

---

## A Fiscal Policy Agenda

DANIEL ARTANA, RICARDO LÓPEZ MURPHY,  
AND FERNANDO NAVAJAS

Almost everywhere in Latin America, fiscal deficits were one of the critical problems that led to the debt crisis and rapid inflation during the 1980s. As table 4.1 shows, the situation improved very significantly during the 1990s, although there has again been a marked deterioration in recent years, presumably at least partly because of recession. In itself, fiscal deterioration during a recession should not be considered undesirable, for it is exactly what should happen if countries have good automatic stabilizers. But the size of recent deficits does raise the issue of whether countries have yet strengthened their underlying positions enough to be able to afford an anticyclical policy.

Making fiscal policy anticyclical is one of the critical dimensions of the design of fiscal policy and fiscal institutions in Latin America that we take up in this chapter. The policy objectives are to improve macroeconomic stability, allocative efficiency, and income distribution, and to

---

*Daniel Artana is a chief economist at Fundación de Investigaciones Económicas Latinoamericanas (FIEL) in Buenos Aires and professor of economics at the National University of La Plata and the Universities of San Andrés and Torcuata di Tella. He was formerly secretary of the Argentine Treasury. Ricardo López Murphy is currently a candidate for president of the Argentine Republic. He has formerly been a minister of economy and minister of defense of Argentina, and also a chief economist at FIEL. Fernando Navajas is a chief economist at FIEL and professor of economics at the National University of La Plata and the University of San Andrés. He was formerly chief of the Cabinet of Advisers to the Ministry of Economy in Argentina.*

**Table 4.1 Central government balances in selected Latin American countries, 1980s-2001 (percent of GDP)**

Country	1980s	1990s	1991-94	1994-98	1999	2000	2001
Argentina	-3.7	-1.1	-0.5	-1.2	-2.9	-2.4	-3.2
Brazil	-8.7	-5.8	-4.9	-7.1	-5.8	-3.3	-3.5
Chile	0.3	1.4	1.9	1.7	-1.4	0.1	-0.3
Colombia	-1.7	-2.7	-1.4	-3.2	-5.9	-6.9	-5.9
Ecuador	-1.5	0.5	1.6	-0.4	-0.7	0.7	0.1
Mexico	-8.5	0.0	1.9	-0.7	-1.6	-1.3	-0.7
Peru	-4.3	-1.5	-1.7	0.9	-2.2	-2.0	-2.3
Venezuela	-1.0	-1.5	-2.3	-1.8	-2.4	-2.1	-2.6

Note: This table shows data only for central governments. A better estimate of the underlying public-sector deficit would take into account the deficit of all public agencies (including the central bank) and subnational governments. It is not possible to obtain a long series for all the countries included in the table. But there are figures available for the 1990s that show that when all public agencies are included, the 1990s deficit doubles in the case of Argentina (mostly because of the deficit of the provincial governments); it increases by about 1 percent of GDP in Peru and Venezuela; and it is reduced to 1.6 percent of GDP in Colombia because subnational governments and the pension system run surpluses.

Source: IMF data.

reduce poverty. The topics discussed here are restricted to those we have studied during the past decade, both in academic discussions and policy involvement.

These themes are particularly relevant to Latin American countries, given the interaction between their fragile economic and financial institutions and the macroeconomic shocks they faced during the 1990s, which hit while they were undergoing structural reforms to lower inflation, free trade, and broaden the use of market mechanisms. We hope it is clear from the analysis that our recommendations seek to avoid getting countries into a situation like the one Argentina suffered in 2001-02. The idea is to prevent a debt crisis through prudent fiscal policies before it becomes too late and countries must then deal with the severe policy dilemma of not having access to financing in voluntary credit markets while being forced to reduce their fiscal deficit in the midst of a recession.

Although good fiscal policy and national fiscal institutions cannot substitute for an adequate global financial architecture, they still are much needed—whether they strategically complement global reform or serve to make the best of a difficult situation in the absence of reform. Our agenda emphasizes rules that favor growth by taking advantage of opportunities in a competitive world, which is the key starting point for improving welfare. This emphasis leads to reforms that avoid both an inefficient use of productive resources and also an increase in the cost of capital stemming from lax fiscal rules and deteriorating fiscal savings. This last aspect is fundamental, because much of Latin America's macroeconomic vulnera-

bility has been caused by an excessive use of foreign savings, resulting in part from lax fiscal institutions.<sup>1</sup>

One theme we will stress again and again is how the proposed agenda complements other macroeconomic policies. For example, a hard monetary regime can coexist successfully with neither an inconsistent fiscal policy nor public behavior that involves high risks resulting from non-transparent or unstable rules of the game. Even if a superficial reading of indicators does not reveal an imminent crisis, the constant danger is that the system will unravel, as indeed happened in Argentina with such tragic consequences for growth and social cohesion in 2001.

This chapter covers seven topics.

- The well-known problem of procyclical fiscal policy in emerging-market economies.
- The problem of hidden liabilities in the form of implicit or unregistered debts.
- The issue of tax expenditures (i.e., tax exemptions or differential tax rates designed to aid particular sectors), which aggravate intertemporal fiscal balance and distort resource allocation.
- Fiscal decentralization, taking into account both microeconomic incentives and macroeconomic coordination.
- The issue of designing, reforming, and administering a tax system.
- Budget mechanisms and the system of incentives and monitoring of public spending in such critical areas as social policy.
- Proposals for explicit institutional rules, such as laws enforcing fiscal responsibility and international agreements, to strengthen the effectiveness and credibility of public policies.

---

1. E.g., Dayal-Gulati and Thimann (1997) compared savings behavior in Southeast Asia and Latin America for the period 1975-95. They found that the mean of national savings to GDP was 28 percent in Southeast Asia and only 19.5 percent in Latin America, and the mean of the central government balance was virtually zero in Southeast Asia compared with a deficit of 2.4 percent of GDP for Latin America. Moreover, while in Southeast Asia fiscal deficits turned into surpluses after 1987, they never were eliminated in Latin America. In their empirical results, these researchers found that the higher national savings rate observed in Southeast Asia can be attributed to higher public savings rates over the period of the study. (In this study, Southeast Asia comprised Indonesia, Malaysia, Philippines, Singapore, and Thailand, while Latin American data were for Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay, and Venezuela.)

## Reversing Procyclical Fiscal Policy

In Latin American countries, an expansion of economic activity and the resulting increase in fiscal revenues is typically not accompanied—as in industrial countries—by a significant reduction in fiscal deficits.<sup>2</sup> This is true despite the fact that in developing countries the aggregate tax base fluctuates more than output, which rises and falls as the economy is exposed to shocks. In Latin America, the standard deviation of GDP from its trend is more than twice that of industrial countries, and the relative figure is even wider for private consumption. The problem is that there is a strong positive correlation between government expenditure and GDP, as strong as that between tax revenues and GDP. Talvi and Vegh (2000) find these correlations to be similar, about 0.53 for developing economies in the past 25 years or so, while the equivalent numbers are much smaller (0.17 and 0.38, respectively) for industrial countries, and even lower—in fact, close to zero in the case of public expenditures—for Group of Seven economies. Among developing economies, including those of Latin America, the differences are minor and not significant.

Some observers have tried to make the case that this behavior is caused by developing economies' vulnerability to capital flows. However, the fact that there have been several episodes of deficits during booms, and even when there are very favorable and clearly unsustainable terms of trade, unambiguously indicates that the problem lies primarily with fiscal institutions. Of course, capital flow reversals and terms of trade shocks can have an acute impact on public finances that cannot be neutralized overnight. However, this calls for developing hard rules of conduct to protect national economies as well as possible, and not for resorting to a "market failure" excuse that neglects domestic institutional buildup and tries to shift responsibility abroad.<sup>3</sup>

---

2. See, e.g., López Murphy (1988, 1994) for Argentina and Gavin et al. (1996) for Latin America. With a broader sample, Talvi and Vegh (2000) find evidence that procyclical fiscal policy (understood as expenditures (taxes) rising (decreasing) in booms and the opposite in recessions) is a pervasive fact in developing economies and to some extent in industrial countries other than the Group of Seven.

3. What we are going to suggest is the creation of sound fiscal institutions that will mitigate "market failure." Other alternatives appear to be less efficient. E.g., restrictions on short-term capital inflows cannot solve the problem of abnormally high dollar receipts caused by transitory improvements in the terms of trade, even if such restrictions could not be circumvented by the private sector. The experience of Argentina and Chile during the 1990s is interesting. Both countries had some regulations on capital inflows (although Argentina opted for imposing regulations that increased the liquidity of the banking sector to very high levels and allowed the banks to invest these requirements abroad), but fiscal behavior was completely different. Although Chile ran surpluses during many years of that decade, Argentina could not eliminate the fiscal deficit even in periods of relatively high real growth.

The absence of fiscal equilibrium during booms and even when terms of trade are favorable can in part be attributed to the fact that public spending is normally repressed by a financial constraint that, once relaxed, generates an expansion in outlays similar to the increase in revenues. This behavior partly is the result of financial programs making the fiscal deficit a key target in the framework of macroeconomic consistency when in reality the deficit is an endogenous variable. Instead, macroeconomic programs should be based on such exogenous variables as the level of nominal public expenditures or statutory tax rates. The International Monetary Fund's programs emphasize the *ex ante* coincidence of fiscal, monetary, and external sectors but do not pay enough attention to the endogenous nature of some of the variables for which ceilings are established. Sound fiscal institutions should restrict quantitative targets to tax rates and nominal public expenditures and should not use them for fiscal deficits.

The financial repression of expenditures reflects the weakness of budgetary processes. Budgets are in principle estimated in nominal terms. However, growth is often deliberately overestimated to avoid showing a planned cut in spending; when more growth does occur, this leads to higher spending and thus to a higher correlation of taxes and expenditures than would result from a more rational budget. This problem becomes even more acute in recessions, given inflexible debt-service and social security payments. In the past, this was less significant because high inflation allowed flexibility in real public expenditures, by cutting real wages. When reduced growth results from an external shock, rather than a normal business cycle, the problem is further aggravated because it may be necessary to boost interest rates.

Supply shocks can reduce—sometimes in a dramatic way—the potential output of an emerging-market economy. These shocks can take the form of a drastic drop in the terms of trade in goods or in the quantity of services (e.g., in economies heavily dependent on tourism), or a rise in the real interest rate in economies that rely heavily on external savings. The impact of these shocks is magnified where the possibility of substitution between traded and nontraded goods is small, which is sometimes due to high protection having made naturally tradable sectors become nontradable or of low tradability outside the borders.<sup>4</sup>

Under these conditions, a shock has a very different impact than in very open economies. If exports have a large component of natural resources, are concentrated in a few sectors, or depend on regional (quasi-domestic) markets, the required (market-clearing) change in relative prices is very large because the elasticity of supply of exports is usually small. Alterna-

---

4. Argentina, Brazil, and India are examples of economies that are relatively closed to foreign trade.

tively, the corresponding recession or contractionary adjustment in quantities is very significant if the exchange rate regime is rigid and (together with rigidities that may be amplified by policy) does not allow prices to be rapidly corrected. This explains why external events can have sizable effects even if trade shares are relatively small.

To minimize these costs, following a prudent fiscal policy is very important. One way of implementing this policy is to recognize that any abnormal excess of domestic absorption over national income causes tax revenues to be overestimated in relation to their equilibrium level, at which the current account of the balance of payments is in a steady state. This is because tax revenues are largely levied on, and therefore determined by, aggregate (i.e., tradable and nontradable) expenditures.

A useful rule of thumb is that, in the presence of an above-normal external deficit, fiscal policy should seek a surplus equivalent to the product of the abnormal deficit times the marginal tax rate. This is a “gross” estimate of the increase in tax revenues that a higher-than-normal external deficit would produce, and that needs to be saved to maintain government expenditures in the years of below-normal capital inflows. In no case should the surplus be less than 35 percent of the external disequilibrium.<sup>5</sup>

This rule would ensure that expenditures are not increased unsustainably in response to a temporary capital inflow. Fiscal institutions need to be powerful enough to avoid twin deficits and to ensure that a fiscal surplus is achieved under favorable external conditions. This is a fundamental necessity of macroeconomic design to avoid capital inflows that create conditions for a serious crisis when the cycle reverts. For countries whose fiscal revenues significantly depend on commodity exports, the need to purchase this “fiscal insurance” is magnified during a boom.<sup>6</sup>

A safe policy is to seek a systematic reduction of the public debt, assuming that interest rate spreads are at their average level of recent years. If one sets public expenditures around their intertemporal equilibrium level (the level that makes the present value of the flow of expenditures equal to the present value of the expected flow of tax revenues), the reduction in the ratio of public debt to GDP would result from the joint and exponential contribution of the real growth rate and the external rate of inflation.

---

5. The 35 percent is a rather arbitrary figure, but it tries to address the situation of countries with low tax rates.

6. It is possible to refine this rule of thumb to take into account the sustainability of the country's public and external debt. However, we emphasize a simpler rule for several reasons: (1) Debt sustainability exercises require defining a ratio of sustainable public or external debt to GDP, and governments and the private sector tend to be optimistic about them in the years of abnormally high capital inflows. (2) These ratios need to be carefully defined so as to include the impact of changes in the real exchange rate and the fiscal impact of natural catastrophes.

What this requires for the purpose of fiscal planning is that the growth trend be corrected by the deviation of the terms of trade and the international interest rate from their respective historical or expected values. This would avoid allowing an unsustainably favorable situation to lead to a dangerously high level of public expenditures. The limit of indebtedness within the cycle should recognize the so-called golden rule, whereby the fiscal deficit should at most reach the level of public investment. One must not forget that public expenditure accounts are based on flows and do not incorporate depreciation allowances, which implies that the level of current expenditures is underestimated and therefore the level of public savings is overestimated.

It would be worth setting a Maastricht-type debt limit of about 30 percent of GDP once reasonable levels of indebtedness are reached. This is only half the level the Europeans have set in the Maastricht agreement, but that reflects Latin America's narrow domestic capital markets, higher interest rates, and lower revenue shares relative to GDP. This would further reinforce the pressure to increase public savings and therefore weaken the vulnerability associated with a fragile fiscal position. The rule would also help to avoid an exaggerated expansion of current expenditures and private consumption, which in turn would reinforce private savings.<sup>7</sup>

A rule of avoiding twin deficits would result in additional capital inflows, leading automatically to a lower interest rate. If the inflow nonetheless continues, debt management policy should complete the arsenal of stabilizing measures by changing the composition toward domestic debt until the capital flow reverses.

These rules are particularly important in the context of fixed or rigid exchange rate regimes. During the preannounced regimes in the late 1970s and early 1980s in Argentina and Uruguay—and in Argentina, Mexico, and Brazil during their periods of convertibility and crawling exchange rates, respectively, in the 1990s—public expenditures went to clearly unsustainable levels. Sooner or later, the truth was uncomfortably revealed by external shocks.

Summing up, destabilizing, procyclical fiscal policy afflicts most Latin American economies. More intriguing, even when countercyclical budget rules would clearly improve welfare, they do not emerge. This points to problems of political economy. In fact, certain models explain procyclicality as an equilibrium between the interaction of political pressures to increase expenditures during booms and the optimal response of an executive branch concerned with deficits and distortions.

In some of these models (see Talvi and Vegh 2000), the inability to restrict public spending gives the economic authorities an incentive to reduce taxes in expansions so as to avoid additional spending—but this

---

7. See, e.g., López Murphy and Navajas (1998) for the relation between public savings and private consumption and savings in Argentina during the early 1990s.

serves to make fiscal policy even more procyclical. Nevertheless, we believe that the so-called procyclical problem arises, in many instances, simply as a result of a very bad reading of the fiscal problem by the economic authorities.

The key point of the agenda to eliminate procyclicality developed above is that current and capital expenditures should be based on an institutional framework that sets stringent debt targets and aims to balance the budget along the projected potential growth trend. This effort will mean adjusting actual revenue by a correction reflecting external conditions, notably the terms of trade and capital inflows.

In practice, this agenda will be affected by the degree of openness of the economy and the history and nature of fiscal institutions; more open economies with exports based on more elastic supplies will be better able to adjust to facilitate macroeconomic corrections, which will give slightly more latitude to take risks with the proposed countercyclical policy. Conversely, the importance and significance of these rules should be accentuated if the monetary (exchange rate) regime is very rigid, in which case fiscal policy must follow a path consistent with the numeraire of the economy and the fact that it is the only instrument left available to cushion the impact of external shocks.

## **Making Hidden Debts Explicit**

A recurrent problem in fiscal management in emerging-market economies has been the existence of implicit debts that have not been incorporated into fiscal accounts, for various reasons. Some examples are the outcomes of judicial processes, losses from operations of the central bank (more important in the 1980s and known as quasi-fiscal deficits), debts resulting from losses in the financial system and more commonly in official banks, and government guarantees that are called and have not been computed in the fiscal accounts. Such “skeletons” have increased public debts substantially in some cases. For example, in Brazil the Fernando Henrique Cardoso administration cleaned up “skeletons” worth about 10 percent of the GDP in the period 1993-2001, and there are estimates that in the subsequent 6 years something above another 5 percentage points may be added (Goldfajn 2002).

Another significant issue arises in reforming a pension system from pay-as-you-go to fully funded. This reform does not result in any net expansion of debt, but rather in an explicit recognition of debt. The intertemporal impact on the fiscal accounts is neutral if the reform is designed to maintain preexisting conditions. But in most of Latin America, pension reform has been designed to improve the actuarial balance of the pension system, because in most countries the so-called implicit pension debt is very large (see table 4.2). The wide range of estimates shown in the

**Table 4.2 Range of estimates of implicit pension debt in selected Latin American countries in the 1990s (percent)**

Country	Ratio of debt to GDP
Argentina	55 to 305
Bolivia	40
Brazil	188 to 213
Chile	130
Colombia	59 to 88
Mexico	37 to 118
Peru	37 to 45
Uruguay	187 to 289
Venezuela	30 to 37

*Sources:* Kane and Palacios (1996), Bravo and Uthoff (1999), FIEL (1998a), Grandolini and Cerda (1998), and Von Gersdorff (1997).

table comes from different methodologies, assumptions, and macroeconomic conditions at the time of the exercises, and it is fair to say that some of them are more simulations than actual estimates.<sup>8</sup> But the point is that a pay-as-you-go system implies debt that is hidden in the fiscal accounts, while this gradually becomes explicit after pension reform. These explicit debts have to be financed voluntarily by capital markets.

The first issue that arises with regard to hidden debts is transparency. Acknowledging potential liabilities may influence expectations and affect capital markets. Making fiscal accounts, projections, and estimates more transparent is fundamental both in the presentation of budgets and in fiscal reports; it narrows uncertainties and avoids private-sector hypotheses that are exaggerated, lack an empirical base, or embody fears that the government will behave in an inconsistent or opportunistic manner. Transparency is crucial to motivate commitment in fiscal policy. This commitment, in turn, is fundamental to the development and efficient working of capital markets, particularly when liabilities of the government need to be processed and calculated as a stream of payments in the future.

A second issue is the macroeconomic impact on aggregate spending of recognizing the debts. One case involves debts that are unregistered and illiquid (the “skeletons”). This is different from the case of debts of the central bank or public-sector financial institutions. But in both cases, it is

8. E.g., for Argentina, studies like FIEL (1998a) have estimated an implicit debt of 55 percent of GDP at the time of the reform, whereas Bravo and Uthoff (1999) estimate a potential figure almost six times greater. In fact, almost all the upper-bound estimates in table 4.2 come from Bravo and Uthoff’s simulations—except for Mexico, for which they estimate 37 percent while Grandolini and Cerda (1998) report 118 percent before the reform; for Colombia, the range is taken from Bravo and Uthoff (1999).

appropriate to compute the debts at the moment they are transformed into explicit debts, and to fully internalize their macroeconomic impact. Part of their impact may indeed have been felt before the moment they accrued, but to assume that there was no impact at that time also requires assuming that economic agents are perfectly informed, even when the debt process is uncertain, and have full access to capital markets to finance the anticipation of expenditures.<sup>9</sup> This is not likely to be the situation in emerging markets, where agents are normally liquidity constrained and markets are narrow and lack financial guarantees.

This latter point is important, because ad hoc treatment of these liabilities can give rise to an incorrect reading of the fiscal situation and mislead about the type of debt instrument that should be used to cancel these obligations. Where the deficit is measured on a cash basis, the impact should be allocated at the moment when the instrument of payment is created, which will avoid underestimating the deficit that is being faced. This procedure could substantially change the reading of the size of fiscal disequilibria that some emerging-market countries have faced in recent years.

The transition from a pay-as-you-go to a fully funded pension system is one example of newly generated liabilities being made explicit and creating an immediate burden on the government's borrowing requirement. If a country's fiscal position is tight, this can add significant pressure on capital markets. It is true that if the change is equivalent—or positive—in actuarial terms, the funds accumulated in the new system should by definition finance the transition. However, the evidence suggests that in emerging markets one cannot assume that the financing of the transition cost is guaranteed simply because the actuarial balance has improved with reform.

The objectives of developing capital markets and of reestablishing incentives through a fully funded system suffer if the effort to make debts explicit is not supported by a greater fiscal effort. The idea that future fiscal surpluses are fully incorporated into the demand for public debt, even though it is attractive theoretically, is too optimistic to furnish a rule for sound financial programming.

This is not to say that principles of intertemporal accounting based on optimizing behavior should not be used to guide fiscal decisions; rather, appearances can also matter in economies that are subject to sudden stops of external financing. More prudence will strengthen the performance of economies that have a tradition of low domestic savings. In the case of hidden debts that stem from judicial decisions, such as claims by retirees, public employees, or government suppliers, the beneficiaries should receive debt with a very long maturity, to avoid more short-maturity debt disrupting thin capital markets and debt management.

---

9. Argentina during the 1990s was a good example of a country with debt increases that could not be fully explained by cumulated deficits.

The resulting agenda can be summarized as follows. First, in the case of as yet unregistered debt pending judicial resolution, fiscal institutions should make potential liabilities more explicit and predictable, and they should clearly state the nature of the potential “skeleton.” Second, in the case of debt originating in financial institutions, reports should establish a clear accountability of the origin of the liability so as to make overall fiscal policy and public finances less difficult to evaluate.

Third, in the case of pension system reform, it is important to clarify both the details of past deficits and the actuarial change that is taking place, to facilitate structural change in public finances. Moreover, the need to augment public savings in an environment of volatility suggests that current revenues should cover a great part of the financial gap created during the transition from a pay-as-you-go pension system to a fully funded one.<sup>10</sup> Fourth, in the case of unregistered debt coming from the resolution of judicial disputes where the government becomes a debtor because of concessions to private agents granted by law, it is convenient that debt be issued at long maturities and with low interest in the intermediate decades. These rules should be applied to all levels of government, and debt statistics should make the consolidation process transparent.

## Controlling Tax Expenditures

Tax expenditures are hidden subsidies to business. They constitute one of the major challenges for fiscal policy and fiscal institutions in emerging-market economies. They introduce distortions, usually increase the inequality in income distribution, promote rent seeking, hinder transparency, impede regional economic integration, and bias fiscal accounts toward deficits. A correct reading of the magnitude of public spending requires making tax expenditures explicit. Transparency in this area, like that just discussed, will facilitate choosing fiscal options with realism and accountability.

These hidden subsidies have generally been biased in favor of capital (by reducing taxes on capital) or in favor of capital-intensive sectors such as manufacturing, and have rarely benefited labor. Moreover, to the extent that they increase the fiscal deficit, they put extra pressure on country risk and thus depress net-of-tax wages in small, open economies. They complicate tax administration and create many loopholes, and promote movement toward untaxed sectors or regions. The quasi-tariffs they often cre-

---

10. The optimal proportion of tax financing of the cash deficit created by pension reform will depend on the magnitude of the gap, the size of the preexisting public debt, and the nature of the country. For poor countries with low country risk premiums on government debt, it may be sensible to finance a larger share of the transition cost of pension reform through debt financing.

ate hinder regional integration, for the reactions of trading partners are often hostile. This is particularly serious where regional integration is a first step toward wider integration.

These mechanisms are sometimes presented as a way to avoid the growth of traditional public spending (explicit subsidies) or as a way of forcing countries to set a limit on business taxation. We believe this viewpoint is wrong in general, and especially so in emerging-market economies. Good economic performance requires similar rules for all participants (i.e., a level-playing field). The distortion of prices and signals, as well as their unpredictability, harms economic efficiency and thus growth.<sup>11</sup> This problem is compounded in the context of weak tax administration and a public sector that chronically runs a deficit.

The costs of tax expenditures are magnified by the proliferation of rent-seeking activities. These waste additional economic resources beyond the traditional estimates of deadweight loss. There is ample evidence that, in countries such as Argentina, tax expenditures give incentives for rent seeking and have contributed to fiscal deficits.<sup>12</sup> In most emerging-market economies, where governance and efficient political processes are still weak, rent seekers focus on tax expenditures, particularly in decentralized and heterogeneous countries.

These considerations add some important points to our fiscal agenda. Ideally, tax expenditures should be abolished. Any political goal can be better handled through explicit subsidies in the budget. If tax expenditures are maintained, fiscal institutions should make a transparent account of these expenditures, distinguishing between old and new measures and estimating their impact on current and future fiscal budgets. And an economic report on the subsidies should make explicit those cases where tax expenditures exceed the capital stock or payroll of the subsidized firms (because these are typically justified as employment promotion). Moreover, these subsidies should be explicitly compared with annual budget allocations to social sectors such as education and poverty reduction.

---

11. The evidence on the regional subsidies to firms granted by some US states and by the European Union proves this point. Incentives were not effective in augmenting growth or creating more jobs. See Artana (1996) for a summary of the empirical evidence.

12. See, e.g., FIEL (1988) on the industrial promotion regime in Argentina, which was designed to give exemptions from national tax obligations to sectors located in certain regions. The provinces had incentives to seek these subsidies because the rest of the country financed them, while pressure groups promoted legislative action. This kind of competitive externality (a variety of the “problem of the commons”) concerning tax expenditures is described in Heymann and Navajas (1989) for the Argentine case. The political resistance in favor of the status quo proved to be very difficult to change during the 1990s, even though the national authorities were more committed to a reform. Estimates of the fiscal costs of this regime gave figures of about 1.5 percent of GDP (World Bank 1993), with the traditional welfare cost (without considering rent-seeking activities) constituting only about 25-50 percent of this cost (FIEL 1988).

## Making Fiscal Decentralization Compatible with Macroeconomic Stability

Fiscal decentralization has a clear policy logic, for it brings decisions on the provision of public and social goods closer to the affected parties. However, vertical imbalances between national and subnational governments are a stylized fact,<sup>13</sup> particularly in emerging markets, which poses the problem of how to make transfers across jurisdictions.

Intergovernmental transfers create incentive problems because they break the link that exists when a public agency makes expenditure decisions and finances all of them with its own-source revenues. The problem becomes more acute when intergovernmental transfers are used to redistribute income from richer to poorer regions. Another issue is whether transfers are based on a formula as opposed to discretion, which may be inefficient and poses dangers of political manipulation.

In this chapter, we are mainly interested in macroeconomic issues.<sup>14</sup> When GDP is growing at a much higher rate than the potential growth rate, the government receives more revenues than when in the steady state. A sound fiscal policy requires that these surpluses be saved so as to ensure that enough resources will be available during the bust, when tax revenues diminish and expenditure needs usually increase. Intergovernmental transfers that are specified as a fraction of federal tax revenues give more money during booms to subnational governments, which are likely to increase their expenditures unless there are constraints on subnational spending, thus exacerbating the federal difficulty in stabilizing the economic cycle. This problem is more severe in countries that are more exposed to changes in capital inflows or in the terms of trade.

Another problem that arises concerns the issuance of debt by subnational governments. Even if there are no intergovernmental transfers, subnational governments may “undo” the effects of the macroeconomic policy of the federal government if they face no restrictions on the issuance of debt. In some industrial countries, there are restrictions on the volume of debt that subnational governments may issue. Alternatively, the federal government’s prior authorization may be required for provinces (states) or municipalities to issue new debt; or else one may rely on the credit-rating process of the capital markets to limit debt issues.

But this raises some problems. Will these restrictions be credible when the risk of a federal bailout exists and is higher than for private firms that

---

13. Although the most onerous expenditures are best decentralized (national public goods like external defense represent today a much lower share of total expenditure in peaceful countries), constraints like factor mobility or administrative problems prevent the decentralization of many taxes to the provincial or municipal level.

14. See, e.g., FIEL (1993), Artana and López Murphy (1995, 1996).

issue debt?<sup>15</sup> Moreover, for public agencies, the problem of incentives is more acute than for private managers; there are similar agency problems, but the intertemporal restrictions are weaker than those faced by private managers because politicians usually remain in office for a relatively short time. The fact is that subnational indebtedness has often appeared again and again (e.g., in Argentina, Brazil, and Colombia), and bailouts finally occurred. Controls on domestic indebtedness can be subject to political manipulation and moral hazard.

We propose a five-point agenda that seeks to strike a balance between decentralization and macro stability. First, we favor implementing the basic principle of public finance that calls for the same authority to be responsible for spending and for raising the marginal revenue to finance those expenditures. Specifically, reduced intergovernmental transfers should be compensated for with more tax decentralization, as administratively feasible.

Second, procyclical elements in the design of transfer rules should be eliminated. Rather than being based on a percentage of federal revenues, transfers should be calculated as lump-sum amounts that may change every year on the basis of variables that are independent of the economic cycle (e.g., population growth).

Third, the principles of budget balancing that guide fiscal policy at the national level should be extended to subnational levels. These measures should emphasize increasing capital expenditures in bad times and building up stabilization funds in good times.

Fourth, the debt policies of subnational governments must be coordinated by the central government. Debt volume caps are one method of coordination; the requirement of a minimum rating to be able to issue new debt is another. The rating process has the advantage of making the information about the finances of subnational governments more transparent and reliable.<sup>16</sup>

---

15. There has been a hot discussion about the need to restrict the access of the private sector to international capital markets, based on the postulate of a positively sloped marginal cost of foreign funds for the country as a whole. Each individual borrower ignores the additional cost he or she imposes on other borrowers by increasing his or her foreign debt, which may suggest a case for taxing borrowing (as Chile did during the 1990s) or imposing more stringent prudential regulations on the banking system (as Argentina did in the mid-1990s). We do not take sides in this discussion, but we want to stress that for public debt of the subnational governments, the problem is aggravated because the risk of a federal bailout is higher than for a single private firm, and this may make the credit rating process less severe (if ultimately the lenders are expected to collect the loan from the federal collateral). Moreover, the process is more likely to be politicized, e.g., because a provincial default may trigger a negative externality to other public and private borrowers.

16. Guillermo Perry suggested to us that developing and applying adequate bankruptcy procedures for subnationals (as in the United States and Hungary) might be the only efficient long-term solution.

Fifth, it is not desirable for subnational governments to have their own financial institutions, especially if these bypass prudent bank regulation. Such institutions have often been a source of soft budget constraints.

## Tax Design and Administration

Emerging-market economies' tax systems have several characteristics that make them different from those of industrial countries. Usually, total tax revenues expressed as a fraction of GDP are lower, and the share of consumption taxes in total tax revenues is larger. In Latin American and other emerging-market economies, income taxes and property taxes account for a much lower fraction of GDP than in countries that belong to the Organization for Economic Cooperation and Development (OECD) (see table 4.3).<sup>17</sup>

There are three principal reasons for this situation, all of which point toward policy recommendations. First, the size of government tends to increase with GDP per capita, which implies that emerging-market economies require lower revenues than industrial countries. Figure 4.1 shows a positive correlation between tax revenues measured as a fraction of GDP and per capita GDP.<sup>18</sup> Moreover, the inflation tax, which is often an important source of revenue in emerging markets, is not included in tax revenue statistics. Recent stabilization attempts have increased the need to raise tax revenues from sources other than inflation.

Second, in emerging-market economies, income distribution is worse than in industrial economies, informality in the labor market is higher, and tax administration is weaker. Therefore, the income tax base is lower; income taxes fall on only a small fraction of the population,<sup>19</sup> many individuals pay hardly any tax at all, and the tax evasion rate is usually higher for taxes on income (which rely on self-declaration for many taxpayers) than for consumption taxes (which often have cross-checks built in, e.g., in the case of the value-added tax, or VAT).

Third, in many countries, foreign savings are very important (either because remittances from their citizens abroad are high or because they benefited from high capital inflows to emerging markets during much of the

---

17. Data for each country have been weighted by the total GDP calculated using the Atlas method of the World Bank.

18. Tax revenues were obtained either from the IMF's *Government Finance Statistics* or from IMF country reports, which usually provide a fuller account of the tax revenues raised by subnational governments. The regression does not change appreciably if oil-producing countries are excluded.

19. Sometimes this is explained by very high exemption levels in the personal income tax. Note that in the 1940s, when the United States had very high exemption levels, the Internal Revenue Service collected about 2 percent of GDP in personal income taxes, a fraction that is similar to that now observed in many emerging economies. See FIEL (1998b) for more details.

**Table 4.3 Average composition of tax revenues, various country groups, 2001**

Group	Social Security					Taxes on goods and services	Other taxes	Total
	Taxes on income, profits, and capital gains	contributions and taxes on payroll workforce	Property tax	Subtotal: Taxes on income and property	Taxes on			
<b>Percent of GDP</b>								
OECD <sup>a</sup>	12.4	9.7	2.4	24.5	7.7	0.3	32.5	
Latin America <sup>b</sup>	4.7	3.8	0.3	8.8	8.9	3.4	21.1	
Other emerging-market countries <sup>c</sup>	6.5	0.8	0.2	7.5	8.3	3.4	19.2	
<b>Percent of total tax revenues</b>								
OECD <sup>a</sup>	38.2	29.8	7.3	75.3	23.8	0.9	100.0	
Latin America <sup>b</sup>	22.1	18.1	1.4	41.6	42.1	16.2	100.0	
Other emerging-market countries <sup>c</sup>	33.9	4.2	1.0	39.1	43.2	17.8	100.0	

OECD = Organization for Economic Cooperation and Development

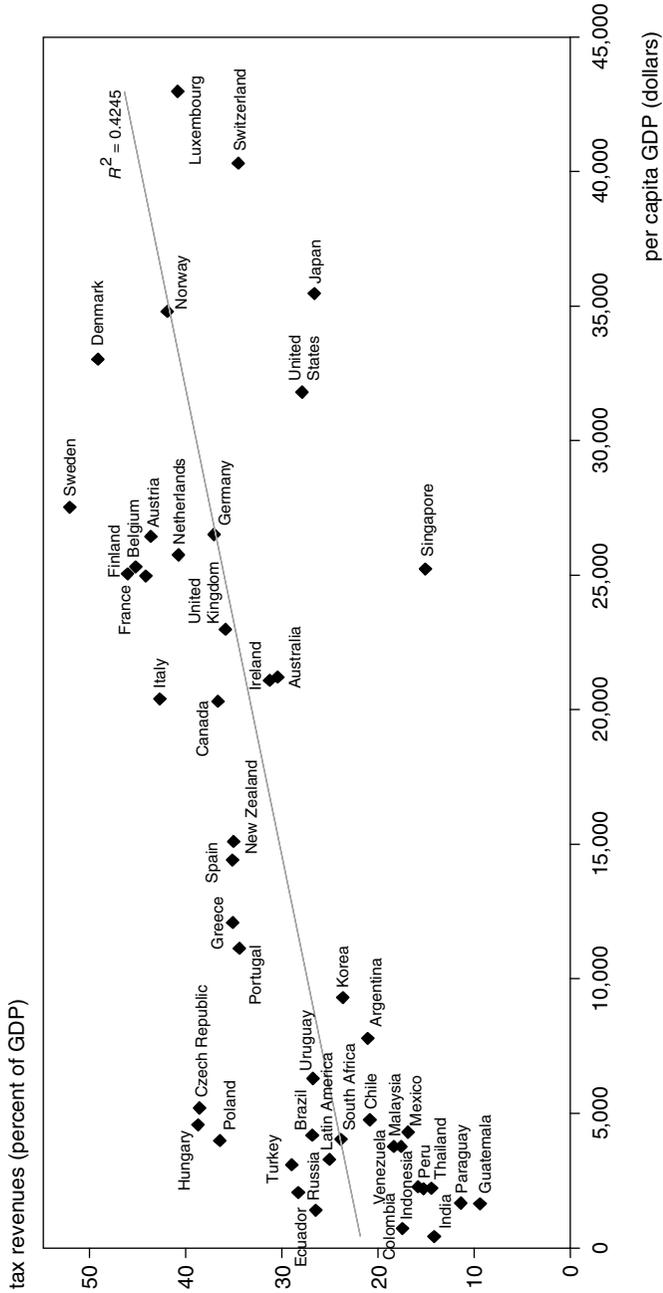
a. Excludes Mexico.

b. Latin America includes Argentina, Brazil, Colombia, Chile, Guatemala, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela.

c. Includes India, Indonesia, Malaysia, Russia, Singapore, Thailand, and Ukraine.

Sources: Own estimates based on OECD, *Revenue Statistics 2001*; IMF, *Government Finance Statistics*; and IMF country reports to complete data for subnational governments.

**Figure 4.1 Average tax revenues (percent of GDP) compared with per capita GDP (average 1997-2000)**



Note: Per capita GDP is determined using the method of the World Bank's Atlas.  
Sources: FIEL, based on OECD Revenue Statistics and IMF Country Reports.

**Table 4.4 Evasion rate for the value-added tax, selected Latin American and other countries, 1992 (percent)**

Country	Evasion rate
New Zealand	5.1
Sweden	5.4
Israel	7.8
Portugal	14.0
South Africa	14.6
Canada	23.0
Chile <sup>a</sup>	23.3
Spain	26.0
Uruguay	27.0
Honduras	35.4
Colombia	35.8
Hungary	36.3
Mexico	37.1
Ecuador	38.2
Philippines	40.8
Bolivia	43.9
Argentina <sup>b</sup>	46.5
Guatemala	52.5
Panama	53.5
Peru	68.2

a. Data are for 1994.

b. Data are for 1996.

Source: Silvani and Brondolo (1993).

1990s). Therefore, the base of consumption taxes is relatively enlarged in comparison with countries that are net exporters of capital. In some extreme cases, consumption is close to 100 percent of GDP.

## Informality and Tax Evasion

In emerging-market countries, high tax evasion rates and labor informality are serious problems. For example, Silvani and Brondolo (1993) estimated the evasion rate for the value-added tax for 20 countries in the early 1990s and found rates ranging from 5 percent in New Zealand to 68 percent in Peru (see table 4.4). Most Latin American countries have rates higher than 35 percent.

Tax evasion and labor informality create a dual economy with substantial differences in productivity whereby informal producers are able to compete with formal firms because they avoid paying the tax that the others pay to the government. This is also aggravated by the tendency to conduct many transactions in cash.

Tax evasion and labor informality have a serious impact on both efficiency and equity. The traditional method used in industrial countries to improve the distribution of income, a progressive personal income tax, is it-

self liable to be a source of serious inequity when evasion rates for taxes on income or property are 50 percent or even higher. One consequence in emerging-market economies with pervasive evasion is that social programs must rely more on targeted social expenditures than on the tax system.

The limited level of redistribution that can be achieved through the tax system and weak administrative capabilities in public agencies together suggest that pro-poor policies in emerging-market economies should put a special emphasis on incentives. For example, policies that rely on self-assessment of the beneficiaries of assistance are better than those that rely on selection by government officials (especially where local governments are too weak to handle the delivery of social policies).<sup>20</sup> Social expenditures that disproportionately benefit rich families should not be free of charge, or might even be privatized. In Latin America, this rule is not always followed; the clearest example is tuition-free public universities, where a large majority of the students usually come from rich or high-middle-income families.

Evasion is usually very high for taxes on labor; in many cases, the individual is not registered for social security. This occurs not only for some labor services performed by individuals but also in firms, where some employees are not declared to the social security system. Lowering taxes on labor has the advantage of encouraging the formalization of more workers and securing wider coverage of the social security network. Low labor taxes would also help to reduce unemployment. A deepening of formal financial intermediation, so as to capture those firms that have a closer integration with formal ones, would also help to reduce labor informality, as well improving controls on money laundering.

Small and medium-sized firms in emerging-market economies tend to enter into arrears for the payment of taxes because this is often a cheap way of accessing credit when the degree of financial intermediation is low and capital markets are underdeveloped. The preservation of the fiscal interest requires a penalty rate above market interest rates, and that rate may need to be very high in real terms to deter small and medium-sized firms because the spread between the borrowing rate of high-grade corporations and small firms is usually much higher in developing countries than in industrial ones. In other cases, the government forces firms to advance working capital to the government, even though this conflicts with normal commercial practices.

High tax evasion rates and weak tax administration have encouraged governments of emerging-market countries to obtain tax revenues from the consumption of some goods whose supply is concentrated and easy to control (e.g., fuels, cigarettes, soft drinks) or to extend the network of withholding devices much more than is the norm in industrial economies.

---

20. E.g., workfare programs for the unemployed look better than unemployment insurance. The role of government officials is less important in the first type of welfare program for the unemployed and individual's moral hazard is also better addressed.

There is, of course, an economic rationale for special taxes on fuel, cigarettes, and alcoholic beverages, because they create negative externalities. Most countries therefore apply higher tax rates to them than to other consumption goods.

However, the high tax rates levied by many emerging-market economies on goods that create no negative externality (e.g., soft drinks) suggest that governments have tried to ensure substantial tax collections from these sectors simply because they are easier to monitor. Although this may be sensible, its potential is limited by smuggling and round-tripping of exports, which have increased the proportion of illegal sales of many of these goods. This constrains attempts to extract revenues from these sectors.

Finally, labor informality is largely an endogenous phenomenon. When the benefits of being formal (access to credit, security, social security, avoiding penalties) are not large compared with the costs (red tape, high taxes), many firms and workers opt for informality. Thus, reducing informality requires a multifaceted approach, including effective enforcement, reduction of red tape and some tax rates, and improvements in transparency and the quality and equity of tax policy and administration, public expenditures, and public services.

## **Volatility in Tax Revenues**

In economies with high resort to external savings and a large fraction of tax revenues coming from consumption taxes, abrupt changes in capital inflows create major stress on tax collections. Consumption taxes tend to have lower payment lags than income or property taxes, and an important fraction of tax revenues comes from durable goods (because these have a relatively concentrated supply), whose consumption is relatively volatile. Thus there are several potential sources of high volatility in tax revenues. This strengthens the need to have budget stabilization funds in emerging-market economies.

## **Incidence of Taxes**

Small, open economies with capital mobility cannot “export” taxes to the rest of the world. In particular, capital will tend to bear the same burden as it bears in the country of origin of the investment because of the pressure for net-of-tax returns to be equalized. If capital is taxed more heavily, investors in the long run will move their investment to those countries where net returns (adjusted by differences in country risk) are higher. The same rule applies to domestic investors given their access to the capital markets of industrial economies.<sup>21</sup>

---

21. Tax havens and exemption of interest income accruing to foreign persons in some industrial countries, such as the United States, magnify the difficulty of taxing domestic residents.

This implies that there is a limit to the tax rate that can be imposed on capital; there is not much room to have tax rates higher than those prevailing in the industrial countries from which the capital came. Labor taxes, in contrast, will usually be borne by workers, except perhaps for the highly skilled who compete in a global market. Consumption taxes (most obviously those on tradable goods, whose price is fixed in the world market) are largely borne by consumers.

## Policy Recommendations

A suitable tax system for the central government of an emerging-market economy should be based on a generalized VAT of the consumption type, a progressive income tax with few exceptions and moderate marginal tax rates, a uniform duty on imports, and special excise taxes on goods that create negative externalities (e.g., cigarettes, alcoholic beverages, and fuels) and perhaps on luxury goods (Shome 1995). Subnational levels of government could rely on taxes on property and on a provincial VAT, calculated on the same tax base as the federal VAT. This tax system should be biased toward savings, so as to reduce dependence on foreign savings.<sup>22</sup> One way of doing this is to allow the expensing of investment, although this has a substantial fiscal cost because it de facto eliminates the business income tax at the margin.

Countries rich in natural resources have another important potential source of revenue. If reserves are relatively well known, it is efficient and transparent to rely on a system that tries to capture the rent of exhaustible resources in a competitive auction (e.g., the “bonus bidding” used by the US government for offshore oil leases) and to subject firms to the same tax treatment as that for other sectors of the economy (plus a small royalty).<sup>23</sup>

Tax administration can be strengthened by encouraging, or even requiring, firms to use the formal financial system (e.g., by obliging firms to pay wages and salaries through the banking system). Replacement of labor taxes by high excises (except perhaps on fuels, which are an important input in many tradable activities) is another reform worth exploring, provided the risk posed by smuggling and round-tripping in exporting countries is not severe.

Summing up, the key reforms in this area are improved tax administration; the promotion of domestic savings through greater dependence

---

22. Tanzi and Zee (1998) found that higher taxes in general reduce household savings in OECD countries, but that income taxes have a much higher impact than consumption taxes.

23. When reserves are not known, the government might find it helpful to use a battery of instruments so as to reduce uncertainty about the value of a field. One alternative is to auction exploration leases with clear requirements of reversals of part of the area; another is to have sliding royalties linked to the size of the discovery, although this creates a distortion in the net price faced by the company.

on the VAT than in industrial countries; more scope for property taxes levied by subnational governments; and a lowering of labor taxes, to encourage the formalization of labor and reduced unemployment.

## **Budget Mechanisms and Critical Public Spending**

We turn now to a discussion of the budget mechanism, including the design, incentives, and monitoring of public spending in critical areas. The budget is a process that coordinates spending decisions, provides a macroeconomic framework, and establishes public policy credibility. But beyond this, certain areas of government spending are especially crucial for emerging-market economies—because they involve functions that only the government can provide, tackle severe problems of social policy, or are fundamental to increasing aggregate productivity. The goals are to design efficient, cost-effective programs, and to avoid corruption and political rent seeking. Privatization has provided a way to delegate expenditures that in industrial economies are in some cases provided by the state, which has shifted resources from the explicit budget. But privatized industries have had mixed results in some emerging-market countries.

Many things could be said on these issues, but we limit our remarks to a few points. First, program evaluation and accountability need to be based on a measurement of output (preferably in physical terms) and costs. This is one of the bases of a system of well-ordered budgetary decisions, spending procedures, registry, disbursement and control, and debt management. Such a system is crucial for orderly and effective fiscal performance, which is important to provide transparency to both domestic and foreign observers, and therefore to achieve access to financing on reasonable terms.

Experience points to the desirability of a legal framework that both covers in an integrated manner the financial management of the country and also establishes a timeline for the delivery of the budget in due time and form. This requires setting guidelines for the presentation of the budget, and describing the financial and macroeconomic hypotheses on which it is based. The legal framework should require that the message accompanying the budget include a careful assessment of the current fiscal year, as well as a comparison with the new budget and with the trend from the past 5 years or so.

In the elaboration of the budget, use and explicit mention should be made of the national accounts projections, of the monetary program, of the balance of payment accounts, and of the 5-year forecast implied by current policies. Also, as stressed in previous sections, explicit estimates of the implicit or contingent debts as well as of tax expenditures should be included in the presentation. A very useful rule that is part of the bud-

get legislation of some emerging-market countries is that initiatives on the level of public expenditures can be taken only by the executive power, leaving the national legislature with the right to accept or reject, but never increase, spending.<sup>24</sup> This avoids incentives for opportunistic or demagogic behavior that are common in many contexts.

These criteria should be applied to subnational governments as well. It is desirable to avoid a proliferation of nonbudget operations, which weaken information and management systems.

It is crucial that budget limits be set so that they cannot be changed, after an executive or legislative initiative, except within the framework of a comprehensive budget amendment. The budget must be elaborated with provisions to accommodate unexpected events. The level of spending should not change if tax revenues increase above the projected level. It is very important to set penalties for noncompliance with the budget, which should be communicated annually to the corresponding authorities, as is enshrined in the laws of many countries.

Emerging-market countries need to improve the productivity of resources devoted to areas of exclusive public spending, such as the provision of justice and legal services.<sup>25</sup> By their very nature, public goods or social goods with multidirectional externalities lack a market reference for the prices or values to be used in a cost-benefit analysis. This makes evaluation of provision and spending a difficult task, especially because the measurement of quality is tricky for many public services. Problems of asymmetric information, transaction costs, and weak property rights are all present and make it difficult to find a solution through either the market or the government. International experience during the 1990s showed important efforts to decentralize and outsource activities<sup>26</sup> as well as to introduce user charges designed to limit severe cost inefficiencies and waste of resources.

Other efficiency mechanisms include benchmarking, multiyear budgets for comparative purposes, and the use of physical units and of explicit costs of provision. In this task, the precise definition of goods, services, and processes is crucial for establishing standards from which to define cost-effectiveness and to facilitate monitoring and control. Here, the agenda is very large and important for emerging-market economies. In the past, high inflation rates and the difficulties of fiscal management in such an unstable scenario weakened efforts to properly monitor expenditures.

---

24. The ministry of finance should be in charge of the consolidation of budget authorizations and may even have a veto power inside the executive branch.

25. Costs in these areas are often high, which acts as a tax on real activity and depresses investment and employment. In Argentina, studies have found high costs in relation to performance at the federal level (see Artana, Cristini, and Urbiztondo 1995) and more serious quality problems at a state level.

26. This is true even of the auditing process in the case of New Zealand.

In some emerging-market countries, services may be provided through regulations that in industrial countries are provided through public spending and financed with contributions earmarked for that purpose. For instance, in some countries unemployment insurance comes in the form of labor regulations that establish compensation for being fired.<sup>27</sup> This is not registered in public-sector accounts, but it should be included when budgets are being compared.

Another important issue is the focalization of social expenditures to avoid undesirable leakages to sectors, households, and regions. This is important for both budgetary and distributive reasons. Here is where it is most important to compare the cost of public provision with the mechanism of subsidizing demand. Education and health sectors are the prime examples of the potential of the latter.

Summing up—given a long list of reasonable points in this area—we stress three topics. First, program evaluation and accountability require mechanisms that incorporate the measurement of physical units and the cost of provision. Second, delegated expenditures in the form of private-sector provision, which usually is done with new regulations and by-passes budget processes, need to be incorporated into the assessment and control of fiscal policy. Third, the demand-subsidy approach seems the best way to tackle problems of efficiency, cost-effectiveness, and corruption in most social programs.

## **National and Supranational Institutional Frameworks**

One of the main contributions of the analysis of fiscal policy and fiscal institutions in the past decade has been the characterization of the incentive problems that exist in weak institutional settings, where decentralized decisions without proper rules or procedures create incentives for overspending and a bias toward deficits. This is the so-called common pool problem, a term borrowed from the literature on competitive or multidirectional externalities that exhaust natural resources. The point is that individuals or actors perceive the full benefit of their action, but common property dilutes the costs among all participants.<sup>28</sup>

---

27. Of course, unemployment insurance and severance payments are not equivalent in allocative or welfare terms. The point here is that regulations are in some cases a substitute, albeit an imperfect one, for spending programs. E.g., in Argentina in 2000, the equivalent of 1.5 percent of GDP was spent on these alternatives to unemployment insurance.

28. See the volume edited by Poterba and von Hagen (1999). For Latin America, Heymann and Navajas (1989) provided an early formalization of the argument for Argentina, and a vast research program has subsequently emerged, with substantial contributions by, *inter alia*, Alesina et al. (1996) and Stein, Talvi, and Grisanti (1998).

In the context of fiscal policy, this cost-benefit asymmetry implies that an absence of rules or coordinated procedures creates a bias toward spending by decentralized decisions that do not fully internalize the costs, leading to inefficient fiscal outcomes. Thus there is a need for institutional and procedural arrangements to eliminate or at least constrain such bad incentives. Explicit fiscal rules or budgetary procedures that lead participants in the budgetary process to internalize the costs of budget deficits will lead to more efficient fiscal outcomes.

The implications of the common pool approach are clear enough regarding the need to change incentives and solve coordination failures among different participants. But the approach leaves open the question of how to achieve the desired change. One way is to design explicit rules intended to restrict outcomes. Another is focus on the design of the budget process. Recent studies have still not definitively answered this question. The preference for explicit (constitutional or statutory) fiscal rules (e.g., debt ceilings, balanced-budget rules, and expenditure limits) is based on the view that designing constitutional rules is difficult and political transaction costs make them difficult to enforce.

However, recent studies—such as Kennedy and Robbins (2001)—have argued that rules are not a necessary condition for good fiscal outcomes; these can be, and have been, attained in contexts without explicit fiscal rules.<sup>29</sup> Kennedy and Robbins use evidence from many industrial countries to compare the performance achieved with and without fiscal rules, and they cite Canada as an example of a country that has achieved fiscal consolidation without explicit rules at the federal level.<sup>30</sup> They argue that the real test of rules (a recession) has not occurred in some cases (e.g., the United States) or has given rise to reversals (e.g., Japan). They do not say that rules cannot be useful, but they question the view that rules are sufficient to ensure good fiscal outcomes.

We do not see this as an argument for not using rules, but rather conclude that efforts to improve institutional design may also be worthwhile, if there is a need for improvements in this dimension. The distinction between explicit rules and procedural design is not a debate on the merits of centralization (for they both attempt to resolve a coordination failure) and does not challenge the evidence in favor of a strong executive role that is stressed in the literature. The relevant question is not so much rules versus procedures as whether countries with given institutions and budget procedures can improve fiscal outcomes by introducing explicit rules. In many cases, the answer seems to be positive.

---

29. Braun and Tommasi (2002) make a similar argument against the “simplistic view” that numerical limits on fiscal variables provide a solution for fiscal profligacy by subnational governments.

30. In fact, Canada has balanced budget rules and expenditure limits at the subnational level, but the brunt of the fiscal consolidation efforts of the 1990s fell on the federal government.

Countries have established or proposed a variety of different mechanisms intended to nurture more balanced and predictable fiscal policies: a variety of fiscal responsibility laws, in some cases extended to subnational levels; debt targets; balanced-budget requirements; and expenditure evaluation programs. In some cases, explicit penalties for noncompliance have been a part of the legal framework; but evidence suggests that commitment is a major problem in the presence of external shocks.

In other cases, supranational agreements have sought to improve fiscal institutions (e.g., the Maastricht Treaty and the complementary European Union Stability and Growth Pact, with the penalties they foresee in case of deviations from the established criteria concerning fiscal deficits). Such fiscal limits are intended to constrain during the adverse phase of the business cycle, and it is therefore expected that countries will achieve a lower deficit than the limit or a surplus in better-than-normal times.

There are also ceilings on public debt that are intended to force a considerable effort in the future to reduce deficits. In all cases, the intention is to provide a transparent and long-term focus for budgeting so as to facilitate parliamentary and public scrutiny and assessment of economic and fiscal plans. They should in turn reinforce the credibility of fiscal policy, reduce risk, and create conditions for more durable stability.

An unusual aspect incorporated into the European Union's Maastricht Treaty is the requirement during the preliminary phase that the rate of interest on public bonds be no more than 1.5 percent above that of the most stable countries. This limits the acceptable spread between countries, a concept similar to the country risk premium concept for emerging-market economies. Its inclusion as a criterion is very significant, because it involves private-sector evaluation of public policy and judgment of the consistency of fiscal plans. Even more, the "price" of public spending, which in the end is no more than a bundle of investment projects, is the same rate of interest on debt issues by which public-sector activities are financed. If enough attention had been paid to this last point, many emerging-market countries would have anticipated the risks of a future crisis and might therefore have avoided the excessive debt buildup so common in the past decade.

Our view is that the promulgation of this legal framework would be an extremely valuable component of an agenda that seeks public policy credibility and facilitates the development of capital markets, thereby fostering macroeconomic stability and growth. It would be even better if such a framework were embodied in international treaties that included agreements on measurement standards for public accounts.

We offer one final comment on how to make new fiscal institutions credible. In emerging-market economies, credibility in public policies and laws is often a scarce resource. Clear "exit costs" for abandoning the rules are key. There is no unique answer to this problem. Depending on the history of each country, the independence of its judicial system, and the qual-

ity of the electoral process for the national legislature, different solutions are possible. In some cases, a law might be enough; in others, it might be necessary to amend the nation's constitution; and in extreme cases, it might be necessary to "buy" that credibility from other countries. Bilateral or multilateral agreements with other countries, analogous to the Maastricht agreement, are a possibility if it is clear what is at stake if a country violates the rules.

## Concluding Comments

This chapter has presented an agenda of reforms that we believe would contribute to creating a transparent and predictable fiscal environment. It would not only consolidate a country's public policy management and performance; it would also achieve better integration into world markets, thus improving the country's opportunities for growth.

The discussion has taken advantage of treatments in previous analyses of fiscal policy in Latin America. We have recommended an agenda for action intended to further a wide-ranging process of institutional reform undertaken by emerging-market economies seeking to overcome the acute difficulties of the 1980s and the very volatile environment of the 1990s.

It needs to be noted that many of the reforms included in the agenda have in fact already begun to be implemented, as part of the macroeconomic stabilization of the 1990s. This move toward stability brought a reward: the end of the previous debt crisis and renewed access to capital markets, leaving behind the financing mechanisms of the 1970s that were based on commercial and multilateral credit and syndicated loans from multinational banks.

It is important to stress that the proposals made here are complementary—particularly concerning the procyclicality of fiscal policy, the recognition of debts, the control of public expenditures, the reconciliation of macroeconomic stability and decentralization, the correct design of the tax system and its administration, the budgetary mechanism and its incentive and monitoring elements, and the various initiatives for institutionally controlling fiscal policy. Such an agenda is feasible in view of the widespread recognition that fiscal policy is at the center of economic performance in emerging-market economies.