and energy, transportation and communications.
[c] Education, health, social security and housing.
[d] General services, defence, security and public order.
[e] Includes wages and salaries.

The above indicates that transfers and subsidies play a different role depending on the level of development of the region. As shown in figure IV-3, there appears to be a positive correlation between the level of development and the relative importance of this item of expenditure.[7] While OECD[8] countries spent an average of 21% of GDP on transfers and subsidies between 1990 and 1996, Latin American countries spent 4.5% and Caribbean countries 4.9% on these items. If Latin American countries are divided into groups according to their level of development, a similar pattern emerges, which suggests the possibility of an analogy with superior goods. The countries of South-East Asia are an exception since, despite their high level of development, they have a relatively low proportion of transfers and subsidies.

[7] In corresponding estimates, transfers to local government authorities are excluded (with the exception of the Caribbean). Whereas transfers abroad could not be deduced, it is assumed that they have not been very high and, therefore, do not affect the main conclusions.

[8] Since the 1960s, the government sector showing the most vigorous growth in the industrialized countries has been subsidies and transfers. Basically, this heading includes pensions, family allowances, unemployment insurance, disability benefits, etc., which, overall, represent the "cash-in-hand" sector of modern welfare States.

The levels of central government **capital expenditure** in the Caribbean have been substantially higher than those in Latin America (7.6% versus 3.3% of GDP in the 1990s); however, over the course of the decade they have been diminishing sharply, falling 26% of total central government expenditure (2.7 percentage points of GDP). While a downward trend was also observed in Latin America in the 1980s, there was a clear turning-point in 1990, marking the start of a generalized recovery in this variable, especially in real investment and in Central America, although this trend has not brought these figures all the way back up to where they were in the early 1980s.

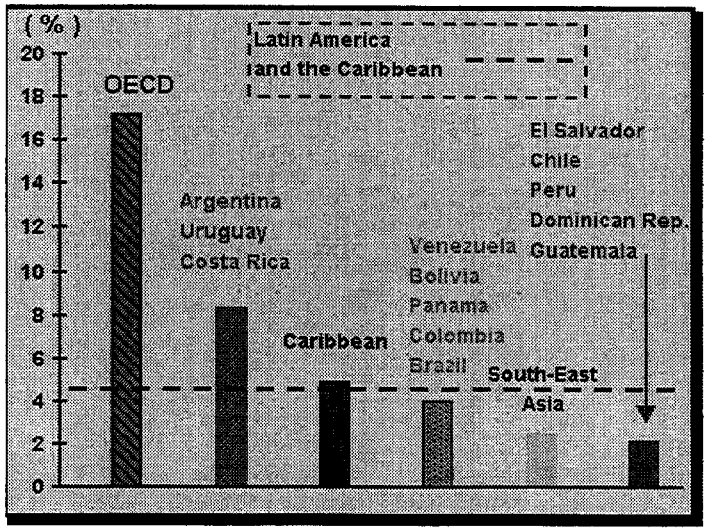
It should be pointed out that in Latin America, this recovery has been concentrated in the mid-to-high and low expenditure countries. The mid-range expenditure countries have been showing a steady decline since the beginning of the last decade. This trend is due mainly to the trend in the real investment component, which represents around 60% of total capital expenditure in Latin America. This item of expenditure has accounted for an increasing share since 1985, especially in South America.

Table IV-4
TOTAL EXPENDITURE NET OF TRANSFERS AND SUBSIDIES
Central government
(Regional averages: 1990-1996)

Expenditure	Latin America	OECD	South-East Asia
Total expenditure	17.8	35.9	20.7
Transfers and subsidies	4.5	21.1	4.4
Net expenditure	13.3	14.8	16.3

Source: ECLAC, on the basis of official figures and IMF data.

Figure IV-3
TRANSFERS AND SUBSIDIES [a]
(Regional averages: 1990-1996)



Source: ECLAC, on the basis of official figures and IMF data.
[a] Transfers and subsidies net of transfers to local governments except for the Caribbean.

2. Priorities in central government expenditure

Apart from the above-mentioned differences in levels of expenditure, there have also been differing priorities in the allocation of public resources. Figures IV-4 and IV-5 and tables IV-2 and IV-3 provide a summary comparison by region of the main changes in public-sector spending priorities between the periods 1985-1989 and 1990-1996.

In the majority of the countries of the region there has been a reduction in the share of expenditure on interest payments and on functions not directly related to productive or social activity.[9] On the other hand, in the second half of the 1980s and the first half of the 1990s, central government spending priorities in Latin America have shifted somewhat towards social expenditure,[10] especially social security, which has increased from 2.5% to 3.2% of GDP.

Social expenditure accounts for around 42% of the total in Latin America[11] (49% in South America and 35% in Central America). It has been given increasing priority since the mid-1980s (especially in South America), and this trend has accelerated in the 1990s.[12] During the current decade, the mid-range countries (in terms of total expenditure) have shown the highest levels of social expenditure (10.3% of GDP, on average), followed by the countries in the mid-to-high range (9.4% of GDP) and those with low expenditure (3.9% of GDP) (see table IV-5).

In the Caribbean,[13] social expenditure (excluding the housing sector) accounts for 28% of total expenditure but has been decreasing slightly, fluctuating between 11.6% and 9% of GDP since the end of the 1980s. Some 85% of social expenditure is invested in human capital (in the education and health sectors).

Non-social spending,[14] on the other hand, has declined since the crisis of the 1980s, although this trend has slowed somewhat since 1990 and has now even leveled out to some extent in South America. The greatest reduction is seen in the countries with total expenditure levels in the mid-range and mid-to-high range, whose non-social expenditure coefficient has decreased by around 25% (around 4 points of GDP) during the current decade as compared with the 1980s. This explains why its main components have either shown a declining trend (general services and economic items) or have remained relatively unchanged (military expenditure and infrastructure) over the past decade.

For **defence expenditure**, the regional average has fluctuated at around 2% of GDP since the 1980s (see table IV-5). Declining expenditure in South America has been balanced out by a trend towards increased expenditure in Central America. As a consequence, since

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[9] Corresponding to expenditure on the sectors of defence, security and public order, and general public services.

[10] For the purposes of the present document, the analysis of social expenditure is limited to spending in the education, health, housing and social security sectors.

[11] Weighted average of 18 Latin American countries for the period 1990-1995.

[12] This topic is examined in more detail in chapter VI, "Social expenditure".

[13] This analysis is based on a smaller sample of countries (Barbados, Dominica, Grenada, Jamaica and Trinidad and Tobago); information is lacking for the other countries.

[14] Consists of expenditure on public order and security, general services and defence, economic sectors (agriculture, energy and fuel, transport and communications, etc.) and others.

1989 Central American levels of expenditure on defence have been higher than those of South America. The lowest levels of military spending are seen in the mid-range countries, which also have the highest levels of social spending

Figure IV-4
PUBLIC EXPENDITURE: SIZE AND PRIORITIES
(In percentages, regional averages, 1999-1996)

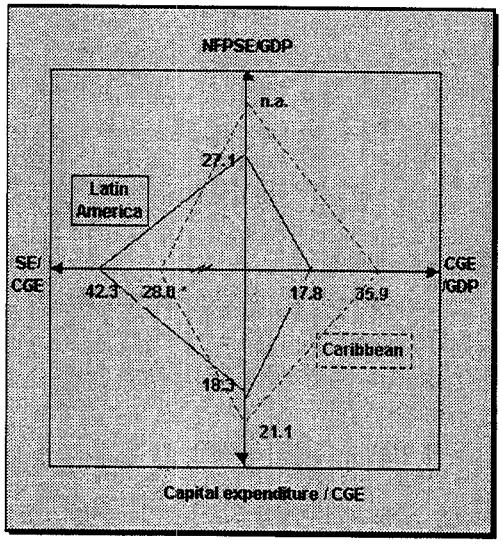
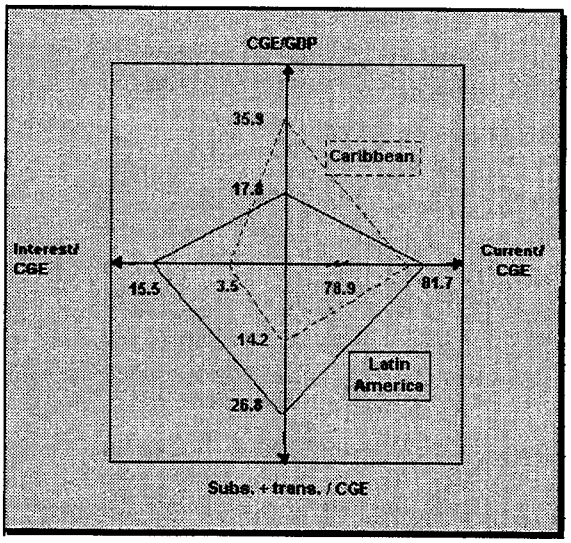


Figure IV-5
PUBLIC EXPENDITURE: BREAKDOWN BY ECONOMIC TYPE
(In percentages, regional averages 1990-1996)



Source: ECLAC, on the basis of official figures and IMF data. n.a.: no information available; NFPSE: non-financial public sector expenditure; SE: social expenditure; CGE: central government expenditure.

Table IV-5
MAIN COMPONENTS OF CENTRAL GOVERNMENT EXPENDITURE (CGE)
Latin America, averages, 1990-1995

COUNTRIES	SOCIAL EXPENDITURE	NON-SOCIAL EXPENDITURE					
		Total	General services	Defence	Order and internal security	Infra-structure	Economic matters
Latin America	8.0	10.4	2.3	1.9	1.3	1.7	1.6
By subregion							
South America	8.9	9.2	2.1	1.7	1.0	1.9	1.3
Central America	6.7	12.0	2.4	2.3	1.7	1.8	1.8
By level of central government expenditure [a]							
Mid-to-high group	9.4	14.0	2.4	2.7	1.8	2.7	1.2
Mid-range group	10.3	8.4	2.6	1.4	1.0	1.4	1.6
Low group	3.9	8.6	1.7	1.5	1.1	1.8	1.8

Source: Social expenditure: ECLAC, on the basis of official figures. Non-social expenditure: ECLAC estimates on the basis of official figures and IMF data.

[a] Mid-to-high expenditure: between 20% and 30% of GDP; mid-range expenditure: between 15% and 20%; low expenditure: less than 15%.

Expenditure on public order and internal security has been the most dynamic component of growth. In the 1980s, it accounted for the lowest share of expenditure. In the 1990s, the average level of expenditure has been 62% higher than in 1985-1989 for South America and 45% higher for Central America.

3. Public employment

During the 1990s, a decline has been noted in spending on wages and salaries by central governments, measured as a proportion of GDP (see tables IV-1 and IV-2). Moreover, in Latin America this variable exhibited a persistent decline from the 1980s onward which only began to change in 1995.

During the 1980s, the earlier trend of expanding public employment was interrupted, and this sector's share of employment stopped growing.[15] The fact that —public statements notwithstanding— there was no actual reduction of any significance in this share is explained by the political function of public employment and the wave of new tasks for the public system in the reform context.[16] Furthermore, there were large differences from one country to the next, reflecting not only different policies but also differing degrees of decentralization, political patronage and opposition on the part of public-sector employees.

Nevertheless, during the first six years of the current decade, the share of the public sector in non-agricultural employment declined significantly in almost all countries in the region. Region-wide, the decrease amounted to 15.3% in 1990 and 13.0% in 1996. The only exceptions were Chile, where public-sector employment had contracted considerably in previous periods, and Paraguay (see table IV-6). Among the important factors contributing to this trend was the modernization of the public sector, which led to considerable reductions in central government employment. These reductions were offset to some extent by the job creation generated by decentralization; nonetheless, the privatization of public enterprises, which gathered considerable momentum from 1989 on, was the factor that most affected the State in its role as an employer.

It may be surmised that the declining trend in the public-sector share of employment will continue, for fiscal reasons of either a short-term (to cover the deficit) or long-term (to improve efficiency) nature. On the one hand, public enterprises and institutions are continuing to be privatized and an increasing number of areas managed by the public sector are being franchised to the private sector; on the other, efforts are being made to increase labour productivity in areas remaining in the public sector. Both types of measures limit the volume of public-sector employment.

All the same, it is doubtful whether such trends will lead to a reduction in public-sector employment in relative terms. Once large-scale privatizations have been carried out, factors remain which tend to encourage restructuring, rather than continued downsizing, of public-sector employment. Such factors include the ongoing redefinition of the role of the State in many countries, decentralization processes and the manifest needs of the population.

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[15] ILO Regional Employment Programme for Latin America and the Caribbean (PREALC) (1991).

[16] Marshall (1996).

Table IV-6
SHARE OF PUBLIC EMPLOYMENT IN NON-AGRICULTURAL EMPLOYMENT
(In percentages)

Country	1990	1996
Argentina	19.3	13.2
Bolivia	16.5	11.1
Brazil	11.0	9.6
Chile	7.0	7.6
Colombia	9.6	8.3
Costa Rica	22.0	17.2
Ecuador	17.6	13.9
Honduras	14.9	11.3
Mexico	25.0	22.0
Panama	32.0	23.0
Paraguay	12.2	13.1
Peru (metropolitan Lima)	11.6	8.2
Uruguay (Montevideo)	20.1	17.0
Venezuela	22.3	19.1
Latin America	**15.3**	**13**

Source: International Labour Organization (ILO), *Panorama laboral, 1997*, No. 4, Lima, Regional Office for Latin America and the Caribbean, 1997.

4. The procyclical nature of public spending

Contrary to the customary recommendations to be found in the macroeconomic literature to the effect that public expenditure should be used to dampen fluctuations in the level of economic activity around its trend level, public expenditure in the region has been managed in a markedly procyclical manner.

Analysis of fluctuations during crisis periods between 1981 and 1995 in the per capita expenditure of 15 central governments in Latin America and six in the Caribbean in relation to the economic cycle, measured in terms of trends in GDP,[17] reveals procyclical behaviour in the majority of cases (86%). Indeed, in more than 70% of these cases, public spending was reduced by a percentage equal to or greater than the reduction in GDP. If the Latin American and Caribbean region is compared with the OECD countries and South-East Asia, it can be seen that in the latter two regions public expenditure has enjoyed a greater degree of protection. In South-East Asia it has even been countercyclical in many cases (see table IV-7).

Thus, social expenditure has not played its expected countercyclical role in the region. What is more, these reductions in social expenditure in times of recession have, in most cases, actually exacerbated the economic cycle because proportionately larger cutbacks have been made in social expenditure than in total expenditure and primary expenditure net of interest.

[17] See Mostajo (1998) for details of the methodology used.

Table IV-7
PUBLIC SPENDING BEHAVIOUR *VIS-A-VIS* GDP
Periods of falling GDP
1981-1995
(In percentages)

Type of behaviour	Caribbean	Latin America			Latin America and the Caribbean	OCDE	South-East Asia
		Central America	South America	Average			
Countercyclical	14	14	14	14	14	27	40
Highly protected	-	14	14	14	10	18	40
Highly vulnerable	14	-	-	-	4	9	-
Procyclical	86	86	86	86	86	73	60
Moderates	43	14	21	19	25	64	40
Neutral	-	58	58	57	43	-	-
Exacerbates	43	14	7	10	18	9	20
Total cases	100	100	100	100	100	100	100

Source: Rossana Mostajo, "Comportamiento del gasto social en América Latina y el Caribe: pro o contracíclico", Santiago, Chile, ECLAC, Economic Development Division, 1998, unpublished.

Note: "highly protected": expenditure increased during the crisis; "highly vulnerable": expenditure fell when GDP grew; "moderates": reduction less than that of GDP; "neutral": reduction proportional to that of GDP; "exacerbates": reduction greater than that of GDP.

To implement the proposal put forward by ECLAC in 1990 for changing production patterns with social equity requires a stable economic, political and social environment in which agents can draw up projects for the medium and long term with the least possible degree of uncertainty. Such freedom from uncertainty depends, among many other factors, on the extent to which stable management of overall public spending can be achieved and, in particular, on the extent to which any unnecessary or disproportionate disruption of public spending can be avoided at times when the most vulnerable groups in society are most in need of it. Hence the importance, in formulating and designing programmes, of paying great attention to the sustainability of public expenditure over time. This can prevent the wastage and social costs in stop-and-go policies while contributing to fiscal consolidation and macroeconomic stability, thus improving the prospects for sustained growth.

It is therefore necessary: (i) to analyse spending projects or programmes in order to identify any non-sustainable elements at the formulation and design stage; (ii) to test the programmes periodically for sustainability, beginning at the start-up stage, so that if a risk that they will have to be discontinued is detected, problems can be foreseen and less costly solutions adopted than simply abandoning the programmes; (iii) to design stabilization mechanisms for public revenues that can mitigate fluctuations in expenditure in response to the economic cycle by extrapolating the region's successful experiences, with what has so far consisted of the creation of stabilization funds for commodities (such as coffee in

Colombia and copper in Chile); (iv) to refrain from expanding public spending on the basis of temporary sources of public revenues, thereby avoiding unsustainable increases that lead to severe contractions on the downward swing of the economic cycle; (v) consequently, as is argued in chapter V, to concentrate the authorities' attention on the structural aspects of public-sector deficits in order to avoid accentuating the effects of short-lived phenomena that affect revenue and expenditure.

C. MILITARY SPENDING

1. Trends

Military spending is a little-explored area of public expenditure in the region, both for want of data and for political reasons. There is an overall information problem in this area. It is common practice for military expenditures to be allocated and accounted for under items which are difficult to identify, a practice partly explainable by their political sensitivity and the associated desire to conceal them from public scrutiny.

Probably owing to the elusive nature of military spending, the sources of information in this area are varied. Moreover, the available information sources[18] apply different definitions of military spending. For example, a clear distinction is not always made between spending on defence and on police forces, and spending on social security benefits for members of the security forces is not always included.

Despite these problems, approximate estimates have been made of the levels of military spending in the countries of the region. According to the most conservative estimate, based on official information on defence spending, military expenditures accounted for 10.3% of central government expenditure in Latin America during the period 1990-1995 (1.9% of GDP), or about US$ 20 billion (see table IV-8).

[18] The main sources include the International Monetary Fund (*World Economic Outlook* (WEO) and *Government Finance Statistics* (GFS)), the Stockholm International Peace Research Institute (SIPRI), the International Institute of Strategic Studies (IISS) and the Arms Control and Disarmament Agency of the United States of America (ACDA).

Table IV-8
MILITARY SPENDING INDICATORS IN LATIN AMERICA
(1990-1995 averages)[a]

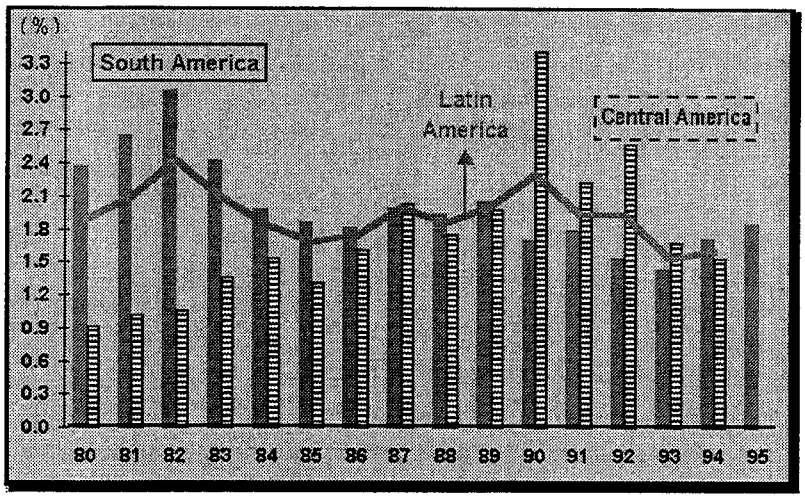
Countries	Percentage of GDP	Percentage of CGE	Percentage of CGE on	
			Education	Health
By level of CGE				
Mid-to-high group	2.7	11.9	73.2	110.9
Mid-range group	1.4	7.7	80.0	59.2
Low group	1.5	11.7	130.2	185.7
By region				
South America	1.7	9.0	69.8	99.2
Central America	2.3	12.9	136.2	149.8
Latin America	1.9	10.3	92.7	116.0
By country				
Argentina	1.1	6.1	53.6	40.2
Bolivia	2.4	12.1	54.7	127.8
Brazil	1.2	6.3	121.8	58.4
Chile	2.6	12.2	96.5	116.4
Colombia	1.0	8.1	76.0	158.8
Ecuador	2.7	11.9	84.5	175.6
El Salvador	2.5	17.3	202.1	251.2
Guatemala	1.3	13.1	88.8	159.7
Mexico	1.1	6.7	28.8	31.0
Nicaragua	3.8	12.7	76.9	82.5
Panama	2.8	14.5	152.4	119.4
Paraguay	1.5	12.9	84.0	232.5
Dominican Rep.	0.9	7.0	160.6	136.0
Uruguay	1.3	6.7	72.6	60.6

Source: ECLAC, based on official figures and IMF data.
[a] Average from 1990 to the most recent year available from the sources.
[b] CGE: central government expenditure.

On average, military spending in Latin America is the lowest in the developing regions, both as a percentage of GDP and in relation to central government expenditure. Perhaps for that reason, military spending as a percentage of GDP decreased less in the region than elsewhere between 1990 and 1995 (it increased by about US$ 6.5 billion in absolute terms during that period). These preliminary figures suggest that, despite the peace agreements in Central America and the absence of major military conflicts in the region, Latin America has not benefited from a real disarmament dividend.

A closer look at the region reveals greater defence spending in Central America, due in part to the carry-over of aggressive stances from past decades and in part to the smaller scale of its economies. The lower ratio of military spending to GDP in South America is attributable to the relative absence of conflict in the region during its period of democratic consolidation and to corresponding progress in achieving an arms balance among the countries of the subregion (see figure IV-6).

Figure IV-6
MILITARY SPENDING TRENDS IN LATIN AMERICA
(Percentage of GDP)



Source: ECLAC, based on official figures and IMF data.

Military spending has increased relative to spending on education (from 77.6% in the 1980s to 92.7% in 1990-1995), but has fallen in relation to health spending (from 161.7% to 116% for the same periods). During the first half of the 1990s, on average, the countries of the region spent one dollar on defence for every US$ 1.70 on education and US$ 1.20 on health. These ratios reveal major national differences; in some countries, military spending exceeds health spending (Bolivia, Chile, Colombia, Ecuador, Guatemala and Paraguay) or spending on education (Brazil), and in others, it exceeds spending on both health and education (Dominican Republic, El Salvador and Panama) (see table IV-7).

With respect to the range of possible strategies, countries' expectations can help to generate a chain of actions and reactions on the regional and subregional scale that may lead to an excessively "reactive" pattern of military spending. Conversely, the same sort of expectations can also generate quite different effects, since the postponement of arms purchases or sales at the regional, subregional or bilateral level may lead to reductions in military spending.

The strengthening of democracy in the region, increasing economic integration, and a marked lessening of tensions among countries are contributing to an environment which greatly helps to promote reductions in military spending over time, freeing resources for other uses, and to improve transparency in that spending, a prerequisite for achieving a better allocation of government finances. Thus, the converse of the vicious circle of the arms race is the virtuous circle of disarmament.

2. Economic impact

Military spending is an obviously complex subject, clearly transcending purely economic considerations. In particular, it entails delicate matters of domestic and international policy.

Nonetheless, the mere fact that its economic dimensions are beginning to be systematically examined in each country can make a real contribution to improved knowledge and understanding of the issues.

One of the most frequent justifications for military spending is that it generates a positive externality by guaranteeing certain levels of security, which are conducive to improved economic growth. However, this argument falls far short of explaining the significant variations in levels of military spending recorded in the region (from 0.7% to 9.6% of GDP).[19]

Military spending can also have an adverse effect on economic growth through its negative impact on capital formation and resource allocation. Various studies have shown that overall reductions in military spending have produced a "peace dividend" in the form of faster growth.[20] Conversely, increases in military spending can reduce the amount of resources available for other uses, such as investment in productive capital, education and market-oriented technological innovation. In addition, such increases tend to add to external debt and shift the investment mix towards less the productive channels. Military spending may also result in a decrease in government saving, put pressure on the current account and depress private agents' propensity to save, owing to the increased consumption required to compensate for a reduction in social and economic services supplied by the public sector.

From the standpoint of human capital, the cost of each job created by military spending is high. Although it has been said that spending on military training in developing countries can improve the educational level and discipline of the workforce, others maintain that the military is not a significant source of technical skills. Many of the skills acquired in military training are specifically related to the use of weapons; useful skills which could be carried over to other economic sectors are not necessarily acquired.[21]

The confidential and strategic nature of military information and management can generate negative externalities which reduce the efficiency of resource allocation. Since military spending is not market-led, it tends to create distortions in relative prices, reducing the social efficiency of the allocation and use of public resources. The non-competitive allocation of funds can also encourage rent-seeking activities, which have equally adverse effects on resource allocation.

Despite the potential adverse effects of military spending, its economic role is not entirely unproductive. In view of the need to strengthen infrastructure in order to achieve growth in the developing economies, defence-sector capital spending can also have productive uses, thanks to the positive externalities deriving from the transport and telecommunications networks established for military activities for the economic structures of countries which otherwise would not have such services.

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[19] UNDP (1997).

[20] Knight, Loayza and Villanueva (1996).

[21] Ball (1990).

D. BUDGETARY INSTITUTIONS: INCENTIVES, PROBLEMS AND OUTLOOKS

Budgetary institutions (defined here as the set of rules, standards and formal procedures governing the preparation, debate, approval, implementation and supervision of budgets) have considerable impact upon the results of fiscal policy.[22] Issues and dilemmas relating to the level, composition, trend and funding of public expenditure assume prominence from the moment that fiscal authorities submit the draft budget for the next fiscal year to the legislature.[23] Although each country has its own institutional arrangements regarding budgetary rules and procedures, it is the parliamentary debate that reveals the constraints that inevitably limit what can be done, whether the aim is to obtain resources for new spending programmes or to increase allocations for programmes begun during previous financial years.[24]

1. Incentives that generate opacity and weaknesses in fiscal discipline

The public budget is the main formal instrument for collective action and decision-making on the requirements of society for goods and services which cannot be satisfactorily met through market mechanisms and on the means of financing those requirements. It is therefore an institutional area in which the most diverse socio-economic demands compete for tax revenue. It mirrors the distributive conflicts of society and the public interests of its representatives; it also brings to the fore demands for preferential treatment in taxation and government spending and the supply-side counterparts of those demands.

As discussed in chapter II, budgetary policy is the visible face of fiscal policy. However, visibility is not synonymous with transparency in the stages of budget preparation, debate and legislative approval, and above all in the budget implementation stage. Generally, the degree of opacity prevailing at any of these stages depends on the degree of fragility exhibited by the fiscal covenant upon which the budget rests.

Although the collective decision-making process calls for simultaneous consideration of both sides of public-sector budgetary constraints, there are clear political

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[22] The relation between budgetary institutions and fiscal results in terms of deficit and indebtedness has been examined systematically by many authors in recent years. These include Alesina, Hausmann, Homs and Stein (1995), Alesina and Perotti (1995), Alesina (1996, 1997), Gavin and others (1996), Hausmann and Stein (1996), Milesi-Ferretti (1996) and von Haguen (1991, 1992, 1994). The basic outcome of these studies is that, in general, institutional arrangements of a more hierarchical and transparent type (as opposed to procedures of a collegial nature) lead to better fiscal discipline. This line of investigation reflects the particular concerns of economic authorities over the past two decades regarding macroeconomic stability. Regrettably, there has been no equivalent concern for the impact of budgetary mechanisms on distribution, efficiency and growth. These issues remain to be addressed.

[23] While the clearest case is the national budget, something similar occurs, although of course on a smaller scale, with the budgets of provinces, states, regions and municipalities.

[24] Marcel (1998).

incentives to: (i) include in the budget the greatest possible number of spending initiatives compatible with the most optimistic estimates of expected revenue; thus, for example, the less the executive branch is politically able to resist demands for new spending programmes or to justify fiscal deficits, the greater will be its incentive to put forward over-optimistic estimates of anticipated economic growth rates and reductions in the rate of inflation; (ii) give preferential treatment to certain interest groups, both in the allocation of resources to particular items of expenditure and in the assignment of tax liability; and (iii) shift onto the future the tax burden necessary to cover spending levels in excess of present revenue.

Since, in addition, the benefits of government spending are generally enjoyed at the local level, whereas the tax burden tends to be distributed at the national level, the stage is set for the all-too-frequent tragedy of wasted resources.[25] That prospect adds urgency to the need for budgetary institutions designed to impose overall rationality.

As the aforementioned examples suggest, even in an institutional context such as the budgetary process, which is highly structured and regulated by formal, explicit, widely-known standards and procedures, there is ample room for the exercise of tactics and strategies characterized by a considerable degree of opacity. Ultimately, this seems to be the inevitable result of interactions among agents guided by conflicting sets of motives and objectives. On the one hand, there are interest groups that are basically motivated by incentives of a material nature (such as taxpayers or the numerous groups of those who benefit from public spending); on the other hand, there are the members of the political echelon, within the executive and legislative branches, who are basically guided by ideological, ethical and political, as well as electoral and material, motives. Finally, there are the members of the technocratic and bureaucratic class, located primarily within the machinery of the executive branch, who are guided by a complex set of legal and bureaucratic, or even ideological or material, motives. From that viewpoint, it is easy to understand why interaction among all these actors, who have such different goals and motives, generates disjointed situations whose practical resolution requires promises, agreements, concessions, pacts, and other forms of behaviour of varying degrees of opacity.

[25] This problem, characteristic of situations where property rights are not properly established or regulated, generally leads to an over-exploitation of collective resources. One example is the over-exploitation of rivers, lakes or seas, from which assets are taken (such as fish or shellfish) or in which liabilities are disposed (such as chemical residues and industrial or other waste), in both cases at rates which exceed optimum levels. By analogy, for want of basic agreements for sharing the costs of using collective assets (such as spending on public goods), it is to be expected that there will be a bias towards over-expansion of that spending or reduction of its voluntary financing.

2. Equilibria of poor budgetary quality

In the context described above, two opposing and self-reinforcing trends arise that work to the detriment of the quality of budgetary policy.

(a) The political mobilization of economically-motivated interest groups seeking to ensure a permanent flow of high-quality resources for particular budget items, or, at the least, legal provisions to maintain their purchasing power

When such initiatives succeed, not only do they protect items against budget cuts, but they can also —depending on the nature of the solution— generate considerable material benefits. Seeking, identifying and capturing monopolistic State rents as a permanent and high-quality source of financing for selected programmes is a competitive and highly profitable activity. Consequently, for any politically influential and well-informed group, there is an obvious incentive to link its preferred programme to a desirable source of income or a protective legal provision.[26]

The most widely used overall solution for obtaining permanent funding for particular items of expenditure is to link them to certain clearly identified sources of income. This mechanism tends to be reflected in the creation of numerous "funds" that, in reality, are merely budget items for which the annual funding is provided by "tied" sources. In some countries, the abusive creation of such funds has come to be one of the main sources of budgetary inflexibility (see box IV-1).

It can be assumed that the more abundant the source, the greater will be the benefits for those who depend upon these earmarked, or tied, rents or revenues. Indeed, in economies where inflation is a factor, the automatic linking of a particular spending item to a given source of income means that the former benefits from the same degree of inflation-proofing as the latter.

[26] A conspicuous example of this type of practice is the allocation of 10% of the profits of CODELCO (Corporación del Cobre de Chile) to the budget of the Armed Forces. The shrewdness of this measure lies in the fact that, at the time of its adoption (it is still in force), CODELCO was not only the largest State-owned enterprise in Chile, but also the most profitable (its average annual profits during the period 1985-1989 were equivalent to about 6% of GDP). Another noteworthy example of the protection of corporate interests is the constitutional status given in Brazil to the requirement for the executive branch to pay the budgetary allocations corresponding to supplementary and special credits for the legislative and judicial branches by the twentieth day of each month (article 168 of the Federal Constitution of 1988). The cleverness of this protective provision becomes clear if we recall that the inflation rate during the year in which the constitutional reform was adopted was 993% (and, 1,864% in 1989, 1,585% in 1990, 476% in 1991, 1,149% in 1992, 2,489% in 1993 and 929% in 1994). These inflation rates, measured in terms of changes in the consumer price index, were provided by ECLAC (1995).

Box IV-1

THE EXPERIENCE WITH SPECIAL FUNDS: THE CASE OF BRAZIL

The planning and execution of fiscal policy in Brazil over the past 30 years have involved the use of a wide variety of instruments, including a host of special funds and budgets (the fiscal budget, the monetary budget and public corporation budgets, to name a few). The single-budget system at the federal level did not exist until the 1980s, and some special funds still remain, despite the provisions of the Federal Constitution of 1988, which, in response to the proliferation of sectoral funds in the 1970s and 1980s, established a two-year time frame, effective from the date of its adoption, during which funds not ratified by new laws passed by Congress would be eliminated, with the exception of those resulting from fiscal incentives or relating to national defence.

The types of funds used during the last three decades have varied, both in budgetary terms (financial, accounting, rotating, constitutional and others) and economic terms (general, sectoral, savings, etc.). Certainly, most of them have related to a specific sector and have been used for specific types of expenditures.

Although the aim of legislators was to reduce the use of funds and revenue earmarking, the very legal provision used to achieve this goal (article 167 of the 1988 Federal Constitution) opened up a large number of exceptions. The table below shows the changes occurring in the number of active funds in Brazil in the last two decades.

As recently as 1997, there were still 47 funds, accounting for 21% of the current revenues of the National Treasury. The most important of these are the National Health Fund, the Workers' Support Fund and the Regulation Fund, which together account for 75% of the total resources allocated to such funds.

FEDERAL FUNDS IN BRAZIL: CLASSIFICATION BY SECTOR

SECTOR	1977	1984	1989	1997 [a]
Administration and planning	47	32	15	20
Agriculture (including livestock farming)	21	5	5	4
Communications	2	2	1	1
Defence and national security	7	3	5	9
Education and culture	23	14	11	2
Energy and natural resources	7	6	2	1
Housing and urban development	5	8	3	2
Industry, commerce and services	14	11	6	1
Financial and capital market	6	4	0	0
Foreign affairs	3	0	1	0
Health and sanitation	15	7	3	1
Labour, welfare and social security	11	10	5	3
Transport	8	4	2	2
Science and technology	0	1	2	1
Total number of funds	**169**	**105**	**61**	**47**

Source: On the basis of Instituto de Programação e Orçamento (INOR/SOF), Cadastro de fundos federais 1977, 1984, 1989, 1997, and C. Mussi, "La experiencia de los fondos fiscales en Brasil", Brasilia, ECLAC office in Brasilia, 1997, unpublished.

[a] Excluding the Fiscal Stabilization Fund, established in 1994 as an emergency fund, which receives 20% of all taxes and social contributions.

It should not be assumed, however, that earmarked revenues exist merely because private or corporate interest groups in search of material advantages demand them. There is also the supply side to take into account, represented by economic and political authorities (in both the executive and legislative branches) with decision-making powers in this area. The supply of earmarked revenues —like the "supply" of regulations which create entry barriers and ensure a gradual progression of price adjustments— entails a premium which is in some sense linked to the size of the subsidy that is granted. Hence, in general, even when lawmakers express the firm intention of reducing the incidence of earmarking in the budget,[27] there is no real incentive to eliminate this mechanism completely.

As one might expect, the combination of supply and demand factors tends to saturate the expenditure structure with embedded programmes and to lower the level of discretionary funds. Once such processes are entrenched in budgetary policy, they tend to be self-perpetuating through the operation of internal forces generated by interest groups such as civil servants themselves, input suppliers, contractors and, not least importantly, users of government services. Thus, the budget becomes overburdened with recurrent expenditure commitments, leaving little room for funding of new investment projects or spending programmes.[28]

As a corollary, budgetary authorities today are bound by yesterday's decisions, which cannot be changed except at a high political cost. In these circumstances, they perceive that they do not have much manoeuvering room for economic policy-making because they are faced with budgetary rigidity and inflexibility which has originated and solidified in the past.

(b) The reaction of groups and institutions hurt by rigidities that seek to identify the most efficient escape routes in order to minimize the short-term costs and adverse effects of the situation

One of the best-known ways of balancing spending demands with available tax revenue is through inflation. When inflation is low enough to permit the indexation or monetary adjustment of contracts to be dispensed with, inflation helps to increase the effective volume of net revenue effectively available to the government by means of: (i) the "inflation tax"; (ii) the extra revenue obtained through administrative tax procedures, such

[27] A paradigm of this situation is to be found in article 167 of the Constitution of Brazil, which prohibits the earmarking of tax revenue for bodies, funds or expenditure items, but which also includes a long list of exceptions. An excellent account of the history of earmarking in the case of Brazil is to be found in Oliveira, Tacca and Fontenelle e Silva (1995) and Oliveira and Fontenelle e Silva (1997).

[28] By analogy with a mode of public transport, the budget can be seen as a bus in which the seats on the left are reserved for taxpayers (who tend to leave many seats unoccupied), while the seats on the right are for those who benefit from expenditure (some of these seats are the object of heated arguments). Everybody wants to board the bus and sit on the right; nobody wants to leave the bus, or move over to the left. The operators of the bus have reserved permanent places on the right for increasing numbers of passengers, so there are fewer and fewer seats on the right that they can allocate to the new passengers who will inevitably board the bus at the next stops, however much they may need or deserve those seats.

as calculating personal income tax without adjusting income brackets for inflation;[29] (iii) the reduction in the amount of real debt that results from not indexing the principal;[30] and (iv) the reduction in the real value of budget allocations which are fixed at nominal values estimated on the basis of an anticipated inflation rate that is invariably lower than the observed rate.

Another method widely used by budget officials to manage scarce resources is to limit the volume of payments that may be made within a given period of time. This practice is facilitated by the fact that the most commonly used basis for recording transactions in public finances is cash-basis accounting.[31] Cash-basis accounting makes it possible to concentrate solely on flows into and out of a single account located, for example, in the Treasury. In this way, the budget authorities can schedule payment flows to match revenue flows, granting special authorizations which may be differentiated by ministry, agency, sector, region or other categories, in accordance with various criteria.[32]

In this way, the interaction of agents influenced by naturally opposed systems of incentives tends to generate budgetary rigidities that are incompatible with efficiency. At the same time, it promotes the adoption of equally counterproductive tactics and behaviours in fiscal activities.

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[29] This result should not be confused with the Olivera-Tanzi effect. The latter refers to the loss of real revenue resulting from an acceleration in the inflation rate (not compensated for by a reduction in the average interval between the event which generated the tax and the time at which the corresponding resources become available to the Treasury).

[30] The well-known recommendation made by Keynes to the Ministry of Finance of France in 1929 has been losing ground, inasmuch as the sale of indexed government bonds is now more widespread than before. That trend is certainly reinforced by the recent adoption of indexed bonds by the United States in 1997, following the example of New Zealand (1995), Sweden (1994), Canada (1991), Australia (1985), the United Kingdom (1981) and Israel (1955), although it contrasts with the abandonment of indexing by Argentina (under the Convertibility Plan of April 1991) and by Brazil (under the Real plan of May 1994).

[31] Cash-basis accounting, adopted by the IMF *Manual on Government Finance Statistics*, is currently under review as part of an international initiative to harmonize accounting methods in government finance with national accounts and the balance of payments. Among the alternatives most widely cited as possible new accounting methods is the accrual basis, which would provide a means of harmonizing the records of the aforementioned three systems. On this subject, see Efford (1996).

[32] This practice, known as *contingenciamento*, has been widely used by the Federal Government of Brazil. In addition to its beneficial effects for macroeconomic stability objectives, the imposition of quantitative limits on expenditure per unit of time introduces significant distortions, since: (i) it reverses budgetary priorities, creating an incentive to carry out minor expenditure first and postponing requests for additional credits from central government for major payments; (ii) it encourages political patronage by enabling the Ministry of Finance to use its discretionary power to withhold or release resources according to political considerations; and (iii) it encourages departments to make certain programmes irreversible (which is the case when a project reaches a stage at which it is cheaper to complete it than to stop it). For an analysis of these and other distortions of the Brazilian budgetary system, see Franco (1995), Olivera, Tacca and Fontenelle e Silva (op. cit.); Olivera and Fontenelle e Silva (op. cit.).

3. Budget rigidity

As suggested above, the amount of discretionary resources on which authorities can draw to increase current expenditure or initiate new investment projects called for in their government agendas is usually just a small fraction of GDP. Apart from the specific measures required in each country to alleviate excessive budgetary inflexibilities, a close look at the issue will reveal the incremental character gradually assumed by the expenditure programmes of each Administration. It is fair to say that, under normal circumstances, the credibility of those agendas will be in inverse proportion to the degree of budgetary rigidity that Governments have to contend with, and this, in turn, suggests that this credibility is in direct proportion to the strength of the fiscal covenant on which the programme is based.

In examining the difficulties that authorities subject to tight budgetary rigidities must resolve in attempting to carry through economic policy in a manner consistent with the general policies of their government agenda, attention should be paid to the various interpretations of the concept discussed in box IV-2. Despite a lack of comparative information for all countries of the region, an estimate of variant 2 (rigidity of level) indicates that discretionary resources at the disposal of the central government of Brazil in 1997 represented barely 8.6% of non-financial revenues. For Paraguay, again based on preliminary estimates, the manoeuvring room for initiating new programmes was equivalent to approximately 11% of non-financial revenues.[33]

Another way of addressing the topic of rigidity is through the concept of "budgetary lag"; such lags are created by the adoption of spending budgets in excess of the limits established by financial programming. The idea here is to pinpoint the proportion of approved appropriations which are not executed because of insufficient funds. In the case of Colombia, this indicator fell from 1.9% of GDP in 1990 to 0.9% in 1992, after which it increased steadily, reaching 3.6% in 1996.[34]

[33] According to Makon's estimate (1995) for Argentina, using a procedure not strictly comparable to that presented in table IV-9 for Brazil, the central government's leeway in managing public expenditure is equivalent to 25% of total tax receipts for 1995. Similarly, Marcel (1997), using his own methodology, estimates this margin to be 30% for Chile in 1993.

[34] Committee for Rationalization of Expenditure and Public Finances of Colombia (1997).

Box IV-2

TYPES OF BUDGETARY RIGIDITY

(1) **Intertemporal rigidity**: In this case, a good number of the expenditures that must be included in the proposed budget are predetermined by decisions taken previously. This type corresponds to a situation in which expenditure for period t depends on the level of expenditure in period t-1. Clearly, this is a simple way of showing that the past influences the present (a variant of the concept of "inertia" or "path dependence") or alternatively, it sums up the idea that the time path of periodic expenses is defined, with the passage of time, by the accumulation of numerous decisions taken incrementally during successive budgetary exercises. These factors constitute what could be called the "inherited component" of each year's budget, which goes beyond the payment of interest (usually considered as the typical example of inherited expenditure for debts contracted in the past) and includes wage payments, social security contributions and other responsibilities, in respect of which financial authorities have limited manoeuvring room. In this respect, it is often said —without explanation as to the method used for computing it— that around 80% to 90% of expenditure for the next budget is predetermined by the level of expenditure of the preceding period.

(2) **Rigidity of level**: This refers to the limited amount of discretionary resources (available for current or capital expenditure) that remains after the amounts approved by Congress have been adjusted to provide for commitments or obligations: (i) of a contractual nature (such as debt refinancing); (ii) of a constitutional nature (such as the obligation to transfer resources to subnational levels of governments for tax sharing); (iii) of a legal nature (such as the obligation to earmark resources for specific purposes, such as funds and action programmes for health, education and other purposes); these and other cases of earmarked revenues still seem to be quite common and important in some economies of the region, although no quantitative estimates are available for comparisons between countries; and (iv) of an administrative nature (such as payment of civil service salaries and social security contributions) —in short, what really remains at the disposal of the central government for use on infrastructure or new current expenditure programmes, after all its commitments have been met. As may be observed, this type of rigidity is attributable, in large measure, to the practice of earmarking revenue for specific purposes (a proxy variable for measuring this concept would be the percentage of the total that this type of revenue represents). This is closely related to the previous type of rigidity, but the two are different in their theoretical bases.

(3) **Rigidity of composition**: This refers to the difficulty of reallocating earmarked funds across budget items in response to changes in the macroeconomic context. There is no doubt that, in the interests of transparency, the executive branch should respect the composition of the budget as adopted by the legislature following arduous congressional negotiations. However, when substantial changes occur in the parameters that influence the drafting and adoption of the budget (e.g., major changes in relative prices), economic logic would suggest that there should be a reallocation of budgetary appropriations in line with new external conditions. Appropriate institutional mechanisms capable of preserving the transparency characteristic of budget policy in democratic societies and, at the same time, avoiding suboptimal allocation due to unnecessary rigidities are therefore required.

Source: On the basis of J.C. Lerda, "Informe de avance", Santiago, Chile, ECLAC, Cooperation programme between ECLAC and the Government of the Netherlands on fiscal policy, efficiency and equity in Latin America and the Caribbean, 1998, unpublished.

Table IV-9
BRAZIL: CENTRAL GOVERNMENT BUDGET (1997)
National Treasury Resources

ITEMS		Millions of *reais*	Millions of dollars	Percentage
1.	Non-financial revenue	171.836,5	159.284,9	100,0
2.	Constitutionally and legally mandated transfer to lower levels of government (states, provinces and municipalities)	27.092,1	25.113,2	15.8
3.	Non-financial central government revenue after mandated transfers (1-2)	144.744,4	134.171,7	84.2
4.	Earmarked revenues	102.104,7	94.646,6	59.4
4.1	To social security (pensions, health and social assistance)	84.134,2	77.988,7	49.0
4.2	To education	7.361,7	6.823,9	4.3
4.3	To funds	2.908,9	2.696,4	1.7
4.4	Donations to international agencies	35,6	33,0	0.0
4.5	Other	7.664,3	7.104,5	4.5
5.	Non-earmarked non-financial revenue (3-4)	42.639,7	39.525,1	24.8
6.	Mandatory expenditure chargeable to non-earmarked revenue	27.880,6	25.844,1	16.2
6.1	Wages and salaries	22.158,0	20.539,5	12.9
6.2	Pension benefits	4.068,5	3.771,3	2.4
6.3	Debt service	694,4	643,7	0.4
6.4	Counterpart to external loans	959,6	889,5	0.6
7.	Discretionary resources (6-7)	14.759,1	13.681,0	8.6

Source: Preliminary information obtained from the National Treasury of Brazil.

In addition to the foregoing, there are formal/legal obstacles inherent in the budget process which make it difficult for authorities to react in a flexible way to adverse shocks. The latter can drastically alter the conditions under which the budget is implemented by changing the parameters that prevailed during the formulation, debate and adoption of the budget in the year prior to its implementation.

The risks discussed above should, of course, be minimized by redesigning more appropriate budget mechanisms in order to reduce the probability of producing undesirable results from both an economic point of view (for example, waste of public funds) and a moral point of view (corrupt practices as a result of arbitrary reallocations of budgetary items by budget authorities). Clearly, the more accentuated the rigidity or inflexibility that may have accumulated over the years, the greater the need to: (i) undertake substantive reform of the rules and procedures governing budget mechanisms; and (ii) introduce criteria for evaluating management of public expenditure through the use of performance indicators in the interests of effectiveness, efficiency and quality.

E. INTEGRATED FINANCIAL ADMINISTRATION SYSTEMS

One area of public finance which the countries of the region have worked on intensively since the second half of the 1980s is the development, testing and implementation of integrated financial administration and control systems. This interest has intensified during the 1990s, and all indications are that the transition to the next century will see significant progress made in this field.[35]

An integrated financial administration system seeks to optimize the financial management of government resources over time. In order to achieve this, it uses a computer system which links the subsystems of budget, treasury, government credit and accounting into a network, thus providing the economic authorities with real-time information about their liquid assets at any given moment, together with the contribution from each source.

At the same time, an integrated financial administration system helps streamline and improve the quality of tax administration by exercising greater control over agencies and localities where collection of taxes or various other receivables is lagging, calculating the amounts due and identifying the agents responsible, both of which are real-time functions. In this way, legal proceedings can be initiated rapidly against those responsible, sending a clear signal that the authorities are determined to enforce the tax code.

The system also makes it possible to control the flow of many payments made in a decentralized manner, in accordance with the priorities that financial planning officials have set based on projections of anticipated income. In particular, such a system facilitates coordination over time between the commitments and resources available in each period, thus averting unnecessary financial costs.

The latter point is unquestionably of relevance in countries where domestic interest rates are very high. Where such conditions prevail, the integrated system enables the central government to operate a single till or cash pool, thus avoiding recourse to lines of credit from banks when excess liquidity is available in public accounts as well as the loss of potential financial income through failure to put idle balances to work.

The point of the single till arrangement made possible by an integrated system is to keep public accounts balanced over the short term, whether in the pursuit of domestic goals (imposed by financial planning) or external goals (required by multilateral aid programmes run by international agencies). Bearing in mind that most government transactions are recorded on a cash basis, it is clear that coordinated single-till management leads almost by definition to the balancing of public accounts: only what comes in can be paid out.

At the same time, an integrated system encourages more rational management of the public debt. In particular, it makes it possible to reconcile the maturity profile with projected trends in revenues using financial planning procedures. This activity has taken on added importance in recent years thanks to the increasing globalization, integration and sophistication of international financial markets, in which sovereign debtors place their

[35] According to most definitions, an integrated financial administration and control system entails the methodically coordinated management of information, decisions and activities associated with such subsystems as planning and budget, tax collection, treasury, government debt and credit, accounting, auditing, and evaluation and oversight of public management. See, for example, Asselin (1995) and Brusa (1997).

securities. This development has undoubtedly expanded the range of options open to Governments in terms of maturities, costs and the currencies in which new issues can be denominated.[36]

The design of an integrated financial administration system calls for one government agency to be in charge of centralizing control of the single till. In this respect, each country makes its own institutional arrangements; options range from putting the Treasury in full charge to assigning responsibilities to a special agency which may or may not be part of the Ministry of Finance; the choice depends on a country's history, traditions, technical and administrative capabilities, and on its internal political stability, among other factors. In any event, the important thing, regardless of the agency's position within the bureaucratic hierarchy or relationship to a ministry, is that it should unite all information about government liabilities denominated in both local and foreign currencies, including contingent liabilities in the form of guarantees extended by the Government to the private sector.[37]

The economies of the region show widely differing results with regard to the development, introduction and consolidation of integrated financial management and control systems.[38] Some countries boast relatively well-established legal frameworks and institutional arrangements, and have successfully accumulated wide-ranging practical experience. One particularly noteworthy example is Brazil's Integrated Financial Administration System (SIAFI) (1986), which has served as a model for other countries in the region. Others of its kind are Bolivia's Financial Administration and Control System (SAFCO) (1985) and, more recently, Argentina's Integrated Financial Information system (SIDIF) (1992) and Panama's Integrated Financial Administration System (SIAF) (1994). Chile is a special case, for despite the fact that its ground-breaking Financial Administration Act of 1975 was not designed to create an integrated system of the sort established in the other countries mentioned, the results achieved in terms of fiscal discipline have given the law the force of a fully consolidated and successful institutional arrangement.

A second group of countries has made significant but partial progress in this area —as in the case of Colombia's Integrated Financial Information System (SIIF) and Peru's Integrated Financial Management System (SIAF)— these countries must complete a number of stages in order to get their systems up and running efficiently.[39] Many other countries in the region are also developing and experimenting with various components of an integrated system, but have yet to attain the degree of consolidation achieved in the first group of countries. Often their initiatives have an approved legal framework —as is the case of El Salvador's Integrated Financial Administration System (SAFI) and Control System (SICON), Paraguay's Integrated Financial Information System (SIIF), Ecuador's Integrated Financial Management System (SICEF) and Uruguay's Integrated Accounting and

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[36] Ter-Minassian (1997), Kiguel (1998), Barbosa (1998), Boamah (1998) and Brusa (1997).

[37] For more information on this subject, see the chapters on the public deficit and privatizations.

[38] See Asselin (1995). An analysis of the case of the Central American countries is presented in Torres (1997).

[39] In Peru, SIAF already has data on income and expenditure from 510 agencies located throughout the country (300 of which are outside the Lima metropolitan area). In Colombia, SIIF is expected to become fully operational on 1 January 1999, though it will be limited to the central government.

Budgeting System (SICOP)— but have nonetheless made only limited progress, generally in the areas of improving tax administration and raising the corresponding tax ratio.

A third group of countries has taken the first steps towards the creation and consolidation of an integrated system. Examples include Guatemala's Integrated Financial Management System (SIAF), Nicaragua's Integrated Financial Management and Auditing System (SIGFA) and Venezuela's Integrated Financial Management and Control System (SIGECOF).

F. CONCLUSIONS AND FINAL OBSERVATIONS

- Recurrent financing difficulties and the unsatisfactory results achieved in the area of the equity, efficiency, efficacy and quality of public expenditure in Latin America and the Caribbean over the past two decades underline just how important it is for these issues to be accorded higher priority on the political and technical agendas of the countries of the region. This state of affairs not only reflects a backlog of deficiencies built up over the past; it is also in line with international experience, which indicates that as countries develop, public expenditure tends to increase as a proportion of GDP, and that the ratio of subsidies and in particular transfers to total expenditure and hence to GDP also rises. Moreover, it is consonant with the long-standing trend towards relative growth in the service sector of the economy and the greater demand for the provision of safety nets to be observed in today's societies.
- In order to consolidate the expenditure side of public finances, it is necessary to: (i) control the causes of the high degree of budgetary rigidity affecting many central governments today; this entails, in essence but by no means exclusively, curbing the practice of earmarking sources of tax revenue for predetermined uses; (ii) make the budgetary process more transparent —especially in the implementation stage— in order to improve the ethical quality of actions that entail public spending and enhance the equity, efficacy and efficiency of their results; (iii) raise the productivity of expenditure through an efficiency drive to eliminate flagrant waste and inefficiencies and through programmes to evaluate management performance that can improve the efficiency, efficacy and quality of public services.
- It is important to foster the conditions necessary for countercyclical management of public expenditure, paying particular attention to the intertemporal sustainability of social spending in order to minimize the economic and social costs associated with excessive volatility in such spending. That, in turn, requires the design of mechanisms to stabilize public revenues. It is also important to promote the design and implementation of medium- and long-term spending programmes in areas considered vital to public welfare, such as social programmes.
- Efforts at implementing policies to improve the productivity of expenditure show promise, but remain inadequate. With respect to efficiency, it is necessary to push ahead with institutional and administrative modernization so as to eliminate, or at least reduce, glaring instances of unproductive and wasteful expenditure; institute and prioritize a culture of evaluation of substantive outcomes of public spending management in relation to compliance with standards and procedures; decentralize the

management and financing of subregional programmes and autonomous public agencies; put in place mechanisms for monitoring and follow-up of resource utilization; and minimize the costs associated with the political cycle by striving for greater consensus on national priorities.[40]

- Again in relation to the streamlining of expenditure, alternative methods for freeing up resources and reducing pressure on the fiscal accounts should be introduced. In point of fact, a number of countries have already made substantial progress in financing infrastructure projects by awarding concessions to private interests to build and operate roads, tunnels and bridges. In this connection, great care should be taken to assess the fiscal costs implicit in extending guarantees to the private sector, in order to prevent the immediate fiscal relief from turning into a fiscal nightmare in the future.[41] The delivery of social services is another area which offers potential for involving the private sector in investment. Again in this case, there is a need for a public regulatory framework capable of organizing and overseeing the private delivery of social services.[42]
- Military spending is one of the least studied areas of public expenditure, and also one of the most opaque in terms of information and evaluation. In order to increase the transparency of military spending and free up resources for other purposes, such as social expenditure, it is important to encourage debate and to adopt mechanisms for the design, management and evaluation of public military expenditure. This requires upgrading accounting procedures to identify the indirect costs, industry subsidies and debts that result from weapons spending.
- One problematic aspect of fiscal policy in various countries in the region is the budgetary rigidity of central governments. This situation not only makes it difficult to execute new government programmes in a satisfactory manner (as there is little room to incorporate them into the budget or to eliminate recurrent expenditure carried forward from previous fiscal years), it also hampers countercyclical fiscal management. Such management requires the flexibility to adjust the level of expenditure, but the above-mentioned budgetary rigidity prevents this. Of course, the more prevalent and intensive the practice of earmarking tax and non-tax sources of revenue to predetermined expenditure items, the greater the bias in favour of procyclical fiscal behaviour.
- In order to reduce budgetary rigidity, it is necessary not only to loosen the ties between sources of revenue and their present uses, but also to curb the practice of granting various types of tax breaks. There is generally little information available about the amount of resources the Government forgoes as a result of these types of mechanisms, but in all probability it is not negligible. One measure that would undoubtedly contribute to an assessment of the results of such policies would be for the authorities to supplement the annual budget proposal with reports estimating the level, origin and intended purpose of revenue that the Treasury chooses to forgo out of development or social equity considerations.

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[40] These topics are analysed in greater detail in chapter I of this document.

[41] For more information on this subject, see chapter IX.

[42] See chapter VI.

- Initiatives aimed at implementing integrated financial administration systems in the region should be seen not only as a rational way to manage flows of financial resources in a manner compatible with the goal of macroeconomic stabilization (and, in particular, that of improving efficiency in the management of government spending, making it akin to the financial management of a private company) but also as a highly desirable institutional step towards greater transparency and responsibility in the management of public resources. The importance of this aspect of the adoption of integrated systems by the countries of the region should not be underestimated, as it can be instrumental in improving and expanding the prospects for monitoring and evaluating public management.[43]

[43] See chapter X.

V. DEFICIT AND DEBT

A. INTRODUCTION

According to the information given in chapter I on trends in the central government deficit in 19 Latin American and Caribbean countries, during the first seven years of the present decade the excess of expenditure over income never exceeded 2% of annual GDP on average. Indeed, the annual average for the whole period corresponds to a deficit of only 1.2% of GDP, which represents considerable progress compared with the 1980s, when the public deficit, as a proportion of GDP, was as much as seven or eight times greater than it is now.

Furthermore, there is a general consensus that the "debt problem", which caused so much concern and suffering during the past decade, appears to have been under control since the launching of the Brady Plan in the late 1980s. There have also been a number of other positive developments since then, such as lower interest rates, lengthened maturities and renewed access by sovereign debtors to international markets.

The above results suggest that the Latin American and Caribbean region has achieved a sounder fiscal consolidation than that attained by the European economies over the same period, which explains the relative optimism displayed for some time past in studies of the present situation and future prospects of the public finances in the region.

That optimism must be tempered, however, by some reservations about aspects of fiscal conditions in the countries of the region which are not duly reflected in the conventional indicators on the deficit and the public debt. Thus, for example, in the 1990s quasi-fiscal activity has again taken on considerable importance in a number of Latin American and Caribbean economies, basically because of numerous serious episodes of bank crises in both the public and private sectors. This situation is not entirely new in the region, of course, and seems to derive from a combination of under-regulation and over-

protection of the banking sector, together with the frequent use of official banks in line with criteria which go beyond those justified by strictly technical considerations. This jeopardizes the consolidation of central government finances because of the high fiscal costs of bank rescue operations and the unusually long duration of these problems.[1]

Furthermore, the most frequently used indicators do not provide information on the effects that the different phases in the economic cycle may have on public-sector accounts. Thus, since it does not distinguish between structural and cyclical components, the usual manner of measuring the public deficit does not reveal whether a downward trend in the deficit as a proportion of GDP is mainly due to economic growth rates above the trend level or to the successful consolidation of government accounts.

In addition, the level of public debt may be unexpectedly affected by the need for the explicit recognition of liabilities associated with certain types of commitments not previously incorporated into public-sector accounts, either because of a lack of foresight (as, for example, when the State has given guarantees without making provision for them in the budget and those guarantees eventually come into effect) or because of relatively unforeseeable events (as, for example, when the courts hand down verdicts against the State which involve the payment of large indemnities to the private sector or when it becomes urgently necessary to readjust the salaries of public employees). In view of the frequency with which public liabilities not taken into account in the budget have accumulated in various countries of the region in the past, the possibility should be borne in mind that some debts whose existence was not evident to most economic agents may have to be made explicit in the future.

Finally, it should be noted that the information generally available for the study of the public sector significantly limits the reliability of evaluations and diagnoses made on the basis of isolated indicators. Consequently, the analysis of recent trends in public finances in the region should be tempered by the considerations set forth below.

B. THE FISCAL SITUATION

A global appraisal of public finances in the region indicates that very positive results have been achieved in recent years compared with the previous decade. This significant improvement in public finances (achieved within the context of substantial macroeconomic adjustment processes), however, conceals special features inherent to each country which are lost sight of in the aggregate result. Thus, analyses of the individual fiscal situations of

[1] As a result of the crisis which took place in the financial sector in Chile in 1982 and 1983, in 1985 the Central Bank purchased loan portfolios from private banks, subject to undertakings by the latter that they would buy these portfolios back within a given length of time. In 1989, Act No. 18,818 changed this obligation to buy back the portfolios by converting those portfolios into what was called "subordinated debt", the repayment of which was subject to the existence of surpluses in the banks concerned, without fixing any final deadline for their repayment. In 1996, however, agreement was reached between the Central Bank and some banks which had not yet completed the repayment of their subordinated debt, whereby the latter were given a maximum term of 40 years for its repayment. This shows how the after-effects of a banking crisis may last over half a century before they are completely overcome.

the countries and subregions of Latin America and the Caribbean reveal disparities not only as regards when fiscal reforms were initiated but also their content.

Although in the last five years a considerable number of countries of the region have shown clear signs of having achieved major fiscal adjustments (by increasing their income and/or reducing their expenditure), the results of their efforts have differed in terms of both the degree of adjustment achieved and the nature of the deficit itself (nominal or real, current or capital, present or future commitments, etc.), so that a comparative exercise based on different measurements of the deficit, with the aim of making a fuller evaluation of fiscal management, would not only bring out trends in regional finances more clearly, but also make it possible to appreciate the wealth and diversity of the different national experiences (see box V-1).

Box V-1

CLASSIFICATION OF COUNTRIES BASED ON MEASUREMENTS OF THE DEFICIT AND FISCAL PERFORMANCE

Fiscal performance is classified by breaking down the results for each of various deficit "yardsticks" into different brackets. This makes it possible to group the countries according to their performance with respect to each form of measurement. The traditional deficit indicators (borrowing requirements, primary deficit and current saving) were used for this purpose, since they are available for most of the countries of the region.

FEATURES OF FISCAL PERFORMANCE

INDICATORS	**LEVELS (% of GDP)**		
	Over 3%	**Between 1% and 3%**	**Less than 1%**
BORROWING REQUIREMENTS (Total expenditure - total income)	Serious fiscal imbalance (heavy financial impact on the economy)	Moderate fiscal imbalance	Minimal fiscal imbalance
CURRENT SAVING (Current income -current expenditure)	Major fiscal adjustment needed to sustain the capital account	Moderate fiscal adjustment	Minimal fiscal adjustment
	Over 1%	**Between 0% and 1%**	**Less than 0%**
PRIMARY DEFICIT (Borrowing requirements - interest payments)	High percentage of borrowing requirements accounted for by current commitments	Moderate adjustment in real government operations	Major fiscal adjustment to cover part of inherited component

Three definitions of the deficit may be distinguished for this purpose: (i) the *borrowing requirements* (BR), understood as the difference between total income and total expenditure; (ii) the *primary deficit* (PD), which excludes interest payments from the preceding definition; and (iii) *current saving* (CS), which only takes into account net current income and expenditure.[2] In some countries, other indicators are used, such as the *operating deficit*, which makes it possible to take into account the impact of inflation on the interest payments due on the debt (see boxes V-2 and V-3), and also some other forms of adjustment of the traditional indicators (for example, adjustment for economic cycles). Although these latter indicators are excluded from the present study because they are not available for the majority of the countries of the region, it is worth bearing in mind that these supplementary measurements would help to give a better idea of the fiscal status of each particular country.

It should be noted that comparison of the three traditional definitions calls for the separation of the inherited component of the deficit from the non-inherited component in order to shed more light on the differences and similarities between national adjustment strategies.[3] One way of determining the inherited component is on the basis of the *interest payment commitments* that the current Administration must meet, which will be described in conjunction with the three indicators already mentioned. Adjustments which are based on a reduction of the difference between the non-inherited components, without taking much account of the inherited component (adjustment of the primary deficit, but probable future problems with current saving and borrowing requirements), are naturally very different from those which, in an effort to reduce the gap between income and expenditure (non-inherited components), have also focused on the inherited component (adjustments in the primary deficit and current saving, reflected in borowing requirements).

1. Borrowing requirements (BR)

Measurements of the deficit according to the difference between total income and total expenditure (see figure V-1) show that the adjustment processes of the countries of the region are tending to result in generally lower overall deficits. Thus, whereas in 1989-1990 only nine of the 19 countries studied had borrowing requirements equivalent to less than 3% of GDP, in 1995-1996, 15 countries were in that position.

[2] For the comparative analysis, the fiscal status of the countries was determined at the central government level. The countries of the region were ranked according to brackets established for each fiscal indicator (borrowing requirements, primary deficit, current saving and interest payments) in rising percentage order (except in the case of current saving), so that an increase in the bracket for each indicator corresponds to a deterioration in the fiscal situation.

[3] In this study, the inherited component of the deficit means those outlays which have to be made in respect of commitments "inherited" from past Administrations, including interest payments.

Box V-2

THE EXPERIENCE OF COLOMBIA, 1990-1997

Different forms of measurement of the public deficit can lead to differing conclusions on the state of the public finances. As there is no single form of measurement which sums up all the relevant information, it is necessary to choose one or another form according to the purposes of the analysis. The following table gives a set of indicators which show the fiscal situation of Colombia in recent years:

COLOMBIA: SELECTED FISCAL INDICATORS (CENTRAL GOVERNMENT)

(As a percentage of GDP)

Year	Financing requirements[a]	Current deficit	Primary deficit	Operating deficit	Interest payments
1990	0.68	1.34	-0.60	-1.43	1.30
1991	-0.44	2.78	-1.74	-1.41	1.40
1992	-0.16	2.53	-1.25	-0.81	1.22
1993	0.32	1.90	-0.73	-0.40	1.33
1994	1.38	0.93	0.25	0.10	1.35
1995	2.41	-0.03	1.19	1.54	1.41
1996	3.73	-1.12	1.95	2.66	2.11
1997[b]	3.98	-1.05	2.05	2.92	2.28

[a] Real deficit (including privatization operations) used as form of measurement. [b] Preliminary figures.

In the case of Colombia, the most traditional (and most widely used) measurement of the deficit has been the ***real deficit*** (or net deficit), which measures the global financing needs of the government (total deficit), but separates the operations of the national government proper from those which it carries out with other public agencies for economic policy reasons. It may be noted that in recent years this indicator has grown to alarming levels (over 3% of GDP). This indicator does not of itself tell us much about the reasons for fiscal problems. A more appropriate manner of analysing this behaviour shows that in recent years there has also been rapid growth in ***interest payments on the debt***, which rose from 1.3% of GDP in 1990 to 2.3% in 1997. This explains a large part of the deterioration in the government fiscal balance and, particularly, the marked reversal in the behaviour of ***current saving***, which has steadily deteriorated from a surplus of 1.3% of GDP in 1990 to a deficit of -1.1% of GDP in 1997.

It should be noted, however, that the pessimistic picture given by these indicators is not entirely correct, because they overestimate the real deterioration in the Colombian government finances. Thus, both the change in the profile of the public debt (in which domestic indebtedness at market interest rates now predominates) and the high cost of the inflationary component included in interest payments on the domestic debt suggest that we should look for indicators which define this situation more accurately.

Since interest payments on not, strictly speaking, a discretional outlay and, moreover, they reflect commitments assumed in previous budget exercises, the effect of interest payments on the real deficit may be discounted, thus giving us the ***primary deficit***. This form of measurement of the deficit shows how current commitments affect the financing requirements and is a more accurate reflection of the operations carried out by the central government proper. As may be seen from the table, although the primary deficit has steadily deteriorated since 1994, it only accounts for some 50% of the real deficit, and the gap has begun to widen in recent years as interest payments absorb a growing proportion of total government outlays. This form of measurement allows us to appreciate more clearly the efforts made to adjust current expenditure and brings out the fact that in Colombia not only are current commitments increasingly large, but the dynamics of interest payments on the public debt are determining much of the evolution of the fiscal deficit.

Other authors have suggested that the nominal impact of interest payments on the deficit should be separated out. The idea is to identify that part of interest payments which corresponds to the financial performance needed to make up for the loss of value of money through inflation. This inflationary component of interest payments distorts the magnitude of the deficit at times of high or moderate inflation. A more suitable form of measurement would therefore be the ***operating deficit***, which eliminates the inflationary component of interest payments from the real deficit. In line with this indicator, and also in line with the primary deficit, the "real" financing requirements of the government would be lower than is usually estimated, although not as optimistic as those shown by the primary deficit.

These four indicators show that, on the one hand, the total government deficit (and current dissaving) continue to register high and rising levels, which is largely explained by the growth in interest payments, while at the same time the primary and operating deficit indicators also display relatively high and rising levels, thus calling for redoubled efforts to consolidate the adjustment in the central government finances initiated in recent years.

Source: Consejo Superior de Política Fiscal (CONFIS) of Colombia and J.A. Ocampo, "Una evaluación de la situación fiscal colombiana", *Coyuntura económica*, vol. 27, No. 2. Bogotá, June 1997.

Box V-3

THE BRAZILIAN EXPERIENCE

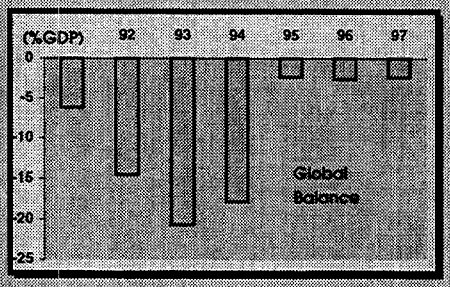
In the case of the central government of Brazil, it is likewise necessary to take various indicators into account in order to make a proper diagnosis of the evolution of the public accounts, since the analysis of only one series of data on the fiscal deficit could lead to a distorted view of the real state of the government finances.

The ***global fiscal balance*** shows the nominal financing requirements and is therefore very sensitive to the current rate of inflation. As may be seen from the following bar chart, just after the Plano Real succeeded in 1994 in bringing the inflation of the previous years under control, this balance registered a spectacular drop and subsequently remained almost unchanged from 1995 to 1997. Since this indicator is not the most appropriate one for measuring the pressure that the public sector exerts on the demand for goods and services, however, its values need to be corrected by eliminating the monetary correction of public securities, on the assumption that the marginal propensity of public debt holders to consume the principal is equal to zero. This gives us the ***operating balance***, which shows an improvement in the central government accounts during the period 1992-1994 (possibly as a result of the efforts of the authorities to check hyperinflation) but also reflects a significant deterioration in the public finances immediately after the Plano Real (attributable basically to pension system liabilities, the public sector payroll and real interest payments). This deterioration in the fiscal accounts is also observed in the evolution of the ***primary balance***, which illustrates the degree of commitment of the economic authorities to the attainment of fiscal balance in each year, since it is obtained by comparing income with expenditure (net of interest payments). The difference between the operating and primary balances reflects ***real interest payments***, which in this case went down between 1995 and 1997 (but are likely to increase in the immediate future as a result of the policy of high real interest rates being applied by the Central Bank in order to defend the national currency from speculative attacks deriving from the Asian crisis).

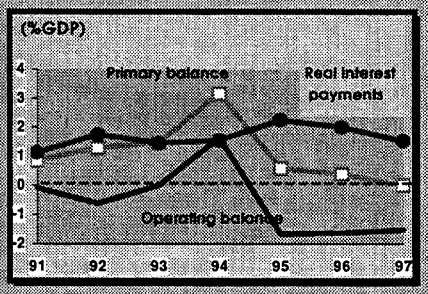
Thus, since 1994 there has been a significant improvement in the global fiscal balance -which has been below 3% of GDP in recent years— as a result of the control of hyperinflation. Although real interest payments have fallen over the same period, this progress is not reflected in the other two indicators, since both the primary balance and the operating balance have deteriorated by over 3% of GDP. This means that much of that fiscal improvement is the result of a noteworthy effort centred on reduction of the inherited component rather than on the current operations of Government.

BRAZIL: INDICATORS OF THE CENTRAL GOVERNMENT FISCAL SITUATION, 1990-1997*

% GDP



% GDP



Source: Banco Central do Brasil, *Boletin estadístico*, Brasilia, 1997.

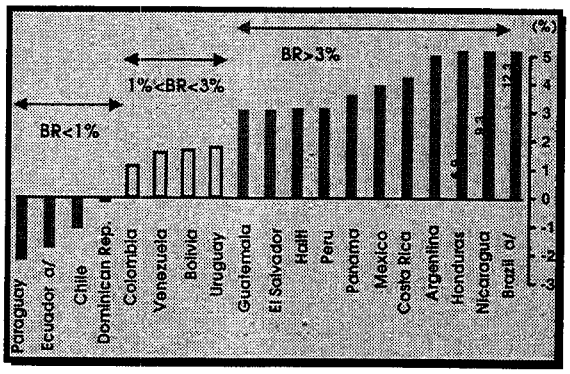
* The series presented here correspond to twelve-month movements, as a percentage of GDP, in the December prices of each year. The figures for 1995, 1996 and 1997 are preliminary estimates.

Figure V-1

LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): CENTRAL GOVERNMENT BORROWING REQUIREMENTS

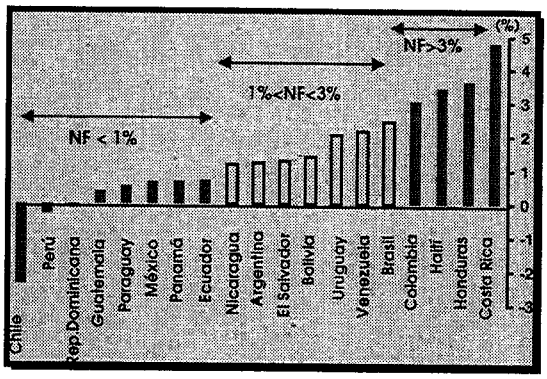
(As a percentage of GDP)

1.a 1989-1990



Source: ECLAC, on the basis of official figures.

1.b 1995-1996



Source: ECLAC, on the basis of official figures.

The biggest efforts have been made in those countries which had severe fiscal imbalances (over 3% of GDP) in 1989-1990, since in most of those cases the deficits have now fallen below that level, the only exceptions being Haiti, Costa Rica and Honduras.

The relative positions of the countries with borrowing requirements under 3% of GDP in 1989-1990 (moderate or minimal fiscal imbalance) have varied less than those of the group that is in a critical situation. The figures confirm that the countries do not have a propensity to maintain surpluses, however, because the bulk of the countries which were in this position in the early 1990s registered moderate deficits in the 1995-1996 period. This suggests that for most Governments the fiscal adjustment is only profitable up to a certain point.

2. The primary deficit (PD)

Changes in the primary deficit reflect the countries' efforts to adjust their income and expenditure, excluding from the latter the interest payments on the debt "inherited" from previous periods.

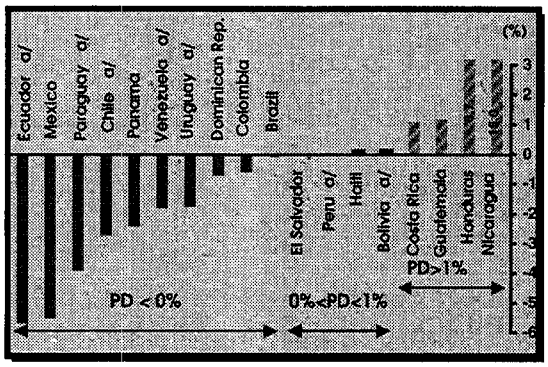
In order to get a proper idea of the results of this indicator, figures V-1 and V-2 may be viewed together. If this is done, it will be noted that most countries have moved from deficit to surplus positions in this respect, which reflects a clear concern for minimizing the incidence of current commitments. This improvement in the fiscal situation has not been accompanied in all cases by progress in respect of the inherited component, however.

Among the countries which have managed to keep up the adjustment without necessarily focusing their efforts on the inherited component are Chile, Ecuador, Bolivia and, to a lesser extent, Brazil. The other cases are countries which have reached moderate

levels of adjustment by taking action on the inherited component or have not undertaken such an adjustment but have nevertheless kept their primary deficit below 1%. Finally, countries such as Honduras and Costa Rica show a considerable improvement in their deficits if interest payments are excluded, which means that the "Achilles heel" of their economies is connected with their level of indebtedness, which implies substantial future commitments.

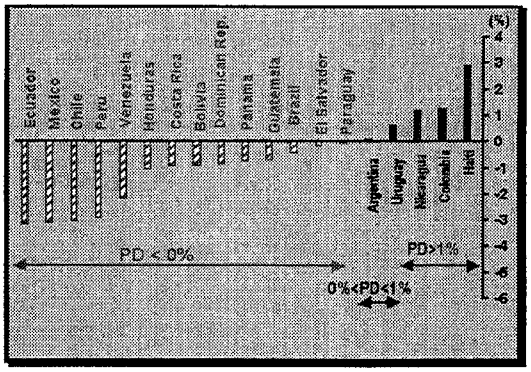
Figure V-2
LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): CENTRAL GOVERNMENT PRIMARY DEFICIT
(As a percentage of GDP)

2.a 1989-1990



Source: ECLAC, on the basis of official figures.

2.b 1995-1996



Source: ECLAC, on the basis of official figures.

3. Current saving (CS)

This measurement of the deficit makes it easy to see whether a country's house is in order or not. As in the case of a family's finances, a negative level of current saving suggests that the public sector is borrowing to finance current consumption.[4] In contrast, when this indicator registers positive values, this attests to the Government's capacity for financing the capital account without the need for credit.

The great majority of the countries for which information is available display a considerable improvement in their position between 1989-1990 and 1995-1996 (see figure V-3). This is shown by the greater concentration of the countries away from the "minimal fiscal adjustment" group into the "moderate fiscal adjustment" group. This trend shows that, once again, the best results have been obtained by the countries which had the biggest fiscal imbalances, and also that there has been more concern to generate their own resources to finance part of the capital account.

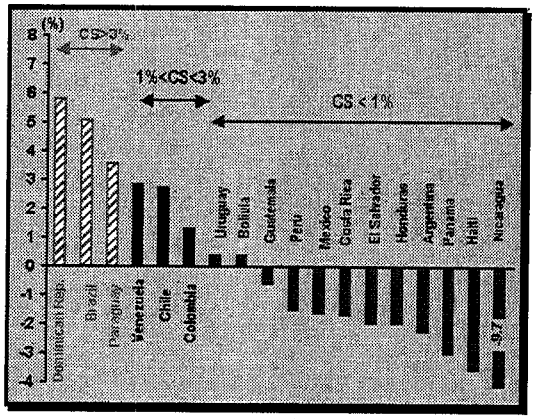
[4] Thus, a conventional 'golden rule' for proper management of public finances is that Governments should only borrow to finance investment (in physical or human capital). This rule actually forms part of the Constitution in Germany (although the financing of reunification was treated as a special case).

Figure V-3

LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): CENTRAL GOVERNMENT CURRENT SAVING

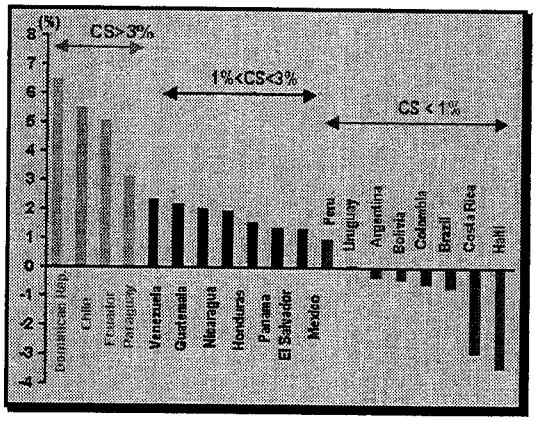
(As a percentage of GDP)

3.a 1989-1990



Source: ECLAC, on the basis of official figures.

3.b 1995-1996



Source: ECLAC, on the basis of official figures.

Thus, countries like Chile, which had begun their adjustment processes before the beginning of the present decade, have maintained and even improved their surplus position with regard to saving. There have also been improvements in the Central American countries (Guatemala, Honduras, Panama, El Salvador and Nicaragua), which had substantial capital account deficits at the beginning of the decade. Some South American countries, such as Argentina, Brazil and Colombia, however, together with Haiti and Costa Rica, have not managed to balance their current income and expenditure, which restricts the availability of their own resources for long-term growth.

4. Interest payments (IP)

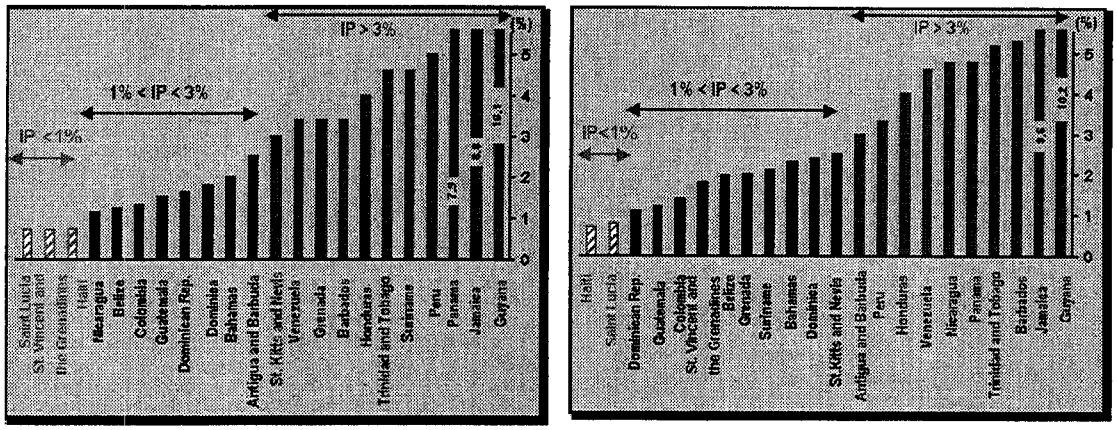
On average, interest payments by the Governments of the region on their domestic and external debt have gone down over the last five years (although not as markedly as the level of the deficit). Thus, as a percentage of GDP, total interest payments went down from 3.5% to only 2.9%, according to the available figures for 22 Latin American and Caribbean countries.[5] In spite of this reduction, however, interest payments continue to be high, thereby keeping alive the threat of future crises of insolvency.

In order to make a more detailed analysis of central government interest payment commitments, the countries were grouped together in the same way as in the case of the previous indicators (see figure V-4). Thus, three main groups may be distinguished, in terms of the level of interest payments as a percentage of GDP:

[5] In the 12 countries for which information is available on the non-financial public sector, interest payments on the total debt remained at around 3.5% of GDP over the period 1990-1995.

Figure V-4
LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): INTEREST PAYMENTS BY THE CENTRAL GOVERNMENT
(As a percentage of GDP)

4.a 1990 **4.b 1995**



Source: Prepared on the basis of IMF *Country Reports.*

(i) High level: payments over 3%
(ii) Middle level: payments between 1% and 3%
(iii) Low level: payments under 1%.

In line with this criterion, when comparing the years 1990 and 1995 it may be noted that there is no major change in the composition of the groups for the region as a whole. There is a slight tendency towards greater concentration in the middle-level group, which increased from 8 to 10 countries, but with very few exceptions the countries of the region remained in the same interest payment brackets as at the beginning of the decade.[6]

With regard to the high-payments group, it may be noted that although it consisted of almost exactly the same countries in both 1990 and 1995, the group's total interest payments went down from 5% of GDP in 1990 to 3.7% in 1995, which represents a considerable improvement, even though this proportion is still high enough to be a source of concern. This fits in with the observation made in the previous section that the Governments facing the biggest fiscal problems (in this case a large inherited component) were those which made the biggest adjustments.

[6] Major changes to be noted include the following: Suriname moved from the high to the high to the mid-level category; Nicaragua moved from the mid- to high-level category; and Saint Vincent and the Grenadines moved from the low to the mid-level category.

An overall appraisal of these results shows moderate improvements in the fiscal position in the course of the decade, especially with regard to borrowing requirements. This is due to the fact that in spite of the growing adjustment in the primary deficit indicators and even more so in the current account —particularly in the countries which started the present decade with the biggest deficits— there has been less concern in a number of countries with efforts to control the inherited component (interest payments).

C. FISCAL POLICIES, AUTOMATIC STABILIZERS AND INDICATORS OF DISCRETIONALITY

In September 1949, 16 distinguished economists from such different schools of thought as those represented by John K. Galbraith, Paul Samuelson and Jacob Viner, to name only three, published the 'Princeton Manifesto', in which they unanimously called for the design of macro-fiscal policies based on the idea of budgetary flexibility as incorporated into automatic stabilization mechanisms. From this standpoint, the contribution of budgetary policy to the task of stabilization is limited to what can be achieved within the bounds of: (i) marginal budgetary balances (i.e., all additional expenditure must be financed with fresh budgetary resources; and (ii) the deficits and surpluses automatically generated by fluctuations in the level of national income (corrected by discretional changes in exceptional cases, but only when this is warranted by the seriousness of the circumstances).[7] This was doubtless a post-war over-reaction to the vogue enjoyed for some years past —under the leadership of John Maynard Keynes and Richard Musgrave— by the compensatory functions of fiscal policy and public finances in general. It can thus be seen that the tension between automatic stabilizers and discretional budgetary changes is a more particular case of the traditional trade-off between rules and discretionality.

In principle, fiscal management in the Latin American economies seems to have decidedly favoured various types of discretional changes. Over the last two decades, the adoption of this management style has clearly been due to the need to reduce the deficit and bring the public debt down to manageable levels and trends. Although automatic stabilization mechanisms have also been present in fiscal policy formulation and design in the economies of the region, they are markedly less frequent and important.

By concentrating fiscal policy management on the aim of balancing public income and expenditure, the Governments of the region have left the handling of the other components of aggregate demand to monetary policy, which, however, already has its hands full with its responsibilities in connection with managing the liquidity of the system (in order to ensure price stability) and defending the exchange rate (a task which is considerably more complex when there are sharp fluctuations in capital flows). At all events, when fiscal policy seeks to 'lend a hand' to the monetary authorities and/or to 'make up' for the phases of the economic cycle, the results obtained with respect to the deficit are influenced by both permanent and transitory factors.

Traditionally, the tendency has been to evaluate the effects of fiscal policy directly, through the budget balance, so that when the public deficit increases (or the surplus goes down) fiscal policy is seen as expansionary or, in the opposite case, contractive. This

[7] Heller (1957).

interpretation is somewhat of an over-simplification, however, as public-sector accounts depend both on decisions by the public authorities and on factors beyond their direct control. The gross budget balance is an ambiguous indicator of the fiscal approach or the position taken in government policies. The problem is how to separate budgetary and tax operations into a discretionary component, on the one hand, which reflects the deliberate dimension of State action, and, on the other, into a cyclical component which reflects the effects of conjunctural factors on the budget. It is therefore a question of establishing indicators of discretionality which make it possible to distinguish the exogenous or endogenous origin of the budget balance.

This section seeks to put forward and analyse some simple indicators which make possible an appraisal of recent fiscal policy in Latin America and the Caribbean.

1. Fiscal discretionality

In periods of expansion, public income grows rapidly and the outlays connected with unemployment tend to go down, thus temporarily easing the difficulties involved in the management of public finances. At times of recession, in contrast, the low level of activity adversely affects the budgetary balance, through both lower tax revenues and higher outlays in certain fields, such as social benefits in general and employment promotion and aid for the unemployed, in particular. The types of public income and expenditure whose evolution is linked to the economic cycle are termed automatic stabilizers. Their importance varies from one country to another, depending on the size of the public sector, the progressiveness of the tax system, the sensitivity of the tax bases to fluctuations in economic activity, the nature of the unemployment benefits that exist, and the extent to which unemployment reflects variations in GDP.

The distinction between discretionary and automatic actions is no trivial matter, since in essence all public income or expenditure is discretionary, in that it corresponds to decisions by the public authorities. Consequently, the concept of discretionality is necessarily relative, it has a time the dimension, and it represents a field of inquiry which is not subject to factual analysis. The identification of fiscal neutrality or discretionality therefore depends on the analyst's own definitions.

In a narrow definition, it is a matter of seeking fiscal policy indicators which are independent of the economic cycle. This is the methodology used by the Organisation for Economic Co-operation and Development (OECD),[8] according to which the deficit can be broken down into a cyclical component and a structural component. A variation in public income or expenditure is of a cyclical nature when it depends on the difference between the actual product and the trend product.

In a broader conception, it is possible to design fiscal policy indicators which separate out all the automatic components of the deficit: that is to say, those components which are beyond the control of the authorities in the short term. In such a context, a variation in public-sector income or expenditure is automatic when it is due to factors endogenous to the economic model and exogenous to the public sector. In other words, it is a question of the variations in the budget components which are sensitive to the influence of

[8] Giorno, Roseveare and van de Noord (1995). The methodology used by the IMF emphasizes the concept of fiscal neutrality (Chand, 1992).

economic aggregates. Conversely, when the variations correspond to decisions by the public authorities, they may be considered as discretionary.

Among the main macroeconomic variables influencing public income and expenditure are GDP, the unemployment rate, the rate of inflation, the real exchange rate, raw material prices, and domestic and international interest rates. The mechanical effects go beyond such variables, however: the automatic deficit may also be defined as the variations in income and expenditure deriving from existing legal provisions. This means, for example, that variations in the budget due to wage settlements with public officials (including any indexing provisions they may contain) may be considered as automatic variations. Thus, in the OECD definition referred to earlier, the impact in terms of the deficit generated by inflation, variations in interest rates and variations in raw material prices are considered as discretionary. This is doubtless due to the lesser relative importance of these factors in the developed countries.

2. Main results

In the OECD countries, the cyclical balance has fluctuated on average between 0.8% and -0.5% of GDP during the period 1985-1996, although it has reached maximum levels of 2.6% in the United Kingdom and 1.4% in Japan, as well as minimum levels of -2% in Canada and -1.8% in France.[9] Table V-1 shows that the application of this method to the Latin American countries reveals a highly significant cyclical component of the deficit in the 1990s, with fluctuations of between -1% of GDP in Argentina (1996) and Brazil (1992) and +1% in Argentina and Peru (1994). As already noted, the methodology adopted tends to underestimate the cyclical component. If taxes are assumed to have an income-elasticity equal to unity for all countries, then the relative importance of the cyclical deficit depends on only two factors: (i) the gap between effective and potential GDP, that is to say, the distance between the effective growth of the economy and its medium-term trend; and (ii) the weight of taxes —whose collection is directly linked to the level of activity— in total public income.

Obviously, in the countries with the biggest fluctuations the cyclical component has greater weight. In decreasing order, this was so in the cases of Peru (with a standard deviation of 0.062 in the 1990s), Argentina (0.05), Venezuela (0.047), Mexico (0.042) and Brazil (0.037). In the more stable countries, in contrast, the cycle of the level of activity has less influence on public accounts. This has been the case in the 1990s in Paraguay (standard deviation of 0.011), Bolivia (0.012), Colombia (0.016), Ecuador (0.017) and Chile (0.024).

The second determining element is the weight of tax revenue in total public-sector resources. In some countries, this weight is very significant (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 tax revenue is not so important (23% in Venezuela, 29% in Ecuador and 30% in Bolivia).

[9] Giorno and Suycker (1997).

Table V-1

LATIN AMERICA (SELECTED COUNTRIES): BREAKDOWN OF FISCAL BALANCE, 1990-1996

(As percentages of GDP)

COUNTRY	BALANCE	1990	1991	1992	1993	1994	1995	1996
Argentina	Observed	-3.8	-1.6	-0.1	1.4	-0.2	-0.6	-1.9
(NPS)	Structural	-3.1	-1.5	-0.7	0.6	-1.5	0.1	-1.1
	Cyclical	-0.7	-1.0	0.6	0.8	1.3	-0.7	-0.8
Bolivia	Observed	-4.5	-4.3	-4.4	-6.1	-3.0	-2.0	-1.9
(NFPS)	Structural	-4.5	-4.4	-4.3	-6.0	-3.0	-2.0	-1.9
	Cyclical	0.0	0.1	-0.1	-0.1	0.0	0.0	0.0
Brazil	Observed	1.4	-0.2	-1.8	-0.8	1.1	-4.9	-3.9
(NFPS)	Structural	0.8	-0.3	-1.1	-0.4	1.0	-5.2	-4.2
	Cyclical	0.6	0.1	0.7	-0.4	0.1	0.3	0.3
Chile	Observed	0.8	1.5	2.2	1.9	1.7	2.5	2.2
(CG)	Structural	1.0	1.7	1.8	1.6	2.1	2.6	2.4
	Cyclical	-0.2	-0.2	0.4	0.3	-0.4	-0.1	-0.2
Colombia	Observed	-0.5	0.0	-0.1	0.3	2.6	-0.5	-1.1
(NFPS)	Structural	-0.8	0.2	0.2	0.6	2.5	-0.8	-1.1
	Cyclical	0.3	-0.2	-0.3	-0.3	0.1	0.3	0.0
Costa Rica	Observed	-2.5	-0.1	0.7	0.6	-6.6	-2.0	-2.7
(NFPS)	Structural	-2.4	0.3	0.6	0.2	-7.0	-2.1	-2.1
	Cyclical	-0.1	-0.4	0.1	0.4	0.4	0.1	-0.6
Ecuador	Observed	0.1	-1.0	-1.7	-0.4	-0.2	-1.5	-3.1
(NFPS)	Structural	0.2	-1.0	-1.8	-0.4	-0.3	-1.5	-3.0
	Cyclical	-0.1	0.0	0.1	0.0	0.1	0.0	-0.1
Mexico	Observed	-2.8	3.5	4.8	0.8	-0.7	-0.8	-0.5
(CG)	Structural	-2.5	3.5	4.6	0.6	-1.3	-0.4	-0.4
	Cyclical	-0.3	0.0	0.2	0.2	0.6	-0.4	-0.1
Paraguay	Observed	5.2	2.9	0.1	1.2	2.4	0.0	0.0
(NFPS)	Structural	5.1	2.9	0.2	1.2	2.4	-0.1	0.0
	Cyclical	0.1	0.0	0.1	0.0	0.0	0.1	0.0
Peru	Observed	-2.1	-1.4	-1.5	-2.3	1.8	-1.6	2.2
(CG)	Structural	-2.4	-1.5	-1.0	-1.7	1.6	-2.1	2.2
	Cyclical	0.3	0.1	-0.5	-0.6	0.2	0.5	0.0
Uruguay	Observed	0.3	1.3	1.5	-0.8	-2.5	-1.3	-1.2
(NFPS)	Structural	0.5	1.6	1.2	-1.0	-3.3	-0.8	-0.9
	Cyclical	-0.2	0.3	0.3	0.2	0.8	-0.5	-0.3
Venezuela	Observed	0.1	-2.2	-5.9	-1.3	-13.8	-5.9	7.5
(NFPS)	Structural	0.4	-2.3	-6.2	-1.6	-13.7	-5.9	7.9
	Cyclical	-0.3	-0.1	0.3	0.3	-0.1	0.0	-0.4

Source: Ricardo Martner, Políticas fiscales, estabilizadores automáticos e indicadores de discrecionalidad en América Latina (LC/IP/R.199), Santiago, Chile, Latin American and Caribbean Institute for Economic and Social Planning (ILPES), 1997.

NPS = National public sector

NFPS = Non-financial public sector

CG = Central Government.

If we combine the two elements, then Argentina, Peru, Brazil, Chile, Colombia, Costa Rica, Mexico and Uruguay are the countries where the influence of the economic cycle is of fundamental importance for evaluating public accounts. In Bolivia, Paraguay and Ecuador, in contrast, the cyclical component is no more than 0.1% of GDP. In Venezuela, this component has only amounted to 0.4% of GDP in the 1990s, in spite of sharp fluctuations in the level of activity and the public sector's balance sheet. This is because of the decisive influence of variations in oil prices and the bail-outs provided for the financial system.

In some cases, this way of breaking down public accounts leads to radically different interpretations of their results. In general terms, the cyclical component is seen as an important factor in the improvement in public accounts in the early 1990s. In many countries, the reactivation of the economy at rates above medium-term trend levels have led to positive fiscal results which have, however, been based partly on transitory resources. Consequently, it is of fundamental importance to identify a sustainable medium-term trend and formulate fiscal policy in accordance with the ongoing results generated when the economy is on its trend path.

In some situations, the deterioration of public accounts may also be due to transitory factors of a cyclical nature, rather than to deliberate actions by the authorities. In Argentina, for example, the effective deficit in 1995 was 0.6% of GDP, but because of the seriousness of the crisis (the product fell by 4.6%), the available estimates indicate that the whole of the deficit may be attributable to cyclical factors and that, in fact, a slight discretionary surplus was even obtained. In this case, the cyclical perspective conceals a structural effort to improve public accounts.

Thus, the standard for the evaluation of fiscal policy management should not be the deficit, but its discretionary component. Programming income and expenditure as a function of a targeted discretionary deficit would make it possible to manage public finances in a more far-sighted way, thus avoiding the continual vagaries of the budget formulation process. In economies as unstable as those of the region, the public sector must not become an amplifier for short-term fluctuations. In the event of recession, for example, the public sector should accept a certain cyclical deficit in order to avoid making the crisis still worse.[10] If it is not desired that fiscal policy should become an instrument for the propagation and amplification of macroeconomic disturbances, then medium-term budgetary rules should be designed to control the discretionary or permanent component of the deficit.

[10] In highly unstable economies such as those of Latin America, which suffer from periodic financing constraints and difficulties in establishing active fiscal policies (partly because heavy doses of fiscal discretionality have given rise to equally strong budgetary rigidities), it seems desirable to adopt some public expenditure rules which would make it possible to sustain their growth (through borrowing) when the economy is in the lower part of the cycle and to reduce public borrowing when it is in the upper part. In normal conditions, it would be prudent to let expenditure grow at the same rate as the trend GDP. This means seeking compensatory mechanisms (such as stabilization funds) which make it possible to save transitory income in periods of growth and then use it later to stabilize expenditure in times of crisis. This matter is dealt with in greater detail in chapter IV.

D. PUBLIC INDEBTEDNESS

Under ideal theoretical conditions, the variation in the public debt during a given budgetary exercise should coincide with the public deficit approved by the legislature.[11]

Variations in the public debt may ultimately result in a figure significantly different from that approved by the legislature, however, for various reasons which make it easy to understand why transparency in fiscal matters is an objective that is quite hard to achieve. The most usual reason is, of course, the existence of quasi-fiscal activity, as noted in chapter II. Such activity generally hinders the timely identification, estimation and registration of such values as the following: (i) the deficits of State agencies which control extrabudgetary resources and can therefore refinance their debts without these appearing in the central records; (ii) the total fiscal benefits involved in tax exemptions; (iii) public guarantees which are granted to the private sector and eventually have to be paid; (iv) transfers for the the purpose of bailing out financial institutions with solvency problems; (v) outlays in respect of the recognition of debts not previously provided for (such as the payment of material reparations to the families of political prisoners who have disappeared without trace or the payment of other types of moral or social debts owed to underprivileged groups in society such as pensioners).[12]

In addition to the foregoing, there are unforeseen events, such as the Asian crisis and other external or internal shocks, which eventually force lines of policy that were not anticipated and that can significantly affect the level of public indebtedness. Thus, for example, the adoption of a temporary policy of high interest rates (to defend international reserves from speculative attacks on the local currency) or the application of a steep devaluation (to offset the loss of competitiveness of the export sector) are unforeseen courses of action which obviously affect the level of public indebtedness.

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[11] This interpretation requires the fulfilment of numerous theoretical conditions. It assumes, for example, that the budget is unitary and universal and that the entire public debt is denominated in the local currency. In practice, none of these requisites is satisfied in full, so that the effective borrowing requirements of the public sector are often greater than the deficit approved by the legislature. In such a case, the variation in the public debt will exceed the deficit agreed for the period. Naturally, the total variation (registered or unregistered) in the net public debt is equal to the *ex-post* deficit (wholly or partly recognized in public accounts), adjusted in accordance with the effects of the exchange rate on the value of the external debt.

[12] The explicit recognition of previously implicit debts is usually likened to the idea of "taking skeletons out of the closet" and exposing them to the light of public opinion. Thus, for example, in Argentina the State had to pay (in accordance with legal decisions) the debt which it owed to pensioners in respect of pension readjustments which had fallen due but had not been paid. As the Government did not have the necessary resources, it had to give bonds to the beneficiaries, so that in 1993 the domestic public debt increased by some US$ 10 billion (since other unpaid obligations owed by the State, especially to suppliers, were also paid in the same manner). In 1997 it was reported that the previously unregistered debt would amount to some US$ 8 billion (in respect of compensation to the families of political prisoners who disappeared during the military regime, repayments of VAT for exports, and payments on behalf of INDER and PAMI, etc.).

In the 1980s, the countries of the region were in a difficult fiscal position, with high deficits and severely restricted access to external financial resources. These severe imbalances were the result of a combination of external shocks (such as the abrupt rise in international interest rates between 1981 and 1982 or the deterioration in the terms of trade in 1979 due to the rise in oil prices and the subsequent international recession) with steep devaluations (adopted in order to boost exports and thus obtain the foreign exchange needed to comply with external obligations) and the crisis in the financial sector (which obliged the authorities to assume a very considerable portion of the liabilities of the banking system). In the late 1980s and early 1990s, fiscal adjustment programmes made it possible to reduce the deficits and contribute to economic recovery. This improvement in public finances was also aided by the renegotiation of the external debt under the terms of the Brady Plan in 1989, which made possible a significant reduction in its size.

Thus, the public debt went down considerably as a proportion of GDP as from the late 1980s, thanks to the reduction in the external debt under the terms of the Brady Plan and the negotiations with the Paris Club and bilateral sources. Other factors in this reduction were the growth of GDP in almost all the countries of the region and the generalized fall in real interest rates. As a result of this combination of factors, the debt/GDP ratio went down from an average of 50% in 1988 to 30% in 1992, though it has not improved further since then. However, these averages conceal big differences between countries and significant increases in some cases, so that it is necessary to identify the external and internal components of the debt in a more appropriate manner.

1. The external public debt

Table V-2 and figure V-5 afford some idea of the external public debt position of the countries of the region. For purposes of analysis, the 26 countries for which information was available were classified in two groups: group A, consisting of those which reduced their external public debt as a proportion of total external indebtedness between 1980 and 1995, and group B, consisting of the remaining countries (i.e., those which increased their external public indebtedness).

The interpretation which holds that the external debt crisis of the 1980s was of a fiscal nature is based on the following considerations:

(i) On the eve of the outbreak of the external debt crisis in 1982, the liabilities of the public sectors of the economies of the region accounted for a very high percentage of the total external debt (around 65%, as may be seen from table V-2);

(ii) For various reasons, the public sector gradually increased its share of the total external debt between 1982 and 1989, as it assumed responsibility for private liabilities denominated in foreign currency in response to the preferences of a private sector which was averse to exchange rate risk (see the evolution of the debt up to 1989 in figure V-5);

Table V-2

LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): COEFFICIENTS OF EXTERNAL PUBLIC INDEBTEDNESS

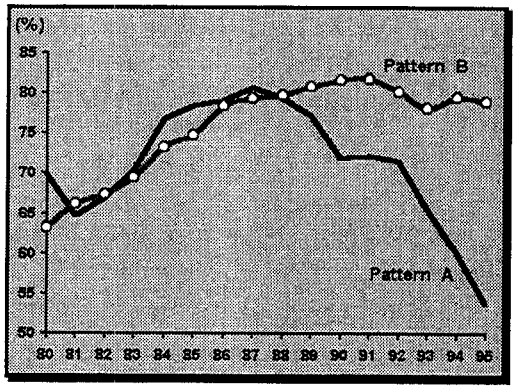
COUNTRY	As a percentage of total external debt		As a percentage of GDP	
	1980	1995	1980	1995
Pattern A	**70.0**	**53.7**	**28.5**	**29.4**
Chile	38.9	28.1	18.0	11.0
Mexico	59.1	56.7	15.5	37.6
Paraguay	66.0	65.0	15.4	15.3
Peru	66.2	61.4	29.9	32.1
Panama	76.3	54.4	63.8	51.1
Trinidad and Tobago	86.0	68.8	n.a.	n.a.
Saint Vincent and the Grenadines	97.2	41.7	n.a.	n.a.
Pattern B	**63.2**	**79.0**	**26.6**	**66.1**
Venezuela	36.2	79.5	17.9	36.9
Argentina	37.5	69.3	5.4	23.8
Guatemala	47.1	76.1	7.0	17.7
El Salvador	54.7	79.6	14.0	19.9
Ecuador	55.0	86.2	29.0	66.4
Brazil	57.9	60.7	17.1	12.9
Colombia	58.9	62.5	12.5	15.7
Barbados	59.0	61.9	n.a.	n.a.
Dominican Republic	60.9	83.4	23.1	31.3
Costa Rica	61.9	82.4	37.6	32.6
Honduras	66.3	87.1	37.6	107.4
Uruguay	67.9	72.0	11.1	22.2
Belize	74.6	84.6	n.a.	n.a.
Guyana	74.8	84.7	n.a.	n.a.
Jamaica	74.8	79.8	n.a.	n.a.
Nicaragua	76.2	85.5	81.8	414.2
Grenada	76.4	87.2	n.a.	n.a.
Haiti	80.1	93.2	23.7	61.3
Bolivia	80.7	84.6	54.3	63.9
Regional average	**65.0**	**72.2**	**27.1**	**56.3**

Source: ECLAC, on the basis of the World Bank, *Global Development Finance,* Washington, D.C., 1997.

(iii) At the same time, as Governments generally did not control the cycle of production and export of tradable goods, they did not have direct access to foreign exchange. The only two ways of obtaining this in order to service the debt were by directly purchasing the foreign exchange generated by the private sector (at market prices or at some other price fixed by the Government) or through fiscal policy —by increasing revenue and/or reducing public expenditure— in order to generate the surplus needed to purchase the necessary foreign exchange.

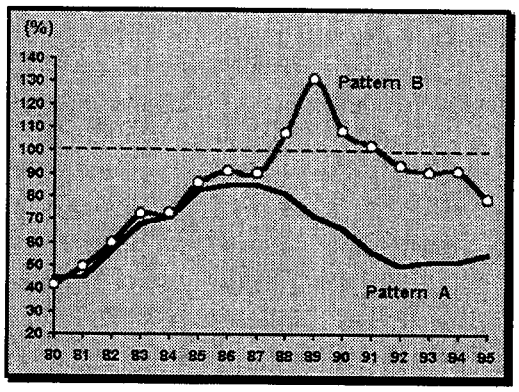
Figure V-5
EXTERNAL PUBLIC DEBT
(Simple averages)

5.a External public debt, as a proportion of total external debt



Source: ECLAC, on the basis of World Bank (1997).

5.b Total external debt, as a proportion of GDP



Source: ECLAC, on the basis of World Bank (1997).

In view of the total restriction of credit imposed by international markets between 1982 and 1989, the countries of the region were forced to take steps to carry out a structural fiscal adjustment. In the medium and long term, this adjustment had to be sufficiently great to reverse the upward trend in external public indebtedness.

However, the empirical evidence clearly shows that the external debt problem (both public and national) has not yet been solved definitively. It may be noted that in the mid-1990s, out of a total of 26 countries studied, in 19 of them (pattern B) the public sector accounted for a higher proportion of external liabilities than at the beginning of the 1980s (see figure V-5). Furthermore, this higher proportion was accompanied by an increase in the total external debt of many of those countries (see table V-2). It is therefore obvious that a considerable number of economies of the region are now in a more vulnerable situation than they were before the crisis broke out in 1982. Although it is only fair to admit that at present there is not a sufficient volume of evidence of any impending interest-rate shock such as the

one observed in the early 1980s, it may be recalled that neither analysts nor the markets have been able to anticipate crises like those which occurred in Mexico in late 1994 or in Thailand and Indonesia in mid-1997.

If we look at the data for the remaining six countries (pattern A), whose public sectors accounted for a lower proportion of external liabilities in the mid-1990s than at the beginning of the 1980s, we see that this progress was offset, except in the cases of Chile and Panama, by an increase in their total external debt (see table V-2). Consequently, even those cases where the public sector has been able to reduce its foreign currency liabilities (as a proportion of the total external debt) should be viewed with caution.[13]

2. The domestic public debt

In recent years, the public sectors of various countries of the region have once again resorted to domestic borrowing. Thanks to greater macroeconomic stability, there has been a recovery in these sources of funding, which had shrunk considerably during the 1980s, so that in many cases it has been possible to reduce the sector's dependence on external financing. Although nothing indicates that a new generalized fiscal crisis could occur, however, there is already concern over the high rate of domestic borrowing displayed by some economies of the region. This concern is connected with the potential effect that this tendency could have on domestic interest rates and, consequently, on the level of activity in general and of private investment in particular.

It should be noted that the phenomenon in question is not limited to the central government, since in some countries it is also to be observed at subnational levels of government, as a result of the progress made in decentralization processes and the borrowing power regained by some state, provincial or municipal governments. In some cases, misuse of this power militates against both the quality of the macroeconomic stabilization process and the progress of decentralization itself.[14]

During the 1980s, the sharp reduction in flows of external financial resources, which had been abundant in the 1970s, and high fiscal deficits gave rise to serious hardships in the public sector, making it necessary to resort to domestic borrowing. The possibilities of obtaining resources from this source were very limited, however, in view of the serious crisis of the banking systems, the contraction in social security funds, and the lack of efficient capital markets in the great majority of the countries of the region. In these circumstances, Governments had no choice but to fall back on the "inflation tax", collected through seigniorage. However, these mechanisms, which were used intensively and for prolonged periods, led to runaway inflation and even, in some cases, to hyperinflation.

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[13] This conclusion is confirmed by the information given in World Bank (1997). Although the classification criterion used is the present value of projected debt service flows as a proportion of GDP, the information given allows us to conclude that 19 of the 26 Latin American and Caribbean countries covered by that report display levels of indebtedness which are either severe (12 cases) or moderate (7 cases).

[14] In Brazil, debt overhang problems have arisen in the case of some states and municipalities which have made use of a clause in the Constitution that allows them to exclude sales of securities made for the purpose of financing monetary awards by the courts ("letters precatory") from subnational indebtedness limits. See Ter-Minassian (1996 and 1997).

In the 1990s, thanks to notable advances in the field of stabilization and the reappearance of external capital flows, the fiscal situation began to return to normal and domestic financing was restored. Some countries were able to strengthen their incipient capital markets, while in others resources were procured through the financial system, mainly through the use of compulsory reserve policies. The remonetization of the economies also helped to improve public-sector financing conditions. As a result, the domestic public debt expanded, and in addition there were the commitments which the State had to assume because of problems affecting the banking sector or major segments of society.

In 1995 a crisis situation arose once again, with characteristics similar to those of the 1980s. External financial resources shrank, while there was also capital flight due to exchange-rate instability and negative expectations about the Governments' capacity to meet their external debt service commitments. After a relatively short period of instability, however, the "Mexican crisis" was brought under control thanks to an adjustment programme and a special aid package put together by the United States Department of the Treasury and international financial agencies. These exceptional financing measures made it possible to restore the flows of external financial resources quite quickly.

This crisis of the 1990s was not generalized, however, and only marginally affected other countries in the region. In recent years, the domestic public debt has once again reached significant levels in some Latin American countries, but it continues to stand at a low level in the rest of the region.[15]

3. The domestic and external public debt

In the great majority of the countries of the region, the public sector's external debt is markedly greater than its domestic debt, due to the limited development of domestic capital markets and banking systems and the low level of domestic saving (the only exceptions being Brazil and Chile, where the domestic debt is markedly greater than the external one).

In Colombia, external borrowing continues to predominate, but it has declined markedly as a proportion of GDP. In Mexico, in contrast, both the domestic and external public debt gradually went down up to 1993, after having reached high levels in the middle of the previous decade. In Peru and Venezuela, the external debt has remained at the high level of around 50% of GDP, but the domestic debt has continued to be very low. In Uruguay, the external public debt has remained at slightly under 50% of GDP, while the domestic debt is almost zero, since almost all government securities are issued in foreign currency.

In Argentina, there has been an increase in both domestic and external public indebtedness. There were no sales of public securities on the domestic market in the years of hyperinflation, and it was only from 1996 onward that operations of this type began to take place once again. The external public debt has grown considerably in recent years because

[15] In Mexico, domestic financing for the public sector had been substantially reduced from 1988 onward as a result of the adjustment policy applied in those years in order to tackle serious macroeconomic imbalances. In 1993 and 1994, the domestic public debt fell markedly because of the lack of investors' interest in local-currency securities. From 1996 onward, there was some increase in the procurement of domestic resources by the public sector, but the high cost of domestic borrowing obliged the authorities to seek external resources on more favourable terms.

of the need to cover fiscal deficits. As a result, the total public-sector debt has expanded quite strongly and is now close to 50% of GDP. Finally, in Costa Rica external indebtedness has gone down, but only as the result of its replacement by domestic indebtedness, which is now equivalent to one-third of GDP.

E. SOME LIMITATIONS OF THE AVAILABLE INFORMATION

In order to avoid the replacement of the justified but undoubtedly excessive pessimism of the 1980s with equally excessive optimism in these last years of the century with regard to the present status and future prospects of the public accounts of the region, some comments should be made on the quality of the basic information used for the evaluation and baseline studies of public finances.

To begin with, the data used for calculating the ratio of the deficit to GDP are usually expressed in current prices. When this is so, it is easy to demonstrate that this ratio has a positive correlation with the rate of inflation.[16] Although generally speaking econometric studies have not managed to establish a sufficiently close and stable direct relationship between the levels of inflation and the public deficit (as a proportion of GDP), it is symptomatic that just as average inflation went down during the 1990s (compared with the rates observed in the 1980s), so public-sector deficits (as a proportion of GDP) were also appreciably smaller than in the previous decade.

Second, it is well known that the coverage, consistency, integrity and general quality of fiscal information —including its level of disaggregation, frequency, and the form and timeliness of publication— leave much to be desired. In various countries of the region it is often observed that official sources in the same country report different figures for the same items and periods.[17] Similarly, the data published by a given international source of reference regarding a given country and period often do not even agree among themselves.[18] Furthermore, the coverage of the information also tends to vary significantly over time.

Third, major privatization operations have taken place in a number of Latin American and Caribbean countries during the 1990s. According to the IMF methodology for calculating the deficit on the basis of public-sector borrowing requirements (PSBR), income in respect of the sale of State assets is recorded "above the line". However, this procedure creates the illusion of a fiscal adjustment which has not actually taken place. For this reason,

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[16] If D = net nominal public-sector debt; D* = nominal deficit (=variation in the nominal debt); Y = nominal GDP; P = index of key prices; d = D/P = real deficit; y = real GDP; gy = spot growth rate of real GDP; gP = spot growth rate of price index (=inflation rate); z = d/y (=ratio of real debt to real GDP), and z* = a time derivate of z, then it can be shown that $D^* / Y = z^* + z\,(gy + gP)$.

[17] Even in countries whose economic statistics are considered to be among the best in the region, such as Colombia, different official sources offer empirical data on fiscal matters which give rise to very different interpretations, as for example regarding the State's participation in the economy. See in this respect Ocampo (1997).

[18] Thus, for example, the information on interest payments and income from donations (among other items) published by the IMF in its Government Financial Statistics often differs significantly from that given in that same agency's Country Reports.

such income should be treated as a source of financing (similar to a net sale of public securities or monetary base) rather than as an item decisively affecting the level of the public deficit.[19] It may be noted that a similar situation tends to arise in the case of countries whose fiscal income depends to a significant extent on grants and/or donations from foreign Governments or international agencies.

Fourth, the conventional data on the public deficit are subject to many well-known methodological criticisms which suggest that caution should be exercised in the conclusions to be drawn from any isolated measurement.[20] Thus, for example, measurements of the public deficit are generally made on the basis of cash-based accounting systems (which may give a false idea of the sustainability of a given policy course) rather than on an accrual basis.

Fifth, no official series are available on the total public debt (i.e., external and domestic; real estate, banking and commercial; short-, medium- and long-term; registered and implicit liabilities). Except in the cases of a few countries which have relatively more complete information, the records are generally deficient, so that they do not permit reliable assessments of the real financial situation of the government sector.

Sixth, public accounts are focused on the flows recorded on the income statement (i.e., connected with the calculation of government-sector income, expenditure and deficit or surplus) but they do not take account of what happens with respect to the public sector's balance sheet (i.e., the level and composition of assets, liabilities and net worth). This lack of information considerably reduces the transparency of public-sector accounts, since it prevents us from seeing if a downward trend in the public-sector deficit actually conceals a marked process of decapitalization or loss of assets.

Seventh, the significance of the concepts of public and private deficit has changed in line with the institutional changes which have taken place between the 1980s and the 1990s. Some years ago, it was expected that the State should help to increase domestic investment through the execution of infrastructure works, not only on the basis of its own resources but also through the procurement of private savings. In contrast, the tendency in these last years of the century is that the State should help to raise the level of domestic saving, while its own functions in the area of investment have been cut back in proportion to the increased private participation in traditional areas of State action. Thus, although the fiscal deficit may have been reduced, this change of roles may have been reflected in greater private-sector deficits. Moreover, in many cases these private investments are backed up by government guarantees whose contingent value is not included in the budget accounts.

Finally, it is well known that since the 1970s bank crises have been increasing in frequency and intensity, both in the industrializing countries and in the rest of the world. The fact that bankers have not prepared themselves to face new —apparently increasingly frequent and costly— shocks suggests that they have not been induced to act in accordance with a system of incentives that is compatible with the avoidance of serious losses. The reason for this is that they have enjoyed the near-certainty that they would be rescued by the Government and/or the Central Bank, which have reasons to accept almost any level of losses in order to avoid a systemic crisis.[21] In addition to this, there are the measures taken,

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[19] See chapter IX in this respect.

[20] Blejer and Cheasty (1991), Ramalho (1997), Jacob de Carvalho (1997), Meyer (1997) and Kotlikoff (1989).

[21] This matter is analysed in greater detail in the following section of this chapter.

through different financial mechanisms, to come to the rescue of bankrupt states, provinces, municipalities and public enterprises. The level of the quasi-fiscal deficit registered in various economies of the region during the 1990s is not known with sufficient accuracy, but according to the available data it could amount to several percentage points of GDP.

The eight foregoing arguments could easily be expanded to include others which also support the view that the available information on the current status and future prospects of the public finances of the region does not provide a basis for over-optimistic interpretations. At all events, it is worth noting that the idea of achieving and maintaining macroeconomic balances —and especially avoiding their deterioration through fiscal mismanagement— has become firmly rooted among the political and economic authorities of the region.

It is therefore not a question of suggesting that we are going through a kind of "bubble" of favourable fiscal results which could burst at any moment, and still less of claiming that public accounts have become more fragile during the 1990s. We should not forget, however, the shortcomings in terms of information which were behind the generalized optimism generated by the successful experiences of Mexico (up to the very eve of its collapse in December 1994) and the "East Asian miracle" (up to the second half of 1997 and, in particular, up to 23 October of that year, when the massive speculative attack on the Hong Kong dollar took place).

These experiences show once again that, once a certain threshold has been passed, the optimism of economic agents tends to become contagious and self-generating. In such circumstances, excessively enthusiastic expectations tend to arise regarding the soundness and continuity of the successes already achieved and the trends already recorded.[22]

In view of the foregoing, a cautious attitude should be adopted in interpreting trends in isolated fiscal indicators.[23] Thus, the above observations suggest the advisability of examining the fiscal adjustments adopted in Latin America and the Caribbean in recent years in greater detail in order to determine whether the improvements observed in the behaviour of some indicators reflect real advances, especially of a structural (or permanent) nature, or whether they are rather of a cyclical or transitory nature and therefore easily reversible.

F. THE FISCAL COST OF BANKING CRISES IN LATIN AMERICA AND THE CARIBBEAN

The evidence on financial crises in the banking system reveals a significant increase in the number of cases of bank insolvency in various parts of the world since the end of the 1970s.[24] Since that time, financial crises have occurred in almost all the countries of the

[22] With respect to the December 1994 crisis in the Mexican economy, Krugman (1995) says: "Something like that crisis was an accident waiting to happen, because the stunning initial success of the Washington Consensus was based not on solid achievements, but on excessively optimistic expectations. The point is not that the policy recommendations that Williamson outlined are wrong, but that their efficacy —the ability to turn Argentina into Taiwan overnight— was greatly oversold".

[23] For a discussion of the pros and cons of various fiscal indicators, see Mackenzie (1993).

[24] Caprio and Klingebiel (1996).

region, and in some countries more than once. The probability of such crises has undoubtedly been underestimated in the economic reform programmes carried out in Latin America and the Caribbean.[25] Practically all the financial crises which have occurred in the region over the last two decades have been due to serious problems of insolvency in banks and finance companies caused by a drastic deterioration in their loan and investment portfolios (and their consequent situations of illiquidity).[26]

1. Quasi-fiscal operations connected with the financial system

Quasi-fiscal operations have become a source of growing concern as the deficits caused by them have taken on significant proportions. The operations of this type that relate to the financial system have taken three basic forms: (i) subsidized loans (via interest rates, maturities or conditions for return of the principal); (ii) exchange-rate operations (subsidized exchange rates); and (iii) private or public bank bail-outs. Box V-4 shows the magnitude of operations of the first two types for five Central American countries.[27] The following analysis will concentrate on the third type of operation, which has been the focus of debate in the region in recent years.

A central bank can carry out various operations, in its capacity as a public-sector agent, to intervene in insolvent banks and adopt measures to restore the payment capacity of debtors and banks. The programmes giving rise to these operations are all additional to its budgeted operations, and any of them can cause serious losses to the central bank during the solution of a banking crisis. Their effects on the financial position of the central bank can be measured on an accrual basis or in terms of net worth; they can also be measured in terms of cash flow or domestic credit. As this last value directly affects money creation, the monetary aggregates and the aggregate expenditure of the economy, the cash losses that these operations cause to the central bank over a given period are assimilated into its quasi-fiscal deficit.[28] The operations thus comprise:

(i) Loans to banks suffering from liquidity crises, to solve severe problems of insolvency or to cover withdrawals of deposits. These become losses for the central bank if the banks do not pay back all or part of the loans, as may occur if the banks go into liquidation.

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[25] Krivoy (1995).

[26] In the case of the 1995 banking crisis in Argentina, "contagion" by the Mexican crisis of that year gave rise to heavy withdrawals of deposits which created liquidity problems.

[27] It should be noted that this quasi-fiscal deficit can reach high levels (as in Guatemala, where in some years it exceeded the public-sector deficit as a percentage of GDP), and exchange-rate losses are a prominent feature of its presumed composition.

[28] In Chile, measurement of the cash deficit includes interest actually paid and received and interest flows voluntarily capitalized on market terms. It excludes interest flows capitalized on special terms and the capital gains and losses underlying real adjustments in assets and liabilities. See Banco Central de Chile (1995).

Box V-4

THE QUASI-FISCAL FINANCIAL DEFICIT IN SOME SELECTED CENTRAL AMERICAN COUNTRIES

Although the problem of the operating losses of the Central Banks of Central America was known at least a decade ago, it was only with the structural adjustment programmes and financial reforms of 1991 that the concept of the integrated fiscal deficit (including both the budgetary and quasi-fiscal components) came into being. Before these reforms, the quasi-fiscal deficit was not of significant magnitude, but the desirability of dealing with this kind of fiscal activity more openly became evident in the region in mid-1994, in the context of the renewed interest of the Central American governments in financial integration. Since then, the Central American Monetary Council has achieved the following: (i) identification of the nature and approximate amount of quasi-fiscal credit; (ii) the use of homogeneous methods for determining its magnitude, as a basis for internal negotiations; (iii) the acceptance of technical, accounting and legal procedures for its consolidation and possible repayment; and (iv) the adoption of mechanisms for immediate correction of the situation in the event of similar occurrences in the future.

It is estimated that in Costa Rica and Guatemala the quasi-fiscal deficit stands at levels which would significantly affect the public sector deficit if the two concepts were consolidated, while in El Salvador and Nicaragua the impact would be less serious. In the absence of official information, indirect estimates for the majority of the selected countries indicate that the quasi-fiscal deficit has mostly been generated by exchange-rate subsidies, except in the case of Guatemala, where it has mainly been due to interest rate subsidies (see the following table).

ESTIMATES OF QUASI-FISCAL DEFICIT
(Percentages)

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
Quasi-fiscal deficit/GDP					
1992	1.8	1.5	1.2	n.a.	1.1
1994	1.4	0.2	1.3	n.a.	0.6
1996	1.5	0.2	1.0	n.a.	0.5
Public-sector deficit/GDP					
1992	2.4	7.6	0.8	5.4	9.5
1994	7.2	2.2	2.2	6.8	12.6
1996	3.5	1.3	10	5	11
Presumed composition of quasi-fiscal deficit in 1996					
Exchange-rate losses	80	60	10	90	80
Interest rates	15	20	85	-	-
Other operations	5	20	5	10	20

Central Bank operating losses in connection with exchange-rate subsidies are due basically to the purchase of foreign exchange by the government to service the external public debt. The exchange-rate differential covered by the Central Bank in 1996 reached significant levels in Costa Rica, Honduras and Nicaragua.

Operating losses attributable to differential interest rates, for their part (especially in the case of Guatemala) were due to the sale on the open market of public debt certificates belonging to the Central Bank at rates below those of the market. Between 1992 and 1996, the Central Bank of Guatemala significantly reduced its holdings of such securities, while the commercial banks and stock exchanges increased their holdings by a similar amount. The differential between the interest rates paid by the government and those paid on the open market amounted to as much as 100% of the government rate.

Independently of the programme promoted by the Central American Monetary Council for seeking practical solutions to the problem of the quasi-fiscal deficit, Costa Rica and Honduras have adopted legal provisions for correcting the cumulative operational losses of the respective Central Banks. In Costa Rica, under the terms of the Charter of the Central Bank, the Ministry of Finance must take responsibility for part of the quasi-fiscal operations carried out by the Central Bank, through the issue of bonds denominated in national currency and in dollars (depending on the origin of the operations). In the case of Honduras, although the reforms to the Charter of the Central Bank did not explicitly refer to the quasi-fiscal deficit, provisions were adopted allowing the issue of non-interest-bearing State bonds to cover the Central Bank's losses (implicitly including operations of a quasi-fiscal nature).

Source: Jorge González del Valle, "Primeras consecuencias de las reformas al sistema financiero en Centroamérica", Mexico City, ECLAC subregional headquarters in Mexico, October 1997, unpublished, p. 26.

(ii) Purchase of the delinquent loan portfolios of banks with severe problems of insolvency (usually through the delivery of central bank bonds), with a commitment by the banks to buy the portfolios back on certain conditions. These operations can also result in losses for the central bank if, for example, the banks do not fulfill their commitment to buy the portfolios back or the conditions for buying them back include subsidized interest rates for the periods in question.

(iii) Reprogramming of loans for debtors whose payment capacity has diminished at below-market interest rates for the longer maturities in question and/or the granting of preferential exchange rates for foreign currency credits (in both cases, usually through the delivery of central bank bonds to cover the differences with respect to the interest rate and the market exchange rate). These subsidies translate into losses for the central bank.

(iv) Access to a preferential exchange rate for debtors holding foreign-currency loans. The exchange-rate subsidy may be granted through the delivery of central bank bonds to private banks for the difference between the preferential and market exchange rates, which likewise signal losses for the central bank.

(v) Swaps whereby the central bank takes over foreign-currency loans granted to private banks in return for central bank securities denominated in the local currency (de-dollarization). If the exchange rate rises, then the central bank will suffer a loss.

(vi) Recapitalization of insolvent public banks by the provision of cash resources. This means that these banks transfer their losses to the central bank.

2. Quasi-fiscal losses

The last column of table V-3 gives estimates of the losses or costs for the central banks of the region of measures designed to rehabilitate or bail out banks and debtors hurt by the financial crises listed in the second column. The estimates usually correspond to the total losses registered in the three or four years following the onset of the crisis (without specifying whether they correspond to cash or accrued losses).[29]

The estimates of the social costs of a financial crisis are only approximate, since these costs are very difficult to evaluate in practice: inefficient allocation of resources through faulty credit processes, faulty financial intermediation, the stagnation of production activity which usually accompanies an unsolved crisis, and the opportunity cost of the public resources used to restore the net worth of the central banks themselves.

A common feature of the insolvency crises which have occurred in the region over the last two decades is that they have been tackled in a belated manner, when the banks had already run up serious losses. This delay has led to still further losses and, consequently, to bigger quasi-fiscal deficits than those which would have been registered if rehabilitation and rescue measures had been taken earlier.

The banking crises in the Southern Cone countries in the early 1980s gave rise to the biggest quasi-fiscal losses and/or costs registered in the region in the last two decades: 55% of GDP in the case of Argentina (although this proportion overestimates the losses suffered) and 41% of GDP in the case of Chile; no estimates are available for the cost of the Mexican banking crisis, which gave rise to a moratorium on that country's external debt payments in 1982. Several of the crises which took place in the mid-1990s have also been on a large scale: Mexico (12%-15% of GDP) and Venezuela (18% of GDP), while in the case of Paraguay, as a result of additional bank interventions in mid-1997, the losses accumulated from 1995 to date are close to 8% of GDP.[30]

3. Prevention and management of bank crises

The heavy quasi-fiscal losses and costs caused by bank crises in the region highlight the need to adopt preventive policies to reduce their likelihood and seriousness and to implement timely and effective corrective measures as soon as banks show signs of insolvency. The investment of public resources for these purposes is undoubtedly an action of the highest social profitability.

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[29] These calculations do not take account of the possible recovery of funds.

[30] See, in addition to these estimates, Amieva-Huerta and Urriza-González (1998).

Table V-3
BANKING CRISES IN LATIN AMERICA AND THE CARIBBEAN

Country	Period of crisis	Extent of crisis	Overdue portfolio	Loss or cost of rescue measures (% of GD)
Argentina	1980-1982 1989-1990 1995	Liquidation of over 70 banks and financial establishments Large number of banks Suspension of 8 banks and collapse of 3		55.3%
Bolivia	1986-1988	Five banks liquidated in 1987	In 1988: 90% of capital	
Brazil	1994-1995 1990 1994-1995	Three banks went insolvent Conversion of deposits into bonds Two large State banks One important private bank went insolvent		4.2% 5% - 10%
Chile	1976 1981-1985	Mistrust in savings and loan system because of conversion of short-term assets into long-term assets State intervention of 14 banks and 8 finance companies		41.1%
Colombia	1981-1982	State intervention of 6 banks and various other financial establishments		5%
Costa Rica	1987 1994	Public banks suffered from serious insolvency problems Widespread failure of unregulated financial establishments An important private bank went insolvent	More than twice the capital	
Ecuador	1982 1992	Conversion of foreign-currency bank liabilities into national currency Two banks went insolvent		1.9%
El Salvador	1982	State-owned banks suffered from generalized insolvency problems Collapse of a finance company	More than 3.4 times the capital	
Mexico	1982 1995	State takeover of banking system because of the external debt moratorium Ten banks went insolvent	20% of credit	12% - 15%
Paraguay	1995-1997	Six banks and six finance companies were intervened		8%
Peru	1990-1993	Insolvency problems in a banking group	22% of credit	
Dominican Republic	1989	Widespread failure of unregulated financial establishments		
Uruguay	1981-1985	Insolvent banks accounted for 30% of the banking system's assets		7% (24% recapitalization)
Venezuela	1980 1994-1995	Three banks went insolvent Nineteen banks went insolvent		18%

Source: G. Caprio and D. Klingebiel, "Bank Insolvency: Bad Luck, Bad Policy or Bad Banking?", Annual Conference on Development Economics, Washington, D.C., World Bank, 1996; ECLAC, *Economic Survey of Latin America and the Caribbean, 1995-1996* (LC/G.1929-P), Santiago, Chile, 1996, table IV-1. United Nations publication, Sales No. E.96.II.G.12; and G. Held, "Bank regulation, liberalization and financial instability in Latin American and Caribbean countries", *Finance and the Real Economy: Issues and Case Studies in Developing Countries*, Y. Akyuz and G. Held (eds.), Santiago, Chile, S.R.V. Impresos, 1993.

A review of some 30 banking crises which took place over the last 15 years, including severe cases of insolvency in Latin America, indicates that the main reasons for these problems have been: faulty banking management, flaws in the systems of prudential regulation and supervision, government intervention, and loans made to firms in the same financial group or granted for political reasons.[31] Likewise, a review of about a dozen bank crises which took place in the region during the last two decades shows that severe faults in prudential regulation and supervision played an important role in large-scale banking crises, although macroeconomic factors were also major elements.[32] The relative weight to be given to these factors in accounting for financial crises is still a matter of controversy.[33]

According to a well-known hypothesis on banking crises, the liberalization of financial variables (interest rates, bank credit and the balance-of-payments capital account) was not accompanied by a strengthening of prudential regulation and supervision of the banks in accordance with the various risks attendant upon loan and investment processes in freer financial markets.[34] In these conditions, banks which were not subject to control or were not subject to firm prudential rules were able to engage in a rapid expansion of their loan operations, using domestic and external funds and very often procuring and investing resources at high real interest rates. All too often, these rates of expansion and interest were not in keeping with the pace and profitability of production activities. The risks were even greater, of course, when financial liberalization was carried out in economies which were simultaneously undergoing processes of stabilization and structural reforms, because of the sizeable changes in relative prices and in the profitability of production activities which usually occur in such a context.[35]

The foregoing highlights the significance of the following factors in the prevention of bank crises, in accordance with the specific situation of each country:

(a) Strengthening of prudential regulation and supervision of banks and financial establishments in order to improve the quality of their management of loan and investment portfolios, especially through measures aimed in the following directions: [36]

(i) Prevention of excessive credit risk due to faulty lending practices, over-lending (in relation to the bank's deposits and capital), and excessively sharp increases in lending aimed at attaining a leading position in the market, at the cost of lower profitability and higher risks.

(ii) Proper coverage and control of the risk of losses through the following measures: more demanding entry conditions for the banking industry, in order to promote the presence of experienced operators who are prudent in their approach to risks; accurate and full measurement of the provisions for facing such risks; adaptation of minimum capital requirements in the light of the proposals of the Basle Committee and the greater instability characterizing the economies of the region; provision of clear and readily available information on the exposure and assets of banks, so that depositors

[31] Caprio and Klingebiel (1996).
[32] ECLAC (1994).
[33] Berry and García (1996).
[34] Mishkin (1996).
[35] Held (1993).
[36] De Juan (1995).

can play their part in "disciplining the market"; and establishment of a public supervisory body which is politically independent and has technical staff who are highly qualified in risk assessment. The existence of prudential regulations which demand the early and automatic restoration of capital in the event of potential portfolio problems is an important factor in preventing the accumulation of losses and forestalling problems of moral hazard when the expected losses exceed the capital of banks or other financial establishments.

(iii) Consolidated regulation and supervision of banks with branches or subsidiaries abroad, as well as of financial conglomerates, which usually include a bank and other financial establishments.

(b) Reduction of the risk associated with volatile macroeconomic environments likely to suffer strong fluctuations in the case of external shocks.[37] In order to achieve this, it is necessary to adopt macroeconomic policies conducive to the creation of an environment with low rates of inflation and with real exchange rates and interest rates which give economic agents the correct resource-allocation signals.

Proper handling of bank crises can also significantly help in limiting losses. When banks are showing signs of financial instability and their owners do not promptly provide the necessary fresh capital, the authorities should step in so as to prevent the accumulation of losses, which can take place very rapidly as a result of the capitalization of interest, granting of high-risk loans, substitution of guarantees, and other practices.[38]

Once a banking crisis has broken out, the following principles can limit the quasi-fiscal losses involved in rehabilitation and bail-out measures:[39]

(a) When the Government takes over the managment of a bank, its book value should be reduced in direct relation with its losses (thus, its shareholders' equity should be reduced to zero if its losses exceed that value); the measures taken could also include the capitalization of that part of the bank deposits not subject to guarantees. In Argentina and Mexico, for example, the management of the banking crises of the mid-1990s included the sale of the banks' portfolios and the creation of "subordinated debt", with demanding repurchase requirements, including the capitalization of that debt and the consequent reduction in owners' equity in the event of non-compliance.

(b) Measures to help out debtors should not be extended to those who have suffered loan losses as a result of fraudulent practices or legally dubious actions.

(c) The public sector would have to allocate resources to the central bank if quasi-fiscal operations caused it serious losses, both in order to recapitalize and in order to prevent the expansion of domestic credit associated with such operations from fueling inflationary pressures.

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[37] Especially by expanding and diversifying exports; increasing national saving and development of domestic capital markets; strengthening the financial position of the public sector; and opening up the balance-of-payments capital account in line with a sustainable current account deficit. For more details see Zahler (1992) and Held and Szalachman (1997).

[38] Hausmann and Gavin (1995).

[39] Suárez-Rojas and Weisbrod (1995).

Box V-5

SOLUTION OF BANK CRISES IN THE REGION

The financial crises in Argentina: Public resources were not made available to tackle the severe bank crisis which broke out in 1980, with the result that the crisis remained latent throughout the rest of the decade, helping to give rise to the acute episodes of inflation in the 1980s and a drastic fall in financial intermediation by the banks (Rodríguez (1994)). Central Bank credit was expanded to finance both the public sector deficit (instead of receiving transfers of resources from that sector) and and its own quasi-fiscal operations in connection with the intervention and liquidation of a large number of banks and the re-programming or purchase and swapping of bank loan portfolios.

Rising inflation, averaging around 500% per year in 1983-1985, and the fixing of nominal interest rates resulted in negative real interest rates (of as much as -50% for deposits in 1984) and also helped to reduce the real value of loans, ***which*** fell from 51% of GDP to only 39% in 1984. This transferred to depositors part of the losses shown in table V-1. Deposits went down from 22% of GDP in 1981 to 14% in 1985.

The exchange-rate and price liberalization applied in 1989 gave rise to hyperinflation (almost 5000% in 1989 and 1300% in 1990), heavy withdrawals of deposits and a second bank crisis. At the same time, the lack of confidence felt by ***depositors*** caused deposits to drop to only 3% of GDP in 1989. It only proved possible to eliminate the quasi-fiscal deficit of the Central Bank with the launching of the "Bonex Plan" in 1990, under which almost the whole of the public debt and bank deposits was converted into 10-year dollar-denominated bonds.

In the first quarter of 1995, withdrawals equivalent to 15% of the total deposits in the Argentine banking system, due to its "contagion" ***by*** the Mexican financial crisis (the "tequila effect"), set off a recessionary adjustment process which jeopardized the stability of the banking system by causing the proportion of overdue credits to rise to 28% of the total.[a]

The Central Bank tackled the situation by establishing a liquidity fund with the support of private banks and the Banco de la Nación and at the same time introduced a scheme for the private deposit insurance, in order to encourage ***depositors*** not to withdraw their funds. The solvency problems of the banks have been tackled through the establishment of a recapitalization fund set up with the sale of US$ 2 billion of bonds and contributions from multilateral financial agencies. This fund has acquired "subordinate debt" for a term of three years, which, if not repaid, will be converted into stock.[b]

The Colombian banking crisis of the early 1980s: In connection with the intervention of banks which began in 1982, the Banco de la República established a rehabilitation plan in the mid-1980s, without resorting to inflation. The banks which were intervened became public property and their shareholders lost their assets. A strict fiscal policy made possible the allocation of public resources from exports to an insurance fund to be used for recapitalizing the banks. Once they had been placed on a sound footing again, most of the banks were reprivatized.[b]

The Chilean banking crisis of the early 1980s: In tackling the banking crisis which broke out in Chile in 1981, the ***possibility*** of transferring the losses to depositors was ruled out in view of the high proportion of indexed deposits and the existence of an implicit State guarantee on deposits.

The Central Bank put into effect extensive programmes of quasi-fiscal operations (except for the recapitalization of the Banco del Estado, for which public sector support was not required) and avoided inflationary pressures by financing them with medium- and long-term indebtedness. The long-term debt increased by the equivalent of US$ 9.7 billion between 1982 and 1989, of which

US$ 5.7 billion corresponded to domestic indebtedness (mainly bonds purchased by the pension funds). The National Treasury recognized that the Central Bank had acted as a fiscal agent in the crisis by giving it bonds equivalent to US$ 7.2 billion between 1983 and 1986, although these had low yields.[c]

In 1986, the end of the reprogramming of loans and the sale of loan portfolios to the Central Bank, together with the adoption of a new general banking law, ***officially*** completed the recovery process of the Chilean banking system. Even in 1996, however —a decade later— the financial situation of the Central Bank still reflected the residual effects of this crisis in its balance sheets and cash flows. Over the period 1991-1995, the Bank's annual cash losses came to around 1% of GDP, largely because of the low yields of the Treasury bonds and the very limited cash flows from the "subordinate" credits deriving from the sales of loan portfolios, whose outstanding balance was some US$ 4.5 billion.

The renegotiation of the ***subordinate*** debts of five banks in 1996 showed that in the case of four of them the proportion of their surpluses that they were to devote to the payment of those debts would not be sufficient to pay them off within the foreseeable future. Because of this, the market value of these obligations was far below their book value. This led the Central Bank to convert its rights to part of the surpluses of those banks into shares, which it then placed on the market. This helped its economic recovery (by some US$ 240 million) by capturing the higher economic value of banks which did not have subordinate debts and were now in a position to enter new areas of business as envisaged in a forthcoming amendment to the general banking law.[d]

The Mexican banking crisis of the mid-1990s: The exchange-rate float decreed in December 1994 by the Mexican Government increased the perception of exchange-rate risk and led to a run on the national currency which caused it to lose half its value in the space of three months, while capital outflows came to the equivalent of 7.2% ***of*** GDP in 1995. In that year, the shock recessionary adjustment caused the banking system's portfolio of overdue loans to increase to 20% of the total, making it necessary to adopt non-inflationary financial restructuring measures designed to shore up the solvency of debtors and banks.

The Temporary Capitalization Programme (PROCAPTE) entrusted the Bank Savings Protection Fund (FOBAPROA) with the ***responsibility*** for granting loans to banks in the form of subordinate debt to be computed as capital (to be deposited in the Banco de México in order to avoid inflationary pressures). The banks which took advantage of this facility have five years to pay back these loans, and if by that time or in the meantime their solvency position does not improve, the subordinate debt will be converted into capital and the net worth of the current shareholders will be reduced accordingly.[e]

Source: [a] ECLAC, *Economic Survey of Latin America and the Caribbean, 1995-1996* (LC/G.1929-P), Santiago, Chile, 1996, table IV-1. United Nations publication, Sales No. E.96.II.G.12.

[b] L. Rojas-Suárez and S. Weisbrod (1995), "Managing Banking Crises in Latin America: the Dos and the Don'ts of Successful Reconstructing Programs", paper presented at the Conferencia sobre la crisis bancaria en América Latina, Washington, D.C., IDB, 1995.

[c] J. Marshall and K. Schmidt-Hebbel, "Chile: fiscal adjustment and successful performance", *Public Sector Deficit and Macroeconomic Performance*, W. Easterly, C.A. Rodríguez and K. Schmidt-Hebbel (eds.), Washington, D.C., World Bank, 1994.

[d] Banco Central de Chile, "Aplicación de la ley No. 19696 sobre obligación subordinada", Santiago, Chile, 1996.

[e] Banco Central de Chile, "Evolución de la economía en 1997 y perspectivas para 1998", Santiago, Chile, 1997.

Making good the quasi-fiscal losses accumulated by the central bank (or a public guarantee fund) in its capacity as a public-sector agent necessarily involves the contribution of resources by that sector (net of the financing that the bank can obtain through seigniorage). In the early stages of the financial crisis, the central bank can of course carry out open-market operations in order to neutralize the expansion of domestic credit connected with the quasi-fiscal operations.

The way major financial crises have been handled in the region (see box V-5) shows that the political will to allocate public resources has made it possible to solve them in a non-inflationary manner and restore the solvency of banks and debtors within short periods of time, albeit of course by transferring significant quasi-fiscal losses to the public-sector, as occurred in Colombia and Chile in the mid-1980s. In the case of the latter country, however, the heavy public-sector transfers did not fully correct the central bank's cash flows, which, partly because of the delayed effects of the banking crisis in the early 1980s, continued to be negative in the 1990s. In contrast, if public resources are not allocated, the problems of insolvency remain pending or latent for a long time, favouring inflationary situations and depressing economic activity, as occurred in the Argentine banking crisis of the early 1980s, which dragged on for the whole of that decade.

G. CONCLUSIONS AND FINAL OBSERVATIONS

- The public finances of the region display undoubted progress, with a notable reduction of the deficit and more careful management. The greater macroeconomic stability of the latter part of the 1990s, supported by the present trend in public finances, has put the region in a better position to cope with external disturbances than at the beginning of the decade.
- The adjustment has not been limited only to reducing the deficit (through efforts on both the income and expenditure side) but has also sought to improve performance in other fiscal tasks, such as the quality of resource allocation and the promotion of growth, in an effort to bring public finances more closely into line with the spirit of the economic reforms. Nevertheless, more permanent changes are still called for in such areas as institutional arrangements, fiscal management and administration models, and the promotion of equity.
- Nevertheless, the above trends conceal various phenomena which still indicate a high degree of fragility in terms of the achievements registered. Although public-sector deficits have been substantially reduced in the 1990s, the transition to a new fiscal system has not yet been completed. In quite a few cases, a substantial part of the reduction in fiscal imbalances is due to reductions in their transitory component, thanks to the recovery in economic activity, and to drastic reductions in the rate of inflation; in this latter case, the Oliviera-Tanzi effect has operated in a manner which favours the equilibrium of public finances.
- The indicators usually presented as proof of fiscal success should be taken cautiously. Careful examination reveals that they should be considered in an integral rather than an isolated manner, in order to gain a better picture of actual fiscal performance. Thus, results which appear to be satisfactory at the level of the more aggregated indicators (such as borrowing requirements) may conceal weaknesses in current fiscal management or in inherited commitments which could be more readily

appreciated by looking at other indicators, such as the primary deficit and the current deficit (the operating deficit could even be used in order to avoid overestimating the real fiscal deficit). Although on average the traditional indicators point to an improvement in the fiscal position of the region, it must be emphasized that there are pronounced differences between the countries, particularly with regard to the extent to which they have taken steps to deal with the inherited component to reduce their deficits.

- In accordance with the foregoing, efforts should be made to ensure the proper accounting of various items (income from privatization operations, social funds, etc.) which can affect the interpretation of the customary indicators and lead to a distorted view of fiscal performance. In particular, there are a number of cases where privatization revenues have been registered above the line; this causes the adjustment to appear more solid than it actually is, since a short-lived source of funding is being used to finance recurrent expenditure.
- In view of these problems, the traditional indicators are not capable of giving a proper picture of fiscal policy. As we know, the figures appearing in public-sector accounts are determined both by the decisions of the public authorities and by factors which are not under the direct control of the latter. Consequently, fiscal policy indicators which are independent of the economic cycle are needed. The programming of income and expenditure as a function of a targeted discretionary deficit would make it possible to take a more medium-term approach to the management of public finances and thus avoid the vagaries associated with their management (in the event of a recession, for example, the public sector must accept a certain level of cyclical deficit in order not to make the crisis worse).
- In other cases, the fragility of the fiscal adjustment is due to the recurrent and growing adoption of an active quasi-fiscal policy which may involve resources that are equivalent to several points of GDP but are not included in the estimates of the central government deficit. This problem of a lack of transparency in public finances is evidenced in subsidized credit or exchange-rate operations and bail-out measures for banking establishments. Its growing impact on the public deficit calls for greater efforts in the areas of measurement and accounting in order to maintain greater control over the budget as a whole.
- The fiscal effects of banking crises —whose persistence has become a matter of growing concern— may be reduced through suitable preventive and management measures. This involves strengthening the prudential regulation and supervision of banks and financial establishments (through the prevention of excessive loan exposure, adequate risk coverage and hedging mechanisms, and consolidated regulation and supervision of banks with branches or subsidiaries abroad) and reducing exposure to volatile macroeconomic environments which are likely to fluctuate sharply in response to external shocks. Furthermore, it may be noted from recent examples of the solution of banking crises that the political will to allocate public resource is is of fundamental importance in paving the way for a rapid recovery and minimizing the adverse effects on the economy, albeit at the cost of burdening the public sector with significant quasi-fiscal losses. At all events, it should be remembered that the after-effects of such problems usually persist for a long time.

- In general terms, the public debt situation has been improving, but continued efforts are needed to achieve a solution which will be stable over time. The desire to find a lasting solution for the fiscal problems underlying the external debt crisis which began in 1982 was one of the catalysts for the changes which have been made in the public finances of the region over the last two decades, and in large part this objective is being achieved. Careful attention must also be given to trends in the domestic debt, however, since in recent years the public sectors of the countries of the region have been borrowing heavily from domestic sources.
- Proper management of public finances requires a substantial improvement in the quality and quantity of the fiscal information currently available in the countries of the region. Urgent attention should be given to this long-deferred objective in order to facilitate the task of the economic authorities, increase the transparency of decision-making processes, promote responsible behaviour by public officials, and build up a solid reputation which ensures credibility and thus transmits confidence to the general public, economic agents and markets.

PART THREE: KEY DIMENSIONS OF FISCAL MODERNIZATION

VI. Social expenditure

VII. Social security

VIII. Fiscal decentralization: current trends and pending tasks

IX. Privatization and public finance

X. Modernization of the State, administrative, reform and evaluation of public management performance

VI. SOCIAL EXPENDITURE

A. INTRODUCTION

Most of the region's economies have made great strides over the past few decades in consolidating their public finances. The assignment of such a high priority to stabilization has, however, detracted somewhat from the government sector's fulfilment of its distributional tasks.[1] Although it may be impossible to gauge the extent to which the use of fiscal policy tools is responsible for the increasing concentration of income, it is generally agreed that the objective of achieving greater equity (both horizontally and, most importantly, vertically) has, in large measure, fallen by the wayside in terms of the design and implementation of public policies in general and fiscal policies in particular.

While the goal of social equity has clearly been accorded a lower priority —particularly in the formulation of tax policy— it has not, of course, been neglected entirely, since a number of the routine tasks performed by the State in the management of its revenues incorporate these objectives indirectly. Nonetheless, this should not obscure the fact that during the 1980s social equity was for the most part subordinated to other objectives that played a more direct and explicit role in the design and implementation of fiscal policy. More recently, many Governments have adopted measures —chiefly in relation to social expenditure— that evince a growing awareness of the fact that social conditions have been deteriorating for many years now, and especially since the start of the 1980s.

Following a decade-long decline in social expenditure in the region, more attention began to be paid to the shortfall in social services and to other related issues during the first half of the 1990s and, as a result, social expenditure has been on the rise. Thus far, efforts in this regard have focused primarily on raising the level of social allocations; the next step is to improve the productivity of social expenditure, especially in regard to its efficiency and effectiveness, in order to optimize its benefits in terms of social equity.

In order to narrow the equity gap, which poses a clear threat to the region's political and economic stability, public finances need to be both sound and transparent so that the

[1] Income distribution is becoming increasingly unequal in most of the countries in the region, particularly in urban areas. See ECLAC (1997), chapter 1, table I.11.

State will be free to devote its energy to effective and efficient action in top priority areas. Addressing the problem posed by the insufficient level of equity in the region calls for the demarcation of a priority sphere of action for social spending, and in order to prevent these expenditures from generating destabilizing fiscal pressures, a number of complementary measures will be needed: (i) a reallocation of funds whereby resources are shifted away from lower-priority programmes or activities that can be performed by the private sector and towards social items of expenditure; (ii) an increase in the efficiency of social expenditure; and (iii) an increase in the level of public funding, where appropriate, to satisfy unmet social needs.

In the regionwide debate surrounding this issue, these three areas tend to be set off against one another. In some cases, this greater emphasis on social policy is confined to the areas of reallocation and efficiency, and the possibility of increased funding is ruled out. In others, the focus is entirely on boosting the level of funding, while the exigencies of reallocation and increased efficiency are disregarded. In view of how much ground needs to be covered in order to attain an adequate level of social equity, seeking a greater degree of complementarity among these three lines of policy would appear to be a more reasonable course of action.

B. PUBLIC SOCIAL EXPENDITURE

1. The macroeconomic priority of social expenditure

Measured as a percentage of GDP, social spending in Latin America over the period from 1981 to 1995 declined during the 1980s but has rebounded in the 1990s (see figure VI-1), falling from an average of 8.3% of GDP in 1981 to a low of 6.9% in 1990 and then bouncing back to an average of 9.7% of GDP by 1995, thereby surpassing the level of the early 1980s.

The countries of Latin America fall into three main categories in terms of the macroeconomic priority they assign to social expenditure:[2, 3]

(i) High social expenditure: Uruguay, Costa Rica, Argentina, Brazil,[4] Chile, Mexico and Panama

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[2] This categorization of countries by level of social spending differs from the classification used in the chapter on public expenditure, which is based on the level of total central government spending.

[3] The methodology used in this study for estimating social expenditure differs from the method used in the *Social Panorama of Latin America, 1996*, but the same system for classifying countries according to their level of social spending (high, moderate, low) is employed. The main methodological changes made for the purposes of this study are the following: (i) the analysis was based on data expressed in the local currency rather than in United States dollars; (ii) revised, updated series on social expenditure, total expenditure and gross domestic product were used; and (iii) a narrower definition of social expenditure was employed (here the term includes education, health, housing and social security only).

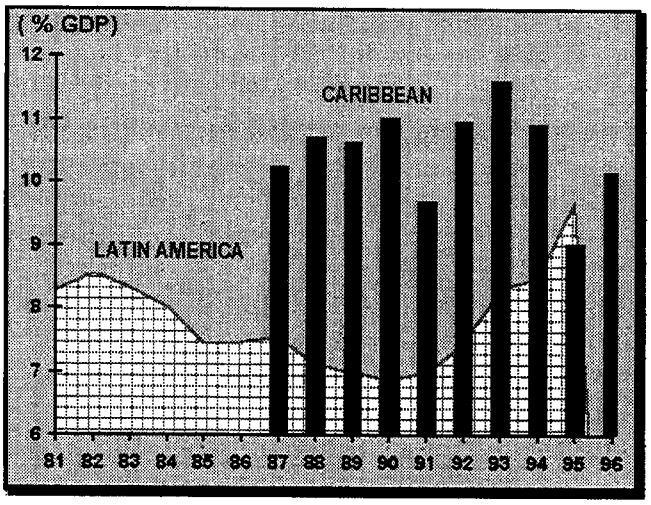
[4] Brazil's statistics underestimate its level of social expenditure by approximately 35% because they refer to social spending by the federal government only.

(ii) Moderate social expenditure: Nicaragua, Colombia and Ecuador
(iii) Low social expenditure: Bolivia, Honduras, El Salvador, Guatemala, Paraguay and The Dominican Republic.

The trend in the macroeconomic prioritization of social spending has been much the same in each of these groups, although it has been more striking in the group with a moderate level of social expenditure. While social spending as a percentage of GDP began to rise in the early 1990s, it regained its early-1980s level in the high-expenditure countries in 1993, in the moderate-expenditure countries in 1994 and in the low-expenditure countries in 1995. The upswing in social spending in the moderate-expenditure group has been so steep that in 1995 these countries' average level of expenditure, in terms of GDP, exceeded that of the high-expenditure group.[5]

In the Caribbean, the macroeconomic priority of social expenditure[6] has fluctuated since the late 1980s within a range of from 9% to 11.6% of GDP and has exhibited a slight downward tendency; this trend appears to have been reversed in 1996, however (see figure VI-1). Moreover, social spending in the Caribbean represents a larger share of GDP than it does in Latin America, and this difference is all the more notable when one considers that the definition of social expenditure used for this subregion does not include the housing sector.

Figure VI-1
PUBLIC SOCIAL EXPENDITURE AS A PERCENTAGE OF GDP
Central government



Source: ECLAC, on the basis of official figures.

[5] The increase registered for the moderate-expenditure group is primarily attributable to an extraordinarily sharp increase in social spending in Colombia.

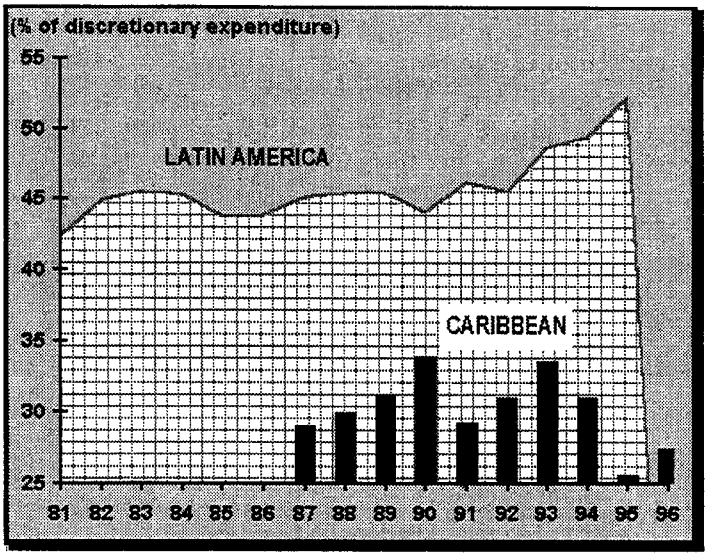
[6] Social expenditure has had to be defined more narrowly for the Caribbean than for Latin America because not enough information is available on the housing sector in this subregion. In addition, fewer countries are covered in this section than in the chapter on public expenditure.

2. The fiscal priority of social expenditure

The upturn in social spending seen during the first half of the 1990s is a reflection not only of an upward trend in discretionary public expenditure in general but also of an increase in the fiscal priority assigned to social programmes (see figure VI-1). Indeed, as a percentage of discretionary expenditure (total expenditure of the central government, net of interest payments), social expenditure in the region has climbed steadily, although the trend in this variable differs from one group of countries to the next. The predominant pattern is essentially the one associated with the high-expenditure category, whose main feature has been a steady rise in social security outlays. The moderate-expenditure group of countries exhibit a steep downturn in the fiscal priority of social spending throughout the 1980s and a sharp turnaround in this trend since 1990. Obviously, social spending carries a lower fiscal priority in the low-expenditure countries, where a slow descent in spending levels had been seen until the reversal of this trend in 1995.

As in the case of its macroeconomic priority, the fiscal priority of social spending in the Caribbean is somewhat variable but has generally exhibited a downward trend (see figure VI-2). In fact, although there have been periods of growth, social spending fell from 33.8% to 27.3% of discretionary government expenditure between 1990 and 1996.

Figure VI-2
PUBLIC SOCIAL EXPENDITURE AS A PERCENTAGE OF GDP DISCRETIONARY EXPENDITURE
Central government



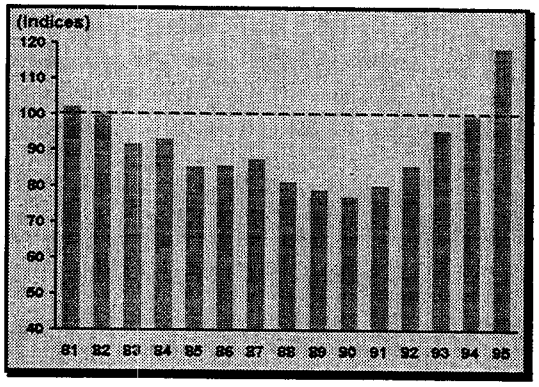
Source: ECLAC, on the basis of official figures.

3. Real per capita social expenditure

The macroeconomic situation observed during the 1980s led to a sharp slump in economic activity in most of the Latin American countries. Consequently, the decrease in the macroeconomic priority of social expenditure during this period was reflected in an even steeper reduction in terms of real per capita expenditure. The higher economic growth rates seen in the 1990s have paved the way for a strong recovery in this indicator, however. As a result of these conditions, real per capita social expenditure dropped sharply during the 1980s, bottomed out in 1990 and did not regain the level reached in the early 1980s until 1994 (see figure VI-3).

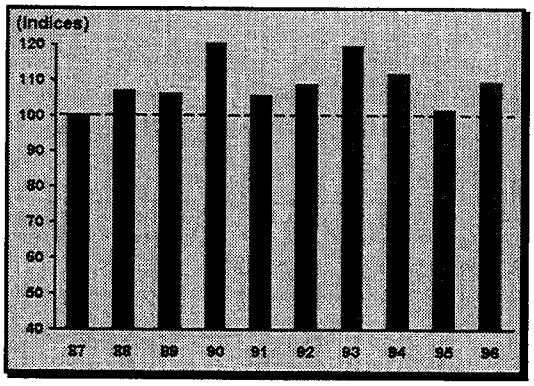
F igure VI-3
PUBLIC SOCIAL EXPENDITURE: PER CAPITA INDICES
Central government

Latin America (1980=100)



Source: ECLAC, on the basis of official figures.

The Caribbean (1987=100)



Source: ECLAC, on the basis of official figures.

Although major cuts were made in all social items of expenditure during the 1980s, for the region as a whole spending reductions were somewhat less drastic in the health sector, where per capital social expenditure decreased by 22% between 1980 and 1990. In the other social sectors —education, social security and housing— this index fell by a full third. During the first half of the 1990s, the upswing in per capita expenditure was fairly even, but was somewhat more notable in the health sector, which is consequently the only sector that has a high growth rate for this period as a whole (see table VI-1).

Table VI-1
LATIN AMERICA: PER CAPITA SOCIAL EXPENDITURE
1980 AND 1995[a]
(Average index: 1980=100)

Group of countries / Sector	1990				1995			
	Level of social expenditure			Latin America	Level of social expenditure			Latin America
	High[b]	Moderate[c]	Low[d]		High[b]	Moderate[c]	Low[d]	
Education	67.4	72.4	61.8	66.9	78.9	138.9	87.6	100.6
Health	80.5	90.7	66.5	78.0	104.5	279.8	104.2	154.6
Social security	96.5	88.2	43.7	67.3	139.4	177.8	55.5	106.1
Housing	61.5	95.8	50.0	64.3	44.4	150.2	160.2	117.6
Social expenditure	82.6	85.9	64.2	76.3	100.3	171.7	92.3	118.3

Source: ECLAC, on the basis of official figures.
[a] Simple averages.
[b] Argentina, Brazil, Chile, Costa Rica, Mexico, Panama and Uruguay.
[c] Colombia, Ecuador and Nicaragua.
[d] Bolivia, Dominican Republic, El Salvador, Guatemala, Honduras and Paraguay.

An analysis of the different country groupings shows that spending patterns differ considerably from sector to sector (although the groups also have quite different levels of real per capita expenditure). The trend in the educational sector is similar in all three groups of countries: a sharp, uninterrupted downturn between 1980 and 1990, followed by a recovery. The fact that per capita expenditure on health enjoyed a relatively greater measure of protection during the 1980s is chiefly attributable to the situation in the moderate-expenditure countries. This is also the group in which spending on health services has increased the most in the 1990s.

The indicator for the social security sector has behaved quite differently. Per capita expenditure plummeted in the countries with low levels of social spending until 1990, when it gradually began to recover. In contrast, this indicator climbed steadily in the high-expenditure group from 1983 on and held fairly steady in the moderate-expenditure countries up to 1990, when it began to rise. Hence, the mounting demand for public funding associated with pension reforms and other adjustments in social security liabilities is clearly reflected in these last two groups.

Per capita spending on the housing sector, which receives the smallest share of social expenditure, has fluctuated sharply. This may signal the presence of a tendency to allocate funds to this sector on a residual basis and to assign it a lower priority than the other social sectors.

In per capita terms, then, reductions in social spending have been the steepest in the low-expenditure countries while the strongest recoveries in all the social sectors have been seen in the moderate-expenditure group.

Per capita social expenditure in the Caribbean has fluctuated more sharply over the past decade than it has in Latin America, but it has never fallen below its 1987 level, thanks to the increases made in different components of social expenditure in the subregion at

different points in time. For example, during the period from 1987 to 1990, the figures on social expenditure were heavily influenced by a sharp upturn in spending on education; in the early 1990s, expenditure on social security rose considerably, and in the period 1994-1996, the trends in spending on education and social security offset the slump in spending on health care (see figure VI-3 and table VI-2).

Table VI-2
THE CARIBBEAN: PER CAPITA SOCIAL EXPENDITURE[a]
(Indices: 1987=100)

Sector	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Education	100.0	105.4	112.2	132.1	106.0	110.2	131.4	117.1	103.4	113.3
Health	100.0	102.5	97.4	107.2	98.4	97.9	102.1	98.8	93.6	98.4
Social security	100.0	119.8	108.1	113.6	120.9	128.6	124.0	124.5	115.2	122.9
Social expenditure	100.0	106.6	106.1	120.0	105.5	108.6	119.5	11.5	101.7	109.3

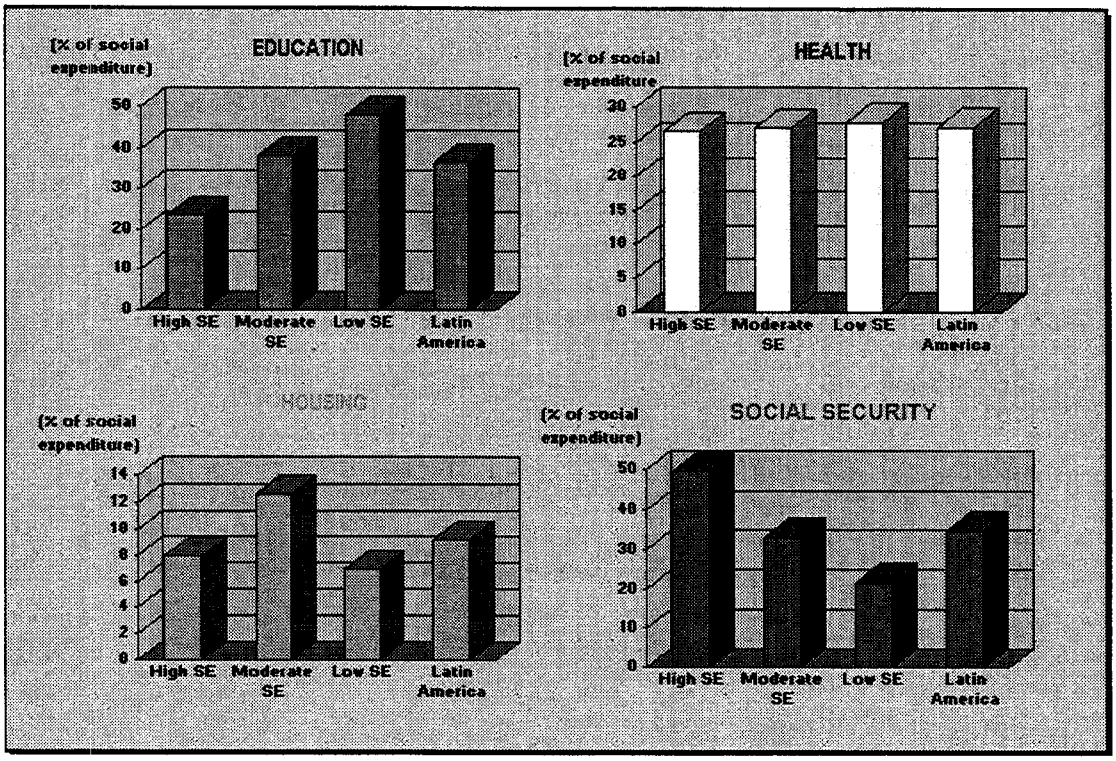
Source: ECLAC, on the basis of official figures.
[a] Simple averages; for Barbados, Jamaica and Trinidad and Tobago.

4. The sectoral distribution of social expenditure

Education and social security account for the lion's share of social expenditure. They are followed by the health sector, while housing has a significantly smaller share. The relative size of these sectors varies from one group of countries to the next; the social security system tends to be the predominant component in the countries with high levels of social expenditure, whereas education is the main component in the countries that spend a comparatively small amount on social services.

When all the countries are taken as a whole, the sectoral breakdown of social expenditure exhibits a slight downward trend in spending on education, a fairly constant level of social security outlays and sharply fluctuating levels of expenditure on the health and housing sectors.

Figure VI-4
LATIN AMERICA: PUBLIC SOCIAL EXPENDITURE, BY SECTOR
1990-1995

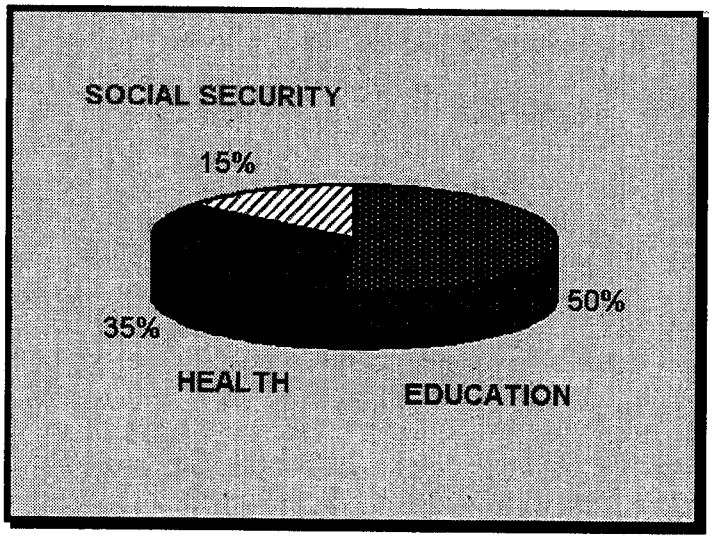


Source: ECLAC, on the basis of official figures.
Note: Simple averages; no adjustments have been made to reflect differences in country samples or years.

The most conspicuous aspect of the high-expenditure countries is the increasing importance placed on social security, to the detriment of expenditure on education and health. This trend is partially offset by the spending patterns of the low-expenditure group, in which education's share of total social funding has remained constant and spending on health services has been rising fairly rapidly since the mid-1980s whereas social security expenditures have fallen. In the moderate-expenditure group, a slight decline in education's share of total social expenditure has been coupled with an equally slight increase in the shares of the social security and health systems.

An analysis of the sectoral distribution of social expenditure in the Caribbean shows that the share of total social expenditure allocated to education has held steady since the end of the 1980s (50%). An increase in spending on social security has driven up this sector's share by nearly 30% since 1992 at the expense of the health sector.

Figure VI-5
THE CARIBBEAN: PUBLIC SOCIAL EXPENDITURE, BY SECTOR[a]
1990-1996



Source: ECLAC, on the basis of official figures.
[a] Simple average for Barbados, Dominica, Grenada, Jamaica and Trinidad and Tobago.

C. THE DISTRIBUTIONAL IMPACT OF PUBLIC EXPENDITURE

In the formulation of the public budget, a series of consistency checks are usually used to guide the budgeting process. This type of exercise is used to determine the probable impact of projected earnings and proposed outlays on basic macroeconomic equilibria (i.e., on future trends in such variables as aggregate demand, saving, public-sector borrowing requirements and debt, the monetary base, interest rates and private investment, price levels, the demand for foreign exchange, etc.). The importance of these considerations notwithstanding, the classic functions of public policy in general —and specifically of fiscal policy— are considerably more complex, and the public budget law must therefore satisfy a variety of objectives.

In fact, the budget is the main vehicle for direct government intervention in the resource-allocation and income-redistribution process, and is therefore expected to do more than simply play its part in maintaining the stability of macroeconomic variables. However, the use of macroeconomic consistency checks in the budgeting process is rarely complemented by other, equally relevant exercises which would allow considerations relating to other fiscal policy functions to be incorporated into the decision-making process. Specifically, little or no attempt is made to estimate the redistributional impact of budget proposals.

The fact that such attempts are not being made can be attributed to the technical difficulty of identifying, measuring and factoring in the direct and indirect effects of different fiscal measures and to the lack of accurate information on the distributional implications of various sorts of taxes and government outlays. However, since one of the major objectives of public policy is to ensure that the tax system is as equitable —in both a vertical and a horizontal sense— as a country's legislators have intended it to be, there is a clear need to equip fiscal authorities with tools for comparing the distributional implications of different fiscal proposals. Inasmuch as weaknesses in the public sector's financial position are a manifestation of distributional conflicts among economic agents as to the form and content of the fiscal covenant, any inroads made in this respect, no matter how partial or preliminary they may be, will constitute a valuable contribution to the Governments of the region in the public debate on fiscal issues and, most importantly, the debate surrounding tax reform and budget approval.

Hardly any country in the region has comprehensive, up-to-date studies on tax implications at its disposal at the present time. This is partly due to the fact that during the 1980s most of the experts on the subject were skeptical about the effectiveness of the tax system as a tool for redistributing income. Such studies will have to be conducted, however, if tax policy and its management are to be prevented from bringing about a further deterioration in income distribution. By the same token, few countries in the region have looked into the implications of given types of expenditures, at either the sectoral or nationwide level. In view of the high priority which the Governments of the region are placing on the need to target social spending and improve its efficiency, it would clearly be helpful to conduct regular studies to assess the impact of selected items of public expenditure, especially those intended for low-income groups.

Although there is no doubt as to the usefulness of separate evaluations of the implications of taxes and of items of expenditure, for certain analytical purposes it becomes necessary to obtain a more complete picture of the situation by combining these two aspects into what might be referred to as a budgetary impact assessment.[7] This type of study attempts to determine the net effect of the Government's budgetary measures on personal income distribution at any given point in time (although it could also focus on their net impact on functional, regional or sectoral income distribution). These kinds of budgetary impact assessments allow certain conclusions to be drawn with regard to the **net** distributional effect of the Government's budgetary actions. For example, a proposal for an increase in public expenditure which is to be financed by raising taxes (e.g., the VAT rate) is tantamount to a proposal for a redistribution of income whose net direction and magnitude should be ascertained beforehand. This raises the question as to how we might go about making a qualitative evaluation of alternative budget proposals from the standpoint of their net distributional effects on each income decile, or, if the poorest sectors of the population are the focus of attention, then how we might evaluate the impact of fiscal measures on the poorest quintile or the poorest half of the population.

[7] If, for example, a study on tax implications arrives at the conclusion that the tax structure is becoming increasingly regressive, while a study on spending implications finds that the structure of expenditure is becoming increasingly progressive, then it would clearly be desirable to have studies that encompass both of these findings.

The strategic importance of this subject area lies in the renewed interest and resulting prioritization by numerous national Governments and international organizations working in the region of such issues as equity in the tax system and in public expenditure, the targeting of social spending, social safety nets, the distributional impact of structural reform, stabilization and adjustment programmes, and other related questions.

1. Partial equilibrium analysis[8]

Despite their many inherent limitations, analyses based on partial equilibrium models are an important indicator of how equitable government measures are or are not. The findings reported by studies conducted on this question in the region are not directly comparable.[9] Nonetheless, these studies do offer a useful frame of reference for estimating the distributional effects of public expenditure.[10]

In the three countries for which sufficient information is available on all four social sectors (education, health, social security and housing), social expenditure benefits higher-income groups the most in absolute terms (Chile, Uruguay and, to a lesser extent, Argentina). Nevertheless, it has a positive distributional impact because the initial pattern of income distribution is even more unequal; in other words, when measured as a percentage of the recipients' incomes, these subsidies are larger for the poorest strata of society. The progressiveness of expenditure on human capital (education and health) marks a sharp contrast to the highly regressive nature of spending on social security and, to a lesser extent, housing; the effects of expenditure on housing do not follow a clear pattern in these countries but, on the whole, are concentrated in middle-income groups.

In the broader range of countries covered in table VI-3, the distribution of spending on human capital is more equitable than it is in the case of housing. Within the first of these two categories, spending on health services is generally more progressive than expenditure on education. Actually, the progressiveness of spending on public education is the net effect of a progressive distribution of expenditure on primary and, to a less marked degree, secondary education and the regressive impact of expenditure on higher education. The reason why expenditure on housing is less progressive is that most housing programmes take the form of preferential credit schemes whose eligibility requirements include some level of prior savings, and the poorest members of the population, who lack any capacity to save, therefore do not qualify for the subsidies.

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[8] For a more detailed discussion of this question, see ECLAC (1994), chapter IV.

[9] This is due to differences in the methodologies they employ to calculate costs and implicit subsidies; their geographic, sectoral and expenditure-category coverage; the simplifying assumptions made; the time periods examined; the sectoral definitions used; and other factors.

[10] Not all of these studies examine the four social sectors discussed here. It should be noted that references to aggregate sectoral results may relate to different samples chosen on the basis of what types of information were available at the time.

Table VI-3
CONCENTRATION OF SOCIAL EXPENDITURE (INDEX)[a]

Sector / Country	Education				Health	Human capital	Housing	Social security	Social expenditure
	Primary	Secondary	Higher	Total					
Argentina	9.5	2.7	0.2	2.6	8.7	3.6	1.2	0.4	1.0
Bolivia	3.6	n.a.	0.3	n.a.	0.3	n.a.	n.a.	0.4	n.a.
Chile	5.3	4.4	1.2	3.2	2.2	2.8	1.0	0.1	0.8
Colombia	9.4	2.1	0.2	1.6	4.5	2.2	1.8	n.a.	n.a.
Costa Rica	3.7	1.1	0.04	0.7	2.6	1.4	n.a.	0.2	n.a.
Ecuador	4.7	4.5	1.6	2.5	2.1	2.5	n.a.	n.a.	n.a.
Peru	2.4	0.9	0.2	1.1	n.a.	n.a.	n.a.	n.a.	n.a.
Dominican Republic	n.a.	n.a.	n.a.	n.a.	1.4	n.a.	0.2	n.a.	n.a.
Uruguay	13.8	3.4	0.1	2.3	3.5	2.9	0.5	0.4	0.8
Venezuela	n.a.	n.a.	n.a.	0.8	n.a.	n.a.	n.a.	1.5	n.a.

Source: ECLAC, on the basis of José Rodríguez, "Educación y distribución del ingreso en el Perú", *Gestión pública y distribución de ingresos: tres estudios de caso para la economía peruana*, Working Paper, No. 115, Washington, D.C., Inter-American Development Bank (IDB), 1992; I. Santana and M. Rathe, "El impacto distributivo de la gestión fiscal en la República Dominicana", Working Papers, No. 107, Washington, D.C., IDB, 1992; J.C. Navarro, "El impacto del gasto público en educación en Venezuela", *Gestión fiscal y distribución del ingreso en Venezuela*, Caracas, Programas para la Red de Centros de Investigación Económica Aplicada, IDB, 1991; G. Márquez, "El sistema de seguros sociales en Venezuela", *Gestión fiscal y distribución del ingreso en Venezuela*, Caracas, Programas para la Red de Centros de Investigación Económica Aplicada, IDB, 1991; R. Urriola, "Incidencia del gasto público social en Ecuador", Política fiscal series, No. 97 (LC/L.1027), Santiago, Chile, ECLAC, 1997; M. Urquiola, "Inversión en capital humano y focalización del gasto social: análisis de la asistencia y cobertura de servicios sociales por quintiles", Documentos de trabajo series, No. 8, La Paz, Unidad de Análisis de Políticas Sociales (UDAPSO), 1993; M.C. Vargas de Flood and M. Harrigue, "Impacto distributivo del gasto social en Argentina", document presented at the Workshop on Methodological Problems in the Measurement of Public Social Spending and its Redistributive Impact, Santiago, Chile, 1993; C.E. Vélez, "La incidencia del gasto público social en Colombia", Bogotá, Departamento de Planeación Nacional, 1994; Ministerio de Planificación y Cooperación (MIDEPLAN), *Programas sociales: su impacto en los hogares chilenos*, Santiago, Chile, 1990; I.H. Petrei, "Distribución del ingreso: el papel del gasto público social", document presented at the VII Regional Seminar on Fiscal Policy, Santiago, Chile, 1995.

[a] Concentration index: % of social expenditure received by poorest 20% of population / % of social expenditure received by richest 20% of population.

In order to compare the amount of assistance given to poor groups with the average level of assistance received by the total population, aggregate and sectoral targeting indices were estimated using the poor population of each country as the target group for social expenditure.[11] The resulting targeting indices fell far short of the maximum or potential index (see table VI-4), which suggests that —above and beyond any steps that should be taken to alter the inter- or intra-sectoral distribution or levels of social expenditure— a great deal remains to be done in order to improve its efficiency and effectiveness.

As was to be expected from the above observations regarding the regressiveness of social expenditure in Argentina and Chile, it was found that poor people in these countries

[11] Although poor sectors of the population are not necessarily the target group for every social programme, this simplifying assumption has been used for purposes of illustration using the poverty lines for the years in which each study was conducted.

receive a smaller share of the benefits than the rest of the population does. In Uruguay, the two groups share equally in the social benefits provided. In Colombia, Ecuador and Peru, poor sectors receive an above-average share. Expenditures on health and primary education are the most precisely targeted types of social spending, and their level of targeting carries over into the category of expenditure on human capital as a whole in every one of the countries studied. Spending on social security, secondary and higher education and, in some countries, housing does not target lower-income groups very accurately.

Table VI-4
TARGETING OF SOCIAL EXPENDITURE (INDEX)[a]

Sector / Country	Education				Health	Human capital	Housing	Social security	Social expenditure	Potential targeting
	Primary	Secondary	Higher	Total						
Argentina	2.1	1.4	0.4	1.6	1.9	1.7	1.0	0.6	1.1	8.3
Boliva	0.2	n.a.	0.5	n.a.	0.8	n.a.	n.a.	0.7	n.a.	1.6
Chile	1.6	1.4	1.0	1.4	1.2	1.3	0.9	0.4	0.9	3.1
Colombia	1.5	1.2	0.5	1.1	1.4	1.2	1.0	n.a.	1.2	2
Costa Rica	1.5	0.9	0.20	0.8	1.3	1.1	n.a.	0.4	0.9	4
Ecuador	1.6	1.5	1.3	1.4	1.4	1.4	n.a.	n.a.	1.4	2.9
Peru	1.3	1.0	0.8	1.1	n.a.	n.a.	n.a.	n.a.	1.1	1.9
Dominican Republic	n.a.	n.a.	n.a.	n.a.	1.3	n.a.	0.4	n.a.	n.a.	5
Uruguay	2.6	1.5	0.3	1.7	1.7	1.7	0.8	0.6	1.0	12.5
Venezuela	n.a.	n.a.	n.a.	0.9	n.a.	n.a.	n.a.	1.1	n.a.	3.7/2.9[b]

Source: ECLAC, on the basis of José Rodríguez, "Educación y distribución del ingreso en el Perú", *Gestión pública y distribución de ingresos: tres estudios de caso para la economía peruana*, Working Paper, No. 115, Washington, D.C., Inter-American Development Bank (IDB), 1992; I. Santana and M. Rathe, "El impacto distributivo de la gestión fiscal en la República Dominicana", Working Papers, No. 107, Washington, D.C., IDB, 1992; J.C. Navarro, "El impacto del gasto público en educación en Venezuela", *Gestión fiscal y distribución del ingreso en Venezuela*, Caracas, Programas para la Red de Centros de Investigación Económica Aplicada, IDB, 1991; G. Márquez, "El sistema de seguros sociales en Venezuela", *Gestión fiscal y distribución del ingreso en Venezuela*, Caracas, Programas para la Red de Centros de Investigación Económica Aplicada, IDB, 1991; R. Urriola, "Incidencia del gasto público social en Ecuador", Política fiscal series, No. 97 (LC/L.1027), Santiago, Chile, ECLAC, 1997; M. Urquiola, "Inversión en capital humano y focalización del gasto social: análisis de la asistencia y cobertura de servicios sociales por quintiles", Documentos de trabajo series, No. 8, La Paz, Unidad de Análisis de Políticas Sociales (UDAPSO), 1993; M.C. Vargas de Flood and M. Harrigue, "Impacto distributivo del gasto social en Argentina", document presented at the Workshop on Methodological Problems in the Measurement of Public Social Spending and its Redistributive Impact, Santiago, Chile, 1993; C.E. Vélez, "La incidencia del gasto público social en Colombia", Bogotá, Departamento de Planeación Nacional, 1994; Ministerio de Planificación y Cooperación (MIDEPLAN), *Programas sociales: su impacto en los hogares chilenos*, Santiago, Chile, 1990; I.H. Petrei, "Distribución del ingreso: el papel del gasto público social", document presented at the VII Regional Seminar on Fiscal Policy, Santiago, Chile, 1995.

[a] Targeting index: % of social expenditure received by target population / target population as a percentage of the total population.

[b] The first coefficient refers to education and the second to social security (in different years).

2. General equilibrium analysis

Analysing the distributional implications of public expenditure is a highly complex undertaking because of the vast number of interactions that must be taken into account. Although a partial equilibrium analysis may provide an idea of the immediate effects of specific types of expenditures, it will not shed much light on any significant consequences of an indirect nature which could have a decisive influence on the end result. One of the factors that is of crucial importance in determining the distributional effect of public expenditure is the overall balancing of the budget.

For example, the region has witnessed cases in which a given spending programme whose direct effect is to improve distribution nonetheless helps to generate a disequilibrium in public finances which leads to a situation of macroeconomic instability that ultimately has adverse distributional effects. Proposed changes in public expenditures should therefore be examined within a frame of reference that encompasses both their direct and their indirect effects and should be coupled with budget-balancing measures. General equilibrium computer models for Argentina, Brazil and Colombia have been developed for this purpose. These models examine the overall distributional effects of changes in given budget items together with those of offsets designed to balance the budget.[12]

Table VI-5 provides an overview of the effects —projected with the help of simulations conducted using general equilibrium models— on GDP and on an income distribution indicator of changes in the level of public expenditure and of offsetting policy measures designed to balance the budget. For each type of increase in expenditure, the effects on GDP and distribution generated by shocks and by budget-balancing measures are summarized.

A first lesson to be drawn from this analysis is that the elasticity of domestic supply and the import capacity of the economy at any given point in time play a vital role in determining the distributional effect of an increase in public spending. The lower the elasticity of domestic supply and the lower the economy's import capacity, the smaller the increase in GDP generated by increased spending and the greater the likelihood that the increase in public spending will crowd out private expenditure via rising prices and real wage reductions, which will in turn cause income distribution to worsen.

In the region's experience, this type of macroeconomic adjustment leads to distributional setbacks owing to the differences existing in the various socio-economic strata's ability to protect their real income levels against inflation. Conversely, the greater an economy's ability to respond to an increase in aggregate expenditure by boosting domestic production and expanding the supply of imports, the greater the likelihood that the distributional effects of such an increase will be progressive. As may be seen from the first column in table VI-5, a positive variation in GDP stemming from an increase in expenditure is correlated with reductions in indicators of inequality.

[12] See Chisari and Romero (1996), Urani, Moreira and Willcox (1997), and Lora and Fernández (1996).

Table VI-5

EFFECTS OF SHOCKS AND ADJUSTMENT POLICIES ON GDP AND THE DEGREE OF INEQUALITY [a b]

SHOCKS		NO OFFSETS	DEFICIT OFFSETS		
			Increase in		Reduction in
			direct taxes	indirect taxes	public investment
Increase in current expenditure equal to 2% of GDP [c]					
Argentina	GDP	0.07	-0.01	-0.36	-0.08
	Gini	0.25	-2.06	0.18	-0.47
Brazil	GDP	3.37	2.21	2.86	1.46
	Theil	-2.19	-1.23	-0.46	-1.97
Colombia	GDP	1.63	0.33	-0.01	-0.59
	Gini (urban)	-0.01	0.05	0.03	0.05
	Gini (rural)	-0.18	-1.24	-0.03	0.31
5% increase in public-sector wages					**Reduction in current expenditure**
Argentina	GDP	0.01	0.00	-0.07	-0.01
	Gini	0.15	0.13	0.13	0.18
Brazil	GDP	0.39	0.15	0.24	0.30
	Theil	-1.27	-1.01	-1.12	-1.21
Colombia	GDP	0.20	0.01	-0.09	-0.17
	Gini (urban)	-0.01	0.00	-0.01	0.00
	Gini (rural)	0.04	-0.16	0.08	0.16
Increase in public investment equal to 2% of GDP					
Argentina	GDP	0.10	0.03	-0.31	0.08
	Gini	-0.10	-2.49	-0.23	-0.44
Colombia	GDP	2.11	0.86	0.45	0.52
	Gini (urban)	-0.05	0.00	-0.02	-0.04
	Gini (rural)	-0.46	-1.52	0.33	-0.29

Source: L.F. Jiménez, "Distribución del ingreso, shocks y políticas macroeconómicas", Financiamiento del desarrollo series, No. 44 (LC/L.1006), Santiago, Chile, ECLAC.

[a] GDP growth rates.

[b] Absolute changes in inequality indices.

[c] Does not include wages.

These results notwithstanding, several other factors need to be borne in mind. First of all, studies on countries in Latin America and elsewhere suggest that the direct and indirect distributional effects of increases in total public expenditure are not especially progressive, since they are not usually oriented primarily towards poor sectors.[13] Furthermore, when factors come into play that interfere with the response of domestic supply, then the net effect of increases in total public expenditure is more likely to be regressive, as noted earlier. In order for spending increases to help bring about a real redistribution of income, they should be made in those components that have the most direct impact on the poor segments of the population and should be done in a way that keeps public finances in balance and does not place any added constraints on the supply of either locally-produced goods or imports.

Second, as shown in table VI-5, the tools that the authorities can use to balance the budget are not distributionally neutral. The lessons of experience, the theoretical work done on the subject and relevant case studies all indicate that indirect taxes are more likely to have spillover effects than direct taxes are. The figures given in the table confirm this, since they show that increases in current public expenditure are more likely to have regressive effects when they are financed by higher indirect taxes than if direct taxes are used to balance the budget.

In most of the cases examined, the use of direct taxes to restore budgetary equilibrium reduces the degree of income concentration. For example, in Brazil an increase in current spending equivalent to 2% of GDP would result in a 2.19-point improvement in the Theil index. The various policy tools that can be used to re-balance the budget will, however, have different distributional results. Thus, if direct taxes are raised, the Theil index of inequality will be reduced by 1.23 points, which compares favourably with the alternative of raising indirect taxes (an improvement of only 0.46 points). Consequently, if the idea is to make the budget more progressive, then much of the funding needed to balance income and expenditure should come from direct taxes.

The choice of instruments for balancing the budget becomes somewhat more complicated when increases in public investment are planned, since other factors, in addition to those discussed above, come into play. The effects of these factors cut across a significant time span and could therefore not be fully incorporated into the simulations. This is because, unlike what occurs with much of current expenditure, capital expenditure tends to boost future production capacity and, hence, to raise the level of well-being of the various socio-economic strata. Depending on the elasticity of supply, the crowding-out of private expenditure and well-being tend to be concentrated in the near future, and a static analysis may therefore overestimate the regressive implications of such changes. In addition, the implementation of tax increases to balance the budget will heighten the short-run losses in well-being caused by the greater pressure on supply and its effect in crowding out private expenditure and well-being.

In order to prevent this crowding-out effect, there are two possible options for covering the increased outlays on investment: shift the structure of public expenditure towards investment, or finance it through increased public borrowing. The distributional implications of the first option are more closely associated with the types of investments

[13] A study by Bourguignon and Morrisson (1992) reports findings that corroborate this observation in the cases of Ecuador, Indonesia, Côte d'Ivoire and Morocco.

that are made. The more such investments do to help boost the future production of the public goods and services that are most heavily in demand in the poorer sectors of the population (primary health care and sanitation services in outlying areas, rural electrification and communications), the more certain they will be to have a progressive effect in terms of the redistribution of income as time goes by. With the second option, the distributional nature of the investment budget will also be influenced by the type of tax structure that is in place when the time comes to service the financial commitments that have been taken on. In any event, the greater the share of public budgetary resources which is obtained from indirect taxes, the greater the probability that the progressive impact of public investment programmes will be reduced; the greater the role played by direct taxation, the more progressive such programmes will tend to be.

D. SOCIAL FUNDS[14]

The subject of social funds has become an important issue in the region owing to the persistent difficulties experienced by public-sector institutions in implementing certain types of sectoral policies that depend largely on their own fiscal resources. Specifically, the aim of these funds is to provide for the on-going financing of strategic programmes that receive insufficient government support.

Although the debate as to the relevance of these funds has yet to be resolved (see box VI-1), it is clear that they represent an option whose advantages and disadvantages need to be weighed on a case-by-case basis. Moreover, the resurgence of these funds has been accompanied by new elements which incorporate the lessons learned from past successes and failures and which thus provide an indication of the most appropriate direction in which to move, as well as pointing up the types of difficulties that could arise in the funds' design and implementation. These new elements are basically associated with a change in strategy as regards forms of financing and the types of programmes to be funded.

[14] For further information on this subject, see ECLAC (1997), chapter V.

Box VI-1
THE CURRENT DEBATE ON SOCIAL FUNDS

There is currently no consensus as to what role social funds should perform in allocating resources. Debate continues both at the academic level —considerations of efficiency and equity— and at the practical level —successes and failures. Some of the most frequent arguments for and against social funds are summarized below.

Arguments in favour of social funds:

- They represent an alternative which is much more autonomous than traditional government institutions.
- They make it possible to mount a frontal attack on the problem of resource shortages in strategic sectors (education, health, transport, etc.).
- Because their funding is not linked to government decisions on resource allocation, they help reduce the instability of resource flows and thus facilitate a suitable planning and organization of activities.
- They generate greater support among the general public (management and funding), since there is no doubt as to how the funds are to be used.
- They make it possible to maintain financial control.
- Government authorities have an incentive to supervise and control the fund's activities since they do not have access to its resources.
- They free the Government from the need to provide funding out of general tax revenues, which can then be used on a discretionary basis.
- They represent a more efficient response to the shortcomings and general decline of public-sector institutions (excessive red tape, high operating costs).

Arguments against social funds:

- Some past experiences have not been encouraging due to inaccurate targeting (e.g., social funds intended to alleviate extreme poverty which failed to prioritize the indigent).
- There has been a lack of coordination with State bodies which has led to a duplication of effort and to problems in relation to project sustainability.
- As a palliative measure, they do not attack the root problem; greater efficiency in public management and proper programme-based budgeting would be a better solution.
- Misuse of earmarked funds is still possible even in the case of well-structured entities. The "principal-agent" problem persists.
- Social funds violate the Treasury's single-till principle, which provides the Treasury with the flexibility it needs to allocate scarce resources efficiently and to diversify risk.

1. Features of social funds

Essentially, social funds are "... decentralized public corporations having their own legal status and assets which enjoy varying degrees of administrative, technical and financial autonomy".[15] Table VI-6 lists a broad sampling of the funds operating in the region. The policies pursued by these institutions are governed by three main criteria: integrality, social equity and participation. In Latin America, they have become effective financial intermediaries thanks to their high degree of autonomy, transparency and efficiency, their rapid and flexible operation, their demand-oriented focus, their emphasis on the use of selective mechanisms for targeting socially high-priority projects and their ability to mobilize international support.

Social funds were originally established to combat poverty and alleviate the effects of the austerity measures adopted by Governments in the 1980s. They were regarded as strictly temporary, emergency measures —with a definite end date— and their funding came from sources outside the regular budget for basic social services.[16] Initially, then, the idea was not to modify the prevailing type of social policy nor to alter the structure underpinning these policies, but simply to create a "parallel" institution that would have political and financial autonomy in administering social services. Thus, the funds were set up outside the bureaucratic structure, and some reported directly to the highest level of political authority. The need to reform the social sector as such did not receive much attention, as top priority was being given to short-term problems. In fact, responsibility for carrying out activities financed by the funds was frequently handed over to private firms.

Now, however, these funds are explicitly linked to the reform of social sectors —it having been demonstrated that public social expenditure was not reaching the poor in a comprehensive or efficient manner— and are viewed as mechanisms that can facilitate a more efficient and equitable management of available resources.[17] The objectives of this line of action are twofold: first, to channel the efforts of the various branches of the public sector so that they will converge upon the most vulnerable social groups; and, second, to allocate fresh resources, via the funds, for both public and non-governmental programmes focusing on structural poverty.[18]

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[15] Godoy and Rangel (1997).

[16] Examples include the FSE of Bolivia, FIS of El Salvador, FISE of Nicaragua, FES of Panama and FHIS of Honduras.

[17] This is the case of the FIS of Guatemala, FIS of Bolivia, FOSIS of Chile, FONVIS of Venezuela and FONCODES of Peru, among others.

[18] A description of sources of funding and of the uses made of such resources is presented in ECLAC (1997), pp. 108-109.

Table VI-6

LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): SOCIAL FUNDS [a]

Country	Year established	FUND[b]
South America		
Argentina	1995	Participatory Social Investment Fund (FOPAR)
Bolivia	1986	Social Emergency Fund (FSE)
	1990	Social Investment Fund (FIS)
Chile	1990	Social Investment and Solidarity Fund (FOSIS)
Colombia	1992	Social Emergency and Solidarity Fund (FOSES)
Ecuador	1993	Emergency Social Investment Fund (FISE)
Guyana	1990	Social Impact Amelioration Programme (SIMAP)
Peru	1991	National Social Compensation and Development Fund (FONCODES)
Uruguay	1990	Emergency Social Investment Fund (FISE)
Venezuela	1990	Social Investment Fund of Venezuela (FONVIS)
Central America		
Belize	1996	Social Investment Fund (SIF)
Costa Rica	1974	Social Development and Family Allotment Fund (FODESAF)
El Salvador	1990	Social Investment Fund (FIS)
Guatemala	1993	Social Investment Fund (FIS)
Honduras	1990	Honduran Social Investment Fund (FHIS, I and II)
Nicaragua	1990	Emergency Social Investment Fund (FISE)
Panama	1990	Social Emergency Fund (FES)
The Caribbean		
Dominican Republic	1993	Community Initiatives Promotion Fund (PRO-Comunidad)
Haiti	1990	Economic and Social Assistance Fund (FAES)

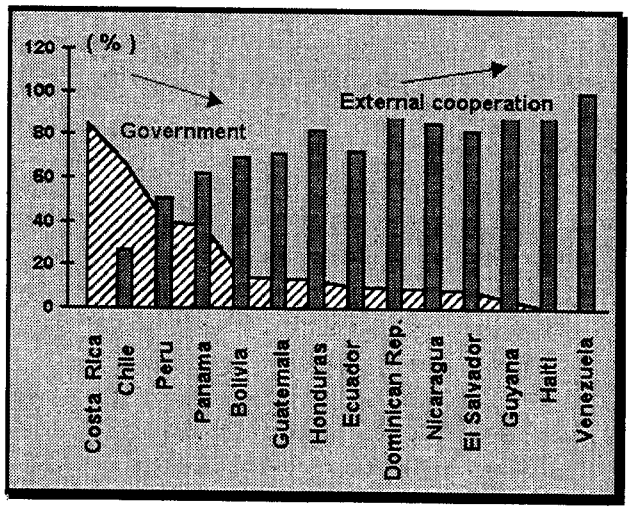
Source: ECLAC, *Social Panorama of Latin America. 1996 Edition* (LC/G.1946-P), Santiago, Chile, 1997. United Nations publication, Sales No. E.97.II.G.4.; and *The Equity Gap. Latin America, the Caribbean and the Social Summit* (LC/G.1954/Rev.1-P), Santiago, Chile, 1997. United Nations publication, Sales No. E.97.II.G.11.

[a] No distinction has been made between emergency and investment funds because almost all the funds have, to a greater or lesser degree, performed both functions, even in those cases where the title of the fund refers to only one or the other. Bolivia is the only exception.

[b] The social funds listed above fit the legal/regulatory definition of such entities; FINSOCIAL-COFINS and FIS of Brazil, PRONASOL of Mexico and SESP of Jamaica were not included because they do not meet this criterion.

The main sources of financing for social funds are foreign grants and donations and national public contributions; together, these two sources account for at least 90% of the total inflow to such funds (see figure VI-6).[19] Generally speaking, external resources provide the bulk of the funding,[20] while public resources, though a feature in virtually all the countries, as yet account for only a minor share of these funds' budgets, except in Chile, Costa Rica and, to a lesser extent, Peru and Panama.

Figure VI-6
SOURCES OF FINANCING FOR SOCIAL INVESTMENT FUNDS[a]
1994-1995
(Percentages)



Source: L. Godoy and M. Rangel (cons.), Nuevas experiencias en política social: los fondos de inversión social en América Latina y el Caribe en los programas sociales (LC/R.1744), Santiago, Chile, ECLAC, 1997.
[a] The sample includes all the funds listed in table VI-6 except those of Colombia and Uruguay.

2. Experiences and challenges

The experience accumulated to date shows that these funds have been an effective mechanism for channelling flows of external financing into specific projects. As a rule, social investment funds have been effective in alleviating poverty,[21] and although they are

[19] The balance is made up of contributions by beneficiaries (cofinancing) and other sources (such as external debt conversion operations).

[20] These include: non-reimbursable grants from foreign Governments, non-reimbursable grants from international organizations (World Bank, IDB, UNDP); soft foreign loans from other Governments and international organizations; foreign donations; and earnings from the administration of all of the above. These contributions are believed to have totalled roughly US$ 1.8 billion over the past seven years.

[21] For further information in this regard, see Flaño, Franco, Bustelo and Isuani in ECLAC (1990); ECLAC (1996), pp. 148-149; and Siri (1996), chapter 1.

not designed to address its underlying structural causes, they have provided a way of dealing with severe economic and social problems.

However, it is important to look at the amount of financing actually at the disposal of these funds. Although on the face of it their resources may seem significant, they are actually quite limited when compared to the level of total public social expenditure.[22] This places certain constraints on their efforts to achieve the goal of eradicating poverty, although it does not block them entirely. In order for the funds to have a real impact, however, they must be given more financing on a continuing basis. This would entail, first of all, obtaining long-term international funding while also clearly defining the interrelationship between the funds and ministerial bodies, demarcating the role that each is to play in social policy and determining which resources each should be responsible for administering. It is also important to seek out other sources of financing by having beneficiaries help to fund such projects —possibly via in-kind (labour) rather than monetary contributions. Second, it is necessary to ensure the sustainability of financing arrangements over time, which in turn calls for income stabilization mechanisms to provide programmes with an on-going flow of resources.

Financial constraints are not the only problems facing these funds. There are many more problems relating to their uses, since in the final analysis these entities are simply mechanisms for providing temporary relief to some of society's most vulnerable groups. As figure VI-7 shows, the priority objectives of these funds have been to create temporary jobs in the execution and management of social and economic infrastructure projects and to support projects aimed at satisfying basic needs.[23]

Although these projects, especially those concerning infrastructure, have been designed to provide long-term benefits to poor communities, the promotion of direct production activities has to a large extent been overlooked or given low priority.

In countries where a substantial portion of the population is below the poverty line, any initiative aimed at tackling the problem head-on needs to emphasize the creation of permanent jobs and the improvement of production, productivity and earnings in poor strata within the private sector. It is not enough simply to reformulate macroeconomic policy and target social spending on basic needs. In order to meet these needs, people must be provided with permanent jobs and incomes.

In this regard, the funds have achieved very little. As a general rule, they have paid scant attention to promoting the development of human capital in poor segments of the population or to raising their productivity.[24] In order to show results, the funds have generally chosen to finance infrastructure and assistance projects, but in so doing they have neglected to help the neediest members of society to enter the formal labour market.

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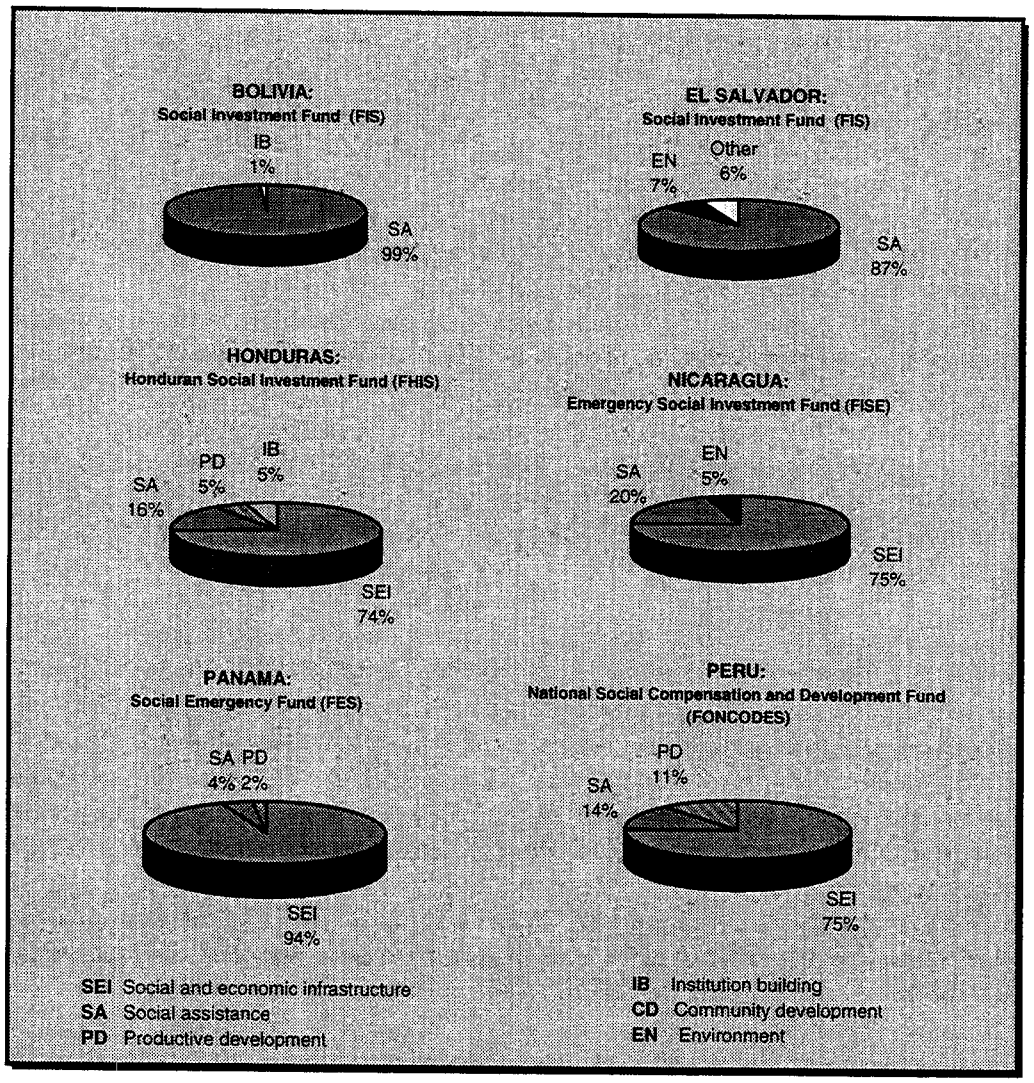
[22] According to fairly rough estimates, these funds' budgets may amount to less than 15% of total public social expenditure; it should be pointed out, however, that to date comparable statistics on this topic are not available.

[23] Although figure VI-7 is based on information for only six countries, several studies by the World Bank cite data which indicate that the lack of human-capital investment programmes may be a more generalized problem.

[24] Examples of initiatives of this sort would include projects to create microenterprises, improve the operations of small landholdings and modernize informal-sector activities.

Figure VI-7
LATIN AMERICA (SELECTED COUNTRIES): USES OF INVESTMENT FUNDS



Source: ECLAC, on the basis of L. Godoy and M. Rangel (cons.), Nuevas experiencias en política social: los fondos de inversión social en América Latina y el Caribe en los programas sociales (LC/R.1744), Santiago, Chile, 1997.

3. Reform proposals

Although the evidence suggests that these social funds have made a tangible contribution to the alleviation of poverty, in-depth comparative studies are needed in order to measure the funds' relative impact and confirm this hypothesis. Thus, the problem here is not so much one of determining the direction of the impact, but rather of gauging its magnitude. This is the only way to find out how well these programmes have achieved their objectives.

In addition, the existence of social funds poses the question of their complementarity (or possible dysfunctionality) with respect to ministerial bodies, as well as the respective roles of each in the design and execution of social policy. Duplication of efforts may lead to a considerable waste of resources. Hence, by defining functions properly and ensuring effective coordination, it may be possible to achieve better results in the various social sectors even without any additional resources.

Successful experiences indicate that there are at least two viable strategies. If, on the one hand, the aim is to produce results on a large scale, then it will be necessary to provide these funds with an abundant, ongoing flow of financing drawn from both domestic and foreign sources. This also means that many of the functions normally performed by ministerial departments would be reassigned to social funds[25] (the assumption being that these funds are more efficient than the corresponding ministry departments in administering social resources, which would need to be proven conclusively). Alternatively, it is possible to view the funds as providing a benchmark for ministerial bodies; in a strategy of this type, they would provide a demonstration effect as an emerging paradigm (the social funds versus the dominant paradigm). In this case, social funds could facilitate experimentation with alternative solutions that could then be applied on a wider basis; they could also be used to demonstrate new methods for managing social programmes and to foster the sense of responsibility that needs to prevail in modern, management-based forms of public administration.

For the above-mentioned reasons, it is both likely and desirable that successful funds will remain in operation for some time to come, provided that they are equipped with income stabilization mechanisms capable of ensuring long-run project sustainability.

Lastly, a clear distinction needs to be made between funds designed to meet basic needs (social emergency funds) and those whose goal is to combat structural poverty (social investment funds). Progress cannot be made towards reducing structural poverty if all of the available resources are channelled into initiatives focusing on immediate poverty alleviation. This means that investment funds need to spend more on raising the productivity of poor segments of the population by promoting the development of human capital, so that members of these strata can gain a foothold in the labour market.

[25] If such reassignments were carried to an extreme, then a superintendency of some sort would need to be created to regulate the activities of the funds.

E. THE ROLE OF THE PRIVATE SECTOR IN PROVIDING SOCIAL SERVICES

As discussed earlier, one of the main challenges is to boost the productivity of social expenditure. A basic step towards accomplishing this is to focus efforts on increasing the efficiency and effectiveness of such expenditures. The empirical evidence indicates that there is a great deal of room for improvement in this regard as well as a wide range of options. In addition to assigning a higher fiscal priority to social sectors, a more determined effort needs to be made in such areas as the rationalization of expenditure (by reducing redundant administrative expenses or, where possible, eliminating them altogether), the targeting of social benefits, decentralization of both the financing and management of social expenditure, the upgrading of services, regulation of their delivery on a decentralized basis and through private agents, etc.

In recent years new means of delivering and financing such services have been developed by means of joint ventures involving the public sector, the private sector and the so-called "third sector" (non-governmental organizations, non-profit institutions, etc.). The private sector has become involved in a variety of different ways: the private management of services financed by user fees (social security pensions, health services or education), administration of services financed by the Government through demand subsidies that allow users to choose their service provider (scholarships, health services or housing subsidies), outsourced or cofinanced service delivery (schools, health centres, community kitchens) and cofinanced community projects (e.g., housing programmes in which the Government contributes the materials and the beneficiaries contribute their labour).

Traditional modes of private-sector involvement in the provision of some social services and the new mechanisms for this purpose that have been designed in the last few years indicate that private supply responds with alacrity to opportunities when they are provided and that it manages to overcome many of the "government failures" that have created a need for private initiatives in these areas. The private sector's role in this regard is not without its problems, however. These problems have to do with two types of "market failures"; the first type is associated with economies of scale and externalities of different sorts while the second is related to the lack of certain types of information, which gives rise, *inter alia*, to imperfect competition, adverse selection and moral hazard.

In economies marked by sharp distributional disparities, the chief problem is that the market naturally induces the private sector to tailor its supply —especially in terms of quality— to the requirements of higher-income sectors. Private-sector supply for the poorer segments of the population responds suboptimally to demand subsidies, and policies therefore need to be specifically designed to encourage the private sector to generate a sufficient supply in terms of both quantity and quality and to promote the creation of new types of more altruistic or community-based agents. Mechanisms for community participation, in combination with the efforts of private foundations, are without a doubt the most effective means of increasing the supply of private services for the poorer segments of the population.

Of course, these difficulties are exacerbated when principles of solidarity have not been designed into the systems established for private-sector participation, as is demonstrated by Chile's health care system. Nevertheless, the introduction of such components does not automatically solve the problem either. For example, in an attempt to avoid the types of problems that have arisen in the Chilean system, the health scheme provided for under Colombia's new social security system does incorporate altruistic elements, yet the private sector's initial response to the poorer segments of the population has been equally disappointing. The absence of such elements also gives rise to other problems. One of the main such difficulties is that of adverse user selection, which increases, rather than diminishing, the relevant service's public financing requirements, as is illustrated by the case of Chile's National Health Fund (FONASA).[26]

Another problem is that private supply may also be geographically unbalanced. Service delivery can be expected to be adequate in fairly large cities but may be clearly unsatisfactory in smaller towns or in rural areas, where natural monopolies may exist in many services under conditions that, what is more, make them unprofitable. In such instances, redoubled efforts to improve the flow of information and protect consumers must be made, since information asymmetries ultimately reduce the quality and delay the delivery of benefits to lower-income groups.

The institutional difficulties associated with the introduction of new schemes must therefore be borne in mind at all times, as should the way in which these schemes are to deal with market failures, both old and new. These factors are often largely disregarded in discussions and designs at the theoretical level. Reforms in this area therefore need to be pragmatic and must provide for an element of learning-by-doing, which in turn calls for an active form of participation and new modes of State involvement. It is equally important to remember that schemes for bringing in private service providers cannot serve as a substitute for government-supplied services in each and every sector, and in many cases it may therefore be advisable to design mixed systems in which public and private agents can compete with one another on a suitably regulated basis.

Experience shows that the effectiveness of pure demand-subsidization schemes varies depending on the sector involved. Hence the importance of ensuring that these reforms are coupled with measures aimed at increasing both public and private supply and at improving the quality of the services provided by the agents from both of these sectors. Possible types of supply-side policies include initiatives to promote the development of mechanisms for involving the community in the provision of social services to the poorer segments of the population. In such cases, it may be preferable to opt for "halfway" financial assistance formulas consisting of what might be described as "demand-based supply-side subsidies" which can influence supply (including the quality of the relevant services) while at the same time reaping the customary targeting-related benefits of demand subsidies. Such schemes may involve contracting the services of agents that have been selected to serve a specific population group through a competitive bidding process or actively promoting the creation of community organizations for the express purpose of entrusting them with the administration of the relevant services.

The design of a mixed scheme for the delivery of social services should, of course, include policies specifically aimed at upgrading the efficiency, effectiveness and quality of

[26] See chapter VII.

the public agencies involved. The steps being taken towards the development of decentralized schemes for administering such services and the modernization of their management systems based on a reengineered system of incentives and the introduction of a "culture" of systematic results-based evaluations will be discussed in detail in chapters VII and X of this study.

A final point to be underscored is that one of the principal benefits of social service reforms aimed at bringing in the private sector —and, more generally, devising competitive systems for the provision of social services— is that they lead to the development of regulatory, information and quality-control systems for those services. This is particularly important when the services in question are so highly specialized that the transparency of the information upon which consumers base their selection of providers may be in doubt. This sphere of government action is just beginning to be explored, and greater efforts will need to be undertaken in this connection in the coming years.

F. CONCLUSIONS AND FINAL OBSERVATIONS

- The procyclical behaviour of social expenditure reveals the vulnerability of social policy during times of crisis. One of the major challenges for social policy-makers in this regard is to design effective mechanisms for stabilizing public social expenditure.
- The need to increase social spending must be addressed in ways that do not put added pressure on public finances. The focus should therefore be on reallocating public resources to social items of expenditure, improving public management and boosting the productivity of public expenditure in general and public social expenditure in particular.
- Given the fact that lower-income groups are more vulnerable to the negative impacts of stabilization and structural adjustment programmes, and in view of the need to incorporate considerations of equity into the formulation, design and implementation of public policy in general and fiscal policy in particular, studies need to be done —on both an *ex ante* and an *ex post* basis— on the distributional impact and actual effectiveness of tax and budget proposals in terms of social equity.
- Social expenditure's actual degree of targeting falls far short of optimum or potential targeting levels. This means that there is a great deal of room for improvement in terms of the distributional effect of social expenditure, since although the impact of some of its components is highly progressive (primary education, health and, to a lesser extent, secondary education), other components primarily benefit middle-income sectors (housing) or are actually regressive (social security, higher education). Efforts to heighten the positive distributional effects of social expenditure should therefore focus on designing means of reducing the regressiveness of these latter components.
- In order to increase the productivity of social expenditure, policy-makers need to work on decentralizing its funding and management and on upgrading the services provided. Means of improving social services would include increased user

participation in their evaluation and perhaps in a wide-ranging debate on priorities at the community and municipal levels. In addition, as private service providers are brought into such fields as health and education, particular care should be taken to ensure proper regulation and to supervise quality and coverage.

- The creation of more social emergency and investment funds as mechanisms for attracting external resources may be one way of easing the pressure on public project funding. These funds, which take in those resources and then channel them to different programmes and projects, have also proven to be useful in promoting social participation and public/private complementarity. The experience gained with this type of mechanism to date indicates that they provide a transparent, efficient, rapid and flexible means of addressing specific social demands.

VII. SOCIAL SECURITY

A. INTRODUCTION

In recent years, most of the countries of the region have embarked on social security reform processes aimed at changing the traditional roles of the public and private sectors in the financing and management of pension schemes and health services. The objective is to increase the efficiency and efficacy of public resource allocation and relieve the financial needs of the government sector.

These reforms have a big impact on public finances. The level of the social security liabilities and the difficulties of the countries in terms of meeting these obligations through current fiscal outlays, or facing the political costs of not paying them, oblige Governments to seek strategies for reforming their pension systems. In carrying out those reforms, it is necessary to bear in mind that they have to be implemented in societies where there is a high incidence of poverty, incipient capital markets, and pension systems which often have only limited coverage or have substantial commitments to workers and retirees who are members of the existing system.

These and other reforms which are under way affect the sustainability of fiscal policy and of the public debt, so that it is necessary to analyse the Government's compliance with budgetary restrictions over time. This analysis is of fundamental importance for appraising the future viability and intergenerational equity of current government fiscal policies and avoiding the application of policies whose costs may have to be borne to a disproportionate extent by future generations. Demographic trends, which point to a more rapid ageing of the population from the present decade onward, emphasize the need to devote attention to this issue, since they will give rise to growing pressure on the financing of social services, many of whose problems are closely related to the age structure of their potential beneficiaries.

Finally, the effects of health system reforms in terms of public-sector financial requirements depend not only on the nature of the financial reforms but also on the capacity of the reforms to shift the demand for health services to private suppliers. Otherwise, the State will be faced with the same structure of expenditure but lower income. What has happened in some countries of the region shows that a faulty public-private mix which encourages persons with higher health risks and lower incomes to enrol in the public-sector health care system, while a substantial part of the income from social security contributions is concentrated in the private sector, will increase the financing needs of the public sector and the global costs of providing health services.

B. SOCIAL SECURITY LIABILITIES, STRATEGIES FOR MAKING THEM EXPLICIT, AND THE FISCAL COSTS OF PENSION SYSTEM REFORMS

The reforms adopted by Chile in 1981, which involved the replacement of a public pay-as-you-go system with an individual capitalization —or funded— system, have been followed by similar reforms in Argentina, Bolivia, Colombia, Mexico, Peru and Uruguay which incorporate capitalization mechanisms to different degrees.

It would therefore be a good idea to analyse the far-reaching consequences that this issue can have for public finances. The financial implications that social security systems can have for the public sector go beyond the mere transition from a pay-as-you-go system to an individual funded system.

Financing schemes based on intergenerational transfers (pay-as-you-go schemes) are systems in which the payment of old liabilities (the present value of the benefits to which pensioners are entitled) is financed with new liabilities (the present value of the contributions made by those currently working) on an ongoing basis.[1] Replacement of this system with a different scheme means acknowledging a social security debt equivalent to the sum of the old and new liabilities. Because of the magnitude of the fiscal resources needed to pay off these liabilities until the last of the currently active workers retires, this system may not be viable from the point of view of public finances.

What is the actual size of the social security debt? Are the countries in a position to pay off these liabilities out of their current fiscal revenues or to face the political costs of not doing so? What strategies have been applied in this respect in pension system reforms?

1. Implicit social security liabilities and the fiscal costs of making them explicit

The instantaneous adoption of compulsory individual savings accounts in all cases would mean acknowledging two components of the social security debt: (i) the present value of the pensions of all those already receiving pensions when the reforms came into effect (social security obligations to pensioners) and (ii) the present value of all the contributions made (or the benefits which they provide) by those still working up to the date of entry into force

[1] Schmidt-Hebbel (1994).

of the reform (social security obligations to the active sector of the population). The sum of these two values, less the value of the reserves of the former system, gives the approximate total amount of implicit social security liabilities.

For a hypothetical case of the replacement in 1990 of an existing system (similar to a pay-as-you-go system) by an individual funded system (similar to the individual savings account component of the Chilean system), table VII-1 gives estimates of the value of the implicit social security liabilities of the Latin American countries, based on a uniform methodology. The figures represent a maximum estimate because they assume: (i) the total and instantaneous replacement of one system by the other; (ii) continuity in employment of all those who were members of the old system; and (iii) total absence of evasion while the old system was operating. The calculations may also differ from more refined estimates because the values used as parameters (rates of replacement, contributions and coverage) are for around 1980 and are fixed in time;[2] moreover, they only take of account liabilities in respect of retirement pensions and past contributions, thus leaving out those corresponding to disability, survivors' and basic pensions. For all the countries of the region, a set of aggregate indicators was used for the economy, labour market, demographic structure and social security system.[3]

The estimates of the social security liabilities given in table VII-1 show the importance of the fiscal dimension in the debate on the design of pension system reforms. The total and immediate replacement of one system with another may not be viable because of the amount of the fiscal resources that would be needed to pay the social security liabilities which would then become explicit.

For a first group of countries, whose social security liabilities are estimated to exceed 200% of GDP (Argentina, Uruguay and Brazil), total and immediate replacement of one system with another would require annual fiscal resources equivalent to over 6% of GDP for a period of 40 years, assuming linear amortization and a discount rate of 5%. Likewise, Chile, Costa Rica, Cuba and Panama, whose social security liabilities are

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[2] Schmidt-Hebbel (1995), for example, estimates for Colombia a social security debt within the range of 59% to 64% of GDP, whereas the ECLAC estimates only come to 35%. If the parameters used by ECLAC are replaced with those used by Schmidt-Hebbel, however, they give a value of 62.5%, using the ECLAC methodology.

[3] Simplifying assumptions were used in these calculations. Among the most important assumptions are: (i) the existence of a pay-as-you-go system since 1950; (ii) average coverage of the system remaining constant at the level registered around 1985 (midpoint between 1950 and the end of the projection); (iii) rates of contribution and replacement which do not change and are the same as those given in the studies by Mesa-Lago (1991 and 1991a); (iv) for all cohorts, contributions begin at the age of 20 and continue without interruption up to retirement at the age of 60; (v) the post-retirement life span is projected on the basis of the life tables of CELADE around 1990; and (vi) the real interest rate is equal to the growth rate of real wages. Using these assumptions, social security obligations to the members of the active population (Da), as a proportion of GDP, may be expressed as follows: **Da = c** x s x **k** x **Aa**, where c = rate of contribution as a percentage of wages, s = share of wages in GDP, k = quotient of the number of contributors among wage earners, Aa = (average) number of years of contributions by persons of working age; and the debt with those currently receiving pensions (Dj) is **Dj = r** x **s** x **k** x **d** x **Aj**, where r = replacement rate on wages, d = dependency index of pension system (persons of retirement age/active persons), Aj = (average) number of years of retirement per retired person.

estimated to be between 90% and 200% of GDP, would need to use fiscal resources equivalent to between 2.8% and 4.6% of GDP. The countries whose social security liabilities are between 20% and 50% of GDP (Bolivia, Colombia, Dominican Republic, Guatemala, Mexico, Nicaragua, Paraguay, Peru and Venezuela) would be in a better position to finance the fiscal costs of a transition from one system to the other while making the whole of the social security debt explicit, since they would need to allocate annual fiscal resources equivalent to between 0.7% and 1.4% of GDP. Finally, in the hypothetical case of a reform of this nature in Ecuador, El Salvador, Haiti or Honduras, the fiscal resources needed would only amount to between 0.1% and 0.6% of GDP.

Table VII-1
IMPLICIT SOCIAL SECURITY LIABILITIES IN LATIN AMERICA
1990
(Estimated as a percentage of GDP)

Country	Obligations to active sector	Obligations to retirees	Total debt
Very high			
Argentina	230.6	74.8	305.4
Uruguay	193.3	96.1	289.4
Brazil	143.6	58.0	201.6
High			
Cuba	108.2	43.2	151.4
Panama	78.2	67.1	145.3
Chile	100.4	30.6	131.0
Costa Rica	51.7	42.3	93.9
Low			
Peru	29.9	14.6	44.5
Mexico	20.8	16.2	37.0
Venezuela	25.5	11.2	36.6
Paraguay	30.5	5.9	36.4
Colombia	19.9	14.8	34.8
Nicaragua	18.5	14.4	32.9
Bolivia	24.1	6.8	30.9
Guatemala	13.1	12.4	25.5
Dominican Republic	16.1	5.4	21.5
Very low			
Ecuador	13.5	5.6	19.1
Honduras	7.5	7.9	15.4
El Salvador	3.7	5.0	8.7
Haiti	2.5	1.8	4.3

Source: ECLAC, using the methodology described in this document and aggregated data on wages as a percentage of GDP, contribution rates, replacement rates, dependency indices, population coverage of the social security system, wage-based employment, demographic structure and mortality.

The differences between countries depend on various factors. One of them is the degree of ageing of the labour force and of the adult population in general. The upper part of table VII-1 contains the countries which are at a relatively advanced stage in the

demographic transition, while the lower part shows the countries where this transition is still relatively incipient. It is clear, however, that population ageing is by no means the only determinant of this classification. Brazil and Mexico, for example, have a similar age structure, but Brazil is much higher in the classification of countries by the level of liabilities, because of the high coverage and greater generosity of its pension system, as well as a slightly higher level of wages as a percentage of GDP. The level of liability is high in countries like Uruguay and Argentina, which have a relatively old labour force and population, with high rates of contribution and replacement and a close relation between contributors and wage earners. In contrast, it is low in Haiti and El Salvador, where wage earners are only a limited proportion of the economically active population and both that population and the population in general have a young age structure.

The reforms carried out in Chile transferred financial responsibility for the total cost of the reform to the State. This cost includes payment of the operational deficit (to pay off the obligations to retirees and recipients of other pensions); payment of recognition bonds (to pay off the obligations corresponding to contributions already made by persons in the active sector when the reform was made); payment of subsidies for minimum pensions payable to those who, although they contributed during the period laid down by law, did not accumulate a sufficient amount of contributions to finance the minimum pension; and payment of social welfare pensions to the indigent. As may be seen from box VII-1, so far these commitments have entailed a much higher level of public outlays than the original projections. The financing of a portion of these liabilities required a substantial adjustment at the time (1981-1987) in the structure of public social expenditure, resulting in a reduction in the resources available for other social programmes in such areas as education, health and housing (see table VII-2).

2. Implications for reform strategies

The viability of making a total and immediate change in pension systems must be seriously weighed by the authorities of each country in the light of its implications for public finances. In practice, alternative reform models have been designed involving a combination of strategies which, while giving priority to the virtues of individual funded systems, try to minimize the social security liabilities that will have to be made explicit. These strategies may be summarized in four categories:

Table VII-2
STRUCTURE OF PUBLIC SOCIAL EXPENDITURE IN CHILE[a]
1970-1995
(Percentages)

Period	Social security	Education	Health	Housing	Other
1970-1973	26.5	37.7	18.6	12.6	4.6
1974-1980	25.9	35.9	14.6	8.1	15.5
1981-1987	38.6	26.3	8.3	3.7	23.1
1987-1995	47.6	26.0	8.9	7.8	9.8

Source: Boletines Mensuales of the Banco Central de Chile.
[a] 1970-1987: public social expenditure given in millions of 1976 dollars; 1987-1996: functional classification of social expenditure given in millions of current pesos for each year.

Box VII-1

FISCAL COST OF SOCIAL SECURITY REFORM IN CHILE

The following table compares previously projected values with the information provided by the Department of the Budget on the effective social security deficit and how it changed after the reform of the pension system which came into force in May 1981. It may be noted that the effective values exceed the ECLAC estimates based on linear amortization of the implicit liabilities with a discount rate of 5%, as well as the original projections made by Iglesias and Acuña on the basis of projections of operating expenditure and of the recognition bonds payable in each period.

The cost of the reform, which means the amount that the Government must pay in terms of social security commitments without having access to the corresponding social security contributions (which are now deposited in individual accounts administered by the pension fund management boards (AFPs)), demands a major effort of fiscal discipline. Even the most pessimistic projections seem to have fallen short when compared with the actual sums that the State has to pay in order to implement reforms like those adopted in Chile.

REAL SOCIAL SECURITY DEFICIT, 1980-1995a

(As a percentage of GDP)

Year	Social security outlays	Social security receipts	Social security deficit	Original projections	Linear amortization
1980	--.--	--.--	1.7		1.7
1981	--.--	--.--	4.1	1.2	4.0
1982	--.--	--.--	8.3	3.2	4.0
1983	--.--	--.--	7.5	3.7	4.0
1984	--.--	--.--	7.7	3.9	4.0
1985	--.--	--.--	6.7	3.6	4.0
1986	--.--	--.--	6.3	3.7	4.0
1987	7.3	1.9	5.4	3.8	4.0
1988	6.7	1.6	5.1	3.4	4.0
1989	6.2	1.7	4.5	3.3	4.0
1990	6.3	1.7	4.6	3.4	4.0
1991	6.1	1.6	4.5	3.4	4.0
1992	5.9	1.6	4.3	3.4	4.0
1993	6.0	1.5	4.5	3.4	4.0
1994	5.9	1.4	4.5	3.4	4.0
1995	5.7	1.4	4.3	3.3	4.0
1996				3.2	4.0

Source: 1980-1984: P. Arrau, "El nuevo régimen previsional chileno", *Regímenes pensionales*, Bogotá, Friederich Ebert Foundation, September 1992; 1985-1986: P. Arrau, "El nuevo régimen previsional chileno", *Regímenes pensionales*, Bogotá, Friederich Ebert Foundation, September 1992, adjusted by GDP figures for 1986; 1987-1995: Chile, Ministerio de Hacienda, *Estadísticas de las finanzas públicas*, Santiago, Chile, March 1996; 1996: P. Iglesias y R. Acuña, "Chile: experiencia con un régimen de capitalización, 1981-1991", Santiago, Chile, ECLAC, Joint ECLAC/UNDP Regional Project "Financial Policies for Development", 1991.

[a] Linear amortization based on ECLAC estimates of the liabilities at a 5% real discount rate.

(a) Strategy 1

This strategy consists of reducing the future financial commitments assumed by the system, through changes in the criteria used for determining eligibility and benefits. The relevant measures are adopted either before or at the same time as the change in the system of financing. Increases in retirement age, reductions in the annual adjustment coefficient, and changes in the system of indexing of pensions through the adoption of a new pension readjustment clause are examples of this strategy. In this case, past contributions are not updated to their present value, as in the calculations discussed in the previous section; instead, the present value is calculated of the benefits to which these contributions entitle the workers in question but the formula for estimating those benefits is changed in order to yield a lower level of explicit liabilities. In order for these pension liabilities to be effectively smaller, the reform must be made as soon as possible.

(b) Strategy 2

This consists of a partial change-over to an individual funded system so that only part of these implicit social security liabilities have to be made explicit. The compulsory system consists of two "pillars": one based on a pay-as-you-go, redistributive system and the other on an individual funded system; the distribution of members between the two is determined, among other things, by fiscal considerations. This is the system which has been applied in Argentina, Colombia and Uruguay and which is strongly influencing the design of other reforms in Latin America and Eastern Europe.[4]

This strategy offers three types of advantages: (i) it permits a reduction in the level of implicit liabilities that have to be made explicit and it keeps the fiscal costs of the transition down to manageable levels, which is particularly important in cases like those of Argentina and Uruguay; (ii) it forms a diversified portfolio, since the rate of return of the mixed system is calculated as a weighted mean of the rate of return of the pay-as-you-go system (rate of growth of total wages) and that of the individual funded system (the rate of return on financial investments); and (iii) it makes it possible to establish a clearer link between the contributions and benefits of each member and reduces the distortions of defined-benefit systems.

These advantages are offset by the following shortcomings, however: (i) the pay-as-you-go component will continue to be subject to political pressures for it to carry out redistributive functions; (ii) because there are two simultaneous systems of financing whose rates of return may differ, there will be pressures to seek offsets between them; (iii) there is still a need to finance and adjust the parameters of the redistributive, pay-as-you-go component (rate of contributions, age of retirement, etc.); and (iv) the individual capitalization (funded) component has inequitable features, in terms of the pensions provided, which are typical of systems strictly defined by individual contributions (see section (c) below).

[4] Queissier (1995) and Holzmann (1997).

(c) Strategy 3

This strategy consists of designing, at the minimum possible cost in terms of "compensation", a mechanism to provide incentives for a person or cohort to transfer to the new system. Some compensation is necessary in order to motivate those who have been members of the old system to leave it. For political reasons, the decision to change must be voluntary, but for financial and economic reasons it is desirable to know how many members will transfer. For this purpose, it is necessary to know the mechanism governing their decisions, which would also help in determining the type of compensation that would minimize the cost in respect of all those who change. The mechanism should be such that it represents an incentive for individual decisions, but involves a minimum cost in terms of compensation for making the change.

The problem with this strategy consists of determining the lowest-cost incentives needed to persuade people of different ages to transfer to a system which offers them bigger returns. The biggest problem arises with the people who are closest to retirement age. The social security debt will be reduced if these people can be induced to change without receiving special compensation, since it is they whose future pensions have the highest present value. In order for the oldest persons to transfer without receiving special compensation, they must perceive that the expected rate of return of the individual funded system is substantially greater than the implicit rate of return of the other system.

(d) Strategy 4

This consists of a system which continues with the pay-as-you-go mechanism but operates it under a "notional" system of defined contributions. This system operates by providing all members with an individual account in which their contributions are recorded just as in any savings account, but are capitalized at a rate of return equal to the growth rate of the average wage from which the contributions were deducted. On retirement, the pension paid is proportional to the amount of capital accumulated (including the returns corresponding to the notional interest rate), divided by the number of years that all the people of that age are expected to live. The pensions are automatically adjusted for inflation, since they are defined in real terms. This system has been adopted in recent reforms to the pension systems of Italy, Latvia and Sweden, and it is among the options most likely to be applied in a number of Eastern European countries, such as Poland.

This option has the following advantages: (i) it links benefits to contributions and penalizes those who do not take part in it, since evasion is reflected in smaller benefits; (ii) it helps to insulate the system from political pressures, as any increase in pensions must be associated with greater contributions; (iii) it encourages members to keep on working longer in order to receive a higher pension; (iv) it automatically adjusts the system to an increase in life expectancy, since this automatically leads to a smaller pension or encourages later retirement; and (v) it defines a structure of benefits which can easily be integrated with a second pillar involving individual capitalization (a system which normally involves defined contributions).

A necessary feature of this strategy is the establishment of a reserve fund to cope with adverse economic shocks and the ageing of the population. The system continues to be operated on a pay-as-you-go basis, but it promises rates of return determined by the growth of average wages in the past, which means that it must have financial reserves. In the absence of these, it would have to draw on the State budget. Since the accumulation of such a reserve fund may be subject to political pressures for alternative uses of the resources in it, a variant known as a "notional defined-contributions plan"[5] has been proposed in which the interest rate is determined by actuarial means on the basis of *expected* changes in variables that influence the equilibrium of the system during the forecast period.

As may be seen from table VII-3, most of the countries where reforms have been made have modified their benefits and eligibility conditions (strategy 1) and have defined minimum incentives for transfer to the individual funded system (strategy 3) in order to reduce the fiscal costs that must be made explicit. In all cases except those of Bolivia, Chile and Mexico, a mixed pay-as-you-go/individual funded formula has been adopted, which also reduces the level of explicit pension liabilities (strategy 2). Strategy 4, which keeps the pay-as-you-go system but uses a defined-contribution scheme, has not yet been adopted anywhere in the region, although in view of the advantages referred to earlier it may be attractive for many countries.

C. SUSTAINABILITY OF FISCAL POLICY: MACROECONOMIC AND INTERGENERATIONAL EQUITY ASPECTS

1. Sustainability of fiscal policy

The social security reforms, privatization measures and changes in financing mechanisms for pay-as-you-go and individual funded systems which have been initiated by many countries of the region involve high costs and impose constraints on the present and future fiscal budget, since making implicit liabilities explicit requires the assumption of heavy budget commitments for a long period. The ageing of the population, which has begun to speed up in the region since the 1990s, will also exert growing financial pressures on other systems of transfers to the elderly, such as public health programmes.

These and other elements[6] suggest that the medium- and long-term sustainability of fiscal policy warrant closer attention.

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[5] Boskin, Kotlikoff and Shouen (1988).

[6] See, for example, the references to government rescue operations in financial crises and to privatization processes in chapters V and IX of this document.

Table VII-3

COMPONENTS OF STRATEGIES FOR DEALING WITH THE PROBLEM OF MAKING PENSION LIABILITIES EXPLICIT

STRATEGY	ARGENTINA Act No. 24241	BOLIVIA Act No. 1732 (1996)	BRAZIL (Reform under discussion)	CHILE Decree-Law No. 3500
Strategy 1 (Eligibility and benefits)	- Increase in retirement age to 60 for women and 65 for men, and increase in minimum period of contribution to 30 years. - Compensatory benefit (CB) subject to the above requirements (same as those applicable to the universal basic benefit (UBB)). The CB is paid monthly along with the other benefits of the system.	- Change in definition of the basic wage. - Minimum replacement rate defined. - Retirement age set at 65, but variable according to amount of capital accumulated.	- Increase in retirement age. - Elimination of retirement for years of service.	- Increase in legal retirement age (60 for women, 65 for men). - Recognition of contributions (not benefits) made economically active persons at the time of the reform's implementation who are changing over to the funded system.
Strategy 2 (Mixed scheme)	- Integrated system of retirement and other pensions set up, maintaining a pay-as-you-go "pillar", but with free option to choose between the pay-as-you-go and individual funded systems. - Benefits provided by the public system (including many of the solidarity components) are financed by workers' and employers' contributions, plus other taxes, on a pay-as-you-go basis.	- Not adopted, since all members must transfer to the new system.	- Complementary measures are being taken, such as the establishment of the Individual Programmed Retirement Fund (FAPI).	
Strategy 3 (Low-cost incentives to transfer to the individual funded system)	- An additional continuity benefit is given to those who stay in the pay-as-you-go system and, proportionally, to those who decide to transfer to the individual funded system as soon as the reform comes into effect.	- Compensation for past contributions is given to existing members. - Independent workers are given a solidarity bond.		- Contribution rate for the individual funded system set at 10%, plus commissions and insurance, which is less than the rate in the old pay-as-you-go system (nearly 20%), thus increasing the take-home pay of those who opt for the individual funded system. - State guarantees provided in respect of minimum pension and minimum rate of return of the individual funded system. - Recognition of *contributions* made by (not benefits due to) members who change to the individual funded system when the reforms are made.

STRATEGY	COLOMBIA (April 1994)	MEXICO (1995 Social Security Act)	PERU (Decree-Law No. 25897, 1992)	URUGUAY
Strategy 1 (Eligibility and benefits)	- Retirement age gradually raised. - Increase in minimum period of contribution needed to be eligible for a pension under the public subsystem.	- Normal retirement age set at 65, with a minimum of 1,250 weeks of contributions.	- Social Security Bureau set up. - Early retirement eliminated. - Minimum period of contributions established. - Maximum pension fixed, to be readjusted by Executive Order.	- Existing rights are maintained for those already retired when the reform came into effect and those in the course of completing retirement formalities who do not wish to change from the old system. - Changes made in the rights of workers over 40 (replacement rate reduced to bring it closer to age of 65 for men and 60 for women; minimum and maximum pensions increased, and change to new system authorized for those under 40). - Changes made in the rights of those under 40 in order to bring in a mixed system.
Strategy 2 (Mixed scheme)	- Entry into new system not compulsory; left to each worker's own choice. - Workers are allowed to move from the public to the private system (and vice versa) every three years. - New entrants into the labour force are not obliged to join the private system.	- Retirement pensions transferred to individual funded system. - Existing members can opt between the benefits of the old and the new systems. - Individual accounts have three subaccounts: retirement, housing and voluntary contributions.	- Individual funded system optional. National Pension System (SNP) and Private Pension System (SPP) established. - Incentives for participating in SPP are lower rates of contributions and recognition of past contributions. -Contribution of 1% of wages established as contribution for purposes of solidarity.	- Those under 40 must enter a mixed system; those over 40 can do so if they wish. - Workers with incomes under 5,000 pesos (at April 1996 values) must enter the solidarity- based system; those with incomes between 5,000 and 15,000 pesos must enter the compulsory saving system, and those with incomes over 15,000 pesos must enter the voluntary system. - Workers with incomes under 5,000 pesos must stay in the pay-as-you-go system.
Strategy 3 (Low-cost incentives to transfer to individual funded system)	- National Pension Solidarity Fund subsidizes contributions of low-income workers.	- Compensation is envisaged for those who opt for the benefits offered under the old law, through accumulated retirement funds.	In the private (SPP) system, past contributions to the State system are recognized through bonds indexed on the basis of past inflation, without payment of real interest.	Employers' contribution is maintained only in the case of the solidarity-based system.

The standard method of analysing the sustainability of fiscal policy and of the public debt[7] assesses Government compliance with budgetary constraints over time, and holds that the present value of the net resources received by the Government over a long time horizon must be sufficient to pay the country's public debt. Such an assessment requires a prospective evaluation which is quite difficult to carry out because of the uncertainty about future trends in government income and expenditure as well as in other factors that affect the future value of the debt, such as the growth of GDP and real interest rates.[8] However, such an analysis is of fundamental importance if the aim is to assess the viability (and the intergenerational equity, as we shall see in the following section), of continuing to apply present fiscal policies in the future.

Unfortunately, no comprehensive studies that would provide a basis for a general assessment of the sustainability of fiscal policy in the region have been conducted, although specific information on some programmes and countries is available. The best-known traditional approach in this respect lays down, as a basic principle of sustainability, that the interest rate for payments on the public debt must not be systematically higher than the growth rate of GDP, since this would drive up the value of the debt as a proportion of that variable. Otherwise, the Government must register an operating surplus in order to ease that upward pressure. It is interesting to note, in this respect, that in recent years average interest rates have exceeded GDP growth in many countries of the region. This goes along with the current concern about the increase in the public debt in a number of countries. It is obvious, however, that these indicators, taken alone, are not sufficient for a full diagnosis of the problem. In the following sections we will briefly review some other important dimensions of fiscal sustainability and its relation with intergenerational equity.[9]

2. Intergenerational equity in pension system reforms

In a previous section we analysed the fiscal costs of pension system reforms under way in the region, noting that both the decision to make social security liabilities explicit and the chosen way of paying them off have a strong influence on the State's budgetary commitments over a long period of time. Consequently, the reforms affect the financial sustainability of the fiscal budget, which is in turn closely linked with their distributive effects, especially as regards the sharing out of fiscal costs among the different generations of contributors and retirees.

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[7] Perry (1997) and Auerbach (1994).

[8] Another difficulty is that until very recently there were no methods of analysis and projection with a sound basis in economic analysis which eliminated arbitrary elements in the accounting classifications of income and expenditure and took proper account of the level and trends of the income, consumption and taxes corresponding to different generational groups. See Auerbach, Gokhale and Kotlikoff (1996) and the discussion in the following section (intergenerational equity of pension system reforms).

[9] See also Auerbach (1994) and Perry (1997).

In order to understand what these distributional effects are, it should be remembered first of all that some of the strategies proposed for making these reforms viable or less burdensome seek the direct or indirect reduction of the level of liability and the corresponding fiscal costs. This really means that today's adult generations are paying part of the social security debt, even before it becomes explicit and begins to be disbursed by the State. Among the measures that may be taken in this respect are an increase in contributions or in the legal retirement age and/or a reduction of the replacement rates or the degree to which pensions for inflation or for the general growth of wages, all of which reduces the present values of benefits in comparison with the contributions made during the working life of all the generations affected.

It should be noted, however, that not every fiscal measure which is "beneficial" (in the sense that it reduces fiscal costs) necessarily has an adverse effect in distributional terms from the intra- or intergenerational point of view. Box VII-2 summarizes some cases where it is possible to improve budget solvency and the intergenerational equity of fiscal policy at one and the same time within the framework of existing pension systems.

Second, the present and future generations of contributors and retirees must pay off the social security liabilities that have been made explicit in accordance with some sort of programme of payments. As we have seen, in many Latin American countries these costs reach high levels for prolonged periods. In most cases, the form of financing is not fixed in advance, but may consist of a combination of current taxes, cutbacks in other programmes, public borrowing and privatization revenues, among other things. Financing policies affect the different generations of workers and retirees in different ways, as the estimates for Colombia and Chile show.[10] As might be expected, if the financing is effected exclusively with current taxes, it becomes a burden for most of the currently active generations; if it is effected through debt financing (State bonds), this reduces the burden on present generations and transfers the cost of the transition to future generations, including those not yet born.

A case worth mentioning in this respect is that of Argentina, which, it will be recalled, had quite a high level of implicit liabilities. In this case, it was decided to adopt a type of reform which reduces the amount of social security liabilities that are made explicit, while adopting financing mechanisms which transfer much of the fiscal cost to the future. The first of these objectives was achieved through a partial capitalization of the system, together with an increase in retirement age and in the number of years of contributions needed for eligibility for a full pension. The second objective was achieved by the stipulation that payment of the liabilities due in respect of members' assets existing at the time when the reform was made would be carried out gradually over the period of retirement and not immediately when they retire, as in the Chilean case.

[10] Arrau (1991); Cifuentes (1995); Schmidt-Hebbel (1995).

Box VII-2

POSSIBILITIES OF RECONCILING INCREASED BUDGET SOLVENCY WITH IMPROVED INTERGENERATIONAL EQUITY OF PENSION SYSTEMS

In pay-as-you-go, defined-benefit systems, which are the most common type in the region and in the world as a whole, as mortality rates go down the most recent generations of retirees enjoy increased survival rates and longer periods of retirement, unless the legal retirement age is changed. This means both a greater tendency towards a budget deficit (since it makes it necessary to pay more pensions for longer periods) and a redistribution of wealth (which may be substantial) from the present and future generations of contributors to the present generations of retirees. In this case, an increase in retirement age is fully justified, both for financial reasons and for reasons of intergenerational equity, since all participants should receive similar treatment in terms of the present value of benefits as compared with the contributions they made in the course of their working life. An example of the application of this criterion is the concept of the "actuarially fair" system, which gives all participants a present value of benefits exactly equal to the present value of their contributions.

Nor would it be inequitable from the distributional point of view to consider the option of maintaining the pay-as-you-go system, but changing the financial system to one of defined contributions: a form which has recently been adopted in Italy, Latvia and Sweden and is being considered in Poland and other European countries.[a] This type of system permits the capitalization of contributions at a rate equivalent to the growth of total wages and gives each generation actuarially fair benefits while at the same time maintaining the budgetary balance of the system.[b] This could be an attractive option for many Latin American countries which are not in a position to absorb the costs of a transition from a pay-as-you-go system to a fully funded system or which find this latter system unattractive because of political or institutional considerations, the limited solidity and development of their capital markets, or other reasons. For different reasons, this could be an interesting option for countries like Brazil, Costa Rica or Paraguay.

[a] Robert Holzmann, "On Economic Benefits and Fiscal Requirements of Moving from Unfunded to Funded Pensions", Financiamiento del Desarrollo series, No. 48 (LC/L.1013), Santiago, Chile, ECLAC, 1997;

[b] Jorge Bravo, "La tasa de retorno de los sistemas de pensiones de reparto", *Estudios de economía*, vol. 23, No. 1, June 1996.

Although this issue has more serious and pressing political implications in countries with an older population and social security systems with greater coverage, it must be remembered that the population of Latin America and the Caribbean has clearly been ageing since the beginning of the 1990s, which means that a growing proportion of countries need to begin analysing their policy options in this respect. Furthermore, as we shall see in the following section, concern for intergenerational equity does not derive solely from principles of altruism or social solidarity but is also based on considerations of sustainability of fiscal policy and the corresponding macroeconomic effects, which go beyond the mere demographic factor.[11]

[11] Kotlikoff (1992).

3. Intergenerational equity and fiscal policy sustainability

Lack of intergenerational equity, especially when it affects future generations,[12] is directly related with the unsustainability of fiscal policy. A marked lack of equity with respect to future generations may even militate against the sustainability of fiscal policy in absolute terms, making it economically and politically unviable, as may be gathered from the preceding analysis on social security liabilities and the considerations set forth below.

There is growing recognition that conventional ways of measuring global fiscal performance and sustainability (for example, the current deficit and public debt) depend on the arbitrary way that fiscal income and outlays are labelled and therefore have no intrinsic relation with the intergenerational equity policies of the Government or the sustainability of fiscal policy.[13] In most countries, for example, workers' contributions to social security systems are usually defined as "taxes" and the pensions and health services provided by the system are defined as "transfers". However, the Government could equally well call the former "loans" (or public borrowing) and the latter "debt amortization", without this changing in any way the real value of government income and expenditure or the payments made and income received by contributors and beneficiaries. The deficit resulting from the first denomination is very different from that resulting from the second, however, not only in volume, but also in terms of how it changes over time. In this context, there would be very little point in a government policy aimed at reducing the deficit to zero, or to any other level considered appropriate or sustainable, unless there is a clear awareness of the concept and measurement to be reduced and the reasons why one figure is more desirable or sustainable than another.

If we compare the present surpluses of the social security systems of the United States or of Paraguay with the deficit caused by the transition in Chile,[14] these balances do not mean that the fiscal policies (regarding social security, in this example) of the United States and Paraguay are sustainable (or more than sustainable) while that of Chile is unsustainable. In the case of the United States, the surplus registered in recent years, which will probably continue for some 20 years longer, is the deliberate result of setting up a reserve fund to finance the pension and health outlays for the large contingent of "baby boomers" (i.e., the generation born in the years following the Second World War) which will begin to retire from the year 2010 onward. It is still too early to say whether the present policy will continue to be sustainable after that decade, but the available estimates indicate that, in spite of the significant funds accumulated over a period of several decades, the system will suffer deficits from about the year 2030 onward.

In the case of Paraguay, the surplus registered since the system was established is due essentially to the fact that the system is still at a very incipient stage; there are very few

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[12] The present adult generations have of course every right to make consumption sacrifices (as many parents do at the family level) to increase the well-being of future generations. The opposite right —to increase the level of present consumption at the cost of reduced well-being of future generations— is not so clear, however. At the very least, this would obviously be "unsustainable" in the sense in which this term is used in development studies, particularly with reference to criteria of environmental sustainability.

[13] Auerbach, Gokhale and Kotlikoff (1991), Kotlikoff (1992), Franco (1995).

[14] The figures for the United States may be found in, *inter alia*, Board of Trustees (1996) and Lee and Tuljapurkar (1997); those for Paraguay are given in RodrPguez (1994), annex, pp. 223-235, and those for Chile are given in box VII-1 of this chapter.

retirees compared with those who are still contributing to the system. Even so, some studies show that this system currently has considerable actuarial deficits: that is to say, we already know with a good deal of certainty that if the present trends in collection of contributions and provision of benefits are maintained, the system will be incapable of covering a substantial part of its future obligations. On the other hand, we have already seen that the transitional deficit of the Chilean system (and of those of Argentina, Colombia, Mexico, Peru and Uruguay) is due to the payment of a debt which has been made explicit. If these commitments are duly incorporated into global budgetary programming, the deficit should not be considered unsustainable from the fiscal point of view. The same kind of analysis can be applied to all items of public expenditure.

For this reason, many analysts and some government agencies are beginning to consider alternative ways of measuring fiscal performance which are more closely related to the present value of fiscal resources and outlays in order to evaluate the present state and future prospects of public finances.[15] Box VII-3 presents some interesting examples in this respect which, although relatively recent, must be considered as positive. In some cases, the budgetary areas covered are specific sectors, such as social security. In others, the whole of the government budget is covered, as in the case of "generational accounting", in which the present value of all government income and outlays is calculated for each cohort up to the end of its members' lives. Through this approach, it is possible to calculate more clearly and precisely the net tax burden that fiscal policy imposes on present and future generations and the viability and some of the macroeconomic effects of the maintenance of present patterns of government income and expenditure in the future.

D. FISCAL ASPECTS OF SOCIAL SECURITY REFORMS IN THE FIELD OF HEALTH CARE

1. The reforms from the fiscal standpoint

In recent years, most of the countries of the region have embarked on processes of reform in the social security health-care subsystem, with the aim of improving its efficiency through the introduction of market-based mechanisms for resource allocation and thus relieving the financial needs of the public sector. The reform efforts may be summed up in two categories: those centred on changing the financing mix for the health-care sector, along with the introduction of changes in the service delivery system, and those centred on improving the efficiency and competitiveness of public suppliers of health services, without necessarily making changes in the area of financing.

One of the key instruments in the most ambitious reforms has been the redefinition of the traditional roles of the public and private sectors in the financing and provision of health services. In principle, shifting the demand for health services from public to private suppliers should make it possible to reduce the financial burden that the State has to bear in order to cover the health-care needs of the population, thus enabling it to concentrate on the financing and provision of services for the poorest segments of the population.

[15] Franco (1995), Blejer and Cheasty (1991), Towe (1991), and Auerbach, Gokhale and Kotlikoff (1991), among others.

Box VII-3

GENERATIONAL ACCOUNTING: A WAY OF ASSESSING THE SUSTAINABILITY AND EQUITY OF FISCAL POLICY OVER TIME

Among the instruments for analysing fiscal policy over the course of time are generational accounts, which reflect the present value of the income and payments that the Government expects to receive from and make to each cohort during the rest of its members' lives.[a] These accounts are of a comprehensive nature, since they include in principle all income and payments made at all levels of government, i.e., national or federal, regional, state or provincial, and local, as appropriate to each country. Unlike the fiscal deficit, generational accounts do not vary according to changes in the accounting nomenclature used, and they make it possible to calculate the net tax burden that the present policy, or any other policy under consideration, imposes on the different generations, both present and future.

This approach has made it possible to determine, for example, that United States fiscal policy is generationally inequitable in the sense that it imposes a net tax burden on future generations which is nearly 45% greater than the burden on the present generations.[b] The estimates also suggest that this policy is likely to be unsustainable, since it is not realistic to assume that it will be possible to impose a tax burden of the order of 83% of their income on future generations, which is what would be required to maintain the present trends in the pattern of government income and expenditure. Moreover, some analyses based on generational accounts have shown that while demographic changes in the United States were an important factor in stimulating the growth of national saving up to 1980, they also explain much of the fall observed since then.

In order to make well informed projections, generational accounting needs adequate, sufficiently reliable and disaggregated statistical information on population profiles, income, consumption, taxes, and expenditure and transfers by the different levels of government. It is therefore not surprising that so far generational accounts have only been available for the United States. Recently, however, generational accounting has also begun to be used in Argentina, Australia, Canada, Germany, Italy and Norway. Although discussion of possible policies to deal with these problems in these terms only began a few years ago, it is very likely that this matter will acquire increasing importance as the countries' populations continue to age and the consequences of this for the public budget begin to be felt increasingly strongly.

[a] Alan Auerbach and Laurence Kotlikoff, *Dynamic Fiscal Policy*, Cambridge, Massachusetts, Cambridge University Press, 1987; Laurence Kotlikoff, *Generational Accounting: Knowing Who Pays, and When, for What We Spend*, New York, The Free Press 1992; Alan Auerbach, Jadgadeesh Gorkhole and Laurence Kotlikoff, "Generational accounts: A meaningful alternative to deficit accounting", *Tax Policy and the Economy*, David Bradford (ed.), vol. 5, Cambridge, Massachusetts, National Bureau of Economic Research, The MIT Press 1991.

[b] J. Gokhale, "Demographic Changes, Generational Accounts, and National Saving in the United States", document presented to the conference "Intergenerational Economic Relations and Demographic Change", organized by the International Union for Scientific Study of Population (IUSSP) and East-West Center, Honolulu, Hawai, September 1995, table 1.

In order to achieve these changes in demand, it is proposed that, in the area of financing, supply subsidies should be replaced with demand subsidies, and that different forms of private risk insurance should be incorporated to operate alongside the traditional systems of social security insurance. One of the main proposals for facilitating the allocation of demand subsidies and expanding coverage is the implementation of a basic health package with universal coverage. If suitably designed, this package could avoid the problems deriving from a discriminatory selection of risks and thus partly cover the solidarity, or redistributive, needs of the system through subsidies from the lower-risk population to the higher-risk segment and (depending on the type of solidarity mechanism chosen) from the higher-income population to the lower-income segment. Likewise, in order to improve efficiency in the area of the supply of services, various schemes have been proposed for the recovery of costs, new forms of budgeting and contracting, new payment mechanisms, decentralized budgets, and targeting of public expenditure.

These schemes involve a change in the nature of public management responsibilities and activities. According to this approach, the fundamental tasks of the State are global health-care policy design; health-care policy regulation and supervision; provision of financing for serving the most vulnerable groups in the population; ensuring a minimum element of solidarity in the provision of health insurance; and financing all health-care activities which are in the nature of public goods.

From the fiscal standpoint, the impact of the reforms on the public sector's financial requirements depends both on the financial reforms put into effect and on the capacity for shifting the demand for health services to private suppliers. Otherwise, the State will be facing the same structure of expenditure but with lower levels of income.

The difficulties in securing significant transfers of demand from the public to the private sector are due, on the one hand, to the typically low-income nature of the countries of the region, which contrasts with the upward trend in the cost and complexity of health care and, on the other hand, to the characteristic features of the health-care market, which encourage practices such as skimming off the low-risk segments or discriminatory risk selection.[16] In this respect, it has been observed that faulty design of the public-private mix can lead to the public sector covering the population with the highest risks and the lowest income. The problem of adverse selection in the provision of health insurance justifies the need to introduce a solidarity component in the design of the corresponding schemes.

The foregoing has important consequences from the fiscal standpoint. If the public-private mix encourages this type of risk selection, the demand for health services facing the State and the consequent financial burden will tend to grow. Reforms in the public health-care system can therefore end up as a kind of regressive tax reform, in that they reduce the net social security contributions of the high-income strata, which are channeled to the private sector, or as a system of implicit subsidies given by the State to private-sector participation in health care.

[16] See, among others, Van den Ven (1997) and Carranza (1997).

2. Public expenditure on health care

The international evidence shows that, in spite of the reform processes begun in many of the OECD countries from the 1980s onward and, more recently, in the countries of Latin America and the Caribbean, the relative share of public expenditure on health care remains as high as ever. In the case of the OECD countries, in 1990 public expenditure on health-care averaged 70% of total health-care expenditure: a similar percentage to 1980. In the case of the countries of the region, the estimates suggest that in 1990 public expenditure on health care accounted for almost half of total health-care expenditure (see table VII-4).

Table VII-4
HEALTH-CARE EXPENDITURE IN LATIN AMERICA, 1990
(As a percentage of GDP)

Type of expenditure	Pan American Health Organization	World Bank
Public expenditure	2.5	3.1
Private expenditure	3.2	3.1
Total expenditure	5.7	6.2

Source: Ramesh Govindaraj, Christopher Murray and Gnanaraj Chellaraj, *Health Expenditure in Latin America*, Washington, D.C., Harvard/World Bank, 1994.

Likewise, the experience of some countries of the region shows that the public-private mix generated by health-care system reforms has not been capable of reducing the financial burden on the public sector, since the latter is still responsible for providing health care to a large part of the population, including especially the persons with the highest risks and costs and the lowest income.

In the case of the Chilean reforms adopted in the early 1980s, which were the first to try to redefine the public-private mix, it may be noted that as a result of the reforms the amounts of financial resources received by the public and private sectors are now similar, although the latter sector only covers some 30% of the population, whereas the public sector is responsible for the remaining 70% (table VII-5). This has led some authors to compare these health-care reforms with a regressive tax reform, because they have reduced the social security taxes of the high-income strata.[17]

The dividing line between the populations served by the public and private sectors is not only in terms of income levels but also in terms of age groups (which have a direct relation with the risk of illness). Table VII-6 shows how the population belonging to the first four income-distribution quintiles is served primarily by the public sector. Only the fifth (richest) quintile is served mainly by the private sector (private health insurance institutions). If we look at the distribution by age, however, we see that in all income-

[17] Arellano (1987).

distribution quintiles the public sector serves the bulk of the population over 50 years of age.[18]

Table VII-5
FINANCING AND COVERAGE OF HEALTH-CARE SYSTEMS IN CHILE, 1995

Indicator	Unit of measurement	Subsystems	
		Private[a]	Public[b]
Total financing	% of GDP	2.0	2.4
Sources of financing	% of total		
- Fiscal contribution		5	48
- Members' contributions		94	33
- Copayment			7
- Other income		1	12
Expenditure per beneficiary	US$	310	197
Average contribution		646	169
Total number of beneficiaries		30.4	69.6
Coverage of labour force	US$	56.5	43.5
Coverage of pensioners	% of population	3.8	96.2

Source: Osvaldo Larrañaga, "Eficiencia y equidad en el sistema de salud chileno", Financiamiento del desarrollo series, No. 49 (LC/L.1030), Santiago, Chile, ECLAC, 1997.
[a] Provident Health Insurance Institutions (ISAPREs). [b] National Health Fund (FONASA).

The unequal distribution of the risk portfolio between the private and public sectors that may be generated by an inappropriate public-private mix is not the only source of pressure on the public-sector budget, however. Faulty design of the institutional and regulatory framework may give rise to problems of cross-subsidization due to the use of public clinics and hospitals by beneficiaries of the private sector, without the latter paying back to the public sector the full cost of the care provided.

Table VII-6
CHILE: SOCIAL SECURITY MEMBERSHIP, BY INCOME BRACKET AND AGE
(% coverage)

Age	Quintile I		Quintile II		Quintile III		Quintile IV		Quintile V	
	Public sector	ISAPREs	Public sector	ISAPREs	Public sector	ISAPREs	Public sector	ISAPREs	Public sector	ISAPREs
0-20	93	7	82	18	69	31	51	49	30	70
21-50	92	8	82	18	69	31	53	47	34	66
51-64	97	3	94	6	88	12	81	19	51	49
65 and over	99	1	98	2	97	3	94	6	77	23
Total	93	7	84	16	74	26	60	40	39	61

Source: Osvaldo Larrañaga, "Eficiencia y equidad en el sistema de salud chileno", Financiamiento del desarrollo series, No. 49 (LC/L.1030), Santiago, Chile, ECLAC, 1997.

[18] It is calculated that the cost of providing health services for the population over 75 years of age is between four and five times greater than the cost for the population between 18 and 34.

In the case of Chile, these cross-subsidies are estimated to amount to some US$ 35 million per year, which is close to 4% of total public health-care expenditure. In addition to these "implicit" subsidies, Governments generally have a structure of supply and/or demand subsidies which absorbs large amounts of resources (in Chile, for example, the official 2% subsidy for the private health-care system absorbs resources equivalent to 5% of total annual public spending on health care). In addition to these subsidies, there is the cost of primary health care, vaccination programmes and, in general, all the health protection and promotion programmes carried out by the Ministry of Health.

Furthermore, an unsuitable public-private mix can also give rise to serious problems from the point of view of equity. Table VII-5 shows how, in the case of Chile, in 1995 the private sector spent almost twice as much per beneficiary as the public sector, but the average contributions it received were 3.3 times greater.[19] At the same time, since the population served by the public sector has a higher risk structure, and lower income levels than the population served by the private sector, the public sector's expenditure on the solidarity component of the system are naturally greater. Table VII-5 also shows that, unlike the private sector, in Chile the public sector has a level of expenditure per beneficiary which exceeds the average contributions received, thus exerting upward pressure on the fiscal contributions which (together with the social security health insurance contributions received) must cover the cost of running the system and of its solidarity component. Analysis of the Chilean reforms, which were the first to redefine the public-private mix in the region, shows the possible consequences of a type of system which ends up transferring profiles to the private sector which previously went to the public sector, without a corresponding transfer of the costs of providing services.

In other countries, however, other types of reforms have been put into effect which seek to solve the problems connected with the solidarity aspect of health-care systems, while at the same time improving their efficiency in resource allocation. In this sense, the reform of the health-care system in Colombia is one of the most radical in Latin America. It is similar to the Chilean reform in that it replaces supply subsidies with demand subsidies, it seeks to separate the financing of health insurance from the provision of services, and it establishes competition among the insurance companies and health-care providers, both public and private. It defines the benefits independently of contributions, however, thus incorporating a solidarity component, both between social sectors with different income levels and between age groups. To this end, it introduces a basic package of services with universal coverage and risk-adjusted payment mechanisms, and it establishes a solidarity fund to administer the allocation of subsidies. The implementation of the new system has not been free, of course, from financial, operational and organizational difficulties.

In particular, the financial balance of the system calls for a significant increase in the population covered (the contributors) in order to secure the increases in resources needed to finance the solidarity mechanisms envisaged in the reform, together with the replacement of supply subsidies with demand subsidies. The expansion of coverage has been severely limited by the nature of the labour market, in which approximately 40% of the population is in the informal sector and is therefore not obliged to pay contributions to the health-care system. Furthermore, the operational mechanisms and the application of risk-

[19] It should be noted that in 1989 the expenditure per beneficiary in the private sector was approximately four times that of the public sector.

adjusted payment mechanisms are very complex, since it is by no means easy to define a risk adjustment formula, nor is it an easy matter to implement mechanisms for the collection and transfer of resources called for by the solidarity component.

The foregoing suggests that in order to establish a solidarity component in contexts of competition in the health-care sector, a certain degree of institution-building and sufficiently well-developed markets are needed to permit the proper functioning of risk adjustment mechanisms, financial funds for the collection and distribution of the resources needed to finance the subsidies, and labour conditions which allow coverage to be expanded to the whole population.

In other countries of the region, efforts have been made to solve the problems of financing without making such radical changes in the overall structure of the sector, through changes in financing mechanisms (as in Argentina) or through management reforms which seek to improve the effectiveness and efficacy of public health-care services (as in Costa Rica). These alternatives contrast with those carried out in Chile and Colombia (and, to a lesser extent, in Brazil), which are all of a considerably more comprehensive nature, since they address both the organization of the sector, its financing and the global management of its resources.

E. CONCLUSIONS AND FINAL OBSERVATIONS

- Pension system reforms must be designed in the light of the fact that they have to be implemented in societies with a high incidence of poverty, emerging (and often incipient) capital markets, systems which do not cover all those who require benefits, and (often very large) commitments to participants in the pay-as-you-go system. The State acts as the guarantor of last resort of a compulsory social security system.
- Even in the absence of financial crises which may affect the minimum guaranteed rate of return of pension funds, the social security liabilities which are made explicit and the transfers needed to cover minimum and social welfare pensions may demand fiscal resources which require higher income and/or reductions in spending in other areas. This is what has happened in the case of Chile. The size of the effective social security deficit exceeds all the original projections, thus demanding a fiscal discipline effort which was not budgeted for.
- The implementation of the Chilean system is based on an institutional context in which public-sector solvency is essential. Its introduction involves high fiscal costs, however. Consequently, the main lesson of this experience is that enormous efforts will be needed in the area of public finances to cover the transition from one system of pension financing to another.
- It is therefore not surprising that most of the countries have followed alternative models, consisting of combinations of four strategies aimed at reducing the level of social security liabilities that must be made explicit. These include: (i) changes in benefits and eligibility conditions; (ii) the design of a mixed system (or one involving partial capitalization), while retaining a pay-as-you-go component; (iii) minimization of the cost of the incentives needed to make current workers enter

the new system; and (iv) the adoption of the defined-contributions, pay-as-you-go component.

- The sustainability of fiscal policy is very closely related to the level and growth of the public debt and the intergenerational equity of the policy applied. Its analysis and evaluation are complex matters and must take into account a wide range of factors which most of the traditional approaches do not adequately cover.
- Demographic trends involving more rapid ageing of the population of the region from the present decade onward heighten the need to give attention to these issues, since they will give rise to growing pressure on the financial viability and distributional equity of social services, most of whose variables and problems are closely related to the age of their potential beneficiaries.
- The efforts being made by the countries in the field of pension system reform are as yet only incipient, but they must nevertheless be viewed in a positive light. From the point of view of economic and development policies, the monitoring of social security policies and their fiscal results over time is an essential complement to the necessary analyses of the immediate macroeconomic situation.
- The reforms already implemented or proposed in the social security health-care subsector seek to redefine the participation of the private and public sectors in the area of health care, with the dual objective of improving resource allocation and easing the tax burden. The achievement of these objectives is no easy matter and depends fundamentally on the institutional design and the dynamics generated by the public-private mix.
- The fiscal impact of the reforms depends on their capacity to transfer the demand traditionally met by the public sector to private suppliers. This is made more difficult by the low-income conditions typical of the countries of the region and the special features of health-care markets, which give rise to incentives for risk-based discrimination.
- The experiences of some countries of the region show that an unsuitable public-private mix encourages the concentration of persons with the highest risks and lowest incomes in the public sector, while at the same time reducing fiscal income because a substantial part of the social security contributions for health services are received by the private sector. Consequently, a mix of this type tends to increase the public sector's financing requirements.
- It is therefore of fundamental importance to ensure that the mix achieved discourages risk-based discrimination and lays down clear principles of solidarity between social strata and age groups. This calls for institutions and markets which are sufficiently well-developed to permit the incorporation and proper functioning of solidarity mechanisms in competitive contexts.

VIII. FISCAL DECENTRALIZATION: CURRENT TRENDS AND PENDING TASKS

A. INTRODUCTION

The question of fiscal decentralization is arousing growing interest in the Latin American countries. In political terms, it reflects the aim of bringing government closer to the people and thus making decentralization a key factor for democracy and governance. In economic terms, it forms part of the broader debate on the role of the State and, in particular, the search for greater efficiency in the allocation of powers and resources among the different levels of government. Decentralization thus seeks to increase the efficacy of public policies, which should be reflected, in turn, in better governance.

In terms of public finances, decentralization has further strengthened the growing importance of local levels of government as the agents directly responsible for public expenditure and, to a lesser extent, as collectors of their own income, which ultimately allows them to acquire a more significant dimension in development strategies. However, this may make the achievement of macroeconomic stability goals more difficult, especially when these new fiscal arrangements have a significant effect on the national budget. Unless suitable conditions are created in terms of institutional support, financial administration and coordination between the different levels of government, decentralization can pose problems in terms of both resource allocation and macroeconomic stabilization.

Consequently, the results of the process will depend on the capacity of State authorities to ensure effective coordination between the different levels of government so as to permit the harmonious and integrated distribution of powers and responsibilities among those various levels in a manner consistent with macroeconomic balance and the pursuit of greater efficiency and equity in the allocation of public expenditure. This calls for the adoption of measures to increase local taxation and promote more efficient options for the mobilization of local resources to permit the financing of the greater fiscal expenditure required; to regulate borrowing at subnational levels; to design systems of transfers between

the different levels of government which will raise the efficiency and equity of public expenditure and encourage the generation of local resources; and, finally, to promote the strengthening of local and regional government institutions within a context of greater citizen participation and political responsibility.

From the point of view of equity, expanding the supply and improving the quality of public goods such as education and health services is one of the most important challenges for the region, but the achievement of these objectives is hindered by serious budgetary constraints. Decentralization offers potential advantages deriving from the local provision of services in that this can foster greater accountability and more control by users and by the respective communities, which may be reflected in more effective social action. In view of the disparities of income and availability of human capital that exist within the countries of the region, however, this transfer of social responsibilities may have a serious impact in terms of territorial equity. In order to achieve the expected results in terms of the efficacy of social action without affecting the achievement of the objectives in the field of equity which underlie that course of action, it is therefore necessary to combine support for the development of local institutions with the design of systems of transfers which ensure equity in the allocation of public resources.

B. FISCAL ASPECTS OF DECENTRALIZATION

In analysing decentralization processes, the question of the financing of the powers and functions transferred to the subnational levels of government is assuming increasing importance. This debate originally arose in the context of the difficult fiscal situation prevailing in the first half of the 1980s and then carried over into the second half of that decade in spite of the adjustment policies which the economies of the region had to adopt. More recently, the outlook has been more encouraging, being marked by the general pursuit of fiscal equilibrium in public-sector finances, which calls for the rationalization of the processes of transfer of powers and resources to the municipalities and intermediate levels of government.

In this context, decentralization processes may be viewed from two standpoints which, while not contradictory, are nevertheless separate and should therefore be complementary to each other in the analysis of government programmes in support of decentralized State management. From the macroeconomic point of view, the main concern is to ensure that these processes are compatible with the maintenance of fiscal stability and balance, in order to avoid the difficulties and adverse macroeconomic effects caused by a faulty system of fiscal relations between the different levels of government and excessive local indebtedness. From the microeconomic and institutional standpoint, on the other hand, the main concerns are to improve the decentralized provision of goods and services and give more possibilities for local participation in the strengthening of local finances. The fundamental problem is how to advance in an even-handed and coordinated manner in both directions in order to further an integrated approach which promotes a government agenda based on consensus between the different levels of government and all the regional actors involved in the process.

1. The macroeconomic dimension of decentralization

From the macroeconomic standpoint, the recent experience of Latin America shows that both in the initial stage of fiscal decentralization processes and in the subsequent transitional period in which many of the countries of the region currently stand, there are strong political and fiscal pressures for the net transfer of resources from the central to subnational levels of government and, to a lesser extent, for a transfer of powers, which in one way or another may complicate the balanced management of public finances.[1]

This latter problem is due to combinations of some of the following factors: (i) rather unclear transfers of powers; (ii) the transfer of considerable resources in various ways between the different levels of government, without the corresponding allocation of responsibility for expenditure; (iii) an unsuitable tax structure which, together with weak tax administration structures at the regional and local levels, leads to faulty design of the system of transfers; and finally, (iv) excessive indebtedness of the subnational bodies. A brief description of these aspects is given below in order to give a clearer picture of the scope for action and possible policy guidelines.

The process in question has been marked by a very uneven redistribution of responsibilities, income and expenditure among the different levels of government. What usually happens is that the local bodies are more willing to receive resources than to accept new responsibilities, while the central government displays a greater tendency to divest itself of powers than to permit greater degrees of autonomy in the area of taxation. In some countries, income has been decentralized more than expenditure, as for example in Brazil and Colombia, where there has been a substantial increase in transfers between the different levels of government, especially after the reforms to the Constitution in 1988 and 1991, respectively; in other cases, however, the opposite has happened, as in the cases of Argentina and Chile, where more importance has been attached to the transfer of powers, especially in the areas of education and health care, but the financing of these services has been left to be defined later. In all cases, however, there have been problems of uneven fiscal arrangements which do not permit fiscal responsibilities to be shared in a suitable manner and which are reflected, in particular, in the very considerable role that the central levels continue to play in the provision and financing of public and social services at the local level.[2]

The experiences of the region clearly show the severe limitations to be observed in the allocation and exercise of new powers. The subnational levels of government have been given quite limited legislative faculties that allow them to act independently in some typically local activities. This has been the practice in most of the countries of the region, and especially in unitary States. There are also unclear structures of responsibilities. Very often, the power to carry out a certain function has not been regulated from the beginning but has been the subject of subsequent negotiations and conflicts between the different

[1] For a more exhaustive analysis, see ECLAC/GTZ (1997), chapter I, where such specialists in this matter as O. Ganderberger, R. López Murphy, J.A. Ocampo, G. Perry, A. Shah, P.B. Spahn, V. Tanzi, T. Ter-Minassian and E. Weisner suggest that the possible conflict between decentralization and stability can be solved by proper design, orientation and coordination of the process.

[2] This problem is described in greater detail in ECLAC/GTZ (1996), part. I.

levels, or has even been left to discretionary action. The Latin American experience shows that these problems generally remain without any satisfactory solution, since the responsibilities of the different levels of government are not clearly established and —what is even more critical— there is a lack of the proper coordination between the different levels of government which is essential in some services in order to tackle the existing shortcomings.

In some countries of the region, transfers between the different levels of government constitute a quite substantial part of total national income (see table VIII-1) and represent a high percentage of the total income of local government agencies. Although this source of funding has been growing substantially, it has unfortunately only been accompanied by an incipient system of follow-up of public expenditure at the subnational level which does not make it possible to assess whether these resources have been used at the local level in line with criteria of efficiency and equity.

It may also be added that the transfers depend on the structure and dynamics of central government taxation rather than on the costs of the services transferred, so that their amount fluctuates according to national tax collection, sometimes causing undesirable macroeconomic effects because of their magnitude. In these systems, fluctuations in national taxes are automatically reflected in higher or lower levels of expenditure, which accentuates economic cycles and prevents the long-term planning of expenditure which, as for example in the social area, should have a more stable financing structure. Furthermore, a system of transfers which depends on national taxes reduces the degree of freedom of tax policy, since any increase in tax rates or in the efficiency of tax collection is automatically translated into higher expenditure, even if those increases are aimed at improving the fiscal balance, as shown by Colombia's recent experience. The foregoing problems undoubtedly call for greater efforts and initiatives aimed at reviewing the systems of transfers and improving the criteria for the allocation and distribution of this important source of funding. The experience of the region in this respect shows that allocations based on shares of national tax revenue are clearly undesirable.

Table VIII-1
IMPORTANCE OF TRANSFERS BETWEEN DIFFERENT LEVELS OF GOVERNMENT IN SELECTED COUNTRIES, 1995

Indicators	Argentina	Brazil	Colombia[a]	Chile	Peru
As a percentage of GDP	5.3	6.0	4.6	2.0	0.9
As a percentage of total current income of national government	39.2	31.2	38.0	8.6	7.3

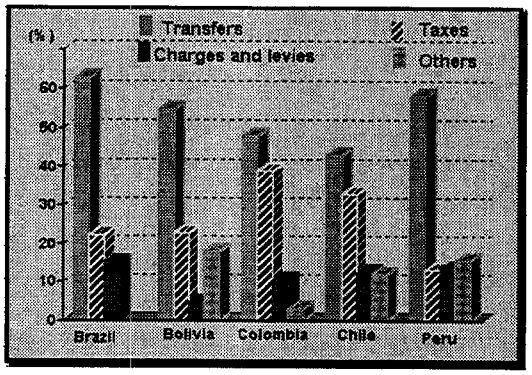
Source: Regional Project on Fiscal Decentralization in Latin America (ECLAC/GTZ).
[a] The Constitution provides that these transfers will gradually increase up to the year 2002, when it is estimated that the indicators will be close to 6.0% of GDP and 46% of total current income.

In contrast with the high proportion of transfers in their income, it should be noted that most subnational governments, especially the municipalities, themselves collect only a small part of the income they need, which reflects the fragility of their finances, that is to say, their high level of financial dependence on external resources and their limited tax autonomy at the local level (see graph for Latin America in figure VIII-1 and table VIII-2). The foregoing may be more readily appreciated if we compare the structure of local income with that of some industrialized countries. Thus, in the graph for OECD countries in figure VIII-1, it may be seen that in those countries two-thirds of local goverment income comes from local sources, while the remainder corresponds to transfers between the different levels of government; this reflects a more solid and sustainable financial situation which allows these levels of government to fulfil their growing responsibilities.

Nevertheless, there are some signs of government efforts to reverse this situation, especially through reforms aimed at the modernization and simplification of local taxes, such as real estate taxes, and the allocation of greater resources to the municipal level through such novel and little-used instruments as taxes on improvements, concessions, etc.[3]

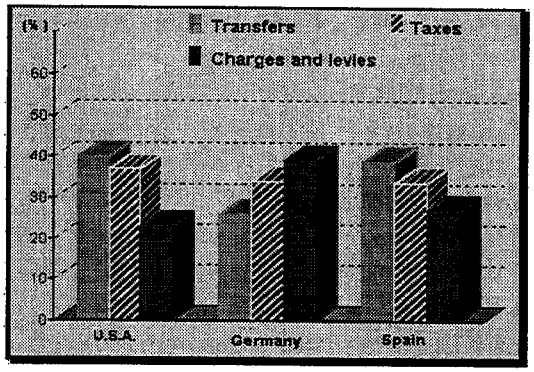
Figure VIII-1
STRUCTURE OF MUNICIPAL INCOME IN SELECTED COUNTRIES, 1994
(Percentages)

LATIN AMERICA



Source: Regional Project on Fiscal Decentralization in Latin America (ECLAC/GTZ).

OECD COUNTRIES



Source: Regional Project on Fiscal Decentralization in Latin America (ECLAC/GTZ).

Table VIII-2
STRUCTURE OF MUNICIPAL INCOME IN SELECTED LATIN AMERICAN COUNTRIES, 1994
(Percentages)

Sources of revenue	Brazil	Bolivia	Colombia	Chile	Peru
Transfers	62.7	54.7	47.8	42.7	58.1
Taxes	22.3	22.8	38.8	32.9	13.0
Charges and levies	15.0	4.6	10.4	12.4	13.3
Other		17.9	3.0	12.0	15.6
TOTAL	100%	100%	100%	100%	100%

Source: Regional Project on Fiscal Decentralization in Latin America (ECLAC/GTZ).

[3] See the following section of this chapter.

Table VIII-3
STRUCTURE OF LOCAL INCOME IN SELECTED OECD COUNTRIES, 1994
(Percentages)

Sources of revenue	United States	Germany	Spain
Transfers	40.0	26.2	38.9
Taxes	37.0	34.2	33.9
Charges and levies	23.0	39.1	27.2
TOTAL	100%	100%	100%

Source: Regional Project on Fiscal Decentralization in Latin America (ECLAC/GTZ).

With regard to subnational government borrowing, it may be noted that in federal countries such as Argentina and Brazil[4] a growing and excessive recourse to local borrowing has undoubtedly made macroeconomic management more difficult and is one of the main sources of controversy in the present discussions within government aimed at solving the financial problems that this type of behaviour has caused in the past. In unitary countries such as Colombia and Ecuador, the use of this source of financing has been increasing in recent years and has reached very high levels which exert pressure on public finances as a whole. Various solutions have been adopted to deal with this problem, such as debt renegotiations and financial rehabilitation in the Brazilian states and Argentine provinces as well as some interesting measures to regulate this source of financing, as in the case of Colombia, details of all of which are given in the following section.

2. Some successful cases

The debate on fiscal decentralization has usually been limited to the macroeconomic area, in which the difficulties and possible effects on consolidated finances are more or less well known. Little mention is made, however, of successful cases whose dissemination could permit advances to be made elsewhere, especially in countries which are only just beginning or are still in the midst of a transition to more decentralized management.

In this context, the countries of the region have tried to take a more pragmatic attitude to the process and have adopted various practices for tackling many of the difficulties in question. As may be seen from the Latin American experience, these improved practices have made it possible to address the different aspects of the problem in question, including, *inter alia*, the adoption of measures to modernize and strengthen subnational taxation and other sources of local income, to control the debt and improve the

[4] According to recent estimates (1997) of the Ministries of State Finances, these debts amount to nearly 100 billion reales. This debt is concentrated in the states of Svo Paulo, Minas Gerais, Rio de Janeiro and Rio Grande do Sul.

financial position of local bodies, and to foster the monitoring of local public management by the citizens themselves.[5]

The efforts made by various municipal governments to improve the collection of real estate taxes are noteworthy in this respect (see box VIII-1). There has also been somewhat of a revival of the benefit principle of taxation at the local level, which is reflected in the fact that user charges and other rates and levies have become an important source of funds for a number of cities in the region (see box VIII-2). It may be noted that there has been a growing tendency to adopt new mechanisms for tapping into the increased land values generated by urbanization processes, as in the case of the revaluation tax levied in Colombian cities and the improvements introduced in various locations in Argentina, Brazil and Mexico, etc. At the same time, encouragement has been given to the mobilization of private capital to finance local infrastructure works, as for example through concessions, especially those granted in some municipalities in Chile, where they are linked to projects for the improvement of urban road systems, conservation of parks and beaches, etc.

It is also worth noting that efforts have been made in recent years to promote more responsible and coordinated management of local government borrowing with a view to minimizing its possible macroeconomic effects (see box VIII-3). In spite of the current constraints in capital markets affecting long-term local and regional investments, instruments such as municipal bonds are beginning to arouse interest, especially on the part of the medium-sized cities and metropolitan areas of the region.

Box VIII-1

RECENT REFORMS IN REAL ESTATE TAXES IN BOGOTÁ (COLOMBIA), LA PAZ (BOLIVIA) AND QUITO (ECUADOR)

The considerable lag in updating the assessed property values used for taxation purposes with respect to the actual commercial value of the real estate in question, with the consequent deterioration in real estate tax receipts in the capital of Colombia, was one of the decisive factors in the establishment of a new legal framework allowing for certain reforms in the city's tax system; thus, in 1994 a self-assessment system was adopted for the determination of the base value for the tax, together with a set of procedures for its administration (private tax returns, payment through the banking system, and some fiscal incentives). The most obvious result of this change was a significant increase in real estate tax receipts in Bogotá, especially during the first year of application, when these receipts doubled. This increase was due more to an increase in the number of properties paying the tax than to any substantial increase in the amount collected per capita: what happened was that there was "better distribution of the tax burden and a significant reduction in evasion" (Piza, 1996).

In the case of Bolivia, the 1993 Popular Participation Act (the basic instrument governing the decentralization process) eliminated direct participation by the central government in the administration of real estate taxes. Consequently, as occurred in the case of La Paz, for example, the municipality took direct control of the administration and collection of this tax, giving high priority to

[5] These successful experiences were described in detail at the Third International Seminar on Fiscal Decentralization in Latin America, sponsored by ECLAC and GTZ in 1996. See Campbell (1997) and Aghón (1997). The World Bank Project on Decentralization in Latin America and the Caribbean: Policy Lessons and Best Practices gives a systematic analysis of a number of cases of innovations in various areas of decentralized management.

its potential and its modernization: as a result, there was a significant increase in these revenues, which almost doubled in 1994. At the same time, efforts were made to modernize the collection process at the local level through the introduction of an integrated computerized system for maintaining taxpayers' records and, more recently, extensive enforcement activities (Cuevas, 1996). The situation has been similar in the case of the other localities which requested the right and had the necessary administrative capacity to collect this tax themselves.

In Quito, the city authorities took steps to modernize the real estate registers using an automated multi-purpose scheme for the development of integrated real estate registers known as the CIMA system; the municipality used its own technical, human and financial resources to implement the system, which was extended to include rural areas in 1994 when the Metropolitan District Act was passed. These changes elicited a notable response from the general public which was reflected in a significant increase in real estate tax receipts; these revenues were subsequently used to finance priority local works.

Summing up these three experiences, the first case shows that options such as self-assessment systems may be attractive in that they help to foster greater fiscal responsibility on the part of citizens, but that they need to be supplemented with suitable private reporting systems and more efficient tax administration. The second case highlights the importance of greater autonomy and responsibility of the local authorities in connection with a typically local tax, provided they have the basic elements needed for modern tax adminstration. Finally, the third case shows the importance of promoting good relations between the municipality and the community in carrying out real estate registration activities and fostering public confidence that the greater resources thus collected will be used for the benefit of that same community.

REAL ESTATE TAXES, AS A PERCENTAGE OF TOTAL CURRENT MUNICIPAL INCOME
(Percentages)

Year	Bogotá	La Paz	Quito
1993	17.0	11.0	6.8
1994	18.1	22.0	5.7
1995	20.0	25.0	8.1

Source: Information provided by the respective municipal offices.

Box VIII-2

IMPROVEMENT OR VALUATION TAXES: POTENTIAL USES AND EXAMPLES OF SUCCESSFUL APPLICATIONS IN SELECTED LATIN AMERICAN CITIES

This local financial instrument is a kind of reimbursement or "contribution" made directly by benefited owners to the municipality in respect of increases in the value of their property as a consequence of the execution of public works.

A good deal of use has been made of these taxes in Colombia, especially in cities which have a large population or are of considerable economic importance, such as Bogotá, Medellín, Cali, and some medium-sized cities such as Pereira, Manizales, Bucaramanga, etc.

The main criterion applied in this case is the recovery of the cost of public works by prorating that cost among the owners of properties in the relevant service area, in accordance with some mathematical method based on such indicators as the size of the property, frontage, economic indices, etc. Property owners are given some role in the analysis of the budget and the methods of sharing out their contributions, as well as in the follow-up and control of the way the funds are invested. In order to provide an idea of the importance of this system, it may be noted that in the cities in question this tax averaged 18.4% of total income over the period 1980-1995 and was the third most important source of local resources, only exceeded by real estate tax and taxes on industry and commerce.

In other cases, such as that of the Municipality of Tijuana (Mexico), the scheme adopted for financing the plan of priority local public works was a system termed the "Urban Activation Plan", consisting of a combination of municipal resources, contributions by the industrial and commercial sectors, and an improvements tax, whereby the community benefiting from the projects assumes part of the cost. An opinion poll was carried out in order to determine the views of the public on the use of this scheme for co-financing the Activation Plan and, even more importantly, a public referendum was held in 1994. The community gave its decisive support (66% of the votes) to the initiative, whose most important result has been the financing of the biggest public works plan ever undertaken by the city (US$ 170 million).

The general conclusion is that these kinds of instruments foster greater fiscal responsibility on the part of the community by strengthening the links between local public investments and the potential beneficiaries, because they give rise to what could be called a "political contract" for the financing of municipal infrastructure. This system is not widely known in the region, and could undoubtedly be used by many municipalities to their advantage.

Box VIII-3

REGULATION OF SUBNATIONAL GOVERNMENT BORROWING: RECENT ADVANCES IN THE CASE OF COLOMBIA

Between 1992 and 1994, loans taken out by the country's departmental governments increased from 0.21% of GDP to 0.50%, while borrowing by municipalities rose from 47% to 1.04%. This notable increase in borrowing by subnational levels of government from financial institutions was strengthened by a rapid process of fiscal decentralization. The main feature of this process was a substantial increase in transfers between the different levels of government, as reflected in the significant expansion in subnational current and capital expenditure which has affected the consolidated public sector's finances.

In view of this situation, and in accordance with article 364 of the 1991 Constitution, a proposal was made to adopt new regulations concerning borrowing by subnational levels of government designed, at the fiscal level, to stimulate saving and avoid over-indebtedness by ensuring that subnational bodies would be in a position to meet their obligations. For this purpose, indicators of creditworthiness and debt sustainability would be established, and suitable systems of accounting, decentralized controls and evaluation of investment programmes would be promoted.

In this context, Act No. 358 of 1997 was adopted, representing a major step forward in this field. These regulations envisage three states of alert (Perry and Huertas, 1997) corresponding to moderate, intermediate and critical indebtedness (green, yellow and red alerts, respectively), to be determined by liquidity indicators (ratio of interest to operational saving) and indicators of creditworthiness (ratio of debt to income). In the case of a red alert, local bodies must apply financial performance and rehabilitation plans until such time as they recover their creditworthiness and are once again in a position to engage in such operations.

PERMITTED LEVELS OF INDEBTEDNESS (Act No. 358 of 1997)

Alert	Interest/operational saving
Green	Up to 40%
Yellow	Between 40% and 60%
Red	Over 40%, with a debt/current income ratio of over 80%

In a simulation carried out by the Ministry of Finance of Colombia on the possible impact of the new regulations on a sample of 331 localities, it was observed that although the regulations represent an important advance towards solving the problem of over-indebtedness and recognize the desirability of altering administrative and control procedures, the limits set for the new indicators, particularly in the case of situations of critical indebtedness, still seem quite broad and should be the subject of future evaluation.

A complementary measure to the foregoing is the implementation of subnational fiscal rehabilitation and adjustment programmes, as in some provinces of Argentina, some states of Brazil, and, more recently, some departments of Colombia. In these programmes, clear goals are fixed for the reduction of the fiscal deficit through the strengthening and modernization of subnational tax bases, the reduction of operating expenses, and the establishment of payment commitments. These processes enjoy the financial and technical support both of the respective Governments, through their Ministries of Finance, and of international agencies such as IDB and the World Bank.

At the level of local budgeting, mention may be made of successful examples of citizen control such as those in Porto Alegre, Brazil (see box VIII-4), Cali, Colombia, and Tijuana, Mexico, which have heightened the transparency and accountability of communities and authorities in the decentralized execution of public expenditure through novel systems of follow-up and evaluation.

Box VIII-4

GREATER CITIZEN CONTROL OF THE BUDGETARY PROCESS: ADOPTION OF PARTICIPATORY BUDGETING IN PORTO ALEGRE, BRAZIL

The municipality of Porto Alegre (Brazil) has begun to implement a participatory budgeting system which combines interesting theoretical and practical elements in an effort to secure greater rationalization of decision-making based on the idea of citizen control over public actions.

On the basis of the general lines of the regular municipal budget, the activities to be carried out during the year are clearly defined with the participation of delegates from the various districts into which the city is divided, through the Participatory Budgeting Council (CPP). The CPP lays down the rules or criteria for the selection of investment priorities for the following year and designates working groups to deal with such sectors as health, education, urban development, etc. On the basis of these guidelines, and under the coordination of the municipality, field work is carried out in the various districts of the city to identify the demands of the citizens and the priority works to be carried out in the areas in question, and the results are submitted to the CPP. The local administrative agency then prepares a preliminary draft investment budget which is submitted to the local executive and then returned to the CPP, where it is reviewed; at the end of the year, an investment plan is prepared which specifies the cost, executing agency and deadline for the completion of each public project. Finally, the plan is circulated to the whole population for follow-up and control.

On the one hand, this successful participatory process has strengthened the credibility of the municipal government and of its new style of local management, while on the other it has had some interesting effects in terms of the fiscal connection between the works requested and the taxes which it is necessary to collect for their execution. This has been reflected in a substantial increase in the resources collected by the municipality itself and an improvement in the city's financial position. Finally, it may be noted that this process has become institutionalized in recent years to the point where it is highly improbable that subsequent municipal administrations could refrain from continuing with it. Instead, it has become a kind of political and fiscal "contract" between the citizens and the administration.

Since this effort by the city to exert greater social control over public expenditure has been put into effect, it has helped to identify, with citizen participation, priority investments amounting to nearly US$ 700 million.

3. Guidelines for the future

Over the last decade, various Latin American countries have taken important steps towards the initiation or consolidation of a process of fiscal decentralization through the adoption of an extensive set of rules and general guidelines which represent the virtual completion of what might be termed the first phase of fiscal arrangements between the different levels of government. This stage has brought to light clear shortcomings in terms of the institutional structure and financial management. The processes of fiscal decentralization in the region are now entering upon what might be called a "second phase" in which, as well as perfecting the present strategies for the transfer of income and responsibilities, it is necessary that they should show their effectiveness in terms of greater coverage and higher quality of basic services and greater fiscal and political accountability on the part of the subnational levels of government.

As it is an eminently political process, decentralization must have a suitable constitutional and legal framework, reflected in a clear definition of the powers and resources of the different levels of government and, what is no less important, in effective institutional coordination which ensures the consistency of this process with other government policies and programmes.

A sustainable process of fiscal decentralization calls for a suitable allocation of powers and for forms of financing which give greater fiscal responsibility to the subnational levels. Beyond any doubt, one of the most important areas of work is the strengthening of the arrangements for raising income from the main local taxes, such as a real estate taxes and different forms of charges and fees for services. The adoption of a strategy for boosting the local fiscal effort and promoting greater political accountability to the community is a basic prerequisite in any sound process of fiscal decentralization.

In the field of fiscal relations between the different levels of government, the design of a system of transfers between those levels which promotes a suitable balance between the criterion of efficiency and that of equity in the distribution of resources must undoubtedly be one of the priority items on the government agenda for the coming years. The structure of this source of revenues must be as simple and transparent as possible and must foster efficient financial management and greater regional equity. In this respect, as already noted, it is necessary to de-link the transfers from national taxes and determine them instead as a function of four fundamental criteria: (i) the target population; (ii) the real cost of providing the services; (iii) the efficiency of their provision; and (iv) the fiscal capacity and effort of the local levels of government. The relative weight of these criteria may vary, of course, according to the local situation. It is also extremely important that there should be a suitable information system to permit the follow-up and evaluation of these measures, as well as certain institutional mechanisms for the review and adjustment of transfers in the light of government priorities and the macroeconomic context.

In order not to undermine macroeconomic management, clear rules must be adopted on borrowing by subnational levels of government. Local-government borrowing must be controlled and, when necessary, drastically restricted.

Institution-building calls for the reinforcement of the national government's role in regulating and guiding the process of decentralization. It also calls for the implementation of

fiscal reforms and programmes of rehabilitation and modernization of local-government financial management. Efforts in these areas are, at least in part, being stimulated by the Governments, with the technical and financial assistance of international cooperation and lending agencies. This necessarily involves the establishment of systems to provide information on budgets, accounting, treasury activities and auditing, as well as systems of follow-up and evaluation, appropriate to the respective needs of the local and national levels. No less important is the strengthening of the administrative bodies directly responsible for carrying out the new subnational functions and the participation of the citizens in the design, follow-up and evaluation of local public action.

C. THE DECENTRALIZED PROVISION OF SOCIAL SERVICES

As already noted, one of the main objectives of the decentralization process in the region has been to raise the efficiency of public expenditure. In this respect —because of their close relation with the question of equity— it is necessary to highlight the efforts made to decentralize social expenditure, with emphasis on the provision of basic education and primary health care in a more direct manner, with greater accountability and with more control on the part of users and the respective communities. In a good many countries of the region, the administration of these services is being transferred to the local levels of government, while the aspects of regulation, supervision and global management of the system continue to be the responsibility of the central government. The recent experience in this field is characterized by the heterogeneity of the processes applied and the results obtained in the various countries, in terms of both the responsibilities and the degree of autonomy effectively transferred to the local levels of government.

The efforts made to improve the efficiency of social expenditure through decentralization have been basically limited by two factors. On the one hand, in general terms the financing model has continued to be highly centralized. However, the importance of general transfers —i.e., transfers that are not earmarked— to these sectors has given rise to greater autonomy in the allocation of the resources transferred in some countries, such as Argentina, Brazil and, to a lesser extent, Colombia. The second limitation is related to the notable centralization of human resources management, which considerably reduces the possibility of taking advantage of community participation and, in particular, exercising more direct control over the provision of these services.

Thus, most of the models are characterized by principal-agent problems whereby the subnational levels of government continue to be answerable to the central level for their activities in these sectors because of a financing structure which is highly dependent on the central authorities and the fact that they are subject to regulations and incentives defined for the entire country, even as regards human resources management. A typical feature of this type of model is the difficulty in striking a balance between autonomy and control displayed in the relations between the actors at the central government level and those at the local level.

1. Results and trends in terms of efficiency and equity

It is now generally acknowledged that community participation is a necessary condition for attaining a satisfactory degree of social efficiency. Although more or less specific channels of participation do exist in the countries of the region, unfortunately little progress has been made in this field, so that it has not been possible to take advantage of all the opportunities offered by the reforms in terms of increasing social efficiency. Nicaragua, and to a lesser extent Brazil and Bolivia, have made the biggest strides in the field of participation; to a great extent, their progress in this respect is related to these countries' objectives with regard to democratization. In the case of education, the degree of financial autonomy of the new bodies responsible for the provision of services and the degree of autonomy of the actual production units themselves (the schools) are factors which have helped to facilitate such participation, as may be seen in the cases of Brazil and Nicaragua.

There is very little information on trends in technical efficiency, as measured through indicators of the cost/impact ratio[6] of the decentralized provision of social services. The time that has passed since the application of the reforms is still quite short, and the information is not very detailed at the local level. Only in the cases of Argentina (in education and health care), Brazil and Chile (in education) and Mexico (in health care) are some data available on the trends reflected by indicators of this type. These trends have been rather ambiguous in respect of delegation of responsibilities to the local levels, since while there have been some cases where increases in real expenditure have been accompanied by at least equivalent increases in the coverage of the services (Argentina, Brazil), there have also been cases where improvements in the cost/coverage ratio have been accompanied by negative movements in the cost/quality ratio (Mexico).[7]

With regard to the possible effects from the point of view of regional and personal income distribution, some data are available on indicators in the fields of education and health care and their relation with the recent reforms. In all countries, the analysis has been centred on the distribution of resources and expenditure between geographical areas as a result of the reforms, as an approximate indicator of equity.[8] In those countries for which comparable data covering more than one time period are available (as in the case of Argentina, Brazil and Mexico for the education sector), the information suggests that the differences in quality of service between different areas have probably been increasing. In Argentina and Brazil, these differences are related to the lack of equity in the distribution of resources between different areas within the context of the devolution and autonomy models applied in them, which has led to an increase in the dispersion of intermediate indicators of educational quality (salaries, teacher qualifications). In Mexico, it is due to the slight increase in the degree of regressiveness of the distribution of federal expenditure. In the other cases, it has only been possible to analyse the distribution of resources or expenditure

[6] In order to measure efficiency directly, indicators of the cost/impact ratio are used; the impact can be calculated in approximate terms from the effects observed in terms of coverage or quality, while the cost can be determined through indicators of expenditure or inputs.

[7] The information given in this section is based on Cominetti (1998) and Di Gropello (1998).

[8] It is assumed that a progressive distribution of expenditure should make possible a reduction in the gap in education and health indicators.

between different areas since the reforms were applied —without any comparisons over time— with a view to detecting the degree of distributional progressivity.

In view of the foregoing, the results of the reforms carried out so far, in terms of efficiency and equity, may be considered disappointing compared with the initial objectives and expectations. In the most recent cases, some positive changes are to be noted, such as the efforts to achieve consensus on the proper sequencing of these reforms for the achievement of greater efficiency and regional equity, the redesigning of transfer systems, and the initiatives taken to promote more effective channels of participation with the aim of ensuring greater accountability for the results. At the same time, however, there are serious limitations which hinder a more thorough application of these reforms, such as the limited autonomy of municipalities and of middle-level management in carrying out key functions, and even in human resources management. There are also shortcomings in the systems of regulation and control of the provision of services and a lack of up-to-date information systems.

2. The main lessons

The proper definition and execution of transfers between the different levels of government is crucial for the success of the reforms. In many countries of the region, the central government is still responsible for guaranteeing a minimum level of financing for the subnational levels. As already noted, however, this financing should be determined as a function of the criteria of equity (economic and social conditions of the population, regional or local fiscal capacity, and cost of providing services), efficiency (expansion of coverage of services, improvements in quality, etc.) and local fiscal effort.

The recent reforms have tried to incorporate these criteria explicitly through the use of more or less complex formulas and guidelines on expenditure and allocations, but there are cases where weaknesses in the regulatory framework and lack of information make this difficult. The system should be designed, above all, to achieve greater equity in the allocation of resources at the regional level.

Comparative analysis of the processes of decentralization of social services in Latin America clearly shows the need to grant some measure of real autonomy to the new bodies providing services at the local level by replacing direct restrictions with national-level guidelines and incentives. The limited nature of the progress made in terms of efficiency is due largely to rigidities in the model adopted and a lack of flexibility in labour related matters.

Decentralization of the main powers to the intermediate level of government (states, departments or provinces) or groups of municipalities, in combination with the decentralization of administrative, substantive and financial functions to the producer units themselves (schools, hospitals), should lead to increased efficiency and equity, as may be seen from the successful experiences of Brazil and Argentina and the preliminary results observed in Nicaragua. The exclusively municipal-level approach which some countries have tried to implement, however, leads to a loss of economies of scale (especially in the field of health) which decentralization at a higher level should solve.

It is essential that there should be a regulatory framework adapted to the supervisory requirements of a decentralized service delivery system, both at the central government level

and at the intermediate and local levels. This framework should clearly define responsibilities and provide for government coordination of the sources of financing for social investment programmes.

Increasing social participation and control is another of the great challenges to be tackled by reform programmes. The initial motivation stemming from democratization, i.e., the granting of greater autonomy to production units, especially in the case of education, and the introduction of financing mechanisms which facilitate such participation (through demand subsidies, for example) should have positive effects in this sense.

The reforms should be supplemented with specific training measures and programmes, especially in the field of management. The lack of technical and administrative skills limits the results of these processes. Finally, high priority should be given to the implementation of a suitable information system to facilitate the functioning of the new schemes of decentralized management in the health-care and education sectors and above all to permit the evaluation of the fulfillment of the functions transferred and the use made by the local levels of the transfers between the different levels of government.

D. CONCLUSIONS AND FINAL OBSERVATIONS

- Among the various processes of State reform, decentralization stands out because of the broad prospects it offers for Latin America and Caribbean. In its political dimension, it complements and strengthens the consolidation of democracy and governance in the countries of the region. In the economic field, it holds out possibilities for increasing the efficiency of the supply of local public goods and services and enhancing the fiscal accountability of subnational levels of government.
- Although this process is relatively recent in the region, some of the difficulties and macroeconomic risks in relation to resource allocation which can arise in the transition to a more decentralized management model have already become evident. At the same time, however, this process has given rise to new dynamics, some of the clearest reflections of which are the adoption of innovations and best practice in various areas of fiscal management and in the decentralized provision of services.
- In many of the countries of the region, the fiscal decentralization process is entering into what might be called a "second phase" in which, as well as perfecting the system of fiscal relations between the different levels of government, greater coverage and higher quality of basic services must be achieved, as well as greater fiscal discipline and responsibility at the subnational levels of government. This calls for a suitable legal framework providing a clear delimitation of powers and resources between the various levels of government and —no less important— effective coordination between the different levels of government to ensure the follow-up and evaluation of the process.
- From the macroeconomic standpoint, a properly designed decentralization process must have four main elements: (i) clear allocation to the subnational levels of government of greater responsibility with regard to those fields of expenditure where they can act most effectively; (ii) greater financial autonomy and the corresponding powers of taxation, to permit the stable generation of resources and

responsible behaviour in fiscal matters; (iii) suitable definition of transfers between the different levels of government in order to overcome the vertical fiscal imbalance and problems of efficiency and equity inherent in the transition to a system of decentralized management; and (iv) clear rules on borrowing by subnational levels of government which provide for effective controls and, when necessary, impose severe restrictions.

- One of the most important areas of work in the decentralization agenda is undoubtedly that of increasing the locally generated income of local governments, especially from real estate taxes and different forms of charges and fees for services. The adoption of a strategy which promotes local fiscal effort, greater budgetary discipline and broad community participation in the control and monitoring of public action, especially in the case of the services most closely linked to the improvement of the population's quality of life, is a basic requisite for a sustainable process of fiscal decentralization.
- Transfers between the different levels of government must be governed by criteria of inter-regional equity, efficiency and local fiscal effort. It is therefore desirable that they should be de-linked from the collection of national taxes and should be determined as a function of four fundamental criteria whose importance will vary in line with the relevant national conditions: (i) the target population; (ii) the cost of providing the services; (iii) the efficiency and efficacy of the services provided; and (iv) the regional or local fiscal effort.
- Decentralization involves the allocation of new roles to the different levels of government and relevant actors. In this respect, the need for institution-building means that the national government must reinforce its role in setting policies and in regulating and guiding the process, while the municipalities and intermediate levels of government must modernize their financial management, improve their technical capacity to provide basic services more effectively, and ensure community participation in the follow-up and evaluation of local public management. This process of institution-building must be accompanied by training programmes for public officials at the different levels. It is also very necessary to implement a suitable information system which will permit the follow-up and evaluation of the different levels of government, in order to ensure that they make proper use of inter-level transfers and, in general, achieve the objectives laid down for the decentralization programmes.
- A comparative analysis of the processes of decentralization of social services in Latin America clearly points to the need to give real autonomy to the new local-level service providers by replacing direct restrictions with national-level guidelines and incentives. The limited nature of the progress made in terms of efficiency is due largely to the rigidities of the model adopted and a lack of flexibility in labour-related matters.

IX. PRIVATIZATION AND PUBLIC FINANCE

A. INTRODUCTION

Privatizations constitute one of the defining characteristics of the first-generation structural reforms undertaken in the region since the start of the 1980s.

The most obvious aspect of this process —which was launched under the aegis of the new paradigm of less direct State intervention in the economy that was beginning to take shape at that time— has inarguably been the sale of State-owned production firms and public utilities (electrical power, gas, water and telephone services, among others). The wave of privatizations has not been confined to the transfer of State assets into private hands, however; such operations have also taken the form of private equity contributions to public enterprises.[1] Other traits of the process have included the following: (i) increased outsourcing of services by the public sector (e.g., publishing and advertising); (ii) the extension or transfer to the private sector of the right to provide services usually (either exclusively or mainly) supplied by the Government (primary education, basic health services, pension systems, garbage collection, street sweeping, the maintenance of public squares and gardens, etc.); and (iii) a much more frequent application of the model whereby government concessions or franchises are awarded to private agents for the construction or operation of infrastructure works such as highways, bridges, tunnels and airports.[2]

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[1] Requena (1996) analyses this type of operation as it has been applied in Bolivia since 1992. More recently, some countries of the region have complemented their privatization programmes by allowing private capital to move into State enterprises (e.g., the electrical power sector in Colombia) or by allowing private agents to take charge of new investment projects in sectors where the State maintains its hegemony through corporations that have been declared ineligible for privatization (e.g., the copper industry in Chile).

[2] The term "privatization" is being used here in a much broader sense than in many studies, which confine their use of the term to the actual sale of public enterprises. For example, Vickers and Yarrow (1991) draw a distinction between the sale of firms –belonging either to the competitive sector or forming part of State monopolies— and outsourcing of publicly-funded services.

Such a sharp change of course in the formulation, design and implementation of economic policy and of the institutional arrangements that provide its underpinnings obviously has major implications for the public finances of the economies of the region, since it entails a complete overhaul of the public-sector's financial model, which will inevitably be reflected in its balance sheet and income statement.

Although more than 15 years have passed since the wave of privatizations in Latin America began, no comprehensive assessment has yet been made of its results. This task is all the harder because in some countries this process is in full swing while in others it has yet to begin. In addition, a comprehensive evaluation would have to look at the impacts of the privatization process in such widely varying and complex areas as trends in the price/quality ratio for consumer services; the profitability of privatized firms' operations; the levels of investment and technical progress that have been absorbed by privatized sectors; the gains in efficiency and effectiveness that can generally be attributed to the change in ownership and/or management; and its complicated fiscal impacts, which will be discussed in this chapter.

Clearly, it is no easy task to arrive at an overall conclusion as to the net effect of privatization. What is more, operations of this type have been just one component of an entire package of complementary and mutually-reinforcing structural reforms. Thus, given the varying combinations of baseline situations, political issues, institutional conditions and specific objectives associated with the individual countries, the actual role played by privatization may also have differed from one country to the next and, within each country, from one period of time to the next.[3]

This having been said, some consensus views have nonetheless been formed regarding privatizations from an economic standpoint: (i) they are not an appropriate means of dealing with short-term imbalances in public-sector accounts;[4] (ii) they usually give rise to improvements in corporate management (along with the resulting increases in operating efficiency) during the run-up to the actual sale, which has a favourable fiscal impact in the short term;[5] (iii) they have a positive impact in terms of saving because the associated reduction in subsidies increases the relevant sectors' financial sustainability; (iv) they bring about enduring productivity gains in the enterprises concerned, which may boost the entire economy's savings rate; and (v) they can serve as an effective mechanism for improving public finances on a lasting basis provided that the proceeds are used to reduce the public debt, and especially if they are used to buy up government debt paper at a discount on secondary markets.

The guarantees that some Governments in the region are offering as part of their privatization packages constitute an issue of some importance in the area of public finances which has not yet been studied to any great extent. This practice means that, in various respects, privatization does not actually signify a complete, perfect or irrevocable transfer of risk to the private sector. In principle, it may seem somewhat odd that, in some cases, these deals would not be concluded if it were not for the public sector's assumption of contingent

[3] For an evaluation of some of the important aspects of different countries' experiences with privatization, see Pinheiro and Schneider (1995), Pinheiro (1996) and Sánchez and Corona (eds.) (1993).

[4] Pinheiro and Schneider (1995); Newbery (1997).

[5] These efficiency gains are usually more frequent during the run-up to the privatization operation itself. See Boycko, Shleifer and Vishny (1996).

liabilities. This question needs to be addressed on an urgent basis by the Governments concerned, since these guarantees constitute payment commitments that can be called in at any time and, as such, should figure clearly in government accounts. Furthermore, they could be used as a concealed channel for providing unwarranted private-sector subsidies. The lack of transparency currently surrounding this question creates a perilous situation, since no estimated value has been assigned to the existing liabilities; in other words, at the present time there is no means of quantifying the impact which such liabilities could suddenly have on government accounts at some point in the future if the Government were suddenly to be called upon to cover them.

B. REASONS FOR THE MOVE TOWARDS PRIVATIZATION

The shift to a new paradigm that began in the 1980s has led to the gradual formation of a consensus body of opinion according to which the public sector should: (i) reduce its presence as an owner of means of production and as a producer or distributor of goods and services which are rivals in consumption and to which the principle of excludability can be applied without incurring excessive costs;[6] (ii) ensure the provision of public goods and services, preferably via private production and distribution even if public financing is required; (iii) produce and supply public goods which are typically rivals in consumption and to which the principle of excludability cannot be applied (at least without incurring extremely high social costs); (iv) assume responsibility for maintaining socially acceptable patterns of income distribution and levels of equity, especially in today's increasingly market-oriented world; (v) increase the efficiency, effectiveness and quality of the public sector's management of income/expenditure and of public enterprises; (vi) upgrade the public sector's regulatory capabilities in general and, in particular, in the areas of environmental protection, public utilities, public safety and health, and others of growing concern; (vii) foster the achievement of suitable levels of competitiveness in the economyand, especially, of efficiency in public utilities operating in concentrated markets, whether the providers are privatized firms or enterprises under the direct control of the State.[7]

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[6] This principle refers to the possibility of preventing a person from consuming a given good or service unless they pay for it. In the case of public goods, however, no such possibility exists, since there is no incentive for the consumer to demonstrate his/her intention of paying for the benefits received.

[7] Efforts to boost efficiency can take either a direct approach (an increase in the number of firms) or an indirect route (when a natural monopoly exists due to the existence of economies of scale or for other reasons which make a direct approach unfeasible). In the latter case, the State must resort to its regulatory powers in order to boost efficiency to competitive-market levels. When public utilities (electrical power, water, etc.) are privatized which are natural monopolies and therefore operate with little or no competition, it is particularly important to have a sound regulatory system in place from the very start, so that tender offers can specify the rules which bidding firms will have to comply with. The subject of regulation is of extraordinary importance and has been researched quite extensively by ECLAC and ILPES. See, *inter alia*, ECLAC (1997), Cominetti (1996), Corrales (1996), Cuevas (1996), Herrera (1996a and 1996b), Melo (1997), Requena (1996), Rudnick (1997), Solanes (1997a and 1997b) and Stark (1997).

Within this context, privatization programmes are usually portrayed as being designed to achieve certain fundamental objectives. The first is to boost the newly privatized firms' efficiency and effectiveness. In order to accomplish this, political interference in their management must be reduced, more emphasis must be placed on operational objectives, private managers must become more responsible and accountable for their performance; and financial discipline must be tightened. The second is to reduce the deficit and contribute to the adjustment of public accounts by using the proceeds from the sale of State assets for this purpose, as well as by eliminating the subsidies embedded in the firms' cost structures (which, as a result of privatization, must be reduced and transferred to the budget) and altering the public sector's debt profile. The third is to break up the monopolistic power wielded by the State through its enterprises by distributing equity in these firms to the community. The fourth is to lay the foundations for "people's capitalism" (as in England and Chile). The fifth is to promote private ownership as a basis for the formation of market economies (as in Eastern Europe). The sixth objective is to attract foreign investment (following the example provided by Bolivia's "capitalization" model).

Of all these possible objectives, the first two are cited most frequently by privatization authorities. In the literature on the subject, the two aims are generally considered to be antagonistic or substitutive in the short term but complementary in the medium and long terms.

The achievement of greater efficiency and effectiveness requires a change in the system of incentives which influence decision-making and this, in turn, calls for a reallocation of scarce resources across sectors and a relatively more important role for private investment.[8] The latter, assuredly, reflects the above-mentioned change in the political/philosophical paradigm which began to emerge in the 1980s. One of the most important dimensions of this process has been the transition from the State-as-owner to the State-as-overseer[9] and from a producer State to a regulatory State.[10]

Privatization can contribute to economic efficiency both internally (which implies a better use of the company's resources) and externally (as a result of inter-firm competition), and should therefore lead to a more efficient social use of the scarce resources available within society. For many, this should be the primary objective of privatization. Both vectors act as direct stimuli for gains in productivity and should fortify one another, thus setting up a "virtuous circle". It should also lead to greater efficiency in companies still in the hands of the public sector, as their administrators begin to attach greater importance to what the public expects of them. In addition, privatization can indirectly promote growth by paving the way for a deepening of capital markets and by stimulating saving as well as domestic and foreign investment. Lastly, since it allows the central government to concentrate on its

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[8] The transfer of State-owned enterprises to private investors is generally made through bids, the flotation of shares, negotiated sales, or the distribution of shares, vouchers or coupons. Other forms of privatization include leases, joint ventures and management contracts.

[9] Rogozinski (1997).

[10] Muñoz (1996). The contemporary debate on State reform basically revolves around the relative importance that should be attributed to the roles of owner, producer, supplier, financier and regulator. It should be noted, however, that this is not an exhaustive list of the types of roles played by the State in the field of economics. Reference should also be made to its role as advisor and facilitator of economic development and, most importantly, to its responsibilities in such areas as income distribution, social equity and solidarity.

fundamental responsibilities, the institutional framework of economic and social development should gain in efficiency and effectiveness.

Clearly, little or none of the foregoing can occur if there is insufficient competition in the markets in which the privatized companies are to operate, and the same is true for public utilities, unless the regulatory framework helps to ensure –and, if need be, demands– levels of competition and of efficiency and effectiveness that are consistent with the expectations generated.

Thus, as government authorities strive to raise more funds for the Treasury in response to the frequent need to achieve or consolidate macroeconomic stabilization goals, the hope is that privatization will help to place public finances –traditionally perceived as a source of inflationary pressures and imbalances in external accounts– on a sounder footing. Its positive results, however, are not limited to achieving or preserving short-term macroeconomic equilibria. In fact, the expectation is that the consolidation of government accounts through privatization will spur economic growth in the long term by improving resource allocation and, by the same token, boosting national savings. These long-term objectives have attracted the attention of the economic authorities responsible for most of the privatization exercises implemented in Latin America.

Notwithstanding the strategic importance of the above considerations, there is no doubt that privatization receipts and their contribution to the stabilization process in the short term are the immediate results that appeal the most to fiscal authorities. First, because public-sector borrowing requirements are reduced (and, hence, pressure on interest rates and domestic prices) and, at the same time, a positive signal is conveyed to the market. Second, because when the proceeds are used to reduce the public debt, the debt burden is lightened. Third, because once foreign investors have access to government assets, the incoming flow of foreign exchange will moderate the external deficit without increasing the volatility of currency markets. Fourth, because if privatization revenues contribute to macroeconomic stabilization –and allow the achievement of a higher growth rate than would otherwise have been possible– higher tax receipts may also be expected, which will strengthen not only the virtuous circle referred to above but also political support for the stabilization programme itself.[11]

Nevertheless, owing to the technical and political difficulties associated with privatization, the flow of income from these operations is often not regular enough to sustain a stabilization programme. An even greater problem, however, is that the market value of the relevant government assets usually falls far short of the level of financial resources required by such programmes, which substantially reduces the effectiveness of privatization as an auxiliary instrument in this sphere.

Above and beyond the analysis presented above, it is difficult to gauge the relative importance of the different objectives of the privatization programmes pursued by the Latin American countries, especially in view of the conflicting implications they may have. For example, the aim of maximizing tax revenues may interfere with efforts to democratize the process of transferring assets to the private sector. The latter may, in turn, run counter to the aim of attracting foreign investors and, in some instances, of more efficient management of the company once it has been privatized (excessive fragmentation of the principal makes it difficult to send coherent signals to the agent). The objective of improving public finances

[11] IPEA (1997), Giambiagi and Pinheiro (1996).

may also be in conflict with other demands of the privatization process, such as, in particular, the provision of "guarantees" to private shareholders; examples would include the fixing of a minimum rate of return (thereby creating contingent liabilities for the Treasury) and the granting of tax incentives (with the resulting reduction in tax receipts). These tax concessions may, moreover, generate ill-advised microeconomic incentives which run counter to the socially efficient management of privatized companies. In addition, the objective of maximizing tax revenues may be incompatible with the quest for greater efficiency, since the Government may grant some measure of monopolistic power to the privatized company by setting up barriers to the entry of future competitors or by under-regulating the area in which the company operates, in exchange for some type of premium at the time of the sale.

The above considerations regarding the many complex reasons for privatization have at least four basic implications for the proper planning of this process. First of all, the objectives must be set out explicitly and their fulfilment closely monitored. Second, privatization ought to be used for purposes of structural adjustment rather than as a short-term instrument for achieving fiscal and macroeconomic balance.[12] Third, it is essential to establish an appropriate regulatory framework for achieving long-term objectives. Finally, the practice of simultaneously granting tax or regulatory incentives that jeopardize the attainment of these objectives must be avoided.[13]

C. THE FISCAL DIMENSION OF PRIVATIZATION

The privatization of State-owned enterprises implies the transfer of State assets to the domestic or foreign private sector. This transfer may be free of charge (as has been the case in the countries of Eastern Europe and, to some extent, in Bolivia) or may be made on a payment basis. In the second case, the public sector collects revenues, which it may then use for financing current and/or capital expenditure or for reducing the public debt. Therefore, privatization has an effect not only on the public sector's income statement but also on its balance sheet. In the first case, it increases government revenues (which, depending on the method used, may be recorded "above" or "below" the line) and reduces expenditures on State-owned enterprises (subsidies, debt servicing, etc.), but it may also result in increased expenditure under other headings, depending on how the funds are used. In the second case,

[12] Pinheiro and Schneider (1995) analyse the reasons why politicians and their economic advisors usually proclaim that privatizations help to "solve the deficit problem", despite empirical evidence and theoretical arguments to the contrary: (i) the limited time frame within which elected officials operate means that they implicitly apply a high discount rate and, hence, exhibit a strong preference for present rather than future revenues; (ii) economic authorities may find it easier to rally support for a programme if the revenues it generates can be linked to so simple and popular a goal as deficit reduction; (iii) privatizations are, in a sense, credible commitments to objectives that warrant broad popular support, such as macroeconomic stability.

[13] The design of privatization programmes calls for attention to a number of dimensions and aspects of the process which are beyond the scope of this document. To touch upon just one aspect of the fiscal dimension, it should be noted that the risk of an undervaluation of the assets concerned must be minimized, since experience shows that this is a common trend. ECLAC (1992) presents some suggestions in this regard.

it brings about a change in the composition and volume of public-sector assets and liabilities.[14]

When privatization is undertaken mainly for fiscal reasons, the authorities may find themselves falling into a trap. Clearly, no Government is in a position to solve, once and for all, fiscal difficulties (e.g., a long-standing deficit), which are usually caused by the fact that its flow of outlays exceeds its flow of revenues, by divesting itself of public assets or increasing its liabilities. The only way to solve this type of fiscal problem is by realigning expenditure and/or income.

The sale of a public-sector enterprise to private agents gives rise to a series of positive and negative flows for the Treasury, the net effect of which will depend on: (i) the baseline position of the firm to be transferred (its status in terms of its assets and income flows); (ii) the terms of sale agreed upon (relationship between the net present value of assets and the sale price, forms of payment and method of privatization); and (iii) the uses to be made of the resources.

In examining the net financial flows associated with the privatization of an enterprise, it is possible to distinguish between short- and long-term effects. Thus, for example, when the public sector transfers an enterprise to the private sector, it receives: (A) the net present value of the firm's assets; plus (B) the revenue stream generated by taxes on the earnings posted by the privatized enterprise, net of any tax benefits and/or guarantees accorded by the Government; less (C) the income that the enterprise would have earned for the public sector if it had not been privatized (including net profits and depreciation of anticipated gross investment, taxes it would have paid and any subsidies it would have received from the central government or other public-sector institutions).[15]

Clearly, then, there is a difference between the fiscal impact of the privatization in the year that the sale takes place and its total impact. The former consists of (A) less (C) and constitutes its short-term effect. In contrast, the latter includes (A), (B) and (C) and will be felt over the long term. This presupposes, however, that payment is made in cash at the time

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[14] The only information generally available for assessing public finances is what appears on the Government's income statement, whereas the analysis of the balance sheet is left in some sort of limbo about which little or nothing is known. This lack of information about the Government's balance sheet detracts from the transparency of public management, leaves potential loopholes for corruption, gives rise to unexpected downswings in government accounts and makes it difficult to piece together a picture of the true financial status of government enterprises; this is one of the main challenges to be overcome in connection with the privatization process.

[15] It should be pointed out that, in relation to the privatizations carried out in the region, this breakdown (i.e., the components A, B and C listed above) is somewhat of an oversimplification as it fails to take into account a range of factors that are quite difficult to pin down. For instance, as regards payment, in several cases the net present value of the State-owned enterprises has not even been ascertained, and in some instances no inventory has been undertaken prior to the sale; also, a large portion of the payments made to Governments have been in the form of debt securities valued above their market price. With regard to taxes, in addition to the anticipated flows of tax revenues, it is necessary to add in, as indicated in category (B) above, any subsidies, tax benefits and/or government guarantees; there are also cases where it is difficult to determine an enterprise's actual level of profits. With respect to forgone earnings, it is worth noting that when enterprises are privatized, they are usually transferred free of liabilities and excess staff (costs absorbed by the State) and have a higher rate structure than before they were slated for privatization; hence, it is necessary to consider the level of earnings that State-owned enterprises would be generating if they were operating under the same conditions as private firms.

of sale. If payments are made in instalments, as has frequently been the case (e.g., in Chile during the first phase of the privatization programme), then (A) includes only the cash payment, while (C) will also encompass the annual payment of the corresponding instalments. It is also possible for the firm to be privatized in stages, in which case payment will be proportional to the amount of assets transferred.

Component (A) is usually the only short-term yardstick used. However, the Government may be losing income and dividends proportional to the assets transferred, less gross investment and subsidies (component (C)), if it has failed to make a proper appraisal of those assets (which should include the dividends generated in the year in question). Consequently, the net income obtained from the privatization is actually lower than the figure shown in fiscal accounts.[16] Over the long term, this will show up in the accounting of the taxes and dividends received, as well as affecting subsidies and investments. Thus, a far more satisfactory measurement of the operations "lasting" fiscal effects is the present value of the sum of (A), (B) and (C) in a specified year; this concept may be difficult to apply in the day-to-day management of public finances, but it is a better indicator of the impact of privatization on government assets.

D. PRIVATIZATION REVENUES: RECENT EXPERIENCES

As noted in chapter III, privatization activity has been especially intense in Latin America since the 1980s. Chile set the pace, embarking on a policy course that was emulated by the rest of the region from the late 1980s onward.

In terms of actual sales of State-owned enterprises, some Latin American countries have clearly taken the privatization process further than others. It is also possible to discern phases during which activity in this regard has become more intense and has then remained so for several years before beginning to taper off. There may be a number of reasons for this loss of momentum, in addition to the obvious fact that there will be fewer firms left to sell: the remaining companies may be worth less, the fiscal crunch which prompted the Government to push ahead with privatization in the first place may have eased and, in new sectors where privatization may be an option, sale transactions of this sort would require a regulatory framework that has yet to be established or has only recently been put in place (see table IX-1).

The operations conducted in Argentina and Mexico have influenced the overall trends shown by the aggregate figures, but they fail to capture the intensity of the privatization process in some of the smaller countries, such as Peru and Bolivia, which have carried this process further than the others in terms of the value of privatizations as a percentage of GDP (see figure IX-1).

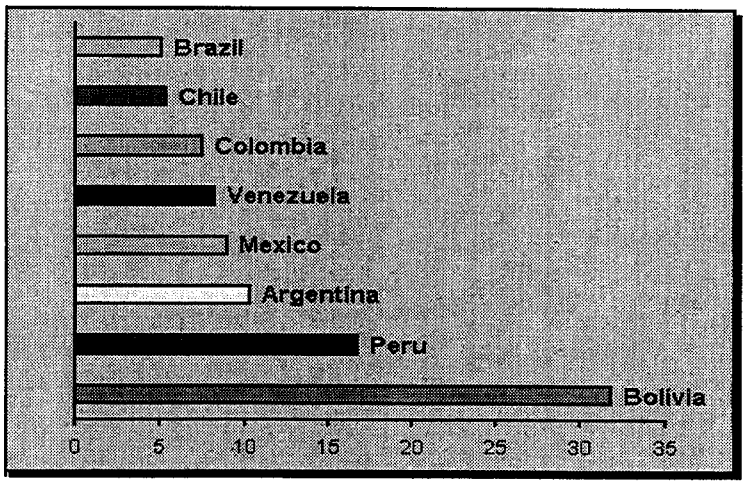
[16] See, for example, Hachette and Lüders (1992), table V-2.

Table IX-1
LATIN AMERICA: VALUE OF PRIVATIZATIONS
1988-1997
(In millions of constant 1990 dollars)

Country	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997[a]	Total	% 1990 GDP[b]
Argentina	...	...	2139	1627	4204	3401	1059	941	448	1085	14904	10.4
Bolivia	...	...	...	...	...	14	...	771	842	34	1667	31.9
Brasil	...	...	...	1662	2495	2445	1470	610	3379	8143	20204	5.0
Chile	526	259	42	12	8	9	413	9	339	...	1617	5.3
Colombia	...	50	117	1001	22	3	473	83	542	1629	3019	7.5
Mexico	...	1498	3580	10108	5768	1802	554	165	...	...	23474	8.9
Peru	...	...	...	3	183	316	2258	871	2061	292	5984	16.7
Venezuela	...	...	10	2323	29	30	15	16	1490	55	3969	8.2
Other	7	...	1	24	28	78	644	53	3	472	1311	n.a.
Total	**533**	**1806**	**5889**	**15861**	**12743**	**8098**	**6886**	**3519**	**9105**	**11710**	**76150**	**n.a.**

Source: ECLAC, on the basis of official figures and information published in *Privatization International* (various issues).
[a] Estimates to September 1997.
[b] Total value of privatizations as a percentage of GDP in 1990, calculated in constant 1990 dollars.

Figure IX- 1
LATIN AMERICA (SELECTED COUNTRIES): TOTAL VALUE OF PRIVATIZATIONS
1988 - 1997
(In percentages of GDP 1990)



Source: ECLAC, on the basis of official figures
[a] Total value of privatization between 1988 and 1997 as a percentage of GDP in 1990, in constant 1990 terms.

Between 1988 and 1993, some 2,655 privatizations were conducted in 95 countries for a total of US$ 271 billion; 35% of this sum was accounted for by developing countries, and 57% of that last figure corresponded to Latin America and the Caribbean (i.e., 20% of the total). The bulk of these sales involved public enterprises operating in the basic services sector in such areas as telecommunications, energy, water and transport. Foreign investors were the source of 25% of the revenues derived from privatizations in Latin America, which represented 15% of all foreign direct investment in the region during this period.[17]

In the Latin American and Caribbean countries, the fiscal revenues derived from the transfer of public assets to the private sector have, in general, been fairly limited in relation to the size of the countries' non-financial public-sector deficits, as is shown in table IX-2 (comparing, unfortunately, somewhat different time periods). In a few instances, privatization programmes have been carried out when the countries in question were running fiscal surpluses (Chile since the mid-1980s, Belize in 1986-1990, Jamaica and Mexico in 1991-1996). Even in the other cases, however, revenues from such operations have been far lower than the respective budget deficits, particularly during the period 1986-1990 (with a few notable exceptions, such as Argentina, Bolivia and Peru in the 1990s).

Table IX- 2

LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): FISCAL DEFICITS AND PRIVATIZATION REVENUES

(Percentages of GDP)

Country	Non-financial public-sector deficits		Privatization revenues	
	1986-1990	1991-1996	1988-1989	1990-1995
Argentina	6.4	1.8	0.02	1.5
Belize	-1.3	5.8	4.6	
Bolivia	6.3	3.8		3.5
Brazil	3.9	1.5	0.004	0.4
Chile	-1.9	-2.2	1.1	0.6
Colombia	1.1	1.0		0.3
Ecuador	4.6	1.5	0.3	
Guatemala	4.7	1.4	0.2	
Honduras	6.7	5.7	0.3	0.4
Jamaica	6.5	-1.3	1.9	1.6
Mexico	10.6	-0.1	0.8	1.6
Nicaragua	16.5	10.3		1.4
Panama	5.1	0.1		0.3
Paraguay	0.4	-1.6		0.3
Peru	7.7	2.2		1.7
Trinidad and Tobago	5.3	-1.3		3.1
Uruguay	5.2	0.3		0.1
Venezuela	3.9	4.2		0.77

Source: World Bank, estimates based on information obtained from the International Finance Corporation and *World Development Indicators*.

[17] IFC (1995).

E. FULL PRIVATIZATION OF PUBLIC-SECTOR ENTERPRISES: ADVANTAGES AND DISADVANTAGES

The countries of the region –including those that have advanced the furthest in the privatization process during the past two decades– have kept a number of major public-sector enterprises in State hands. The fact that not even the most pro-privatization Governments have gone to the extreme of selling off all their enterprises suggests that all-out privatization is not viewed as a panacea. The reasons for this are not necessarily linked to considerations of efficiency or the drive for fiscal revenues. As noted earlier, when decisions are to be taken about matters as delicate as the privatization of State-owned enterprises, a wide range of factors must be considered whose relative importance may differ from one country to the next and even, over the course of time, within any one country.

Every Government has to judge whether its goals –in respect of, *inter alia*, distribution, stabilization, resource allocation, growth, productive and technological development, and geographical and social integration– can best be achieved through regulation and supervision, the taxation system, the creation of joint ventures with private (domestic and international) capital or the concession of exclusive areas of operation in exchange for a share of the profits, or whether it is preferable to keep the producers of goods and services under State ownership and control.

This dilemma is of particular importance in the case of major public corporations which develop and export natural resources (such as oil, mining and hydroelectric companies) whose profits constitute a major source of State revenue, as in Brazil, Chile, Colombia, Ecuador and Venezuela. When transfers of profits from State-owned companies to the national Treasury amount to several percentage points of GDP, the possible adverse political consequences of privatization initiatives should not be underestimated. In addition to their importance as sources of government saving and revenue, the presence of public corporations of this sort can improve the competitiveness of some key markets, (e.g., energy and capital). Some thought might be given to the possibility of having State corporations serve as "sentinel" or "core" agents in certain sectors where, by competing with private agents, they can help to moderate prices and establish quality standards for goods and services.

Finally, those enterprises that the State decides to keep under its control should serve as examples of managerial efficiency and transparency in accordance with current international best practices in human-resources and financial management. It is vital that any enterprise in which the State is a stakeholder, whether or not it is State-run, should pursue its operational objectives rationally. This means that it must apply the standards of efficiency which the competitive sector of the economy (whether public or private) requires in order to provide a return on capital which is commensurate with its opportunity cost.

In addition, various subsidies need to be eliminated from these enterprises' cost structures. Such subsidies, which are frequently linked to the social policy of the Government itself, can undermine a company's income statement to such an extent that

essentially sound and profitable ventures may nevertheless show a loss. These items must be transferred from corporate accounts to the State budget so that they can be explicitly evaluated by the country's elected representatives. This would improve the transparency of public accounts and, at the same time, forestall the privatization of what are actually profitable enterprises on the grounds that they are "inefficient". Another alternative is to design transparent systems for the management of cross-subsidies, such as the scheme now being developed in Colombia, under which the most affluent social strata are required to pay legally defined contributions, in addition to a charge that covers the costs of providing the service; the contributions are paid into a solidarity fund that finances the subsidies, which are also explicitly defined, for poorer social groups (see box IX-1).

Box IX-1

CONTRIBUTIONS AND SUBSIDIES FOR DOMESTIC UTILITIES IN COLOMBIA

The utilities pricing system in Colombia, as in many of the countries of the region, has for some time involved the application of differential charges to consumers in different social strata; those with a greater ability to pay contribute, through a percentage surcharge on their bills, to a percentage subsidy on the service provided to lower-income users. This is done by means of a layered scale of charges, whereby every rural and urban property is classified by socio-economic level (1 to 6 for residential properties; "industrial"; and "commercial"), depending on the location of the property, ability to pay, availability of services, and building type. There are also cross-subsidies among different utilities, so that the high price of one service compensates for the low price of another.

Utility services are regulated under Act No. 142 of 1994 (Domestic Utilities Act), which contains provisions on areas of competence and responsibilities relating to the provision of domestic utilities, their coverage, quality and financing, and the applicable scale of charges taking into account both cost criteria and the criteria of solidarity and income redistribution provided for in article 367 of the Constitution.[a]

The law stipulates that, once a uniform service charge has been determined, representing the cost of the service plus a reasonable profit, a contribution factor not exceeding 20% of the value of the service is to be applied to users in categories 5 and 6 and in the "industrial" and "commercial" categories, and a subsidy factor is to be applied to the basic consumption charge for users in categories 1, 2 and 3. For category 3, the subsidy is not to exceed 15% of the value of the basic consumption; for category 2, 40%; and for category 1, 50%. In the case of category 4 ("intermediate"), neither contributions nor subsidies are to be applied; this is also the case for consumption in excess of the basic amount in categories 1, 2 and 3. The method for determining charges and the maximum percentages for contributions and subsidies applicable during the transitional period from 1997 to 2002 are to be determined by the competent regulatory commission.[b] The utility companies collect the contributions paid by users in categories 5 and 6 and in the "industrial" and "commercial" categories, and use the receipts to provide the subsidies to those in categories 1, 2 and 3. If this process produces a surplus, it is paid into solidarity and income redistribution funds which will be available to other companies providing the same service if and when they show a deficit from the exercise. In 1994, only a few major cities had scaled charges, so Act No. 142 provided for the scaled system to be extended to all urban and rural areas of the country. It also prohibited cross-subsidies among different utilities.

A new method of charging for local telephone services, was introduced on 1 January 1998, using the contribution and subsidy factors currently in force (contributions exceeding 20% and subsidies exceeding 50%), and a transition period ending 1 January 2002 was established for

enterprises to come into line with the legally established percentages of contributions and subsidies. Work is under way on designing a method for transfers between companies and the Communications Fund;[c] currently, enterprises having a surplus transfer the excess amounts to the Fund, but the latter does not provide resources to those showing a deficit.

In the case of electric power utilities, the Solidarity and Income Redistribution Fund was set up under Decree No. 3087 of 23 December 1997; the Fund will act as a distribution mechanism to subsidize the basic consumption[d] of users in categories 1, 2 and 3. As of 1 January 1998, a new method for calculating charges came into force, involving the establishment of a formula to reflect the true cost of providing the service. A measure was also introduced to gradually eliminate subsidies on the standard charge until subsidy levels of 50%, 40% and 15% for categories 1, 2 and 3 respectively, and contribution levels of 20% of the value of the charge for categories 5 and 6 and for the non-residential sector, are reached.

In the case of drinking water it is estimated that, owing to the high proportion of consumption concentrated in the poorer social strata (categories 1-3), the system provided for in Act No. 142 will not be self-financing. It will therefore be necessary to legislate for higher contribution levels or to appropriate resources from municipal budgets for the solidarity funds or enterprises concerned.

[a] "The law shall establish areas of competence and responsibilities relating to the provision of domestic utilities, their coverage, quality and financing, and the applicable scale of charges taking into account both cost criteria and the criteria of solidarity and income redistribution."

[b] The regulatory commissions were established by Act No.142 of 1994. There are currently three commissions: the Regulatory Commission for Drinking Water and Sanitation, the Regulatory Commission for Energy and Fuel Gas and the Regulatory Commission for Telecommunications.

[c] The Communications Fund, under the authority of the Ministry of Communications, functions as a solidarity and redistribution fund for local telephone services. It also collects funds from telecommunications enterprises for investment in social telephone-service projects.

[d] Consumption is subsidized up to 151 Kwh for category 1, and up to 121 Kwh for categories 2 and 3.

F. PRIVATIZATION AND CONTINGENT PUBLIC LIABILITIES

A largely unexplored yet increasingly important aspect of the privatization processes now under way is that they have not always brought about a full or permanent transfer of risk from the public to the private sector. This is because the initiation and/or completion of many privatizations has been made conditional upon the provision by the State of "safety nets" to the relevant private agents in order to shield them from possible mishaps.

There is nothing new about the private sector obtaining guarantees from the State. To some extent, the State can be regarded as a vast "insurer"of the interests of the general public (such as border security, national sovereignty, justice, law and order and environmental endowments) and of specific groups (including pregnant women, children and young people, small and medium-sized enterprises, economically depressed areas, small savers and account-holders with commercial banks, financial entities in difficulties and many others).

For a variety of technical and/or political reasons, privatization programmes may therefore entail the provision of government guarantees to private agents. This usually occurs in the case of new infrastructure investment programmes for which the public sector awards a concession or franchise to private firms. Such guarantees can take many forms;

one of the most usual is a commitment to ensure that a given variable will not fall below a specified level per unit of time (month, quarter or year). This variable may be the volume of traffic passing through a highway toll plaza, the rate of return on a privately-operated government concession, or the pension amount per retired person; should the variable fall below the anticipated level, then the Treasury promises to make up the difference.

Such guarantees constitute contingent liabilities which introduce a measure of fragility into public-sector accounts that may manifest itself at some time in the future. In addition, since these liabilities are of a purely conjectural nature (there is no legal provision which requires that the actual cost of these potential commitments, or the probability of their taking effect at some point in time, has to be made explicit in the national budget) no one knows exactly how much would have to be paid out should the conditions contained in the guarantees arise.

In a way, it is as if today's fiscal authorities were to promise that those of tomorrow will honour certain debts despite the fact that (i) they are not properly recorded; (ii) the amounts of those debts are unknown; and (iii) no one knows if or when they will have to be paid. This gives rise to an issue of intergenerational equity, since the current generation is solving its fiscal problems by incurring contingent liabilities whose payment may fall to future generations. These future generations, which are of course under-represented at the present time, may thus have a surprise in store for them, given the lack of transparency with which these issues are currently being handled. At the same time, this situation creates problems in terms of both horizontal and vertical equity among the contemporary population as well, since the implicit subsidies contained in at least some of these guarantees are not distributed among the population uniformly.

The practice of providing such guarantees militates against transparency in public accounts not only because the budget does not identify the recipients of these implicit subsidies, but also because it does not make clear how or to what extent certain fiscal adjustments are processed.[18] We have seen that conventional measurements of the public deficit do not include any explicit estimate of the expenditure which would be incurred during a given accounting period should a portion of the contingent liability come into effect; it is therefore clear that, the more such guarantees are used, the less transparent measurements of the deficit will be. The underestimation of potential guarantee-related expenditure detracts from the transparency of information on the size of the public deficit and debt. This point can be illustrated by means of two examples.

The first example concerns the award of concessions or franchises to the private sector for infrastructure projects. In seeking to cope with chronic and sometimes extreme budgetary difficulties that have driven down public investment to alarmingly low levels, many Governments have developed schemes for cooperating with the private sector in order to ensure a sufficient supply of infrastructure. One aspect of particular importance in this connection is the guarantees which are provided to private enterprises in some countries of

[18] Fiscal authorities can replace a present outlay (which should appear in the budget as an expenditure) with a guarantee which, if it takes effect, will not appear in the accounts as an expenditure until some unspecified point in the future. In cases where the State charges for such guarantees, that charge may even be recorded as income, and in that event, the substitution of a guarantee entailing a future expenditure for a present expenditure will make current public accounts look even better.

the region in order to induce them to take on the job of constructing and operating infrastructure projects.[19]

The reasons for the provision of minimum-demand or other guarantees are well known.[20] In general they stem from the fact that the projects in question are on a very large scale and have long lead times, so that it is very difficult to prepare accurate projections of the future volume of traffic (in the case of roads) or consumption (of electricity, for example) or of the actual costs of construction. Aside from the fact that political pressure is often applied to obtain subsidized prices or rates for the products or services provided by the franchises, it is also possible that future Administrations may alter the policies adopted by their predecessors. Of course, there are many types of sovereign risk which it is only reasonable to expect the Government, rather than the private franchise-holder, to bear.

The second example of the creation of contingent liabilities arises in the area of social security and concerns, in particular, the minimum pensions guaranteed by the Government to persons who agree to switch over to an individually funded system. This practice made its debut in the region in 1981, when Chile changed over from a pay-as-you-go system to a funded scheme. Perhaps as a way of making this change more acceptable, payment of a minimum pension has been guaranteed under the new regulatory framework. This means that the Treasury undertakes to cover any shortfall between the amount accumulated in the fund (the product of the management of individual pension contributions by the pension fund administrators) and the amount required to pay out the statutory minimum pension. The percentage of the present value of the minimum pension bill not covered by the capitalization of individual accounts represents an implicit liability that may materialize at some time in the future. No actuarial or other estimates of the size of this debt are available at the present time.[21]

A more extensive examination of the issue leads to the conclusion that, basically, any well designed franchise scheme should aim to:

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[19] In practice, Governments provide financial support for infrastructure projects through various mechanisms: full funding, as in the case of construction projects; provision of guarantees against various sorts of risks (demand, convertibility and devaluation, business and political risk, as well as many others); subsidization of projects in advance; granting of loans at subsidized interest rates; and participation in the project as a partner. Infrastructure projects may choose among various modalities as well: build-operate-transfer (BOT), build-own-operate (BOO), and build-own-operate-transfer (BOOT).

[20] On this and related topics, see Irwin and others (1998).

[21] There are diverging opinions regarding this last point, however, since some argue that the minimum pension programme is not a real guarantee because there is no express contract with the private sector (the minimum pension is a subsidy granted by the State to a category of persons, a benefit that at any moment can be modified by a new law). According to this line of reasoning, the minimum pension therefore has the same characteristics as other social tax expenditures, such as subsidies for housing or for inhabitants of hardship zones, and does not constitute a fiscal liability. In any event, the debate on this issue is far from over.

(i) Minimize the risk of future payments by the public sector; this requires: establishing an appropriate regulatory framework; designing a franchise system that explicitly seeks to reduce such risk22; limiting the risks assumed by the Government to those which cannot be insured against and which the private sector cannot in fact control; discouraging the private sector from requesting guarantees, either by charging for them (the Chilean model), or by taking their cost into account when scoring the tenders (the Colombian model); and avoiding granting subsidies under the guise of guarantees.

(ii) Estimate the risks and, preferably, budget the annual cost of contingent liabilities. It is vital that the fiscal authorities reveal the nature of the commitments they take on and provide estimates of their magnitude and of the probability of their having to be met. If the State does not volunteer this information, financial markets will attempt to infer it, from a defensive standpoint. In view of the existing asymmetries between the information available and the incentives that are at work, it is likely that agents will attempt to hedge against possible surprises by anticipating –and calling for– higher interest rates than they would have demanded if the Government had provided the required information spontaneously.

Such estimates, even if imperfect, should be included in the annual budget debate in the national Congress. Even more to the point, the annual cost of contingent liabilities, that is to say, the cost of the "insurance" taken out by the State on behalf of private investors, should be recorded as an expenditure in the budget. These expenditures could be kept in reserve by the entities furnishing the insurance or could be transferred to a central fund, as provided for in a draft law now under consideration in Colombia. Given that the lack of transparency of public accounts, and of fiscal policy itself, drives up transaction costs for the entire economic system, it is clear that any effort to increase transparency in these areas is tantamount to an "investment" in credibility.

G. CONCLUSIONS AND FINAL OBSERVATIONS

- At the start of any privatization, the authorities should specify their short-, medium- and long-term objectives along with their priorities for each of these stages. Doing so has at least two advantages: (i) it helps prevent the programme from straying off course when, as in the case of the recent Asian crisis, the economy experiences an unforeseen shock (when there is usually no shortage of proposals aimed at changing the programmes that are under way at the time); (ii) it makes it possible to orient the evaluation of programme results. For example, if, for reasons of political economy, the Government accords priority to increasing the number of shareholders over the short term –to ensure

[22] Engel, Fischer and Galetovic (1977) propose a new franchising mechanism whereby the franchise would be awarded to the bidder asking for the least present value of user fee revenue (LPVR), calculated at a discount rate set by the Government and known to all candidates before they put in their bids. Use of this method would substantially reduce the risk taken on by the franchise-holder; the franchise would come to an end when the present value of revenue was equal to the franchise-holder's original bid.

sufficient support for a privatization programme– then performance evaluations should focus on this aspect rather than on the volume of income generated by the privatization.

- Of the two short-term objectives most frequently cited when privatization programmes are initiated –i.e., raising the efficiency of the enterprises concerned and helping to balance public-sector accounts– economic authorities should give priority to the first. The proceeds from privatizations, in the short term, usually fall far short of the financing requirements of the public sector. Furthermore, when the principal reason for launching the programme is to rectify a fiscal imbalance, these revenues usually arrive too late to permit a suitable form of crisis management.
- In the light of the above, the economic authorities' best option is either to promote the establishment of a regulatory framework that can generate sufficient competition or to adopt a system of incentives that can –in the medium or long term– boost the efficiency of the enterprises that have been transferred to the private sector. A basic prerequisite for the success of privatization programmes is that they should be accompanied by measures that stimulate competition and thus generate the progressive gains in efficiency upon which fiscal improvements depend in the medium and long term. When, for technological reasons or for reasons of market size, it is not possible to ensure sufficient competition, it then becomes necessary to formulate, design and institutionalize an appropriate regulatory framework, along with the relevant administrative provisions for its implementation and monitoring, in order to promote efficiency. Without clear and comprehensive rules to govern the post-privatization process, the results can be discouraging in terms of both efficiency and fiscal results.
- Short-term fiscal success in the privatization of public enterprises is usually achievied by means of actions not directly linked to the value of the transaction. Thus, for example, significant fiscal progress has been achieved by countries of the region which have used the proceeds from privatizations to retire debts on the secondary market, thereby taking advantage of substantial discounts as well as reducing the financial component of their future pattern of expenditure. Another important form of long-lasting fiscal savings is the elimination –made possible by privatizations– of numerous types of subsidies that had previously contributed to the public deficit.
- It is important to retrain from distributing fiscal or regulatory benefits or privileges that would undermine public finances in the future. Since paying a subsidy today always appears to be more expensive than providing a guarantee which may or may not have to be met tomorrow, there is an obvious bias towards unsuitable forms of resource allocation. This bias arises out of systematically deceptive comparisons between visible (and for that reason clearly expensive) instruments and non-transparent (and thus apparently less costly) instruments.
- The contingent liabilities that are one of the consequences of a policy of providing various types of government guarantees raise an issue which serves to underline the need for economic authorities to assume responsibility for controlling, evaluating and budgeting the fiscal risks assumed by the State. Private participation schemes need to be designed that will help keep guarantees to a minimum, and the authorities need to estimate the costs that may be incurred if the conditions foreseen in the guarantees materialize, as well as calculating the probabilities of this happening. Such estimates, although imperfect, should be taken into account when the annual State budget comes up for consideration in the legislature. Increasing the transparency of public accounts

and decreasing the lack of transparency inherent in quasi-fiscal management helps to lower transaction costs in general and, in particular, allays unnecessary fears in financial markets, all of which helps to hold down the financial costs of public debt management. In an era of increasing uncertainty, economic authorities, and more specifically fiscal authorities, should consider risk quantification and management to be one of their priority tasks.

X. MODERNIZATION OF THE STATE, ADMINISTRATIVE REFORM AND EVALUATION OF PUBLIC MANAGEMENT PERFORMANCE

A. INTRODUCTION

In this study, the advances and limitations observed in the fiscal management of the economies of Latin America and the Caribbean during the last two decades have been identified and recommendations have been made for overcoming lags, reducing weak points and consolidating the strong points of institutional arrangements and the design and administration of policies in the areas of taxation, public expenditure (with special emphasis on social expenditure), financing of the deficit and management of the public debt, social security, privatization, decentralization and other areas.

The recommendations in question seek, of course, to achieve and consolidate permanent changes in the fiscal regime which are compatible with an acceptable level of macroeconomic stability; a systematic reduction of poverty and improvements in equity in terms of income distribution and opportunities; more efficient and effective resource allocation, and sustainable economic growth. It is obvious, however, that much more than mere technical solutions are needed to achieve such objectives. Between the formulation, design and implementation of policies and the results finally obtained from them, there are many levels —among them a variety of institutions, actors, motivations, incentives and forms of behaviour— which can give rise to significant distortions.[1]

[1] Tanzi (1998) gives examples of some frequently encountered types of "sand in the works" of economic policy, as seen from the standpoint of an agent-principal model. In addition to the traditional aspects of the conflict between private and public interests, uneven access to information, diligence in the fulfillment of official duties and the level of competence of the different agents, the author highlights the concept of "gatekeepers" —people located, for reasons of friendship or family relationship, in the highest decision-making circles of government who, because of their disproportionate influence in the taking of decisions, also powerfully affect the results obtained.

The present chapter is focused on the question of the efficiency, efficacy and quality of the results obtained by government actions. These depend, ultimately, on the functioning of the public agencies responsible for implementing government policies. For this reason, not even the best planned and designed policies —in matters of taxation or public expenditure— have much chance of achieving satisfactory results if the civil service responsible for implementing them is not based on a system of incentives, control and evaluation in keeping with the desired objectives.

It is necessary to highlight the importance of the environment surrounding —and undoubtedly conditioning— the functioning of public agencies. Indeed, emphasis has been placed in this document on the eminently political origin of the strength or weakness of the fiscal covenant underlying the functioning of State machinery. The political agreements which legitimize the level, composition and trends of public expenditure and the tax burden needed for its financing in the medium and long term are linked with the model governing the State's intervention in the economy. Likewise, the forms of intervention adopted, the means and instruments used, and the nature and intensity of the way they are applied depend on the actions of government agencies which are constantly interacting with the political sphere and the private sector. It is therefore hardly surprising that the results achieved by such agencies reflect much more than the interrelations among their own internal culture, the objectives guiding them and the means placed at their disposal.

B. THE STRATEGIC IMPORTANCE OF IMPROVING PUBLIC MANAGEMENT PERFORMANCE

The national and international circumstances within which the region is moving towards the next century call for substantial improvements in the efficiency, efficacy and quality of public services in all spheres and levels of government, for two general reasons of a strategic nature.

The first of these is connected with the domestic environment of each country. If the Government changes the way it operates and begins to generate results which are consistently acceptable to the population (the citizens at large, users of services, taxpayers, public officials, private-sector entrepreneurs, etc.), it will have gone a long way towards overcoming the political opposition which weakens the fiscal covenant, and a substantial improvement in the levels of efficiency and efficacy observed in the activities of many public agencies at the various levels of government holds out promising prospects for breaking out of the vicious circle underlying a fragile fiscal covenant. It is particularly necessary to improve the productivity of public expenditure by securing more and better results from the funds assigned for the various items in the State budget, so that even the most demanding users of public services and the most reluctant taxpayers will consider the Government's provision of public goods and the other aspects of the State's involvement in the economy to be justified. Although it is no easy matter to improve the performance of this is a crucial measure for the endogenous strengthening of the fiscal covenant in Latin America and the Caribbean. In the final analysis, it must be borne in mind that:

(a) Better management of public expenditure —by making more and better use of every cent of purchasing power transferred from the private to the government

sector— eases the budget rigidities suffered by the economic authorities and sends positive signals to taxpayers, who naturally feel dissatisfied when they see that poor use is being made of their taxes (and in quite a few cases justify the evasion of their tax commitments on the grounds that the State is a bad manager);

(b) By reducing unnecessary expenses and thus avoiding obvious waste of resources, not only are the justifiable complaints of taxpayers assuaged but resources are also freed which could potentially be applied to programmes and activities aimed at satisfying the needs of lower-income groups, thereby helping to achieve greater equity in terms of opportunities and of income and wealth;

(c) If increases in the efficiency and efficacy of the public segment of the economy are transferred to the private sector in the form of more and better final services for the citizens and inputs for the domestic production of goods and services, there will be a direct improvement in the well-being of the population as well as in the competitiveness of the export sector, the potential growth rate and the average productivity of the economy.

Thus, what might seem at first to be a vicious circle could become a virtuous circle, though achieving this would of course involve profound changes in the organizational and administrative model which has long been applied in the public sector of the economies of the region.

Another important reason for giving priority to this matter is that since the 1980s many economies have taken major initiatives aimed at modernizing the institutional design and operational model of their civil service. Countries such as New Zealand and the United Kingdom, followed by Australia, the United States, Canada and other OECD countries, have already taken substantial steps towards the gradual replacement of bureaucratic models with a management-oriented public administration model in which evaluation of the results is more important than evaluation of procedures.[2]

This change of outlook has called for a clearer definition of the objectives pursued and the methods of follow-up and control to be used, for which purpose autonomous management units have been set up. Thus, follow-up of the level of production of the executing agencies has been carried out through the incorporation of performance indicators, while evaluation of the results has been effected through in-depth studies on the impact of government programmes.

In a context of increasingly open economies, systemic approaches to domestic production structures are required in order to ensure the increases in competitiveness which will allow them to operate successfully on international markets. In this context, Governments must make every effort to ensure that the efficacy, efficiency and quality of public services are as high as possible, since these services act as important inputs for the private sector.

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[2] The various initiatives taken and the progress made by the industrialized countries in this field are systematically and regularly analysed in the many publications of the OECD Public Management Service (PUMA). See PUMA (1995).

To this end, it is necessary to change the present bureaucratic civil service model (officially established at the different levels of government of the countries of the region) and the remnants of antiquated public administration practices which still remain in many State agencies, replacing them with a new model marked by less hierarchical relationships and more emphasis on objectives, in which the staff are evaluated and rewarded on the basis of the results obtained rather than their adherence to established procedures and their seniority. In addition, this new model must be capable of generating innovations and adapting to the changing circumstances of the economic, social and political environment.

The gradual replacement of traditional models of State administration by a management-based approach means bringing private-sector management models into the public sector. In doing this, however, it should at all times be borne in mind that these innovations must not be made in a mechanical manner, since the public sector, unlike private enterprise, is not primarily designed to generate —much less to maximize— profits. To begin with, many aspects of public action are of an intangible, symbolic or purely conceptual nature, so that they do not lend themselves to concrete measurement. Furthermore, the public sector has to coordinate and act as an intermediary in the achievement of complex balances between different objectives (such as efficiency, equity, stability and growth) and interests (those of the poor and indigent, of taxpayers, of public employees, of wage earners, of health system users, etc.), who are competing for scarce resources. In order to fulfill these and other tasks, there must necessarily be a prior political evaluation of the available options and the trade-offs generated by conflicting interests. At the same time, however, the new management models show that, notwithstanding the importance of these considerations, there is nevertheless ample room —largely still unexplored— for the successful application of results- and performance- based approaches which can raise the efficiency and quality of State services.[3]

C. PUBLIC MANAGEMENT REFORM TRENDS

If we look at the public-sector reform and modernization processes which have been carried out since the last decade in many developed economies and, more recently, in Latin America and the Caribbean also, we note an important general trend: a transition from a management attitude centred on production and procedures to a form of management focused on results and service to users (see box X-1).

Such processes have been carried out on two levels. The first of these consists of the redesign of the internal logic of public organizations (structure of governance of State agencies; systems of incentives, evaluation and control; human resources supervision and management model; financial management model, etc.). The second concerns the interactions between public organizations and the rest of the economy (separation of the functions which are the exclusive responsibility of the Government from those which are not; development of systems for regulating the latter). These two levels are clearly interrelated, especially when the reforms lead to the establishment of markets or quasi-markets in which public and private agents compete.

[3] For critical evaluations of the possibility of extending the private sector's results-based approaches to the public sector, see Mintzberg (1996) and Smith (1990).

Box X-1

MAIN FEATURES OF THE NEW PUBLIC MANAGEMENT MODEL

- Adoption of the "citizen-client" or "user" principle, in which the latter's rights are more clearly specified and more effectively protected.
- Definition of a new profile for public administrators, executives or managers, to be guided by the quest for results and evaluated in the light of the latter, and subject to standards of accountability and of consistently high level of competence at all times, rather than solely at the time of recruitment.
- Establishment of management contracts which provide a clearer definition of the objectives, mission and goals of executing agencies and at the same time serve as a basis for the evaluation of the latter's performance.
- Separation of financing activities from service delivery and also from the formulation and design of public policies, including those regarding the (centralized) regulation of (decentralized) implementation or administrative activities.
- Formation of domestic quasi-markets or markets, collection of charges from users, outsourcing, and/or granting concessions to private agents for the administration or construction of works of public interest; privatization of agencies, enterprises and/or services in general.
- Process reengineering with a view to simplifying procedures and downsizing the bureaucracy and thereby reducing the cost to citizens of fulfilling their obligations (as for example in tax matters) and the time needed to complete the necessary procedures.
- Devolution of responsibilities, rights and obligations from the peak of the power pyramid to the intermediate and lower levels, both in the personnel field (where the structures tend to be less hierarchical and more horizontal) and in the fiscal field (through processes of decentralization of resources and powers from the centre to the subnational levels of government).

Source: ECLAC, on the basis of Luiz Carlos Bresser-Pereira , "A reforma do Estado dos anos 90: lógica e mecanismo de controle", Brasilia, Ministry of Finance, March 1997.

With regard to internal modernization, the main contribution that can be made to the new public management models is the delegation of operational and financial responsibilities from the higher levels to the lower levels of authority. This tendency is reflected in various areas of public management, especially financial and human resources management, and in the establishment of clearer schemes for the definition of performance criteria and evaluation.

In the place of traditional financial management, with its rigid annual framework for organizing and recording operations, some aspects of strategic programming have begun to be taken into consideration with the aim of making budgetary planning more flexible and taking longer time horizons into account. The Efficiency Agreement in Colombia is a clear example of this strategy.

In the area of human resources management, the delegation of responsibilities (both operative and financial) has been accompanied by more flexible public-sector personnel policies. Line managers are given greater responsibilities for the training of their own work

teams, and at the same time the process is associated with more dynamic human resources management in which greater prominence is given to training functions, while new systems of results-based incentives are introduced with the aim of training and motivating managers and teams capable of attaining the proposed goals. Thus, for example, Chile has already placed a large part of its public-sector staff on partially performance-based systems.[4] Likewise, Costa Rica has introduced a system of evaluation and rewards of public officials according to their productivity and performance. The Dominican Republic has begun its modernization programme by carrying out a census of public employees in order to form an information system on the basis of which it can design staff training and reorganization programmes; performance-based systems of remuneration will be applied in a second stage.

Along the same line of reasoning, management-by-results can serve as a counterpart to the delegation of responsibilities. In this respect, a basic instrument is some kind of performance agreement between the different levels of authorities or public institutions which defines the purposes, goals and responsibilities of individuals and/or executing agencies. These agreements must be subject to suitable monitoring. The experience in this field in Latin America has mostly consisted of direct contracts or agreements between the Executive and its various departments aimed at ensuring an improvement in the management of the latter. Thus, within the public sector and at the level of the central government, agreements or contracts have been signed in Brazil, Chile, Colombia and Costa Rica for the fulfilment of annual objectives which it is hoped will result in greater efficacy, efficiency and quality of the services provided to the client public.

Where this is feasible, an important instrument which could be complementary to the foregoing in the case of certain services is the design of markets or quasi-markets in which public agents, or public and private agents, compete. In this case, the regulatory system is what determines the incentives to be offered to the agents involved and lays down the rules for evaluating their performance. Depending on the service or department involved, these regulations can provide for the collection of charges to recover all or part of the costs involved, or, alternatively, access to public funds to be distributed as demand subsidies.

It should be noted, however, that not all innovation schemes call for the parallel application of market mechanisms. Thus, for example, in the so-called "agency model", some relatively independent public bodies having executive functions are treated as government agencies. Some OECD countries which are leaders in the implementation of management-based public administration models are using the agency model. There are also some experiences in this direction in Latin America and the Caribbean.

In this connection, mention must be made of the client-oriented approach as one of the principles of the new schools of thought in the field of public management. In this case, the central idea is to provide more information on the services offered and the best ways of gaining access to them in order to ensure the participation of the population in defining and demanding the quality expected from a public service. This concept has been developed through the Charter of Service Quality, the best-known example of which is the Citizens' Charter originally developed in Great Britain and subsequently extended to many other

[4] As from 1998, 90% of central and regional government staff, as well as teachers in municipal and subsidized private schools, will receive their salary readjustments under various kinds of results-based incentive systems.

countries, especially within the OECD. In Latin America and the Caribbean, mention may be made of Chile's introduction in 1997 of the National Prize for Public Service Quality for which central government agencies are eligible.[5]

All the options and experiences mentioned above are connected with routine government programmes and activities. In the past, oddly enough, almost all the evaluation efforts aimed at giving greater economic rationality to government activities were concentrated on new public investment projects, and only rarely on current expenditure. The reasons for this concern with the evaluation of public investment projects are well-known and are due to considerations of a dynamic nature (medium- and long-term effects), to the volume of the financial resources involved, the externalities generated, and the rigidities typical of these activities, etc. Today, however, we are witnessing a complete change in priorities, as a result of which national public investment systems, and the objectives on which they were based, have been losing practical importance to the point of being nearly forgotten in some cases.[6]

D. MODERNIZATION PROGRAMMES IN PRACTICE

As already noted, since the 1980s and particularly since the 1990s, trends towards the modernization of public management have been developed on the basis of the advances made by some leading OECD countries. The corresponding reforms are centred on the delegation of responsibilities and greater control through greater transparency of the information provided. These initiatives have sought to establish a flexible information framework to enrich budgetary discussions, improve the efficiency of fiscal accounts and satisfy the population's needs. Among the most important experiences in this respect are those of the United Kingdom, New Zealand, Australia and the United States.

In 1982, the United Kingdom launched the modernization of its public management systems through the introduction of the Financial Management Initiative (FMI), based on the introduction of a system of management-by-results within the central administration, through the adaptation of its internal organizational structure. This decentralized process, aided by institutional performance indicators, made it possible to delegate management responsibilities to the lower levels of government, build up management information systems which made the management of each Ministry more transparent, and make suitable modifications in budgetary practices.

New Zealand is notable for having embarked on the most radical State reforms. This process began in 1984 and is based on a system of intra-government relations involving service contracts (purchase agreements), established between Ministers and executing

[5] See the paper presented by the Department of the Budget of Chile at the Workshop on Public Expenditure Management Evaluation (ECLAC, 1998).

[6] ILPES (1997) and Vizzio (1998).

agencies having administrative autonomy, which contain the requisite terms of reference, expressed in the form of indicators and goals.[7]

The case of Australia shows the progress that has been made in terms of financial reform. In 1984, Australia launched the Financial Management Improvement Programme, an initiative which included the introduction of such concepts as strategic planning, the design of performance incentives, and other important measures for adapting institutions and organizational arrangements so as to improve the country's financial management. Intensive use has been made of performance indicators, which have been integrated into one of the most complete systems for presenting budgetary information.

The reforms carried out in the United States started with the adoption of the Government Performance and Results Act in 1993. This Act calls for the introduction of budgetary systems based on performance and flexible management. In a first stage, pilot projects were implemented in some government agencies. Subsequently, these agencies prepared their own five-year strategic plans on the basis of measurable results, for ultimate incorporation into the federal budget together with a performance monitoring plan whose fulfillment is communicated to Congress through programme reports.

Unlike these developed countries, some of whose State reforms have already been in operation for almost a decade, the economies of the region are still in the early stages. Furthermore, their experiences are heterogeneous: the magnitude of the reforms and the degree of progress made depend on the different levels of development and the demands faced by the Governments in question, as well as on the different institutional structures in which the management modernization initiatives are being implemented. The countries which have registered most progress in this respect are Chile, Colombia and Costa Rica.

In 1992, Chile began to apply a pilot plan for modernizing public management aimed at introducing new management techniques and instruments such as strategic planning, the assignment of individual responsibilities, and performance evaluation systems, for subsequent integration into a General Plan to be extended progressively to the entire public sector. A methodology was developed on the basis of this experience which has been used for the formulation of management indicators, management balance sheets, performance agreements and systems of institutional performance bonuses. The performance agreements are agreements between the executive manager of a public service ("the agent") and the corresponding Minister ("the principal"), which clearly state the mission and objectives of the organization, as well as the commitments for their

[7] It is worth noting that the reforms begun in New Zealand in 1984 —initially under a Labour government but subsequently continued by a Conservative government— were exceedingly far-reaching measures and were not limited to the areas in question. By coincidence, the reforms of the State in Venezuela were begun in the same year, but their results do not compare favourably with the reforms made in New Zealand.

achievement assumed by each of the parties, in the form of a set of management goals. The dimensions of institutional performance subject to evaluation are:[8]

> Economy: an institution's capacity to generate and properly mobilize the financial resources needed for its institutional mission;
> Efficiency: the ratio between the physical output of a good or service and the imports used to reach that level of output;
> Efficacy: the degree of fulfilment of the objectives set (independently of the resources assigned for the purpose); and
> Quality of service: the capacity of the institution to meet users' needs quickly and directly (in terms of timeliness, accessibility, accuracy in the delivery of the service, convenience and courtesy).

As may be seen from table X-1, 26 institutions had voluntarily joined this system, by 1995,for which 107 performance indicators had been selected. By 1997, the system had expanded considerably, to 67 institutions with 291 indicators. Substantially slower growth is foreseen for 1998, since most of the public services which can apply the instruments provided for by this methodology have already been integrated into the programme.[9] It may be noted that the 1997 Budget Act makes it obligatory for all the public bodies incorporated into the system to produce and publish annual reports on their activities.

Table X-1
CHILE: PUBLIC PERFORMANCE INDICATORS

	1995	1996	1997	1998
Number of public institutions	26	49	65	66
Number of indicators	107	197	282	285
Criteria				
Economy	4	16	33	n.d.
Efficiency	16	37	78	n.d.
Efficacy	76	80	96	n.d.
Quality of service	11	64	75	n.d.

Source: Department of Budget, Ministry of Finance of Chile.

[8] Among the advantages of performance agreements as management instruments are the fact that they oblige both executives and the rank and file to identify, clearly express and analyse their institution's mission, turning these into instruments of strategic planning which make it possible to reallocate financial and human resources to the central objectives and activities of the institution. They also provide formal backing for the activities slated for implementation by top management in accordance with the agreement with the "principal", while putting a brake on the demands and pressures of special-interest groups both inside and outside the organization. See, in this respect, DIPRES-Chile (1998).

[9] The bodies which have not yet been incorporated are departments and agencies whose activities are of a more normative or regulatory nature. In such cases, measuring performance is more difficult and involves a considerable increase in the cost of evaluation.

In 1994, the Inter-Ministerial Public Management Modernization Committee was set up to promote an integrated approach in the introduction of changes in the internal management methods of the civil service and the relations between public agencies and their users or clients. Modernization undertakings have been promoted among various public services and the President of the Republic for this purpose, resulting in the implementation of various modernization initiatives within the State administrative machinery and showing the rest of society not only the intention that exists to improve the quality of services but also the results actually obtained in this field. In 1997, 374 such undertakings were signed, in respect of 128 public institutions, and a first evaluation indicates that some 80% of the proposed goals were actually achieved.

One aspect already mentioned with regard to the progress made through these management modernization efforts is that of the high percentage of public employees whose salary readjustments are now linked to their institutions' performance. It is expected that by 1999 nearly 200 public-sector institutions will be operating under this system.

In Colombia, the 1991 Constitution gave the National Development Plan the status of a law and at the same time made it obligatory to carry out evaluations of public management performance in respect of the policies, programmes and projects in that Plan.

In order to implement these mandates, in 1995 the public management improvement strategy was put into effect. The hub of this strategy is the regular evaluation of the fulfilment of the objectives and goals of each programme and subprogramme in the National Development Plan, through the National Economic and Social Policy Council (CONPES). For this purpose, as soon as a programme is approved in CONPES, management units are formed to prepare an annual indicative plan with priority objectives and a range of measurements for the efficiency and efficacy indicators. On this basis, the Ministries and public bodies analyze their management performance, and the National Planning Department (DNP) evaluates the progress made in the fulfilment of the Plan as a whole, reformulates policies and allocates resources. The information for inter- and intra-agency coordination and evaluation is provided by the National System of Public Management Performance Evaluation (SINERGIA) of the DNP. These guidelines have been strengthened by the Efficiency Agreement adopted in May 1997, which is aimed at improving the conditions for the execution of the National Development Plan in the final phase of the present Administration.

In the period since 1995, Costa Rica's experience has been centred on the implementation of the National Evaluation System (SINE), whose primary objective is to provide the country with a management instrument which will permit the follow-up and systematic evaluation of the 1994-1998 National Development Plan. SINE is based on five basic principles: the social efficiency of public goods and services, strategic directions and accountability reforms in public finances, innovative management of human resources, and modernization of institutions. All these principles are aimed at modernizing the public sector through the evaluation of its management results.

In the case of Chile and Costa Rica, the efforts made in two or three years of practical implementation have given positive and satisfactory results in terms of the achievement of the goals set for the public institutions evaluated. Colombia, however, does not yet have an evaluation of the achievements made in terms of improving the efficiency and efficacy of its government management.

Brazil, Mexico, Uruguay and Paraguay, in descending order, are in a second category in terms of progress. Generally speaking, the initiatives undertaken in these countries seek to improve the processes of allocation of expenditure by restructuring the national budgetary programmes. Actions have been proposed aimed at easing budgetary rigidities, supporting the decision-making process by the generation of reliable information and the incorporation of institutional performance indicators, and introducing changes in the system of incentives for public-sector staff. In the case of Ecuador, the management improvement policy is centred on the evaluation and follow-up of selected programmes in the social sector of the economy. Initiatives of this type have also been launched in Bolivia, Honduras and the Dominican Republic. Special mention should be made of the case of Venezuela, which launched a pioneering effort in 1984, without, however, achieving the expected results.

Thus, the aim of the innovations made by all these countries in their public administration management model is to improve the efficacy, efficiency and quality of public services. The basic instruments used for this are the measurement of performance through indicators, and in-house or external evaluations which, since they are directly linked to the budget programme, form a system of essential information for use by the authorities when taking decisions on economic policy and, in particular, on the allocation of public resources. Albeit with different approaches and degrees of coverage, these experiences seek to raise the efficiency of public management through fundamental changes in the organizational culture and in the incentives offered to public managers and officials.

Table X-2 describes the features of the national experiences in this field in greater detail.

E. CONCLUSIONS AND FINAL OBSERVATIONS

- The management model for the civil service has been thoroughly reformulated all over the world. This trend began in the 1980s in the industrialized countries and has been spreading gradually —especially during the 1990s— to the countries of Latin America and Caribbean.
- The aim of these reforms is to increase the efficacy, efficiency and quality of public services through changes in the system of incentives and the introduction of systematic evaluations of results, with periodic reporting and full accountability by public officials. To this end, different forms of linkages are being created between performance and remunerations in the public sector. These experiments are still at a very early stage of development, however, and there is still some resistance to their application among public officials.
- Although each management evaluation excercise is carried out at the rate and in the manner corresponding to the country in question, the cases analyzed here display some common features: the main objectives are the same; the official status of the bodies responsible for formulating, designing and implementing the programmes is very high; and the coverage of the evaluation initiatives is restricted to the central or federal government. Although some progress has been made in the follow-up and evaluation of the decentralization process, the advances analysed in this chapter have not extended to the subnational levels of government.

- The countries which appear to have progressed furthest in this matter are notable for the fixing of clear quantitative goals, the use of indicators to measure results, and the adoption of management agreements or contracts.
- In most of the countries studied, there is no global mechanism for the overall appraisal of the results of evaluation processes; such a mechanism is almost always restricted to a limited number of important programmes.
- The progress made in respect of management evaluation is concentrated on the aspects connected with current expenditure programmes. The initial boost given to many initiatives for the evaluation of capital expenditure in the past has slackened, and in some cases national public investment systems have effectively been dismantled.
- The initiatives for the evaluation of public expenditure management currently under way in Latin America and Caribbean should not be seen as exercises aimed at achieving greater fiscal discipline but rather as efforts to introduce greater transparency, accountability, efficacy and efficiency into the management of public resources. For this purpose, a true change in organization culture is called for in terms of the way the formal institutional structure of government services operates (juridical-legal-organizational structure, regulations, ordinances and other written normative instruments), as well as changes at the level of informal institutions (norms and values, practices and customs). This process is essentially of an evolutionary nature and therefore calls for an ongoing effort on the part of various government agencies in order to root these reforms firmly in the day-to-day practice of public administration.

Table X-2
MODERNIZATION OF THE STATE: EVALUATION OF PUBLIC MANAGEMENT PERFORMANCE

FEATURES	CHILE	COLOMBIA	COSTA RICA
Initiation of programme and legal and institutional basis	December 1993: Pilot plan for improvement of management in 10 public services. December 1994: Establishment of Inter-Ministerial Public Management Modernization Committee.	July 1991: Article 343 of the Colombian Constitution calls for the application of a performance evaluation of system. June 1995: CONPES document 2790 provides for the establishment of the National System of Public Management Performance Evaluation (SINERGIA).	May 1994: The 1994-1998 National Development Plan provides for the establishment of a system of evaluation as a priority programme. April 1995: Executive Order No. 24174-PLAN establishes the National Evaluation System (SINE).
Objectives	To improve the performance of public institutions and raise efficiency in the provision of public services.	To strengthen: (i) the ongoing evaluation of public policies, programmes and projects; and (ii) the management capacity of government bodies.	To promote a public management culture based on strategic planning, evaluation of results and accountability.
Responsible bodies	Inter-Ministerial Public Management Modernization Committee; Department of the Budget (DIPRES).	National Planning Department (DNP), Ministry of Finance.	Ministry of National Planning and Economic Policy (MIDEPLAN) and Ministry of Finance.
Strategies, instruments and measures established	Establishment of: (i) Ministerial goals; (ii) Indicators of each institute's performance, for its evaluation; (iii) Undertakings to modernize institutions; (iv) Programme of evaluations of public investment projects and programmes.	(i) Establishment of specific goals within the programmes approved by the National Economic and Social Policy Council and regular evaluations of the programmes coming under that body; (ii) Formation of management units to follow up on each investment programme; (iii) Establishment of SINERGIA for the coordination and evaluation of integral management.	(i) Establishment of institutional liaison network for SINE; (ii) Design of the SINE methodology, based on the signing of performance commitments (CDRs); (iii) Execution in 1996 of a pilot plan to test the methodology developed; (iv) Draft bill to link the budget programme to SINE.
Degree of coverage, by level of government	Public bodies of the central government; national-level public investment programmes and projects.	All national-level public bodies: public policies, programmes, subprogrammes and projects.	18 selected bodies of the national Government; in each case, only strategic programmes and projects are followed up.
Introduction and use of public performance indicators	December 1996: 80% of the bodies providing public services have indicators of efficiency, efficacy, economy and quality.	The indicators are prepared by the management units, after which they are incorporated into the indicative plans for each body and the programme briefs for each programme.	The CDRs are based on an institutional performance matrix which contains goals and indicators for each programme.

FEATURES	CHILE	COLOMBIA	COSTA RICA
Performance agreements between the Executive and the responsible authority	March 1997: 374 internal management modernization undertakings signed with 128 public bodies.	November 1997: Efficiency agreement signed with ministers for fulfilment of goals in the final phase of the present Administration.	The 1996 pilot plan consisted of the signing of CDRs with eight bodies. In 1997 SINE was extended to 18 public bodies.
Establishment of incentive systems for public-sector personnel	(i) Salary system based on individual and departmental performance; (ii) Training system.	(i) Definition of a system of incentives and performance evaluations; (ii) Reform of civil service career system; (iii) Training plan.	This is provided for in SINE. It is currently in the process of research and development.
Establishment of information systems	The 1997 Budget Act obliges each body to prepare and publish annual management reports.	Information system containing the results of in-house management evaluations and of strategic external evaluations of periodically selected programmes, projects and policies.	(i) First stage of development of the SINE information system completed; (ii) Application of the System of Sustainable Development Indicators (SIDES).
Frequency of evaluation	(i) Annual in-house evaluations by the bodies themselves; (ii) External evaluations of programmes and projects by a team of experts.	Annual, in the case of public bodies, and variable, in the case of programmes and projects, depending on their duration.	(i) Annual in-house evaluation; (ii) Strategic evaluation of the degree of fulfilment of CDRs in three stages: at the beginning, during their course, and at the end of the year.
Evaluation of process of modernization of public management	December 1996: 92% fulfilment of goals, according to performance indicators; October 1997: 80% progress in respect of commitments.	Not yet effected.	December 1996: Annual report to the President provides for evaluation of the results obtained and improvements in the SINE methodology. The 1997 report is pending.

FEATURES	BRAZIL	MEXICO	VENEZUELA
Initiation of programme and legal and institutional basis	November 1995: Master Plan for Reform of the State Apparatus; December 1997: Programme for Modernization of the Federal Executive.	May 1996: Programme for the Modernization of the Civil Service, 1995-2000 (PROMAP); June 1997: National Development Finance Programme (PRONAFIDE) provides for reform of the budgetary system as a means of achieving the proposed goals.	December 1984: Creation of the Presidential Commission for State Reform (COPRE) by Decree No. 403.
Objectives	(i) To improve the productivity of the public sector; (ii) To limit the action of the State to the functions inherently belonging to it; (iii) To increase its efficiency and efficacy.	(i) To improve the efficiency of the government; (ii) To reduce labour costs; (iii) To foster a management culture in the public sector.	(i) To ensure the efficiency of the various bodies of the Executive; (ii) To facilitate the adoption of an integral reform of the State; (iii) To reorganize the civil service.
Responsible bodies	Commission for Reform of the State of the Ministry of Federal Administration and Reform of the State; Department of Reform of the State.	Department of the Controller and Administrative Development (through PROMAP); Ministry of Finance and Public Credit (through PRONAFIDE).	COPRE; Office of the President of the Republic.
Strategies, instruments and measures established	(i) Decentralization of implementation of government activities; (ii) Establishment of pilot units for the implementation of projects of organizational change; executing agencies and social organizations; (iii) Evaluation of fulfilment of goals.	(i) Restructuring of departments and units of the federal administration; (ii) Establishment of a "Social Controller's Office" to run an evaluation and monitoring system; (iii) Integrated System of Federal Financial Administration; (iv) New Programme Structure of the Budget (NEP) as from January 1998.	November 1988: COPRE presents an Integrated Project for the State, as a medium- and long-term strategy; August 1990: Project for Development of the Management Capacity of the State; December 1990: Reform Pact.
Degree of coverage, by level of government	All organs and bodies of the federal civil service.	The entire public sector: the federal Government, plus para-State bodies.	The entire national civil service.
Introduction and use of public performance indicators	Incorporated in plans for restructuring and management improvement and in the management contracts of all the pilot units.	Introduced at the pilot project level in the areas of public health care and education. To be included in the NEP in respect of government bodies and programmes.	None.

FEATURES	BRAZIL	MEXICO	VENEZUELA
Performance agreements between the Executive and the responsible authority	Management contracts signed by the executing agencies and social organizations.	Performance contracts signed between the policy areas and the responsible officials of programmes and bodies.	None.
Establishment of incentive systems for public-sector personnel	Project in course of implementation for redefining public-sector posts and creating a new civil service career system; project presented for a results-based system of personnel evaluation and promotion.	Not yet conceptualized. Proposed establishment of a civil service career path in federal government bodies.	The Reform Pact provides support for the Institute of Senior level Public Management through proposed arrangements for a civil service career system and promotion by merit.
Establishment of information systems	Modern communications network between the Government and the other administrative areas of the federal Government in the process of implementation and of solution of compatibility problems.	Together with the establishment of the NEP, provision was made for the development of a computerized system to produce a database of performance indicators.	Not envisaged.
Frequency of evaluation	As laid down in the management contracts.	Annual evaluation in accordance with a plan of long-term objectives proposed by PROMAP and PRONAFIDE.	The signatories of the Reform Pact make twice-yearly evaluations of the degree of fulfilment of commitments.
Evaluation of process of modernization of public management	System of evaluation based on criteria of management excellence (leadership, strategic planning, results obtained, information and analysis, emphasis on users' needs, process management, general management).	Not yet effected.	Not yet effected.

FEATURES	HONDURAS	BOLIVIA	DOMINICAN REP.
Initiation of programme and legal and institutional basis	December 1991: Executive Order No. 190-91 sets up the Presidential Commission for Modernization of the State; August 1995: Executive Order No. PCM030-95 establishes the Public Administration Programme (PRAP); December 1996: Executive Order No. 218-96 establishes the Civil Service Act.	July 1990: Act No. 1178 on Government Administration and Control (SAFCO Act) provides for the regulation of the systems of administration and control and those of planning and public investment.	June 1997: National Programme for the Reform and Modernization of the State.
Objectives	To improve and strengthen public management systems, areas of financial management, human resources management, and public investment programmes.	(i) To programme, execute and control the procurement and use of resources; (ii) To collect reliable information; (iii) To develop management capacity.	(i) To achieve greater flexibility, efficacy and transparency; (ii) To increase the productivity of public officials; (iii) To promote the autonomy of public agencies.
Responsible bodies	Presidential Commission for the Modernization of the State; Ministry of Finance; Planning and Management Evaluation Units.	Office of the Controller-General of the Republic, as the lead agency.	Presidential Commission for the Reform and Modernization of the State; specialized sectoral subcommissions.
Strategies, instruments and measures established	Adoption of an amendment to the General Civil Service Act which: (i) establishes Planning and Management Units; (ii) sets up the Technical Support Unit (UNAT) for assisting the President; (iii) provides for the evaluation and monitoring of public investment programmes and projects.	Implementation of systems for: operational planning; administrative organization; budgeting; personnel management; goods and services; treasury and public credit; integrated government accounting.	(i) Preparation of a proposal for the formulation of a strategy; (ii) Evaluation and redefinition of the functions of public bodies; (iii) Application of the Civil Service and Administrative Career Act.
Degree of coverage, by level of government	Central government public bodies and decentralized agencies; investment programmes and projects of the entire public sector.	All public-sector bodies.	The entire central government.

FEATURES	HONDURAS	BOLIVIA	DOMINICAN REP.
Introduction and use of public performance indicators	Provided for in the financial management reform programme and currently in the process of preparation. Indicators of the efficiency, efficacy and economy of public services will be developed.	Incorporated in the following regulations: (i) Government Audit Office, internal controls; (ii) National Public Investment System.	Not yet in effect, but provided for in the proposals.
Performance agreements between the Executive and the responsible authority	None.	None.	None.
Establishment of incentive systems for public-sector personnel	The human resources management reform programme provides for the formulation of a system of performance assessments for officials of the Executive branch: evaluation and training.	(i) Civil service programme in the general government sector; (ii) System of performance evaluation; (iii) Training and award of fellowships.	Proposals have been put forward for a training programme for public officials.
Establishment of information systems	The design and implementation of information systems to improve financial management and the performance of public employees are envisaged.		System to be formed on the basis of performance indicators.
Frequency of evaluation	Annual. (i) The Planning and Evaluation Units will assess the performance of public agencies; (ii) The Technical Support Unit will evaluate public programmes.	Annual. (i) In-house evaluation, with the results reported to the General Accounting Office; (ii) External evaluations.	Annual.
Evaluation of process of moderniza-tion of public management	Not yet effected.	Not yet effected.	Not yet effected.

FEATURES	URUGUAY	PARAGUAY	ECUADOR
Initiation of programme and legal and institutional basis	January 1996: Programme of Reforms and Policies for the Modernization of the Civil Service. Act No. 16,736.	September 1994: Act No. 281/92 approves the IDB loan contract for the Sectoral Investment Programme. January 1997: Programme for the Strengthening and Development of Institutions (Integrated Systems for the Management of State Resources - SIARE).	July 1997: Pilot plan for the evaluation of 500 priority programmes of the "Social Front".
Objectives	(i) Prioritization of substantive functions; (ii) Raising the level of professionalism of the civil service and public agencies.	(i) Making public expenditure more cost-effective; (ii) Aiding the selection of priority economic sectors.	(i) Evaluating the impact of the social programmes underway; (ii) Improving the efficiency and efficacy of social programme management.
Responsible bodies	Executive Committee for Reform of the State (CEPRE), attached to the Office of the President of the Republic.	Ministry of Finance.	Technical Secretariat of the "Social Front", Ministry of Social Welfare.
Strategies, instruments and measures established	Reorganization of institutions; transfer of powers among Ministries. Reallocation of resources in the national budget. Formulation of five-year budgets. Evaluation and follow-up of executing units.	(i) Subprogramme of the Contract: reform of tax and financial management; (ii) Implementation of SIAREs in the National Human Resources System (SINARH); financial management; management of goods and services; communications.	(i) Preparation of the Evaluation Working Plan; (ii) First evaluation of progress made in programmes underway, through interviews of the responsible officials; (iii) Introduction of performance indicators in the near future.
Degree of coverage, by level of government	Priority programmes, through the executing units.	All central government bodies.	The 11 social sectors identified.
Introduction and use of public performance indicators	Introduction proposed in priority programmes and in evaluation of staff performance.	Introduction proposed in the 1998 budget programme, within the Integrated Financial Management System.	Introduction of results-based indicators planned for January 1998.
Performance agreements between the Executive and the responsible authority	None.	None.	None.
Establishment of incentive systems for public-sector personnel	Programme of labour and business reintegration; establishment of systems of voluntary retirement incentives and performance evaluation.	In operation since the 1997 financial year, in the context of SINARH.	Training courses for managers of social programmes in course of preparation.

FEATURES	URUGUAY	PARAGUAY	ECUADOR
Establishment of information systems	Still at the proposal stage.	Integrated Communications System: national-level information network for units of the Ministry of Finance; 20 public agencies in the metropolitan area.	A freely available database system containing all the information on programme follow-ups is being prepared.
Frequency of evaluation	Annual, together with the budget programme.	Annual.	Twice-yearly.
Evaluation of process of moderniza-tion of public management	Not yet effected.	Not yet effected.	Not yet effected.

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