Government at a Glance:
Latin America and the Caribbean 2014
Towards Innovative Public Financial Management

Chapter 1

Fiscal and budget innovations and the commodities boom in LAC countries: A winning decade?

Introduction

Latin America and the Caribbean (LAC) countries have struggled for more than three decades with economic volatility, financial crises, and difficulties to maintain credible fiscal policy frameworks. Throughout the 1980s, a period often referred to as the "lost decade", many countries in the region defaulted on their high debt due to a host of issues, including rising interest rates, skyrocketing oil prices and a deterioration of exchange rates. As a result, inflation increased, income dropped and unemployment soared, generating problems that affected the region for many years.

Nevertheless, beginning in the late 1990s and early 2000s, the region underwent a period of fiscal management reforms that sought to promote stable and sustainable fiscal policy in the short term, and macroeconomic stability and growth in the long term. Among these reforms, fiscal rules, medium term fiscal frameworks, stabilisation funds, and performance budgeting stand out as important tools, even though they were not applied uniformly or in an integrated manner. The ability of a few LAC countries to mitigate the effects of the 2008-09 global economic crisis provides some evidence of the region's capacity to use these reforms to harness the benefits of the commodities boom and to introduce some countercyclical fiscal measures.

During this time, many countries in Latin America and the Caribbean also experienced significant reductions in poverty and inequality, although the region remains one of the most unequal in the world. The road towards macroeconomic and fiscal stability that supports poverty reduction and other development objectives in the region has not been continuous nor is it complete. Although the commodities boom that swept the global economy helped improve macroeconomic and fiscal positions in many LAC economies, the recent financial and economic crisis illustrates some of the structural fiscal shortcomings that are still present in the region.

The data collected in this publication allows for a comparison across countries of the individual progress in these areas within the LAC region and for a comparison of the region as a whole with OECD countries. Such a regional comparison; however, must also consider two key policy issues: 1) the different roles of government, examined from public finance, employment, compensation, procurement and angles; and 2) the relationship between economic and fiscal volatility in the LAC region, and the adoption of innovative fiscal reforms and budgeting practices to improve fiscal stability and to strengthen financial reserves. In addition, it is also important to keep in mind the major differences in these issues across LAC countries.

The role of governments in Latin America and the Caribbean

Citizens and businesses' expectations of governments are broadly similar in both LAC and OECD countries; however, LAC countries have smaller governments and public sectors than the OECD average. While OECD countries have historically accumulated institutional capacity, a trained bureaucracy and sufficient financial resources, LAC countries are at an earlier stage of institutional development with fewer available resources, weaker governmental capacity and are consequently performing fewer tasks and providing fewer services.

Compared to OECD countries, democracies in LAC countries are relatively young. Most were only consolidated by the mid-1980s, with elected presidents in all countries only by the early 1990s (Marcel, Guzman and Sanguinés, 2014). This is in sharp contrast to the majority of OECD countries that developed into well-functioning democracies over the last 60 years. During this period, many European countries consolidated their welfare states. Furthermore, in LAC countries the development of the public administration during the 1990s was strongly influenced by libertarian notions that called for small, non-interventionist governments, as well as by New Public Management (NPM), which emphasises efficiency and contractual relationships (OECD, 2012).

In this new century, significant social changes have also occurred in the LAC region. Between 2003 and 2009 the size of the middle class, measured by disposable income, increased by 30% from 103 million people in 2003 to 152 million in 2009 (World Bank, 2012). In consequence, poverty rates have also steadily declined: since 2002, poverty in the region dropped by 15.7 percentage points and indigence by 8.7 percentage points (ECLAC, 2013a). In addition, the deepening globalisation process and the surge of new communication technologies have strengthened citizens' ability to scrutinise government actions and have improved the organisational capacity of relevant stakeholders.

The increased pace of economic development has added to the number and complexity of tasks that require government intervention. Governments in LAC countries are now responsible for the provision of public goods, the delivery of services, the stabilisation of the economy and the promotion of social equity through the redistribution of resources. Adding to these tasks, governments also regulate the behaviour of economic agents and the civil society, as well as co-ordinate and mediate among them.

More recently, governments became active in the areas of environmental protection, economic integration and gender equality. At the same time, the increase of government activities has been accompanied by the rise of various delivery mechanisms, including direct provision and outsourcing to the private and non-for profit sectors; as well as intermediate schemes, such as Public-Private Partnerships (PPPs), which substantially increase the complexity of government operations and the number of actors involved.

Although LAC societies are predominantly young, demographic change is unfolding: life expectancy will continue to rise, urbanisation will deepen and the empowerment of women will further boost their education and employment prospects but will also increase demand for public services, such as institutionalised care for children and the elderly. The share of women entering the labour market and participating in politics has steadily increased over the last decade and this trend is expected to continue. In LAC countries, the participation of women in general government employment has grown by two percentage points between 2001 and 2010. It is currently slightly below 50%. Nevertheless, the employment of women in the general government represents a higher share of the total female labour force (14%). This figure is 10% for men (see section on "Women in general government").

Furthermore, the demand for tertiary education will continue to rise as more people complete secondary levels of education. This will result in an increased demand for more and new public services, as well as financial help from governments. As democracies, backed by a growing middle class, continue to strengthen in the region, the poor will also attain a stronger voice, increasing the demands for state services. The subsequent increase in fiscal pressure will require the development of comprehensive tax systems. This will only be possible to the extent that citizens in LAC countries trust their governments and their capacity to provide public services transparently and effectively.

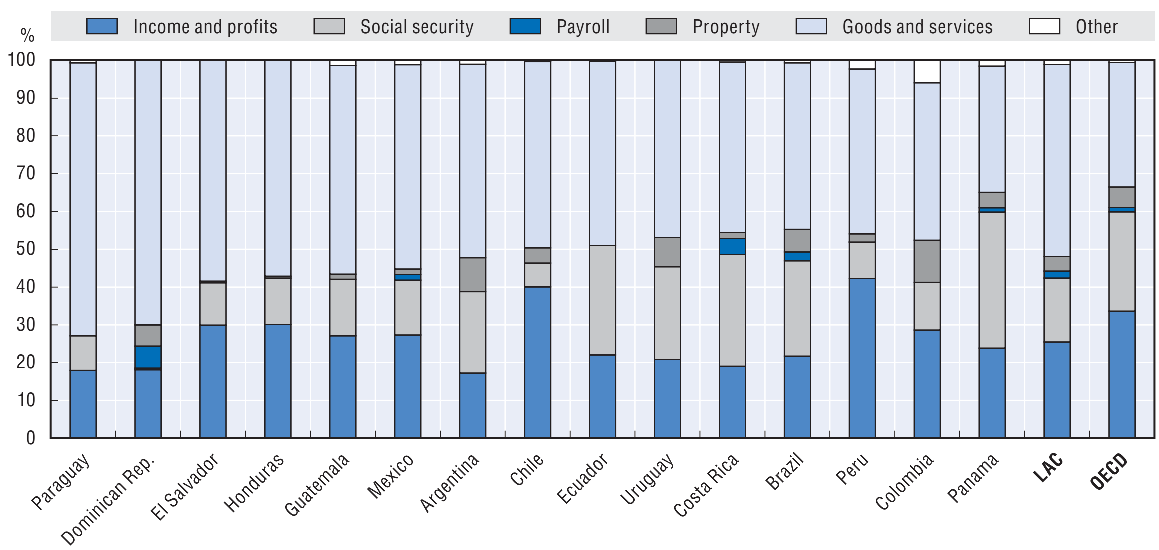
Based on the indicators in this publication, the section and sub-sections below analyse selected dimensions to measure and compare LAC governments' performance in key public management areas.

The size of government

Government revenues and expenditures

On average, government revenues in LAC countries represent 25.6% of GDP: this is in stark contrast to the OECD where they reach 41.9%. Furthermore, the revenue sources also differ substantially. On average, LAC countries rely heavily on taxing goods and services which represent over 50% of their revenues, while OECD countries on average only obtain one-third of tax revenues from this source. In contrast, OECD countries receive more tax revenues from taxing income, profits and contributions to the social security system (Figure 1.1). Taxing consumption is preferable to taxing the sources of production, as its impact on economic growth – especially export growth – and employment is less detrimental. However, it is generally a regressive tax system, disproportionately affecting lower income individuals, as opposed to a progressive income and profit tax system that reduces income inequality.

Figure 1.1. **Breakdown of tax revenues as a share of total taxation (2011)**



Source: Data for the LAC countries: OECD (2014), *Revenue Statistics in Latin America* (database). Data for the OECD average: OECD (2013), *Revenue Statistics* (database).

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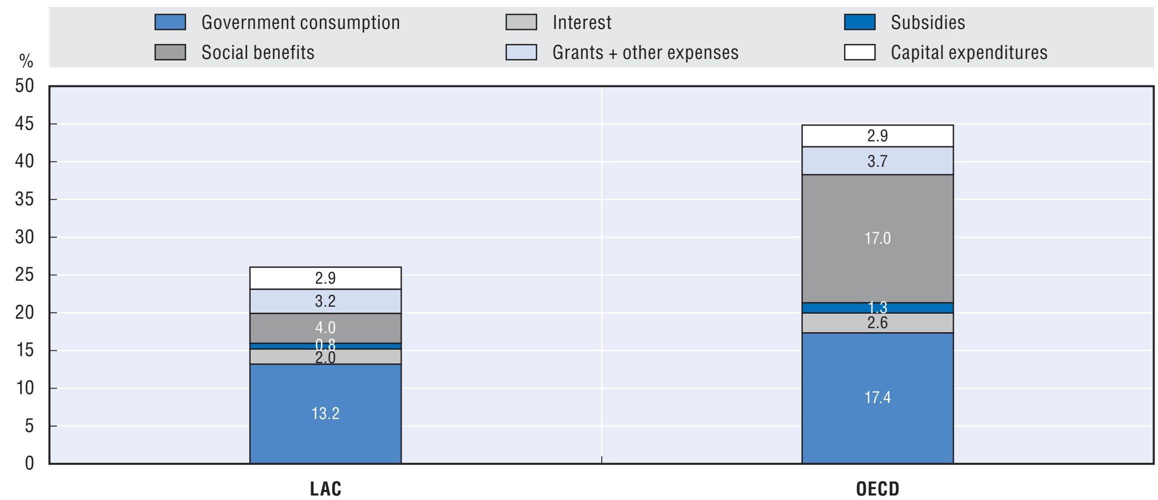
Although LAC countries have made progress in the area of taxation in the last decade, significant challenges remain. Overall, the region collects less than what its level of development would suggest. Furthermore, the structure of taxation is biased towards non-progressive taxes and tax evasion levels are significant. Another important source of tax revenues in several LAC countries is taxation on non-renewable natural resources (NRNR). The revenue collected in many countries, and especially in Central America and the Caribbean countries, that do not benefit from NRNR exports is often insufficient to address developmental needs. In addition, fiscal volatility incurred because of external shocks and commodity price fluctuations aggravates this gap.

More broadly, it can be stated that in spite of important shortcomings in tax collection, most LAC countries over the past two decades have strengthened their tax administrations through increased technical and financial autonomy (including earmarking a part of the collected revenue), better human resources and better information and communications technologies (ICT).

In general, LAC governments are considerably smaller than governments in OECD countries when comparing public expenditures, revenues and employment. In 2011, government expenditures in LAC countries represented on average 28% of GDP, compared to 45% of GDP for OECD countries (see section on "General government expenditures"). Moreover, the expenditure breakdown reveals several differences in how the money is spent. The most salient difference relates to expenditures on social benefits, defined as payments directly linked to the welfare function of governments. As a share of GDP, OECD governments spend 17% on social benefits, compared to only 4% in LAC countries (Figure 1.2). Furthermore, LAC countries spend 4.2 percentage points less in government consumption.

Figure 1.2. **Structure of government expenditures as a share of GDP (2011)**



Note: Government consumption is the sum of expenditures on compensation of government employees plus purchases of goods and services. Interest on public debt has been measured as consolidated interest payable by general government. Subsidies are current unrequited payments that governments make to enterprises on the basis of the levels of their production activities or the quantities or values of the goods or services which they produce, sell or import. Social Benefits refer to the two main categories of social benefits other than social transfers in kind (e.g. pensions and unemployment benefits) and social transfers in kind related to expenditures on products supplied to households via market producers. Grants + other expenses include other current transfers, capital transfers and other remaining expenses (e.g. property income other than interest). Capital expenditures encompass gross capital formation plus acquisitions less disposals of non-produced non-financial assets. Data for Brazil, Peru and Paraguay are recorded on a cash basis. Consumption of fixed capital is not recorded for Brazil, Costa Rica, Honduras, Paraguay and Peru. For the list of LAC countries included please refer to Figure 1.3. OECD average does not include Chile and New Zealand.
Source: IMF, *Government Finance Statistics* (IMF GFS) (database). Data for Mexico and OECD countries are based on the *OECD National Accounts Statistics* (database).

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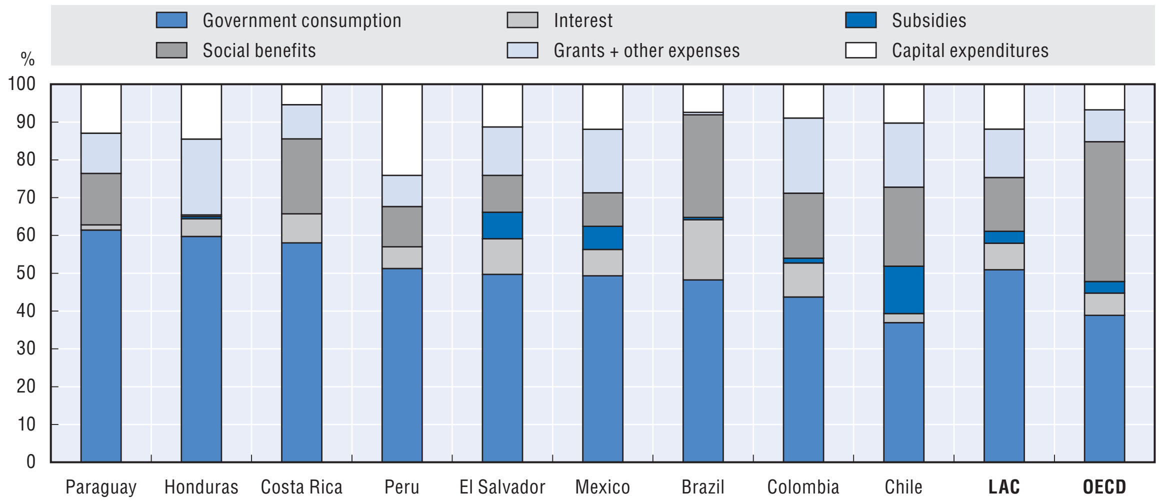
A further breakdown of government expenditures (Figure 1.3), shows that on average, over 50% of expenditures in the LAC region are devoted to government consumption, which is the compensation of government employees plus the purchases of goods and services by the government, compared to 39% for OECD countries. Furthermore, while on average, LAC countries have lower debt levels as a share of GDP than OECD countries (41% and 79% respectively), a higher share of their expenditures is devoted to interest payments (7% in LAC countries versus 5.9% for OECD countries). Markets still perceive LAC countries as risky and charge a higher premium for lending. In summary, LAC governments devote a higher share of resources to the basic infrastructure of government: running a bureaucracy and guaranteeing the state's presence in several areas where it is required, and dedicate substantially less to the provision of social benefits for their populations.

Brazil, Chile and Costa Rica are the countries that spend the most on social benefits (27%, 21% and 20% respectively). Brazil has the highest debt interest, reaching 16% of total expenditure. Colombia (44%) and Chile (37%) have the lowest levels of government consumption. For Chile, the figure is below the OECD average.

Finally, many LAC countries have inherited an organisational structure based on Franco-Iberian traditions and the importance of legislation and rules as mechanisms of regulating public management. This practice, however, has resulted in a proliferation of laws, organisations and

Figure 1.3. **Structure of government expenditures (2011)**



Note: Government consumption is the sum of expenditures on compensation of government employees plus purchases of goods and services. Interest on public debt has been measured as consolidated interest payable by general government. Subsidies are current unrequited payments that governments make to enterprises on the basis of the levels of their production activities or the quantities or values of the goods or services which they produce, sell or import. Social Benefits refer to the two main categories of social benefits other than social transfers in kind (e.g. pensions and unemployment benefits) and social transfers in kind related to expenditures on products supplied to households via market producers. Grants + other expenses include other current transfers, capital transfers and other remaining expenses (e.g. property income other than interest). Capital expenditures encompass gross capital formation plus acquisitions less disposals of non-produced non-financial assets. Data for Brazil, Peru and Paraguay are recorded on a cash basis. Consumption of fixed capital is not recorded for Brazil, Costa Rica, Honduras, Paraguay and Peru. OECD average does not include Chile and New Zealand.

Source: IMF, *Government Finance Statistics* (IMF GFS) (database). Data for Mexico and OECD countries are based on the *OECD National Accounts Statistics* (database).

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oversight procedures that were created in order to control corruption, clientelism and informality in government. This culture of regulation combined with and lack of resources has produced a highly centralised system of decision making and has increased the role played by the presidency and Ministry of Finance in governing the allocation of public expenditure.

Public procurement

Public procurement is the way in which goods and services are purchased by governments. In LAC countries, it represents on average 26% of total government expenditure (see section on "Public procurement spending"), slightly less than in OECD countries with 29%. Due to its complexity, the size of the financial flows it mobilises, and the close interaction between the public and the private sector, public procurement is an activity that is vulnerable to waste, fraud and corruption. This is particularly true for the LAC region, which has been historically plagued by these types of events.

LAC countries have made some progress in establishing public procurement procedures to promote integrity, such as guaranteeing that procurement information is published and made widely available in LAC countries. Nevertheless, the region still needs to promote various integrity and anti-corruption measures to ensure the transparency, good management, accountability and control of procurement systems. Codes of conduct are not commonly used and neither are special measures intended to prevent and detect fraud or corruption. In these categories, Costa Rica and the Dominican Republic are the only two countries that showed some progress.

In the LAC region, public procurement is not widely utilised as a tool to promote strategic governance objectives. The incorporation of social and environmental objectives into the procurement process is relatively low; with 40% of LAC countries incorporating these into their procurement frameworks (see section on "Special feature: Sustainable public procurement"). In contrast, policies and strategies to promote green procurement and SMEs, and to support innovative goods and services exist in 80%, 74% and 51% of OECD countries respectively.

Public employment and compensation

As a percentage of the labour force, LAC countries have fewer government employees – 10.7%. This figure remained unchanged between 2001 and 2010 and it is lower than the corresponding figure for OECD countries of 15.3% in 2010 (see section on "Public sector employment"). Government employment varies greatly in both OECD and LAC countries Argentina, for example, is at one end of the spectrum with 14.8% of the labour force made up of general government employees compared to less than 4% in Colombia, while OECD countries range from 30% in Norway to 6% in Korea. Nevertheless, the biggest difference between OECD and LAC countries is that LAC public administrations are generally "pre-bureaucratic" (OECD, 2012), and are characterised by a high share of political appointments and the lack of a formal professional civil service, affecting the continuity and effectiveness of public policies.

In several LAC countries, bureaucracies are not merit-based and are usually comprised of low-skilled workers protected by strict contractual labour arrangements, and managers appointed based on their political affinities. Furthermore, the region has a reputation for developing clientelistic networks of public staff responding to political leaders. Under such a framework, it is not guaranteed that the most capable people will fill public positions. One of the biggest challenges facing LAC countries is the need for the professionalisation of their civil service. Several countries including Brazil, Chile, Mexico and Peru have undertaken reforms in this direction in recent years, but the effects are still uncertain (OECD, 2012). Building both the autonomy and capacity of bureaucracies in LAC countries is necessary to reinforce public sector innovation and policy effectiveness (OECD, 2014).

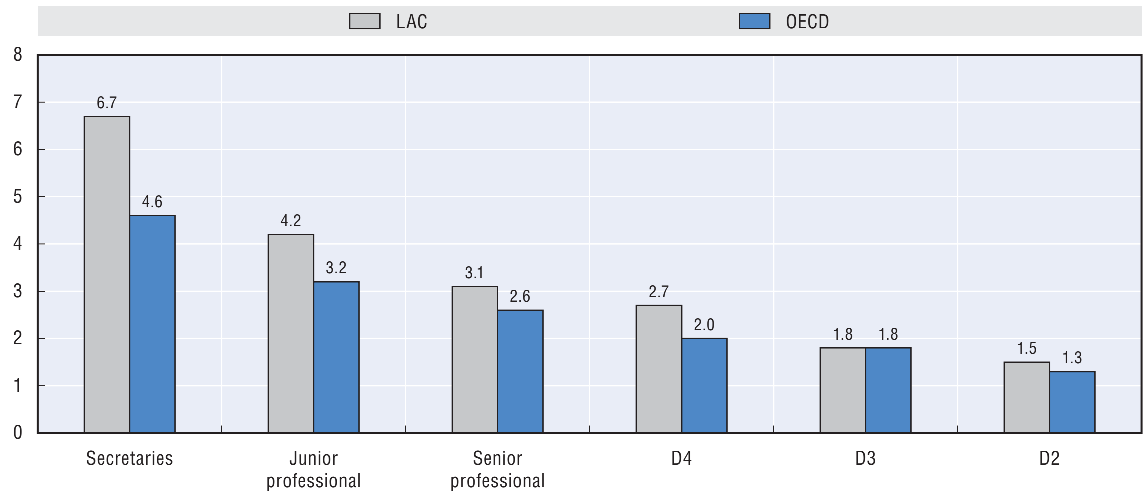
Compensation of key central government occupations

For the first time in the LAC region, this publication collects compensation data for selected key occupations within central government ranging from secretaries to senior managers. The objective of collecting this data is to examine the attractiveness of government employment in the LAC region and governments' ability to attract the most qualified employees, which is an essential component for the professionalisation of the civil service.

In absolute terms, adjusted for purchasing power parity, compensation levels for key government occupations are lower in LAC countries than in OECD countries. This is reflected not only in wage levels, but also in the share of the compensation devoted to social contributions. In relative terms, measured as a share of GDP, compensation levels in LAC countries are higher than in OECD countries (see indicators on compensation of public employees). At the same time, differences in compensation levels are also greater in the LAC region than in OECD countries. For example, while compensation of senior managers in OECD countries is 4.6 times higher than the compensation of secretaries, in the LAC region this difference is 6.7 times (Figure 1.4). This reflects the higher income inequalities within LAC societies. In 2010, the average Gini coefficient for the LAC region was 0.50, ranging from 0.57 in Honduras to 0.45 in Uruguay, where 0 means that each share of the population has the same income, while 1 means that the richest individual has all the income. While these values are close to the Gini coefficient for OECD countries pre-tax (0.47), the tax system performs significantly less well as a tool for redistribution, leaving the coefficient almost unchanged in the LAC region before and after taxes (OECD, 2012).

This section examined the role of government in the economy and society, e.g. as a key spending agent, as a redistributor of revenues, as a creator of public employment, as an employer setting wages and as the allocator of public resources. The indicators show that public resource expenditure in the

Figure 1.4. **Compensation ratio in comparison to D1 – highest level of – senior managers (2011)**



Source: 2013 OECD Survey on Compensation of Employees in Central/Federal Governments.

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region can be further improved by putting public management practices in place that make government more strategic by professionalising the public service and investing in the capacity needed to improve performance and outcomes.

The next section will look at the relative fiscal performance of LAC countries through the lens of the commodities boom and the early adoption of good fiscal and budgetary practices following the last decade boom.

Economic and fiscal volatility in the LAC region and the adoption of innovative fiscal reforms and budgeting practices

LAC countries have made important progress in improving the region's resilience to fiscal volatility and strengthening public finances through the use of fiscal rules, medium term fiscal (and budget) frameworks and stabilisation funds. Overall, the last decade was characterised by sustained growth, a sharp reduction in gross public debt and an increase in tax revenues. Furthermore, these advances led to an increase in public spending in almost all LAC countries that contributed to a reduction in poverty levels in the region (see Chapter 2 on "Public finance and economics").

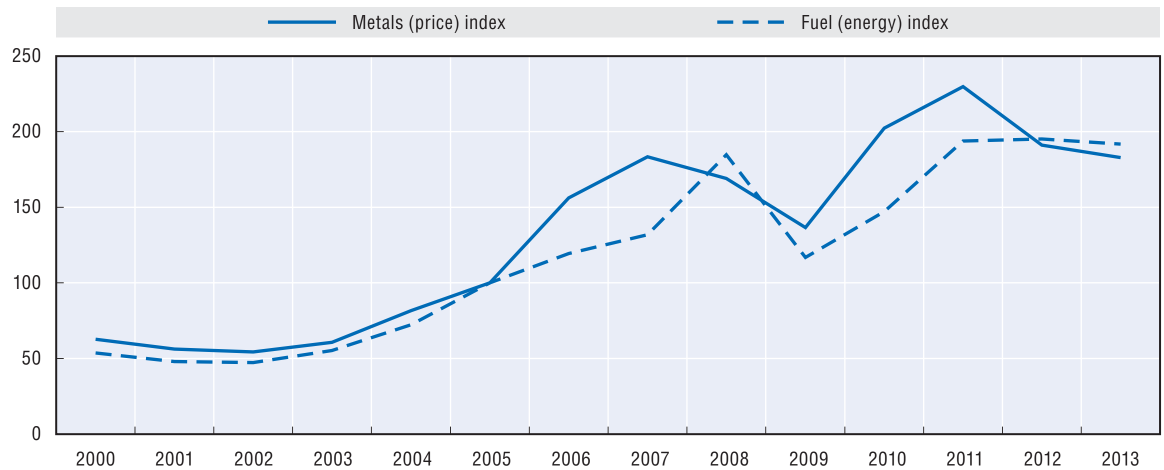
The commodities boom and its effect in LAC

The recent decade-long commodities boom drove revenues derived from oil, minerals, and other primary commodities upwards and paved the way for several LAC countries to improve their macroeconomic performance. As a result of increased demand from China and other emerging economies, prices for NRNR reached unprecedented levels between 2003 and 2008. Copper prices, for instance, increased nearly fivefold between 2000 and 2011, greatly benefitting Chile, which is currently the world's largest exporter of this mineral. Oil prices also reached historic heights during the same period, benefitting several oil-exporting countries such as Mexico and Venezuela (Figure 1.5).

In addition to favourable market conditions, a number of countries enacted legal reforms to increase the governments' take from natural resource rents in light of the economic boom. This stands in contrast to the period 1990-2003, where economic rents and fiscal contributions of the NRNR sector were lower. Governmental reforms to increase revenue from non-renewable resources in the past decade were aimed at direct government participation in the exploitation of these resources, royalties, and taxes with differential rates charged to extractive companies.

Figure 1.5. **Index of international commodity prices (2000-13)**

Index 2005 = 100



Note: Metals Price Index, 2005 = 100, includes copper, aluminium, iron ore, tin, nickel, zinc, lead, and uranium price indices. Fuel (Energy) Index, 2005 = 100, includes crude oil (petroleum), natural gas, and coal price indices.

Source: IMF, *Commodities Database*.

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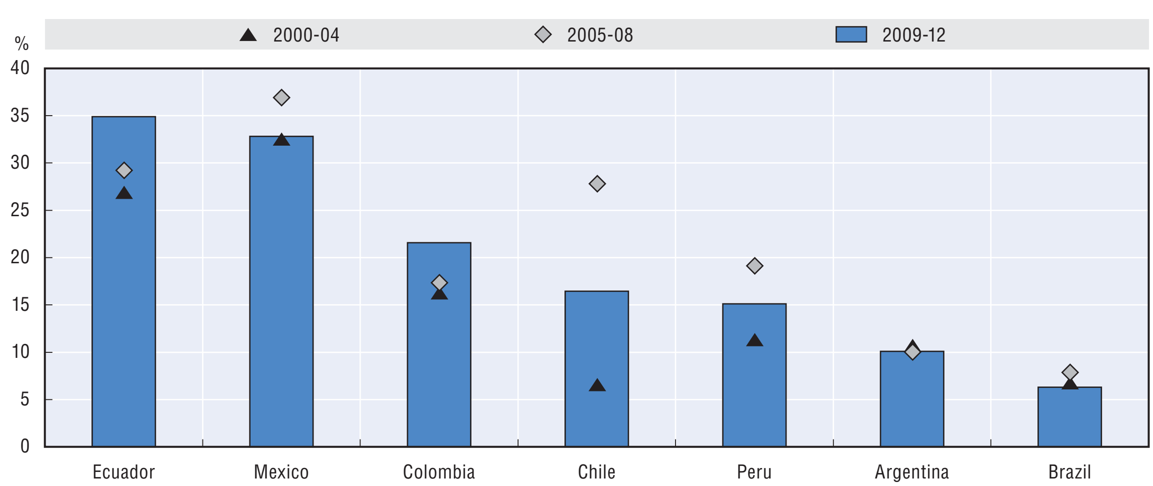
The unprecedented increase in commodity prices and the introduction of legal reforms pertaining to the capture of rents from NRNR, were crucial factors in the improvement of macroeconomic performance and fiscal positions in the region in the last decade.

In some LAC countries, revenues derived from non-renewable natural resources, as a share of total revenues, are substantial. In Bolivia, Ecuador, Mexico and Venezuela, for instance, revenues from NRNR accounted for over 30% of total revenues between 2009 and 2012. The recent financial and economic crisis did, however, lessen the share of revenues derived from commodities of total revenue. Between 2009 and 2012 Chile experienced the largest decrease (11.3 percentage points) in commodity-based revenue as prices for minerals stagnated at levels lower than those registered during the boom. This decline could also be linked to decreased profit margins as a consequence of increasing production costs and exchange rate appreciation (Figure 1.6). In other NRNR exporters, this decline was less pronounced. Overall, NRNR revenues stabilised again during 2012-13 in these countries.

Figure 1.6. **Relative participation of revenues from non-renewable natural resources as a share of total revenues**



Source: OECD/ECLAC/CIAT (2014) based on ECLAC (2013).

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Nevertheless, not all LAC countries benefited equally from the commodities boom. Though 93% of the region's population lives in commodity-exporting countries, they account for only half of the LAC countries. In general, net commodity exporters tend to be the larger economies in South America (in addition to Mexico). Net commodity importers, on the other hand, tend to be the smaller economies of Central America and the Caribbean. These economies are especially vulnerable to commodity price shocks, and suffered an important deterioration in their terms of trade during the crisis due to increased international prices in food and fuels. In these countries, tax policy reform in the last decade has focused on increasing the tax base and effective tax rates on the most important taxes to buttress the commodities economic shock.

The difference between the fiscal effect of the commodities boom on net exporters and net importers of NRNR, particularly hydrocarbons, highlights the vulnerability of the region to external shocks. Historically, the region has been characterised by intense macroeconomic and fiscal volatility (measured by the statistical standard deviation) compared to other regions. Over the period of 1990-2013, for instance, inflation volatility in the region far surpassed that of other regions in the world (see Table 1.1).

Table 1.1. **Indicators of macroeconomic and fiscal volatility in LAC**

Standard deviation of:	Latin America and the Caribbean	Advanced economies	Developing Asia	Central and Eastern Europe	Middle East, North Africa, Afghanistan, and Pakistan	Sub-Saharan Africa
GDP (% change)	2.11	1.56	1.86	3.34	1.70	2.29
Investment (% of GDP)	1.58	1.43	4.08	1.76	2.69	2.35
Inflation (% change)	110.05	1.06	3.48	36.26	3.72	12.41
Terms of trade (% change)	3.96	1.19	2.56	5.21	11.76	5.74
General government revenue (% of GDP)	2.42	0.68	2.39	0.74	3.82	2.04
General government expenditure (% of GDP)	2.41	1.89	2.32	1.70	1.88	1.93
General government net lending/borrowing (% of GDP)	1.31	2.19	1.17	2.22	4.90	2.80
General government gross debt (% of GDP)	4.47	12.54	3.74	5.17	13.63	17.43

Note: Standard deviation is computed over the 1990-2012 period. Group aggregates displayed in the table have been compiled by the IMF WEO (October 2013). The country classification within each group is not based on strict criteria, economic or otherwise. The objective is to facilitate analysis by providing a reasonable method of organising data.
Source: IMF, *World Economic Outlook Database* (IMF WEO) (October 2013).

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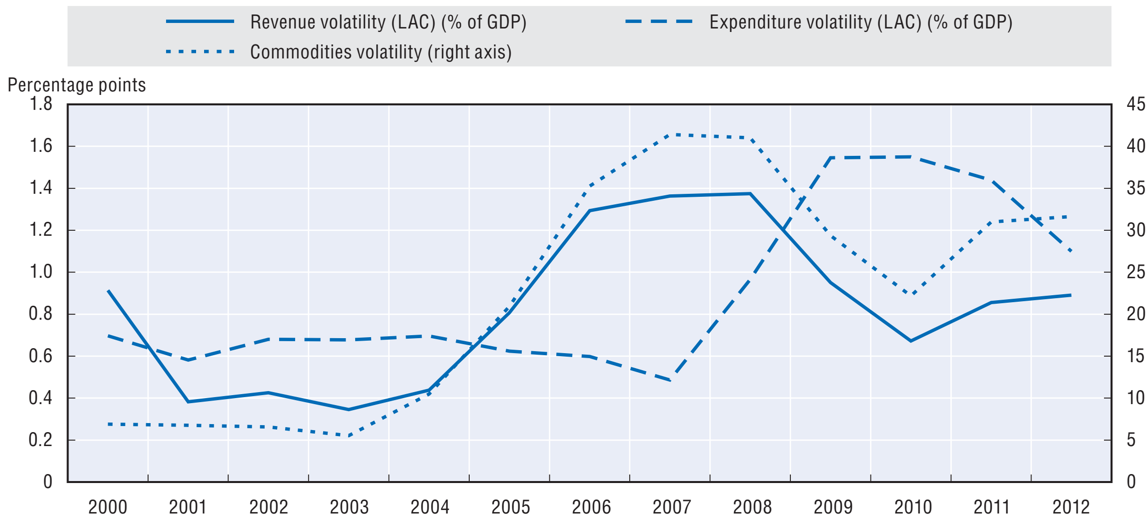
Given the region's dependence on commodity exports of NRNR such as fuel and metals, commodity price volatility and external market conditions have a substantial effect on fiscal revenue fluctuations (Figure 1.7).

Although there are various factors that explain the recurrence of macroeconomic and fiscal instability in the region, the effect of external shocks associated with fluctuations in the price of primary commodities plays a key role.

Fiscal and budgetary reforms in LAC: A search for innovations

Given the region's predisposition for macroeconomic and fiscal instability, many countries introduced reforms in the 1990s and early 2000s focusing on the promotion of stable and sustainable fiscal policy in the short term and macroeconomic stability and growth in the long term. In addition, as the process of democratisation took hold in most LAC countries, there was increased demand from society for greater provision of goods and services to pay for the "social debt" reflected in unjustifiable levels of extreme poverty. Given the increased fiscal capacity in net commodity exporter countries

Figure 1.7. **Revenue and expenditure volatility in comparison to commodity index price volatility (from 2000 to 2012)**



Note: Commodities is an average of Metals Price Index and Fuel (Energy) Index. Volatility is calculated as standard deviation of a 5 year time span, including the year of reference and the 4 preceding years.
Metals Price Index, 2005 = 100, includes copper, aluminium, iron ore, tin, nickel, zinc, lead, and uranium price indices.
Fuel (Energy) Index, 2005 = 100, includes crude oil (petroleum), natural gas, and coal price indices.
LAC average refers to the member countries as described in the "Reader's guide" plus Bolivia, Trinidad and Tobago and Venezuela.
Source: Data for commodities index is from IMF *Commodities Database*. Data for expenditure and revenue volatility is from IMF, *World Economic Outlook Database* (IMF WEO) (October 2013).

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(mainly South America and Mexico), the limited fiscal capacity in others, and the growing number of demands overall, a need for a more effective use and allocation of resources led to a series of innovations in fiscal and budgetary management.

Although fiscal results are determined by political institutions and legal and institutional frameworks, many governments began to reform budget institutions in the early 1990s in order to improve the predictability of fiscal results. These institutions are particularly important for public finance as they compose the rules and procedures that are used to prepare, approve, execute, control, and monitor budgets. Budget institutions thus determine: a) the size of total public expenditure, the fiscal deficit and public debt (and implicitly the sustainability of public sector accounts); and b) the appropriation of resources by type of expenditure and by groups of beneficiaries (Lora, 2007).

In general, each LAC country underwent a process of fiscal and budgetary reforms that began in the late 1990s and continued into the mid-2000s. Although these reforms reflected the specific needs and political context within each country at the time, some LAC countries adopted a particular set of reforms to improve fiscal results and make them more sustainable. The reforms were also important to identify the level of savings needed to progressively reduce public debt and open fiscal space to sustainably increase social and infrastructure investment that was lagging in most LAC countries, and which is a necessary element for sustainable economic growth.

These fundamental reforms consisted in the adoption, although not necessarily the integration, of fiscal rules, medium term frameworks, and the creation of stabilisation funds, while performance budgeting systems have been used to promote some transparency of decision-making and to help prioritise spending. As opposed to piecemeal reforms, a few LAC governments enacted integrated fiscal responsibility laws that encompassed these reforms and that were meant to provide the necessary tools to improve fiscal results. In general, these laws imposed limits on public expenditure or borrowing among other components. In the LAC region, Argentina (1999), Brazil (2000), Peru (2000), Ecuador (2002), Panama (2002), Colombia (2003), and Venezuela (2003) all enacted fiscal responsibility

Table 1.2. **Summary of Fiscal Reforms**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina		N,F		U,Ea					R(N,C,T),S	P,*r(c)*,S,E,Fb	*r(n)*,s			R(N,S,C)	
Bolivia			S							U					
Brazil								N		R(N,S,T),P					
Chile										Re(N,C)			*ef*,T		
Colombia	*fc*			Fd	C					N	S		R(N,P,T)		
Costa Rica											U,A				
Ecuador					U		Eg	N	C			R(N,P,C,T)		T	*r(n)*
El Salvador			U			A									
Guatemala										P,N,U					
Honduras													P,U		
Mexico								C				Ch,P,T			
Nicaragua												S,Fi,A			P
Panama								U				R(N),S,T		*r(n)*	P,U
Paraguay			ei							U			P,U		pk
Peru				U						R(N,P,C,T)		*r(n)*,C,T			
Dominican Republic								Fl						T	
Uruguay						U,Em									
Venezuela								C,U		P			R(N)n		

Notes: N = numerical rules; C = countercyclical fund; P = multiyear framework; R = fiscal responsibility law; S = subnational governments; U = single account; E = increase in executive power; F = increase in power of finance ministry; T = transparency; and A = principles of transparency.
Italic lowercase letters mean that the previously established reforms were reversed or the restrictions weakened.
R(X,Y) means that the Fiscal Responsibility Law included restrictions to X and Y.
a) Decrees of need and urgency.
b) Powers of head of cabinet.
c) Constitutional mandates that make public expenditure less flexible.
d) There was a substantial reform of the way the National General Budget was executed. In 1994 Law 179 of 1979 was changed to introduce an Annual Cash Program, replacing the Expenditure Agreements.
e) R here means the establishment of a structural balance rule. A bill was sent to congress in 2005.
f) Law 19.875 (of 2003) makes the Joint Budget Committee of the National Congress permanent and establishes the Budget Advisory Unit to give technical support to parliament for budget analysis.
g) The constitution prohibits congress from increasing the estimated amount of revenue and expenditure established in the budget proposal.
h) Automatic stabilisers were introduced.
i) Some provisions to improve cash management are included in the financial administration law.
j) Congressional powers were increased.
k) Beginning in 2006 a multiyear budget is being used pursuant to a transitory decree. It was used previously but was not a legal requirement.
l) The Integrated Financial Administration Program has made important changed in the management of the information on revenue, payments, and administration of bank accounts. These changes took place on the basis of an integrated information system that retrieves the previous information and integrates it into the full budget economic cycle.
m) Change in the review of the multiyear framework.
n) Includes components of the countercyclical fund and of the previously existing multiyear framework.
Source: IDB (2007), Table 5.1 from *The State of State Reform in Latin America*.

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laws within a four year period (IDB, 2007). The common characteristic of these countries is that they became important net commodity exporters and/or were dependent on one or two commodities (export of services in the case of Panama) for a big share of their exports. Following the policy trend in OECD countries such as Israel and Norway, the adoption of fiscal responsibility laws and macroeconomic stabilisation funds to manage the effects of volatile commodity price fluctuations became an apparent macroeconomic and fiscal policy need in countries such as Chile, Colombia, Peru, and Mexico. In other countries, these reforms were reversed.

Fiscal rules

The majority of LAC countries that adopted fiscal rules, both procedural and numeric, enshrined them in reforms that took place at the end of the 1990s and in the early 2000s. Numeric fiscal rules, which place long-term restrictions on fiscal policy through explicit numeric limits on fiscal aggregates, typically cover revenue, expenditure, budget balance or debt.

As the indicator on fiscal rules for the LAC region in this publication shows, there is no one-size-fits-all approach. In adopting these rules, the specific economic, political and social factors that influence fiscal policy in each country were considered. For instance, a small number of countries that wanted to limit the size of government, adopted expenditure ceilings, whereas those with a history of public debt defaults capped public borrowing through debt rules. In addition to determining the type and objective of the fiscal rule, an even smaller group of LAC countries explored how to determine the fiscal rule's anti-cyclical capacity and its escape clauses to maintain some budgetary discretion in extreme cases. Once these countries adopted fiscal rules, attention in some countries moved to ensure that budget procedures were adjusted accordingly in order to guarantee their consistency with the existing fiscal rule.

Fiscal rules in Chile introduced predictability and stability in fiscal policy over the economic cycle. In this case, the fiscal rule was created with a sophisticated methodology that determined the necessary structural primary balance and the levels of permanent and temporary revenues that could be expected from commodity price fluctuations (mainly copper), hence defining a sustainable trajectory for fiscal expenditures.

Medium-term frameworks

Medium-term frameworks (MTF) are institutional tools that aim to extend the planning horizon of public policies beyond the annual budget cycle but without the characteristic deficiencies of medium-term development plans (Shack, 2008). Although MTFs emerged among OECD countries in the second half of the 1990s, the majority of LAC countries began adopting them in the mid-2000s, as mentioned above, to complement fiscal rules.

MTFs require authorities to commit to a predefined evolution of the primary fiscal balance. In this way, they were forced to take into account the long-term effects of current expenditure decisions. In addition, transparency was increased as stakeholders and citizens in LAC countries have become more aware of the outlook of public finances with the introduction of macroeconomic projections in the legislative budget debate. A key instrument derived from MTFs was the development of macroeconomic projections, such as GDP growth and tax revenue growth. These projections increased the predictability of financial flows and allowed LAC governments to link the budgetary process to broad fiscal policy goals that extend beyond the annual budget cycle, while maintaining a sustainable fiscal position over the medium term.

MTFs, however, vary in terms of the level of depth with which they are promoted, and the type of projections that are included (Oxford Policy Management, 2000). A medium-term fiscal framework (MTFF), the most basic of the MTFs, usually focuses on the evolution of public debt, and the relation of expenditure, revenue, inflation and GDP to this variable. A more comprehensive MTF is called a medium term budget framework (MTBF). The objective of this framework is to provide some predictability to expenditures across units that are consistent with overall fiscal discipline. The last and most comprehensive framework is a medium-term expenditure framework (MTEF), which not only helps to improve fiscal discipline, but it also increases the efficiency of public sector spending by harmonising public expenditure with national priorities. The majority of LAC countries have a MTFF, but only eight have adopted a MTEF.

In the presence of sizeable increases in revenue windfalls in Chile, Colombia, Mexico, and Peru, the introduction of medium-term fiscal and expenditure frameworks created the necessary budget discipline to manage expenditure in an anti-cyclical manner. The MTFs in these four countries allowed for an orderly debate between the executive and legislative powers, based on clear parametres for expenditure ceilings and objective fiscal data.

Stabilisation funds

In the case of LAC, where net commodity exporter countries are highly dependent on fiscal revenues derived from NRNRs, the volatility, unpredictability and exhaustive nature of these revenues pose a great challenge to fiscal policy. In order to insulate the government and the economy from shocks arising from the volatility of non-renewable resource revenue, some LAC governments established macroeconomic stabilisation funds. These funds were set up in order to attenuate the effect of price fluctuations in non-renewable natural resource exports, shielding budgets from revenue uncertainty and volatility. These stabilisation funds do not, however, set formal restrictions on the overall conduct of fiscal policy. For instance, they do not affect spending nor can they reduce revenue uncertainty and volatility facing the public sector as a whole.

Anti-cyclical stabilisation funds operate under pre-established rules, easing fluctuations in non-renewable commodity revenues by accumulating additional revenues during price surges and by financing necessary expenditures during declines. Deposits and withdrawals from the stabilisation fund depend on the attainment of a pre-defined target in relation to a specific price outcome. However, the reference trigger values that govern withdrawals and deposits vary across LAC countries. In some countries, for example, funds are centred on price fluctuations in exports, whereas in other countries they are governed by fluctuations in fiscal revenues. Some funds may also be subject to caps in funding, whereby a fund's maximum size is predetermined, or it may be required to maintain a minimum balance.

All of the main exporters of NRNRs in the LAC region, with the exception of Bolivia, have created macroeconomic stabilisation funds in recent years. It is clear that the creation of diverse macroeconomic stabilisation funds that similar principles, allowed the net commodity exporting

Box 1.1. **The role of Colombia's General System of Royalties within its new Institutional Fiscal Framework**

As a result of the crisis in 1999, Colombia applied structural reforms intended to promote stable economic policy in the long run by addressing macroeconomic fundamentals. Recently, Colombian authorities ratified the adoption of three reforms geared towards increasing public savings and promoting fiscal sustainability. These reforms are part of a new General System of Royalties (SGR), a fiscal rule that sets a deficit target of 1% of GDP for the central government's structural balance in 2022, and the adoption of a fiscal sustainability principle in the Constitution. Together, these reforms strengthen the country's Institutional Fiscal Framework and reaffirm the government's commitment to fiscal responsibility.

The new SGR (Legislative Act 5/2011 and Law 1530/2012) is an important component of Colombia's Institutional Fiscal Framework. Its objectives are, among others, to more equitably distribute the revenues generated by the exploitation of non-renewable resources, generate savings from these resources, and increase the competitiveness of its regions through development. In order to fulfil these goals, the SGR contributes to five funds, one of which is the Stabilization and Savings Fund (FAE).

The FAE is the primary tool, within the SGR, for dealing with the volatility and unpredictability of non-renewable resource prices by accommodating the accumulation of resources in upswings and the decrease in resources during downswings. This, in turn, shelters projects funded by royalties from the fluctuations in resources, and generates savings for future generations. More importantly, given the adoption of the new fiscal rule, FAE funds may be utilised by the government to reach fiscal deficit targets, contributing to a long-term reduction in debt.

The design of the new SGR, in conjunction with the fiscal rule, stand as an innovative approach to ensuring good performance in public finances in the medium-term, while also carving out a path for long-term sustainability through a decrease in the public debt/GDP ratio.

countries in the LAC region (those who did not dismantled them) to shield public finances from abrupt expenditure surges derived from positive revenue shocks associated with the volatile increase of non-renewable resource revenue. This anti-cyclical mechanism, when combined with a sound fiscal rule, explains to a great extent the sustained GDP growth and fiscal stability that a few net commodity exporting LAC countries displayed during and after the global crisis of 2008-09. An important caveat should be introduced here. Recent fiscal results in most LAC countries reveal that with the stabilisation of commodity prices after 2010, an anti-cyclical fiscal stance was not necessarily maintained by most LAC countries, risking a future deterioration in the fiscal primary balance. This shows that even though fiscal management reforms temporarily contributed to strengthening anti-cyclical fiscal policy, the instruments created in the most sophisticated LAC countries are not sufficient to curtail expansionary expenditure pressures.

As we have discussed in this section the adoption of fiscal rules, medium term frameworks, and macroeconomic stabilisation funds allowed several LAC countries to harness the positive effects of the commodities price boom in the last decade while the introduction of performance budgeting systems should support increased transparency and prioritisation of spending. However, the capacity for creating a permanent anti-cyclical fiscal policy remains an elusive question even in the few advanced LAC countries like Chile, Colombia, Mexico, and Peru. Many LAC countries still lag behind in fiscal management innovations and anti-cyclical fiscal policy in the presence of commodity price volatility.

Performance budgeting

Performance budgeting has become one of the main tools by which countries can prioritise their expenditure plans within the spending envelope set by the medium-term framework. Performance budgeting is also an important instrument for improving accountability and transparency of budgetary decision-making.

The combination of scarce resources and the application of the NPM paradigm as the driver of public administration reforms in LAC countries are making performance budgeting a core component for several governments in the region. Consequently, fiscal governance frameworks are permeated by elements of performance measurement and performance budgeting practices. It has to be noted, however, that this trend is not yet consolidated in all LAC countries.

While some LAC countries have sought to adopt performance budget practices, there are vast differences in the approaches taken and there is no consensus on the optimal combination that should be applied. However, it is clear that a few countries in the region (notably Chile, Colombia, Mexico, and Peru) have embarked on this path in order to increase the effectiveness of public spending allocation and to reduce corruption. In the future, the move towards performance budgeting will be reflected in the budget laws of a greater number of LAC countries.

Results for LAC countries indicate that the adoption of these reforms has not been uniform within the region as countries have adopted different types of performance budgeting schemes, elements, targets and information. Overall, many countries have a standard framework that applies to all ministries and that generates performance information to some extent. However, this information is not used directly in the context of budget negotiations between line ministries and central budgeting authorities. In addition, there are usually no consequences when performance targets are unmet, suggesting performance information is not easily transformed into budget corrections. This experience is similar to that of OECD countries that have also put in place performance budgeting systems.

Chile and Mexico, for instance, have both implemented a standard performance budgeting frameworks at the central government level and produce a relatively high level of performance information. Brazil stands out as having leading performance budget practices in the region. In addition to having a standard framework, performance information such as financial data, operational data, spending reviews and statistical information are all produced. Furthermore, performance monitoring and evaluation covers a substantial amount of budget expenditure and there has been some success in adapting the budget cycle to incorporate performance information.

Advances in performance budgeting are more limited in the smaller Central America and the Caribbean countries. The he countries that produce the least amount of performance budgeting information are the Dominican Republic, Honduras and Panama. In this group, the majority of countries are still developing standardised performance budgeting frameworks. Although many countries have now adopted some form of public financial management information systems (IDB 2012), the amount of performance information generated and linked to the budget is still relatively low and its use in budget negotiations is mostly presentational.

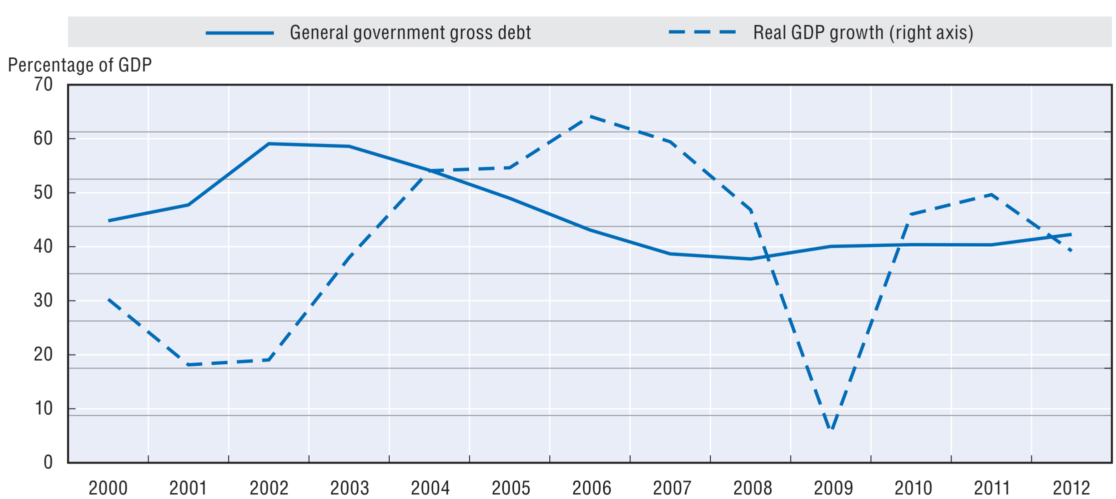
In contrast to a greater prevalence of parliamentary systems in OECD member countries, most LAC countries have presidential systems in which the head of the state is also the head of government. This characteristic of the LAC political system makes budget transparency all the more relevant. Publishing the main policy documents in a manner that is both understandable and accessible to the general public can increase the likelihood of generating discussions on public policies and, together with performance budgeting, can improve the effectiveness and efficiency of public spending.

What major differences can be observed in the fiscal results of the LAC region after the commodities boom?

Differences in macroeconomic and fiscal conditions

Following the commodities boom, several LAC countries shifted the composition of public debt towards instruments denominated in local currency and facilitated the expansion of the local financial markets. At the same time, lower debt and debt service, within an international context of low interest rates extended over a prolonged period, and the revenue windfall from commodities, allowed many LAC countries to reduce dollarisation, and increase their levels of international reserves (Figure 1.8).

Figure 1.8. **LAC average: General government debt and GDP (from 2000 to 2012)**



Note: LAC average refers to the member countries as described in the "Reader's guide" plus Bolivia, Trinidad and Tobago and Venezuela.

Source: IMF, *World Economic Outlook Database* (IMF WEO) (October 2013).

StatLink http://dx.doi.org/10.1787/888933089624

In this context, there was an important shift in the composition of primary expenditure in the region. A significant reduction in interest payments on the public debt, in some countries even amounting to 2% of GDP, was redirected towards primary social expenditures, particularly towards conditional transfer programmes. This shift did not increase the level of primary expenditures in most countries in the initial years of the commodity boom but helped to reduce poverty levels notably.

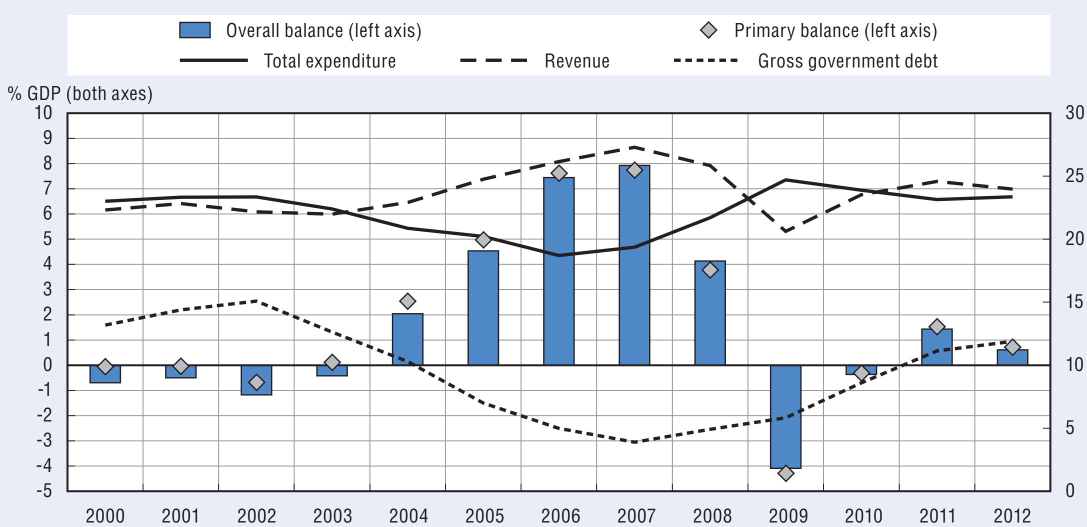
In 2008-09, LAC countries were for the most part able to provide a countercyclical response to the Great Recession in the form of a moderate fiscal stimulus. Fiscal balances were relaxed but not beyond a reasonable trajectory of the long-term primary balance for most countries. Anti-cyclical fiscal policy was easier in net commodity exporter countries that adopted integrated fiscal and budgetary reforms described in previous sections of this chapter.

The reaction to the Financial Crisis of 2008-09 and the Great Recession that followed it revealed four different types of fiscal policy stance (and fiscal outcomes) among LAC countries. In particular, a differentiation emerges regarding the individual responses to the crisis, the role played by NRNR, and the management of macroeconomic and fiscal policy.

Box 1.2. **Chile's "structural" fiscal balance rule**

Chile was an early adopter of a "structural" fiscal balance rule. This rule introduced three key measures: a) a measure of the structural fiscal balance of the central government; b) an annual primary balance target; and c) a clear methodology to apply the fiscal rule to the budget process. The fiscal rule was subsequently complemented with the introduction of a savings/ stabilisation fund and the introduction of a performance-based budget process, all in line with best OECD practices.

Chile: Selected government indicators (from 2000 to 2012)



Source: IMF, *World Economic Outlook Database* (IMF WEO) (October 2013).

StatLink http://dx.doi.org/10.1787/888933089510

Notably the savings accumulated during the commodities boom, due to a firm commitment to the application of its fiscal rule, allowed Chile to undertake an active anti-cyclical fiscal policy during the global crisis in 2008-09.

One group of countries (A) is currently undergoing sustained economic growth and has adopted some form of fiscal rules complemented by inter-temporal saving/stabilisation funds to counteract large shocks. These countries enjoyed sizeable windfall revenues from NRNR during the commodities boom. During the onset of the crisis, therefore, savings generated by the commodities boom allowed them to provide an anti-cyclical response in the form of moderate fiscal stimulus. The fiscal balance was relaxed, but not beyond a reasonable trajectory of the long-term primary balance, and debt levels remained largely unchanged. In general, macroeconomic policy prior to the 2008-09 crisis focused on aligning the expansion of public expenditure with a carefully constructed measure of permanent revenue. In this way, savings were achieved, as expenditures did not exceed revenues beyond reasonable levels. Furthermore, public debt as a share of GDP was reduced, in part by savings achieved, and in part by shifting the composition of public debt towards instruments denominated in local currency.

A second group of countries (B) also experienced a substantial influx in revenues derived from commodity exports. Since the onset of the crisis, fiscal stabilisation and monetary policies were partially observed. These net-commodity exporting countries currently exhibit moderate debt-to-GDP ratios. On average, they also have high levels of primary expenditure, a deteriorating primary balance, and a deficit-prone overall fiscal balance. These countries have applied some fiscal and budget management reforms but in a partial, non-integrated fashion.

A third group of countries (C) experienced a substantial influx in revenues derived from commodity exports. Since the onset of the crisis; however, fiscal stabilisation and monetary policies were not clearly observed. Although these are net-commodity exporting countries, they currently exhibit, on average, high levels of expenditure, a fast deteriorating primary balance, medium to high debt-to-GDP ratios, and a markedly deficit-prone overall fiscal balance. This type of country not only enacted fiscal and budgetary reforms partially, but also reversed or deactivated them altogether.

The fourth group of countries (D) is characterised primarily by a lack of substantial NRNR revenue and is primarily composed of small, net commodity importers. Their economies are still very vulnerable to commodity price volatility, external economic shocks, natural disasters and the slow pace of world economic recovery. These countries have also experienced low or declining economic growth since the crisis. Furthermore, most exhibit a deteriorating primary balance, high debt-to-GDP ratios and persistent fiscal deficits that result mainly from limited revenue collection and high expenditures linked to entitlement schemes and state-owned enterprises.

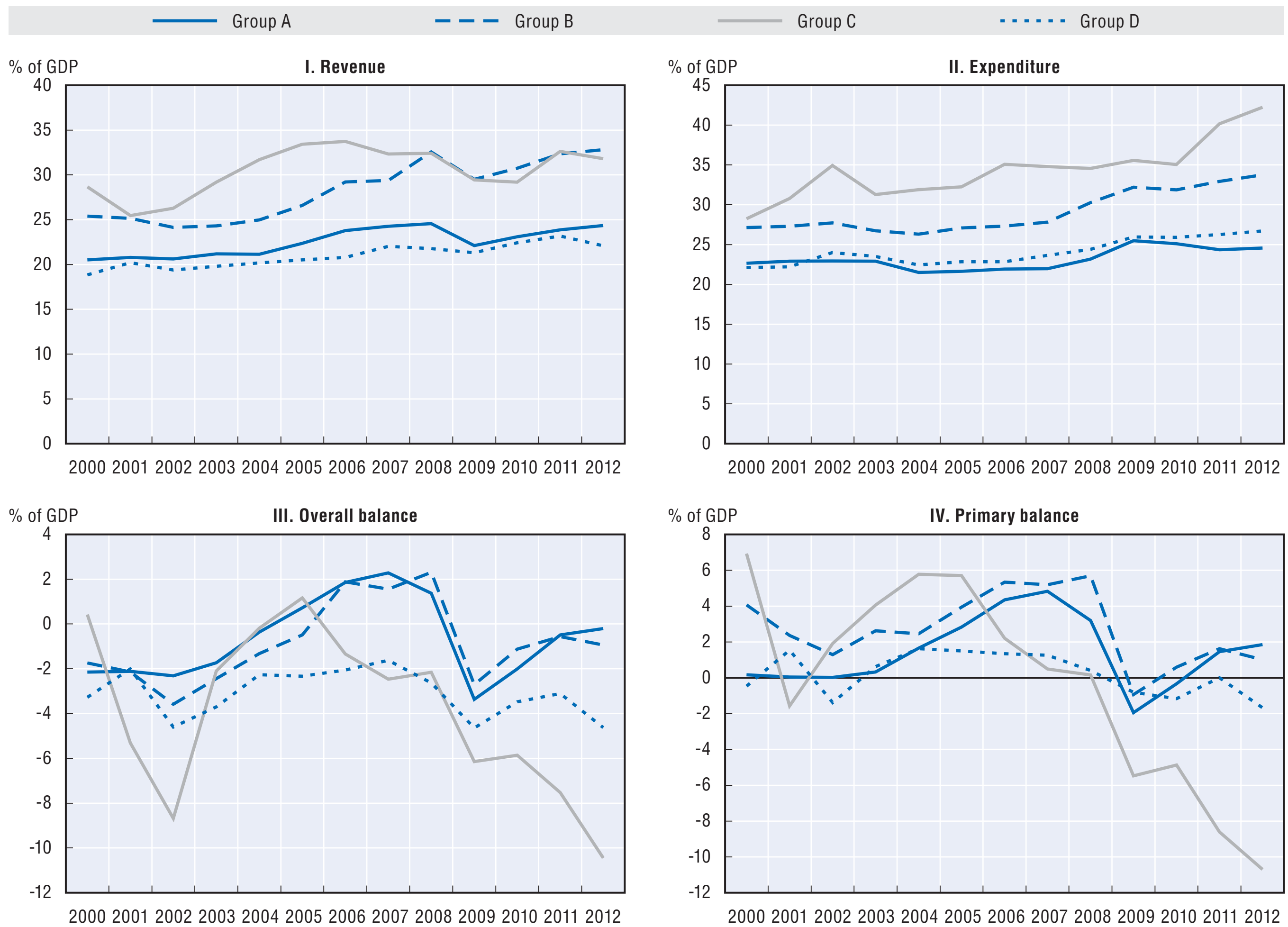
Overall, most LAC countries benefited from a surge in commodity export revenues (Figure 1.9.I), and most countries in the region, particularly those in group C, expanded expenditures during this boom (Figure 1.9.II). Furthermore, a significant number of countries show deterioration in fiscal results since the onset of the Great Recession (Figure 1.9.III). Only a select group of countries did not experience a significant deterioration in their primary balance (Figure 1.9.IV).

Conclusion

Latin America and the Caribbean countries undertook significant fiscal and budget reforms throughout the last two decades. During this process, some countries adopted a deeper, more structural approach to reforming the economy and the performance of the public sector. The solid foundation created by these reforms allowed many countries to benefit from the commodities boom from 2003-08 and to withstand the global economic crisis in 2008-09 with relative success.

The introduction of important reforms and innovations in fiscal policy and budget practices set the foundation for fiscal stability and allowed countries to manage expenditures in an anti-cyclical way. For most LAC countries, fiscal management reforms were limited and had no meaningful effect on the improvement of fiscal results, even in the presence of important increases in public revenues during the commodities boom. Key among these innovative reforms was the introduction of fiscal

Figure 1.9. **Selected government indicators by group of LAC countries (from 2000 to 2012)**



Note: Overall balance (general government net lending/borrowing) represents total revenues minus total expenditures. Primary balance is net lending/borrowing plus net interest payable/paid (interest expense minus interest revenue).
Group A: Countries with stable revenue, controlled levels of primary expenditures, positive primary balances or moderate deficits, sustainable levels of public debt.
Group B: Countries with increasing revenues, high levels of primary expenditures, a tendency towards permanent primary deficits and medium levels of public debt.
Group C: Countries with increasing revenue, very high levels of primary expenditures, a markedly deficit-prone overall fiscal balance, a fast deteriorating primary balance and elevated levels of public debt.
Group D: Countries with limited revenue, low levels of primary expenditures, a persistent fiscal deficit, deteriorating primary balance and high levels of public debt.
Data for primary balance are not available for Ecuador, El Salvador, Haiti, Mexico and Paraguay.
Source: IMF, *World Economic Outlook Database* (IMF WEO) (October 2013).

StatLink http://dx.doi.org/10.1787/888933089643

rules, medium-term frameworks, stabilisation funds, and performance budgeting systems. For Chile, Colombia, Mexico and Peru, adapting the best practices in fiscal and budgeting reforms of OECD countries to the political and institutional reality of LAC countries has resulted in the creation of fiscal and budget institutions that incorporate a structural view for long-term fiscal consolidation. These countries established quantitative public debt, primary balance or expenditure targets and maintained the firm policy objective of applying fiscal rules up until the advent of the 2008-09 global economic crisis.

The commodities boom of the last decade was a unique test to fiscal and budget institutions in the LAC region. In several cases, such innovations helped net commodity exporting countries to mitigate the effect of the Great Recession by allowing them to accumulate fiscal savings out of pre-crisis windfalls and use them to fund anti-cyclical spending, without jeopardising the long-term primary balance.

The integrated application of these reforms and innovations in Chile, Colombia, Mexico and Peru countries should serve as a guide to the more vulnerable LAC countries in finding their own formula to attain fiscal sustainability. Whereas comparative data on input levels such as government expenditures, public sector employment and compensation; and on practices such as public procurement, can help countries to determine the right mix of inputs, delivery mechanisms, human capital investment and outputs to meet expectations as well as governments' own means and political goals.

The application of the OECD surveys on performance budgeting, budget practices, public compensation and employment, as well as of public procurement practices, shows that LAC countries still have important gaps in key public policy areas. LAC policy decision makers may find that a systematic approach to close these gaps utilising the benchmarking possibilities of this publication could be a worthwhile effort.

The collaborative research effort between the IDB and the OECD represents a useful model upon which to build. Furthermore, future joint work could be expanded to include other dimensions of public governance such as the quality and efficiency of public expenditures, the use of open government tools, and the quality of public statistics and public information systems.

This and future *Government at a Glance* publications for the LAC region will be useful to inform public policies which seek to improve fiscal, budgetary, and public finance performance; and to open fiscal space to invest in poverty reduction, create human capital, and improve infrastructure for sustainable social and economic growth in Latin America and the Caribbean.

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